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on Economics

Inquiry into competition in the banking and
non-banking sectors

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EXECUTIVE SUMMARY

1. **Competition is the cornerstone of efficiency and productivity in any market. It promotes fair prices, enhances living standards and ensures that scarce resources are allocated to their highest value uses.**
2. **In addition to its services to its customers, the banking sector makes a significant contribution to the wider Australian economy. This means that healthy competition between financial institutions has a broad impact on Australia's wellbeing.**
3. **The banking sector has undergone significant changes over the past two decades, following its deregulation and rapid developments in banking technology and markets. These changes have resulted in greater competition in Australia's banking sector and delivered greater choice and cost savings for banking customers.**
4. **While market share in the banking sector is relatively concentrated, the major banks are subject to competition from a wide range of other financial institutions. Concentration ratios have fallen over the past decade, some smaller institutions are major players in particular regions, and existing institutions have been forced to match the prices and features offered by new competitors.**
5. **While participants in Australia's banking sector are required to meet certain regulatory requirements, these do not prevent entry from new competitors. In addition, innovations in electronic banking and alternative distribution methods have made it easier for new participants to compete against incumbent players and for existing providers to expand into new product markets or geographic regions.**
6. **Profits in the banking sector have been sustained by: growth in business activities; low levels of problem loans; reductions in operating costs; and income from non-banking activities. In contrast, net interest margins have fallen, partly reflecting increased competition in lending and deposit markets. While fees have increased, banks' fee revenue has grown at a slower pace than their assets.**
7. **Overall, the total savings to bank customers from lower interest margins have more than offset the cost of higher fees. However, it is recognised that these benefits have not been distributed equally among bank customers.**
8. **The range of banking products available today are significantly different to those available a decade ago, partly reflecting innovations by new entrants keen to attract market share. Banking customers have benefited from increased choice.**
9. **Recent developments in international credit markets have partially unwound the reduction in interest rates and market concentration of the previous 10-15 years, a trend which will continue to warrant close monitoring. To the extent that the pricing of risk in international capital markets is moving to a more sustainable basis, interest margins may not return to the narrow levels that existed immediately prior to the turmoil. Nonetheless, Australians are served by a wide range of providers, and the lending environment can be reasonably expected to improve as conditions normalise.**
10. **Initiatives enacted or under consideration to further improve competition include: the Government's Account Switching Package and disclosure projects (which will assist customers to switch providers); the RBA's payments system reforms (which have exposed 'hidden' fees to competitive pressures and reduced barriers to entry); Commonwealth regulation of credit (which will reduce barriers to entry and regulatory distortions); comprehensive credit reporting (which may reduce barriers to entry and switching); and revised Commonwealth Government securities arrangements (which support the efficient functioning of financial markets).**

INTRODUCTION

11. Competition is the cornerstone of efficiency and productivity in any market. It creates incentives for suppliers to minimise their costs, and pass these savings to their customers in the form of lower prices. It also encourages suppliers to create innovative new products and services to better meet customers' needs. In this way, competition promotes fair prices for the products and services consumed, enhances consumers' living standards and ensures that the economy's scarce resources are allocated to their highest value uses.
12. The retail banking sector¹ is one of the largest sectors in the finance and insurance industry, which is the third-largest industry in Australia and accounts for more than 9 per cent of GDP.² In addition to contributing directly to Australia's GDP, the banking sector performs a number of functions that underpin economic activity in the broader economy, such as financing investment and facilitating payments. It also provides consumption- and investment-related services to virtually all households in Australia. This means that the efficiency of the banking sector impacts on output, growth and living standards, not just in the finance and insurance industry, but across the entire economy. Healthy competition between financial institutions is a means of improving these outcomes and, ultimately, wellbeing.
13. Developments in the banking sector over the past 10-15 years suggest that, in general, the sector is subject to increasing competitive pressures. These pressures have resulted in benefits for banking customers, including lower borrowing costs and a greater variety of products, services and pricing structures. Nonetheless, it is acknowledged that: competition has not increased uniformly across all products and services; the benefits have not been distributed equally across all banking customers; and banking customers are concerned that competition has failed to put downwards pressure on some fees and interest charges. In addition, the recent repricing of risk in international credit markets has impacted on the competitiveness of certain business models, raising concerns that some of the increase in competitive pressures over recent years may be partially unwound.
14. Notwithstanding the improvements of the past 10-15 years, there is scope to improve competitive pressures in some parts of the banking sector. It is important that industry and governments continue to pursue available opportunities to enhance competition, for the benefit of banking customers and the broader Australian economy. Competition can be enhanced by initiatives that: remove unnecessary barriers to entry or innovation; reduce regulatory compliance costs and distortions between markets; promote transparency; and empower consumers to compare products and switch between providers. There are a number of government and industry initiatives under way in the banking sector that are designed to achieve these objectives.

¹ In this document, 'banking sector' refers to the markets for retail banking products provided by authorised deposit-taking institutions (ADIs, comprised of banks, building societies, credit unions and specialist credit card institutions) and non-ADI financial institutions. These products include: transaction accounts; savings accounts; term deposits; credit cards; personal loans; car loans; home loans; and investment loans. As such, references to the 'banking sector' encompass the 'banking and non-banking sectors' that are the focus of the Inquiry.

² ABS Cat. No. 5206.0. Measured as the finance and insurance sector's share of gross value added, March quarter 2008.

RECENT DEVELOPMENTS IN THE BANKING SECTOR

15. The Australian banking sector has undergone significant changes over the past two decades. This partly reflects the deregulation of the sector in the 1980s, which removed a range of restrictions on participation in the sector and the nature of products and services that could be provided. It also reflects the rapid changes in banking technology (such as the move to electronic banking) and the evolution of financial markets. These changes have resulted in greater competition in Australia's banking sector and delivered greater choice and cost savings for banking customers.

Market structure

Concentration

16. As in other countries, market share in Australia's banking sector is relatively concentrated, compared with some other industries. In particular, Australia's five largest banks account for the majority of market share for many popular banking products, such as deposits, credit cards, personal lending and mortgages.
17. However, it is well recognised that competition can exist in markets with a small number of major suppliers, particularly where there is a 'competitive fringe' of smaller players or where barriers to entry and exit are sufficiently low for there to be a credible threat of competition from new entrants. Such a market is said to be 'contestable'.
18. Notwithstanding the prominence of the five major banks in the Australian banking sector, there is evidence that the sector is contestable. Australian banking customers are served by a wide range of banking providers, including: 13 domestic banks; 12 building societies; 139 credit unions; and a subset of Australia's 10 foreign bank subsidiaries, 31 foreign bank branches, and more than 100 non-ADI financial institutions.³ According to financial services research firm CANNEX, there are currently around: 140 providers of over 2,400 mortgage products; 70 providers of over 300 different credit cards; and 130 providers of over 2,400 different types of deposit accounts.⁴
19. Concentration ratios have generally fallen over the past decade, with foreign banks and non-bank lenders in particular winning market share from the major banks. For example, since 2002 foreign banks have increased their shares of: household deposits (from just under 9 per cent to 12½ per cent); credit cards (from around 8 per cent to 13 per cent); and housing loans (from under 8 per cent to nearly 9 per cent).⁵
20. In addition, many of Australia's regional or 'second-tier' banks are major players within their own region. For example, BankWest has a significant share of the Western Australian banking market and the recently merged Bendigo and Adelaide

³ Not all banking providers participate in the retail banking market. In particular, while almost all of Australia's domestically owned banks, building societies and credit unions have a strong retail banking focus, many foreign bank subsidiaries and branches focus on Australia's wholesale markets. Similarly, while a significant number of non-ADI financial institutions participate in the mortgage, credit card and personal lending sectors, others focus on loans to the financial and business sectors or the financing of motor vehicle sales or machinery and equipment. Further information on the structure of the Australian financial system is outlined in the RBA's *Financial Stability Review*, March 2006.

⁴ CANNEX *Mortgage Star Ratings*, Report No. 21, March 2008; *Credit Card Star Ratings*, Report No. 14, May 2008; *Deposit Account Star Ratings*, Report No. 6, August 2007; and data provided to Treasury by CANNEX.

⁵ RBA *Financial Stability Review* March 2007 and data provided to Treasury by the RBA.

Bank accounts for a significant share of the markets in Tasmania, Victoria and South Australia.

21. The introduction of innovative and competitively priced banking products by smaller participants has forced the major banks to defend their market shares by matching the product offerings of their competitors. This has resulted in a competitive dynamic and improved outcomes for bank customers, even in the absence of reductions in concentration. Examples of such products include 'no-frills' credit cards, high-interest 'online' savings accounts and 'low-doc' loans.

Entry and exit

22. Entry into the Australian banking sector is open to any institution (Australian or foreign), provided that it meets the relevant regulatory requirements. For example, the provision of financial products other than credit is subject to the financial services licensing regime of the Australian Securities and Investments Commission (ASIC). In addition, financial institutions that raise funding through deposit-taking activities are subject to prudential regulation by the Australian Prudential Regulation Authority (APRA), which is designed to promote the safety of deposits and protect the stability of the financial system. The provision of credit is currently subject to consumer protection regulation by the State and Territory governments, pending the Commonwealth's assumption of the regulation of credit (as discussed on page 15). Other regulatory requirements specific to the banking sector include payments system regulation and anti-money laundering and counter-terrorism financing requirements.
23. These requirements are designed to balance the goals of safety, competition, efficiency, market integrity and consumer protection and are consistent with international best practice. They do not represent a significant or unnecessary barrier to entry.
24. In addition to meeting regulatory requirements, participation in some parts of the banking sector may require the establishment of certain infrastructure, such as branch networks and other distribution channels. However, over the past decade, the development and adoption of electronic banking methods (such as Internet banking, ATMs and EFTPOS) and alternative distribution methods (such as mortgage brokers) has reduced the impact of such non-regulatory requirements. Such developments have improved the ability of potential new entrants and smaller existing players to service Australian banking customers, helping them to compete more effectively with the larger banks with established branch networks.
25. For example, the increasing use of mortgage brokers has enabled regional banks to increase their share of on-balance sheet housing loans to borrowers outside their home State from around 32 per cent in 2002 to around 39 per cent in 2006.⁶ Similarly, the more widespread distribution of banking services via the Internet has been a key driver of foreign banks' renewed interest in the retail banking market in recent years.⁷ Some new entrants have bypassed the need for a physical branch network altogether, basing their business models predominantly on Internet, telephone and postal banking, such as by offering 'online' savings accounts or home loans that are applied for and administered over the Internet.
26. There have been a number of new entrants to the Australian banking industry since the late 1990s, including: domestically owned banks; foreign bank subsidiaries;

⁶ RBA *Financial Stability Review*, September 2006.

⁷ RBA *Financial Stability Review*, March 2007.

foreign bank branches; and non-ADI providers. In addition, existing financial institutions have expanded their operations across a broader range of products and geographic areas.

27. Nonetheless, the total number of participants in the market may have fallen over this period, with mergers and acquisitions among existing ADIs outweighing the number of new entrants. In particular, the number of credit unions fell from 213 in 2001 to 143 in 2008⁸, as Australia's smallest financial institutions sought greater scale.

Profitability

28. The profitability of Australia's banks has remained relatively stable in recent years. The five largest banks recorded an average before-tax return on equity of over 20 per cent per annum over the period from the mid-1990s to 2007, while their average before-tax return on assets remained stable at around 1½ per cent.⁹ Over the past few years, the major banks have recorded a slightly higher average return on equity than the largest regional banks, and significantly higher than finance companies, credit unions and building societies.¹⁰
29. Profits have been sustained by strong growth in lending and transaction volumes, low levels of problem loans and significant reductions in operating costs. Some diversified financial institutions, including the major banks, have also benefited from higher income from non-banking activities, such as wealth management income associated with the growth in superannuation assets. Partly offsetting this, net interest margins (the difference between average interest earned and average interest paid) have fallen.
30. Cost reductions have been particularly important in contributing to improved profitability, efficiency and productivity in the banking sector. The major banks' costs fell from around 60 per cent of income in 1996 to around 45 per cent in 2007, bringing Australia's banks into closer alignment with international best practice. These cost reductions can be partially attributed to the need for Australia's banks to compete more effectively with new competitors.
31. The profitability of the major banks appears to be broadly consistent with other large Australian companies. Over the five years to 2007, the returns on equity of Australia's largest banks were, on average, slightly below those of other large Australian companies (even excluding the mining sector)¹¹, and banks' share prices performed consistently with the broader stock market¹².
32. On the other hand, there is evidence that the Australian banking sector may be more profitable than those of other jurisdictions. Over the six years to 2007, the returns on equity of Australia's largest banks were higher than those of banks in comparable international sectors, including the United States, Canada and the United Kingdom.¹³ This partly reflects Australia's relatively low level of problem loans.

⁸ APRA *Insight*, Issue 1 2001 and Issue 1 2008.

⁹ RBA *Financial Stability Review*, March 2008.

¹⁰ KPMG *Financial Institutions Performance Summary* (various).

¹¹ Based on data published by Reuters at www.reuters.com.

¹² RBA *Bulletin*, Table F07.

¹³ International Monetary Fund *Global Financial Stability Report* 2008, Table 27.

Pricing

Interest margins

33. Interest margins on lending products have fallen since the early 1990s (although this trend has partly unwound over the past year). This reflects a range of factors, including increased competition from new and existing lenders and favourable pricing conditions in international capital markets.
34. Using the RBA's official interest rate as a basis of comparison, the difference between the average standard variable bank mortgage interest rate and the RBA rate fell from over 4 percentage points in 1993 to around 1.8 percentage points in 2007.¹⁴ The interest rate savings were even greater for new borrowers and borrowers who refinanced their loan in this period (which comprise the significant majority of borrowers), as most lenders increased the interest rate discounts offered on new loans, to up to 0.7 percentage points.
35. Small and large business borrowers also benefited from a reduction in margins, from around 6 and 5 percentage points, respectively, in 1993 to around 2.4 and 0.7 percentage points in 2007.¹⁵
36. Over this period, the reduction in interest earned by lenders more than offset the reduction in their cost of funds, resulting in a decrease in their net interest margins. For example, when measured as the difference between average interest earned and average interest paid, the five largest banks' net interest margins fell by an average of 40 basis points between 2003 and 2007, more than half of which was attributed to increased competition in lending markets.¹⁶
37. Interest margins on deposit products also improved over the past 10-15 years, reflecting an increase in the interest rates earned by depositors relative to the official cash rate. In particular, the 'online' savings accounts introduced in the late 1990s offered rates of 5-7 per cent, significantly higher than the existing deposit products such as transaction accounts (which typically offered rates of well under ½ per cent) and 'bonus saver' accounts (which offered around 3-5½ per cent).¹⁷

Fees and charges

38. Bank fees and charges have risen since the early 1990s. Between 1997 and 2007, banks' total fee income rose from \$3.9 billion to \$10.5 billion, an increase of \$6.6 billion or 170 per cent.¹⁸
39. Most of the increase in fees and charges occurred in the late 1990s. During this period, a range of fees and charges increased in size, some new charges were introduced, and the fee revenue of banks and other institutions providing banking services increased relative to total revenue and assets.
40. This partly reflects the banking sector's transition away from traditional pricing structures, in which the cost of operating transaction accounts was cross-subsidised by the interest earned on lending, towards a 'user pays' pricing system. During this time, fees on most banking products increased, while lending margins fell. This

¹⁴ RBA *Bulletin*, Table A02 and F05.

¹⁵ RBA *Bulletin*, Table A02 and F05.

¹⁶ KPMG *Financial Institutions Performance Summary, Major Banks year end* (2004, 2005, 2006 and 2007).

¹⁷ RBA *Bulletin*, Table A02 and F04.

¹⁸ RBA *Bulletin*, Table F6. Data is based on the largest 19 participant banks, which together account for over 90 per cent of the total assets of the Australian banking sector.

partly reflected competition from new niche participants, who could target the most profitable banking markets without having to cross-subsidise other banking services.

41. Another factor resulting in higher reported fees in recent years is the RBA's payments system reforms. While the reforms reduced the level of 'hidden' fees that were paid between financial institutions (and were ultimately reflected in higher prices for goods and services), banks responded to the loss in revenue by increasing the fees levied directly on banking customers.
42. Over the past few years many fees have levelled off (or even fallen), reflecting renewed competition in fees and charges. The continued growth in aggregate fee revenue over this period has generally been driven by increased levels of banking activity, such as a higher number of transactions, rather than an increase in individual charges. In fact, aggregate fee revenue has grown at a slower pace than banks' total assets, revenue and transaction volumes over the past few years. One possible exception to this trend is 'penalty' or 'exception' fees, some of which are relatively new and appear to have grown relative to other fees in recent years.
43. Since the early 1990s consumers have gained access to a range of banking products that potentially reduce the number and size of fees incurred, including: basic bank accounts for low-income earners; 'all-you-can-eat' transaction accounts; 'no-frills' products such as credit cards; and fee discounts offered as part of product bundles. More recently, a number of providers have begun to offer their customers mechanisms to manage and potentially avoid exception fees.

Impact on bank customers

44. The RBA has previously found that, on average, the total savings to bank customers from lower interest margins have more than offset the cost of higher fees and charges.¹⁹ However, it is acknowledged that this does not mean that all bank customers have gained from the changes in the pricing of bank products. Those who have benefited most are borrowers with residential mortgages, who use electronic payment channels and who avoid exception fees. In contrast, customers without a loan who have low deposit balances and a high number of transactions may be exposed to higher prices for their banking activities.

Products and features

45. The range of products available in the Australian banking market today is significantly different to those available a decade ago. In many cases the new products reflect innovations by new entrants keen to attract market share, thereby effectively forcing the incumbent bank and non-bank providers to match the improved pricing or product features in order to defend their market shares.
46. Examples of banking products and services that have been introduced or become increasingly available over the past 10-15 years include:
 - high-interest online savings accounts, which offer higher interest rates than traditional transaction accounts, but may impose limits on the number and/or types of transactions that can be made using the account;
 - 'all-you-can-eat' transaction accounts, which involve a simplified fee structure of unlimited transactions (of certain types) for a fixed monthly account-keeping fee;

¹⁹ RBA *Bulletin*, 'Bank(ing) fees in Australia' (June 1999, July 2001, April 2003 and May 2005).

- ‘basic bank accounts’, which are transaction accounts targeted towards low-income customers and are fee-free, providing that certain transaction limits and, in some cases, minimum balances are met;
 - ‘no-frills’ credit cards involving lower interest rates and/or fees than traditional cards;
 - mobile phone banking, which allows customers to check their account balance, transfer funds, pay bills and make purchases using their mobile phone;
 - low-doc and no-doc loans, which provide greater access to credit for customers without the requisite documentation, such as self-employed small businesspeople;
 - zero- or low-deposit home loans, which enable borrowers to enter the housing market earlier, or buy a more expensive property, than if a larger deposit were required;
 - reverse mortgages, which enable asset-rich but income-poor home owners to unlock some of the equity tied up in their housing asset;
 - shared equity mortgages, which can assist borrowers who cannot afford to purchase a home using a traditional mortgage to enter the housing market, by sharing ownership of the home with the lender or another entity; and
 - flexible mortgage structures and features, including: redraw facilities; ‘offset accounts’; ‘lines of credit’; and a wider range of fixed-interest options.
47. Overall, banking customers have benefited from an improved range of product features and wider choice. Most financial institutions now provide a range of options within each product type, providing for different transaction patterns, income levels, price sensitivities and service requirements.
48. Nonetheless, concerns have been raised that Australia lags other countries in adopting new banking technologies and products. For example, in its review of the RBA’s payment system reforms in 2006, the House of Representatives Standing Committee on Economics, Finance and Public Administration noted that, while Australia was once considered to be a world leader in payments system technology, the consensus of participants at its public hearings was that Australia had fallen behind.²⁰

THE CURRENT STATE OF THE BANKING SECTOR

49. The Australian financial system and its regulatory framework have demonstrated their effectiveness and resilience over recent months during a period of severe stress resulting from global financial market turbulence. The resilience is largely due to the sound position of Australia’s major financial institutions with Australian banks continuing to report high levels of profitability, low non-performing loan ratios and strong capital positions in direct comparison with many of their overseas peers.

²⁰ House of Representatives Standing Committee on Economics, Finance and Public Administration *Review of the Reserve Bank of Australia and Payments System Board Annual Reports 2005 (First Report)*, June 2006.

50. Australian lenders were not active in the US sub-prime lending market and, in general, do not engage in similar practices in Australia, with Australia's equivalent of the sub-prime market accounting for only 1 per cent of the domestic lending market. Nonetheless, Australia's banking sector has experienced significant difficulties arising from dislocation in many domestic and international credit markets. In particular, they have been affected by the subsequent increase in margins and reduction in availability of credit in these markets, which have resulted in an increase in the cost of funding loans.
51. The tightening of credit markets has particularly impacted on lenders that previously relied heavily on securitisation markets for funding. Australian securitisation markets have experienced limited activity and are currently experiencing a period of price adjustment. This has been the result of a global shift in investor sentiment against structured finance products, including residential mortgage-backed securities (RMBS). Lenders heavily reliant on securitisation have been forced to curtail their lending and/or rely on existing warehouse facilities to fund lending activities. Lenders reliant on wholesale borrowing have also been affected by the increase in margins, particularly those with lower credit ratings.
52. In contrast, financial institutions that rely more heavily on their deposit bases have been less exposed to the increase in funding costs. These institutions include many of Australia's credit unions and building societies, as well as Australia's largest banks.
53. The higher cost of funding partially represents a cyclical correction of the cheap cost of credit and underpricing of risk in global credit markets in recent years. Rapid growth in global credit led to spreads on a number of financial products narrowing to unusually low levels that did not adequately reflect inherent credit risks. Lenders that established business models with the expectation that this low cost of credit would continue have experienced significant pressures on their competitive positions.
54. While a number of institutions claim to have absorbed the increase in their funding costs, particularly in the early days following the credit tightening, over time these costs have been reflected in higher average lending rates. Between January and July 2008, the major banks increased their interest rates by 0.5 to 0.6 percentage points more than the increases in the RBA's cash rate²¹, attributing the move to the need to recover some of their increased funding costs. This means that a significant number of borrowers have experienced interest rate rises of 1.5 to 1.6 percentage points over the year to July 2008, comprised of 1 percentage point due to increases in the RBA's cash rate, and 0.5 to 0.6 basis points due to independent interest rate rises by the major lenders.
55. The recent increase in the margin between banks' interest rates and the cash rate of has partially offset the reduction in this margin since the early 1990s. However, lenders' net interest margins (the difference between average interest earned and average interest paid) have continued to decline.²²
56. Recent developments have also partially unwound the reduction in market concentration that occurred over the previous 10-15 years. For example, bank lenders increased their market share of new home loans from 79 per cent in 2007 to 89 per cent in April 2008, largely at the expense of non-ADI lenders.²³ This reflects a combination of factors, including the winding back of lending by some major

²¹ RBA *Bulletin*, Table A02 and F05; and bank announcements.

²² KPMG *Financial Institutions Performance Summary, Major Banks Half Year 2007/08*.

²³ ABS Cat No 5671.0.

non-ADI lenders in response to their higher costs of funds and the fact that the major banks were slower to lift their interest rates than other significant lenders. In addition, some commentators have reported a 'flight to quality', with customers switching from non-ADI lenders and smaller ADIs to larger ADIs as they believe the latter can offer a more stable banking relationship and greater safety for their deposits.

57. Nonetheless, as noted above, Australia continues to be served by a wide range of banking providers, including 140 providers of over 2400 mortgage products.²⁴ In addition, while some financial institutions are winding back their operations in response to recent events, many are adapting without major changes to their business models, and some are expanding their Australian businesses. For example, BankWest recently indicated that it is continuing the major expansion into the eastern States of Australia that it announced in July 2007, which will increase the bank's branch network from 90 to around 250 branches by 2011.²⁵
58. Another encouraging development following the tightening of international credit markets has been the increased competition for deposits. Recognising the importance of deposits as a cheaper and more stable source of funding, a number of deposit-taking institutions have increased the rate of interest paid on deposit accounts in an effort to expand their deposit bases. This has been particularly evident in the case of 'online' savings accounts and 'blackboard specials' offered on term deposits.
59. Going forward, it is not certain how long it will take for credit markets to adjust following the recent period of turmoil. The conditions in international and domestic credit markets, and their impact on competitive pressures in the Australian mortgage market, will continue to warrant close monitoring by the Government and financial sector regulators for some time to come.
60. Nonetheless, activity in the wholesale credit and securitisation markets can be reasonably expected to improve in the medium to long term as conditions normalise. As investor confidence in international credit markets increases, the robust historical performance of the Australian mortgage market and the underlying quality of our mortgages are likely to assist in driving renewed demand for Australian RMBS. While it is not clear whether such a recovery has begun, there are signs of activity in Australian securitisation markets with new prime and non-conforming RMBS being issued and a number of issuances reportedly in the pipeline.
61. Over time, renewed activity in the RMBS market will enable competitors that are relatively reliant on these sources of funds to renew their competitive pressure on the industry and recover some of their previous market share. However, to the extent that the pricing of risk is moving to a more sustainable basis, a return to the exceptionally narrow spreads of recent years is unlikely to be a feature of the market for some time to come.

INITIATIVES TO IMPROVE COMPETITION

62. Notwithstanding the improvements of the past 10-15 years, concerns remain that competition is not working as effectively as may be desired in some parts of the banking sector. It is important that governments continue to pursue opportunities to

²⁴ CANNEX *Mortgage Star Ratings*, Report No. 21, March 2008 and unpublished CANNEX data provided to Treasury.

²⁵ Media release 'BankWest has Griffith expansion in its sights', 19 June 2008, www.bankwest.com.au.

improve the operation of the banking market, including those that enhance competitive pressures or remove any remaining impediments to competition from new and existing providers. The banking industry also has an important role to play in promoting competitive pressures, such as by supporting government policy and through industry-led initiatives, particularly in areas that are subject to industry self-regulation.

Addressing barriers to switching

63. For competition between suppliers of a product to be effective, it is essential that consumers can switch between suppliers to take advantage of a better deal. Barriers to switching in the banking industry have received increasing attention in international forums such as the Organisation for Economic Co-operation and Development (OECD) and the European Commission in recent years, which have found that there is scope to enhance competition by helping customers to move more easily between providers.

Product complexity

64. One potential barrier to switching between financial institutions is the complexity of banking products and the difficulties that potential customers may face in comparing a number of different products from different providers, to determine whether they could get a better deal with an alternative provider. To some extent, these concerns reflect the wider range of options and product features that are now available to consumers compared with 10-15 years ago. For example, while it may be relatively straightforward to find the home loan with the lowest interest rate, it is much more difficult to put a numerical value on features such as a redraw facility or repayment holiday in order to objectively compare products with different features.
65. A range of market-based solutions have emerged to assist customers to compare the pricing and features of the various banking products available in the market. For example, financial services research firms such as Infochoice and CANNEX provide searchable databases outlining the pricing and features of different banking products, and CANNEX also publishes reports that rate individual products against a range of key criteria. In addition, financial institutions have responded to concerns about increased complexity by introducing a range of simpler or 'no-frills' financial products, such as 'all-you-can-eat' transaction accounts, which provide the simplicity and certainty of unlimited transactions for a fixed monthly fee. More recently, the banking industry has sought to improve transparency around exception fees, by publishing additional information on the size and application of these fees.
66. The Government is also seeking to improve product disclosure requirements to make it easier for consumers to make informed financial decisions and compare products. In February 2008 the Government created the tripartite Financial Services Working Group, comprised of officials from Treasury, the Department of Finance and Deregulation and ASIC. The Working Group is looking to develop short, concise and readable product disclosure documents that are effective for consumer decision making and for business in managing cost and legal requirements. The group is examining disclosure documentation in a staged process, beginning with a concise four-page Product Disclosure Statement (PDS) for First Home Saver Accounts before moving on to look at superannuation and managed investments disclosure. While basic deposit products do not require a PDS under the *Corporations Act 2001*, there is scope in the future to examine disclosure documents covering a broader range of financial products, such as cash management trusts, that are offered by banks. There is also scope for the Australian Government to examine the disclosure associated

with credit products, as part of the Commonwealth's assumption of responsibility of the regulation of credit (as discussed on page 15).

Switching costs

67. Another potential barrier to switching is the administrative and financial costs of moving to a new provider.
68. In terms of administrative costs, the growth in electronic payment methods such as direct debit and credit arrangements has increased the complexity of switching products that are used to make a lot of direct debit and credit transactions. If a customer switches transaction account providers, they must notify the merchants with which they have such arrangements of changes to their account details. The 'hassle' of contacting merchants, and the risk that not all payments will be seamlessly moved to the new account, may deter customers with a significant number of direct debit and credit arrangements from switching between transaction accounts.
69. In terms of financial costs, entry and exit fees are most commonly applied in relation to mortgage products. Entry fees include: application fees; establishment fees; valuation fees; legal fees; settlement fees; and the cost of lenders' mortgage insurance. They may be levied up front, or may be capitalised into the loan principal. Exit fees include early termination fees and discharge fees.
70. In contrast, in general, there are no account opening or closing fees associated with most 'at-call' deposit products. However, term deposits may be subject to a 'break fee' for being terminated early, which reflects the cost to the ADI of forgoing the use of those funds for the agreed term and the administrative costs of closing the contract. In the case of credit card accounts, there are generally no costs associated with closing these accounts, however switching to a new credit card provider may involve the up-front payment of an annual fee.
71. In order to simplify the switching process for banking customers, in February 2008 the Treasurer introduced an Account Switching Package.²⁶ A key element of the package is a switching and listing service, under which financial institutions will be required to assist customers in moving their transaction account(s) to another provider. By November 2008, all banks, credit unions and building societies will be required to provide switching customers with a list of their existing direct debit and credit arrangements and periodic payments. The 'new' financial institutions will be required to assist customers in re-establishing their direct credit and debit arrangements, including by contacting the customer's merchants and paying organisations on the customer's behalf, at their request. This service is broadly consistent with initiatives being undertaken in international jurisdictions and the recommendations emerging from OECD discussions on switching barriers.
72. Another key element of the Government's package is an industry review of mortgage entry and exit fees, convened by ASIC. ASIC's report²⁷ reviews a number of factors that impact on the consumer's ability to get the best deal in the mortgage market. It finds that exit fees can be significant and may deter some borrowers from refinancing, especially during the three- to five-year period within which a deferred establishment fee may be charged. However, the report also reveals that exit fees vary widely, and that for some products no exit fees apply. By improving the

²⁶ 'Rudd Government making it easier for Australian families to switch banks', Press Release No. 006, 9 February 2008, www.treasurer.gov.au.

²⁷ ASIC *Review of Mortgage Entry and Exit Fees*, www.asic.gov.au.

information available to borrowers, the report may assist borrowers to compare products and prices and find the loan that represents the best value for money.

73. At the Treasurer's request, ASIC is undertaking further work on mortgage entry and exit fees, focusing on: the application of these fees in different circumstances, how they are disclosed to consumers, and the extent to which consumers understand what is being disclosed to them. It is anticipated that this research will inform the development of disclosure requirements for credit products under the new national regime for regulating mortgages and mortgage advice, as agreed by the Council of Australian Governments (COAG). ASIC's work will also inform the work of the Financial Services Working Group on improving disclosure of other financial products. More generally, the research will assist consumers to compare mortgages, and thus help to enhance competitive pressures in the mortgage market.
74. A number of industry initiatives may also help to reduce the administrative barriers to switching and maintain competitive pressures on exit fees. In relation to administrative barriers, the banking industry has an important role in implementing the Government's switching and listing service, including by committing to the service in industry codes of practice. In addition, the Australian Payments Clearing Association (APCA) has indicated that it will consider ways in which the payments system can assist customers to switch between accounts as part of future upgrades to the system. In relation to exit fees, financial services research and ratings firms such as CANNEX take entry and exit fees into account in some of the information and ratings provided on mortgage products. For example, in March 2007 CANNEX published a feature article on exit fees in its Mortgage Star Ratings report, which identified mortgages that CANNEX assessed as representing good value for money, taking into account exit fees, interest rates and other product features.²⁸

Reforms to the payments system

75. In accordance with the recommendations of the *Financial System Inquiry 1997*, in 1998 the RBA was charged with promoting competition, efficiency and stability in the payments system.²⁹ As its first step in the reform process, the RBA undertook a joint study with the ACCC, focusing on credit card, EFTPOS and ATM arrangements.³⁰ The study found that the normal forces of competition were not operating effectively to put downward pressure on interchange fees in these markets, and that the resulting configuration of fees was not conducive to the efficient evolution of the payments system.
76. Based on these findings, from 2002 onwards, the RBA introduced a series of reforms to the credit card, EFTPOS and ATM markets. These were designed to:
- promote efficient pricing signals, through the introduction of cost-based benchmarks for 'hidden' interchange fees flowing between financial institutions;
 - address restrictions on merchant behaviour that limited competition, including rules that prohibited them from refusing to accept payment methods or passing the costs onto customers;

²⁸ CANNEX, *Mortgage Star Ratings*, Report No. 19, March 2007, www.cannex.com.au.

²⁹ The 'payments system' refers to arrangements for transferring funds between accounts at financial institutions, such as from a customer's account to a merchant's account when a customer pays for a purchase. It includes payment instruments such as cash, cheques and credit cards. As most transactions are made using this system, its efficiency impacts on the broader Australian economy.

³⁰ RBA and ACCC *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access*, October 2000.

- liberalise access to the payments system, by prohibiting unnecessary entrance requirements, reducing the burden of bilateral negotiations and preventing incumbent participants from unduly discriminating against new entrants; and
 - improve the system's transparency, by making more information publicly available.
77. Other countries have also taken regulatory action to address payments system inefficiencies. In particular, a number of jurisdictions have sought to reduce the level of interchange fees, either through direct regulation or agreement with industry. Concerns about competition and efficiency in the payments system have also been discussed in international forums, such as the OECD.
78. The RBA is currently undertaking a comprehensive review of its reforms. Its preliminary findings indicate that the reforms have improved competition and efficiency in the payments system and have contributed to substantial welfare gains for the community.³¹ In particular, the reforms have improved the allocation of resources across the economy, by promoting a more efficient pricing structure that encourages transactors to use the payment instrument of most value to them. However, it is acknowledged that the reforms have affected different groups differently, and that elements of the reforms are considered intrusive and burdensome by the payments system industry.
79. The RBA's preliminary findings also suggest that further reforms may be desirable to improve competition and efficiency in the payments system, including:
- changes to the EFTPOS system to: reduce barriers to entry, including by replacing the existing system of bilateral contracts with a multilateral arrangement; create incentives for innovation and development of the EFTPOS system; and promote the introduction of alternative payment instruments;
 - further changes to payments system rules to ensure that merchants can make independent acceptance decisions about pre-paid cards, which will enhance the downward pressures merchants exert on payments system fees; and
 - improved transparency of the payments system, including the publication of average interchange fees and average scheme membership fees.
80. The RBA has also indicated a willingness to consider removing some of the more contentious elements of its payments system reforms, should industry be prepared to make these changes voluntarily.
81. The RBA is currently undertaking further consultation with interested parties and is expected to publish its final conclusions in late August or early September 2008.
82. The payments industry has actively participated in the RBA's reform process and is also pursuing a number of initiatives to improve the payments system not directly covered by the RBA's reforms. In particular, APCA's review of Australia's low value payments systems³² is examining options that, among other things, may reduce barriers to participation in the low value payments system by streamlining access

³¹ RBA *Reform of Australia's Payments System: Preliminary Conclusions of the 2007/08 Review*, April 2008.

³² Low value payments is an industry term including all those payments not flowing through the 'high value' payments system or the real-time gross settlements system, and excluding cash and card-based payments. It includes cheques, direct entry arrangements (direct credit and direct debit) and BPAY. Low value payments account for nearly 50 per cent of all non-cash payment transactions by volume and 30 per cent by value.

arrangements, and enhance customers' ability to switch between financial institutions.³³

Australian Government regulation of credit

83. While most banking products are regulated by the Australian Government, responsibility for consumer credit, including mortgages, is shared between the Australian and the State and Territory governments. This arrangement has been subject to a number of reviews in recent years, including the Productivity Commission's *Review of Australia's Consumer Protection Framework*, and a number of gaps have been identified.
84. Of particular relevance to competition is the criticism that the existing approach imposes unnecessary burdens on service providers (which will ultimately be passed on to consumers in the form of higher prices) and may create regulatory distortions between different geographic and product markets. This arises because, although the States and Territories have adopted a substantially uniform approach to credit regulation, differences between jurisdictions mean that service providers operating in multiple jurisdictions incur additional costs from the need to vary their business practices to meet the local requirements. In addition, the many credit providers which supply other financial services that are regulated at the Commonwealth level must also comply with Commonwealth regulation.
85. Such additional costs and complexities may be considered a barrier to entering the Australian banking sector, or to expanding existing operations into a new State or Territory. To the extent that this is the case, addressing this obstacle may enhance competitive pressures in the banking sector.
86. In view of the gaps in the existing framework and the nationalised market for credit, on 3 July 2008, the Australian, State and Territory governments reached an agreement at COAG for the Australian Government to assume the responsibility for regulating mortgage lending and advice and margin lending. COAG also agreed to develop a national regulatory framework for other parts of the credit sector (including, for example, credit cards and personal loans), to be regulated by the Australian Government. COAG's decision reflects consultation with a wide range of stakeholders on the Government's *Green Paper on Financial Services and Credit Reform: Improving, Simplifying and Standardising Financial Services and Credit Regulation*, which canvassed a number of options for the future regulation of credit markets.
87. Over the coming months the Australian Government, in consultation with the States and Territories, will develop a proposed national approach to regulating consumer credit (including mortgages) for final agreement by COAG before the end of 2008. Among other things, this approach will seek to ensure greater consistency of regulation of similar products and across jurisdictions, which will reduce the costs and complexities of participating in Australia's banking sector.

Comprehensive credit reporting

88. Another regulatory requirement that is being examined is the impact of restrictions under the *Privacy Act 1988* that limit the information credit providers can obtain to

³³ APCA *Low Value Payments: Challenges of Evolution — A consultation document on the future of Australia's Low Value Payments systems*, May 2008.

check credit histories. Under the Act, credit providers are only allowed access to 'negative' information on consumers, such as delinquencies, serious credit infringements and bankruptcy and the number of applications for credit sought (but not whether those applications were successful). In contrast, in most other OECD nations credit providers can obtain comprehensive information on a borrower's repayment history. The Australian Law Reform Commission (ALRC) has examined the impact of these restrictions as part of its inquiry into the Act.

89. While participants in the credit sector have differing views, some providers argue that the existing arrangements represent a barrier to competition as they prevent new entrants and smaller existing lenders from obtaining comprehensive information on a prospective customer's ability to service a loan. This may put them at a competitive disadvantage to a prospective customer's existing lender, which has access to the borrower's repayment history, and more generally, to large lenders with more comprehensive client databases. This disadvantage is reinforced by the current voluntary approach to credit reporting, in which lenders can gain access to prospective customers' credit reports but are not obliged to contribute to reports on their existing customers.
90. The ALRC's *Issues Paper on Privacy – Credit Reporting Provisions* proposes that credit reporting be expanded to include additional information on the borrower's previous credit arrangements. However, unlike the comprehensive reporting frameworks adopted in other jurisdictions, lenders would not gain access to a customer's overall level of indebtedness. The paper also proposes that the current system of voluntary reporting be replaced with a system of reciprocity, whereby lenders who seek credit reporting information must also provide information.
91. The Government will respond to the final report of the ALRC inquiry following its release.

Revised Commonwealth Government securities arrangements

92. On 20 May 2008 the Government announced that it would increase its issuance of Commonwealth Government securities (CGS). While the Government does not need to issue securities to finance spending, it does so because CGS play an important role in credit markets. Because of their risk-free nature, Australian Government Treasury Bonds are used by participants in Australia's financial markets as the benchmark to set interest rates beyond the short end of the yield curve. As such, CGS are used in the pricing and hedging of a wide range of financial instruments and in the management of interest rate risk by financial institutions (including mortgage lenders) and other market participants.
93. Following the public announcement regarding CGS issuance on 20 May 2008, the *Commonwealth Securities and Investment Legislation Amendment Act 2008* came into effect on 12 July 2008, which provides for the issuance of up to an additional \$25 billion in fixed-coupon Treasury Bonds (around \$50 billion of fixed-coupon Treasury Bonds are currently on issue). The Government will issue around \$5 billion of this additional issuance in 2008-09, in bond lines that are in shortest supply in the market, particularly mid-curve stocks, and will continue to monitor market conditions to determine whether further issuance is required.
94. The proceeds of the increased issuance will be administered by the Australian Office of Financial Management (AOFM), the Government agency responsible for debt management. The Act provides for the expansion of the AOFM's investment powers

to allow it to invest in a broader range of assets than under its current mandate. This will better enable the AOFM to offset the cost and risk of the additional issuance.

- 95. The Act also widens the range of assets that the AOFM can accept as part of its securities lending facility. This facility supports the CGS market by allowing market participants to access bonds that are in temporary short supply, which helps to smooth the operation of the market.**
- 96. By enhancing liquidity, risk management and price discovery, these initiatives will support the efficient operation of Australia's credit markets and contribute to their resilience and robustness during times of financial market stress.**