TITLE: **A licence to print money: bank profits in Australia**

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A decade ago the former Governor of the Reserve Bank of Australia, Ian Macfarlane, mused in front of a Parliamentary Committee:

I have often wondered why banks are so profitable - and they certainly have been extremely profitable in Australia … They always were very profitable, let's face it. They were very profitable in the regulated phase, and some of us thought that those profit rates would go down in the deregulated phase, as competition heated up. So you can understand why people are very interested in profits and very surprised that profits or rates of return on equity have remained so high.

Going back earlier, in 1964 Nugget Coombs, who had been the Governor of the Reserve Bank (and its predecessor) since 1949, said:

Banks are exceedingly privileged people. They are - of all industries - the most privileged people. They are guaranteed against loss - and even guaranteed against competition.

Banking is an essential part of the Australian economy - almost an essential service. So why should it be "extremely profitable" to use the Governor's words? Why do bankers have to be exceedingly privileged? What does that mean to those of us who need to use the banking system? And what can we do about it?

The Australia Institute has just published a paper, *A licence to print money: bank profits in Australia*, that tries to answer some of those questions. It confirms the Governor's words that the banks are indeed extremely profitable, especially the big four; the ANZ, Commonwealth, National and Westpac. Despite the setback due to the global financial crisis the profits of the big four have been gradually increasing from 1 per cent of GDP 20 years ago to around 2 per cent today - and they would have been higher still if not for the global financial crisis.

In the 2009 financial year the big four banks earned underlying profits before tax of $35 billion or just under 3 per cent of GDP. That figure adds loan losses back to adjust for the effects of the global financial crisis. It means that of every dollar spent in Australia, three cents ends up as banks' underlying profit for just the big four. And when the global economic and financial crisis passes banks' actual profit will again reflect their underlying profit.

Mr Macfarlane claimed that bank profits were excessive when they aimed for a return on equity of 18 or 20 per cent in a low inflation environment. That's equivalent to 26 to 29 per cent before tax. Underlying profits in 2009 gave the big four a massive 29 per cent return on equity before tax.

If banks were earning more normal returns on their equity their profits would be much lower. In more competitive industries returns of around 10 per cent are more likely. It is estimated that around $20 billion is the additional profit banks earn as a result of their market power.

Part of the reason for the huge profits of the banks is the high degree of concentration in the financial market generally. In the early 1980s banks accounted for 50 per cent of all lending in Australia. Today it is over 90 per cent. In the meantime banks have seen off the credit unions, building societies, finance companies, mortgage originators and even the foreign banks. The banks became stronger during the period of deregulation.

Among the banks themselves the big four used to face some competition from the smaller and regional banks. However, St George and BankWest have recently been taken over by Westpac and the Commonwealth respectively. That follows the end of the Advance Bank, various state banks, the National Mutual Royal Bank, the Town & Country Bank, the Bank of New Zealand and the Bank of Melbourne. The St George and BankWest takeovers should never have gone ahead.

While those takeovers are now water under the bridge, there should be no more takeovers allowed in Australia. Competition from the other banks may not mean much to the big banks' profits but at least it provides some variety in the market. It gives consumers some scope to avoid the plain vanilla services now offered by the big four.

The result of the tendency for increased concentration is that the big four banks have increased their share of banking itself. The big four now have 76 per cent of the banking market and the rest is shared among 57 other banks. Most of those 57 are foreign banks that are represented here but never took off as was hoped.

A good example of the exploitation of market power on the part of the banks follows the increases in official interest rates by the Reserve Bank. Objectively the banks' costs have not changed from one day to the next but they use the official interest rate decisions as cover to increase their interest charges. For example, on Tuesday, March 2, the Reserve Bank put interest rates up 25 basis points (0.25 per cent). The four major banks followed within a day or so with increases of 25 basis points. Their excuse is that as official interest rates increase, so do bank costs. Yet most customers know that the banks pay zero interest on a large number of their deposits. Likewise, the banks fund a lot of their operations through overseas borrowings. The Reserve Bank decision has no effect on the cost of those funds.

At most, around half of bank deposits and borrowings are market related, or at least potentially affected by changes in official interest rates and then with a long lag. Only a very small fraction of banks' borrowings reflect the actual official interest rates that rule in the money market.

Westpac taught us that when the price of bananas goes up the maker of banana smoothies has to put up the price of smoothies. But Westpac did not say the price of smoothies has to go up by the same percentage - bananas are only part of the cost. Likewise when official interest rates increase that does not affect all of a bank's costs. We should not expect to see banks' interest charges respond exactly to changes in official rates.

So far Australian policy-makers have used competition as their main weapon against the banks. Almost a century ago the Commonwealth Bank was established as a people's bank to provide genuine competition against the private banks. Since then there have been waves of competition coming from the credit unions, building societies, finance companies, mortgage originators and the foreign banks. Despite a century of competition the big four banks are as strong now as they have ever been.

Clearly competition and deregulation have not worked. It is time for other approaches to be considered.

The Finance Sector Union has called for a social contract with the banks. There should be a community debate about what society wants from its banks to inform the content of the social contract. To reinforce the social contract there should be tough regulation that gives everyone access to low cost banking. Fees and charges should be controlled so that they represent actual costs and no more.

If we try everything and still banks earn excessive profits they should be controlled through special taxation measures of the sort used with respect to the mining companies when they make excessive profits through their access to Australian resources. Clearly bank profits depend on privileged access to the Australian payments system just like the high profits of some miners is due to their privileged access to Australia's unique resource endowment. In both cases, high profits reflect the attributes of what the companies are exploiting and should share that high profit with the owners of the resource in question.

Since the report was written the Australian Bankers' Association accused The Australia Institute of a "disappointing interpretation" of the banks' role especially during the financial crisis. It should come as no surprise to anyone that the Australian Bankers' Association would have a different interpretation of the industry's profit. Their job is to defend the banks, not to critically analyse them.

Among other things the Australian Bankers' Association says the Institute "ignores the social benefits of successful banks - profitable and well capitalised banks provide finance for businesses and, therefore, keep people employed". The point that has to be emphasised is that while the economy requires a healthy finance sector it does not require one that is "extremely profitable" or "exceedingly privileged".

The Australian Bankers' Association tries to assert that banking in Australia is competitive. The role of competition in a market economy is to ensure that suppliers are not in a position to earn excessive profits. The idea is that if anyone is earning excessive profit, new competitors will be attracted into the industry offering consumers a better deal and forcing the incumbent to match the new-comers. The effect of that type of competition is to eliminate excessive profit. It is obvious that competition in the banking industry has not been sufficient to eliminate excessive profit. The excessive profit is evidence that competition has been ineffective.

The Australian Bankers' Association also refutes the suggestion that banks are profiteering. The report certainly accuses the banks of exploiting their market power. To accuse banking corporations of exploiting market power is not a criticism of the banks themselves or any of the individuals involved in the banks or elsewhere. Indeed, the management of a bank has an obligation to act in the interests of shareholders. It is certainly not in shareholders' interests to have a bank voluntarily refrain from earning its full potential profit. A management would be sacked if it did not seek to maximise its bank's profit.

Instead it is the duty of government to address monopoly power with policies appropriate for the industry to ensure that Australians get their essential services at a reasonable price. So when the banks are accused of making excessive profits it effectively amounts to saying that governments have not done their job in controlling the monopoly power of banks.

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