

Submission to the Senate Economics Committee inquiry

‘Competition within the Australian banking sector’

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Former Governor of the RBA, Ian Macfarlane, in one of his semi-annual appearances before the House of Representatives Economics Committee, was once questioned on the high profits earned by the banks. He replied;

I, like you, 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.

Any business, whether it is a bank or any other business, if it is aiming for extremely high rates return on equity—if it is aiming for 18 or 20 per cent in an environment of two per cent inflation—it seems to me there are an awful lot of very useful things that could be done which are profitable, but they are not quite that profitable.

If they are literally doing what they are aiming to do they are failing to invest in a lot of things which are reasonably profitable and socially very useful (Macfarlane, 1999).¹

Introduction

The present submission responds to the request for submissions to the Senate Economics Committee inquiry 'Competition within the Australian banking sector'.

This submission is to be read in conjunction with earlier work by The Australia Institute and especially the publication *Money and Power: The case for better regulation in banking*.² By way of introduction we begin with a summary of *Money and Power*. Following that this submission updates some of the figures from that report, adds additional detail on matters related to this inquiry and provides some new material.

It is important to appreciate the macroeconomic context in which banking takes place. Ultimately banks and the rest of the financial system sit in between ultimate lenders and borrowers who respectively make the critical savings and investment decisions in society. Banks of course dominate the financial system. The investors in the first instance receive the non-labour incomes (defined as the 'gross operating surplus' by the Australian Bureau of Statistics) and distribute them to the owners of the capital, the ultimate savers. However, between the gross operating surplus and the 'rewards' to savers, a margin is often earned by the financial system as a deduction of the flow of income from its source to the ultimate savers.

It can be appreciated how important are the banks and the rest of the financial system for the allocation of funds to investors and for the stability of the macro-economy. In the perfectly competitive economy of the text book, savers would have full knowledge of all the options open to them as would the borrowers. Competitive financial intermediaries would find it difficult to earn more than a normal return. There is another completely contrasting view; banks are the experts and most savers and borrowers have little knowledge and little incentive to acquire the knowledge. The 'information asymmetry' between banks and their customers allows banks to earn 'rents' by underpaying savers and overcharging borrowers (Goodhart, 2010).

¹ Australia, House of Representatives, Standing Committee on Economics, Finance and Public Administration, *Reference: Reserve Bank of Australia annual report 1997–98*, Melbourne, Hansard, Thursday 17 June 1999, pp. 77–80. (Mr Ian Macfarlane, Governor of the Reserve Bank of Australia).

² J Fear, R Denniss and D Richardson (2010) *Money and Power: The case for better regulation in banking* Institute Paper No 4, August. See also Richardson (2009). These are reproduced as an attachment to this submission.

In addition banks and other financial institutions have managed to increase the intermediation in the economic system. There is less direct contact between savers and investors. In addition, there is more emphasis on derivative arrangements—the investment of funds that invest in the final real investors. That includes the issuance of managed fund products on the part of banks as well as the shadow finance system that includes hedge funds. Sometimes the chains can be very lengthy. The lengthy and complicated chains between savers and real investors do not increase the size of the total gross operating surplus but they certainly increase the number of players that take a cut of the gross operating surplus. In June 2010 the total off-balance sheet business of the Australian banks was \$15.2 billion or 12 times GDP (RBA, 2010b). These comprised mainly forward contracts, swap contracts and credit derivatives. None of these create new sources of capital income but they are means through which players in the financial system share in it, including through the fees charged by banks and other financial institutions.³

In the US and UK profits in the financial system had increased to around 40 per cent of all profits on the eve of the global financial crisis (Woolley, 2010). In Australia things are much less advanced and the profits of the financial sector has increased over the last two decades from around 5 to 11 per cent of GDP (ABS, 2010a).

Money and Power

The power of Australia's big four banks is unmistakable. Their underlying profits equate to almost three per cent of GDP, up from less than one per cent a quarter of a century ago. Of every \$100 spent in Australia, nearly \$3 ends up as underlying profit for the banks.

Profits are so high because the banking market is highly concentrated. The big four banks now control more than 75 per cent of all bank assets and banks account for over 90 per cent of all lending by financial institutions in Australia. This level of concentration has distorted competition, allowing the big banks to reap underlying profits of around \$35 billion per year, including \$20 billion in 'superprofits'⁴ attributable to their market power. Most Australians believe that the banking market is overly concentrated: three in four survey respondents (72 per cent) said that the big four banks in Australia have too much market power (Fear et al, 2010).

But is the extreme profitability of Australia's banks in the public interest? Many workers hold shares in banks indirectly through superannuation, and therefore arguably receive a share of their profits. Yet the distribution of share ownership and superannuation balances means that the wealthiest Australians capture the majority of the dividends flowing from bank profits. And in other important respects the behaviour of the banks runs counter to the interests of the broader community.

Traditionally, banks have served a social as well as an economic function, providing a service to the community and helping to control the supply of credit. But modern banking practice involves striving for maximum market share, even if this means acting against the interests of individual customers or the community as a whole. The logic of maximising shareholder value has put the marketing of debt, through credit cards and housing loans, at the centre of the banking endeavour.

³ Arguably these developments seem to offer individuals the chance to reduce their own risk but often at the expense of greater systemic risk for the economy as a whole.

⁴ 'Superprofits' refer to the profits over and above those profits that would be obtained in a competitive market.

This submission presents survey results that reveal the extraordinary extent to which ordinary Australians are offered new credit products, often without asking for it. Two in three respondents (66 per cent) reported receiving an unsolicited offer for a new credit card in the previous 12 months, while one in two (49 per cent) had received an unsolicited offer to increase their credit-card limit. One in three (36 per cent) had received an offer for a personal loan and one in five (18 per cent) had an offer to increase the available credit on their home loan. While people on higher incomes are more likely to receive such offers, the marketing of debt among people on low incomes is clearly widespread. For example, one in three people living in a low-income household has received an offer of a personal loan in the past year without seeking one out.

When faced with calls for greater regulation, banks argue that individuals are responsible for their own financial decisions and that the predominant form of government action needed in the sector, if any, is to provide consumers with the information necessary for them to make educated individual decisions. Informed consumers, they insist, will behave rationally to ensure competitive discipline in the market, which will in turn bring about socially optimal outcomes.

This submission argues that the role for government should be much greater than the mere provision of additional information to consumers. In short, government should ensure that banks behave in ways that are consistent with the public interest rather than simply 'leaving it to the market'.

When people are asked to make financial decisions that they do not fully understand, they often rely on other people for help, particularly people that they regard as better qualified or informed. In the case of bank products, people often rely on the advice they receive from bank workers. What is not well understood is that **bank workers in Australia are often paid commissions to sell their bank's products**. The more products they sell—in other words, the more debt they convince customers to take on—the more money they make. In fact, encouraging bank tellers and call-centre workers to sell debt products is an integral part of a bank's marketing strategy. Consumers can no longer be confident that the advice they receive from bank workers is objective rather than conflicted.

Debt-pushing by bank workers is just one part of the sophisticated and multifaceted marketing operations of Australia's big banks. They also spend enormous sums of money on advertising in the mass media, on junk-mail campaigns, and even on face-to-face marketing in public places. **In fact, the big four banks spend over \$1 billion every year on advertising—more than it costs to run the ABC.** Together, all this marketing allows banks to take maximum advantage of the confusion and disinterest that consumers feel when faced with financial choices. And while constant marketing can maximise shareholder returns, the effect on broader society is a negative one.

The banks claim that because they compete with each other, interest rates and fees are kept at reasonable levels, a claim that rests on the assumption that consumers will readily switch banks when they see the opportunity for a better deal. By contrast, the survey results presented below show that 43 per cent of big-bank customers have never even considered switching. In fact, only three per cent of bank customers switch banks each year, an astonishingly low figure for a sector that is allegedly subject to free and open competition. Once a bank signs up a new customer, it can be quite confident of keeping that customer for decades to come. It is estimated that the average big four bank can expect an additional lifetime profit of \$27,000 from attracting the additional 15 year old customer.

The global financial crisis has fostered a view in the community that the bigger a bank is, and the bigger its profits, the safer it is. Indeed, around one in five Australians appear to hold this belief, with 19 per cent of survey respondents agreeing that it is safer to deposit money in a

bank with bigger profits. If one in five Australians believe that a bank with bigger profits is safer, there is a pool of more than three million adult Australians who hold this view. This constitutes a massive marketing advantage for the incumbent players in the sector against smaller banks and credit unions.

In recent years policymakers around the world have come to recognise that many people struggle with financial decisions. In Australia, this has been officially acknowledged by the recent Cooper Review into Australia's superannuation system which recommended a default superannuation fund. The standard policy response has been to promote financial literacy through education and awareness-raising. The assumption behind these initiatives is that consumers possess the motivation and capacity to improve their financial knowledge.

But there is something missing in this approach. Consumers also need to be aware of the various ways in which financial providers may attempt to persuade them to take on more debt than they need, or to use a financial product that is not in their best interests. They also need to understand the extent to which certain providers in the retail financial sector dominate all the others and the techniques they use to reinforce their dominance.

More broadly, government needs to ensure that the environment in which consumers make financial choices is structured fairly and in a way that empowers ordinary people rather than just the big banks. To date, the principal weapon used by Australian policymakers in their battle against the might of the banks has been competition. The Commonwealth Bank was established to provide genuine competition against the private banks almost a century ago; since then there have been waves of competition from credit unions, building societies, finance companies, mortgage originators and foreign banks. **Despite a century of competition, the big four banks are stronger now than they have ever been.** They have bought up much of the competition and the federal government sold the Commonwealth Bank.

The lesson of history is that competition policy is not very effective against a large, powerful industry enjoying the competitive advantages that result from incumbency and economies of scale. One solution might be to require functional or structural separation between the different functions performed by banks: namely deposit-taking and lending, payments facilitation, retail investment, investment banking and so forth. **It is important to note that the Parliament has just passed legislation to structurally separate Telstra.** The aim should be to reduce bank profits to one per cent or less as a share of GDP, the level they were at two decades ago.

The rest of this submission updates and extends some of the material in *Money and Power* while some new approaches are also included.

Latest Profit figures

Since *Money and Power* was published the big four banks have published their 2010 financial statements.⁵ The relevant figures are included in the following table.

⁵ The Commonwealth Bank reports on a financial year ending 30 June while the other big four banks report on a financial year ending 30 September.

Table 1: 2010 Profit figures for the big four banks

| | Profit after tax | Bad and doubtful debts | Other | Tax | Underlying profit |
|-----------------------|------------------|------------------------|------------|-------------|-------------------|
| | \$m | \$m | \$m | \$m | \$m |
| ANZ | 4501 | 1787 | 4 | 2096 | 8388 |
| Commonwealth | 5664 | 2379 | 0 | 2383 | 10426 |
| National | 4225 | 2791 | 309 | 1451 | 8776 |
| Westpac | 6346 | 1456 | 510 | 1626 | 9938 |
| | | | | | |
| Total | 20736 | 8413 | 823 | 7556 | 37528 |
| | % | % | % | % | % |
| Total as share of GDP | 1.60 | 0.65 | 0.06 | 0.58 | 2.89 |

Sources: ANZ (2010), CBA (2010), NAB (2010) and WBC (2010).

On these figures 'underlying profits'⁶ of the big four are still massive. The underlying profits are also significant when the figures are divided by GDP as they are in the bottom row.

The Institute has previously argued that a benchmark of 10 per cent was the cut off point used to define the ordinary returns that an investor might expect in a competitive market and the monopoly profits actually earned in the industry (Richardson, 2010). On that basis it was estimated that some \$20 billion in underlying profit was due to the monopoly power of the banks.

Another approach might be to suggest that a competitive benchmark is the actual returns in the share market on a particular stock. The share market gives the valuation of the company's equity that the owners are satisfied with. Shares in a bank sell in a fairly competitive market and it would be expected that the market price will give the yield that investors are satisfied with given the profits earned, the risk in the industry, and so on.

At close of business Monday 22 November 2010 the banks gave investors yields as shown in table 2. The yields here are calculated by dividing earnings per share by the share price. This is done on the assumption that the returns investors value include both dividends and retained earnings since the latter increases the value of the company and so provide capital gains to augment any dividends earned.

⁶ 'Underlying profits' or 'core profits' for the ANZ use profit before tax and add back the provisions for bad and doubtful debts. The reason is that those provisions have increased dramatically with the global financial crisis so that their inclusion hides the true long term position of the banks.

Table 2: Banks' market yields

| | Share price \$ | Earnings per share ¢ | Yield % |
|---------------------------|----------------|----------------------|-------------|
| ANZ | 22.48 | 178.9 | 7.96 |
| CBA | 48.73 | 344.5 | 7.07 |
| NAB | 24.00 | 191.8 | 7.99 |
| WBC | 21.72 | 214.2 | 9.86 |
| Unweighted average | 29.23 | 232.35 | 7.95 |

Source: The Australian Financial Review (2010).

This exercise shows that bank owners are receiving an average yield of 7.95 per cent on their bank shares. Given everything that owners take into account, that yield can be taken as the return bank owners expect on their investment. Now the profitability that the banks report is their return on equity which is entirely different. Equity in that calculation refers to the actual capital originally paid by the first owners of the company's shares together with the accumulated retained earnings in the company.⁷ Equity in that sense refers to the actual amount contributed by the owners of the company. So return on equity measures profit divided by the amount actually contributed by the owners to the operation of the company and is entirely separate from the value of the shares at any one time. However if the two were the same it would suggest that the return on equity was just equal to the return sought by the owners. However, if the return on equity is greater than the market yield it implies that the company's profit is so much higher than the owners are content with and so they are happy to pay a premium to purchase shares in the company. As a result the company's shares are also worth much more than the accumulated capital contributed by the owners of the company.

Suppose a company earns profit of \$100 million, its shares are trading at a yield of 8 per cent but its return on equity is 16 per cent. That means its yield is twice that required by its owners in which case we can say half its profit, \$50 million, is excess or super profit. Table 3 reports the actual return on equity earned by the big four banks.

Table 3: Reported return on average shareholders' equity

| | Return on shareholders' equity % |
|----------------|----------------------------------|
| ANZ | 13.9 |
| CBA | 17.5 |
| NAB | 13.2 |
| WBC | 17.4 |
| Average | 15.5 |

Sources: ANZ (2010), CBA (2010), NAB (2010) and WBC (2010).

The figures in Table 3 are the figures quoted by the banks themselves. Clearly the return on shareholders' equity at 15.5 per cent is much greater than the market yield of 7.95 per cent. It

⁷ Other items may also affect the value of the shareholders' equity. One that is discussed below is the role that 'goodwill' plays in estimating returns on equity.

implies that shareholders want returns of 7.95 per cent but the businesses are earning average returns of almost double that and that underlying super profits are around \$18 billion for 2009-10. It could be argued that the figures in table 3 are understatements—in the annual reports of the big four banks goodwill is valued at a total of \$29.7 billion out of a total shareholder's equity of \$150.8 billion. Excluding goodwill would give an average return on equity around 19.4 per cent rather than the 15.5 per cent reported in table 3.

The estimate of super profits is important since the debate has included some discussion about taxing banks' super profits.⁸ **The argument would be analogous to the argument for taxing mining rents.** In particular, banks make enormous profits not necessarily because they are particularly good at what they do but because they have the privilege of owning a bank license, have a large customer base and so have access to the clearing system and the cheap funds as part of their role in the payments system. Of course, unlike the miners, bank prices are not set on international markets but at least in part reflect the monopoly power of the banks. Hence there is the danger that banks could pass on any new tax to their customers by way of even higher interest rates or other charges. The way the big banks managed to offset their increased bad loans in the global financial crisis suggests that may well be the reaction from the banks.

Of course if a super profit tax applied to the banks and it was found that they increased their margins in response it would be proof of their market power and so constitute a powerful reason for regulating bank profits.

What are the banks' costs of raising funds?

One of the banks' recent claims is that borrowing costs have increased, and they cite especially increases in wholesale and foreign borrowing costs. For example, in announcing the 2 November increase in mortgage interest rates the Commonwealth Bank said 'forty per cent of the Bank's home loan funding comes from international and domestic wholesale markets and these have increased by 1.33 per cent and continue to rise as pre GFC funding is replaced by more expensive, longer term funds' (Commonwealth Bank of Australia, 2010b).

Turning first to foreign borrowing costs, it seems hard to find evidence of an increase in funding costs in official statistics. The ABS balance of payments figures include interest paid abroad and foreign investment in debt securities issued by Australian deposit taking corporations. Those figures are reproduced in table 4 below which then allows us to calculate the implied annual equivalent rate of return on funds borrowed from abroad by Australian deposit-taking organisations which are mainly the big four banks. These figures go up to September 2010 as a result of the release of new balance of payments figures on 30 November 2010.

⁸ The Australia Institute has advocated a super profits tax in the past. For example Richard Denniss called for the super profits tax in an interview on 11 August 2010. See ABC (2010).

Table 4: Foreign interest paid and foreign debt for deposit-taking corporations.

| | Investment income, Portfolio investment, Interest, Short-term, Depository corporations | Investment income, Portfolio investment, Interest, Long-term, Depository corporations | Other liabilities, Financial corporations, Depository corporations, Short-term, Loans and other liabilities | Other liabilities, Financial corporations, Depository corporations, Long-term | Implied rate of return; annual equivalent of quarterly figures |
|----------|--|---|---|---|--|
| | \$ Millions | \$ Millions | \$ Millions | \$ Millions | % |
| Mar-2004 | -275 | -1309 | 37877 | 142757 | 3.55 |
| Jun-2004 | -269 | -1700 | 34491 | 168924 | 3.93 |
| Sep-2004 | -251 | -2095 | 35754 | 176447 | 4.50 |
| Dec-2004 | -242 | -2069 | 39943 | 178992 | 4.29 |
| Mar-2005 | -234 | -2122 | 41823 | 183485 | 4.25 |
| Jun-2005 | -261 | -2125 | 41669 | 191409 | 4.16 |
| Sep-2005 | -274 | -2179 | 47011 | 191485 | 4.18 |
| Dec-2005 | -295 | -2364 | 38800 | 203306 | 4.47 |
| Mar-2006 | -355 | -2573 | 37787 | 227313 | 4.49 |
| Jun-2006 | -540 | -2951 | 37276 | 230196 | 5.32 |
| Sep-2006 | -772 | -2997 | 38432 | 243833 | 5.45 |
| Dec-2006 | -856 | -3123 | 37061 | 253208 | 5.60 |
| Mar-2007 | -813 | -3285 | 37182 | 262993 | 5.57 |
| Jun-2007 | -869 | -3533 | 47712 | 263141 | 5.79 |
| Sep-2007 | -890 | -3611 | 53169 | 264460 | 5.79 |
| Dec-2007 | -582 | -3657 | 69707 | 277052 | 4.98 |
| Mar-2008 | -574 | -4085 | 65645 | 291444 | 5.32 |
| Jun-2008 | -548 | -4413 | 76685 | 282511 | 5.64 |
| Sep-2008 | -544 | -4031 | 89472 | 316770 | 4.58 |
| Dec-2008 | -432 | -4659 | 94590 | 351010 | 4.65 |
| Mar-2009 | -261 | -4722 | 97107 | 353430 | 4.50 |
| Jun-2009 | -243 | -4780 | 98762 | 344143 | 4.61 |
| Sep-2009 | -206 | -4233 | 95690 | 335116 | 4.19 |
| Dec-2009 | -341 | -4253 | 109829 | 368648 | 3.90 |
| Mar-2010 | -141 | -4402 | 90456 | 375122 | 3.96 |
| Jun-2010 | -94 | -4332 | 93856 | 382579 | 3.77 |
| Sep-2010 | -87 | -4049 | 84503 | 365443 | 3.73 |

Source: ABS (2010b).

Quite clearly the average interest rates on debt issued abroad has fallen since the beginning of the global financial crisis from the peak in the December quarter 2008⁹ and they have fallen during the course of 2010. Other official sources do not indicate any significant upward movement in overseas commercial markets since the March 2010 quarter. For example, the biggest market is the US and the US prime lending rates have been stable at 3.25 per cent since 16 December 2008 through to October 2010 (Federal Reserve Statistical Release, 2010). The US 10 year Treasury bond rate is a good indicator of how long term rates are moving and it has moved around a bit more, ranging between around 2.5 to 4.0 in the last two years but is around 3.0 now, not much above its lows for the last two years. It certainly does not indicate a trend towards higher interest rates.

Table 5 gives some other examples of private, market-related interest rates being earned overseas.

Table 5: Overseas interest rates

| End | US Prime loan rate | Japan prime | Germany business lending rate | UK interbank lending rate 3 months | Hong Kong prime lending rate | S Korea interbank lending rate 3 months | NZ interbank call rate |
|--------|--------------------|-------------|-------------------------------|------------------------------------|------------------------------|---|------------------------|
| 2008 | 3.25 | 1.68 | 4.35 | 2.63 | 5.38 | 3.37 | 5.00 |
| 2009 | 3.25 | 1.48 | 2.57 | 0.65 | 5.38 | 2.17 | 2.50 |
| Oct-10 | 3.25 | 2.48 | 2.62 | 0.80 | 5.38 | 2.93 | 3.00 |

Source: Reserve Bank of Australia (2010b). Note Germany's last entry refers to August 2010.

Some international rates have moved upwards over the last year but not by much and, with the exception of Japan, remain well below the beginning of the global financial crisis. The main point is, however, none seem to have increased by as much as the Australian official interest rate.

It is also difficult to find evidence of such pressures in the Australian money markets and capital markets. For example, AA grade corporate bonds had yields of 6.11 per cent in October 2010 down slightly from a year earlier and well down on yields before the global financial crisis. In the meantime, money market yields seem to be fairly stable as a mark up on official rates.¹⁰

If interest cost pressures are not coming from abroad or in the wholesale markets then perhaps they show up elsewhere. Table 6 examines the big four banks' total interest expenses and compare that with total liabilities. Those figures are based on APRA's quarterly banking statistical series. Table 6 includes a figure for official interest rates at the time. Since official interest rates change from month to month that row gives official interest rates during the quarter weighted by the number of days in the quarter at which particular interest rates applied. Hence, if during a quarter the official interest rate was 4.00 per cent for 45 days and 4.50 per cent for another 45 days the figure here would read 4.25 per cent. Finally for

⁹ The beginning of the GFC can be put at 28 September 2008, the date Lehman Brothers failed. However, in discussions with the Commonwealth Bank it is clear they date the GFC well before then and begin with the first rumblings in the US home loan market. Even when the start dates are varied it still remains hard to find evidence that backs up their claim.

¹⁰ All interest rates in this paragraph come from the Reserve Bank statistics site.

comparison the following table includes the Reserve Bank indicator rate for housing loans based on the banks' standard variable rate.

Table 6: big four banks interest expenses and official rates compared

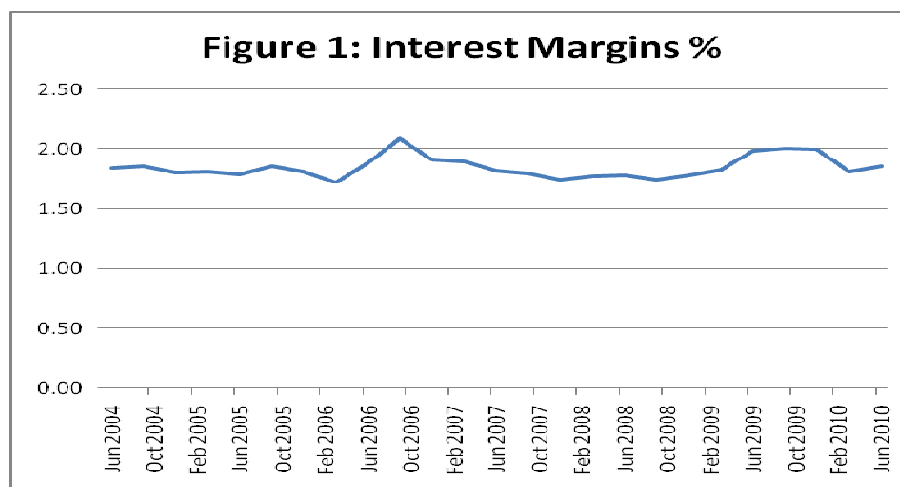
| | June quarter 2009 | September quarter 2009 | December quarter 2009 | March quarter 2010 | June quarter 2010 | June 10 on June 09 increase |
|--|-------------------|------------------------|-----------------------|--------------------|-------------------|-----------------------------|
| interest expense \$million | 14,502 | 15,116 | 16,484 | 18,713 | 20481 | |
| total liabilities \$million | 2,194,397 | 2,179,776 | 2,237,351 | 2,232,300 | 2338807 | |
| Implied annualised interest rate on liabilities % | 2.67 | 2.80 | 2.98 | 3.40 | 3.55 | 0.88 |
| Official rates % | 3.02 | 3.00 | 3.47 | 3.83 | 4.38 | 1.36 |
| RBA indicator rate: Banks' standard variable housing loan rate % | 5.77 | 5.80 | 6.33 | 6.73 | 7.32 | 1.55 |

Sources: Australian Prudential Regulation Authority (2010b).

Note: Where official rates change during the month they are allocated pro-rata over the quarters in the table.

Total interest costs have been increasing for the period examined in table 6 but they have not kept pace with the increase in official rates over the same period. According to APRA data interest costs on bank liabilities increased by 88 basis points but official interest rates increased by 136 basis points. The big four banks used the official interest rates to increase mortgage rates during this period but at times they put interest rates up by more than the increase in official rate (see below).

The Australian Bankers Association (ABA) has responded to the discussion of APRA data by trying to shift the attention to a discussion of interest margins. The ABA point to declining margins over the course of 2010 but as APRA figures show, margins have been roughly constant over the last four years. These are shown in Figure 1.



Source: Australian Prudential Regulation Authority (2010b).

The data in Figure 1 are based on net interest income (actual interest income minus interest expenses) and are compared with the total assets of the big four. It has to be admitted that two per cent seems a bit small if we think in terms of the typical lending rates (7.99 per cent as the average from the big four for the standard variable mortgage) and think of typical bank borrowing costs. Of course the margins would look bigger if we only included those assets that produce interest income in the divisor. Obviously profits are much higher when fee income is included.

The observation that margins tend to be fairly stable naturally raises the question of how profits can grow so quickly when margins have remained roughly the same. The answer seems to be that the big four banks have been growing their businesses very quickly. As a mature industry it might be expected that the growth in banking would roughly conform to the growth in nominal GDP. However, in the six years to June 2010 GDP grew at an average annual rate of 7.0 per cent while bank assets grew 12.6 per cent per annum with net interest income and net profit after tax growing just behind at 12.4 and 12.0 per cent respectively (APRA, 2010b).

As discussed above, banks have been very profitable. The fact that margins have been roughly stable since 2004 means that profit per unit of business has remained high. For the big four the growth in their own profits seems to have been a combination of two main factors

- First the big four banks have increased their share of the Australian market, banks have squeezed out non-bank financial institutions and the big four have increased their share of the bank sector.
- Second banking business has been growing more quickly than the economy as a whole.
- Third, as discussed below, economies of scale are important in banking.

The first point we have dealt with earlier in *Money and Power*. On the second point the only way bank business can grow is if the banks can extend more loans to the Australian economy. It is worth noting that one of the sources of growth has been the increasing level of household debt through a combination of higher house purchase costs, the increasing incidence of investment properties and more credit card and other forms of consumer debt. According to the Reserve Bank estimates household indebtedness as a proportion of household disposable income increased from under 50 per cent of GDP in 1992 to over 150 per cent of household disposable income in 2010 (Reserve Bank of Australia, 2010b). As a consequence interest payments also soared as a proportion of household disposable income.

Incidentally, households account for 69 per cent of total bank loans. Had household indebtedness remained at approximately 1990 levels total bank profits would now be in the order of half their present value.

The home equity loan has probably been an important initiative on the part of the banks which has contributed to higher consumer debt. Others would also point out that banks these days are much more aggressive in trying to sell their loan products although there is no hard evidence on that to enable comparisons over time.

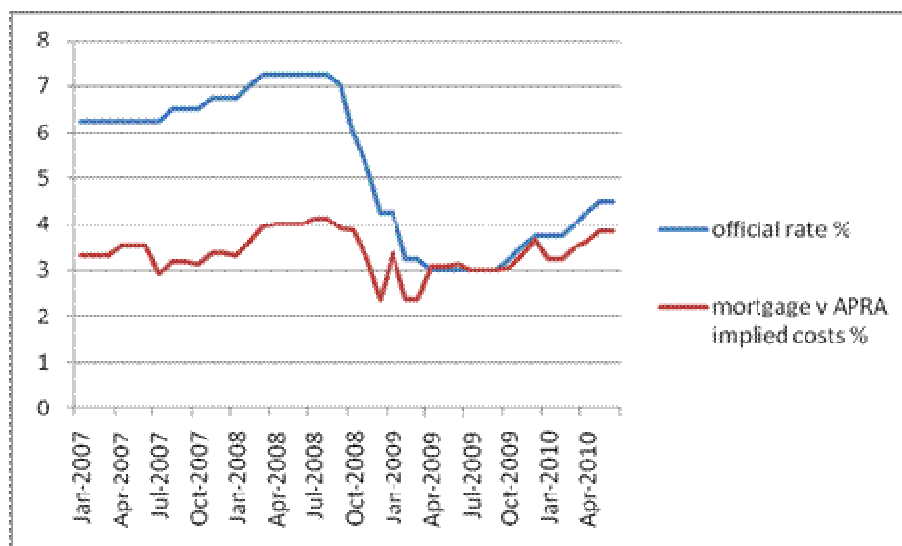
It is also worth noting that the banks were able to grow their businesses at 12 per cent or more since 2004 while shareholders' equity has grown more slowly at 9.1 per cent over that period. The differences may appear small but over longer periods of time profit of the big four is growing relative to both the economy as a whole and also relative to their own shareholders' equity. In other words with time the big four get much more profitable in an absolute sense and also in terms of returns on equity even though net interest margins may relatively constant.

Another factor may just be that profits grow disproportionately with the size of banks through economies of scale effects (see below for a discussion of economies of scale).

In a more competitive economy we would expect that the increasing profitability should lead to downward pressure on interest margins. Margin figures fluctuate but there is no evidence of any downward trend in the figures.

While the aggregate margin seems to have been roughly constant mortgage rates look interesting when compared with official interest rates and the banks' cost of funds. Figure 2 compares the official rate with the mark up of the mortgage over the APRA estimate of the actual costs of funds.¹¹

Figure 2: Official interest rates and the mark up of mortgages over the banks' cost of funds.



Sources: Australian Prudential Regulation Authority, (2010b), Reserve Bank of Australia (2010b).

These figures suggest that on the way up official interest rate increases are associated with increases in interest rate home loan margins. The banks are quick to put rates up but slow to bring them down again. But the big decline in official interest rates following the GFC was not associated with a large reduction in home loan margins.

Before leaving this section it is also important to note that as the structure of interest rates increases total bank profits will increase even with the same margin. This point was recently made by Professor Milind Sathye from the University of Canberra. As interest rates increase the principle is paid off less rapidly. So the same interest margin applied to a higher average principle will generate higher profit (Gardner, 2010).

Banks interest rate increases just substitute for the Reserve Bank

There seems to be an emerging view among some journalists and financial commentators to the effect that if the banks put up interest rates by more than the RBA then it just means official

¹¹ The latter figure is once again the implied annualised interest rate on liabilities calculated from APRA quarterly figures.

interest rates need not go up quite so far. The implication is that it does not really matter who puts up the interest rates so long as they go up. For example, one commentator said that:

'the RBA must be a little relieved that the big banks have done some of the heavy lifting. It can now use the banks' extra mortgage rate rises as a ready-made excuse for delaying its next rate rise, should it so desire (Winestock, 2010).

And *The Australian's* economics editor suggested the banks' excessive increase in rates

'effectively means mortgage borrowers are not worse off if the big four banks raise their mortgage rates by more than the Reserve Bank's cash rate increases.

'That's because the Reserve Bank is ultimately targeting the interest rate paid by borrowers in determining how far to turn the monetary policy screws to keep inflation under control.

'If the banks lift mortgage rates independently, the Reserve Bank does not have to increase its cash rate by as much as it otherwise would' (Stutchbury, 2010).

The idea that we should privatise interest rate decision-making seems bizarre. But the serious point is that by their actions on rates in November the banks have increased the margin between mortgages and the banks' cost of funds. Not only does that add to banks' monopoly profit but economists would argue that it distorts the capital market. Competition in the finance sector should mean that there is minimal difference between borrowing and lending rates in Australia. The opportunities facing investors are best communicated to the ultimate savers when there is minimal distortion in the financial market. In that case the decisions of savers are more closely related to the actual returns on financial investments. In the limit if home buyers are paying 8 per cent and savers receive zero interest then there will be little incentive for retail depositors to invest in institutions that make home loans. The attempt to extract monopoly profit out of the financial system is a distortion that drives a wedge between borrowing and lending rates and so produces a less efficient allocation of capital between competing ends.

Competition

Money and Power stressed that the banking industry is very concentrated and found that the top four banks controlled 75.7 per cent of all banking when measured by assets (mainly loans and advances). That lack of competition is exploited by banks who are intent on maximising profit—just as the text book firm with market power would be expected to behave.¹²

By contrast with *Money and Power* the CEO of Westpac, Ms Gail Kelly, said the banking industry 'is a strongly competitive environment even among the big four—there is a lot of competition there' (Crowe et al, 2010). When people like Ms Kelly talk about competition it is likely they have in mind the day to day struggle they have for market share with their rivals. The big four banks spend \$1 billion on advertising (ANZ, 2010; CBA, 2010a; NAB, 2010 and WBC, 2010) and no doubt much more on designing new product, holding strategy meetings and so forth.

The type of competition observed in banking is not unusual. Under the two airline policy TAA (now Qantas) and Ansett Airlines were involved in 'fierce competition', but not on price—the thing that really matters to consumers. That is typical of oligopolies, price competition is

¹² The use of the terms 'monopolists', 'monopoly' etc to describe the banks may objected to. It is not suggested here that any one bank is an absolute monopoly. The term 'oligopoly' is often used to describe industries such as banking. However, the word oligopoly is less well understood by the general reader and, in any case, the players in an oligopoly are motivated to join forces and act like a monopoly. Hence the term 'monopoly' is used here as a readily understood short-hand for a market player that can exercise a degree of market power.

avoided and instead competition takes the form of product differentiation through image building, adding flair, multiple options etc. Indeed price competition is avoided through such devices as making prices look very complex so that consumers find it difficult to compare product prices between sellers.

Some empirical evidence on these points was referred to in a recent OECD report on competition in financial markets. A rapid succession of bank mergers in Korea following the Asian financial crisis provided a useful case study of the impact on profits of changes in the structure of the industry. Between 1997 and 2003 the number of banks fell from 16 to just 8 and the share of the top three banks increased from 33 per cent to 58 per cent. The share of the top bank increased from 12 per cent to 31 per cent. The result seemed to be that there was an improvement in cost efficiency but also higher profitability from the 'increased market power and reduced competition' (OECD, 2009). The latter effect transferred over to banks that were not engaged in mergers—they just seemed to have enjoyed the reduction in competition. Note that the improvements in 'cost efficiency' probably reflected 'economies of scale' to which we now turn.

Economies of scale

Money and Power showed that competition has been ineffective in this industry as noted above. One of the features of banking is that economies of scale are important. 'Economies of scale' refers to the case where the unit cost of a 'product' falls as the quantity produced rises. However, economies of scale undermine the notion of perfect competition. As production costs keep falling as more is produced, a firm that happens to grow bigger will thereby become more competitive.

It is important to point out that the textbooks say there are no economies of scale in perfect competition. Competition among a large number of producers can only be guaranteed in the absence of economies of scale so that no producer or small group of producers can dominate a market. However, with greater domination of the market the firm has more market power to extract monopoly profits. An industry with these characteristics represents a clear case of market failure and the need for government intervention.

In one recent study of Canadian banks by the Bank of Canada the authors found their 'best' model indicated economies of scale that gave a 6 per cent cost savings by which they meant that a one per cent increase in output increased costs by 0.94 per cent (Allen and Ying, 2005). If that figure applied in Australia it means a doubling of the size of a bank would reduce its unit costs by around four per cent.¹³ Perhaps more importantly, an institution with one per cent of the assets of the smallest of the big four will have a cost structure 32 per cent higher than the smallest of the big four. The ANZ is the smallest of the big four with assets of \$361 billion in September (APRA, 2010a). A bank with assets of \$3.6 billion would therefore face a cost penalty that virtually wipes out its profit margin. Twenty of Australia's 54 operating banks fall into that category with assets of \$3.6 billion or less. In the meantime a bank that catered for the whole market would be expected to have assets over five times bigger than the average of the big four and with a cost advantage of 9.5 per cent compared with the big four.

While these figures should not be taken too literally, they are indicative of the likely orders of magnitude involved. They also explain why the big banks are so much more profitable than the smaller banks in Australia. For example, APRA figures show that the profit margin of the

¹³ The earlier report by the Senate Economics Committee included a chart that also showed economies of scale in Australian financial intermediaries. Visual inspection of chart 3.1 suggests that a doubling of the size of institution's assets (going from 4.0 to 5.0 on the assets scale) is consistent with a reduction in unit costs of 75 per cent. That finding is much larger than implied by other estimates (Senate Economics Committee, 2009).

big banks was 25.2 per cent in 2010 compared with only 11.9 per cent for the rest of the banks (APRA, 2010a). The important point is that governments face the trade-off between an efficient banking system if there is more consolidation, but at the expense of creating ever more powerful monopolies. Maintaining competition through the four pillars policy might reduce monopoly power but at the expense of a more inefficient system. Even then, as the Australian experience suggests, the main players may exploit their small numbers by acting as a monopoly. In many industries the result is to allow consolidation but address market power through regulation and government ownership.

A consequence of the global financial crisis is that the smaller banks are now even less competitive against the big banks. This was pointed out in Richardson (2010) and recently documented in an analysis of APRA data by Jarnecic (2010).

The Governor of the Bank of England, Mervyn King, recently said 'Of all the many ways of organising banking, the worst is the one we have today' and moreover 'ever since the Industrial Revolution we have not cracked the problem of how to ensure a more stable banking system' (King, 2010).

We now turn to examine another possible form of competition but based on structural separation of the banking business. We note that Australian banks are prohibited under the Banking Act from applying depositors' funds for purposes other than strictly traditional forms of bank lending. Banks are certainly not allowed to apply depositors' funds to, for example, purchases in the share market. That prohibition had been lifted in the US and elsewhere and the global financial crisis was one of the consequences. Following the global financial crisis governments in other countries have been trying to return to a separation of traditional and investment banking.

We should congratulate ourselves that we avoided making the same mistaken deregulation. However, it has to be appreciated that the traditional model allows banks to monopolise the mobilisation of funds through the payments system and then to dominate the lending market. The Australian banking system is dominated by the four big banks.

Banks, through their access to the clearing system, have monopolised the payments system which gives them an abundant source of cheap money and places them in an ideal position to monopolise the nation's lending behaviour. Governor King's concern was more about the regulatory problems inherent in banking and the propensity for banks to use other people's money to invest in risky undertakings. For him the issue was that the 'damaging externalities created by excessive maturity transformation and risk-taking must be internalised' (King, 2010).

King did raise the possibility of divorcing the payment system from the rest of the financial sector:

if banks undertake risky activities then it is highly dangerous to allow such "gambling" to take place on the same balance sheet as is used to support the payments system, and other crucial parts of the financial infrastructure (King, 2010).

For King the issue is that 'Banks [lending] should be financed much more heavily by equity rather than short-term debt'. (King, 2010 p18) Professor John Kay, supernumerary fellow economics at Oxford University, refers to the need for 'the separation of utility from casino banking' (Kay, 2009). King also compares banking with the electricity sector. The essential feature of both finance and electricity is a system which links, in real time, the initially mismatched demands of suppliers and customers. In both industries, there is a choice between two broad structures, hierarchy or markets. Coordination can be achieved by a single integrated organisation – which in practice must be publicly owned or behave as if it were a

public agency rather than a private business. Or coordination can be accomplished through a competitive market place, with a core monopoly utility – the grid, the payment system –tightly regulated on price, service quality, and access (Kay, 2009).

In a free market, narrow banking would have emerged spontaneously and immediately. As a result of recent history, depositors would strongly favour conservative, transparent institutions which eschewed complex financial instruments and demonstrated comprehensible balance sheets and organisational structures. The reason this outcome has not emerged is that government intervention has distorted the market. All savers enjoy equal deposit protection, however risky the activities of the institution with which they save. Those who save with large financial conglomerates enjoy the further reassurance that comes from frequent reiteration of the slogan that these businesses are ‘too big too fail’. The outcome of market forces has been suppressed, and the natural outcome of market forces – narrow banking - should be imposed by regulation (Kay, 2009).

Structural separation would have benefits for the stability of the financial system, however, it should also address the problems of a small group of banks monopolising the payments system. As a utility the clearance and electronic networks that make the payment system work should be regulated in the public interest. The more transactions migrate to electronic forms the cheaper will the payments system be to operate. In principle, the marginal cost of making an electronic payment is already zero.

A possible model would involve;

1. a sound group of institutions engaged in **deposit-accepting** with access to the transfer and clearing system able to accept all types of long and short deposits.
2. a supervised group of commercial institutions engaged in **retail lending** able to borrow from the deposit-accepting institutions and would be subject to similar prudential supervision as applies to lenders at the moment. Loans to big business would need to be secured.
3. other lenders, investment funds, wholesale lenders etc, who would not be permitted to raise funds through deposits but could issue bonds and equity and are fairly free to make any loans or investments they wish. The main restriction would be that they cannot apply any short term debt towards long term loans and investments.

It would be unlawful to raise deposits outside this framework, however, other lenders would be free to use their own funds, or equity like funds to apply against their other lending activities. Indeed, for John Kay, the rest of the banking system could be further deregulated, safe in the knowledge that they are not putting depositors’ funds at risk.¹⁴ However, it is unlikely that the rest of the financial system could realistically be deregulated, but the regulation would be different to that applying to the deposit acceptors and retail lenders.

King points out that the attraction of the more radical solutions is that they offer the hope of avoiding the seemingly inevitable drift to ever more complex and costly regulation (King, 2010). However, we believe that retail lending would be more competitive if all lenders had the same access to the pool of funds generated through the deposit-acceptors. The OECD (2009) argued that lending for small and medium-sized firms tends to remain local rather than centralised. By contrast the payments system relies on one network which operates the

¹⁴ They would still be subject to normal regulatory controls over corporations including fraud etc.

transfer and clearing functions. At present that network is operated by the member institutions and regulated by the Reserve Bank of Australia through the Payments System Board. There is no reason to change this arrangement, but existing institutions would have to decide whether they would become retail lenders or deposit acceptors able to provide retail access to the payments system.

There is a lot of detail that would need to be fleshed out to offer a fully workable system. However, it seems very important that we seize the present mood about banking and raise more radical options in the public debate. The detail can be worked out later.

Conclusions

Some observers look at the Australian banking industry and see a perfectly competitive industry in which market forces can be relied on to discipline the players and ensure that Australia has high quality banking services at a competitive price that covers just the cost of providing those services together with a reasonable rate of return on investment.

This submission is based on the alternative view that Australian banking should be seen as one dominated by a small number of players that exploit their market power. Competition has been reduced since the global financial crisis, but the banks were already wielding substantial market power well before the global financial crisis.

If there was a genuine way of making the industry competitive Australian policy makers and those in the rest of the world would have found it by now. There is a history of relying on competition to check the power of banks going back well over a century (Richardson, 2009). Obviously there is still a role for competition policy but it needs to be buttressed with other regulatory and structural reforms.

Other policy changes that would contribute to a better banking outcome include:

- reducing the one-sided ability to vary interest rate margins by, for example, legislating to ensure that interest rates charged by banks move in line with changes to the RBA cash rate and are set and advertised as a mark-up over the cash rate
- capping certain kinds of bank fees at a level sufficient to cover costs, including a reasonable return on assets
- mandating that all financial institutions offer a no-frills, low-cost everyday savings/transaction account to every customer as the default option
- restricting the interest rates that can be charged on unsecured credit to levels that reflect the underlying risk to the lender—at the moment lending rates seem to be much higher than objective measures of bad and doubtful debts would suggest¹⁵

Such initiatives would help bring profits back to a reasonable level, but it is also important that banks do not use their privileged position to exploit the vulnerabilities of individual customers. Something more is needed to ensure that banks behave in socially responsible ways that contribute to the wellbeing of the broader community. We have discussed initiatives in Fear et al (2010) that address the imbalance between banks and their customers but those are

¹⁵ Even during the global financial crisis bank provisions for bad and doubtful debts were less than one percent of bank assets (APRA, 2010b).

perhaps beyond the scope of the current submission. However, some that are relevant to the present inquiry include:

- restricting or banning sales targets and commissions for bank workers
- providing bank workers with a decent ordinary wage independent of sales-based commissions
- preventing banks from claiming money spent on the advertising of credit products as tax deductible business expenses.
- There should also be a serious examination of the options for structural separation of the deposit taking and lending functions that are presently provided by the one bank or other authorised deposit-taking institutions. Accordingly it is suggested that the committee and the government
- establish a working party to follow up the suggestions of, among others, the Governor of the Bank of England, that banking undergo a structural separation.

At the very least and as a preliminary step

- establish a separate licensing regime for financial institutions that provide payment services and infrastructure to retailers to encourage new entrants into this market

However, in addition to all of the above

- establish a means of addressing excessive bank profits by returning them to the community through such devices as a super profits tax on banking
- either expand the APRA mission to include the surveillance of all bank fees, charges, and commissions including interest rates or charge the Australian Competition and Consumer Commission with those functions.

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