Bank competition in the post-crisis environment

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Good morning

I'm delighted to be here today, and I appreciate the initiative of Citi in organising this conference to discuss the issues which affect us all.

Treasury is working to improve Australia's productivity and international competitiveness, and deepen the potential of the economy.

This work focuses on promoting economic growth and supporting employment, ensuring Australia's financial system remains robust and dynamic, and ensuring that regulatory frameworks promote macroeconomic stability and market confidence.

We also monitor and provide advice on the general prudential framework applying to the banking sector, insurers and superannuation funds.

As well, we participate actively in international forums, such as the G20 and Financial Stability Board, to enhance the regional and global financial architecture.

This work gained greater prominence during the global financial crisis.

Putting our work in a broader context, as a central policy agency, Treasury needs to ensure that the long-term challenges facing Australia are not sidelined by the more immediate and urgent issues.

And Australia is facing some significant challenges.

The Government's third Intergenerational Report highlighted some of the challenges in relation to demographic change and an ageing population; economic infrastructure; and climate change.

A safe and efficient financial system will help us meet these challenges.

A safe and efficient financial system is also important from a wellbeing perspective, given the role the financial sector plays in people's lives.

The financial system:

- facilitates payments;
- supports Australians so they can invest and save for retirement;
- enables households to save for, and buy, housing; and
- ensures that capital is allocated efficiently, supporting investment in essential infrastructure.

We also need a safe and efficient financial system because our financial institutions play an essential role in funding the gap between domestic investment and national saving. Our institutions need the confidence of foreign investors that they will service what they borrow.

A safe and efficient financial system is very much about the wellbeing of the Australian community as a whole.

The question Treasury must consider continually is whether the current financial system adequately services all aspects of the community.

For Australia's financial system to be both safe and efficient, it is important that we have competition between providers of financial services, and a sound prudential regulation framework.

As you would all be well aware, the global financial crisis was the most fundamental dislocation in global financial markets in our lifetimes.

While the stability of banking sectors around the world has been very much the focus since we started to emerge from the crisis, it also raised concerns about weakened competition in many jurisdictions.

Australia's financial system has been more resilient than others but, like other countries, we have experienced a change in the competitive dynamics of our banking sector as a result of the crisis.

So I would like to spend some time today talking about the competitive dynamics in Australia's banking sector.

But first, I would like to reflect on the performance of the Australian financial system over the course of the global financial crisis.

The Australian financial system

The strength of our financial system, particularly the banking sector, has cushioned Australia from the impact of the global financial crisis.

Our financial system continued to function well throughout the global financial crisis. Overall, Australia's institutions remained profitable and well-capitalised, and this allowed them to continue to lend throughout the crisis. Even so, intermediated credit from the banking sector became more expensive and subject to tighter conditions.

Some borrowers, particularly large- and medium-sized businesses, were able to raise funds from equity and debt capital markets to supplement their bank funding. Other businesses, which don't have access to these financing alternatives, have been most affected by the tightening in conditions for intermediated credit.

The strength of our banking sector reflects several factors, including:

- the fact that, in contrast to many of their overseas counterparts, Australian institutions entered the crisis with relatively low exposure to high-risk assets;
- the strength of the equity markets, which allowed banks to raise large amounts of equity in 2009;
- the quality of our financial regulatory system; and
- timely action by the Reserve Bank of Australia and the Government in response to the global financial crisis. In particular, the monetary and fiscal stimulus played a key role in supporting the Australian economy. The Government also introduced guarantees to support Australian institutions' access to funds.

Credit flows over of the course of the global financial crisis

At the height of the crisis in 2008, there were concerns that the extreme dislocation in financial markets would mean that Australian institutions would have to ration credit.

But this did not occur to any great extent.

Housing credit continued to grow over the course of the crisis, supported by historically low interest rates, the Government's First Home Owners Boost and lenders' continued appetite for mortgage assets.

In fact, total housing credit grew by 8.2 per cent over 2009.

Credit flows to businesses, though, have fallen. However, taking into account other sources of financing — that is, intermediated credit, equity, and non-intermediated debt such as corporate bonds — businesses' net stock of external funding increased over 2009.

As the price of intermediated credit increased, businesses elected to diversify their funding. This compares favourably with the experience of the early 1990s, when the fall in intermediated credit was not fully offset by increases in non-intermediated debt and equity issuance.

Australia's economy post-GFC

It's Treasury's view that the Australian financial system remains in relatively strong condition, as does the broader economy. The impact of the global financial crisis on the

Australian economy and financial system were well managed by the Government, and economic growth has now broadly returned to pre-crisis levels. Pleasingly, our employment levels have been maintained.

In their latest available half-yearly results, Australia's 'big four' banks reported aggregate headline profits, after tax and minority interests, of almost $10 billion. This result was about $1¼ billion higher than in the same period last year, signalling a recovery to pre-crisis profitability.

Another encouraging feature of the banks' latest half-yearly results is that bad and doubtful debt charges have declined markedly. This is the first decline since the financial crisis began, and drove the recovery in profitability.

Changes in consolidation post-GFC

But while Australia's banking system has proved itself to be extremely resilient, it has not been immune from the fallout.

The banking sector has become more concentrated due to mergers, as well as firms either exiting the market or scaling back their operations.

Many non-bank lenders exited the market or significantly scaled back their operations due to the closure of securitisation markets, which constituted the primary source of funding for many of these entities. These competitors were particularly important in driving competition in home loan lending.

Other non-bank lenders have exited the market or significantly scaled back their operations due to constraints in other funding markets. Some of these constraints originated here in Australia, for example, in commercial paper markets. Other funding constraints began in the jurisdiction of their parent companies overseas, restricting the parents' ability to provide capital injections to their Australian subsidiaries.

As well, some foreign banks have exited the Australian market or significantly scaled back their operations here due to funding constraints. These competitors were particularly significant in providing corporate business banking services.

Several smaller Australian banks have also scaled back their operations, largely due to increased funding costs, particularly in wholesale funding markets.

This impact was mitigated by the Government's large deposit and wholesale funding guarantee scheme and the financial claims scheme. Under these schemes, smaller institutions were able to raise deposits and wholesale funding using a Government guarantee.

The home lending portfolios of these banks were further affected by closure of securitisation markets, however the Government's $16 billion investment in RMBS helped to offset this impact. The business lending portfolios of these smaller banks were also affected by increased impairment rates.

Changes in competition post-GFC

The concentration of Australia's banking sector which occurred during the global financial crisis has altered the competitive dynamics of the sector.

A particular concern is the exit and slower growth of smaller lenders which traditionally relied on securitisation markets for funding. Over the past two decades, these institutions played an important role in driving competition in lending, and reductions in interest margins.

In the short-to-medium term, we don't expect to see competition levels rebounding to their previous highs. Rapid growth in global credit in the lead-up to the crisis led to spreads on a number of financial products narrowing to unusually low levels that did not adequately reflect inherent credit risks.

With the permanent repricing of risk, these highly favourable conditions are unlikely to return. So those lenders which established business models on the expectation that the low cost of credit would continue are likely to experience significant ongoing pressures on their competitive positions.

But we do anticipate that competitive pressures will increase as funding markets continue to recover.

There appears to be some competition between the remaining participants, including the four major banks.

Competition for deposits has intensified, supported by an increased market focus on liquidity. The focus on liquidity has prompted the banks with more wholesale funding to further increase their deposit base.

Corporate bond market

When the crisis began, Australian non-financial businesses seeking access to the bond market were faced with a sharp increase in costs, as spreads jumped.

Subsequently, the stock of corporate bonds outstanding fell for a short time during the crisis as businesses had difficulty accessing the market, and were often forced to turn to the banks for funding.

However, last year, corporates began to again tap the bond market. The proportion of corporate bonds on issue compared with the total Australian non-government bonds outstanding is now close to pre-crisis levels.

Australian corporates have tended to source a larger proportion of their debt from overseas bond markets since the crisis, with only $32 billion worth of corporate bonds currently on issue being issued domestically, compared to around $140 billion issued offshore.

We are closely monitoring the development of the domestic bond market, particularly in light of the considerable refinancing requirements over the coming 12 months.

And we are looking to industry to show leadership in harnessing this opportunity.

Initiatives to increase competition

The Australian Government is committed to supporting strong competition in the financial services sector.

Competition is critical to ensuring consumers get the range of services they want, at the lowest possible prices. Ensuring that Australia's financial markets are competitive internationally in terms of safety and innovation also has the potential to draw additional liquidity to Australia. This is vital for the growth of Australia's financial services industry into the future.

We are addressing unfair exit fees and other unfair contract terms.

From 1 July 2010, ASIC has the power to take action against any bank if it charges an early exit fee which is considered unfair or unconscionable to a consumer. Consumers will also be able to challenge early exit fees that are unfair or unconscionable.

The Government has given ASIC these tough enforcement powers by passing two new national laws to protect consumers.

Firstly, the new Australian Consumer Law voids any 'unfair' term in a standard-form consumer contract.

And secondly, the new National Consumer Credit Protection Act gives ASIC further powers to take action on any fee which it considers to be 'unconscionable'.

These reforms will strengthen ASIC's hand in pursuing banks over unfair mortgage exit fees.

These new powers will also make it easier for borrowers to switch to a competitor offering a better mortgage product. This will no doubt stimulate competition in the mortgage market.

As I mentioned earlier, we are supporting securitisation markets through the Government's investment in mortgage-backed securities. We are also boosting support for competition in the market through deposit tax and interest withholding tax rates initiatives.

The Government will phase down the interest withholding tax rate incurred by financial institutions starting in 2013-14, including local subsidiaries and branches of foreign financial institutions, on most interest paid on offshore borrowings.

We expect that this measure will help support them further in putting competitive pressure on Australia's major banks as offshore borrowings from related parties are a source of funding for some non-major banks.

The Government will also provide savers with a tax discount equal to 50 per cent of the interest earned on deposits held across any bank, building society or credit union up to $500 from 2012-13, rising to $1000 in 2013-14.

Because deposits typically represent a high proportion of funding for smaller lenders, the Government expects this reform to help reduce the funding cost incurred to support their mortgage lending business.

Future of Financial Advice

As I'm sure you would be aware, in April this year, the Government announced the Future of Financial Advice reform package.

The reforms are designed to improve the trust and confidence of Australian retail investors in the financial planning sector. More specifically, they are designed to tackle the conflicts of interest that have threatened the quality of financial advice provided to Australian investors in the past.

Key reforms in the Future of Financial Advice package are:

- a prospective ban on conflicted remuneration structures, including commission payments and any form of volume-based payments; and

- a statutory fiduciary duty for financial advisers requiring them to act in the best interests of their clients, subject to a 'reasonable steps' qualification.

The reforms also expand the provision of low-cost simple financial advice, enhance the licensing and banning powers of ASIC, and introduce a product-neutral adviser charging regime for advice.

The majority of the reforms will commence from 1 July 2012.

Conclusion

Ladies and gentlemen, Treasury is working closely with the regulators and industry to ensure that our markets are operating as smoothly and efficiently as possible.

This can often require a high level of fine-tuning, as we balance the interests of both the financial sector and its customers.

Once again, thank you for inviting me to talk with you today.