

# RBA SUBMISSION TO THE INQUIRY INTO COMPETITION IN THE BANKING AND NON-BANKING SECTORS

---

## 1. Introduction

This paper is a submission to the Inquiry into Competition in the Banking and Non-banking Sectors being conducted by the House of Representatives Economics Committee.

The submission is in two broad parts reflecting the Inquiry's terms of reference. The first part provides factual material available to the Reserve Bank of Australia on developments in the markets for mortgage finance, deposit accounts and personal finance. The second discusses some of the longer-term determinants of competition, including the ability of new firms to enter the market, financial innovation, and the ease with which customers can switch institutions.

The main conclusions can be summarised as follows:

- Australian households have benefited from strong competitive pressures in the mortgage market over the past decade. Margins have fallen significantly and are in line with international norms. In addition, the variety and flexibility of mortgage products offered in Australia is high by international standards.
- The recent turbulence in financial markets has changed the competitive dynamics in the system, particularly affecting lenders that rely heavily on the securitisation markets. This has led to a tightening in the conditions under which higher-risk borrowers are able to obtain housing finance, although there has been little change in the availability of housing finance for high-quality borrowers. There has also been an increase in the cost of mortgage finance for all borrowers which, at the time of writing, broadly reflects a rise in lenders' cost of funds. The Reserve Bank does not see a case for government intervention in the mortgage market to address what is a cyclical issue due to the tighter conditions in financial markets, rather than a structural change.
- Competition in deposit markets has strengthened considerably over recent years, with the competition more evident for savings accounts than for transaction accounts. Over the past six months there has been a noticeable pick up in competition for term deposits.
- A major source of competition in Australian retail banking over the past decade or so has been the entry of new players. In a number of areas, new entrants have been able to take advantage of financial innovation and improvements in technology, and have led to significant reductions in the prices of a range of financial services. These innovations and improvements are now features of the landscape and are unlikely to be reversed. Looking forward, ensuring that new entrants are able to enter the market is the most important means of sustaining strong and effective competition. Currently, there are no significant

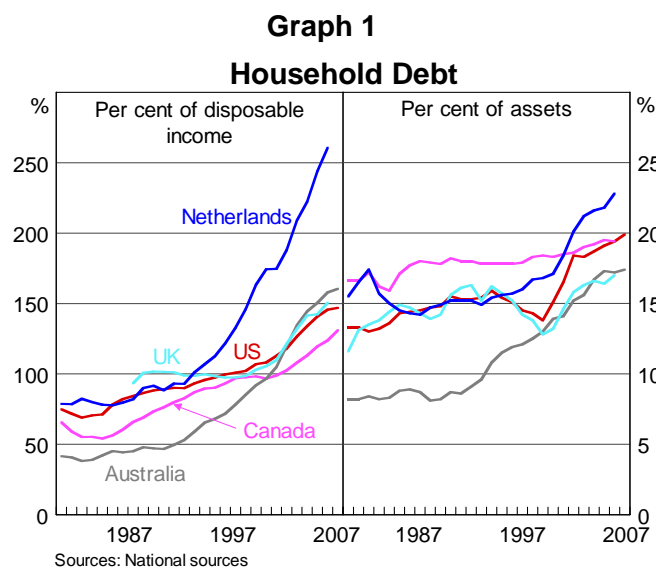
regulatory barriers to entry, although there is a case for further improvements to be made to access arrangements to parts of the payments system.

- Another important influence on competition is the ability of consumers to compare prices and to switch institutions. There have been significant improvements here over recent years, although the ‘bundling’ of financial services has increased the difficulty that many people face when switching institutions.

## 2. Housing Finance

The Australian mortgage market has been characterised by strong competitive pressures over the past decade or so. The result is that housing finance has been much more readily available, and at lower cost, than was the case in the past. Many new lenders have entered the market, the range and flexibility of products has expanded, and margins have narrowed. Competition has also led to an easing in lending standards, although not nearly to the same extent as occurred over recent years in the United States, where overly aggressive competition is one of the factors that contributed to the sub-prime problems.

Reflecting these developments, together with the significant reduction in nominal interest rates that was made possible by the decline in inflation in the early 1990s, household debt in Australia has grown at an average annual rate of around 13 per cent since 1990. As a result, the ratio of debt to disposable income has roughly tripled to 160 per cent, and the debt-to-assets ratio has risen from 8 per cent to 18 per cent (Graph 1). These trends have seen Australian households move from a situation in which they were relatively lowly geared 20 years ago to one in which their gearing is now similar to that of households in many other countries.



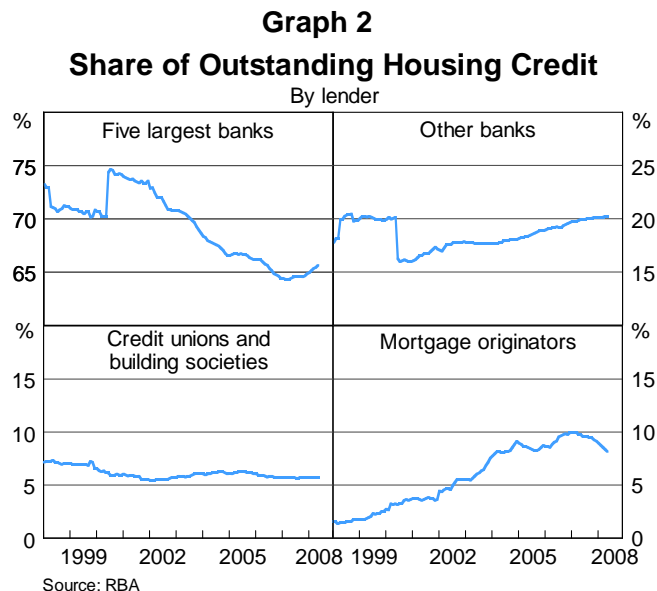
As discussed below, the recent capital market turbulence has changed the competitive dynamics in the mortgage market. In particular, it has improved the competitive position of lenders that rely relatively heavily on deposits for their funding, with lenders that rely on the securitisation markets facing a sharper increase in costs

than other lenders. It is not, however, unusual for the competitive position of different lenders to vary over the course of the credit cycle. For much of the past five years, the availability of cheap credit in global markets – which saw spreads fall to unusually low levels – has underpinned the competitive position of lenders relying on securitisation.

The recent developments in financial markets have reduced the availability of finance to some higher-risk borrowers, although the bulk of borrowers have not experienced significantly tighter lending conditions. Lenders have also increased their variable lending rates relative to the cash rate, although for most lenders the increase has been broadly in line with the increase in their cost of funds.

## 2.1 Market shares and funding mixes of different types of lenders

The structure of the mortgage market has changed significantly over the past decade or so. In particular, since the mid 1990s, the share of *outstanding* loans accounted for by ‘mortgage originators’ has increased from less than 2 per cent to around 10 per cent in mid 2007 (Graph 2). Conversely, the share of outstanding housing loans accounted for by the five largest banks has declined, despite their acquisition of a number of other lenders over this period. The share of outstanding loans accounted for by the smaller banks has risen since 2000, while the share accounted for by credit unions and building societies has declined.



These longer-term trends have been influenced by changes in the funding costs of the different types of lenders. In particular, the strong growth of the mortgage originators from the mid 1990s until quite recently was underpinned by their ability to securitise mortgages at ever narrower spreads to the bank bill rate. As an illustration, prior to the recent turmoil, the spread on the AAA-rated tranche of residential mortgage-backed securities (RMBS) had fallen to around 15 basis points, compared to 34 basis points in 2000 (Table 1).

**Table 1: Spreads on Domestically Issued Prime RMBS**

	Spread to BBSW		
	2000	First half of 2007	June 2008
AAA-rated tranche	34	15	120
AA-rated tranche	65	21	n/a

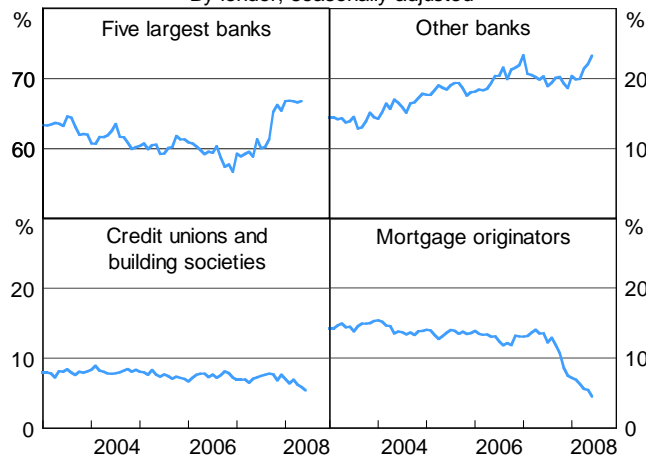
Source: RBA

In aggregate, over recent years about 20 per cent of Australian mortgages have been funded via the issuance of RMBS. This is similar to the share in Canada, but much lower than that in the United States, where around 60 per cent of mortgages are funded by RMBS, around two-thirds of which are guaranteed by government-sponsored enterprises. In Europe, RMBS provide only about 5 per cent of funding, with covered bonds – where the investor has a claim over a specific pool of loans and the lenders’ broader balance sheet – accounting for a further 15-20 per cent.<sup>1</sup>

The recent strains in financial markets have seen a turnaround in these longer-term trends, with the five largest banks significantly increasing their share of *new* loans since late 2007 (Graph 3). Over recent months these banks have accounted for 67 per cent of owner-occupier loan approvals, while the share accounted for by mortgage originators has fallen from around 12 per cent in 2006 to 5 per cent.

**Graph 3****Share of Owner-occupier Loan Approvals**

By lender, seasonally adjusted



Sources: ABS; APRA

Since August 2007, spreads on RMBS have increased markedly and issuance has been limited. Where issues have taken place, they have recently been at spreads of around 120 basis points over the bank bill rate. At this pricing, new mortgage business financed through the RMBS market is unlikely to be profitable. This change in funding costs has had a significant impact on the competitive position of different lenders, given the differences across lenders in how housing loans are funded. The five largest banks have diversified funding bases, with a

1. Data for the US are from the Board of Governors of the Federal Reserve System. Data for Europe are from the European Mortgage Federation.

little under half of total funding coming from deposits, around half from domestic and foreign capital markets, and only about 5 per cent from securitisation (Table 2). The foreign-owned banks have traditionally relied less on deposits, and more heavily on domestic capital markets and offshore funding. As a group, the regional banks rely more heavily on securitisation than the other banks, although deposits still account for the largest share of their funding. Mortgage originators source essentially all of their funding from securitisation, as typically they have neither the balance-sheet size nor the capital base from which loans could be provided.

**Table 2: Lenders' Funding Mix**  
June 2007

	Deposits*	Domestic capital market liabilities*	Foreign liabilities	Securitisation
Five largest banks	48	21	26	5
Regional banks	44	24	12	19
Foreign-owned banks	36	31	30	3
Credit unions and building societies	73	6	0	21
Mortgage originators**	0	0	0	100

\* Includes household and business deposits. Certificates of deposit are included in domestic capital market liabilities.

\*\*Excludes warehouse funding.

Sources: APRA; RBA

While there has been very limited issuance of RMBS over the past six months, there are some tentative signs of recovery in the market. The relatively low credit risk historically associated with Australian prime mortgages, together with strong longer-term demand for highly rated bonds from institutional investors, provide some basis for expecting that this recovery will continue. In time, spreads could be expected to decline from current levels, although probably not to the very low levels seen in 2007. This would help to restore the competitive position of institutions that rely heavily on securitisation to fund their lending.

The changed competitive dynamics have led to a number of proposals for government support of the RMBS market, including the adoption of arrangements similar to those that exist in Canada; these arrangements and the recent experience in the Canadian mortgage market are discussed in Appendix A. The changed environment, however, does not warrant government intervention in the structure of the housing finance market. As evidenced by overseas experience, such intervention can have long-term unforeseen consequences. The recent increase in the cost of funds for securitisers comes at the end of a prolonged period of easy global credit and, as noted above, is likely to be at least partly reversed over time.

## 2.2 Product types

By international standards, Australian borrowers are offered a wide range of mortgage products and are able to choose from a large number of different loan types, with many of these offering more flexibility than is available in other countries.

The standard housing loan in Australia is a prime, fully documented loan with a 25-30 year maturity, and a maximum loan-to-valuation ratio (LVR) of about 95 per cent. These loans – which account for just under 70 per cent of all housing loans – are offered with various features including (Table 3):

- flexible repayments (including scope for excess repayments, refinancing and repayment holidays);
- redraw and offset facilities;
- the ability to make interest-only payments for up to 10-15 years, after which the loan typically converts to a principal-and-interest loan<sup>2</sup>; and
- the capacity to split the loan into investor and owner-occupier components.

The majority of Australian housing loans are at variable interest rates, with fixed-rate loans typically accounting for between 10 and 20 per cent of new housing loans.

In addition to standard loans, a number of other types of loans are offered, including:

- *high LVR loans*, which allow borrowers that do not have a deposit to cover the transaction costs associated with buying a home. These loans have maximum LVRs of up to 105 per cent, and are only offered by a few specialist lenders;
- *home equity loans*, which provide a line-of-credit secured against the property that can be used for home improvements or non-housing purposes, such as to purchase a car, holiday or financial assets. These loans have been available since the mid 1990s and typically have a maximum LVR of 80-90 per cent, and a maximum loan term of 30 years. Home-equity loans are offered by all of the major lenders, and currently account for 17 per cent of all outstanding owner-occupier housing loans;
- *low-doc loans*, which tend to be used by households with undocumented or irregular incomes. Initially, these loans were offered by a few specialist lenders, but over recent years the five largest banks have expanded their presence in this market. Low-doc loans currently account for about 7 per cent of all outstanding housing loans;
- *non-conforming loans*, which are offered to borrowers who do not meet the standard lending criteria of mainstream lenders, usually because of poor credit or repayment histories. Almost all non-conforming loans are provided by non-bank lenders, and they currently account for only about 1 per cent of outstanding loans;
- *shared appreciation loans*, where, rather than paying interest, the borrower surrenders a proportion of any capital gain/loss that has accrued between the time that the loan was taken out and the time

---

2. In 2006, interest-only loans accounted for about 20 per cent of all outstanding loans and about 60 per cent of outstanding investor loans. See Reserve Bank of Australia (2006), 'Box B: Interest-only Housing Loans', *Financial Stability Review*, September.

that the dwelling was sold or the loan repaid. These loans are usually structured as a second mortgage, with the borrower also taking out a standard mortgage to fund the bulk of the cost of the dwelling. This market is currently very small, with several state government agencies having offered these loans to low-to-medium income households on reasonably attractive terms, and a small number of private lenders marketing shared appreciation loans to all borrowers at commercial rates; and

- *reverse mortgages*, which tend to be used by older homeowners to access equity in their property while they continue to live there, in order to fund other expenditures. Provided the loan is not repaid early, the principal and accumulated interest is repaid from the proceeds of the sale of the property when the borrower dies or moves home. While reverse mortgages are widely available in Australia, including from several of the largest banks, they accounted for less than ½ per cent of outstanding housing loans in 2007.

**Table 3: Owner-Occupied Housing Loans by Type**

	Per cent of approvals			Per cent of outstandings
	2002	2004	2006	2007
Standard	76	69	63	67
Home equity	12	11	9	17
Reverse mortgage	n/a	<½	<1	<½
High LVR*				
- LVR of 90-100 per cent	7**	n/a	16	7
- LVR >100 per cent	0**	n/a	<½	<½
Shared appreciation	n/a	n/a	<½	<½
Non-conforming	<1	1½	2	<1
Low-documentation	4	7	8	7

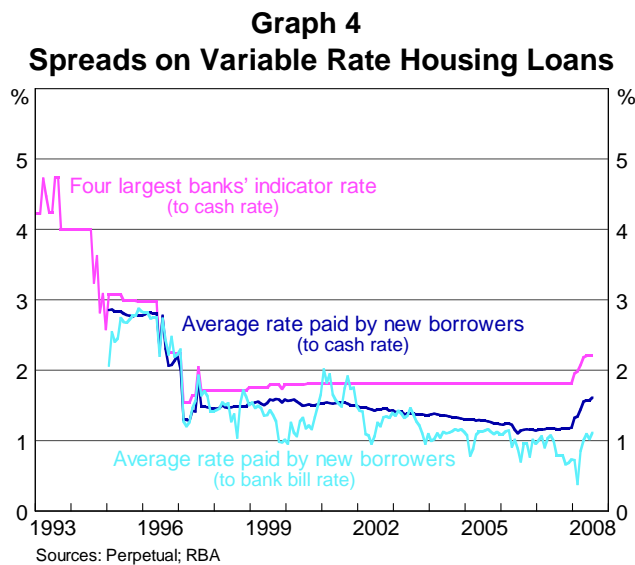
\* Owner-occupier and investor loans. \*\* Data are for mid 2002 to mid 2003.  
Sources: ABS; APRA; RBA; Standard & Poor's; Trowbridge Deloitte; Company reports

One aspect of the Australian market that is unusual by international standards is the limited use of long-term fixed-rate loans, with only around 5 per cent of new fixed-rate loans (and less than 1 per cent of all new loans) having an initial maturity of greater than five years. While such products are offered by some lenders, Australian borrowers have chosen not to make much use of them. This stands in contrast to some other countries, including the United States, Denmark, Belgium and Germany, where long-term fixed-rate mortgages predominate. Another feature of the Australian market is that virtually all variable home loan interest rates can be changed at the discretion of the lender. While similar variable-rate products are available in a number of other countries, banks also offer variable-rate loans that are linked to an independent benchmark rate (eg. in the United Kingdom and the United States), or are only variable up to a maximum interest rate 'cap' (eg. Canada, New Zealand, and the United Kingdom).

## 2.3 Cost of housing finance

The competitive pressures in the Australian mortgage market over the past decade or so have seen interest margins on mortgages fall considerably.

In 1993, the margin between the four largest banks' indicator rate on *prime, full-doc*, variable-rate housing loans and the cash rate was around 450 basis points (Graph 4). By the mid 1990s, this margin had fallen to 180 basis points. Subsequently, strong competition has meant that it has become commonplace for lenders to offer almost all borrowers a discount of up to 70 basis points on the indicator rate.



Since the mid 1990s it has become common practice for banks to move their indicator rates in line with the Reserve Bank's cash rate. Similarly, money-market interest rates have tended to move broadly in line with the cash rate. The recent tightening in credit conditions has, however, seen a change in these long-standing relationships, with short-term money-market rates increasing by considerably more than the increase in the cash rate, and there has also been a significant increase in long-term funding costs. Reflecting these higher costs, lenders have increased their mortgage rates relative to the cash rate by an average of 40 basis points, although the spread between the mortgage rate and the 90-day bank bill rate is similar to its average level over the past few years of around 100 basis points. While it is difficult to precisely estimate the impact of the tighter financial conditions on the banks' overall cost of funding – including from deposits and short-term and long-term capital market sources – it appears that, at the time of writing, the higher margins to the cash rate are broadly in line with the higher cost of funding for most lenders.

Interest spreads on prime *low-doc* housing loans have also declined noticeably over an extended period, with the spread over the cash rate falling from 280 basis points in 2000 to 150 basis points in mid 2007. As is the case for full-doc loans, spreads on low-doc loans have risen recently, although they remain low by historical standards. The same general pattern is evident in spreads on *non-conforming loans*, although the recent increase



has been more pronounced due to the problems in securitisation markets and a reassessment of the risks of lending to credit impaired borrowers.

International comparisons of interest margins on housing loans are always difficult, as the nature of the standard mortgage product differs across countries and there is often discounting of posted rates. In some countries, including Australia and the United Kingdom, variable-rate loans predominate, whereas in Sweden, New Zealand and Canada, 2-5 year fixed-rate loans are the most common, and in the United States and some European countries long-term fixed-rate mortgages predominate. The features offered on housing loans also differ significantly across countries; for example, loans with redraw facilities and flexible repayment structures are relatively uncommon in many continental European countries.<sup>3</sup> Notwithstanding the difficulties in making comparisons, the available evidence suggests that interest margins on variable- and fixed-rate full-doc housing loans in Australia are broadly in line with those in most other developed countries, although margins in the United Kingdom had been lower than elsewhere over recent years.

Further, the evidence suggests that the impact of the capital market turbulence on mortgage rates in Australia has been similar to that seen on the predominant mortgage products in many other countries. As noted above, since mid 2007, the largest Australian lenders have raised their rates on prime full-doc variable-rate mortgages by about 40 basis points more than the cumulative increase in the cash rate. In comparison, in the United States, the spread between the interest rate on conforming 30-year fixed rate mortgages and government bond yields of the same maturity has risen by 30-40 basis points, with spreads on adjustable-rate mortgages increasing by considerably more than this. Similarly, in New Zealand spreads (to government bond yields) on 2-year fixed-rate mortgages have increased by around 40 basis points. In contrast, in Canada spreads on 5-year fixed-rate mortgages, relative to government bond yields, have increased by around 100 basis points, while the spread between the rate on variable-rate mortgages and the Bank of Canada's target for the overnight rate has increased by 35-40 basis points.

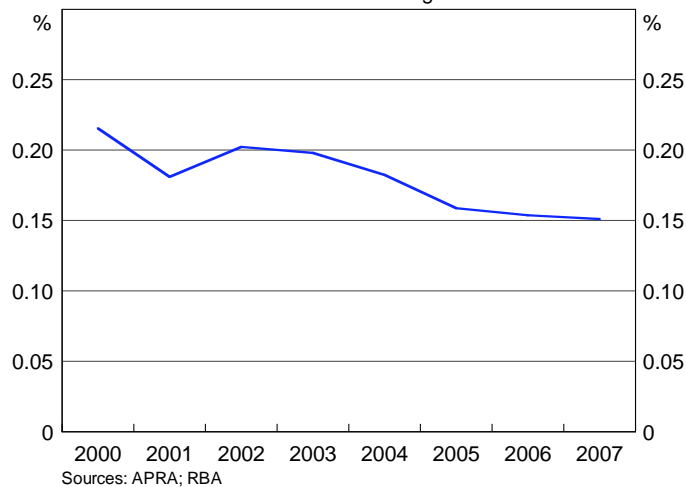
As interest margins in Australia have fallen over the past decade or so, lenders have introduced, or increased, a number of fees. Despite this, the ratio of total fees paid on housing loans to the value of housing loans has fallen over this period. This can be seen in the Reserve Bank's annual Bank Fees Survey which shows that banks' annual fee income from housing loans (which includes establishment fees, ongoing loan-servicing fees and early-repayment fees) has fallen from 0.20 per cent of the value of outstanding housing credit in 2000 to 0.15 per cent in 2007 (Graph 5).<sup>4</sup>

---

3. Bank For International Settlements, *Housing Finance in the Global Financial Market*, 2006; European Mortgage Federation & Mercer Oliver Wyman, *Study on the Financial Integration of European Mortgage Markets*, 2003; and European Mortgage Federation Factsheets.

4. Reserve Bank of Australia (2008), *Banking Fees in Australia*, RBA Bulletin, May.

**Graph 5**  
**Banks' Housing Loan Fees**  
 Share of banks' housing loans



Recent research by ASIC/Fujitsu Consulting suggests that Australia has lower loan establishment and discharge fees than the United States or the United Kingdom, but higher early-repayment fees. ASIC suggests that the compulsory use of comparison rates in Australia (which do not include early-repayment fees as they are deemed to be optional for the borrower) has contributed to the relative composition of fees in the three countries. Overall, ASIC/Fujitsu Consulting suggest that the level of total housing loan fees in Australia is similar to that in the United States and lower than in the United Kingdom.<sup>5</sup>

### 3. Deposit Market

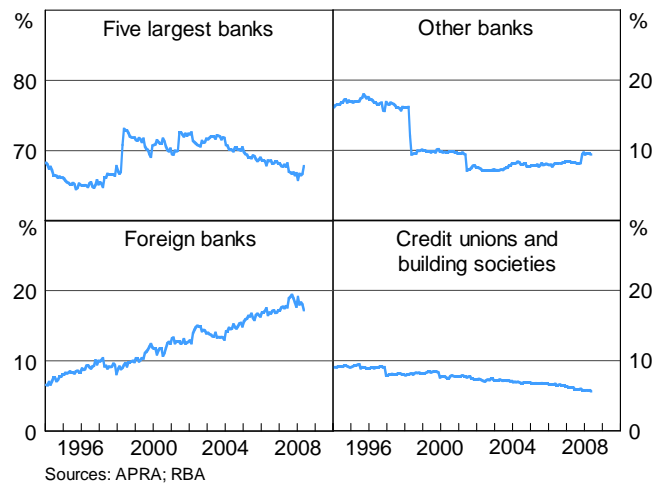
A second important element of retail banking is the market for deposit accounts, with these accounts used for both savings and to make transactions. Like the housing market, competition in this market has strengthened over the past decade. An important driver of this competition has been the entry of foreign banks offering high-interest online accounts, while more recently, the banks' strong demand for deposits as an alternative source of funding to capital markets has also been a factor.<sup>6</sup>

The role that foreign banks have played is evidenced by the more than doubling over the past decade in their share of total deposits, to 18 per cent, with strong growth in their shares of both business and household deposits (Graph 6). In contrast, the five largest banks' share of total deposits has been fairly steady over this period at around 70 per cent, with acquisitions of several regional banks offsetting losses in their underlying market share. The market shares of the smaller Australian banks and the credit unions and building societies have both declined since the mid 1990s.

5. Australian Securities & Investments Commission, *Review of Mortgage Entry and Exit Fees*, 1 April 2008.

6. Reserve Bank of Australia (2007), 'Box C: Foreign-owned Banks in Australia', *Financial Stability Review*, March.

**Graph 6**  
**Share of Total Deposits**

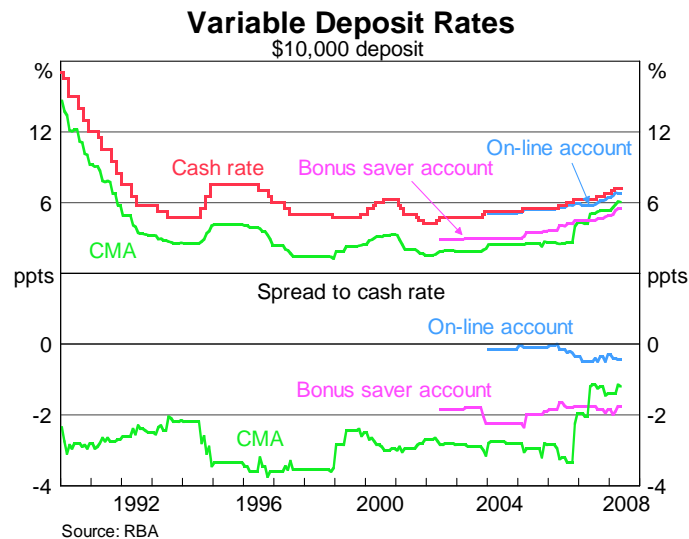


The most common form of deposit account is a transaction account; in total, there are almost 30 million of these accounts in Australia, and they constitute around 15 per cent of the value of total household deposits. Transaction accounts normally charge a fixed monthly account-keeping fee (typically \$4-\$6), with some institutions waiving or discounting fees for pensioners, students and home loan customers. Some institutions also charge fees on a per-transaction basis, but this has become less common over recent years, particularly for transactions that are made electronically. The interest rate on most transaction accounts is close to zero, however over recent years a small number of banks have introduced transaction accounts that pay a higher rate of interest (around 5 per cent currently) provided that deposits of at least a specified size are made each month.

In terms of variable-rate savings accounts there are three main types of accounts: bonus savings accounts; cash management accounts; and on-line savings accounts.

Bonus savings accounts typically pay a higher rate of interest than transaction accounts if at least one deposit and no withdrawals are made each month (Graph 7). These accounts were introduced in the late 1980s, and are now offered by a wide range of institutions. Similarly, cash management accounts, which are also offered by most institutions, have been around for a number of decades. Most offer a tiered interest-rate structure, with interest rates rising with the account balance. Bonus saver, cash management and other branch-based savings accounts together comprise about 25 per cent of total household deposits.

Graph 7



The fastest growing form of savings account has been the high-yield online accounts. These accounts typically offer an interest rate that is around the cash rate. They were pioneered by the foreign-owned banks in the late 1990s, with the Australian-owned banks subsequently introducing similar accounts after their share of the household deposits market started to decline. These accounts typically have no fees and generally do not have a minimum balance requirement, and they typically cannot be used to make payments other than to transfer funds to and from a transaction account. It is estimated that these accounts comprise about 20 per cent of banks' household deposits.

The other main type of deposit is a term deposit, with these deposits accounting for around 40 per cent of all household deposits. Most term deposits have maturities of 1 year or less, and the interest rates typically move with 3-6 month bank bill rates. In pricing these deposits, it has become common for banks to offer short-term 'specials' for particular maturities, with the 'special' rates being at least equivalent to money-market interest rates with a similar maturity. Depositors with flexible investment horizons are able to take advantage of these specials, but given that the maturities to which they apply change regularly, households must take care to avoid funds being rolled over into a deposit with the same term but a much lower interest rate at maturity. Over the past six months, competition for term deposits has increased considerably as banks have sought alternative sources of funding to wholesale markets. Reflecting this, the value of term deposits held in banks by the household sector has increased by over 35 per cent over the past year.

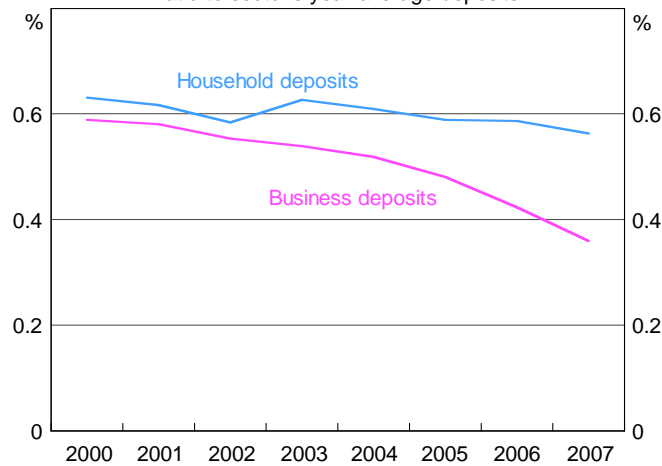
While financial institutions have introduced a variety of fees on deposit accounts, total fees relative to the value of outstanding deposits have declined slightly over recent years. The Reserve Bank's annual Bank Fees Survey shows that banks' annual fee income from household deposits (which includes account-servicing fees, transaction fees and other fees) has fallen from 0.65 per cent of the value of outstanding deposits in 2000 to

0.55 per cent in 2007 (Graph 8). Fees on business deposits have fallen more sharply, dropping from 0.55 per cent to 0.35 per cent over the same period.

**Graph 8**

**Deposit Account Fees**

Ratio to sector's year-average deposits\*



\*Series break in 2003. RBA estimates prior to 2003  
Sources: ABS; APRA; RBA

#### 4. Personal Lending Market

Competitive pressures have also been evident in the market for personal credit, particularly credit cards, over recent years. The five largest banks currently account for just over 70 per cent of outstanding credit card balances, which is down from 84 per cent in 2002 (Table 4). Over this period, the market share of foreign-owned banks has increased from around 7½ per cent to 13 per cent, with non-bank financial institutions also increasing their market share significantly, from 6 per cent in 2002 to nearly 15 per cent currently.

**Table 4: Credit Card Market Shares**  
As at May

	2002	2004	2006	2008
Five largest banks	84.2	78.8	74.6	70.7
Other Australian-owned banks	2.2	1.4	1.7	1.5
Foreign-owned banks	7.7	9.6	10.3	13.1
Non banks	5.9	10.1	13.4	14.7

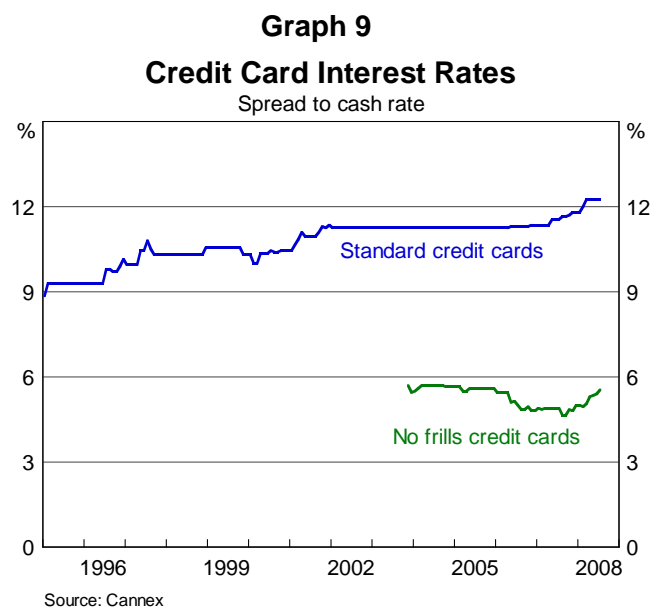
Source: RBA

Competition in the credit card market has taken a number of forms. In the mid 1990s, it largely manifested itself in the introduction of loyalty, or ‘rewards’, points rather than a reduction in interest-rate margins.<sup>7</sup> More recently, following the Reserve Bank’s reforms to card-based payment systems in 2003 (which saw a significant decline in interchange fees paid between banks) there has been significant competition in the ‘no-frills’ cards market, with these cards offering lower interest rates than traditional cards (but typically no loyalty points).

7. See, for example, Gizycki, M and Lowe, P (2000), *The Australian Financial System in the 1990s*, in Gruen, D and Shrestha, S (eds), ‘The Australian Economy in the 1990s’, RBA Conference, July.

These no-frills cards are likely to appeal most to people who do not pay off their credit card balance in full each month and so incur interest charges on a regular basis. Over recent years, some credit card issuers have also attempted to attract business by offering discounted introductory rates or interest-rate concessions on balance transfers for certain periods.

Notwithstanding these competitive pressures, the average interest-rate spread (to the cash rate) on standard credit cards has trended up over the past decade, although this spread was largely unchanged from the beginning of 2002 to mid 2007 (Graph 9). The increase since mid 2007 partly reflects banks' higher funding costs, while the longer-term increase is partly explained by the competition for standard credit cards focussing on features other than interest rates. Spreads on no-frills cards have also increased over the past six months or so, but remain lower than when these cards were introduced earlier in the decade.



## 5. Factors Influencing Competition

As discussed above, changes in the cost of funding for different lenders have been an important factor shaping the competitive dynamics in retail banking. In addition, two other factors play a key role in influencing the degree of competition in the system. The first is the entry of new players and advances in financial technology. And the second is the ability of customers to compare prices and switch institutions. Both of these factors are discussed below.

### 5.1 New players and innovation

In most markets, including retail financial services, the ability of new players to enter the market is an important source of competitive discipline on the existing players. In retail banking, one reason for this is that new entrants need only be concerned about attracting new customers when setting their prices, and not the

impact of their pricing decisions on the profitability of their existing customer relationships. New entrants are also sometimes more easily able to take advantages of improvements in technology, as they do not have to deal with 'legacy' issues.

Not surprisingly, over the past decade a major source of competitive pressure in retail banking in Australia has been the entry of new players using new technology and taking advantage of financial innovations. Examples include:

- *the entry of specialist non-bank lenders to the mortgage market in the early to mid-1990s.* As noted above, in the early 1990s the spread between the standard variable mortgage rate and the cash rate was around 450 basis points. At this spread, new housing loans were very profitable. Reflecting this, banks competed strongly for new business by offering 'honeymoon' rates, but maintained the high interest margins on existing loans. In contrast, the specialist non-bank lenders had no existing customers and were able to offer lower rates to all borrowers. They were able to do so because of their ability to issue residential mortgage-backed securities at relatively low spreads.<sup>8</sup> The banks eventually responded to this new source of competition by lowering their standard variable interest rates, with the margin to the cash rate falling to around 180 basis points by the mid 1990s.
- *the entry of foreign-owned banks in the retail deposit market.* Again, the new entrants – in this case the foreign-owned banks – did not have to take into account the impact of their pricing decisions on the profitability of their existing deposits. Their entry, without establishing costly branch networks, was made possible by improvements in technology and, in particular, the development and widespread take-up of the internet.
- *the entry of new players into stock broking offering non-advisory discount broking services.* Competition in this market was increased by the entry of one of the largest banks and the development of technology that allowed trades to be placed over the internet. Over time, each of the five largest banks has developed on-line stock broking services. This competition has seen the commissions on small parcels of ASX-listed equities fall from around 2 per cent in the early 1990s to about 1 per cent for full-service brokers and about 0.1 per cent for online transaction-only brokers. The range of services offered by these platforms has also expanded. Reflecting these developments, 53 per cent of respondents to the ASX's 2006 Australian Share Ownership Study who had purchased or sold shares in the preceding two years had done so using a discount broker, up from 13 per cent in the two years to November 1999.

---

8. For further details see Gizycki and Lowe (2000).

- *the entry of foreign-owned banks in the credit card market.* A foreign-owned bank was the first to offer a credit card with a loyalty scheme in the mid 1990s, and more recently, foreign-owned banks, along with some other smaller players, have been at the forefront of introducing no-frills credit cards.

These experiences illustrate the importance of ensuring that the regulatory regime is conducive to new entrants. If the profitability of a particular financial service is very high due to a lack of competition, then over time new entrants would be expected to enter the market to push down prices. Ensuring that barriers to entry are minimised is therefore a very important element in promoting a competitive market place.

In general, advances in technology have lowered entry barriers, as has the increased willingness of customers to use new technologies to access a variety of financial services. Furthermore, the regulatory regime in Australia is for the most part, access friendly, and does not impose significant impediments to the establishment of new entrants.

One area that the Reserve Bank has been closely involved in is the credit and debit card markets. Through its various reforms it has sought to increase the competitive pressure on the hidden interchange fees that banks pay one another. It has also established access regimes for the MasterCard and Visa credit card schemes as well as the EFTPOS system. These reforms have liberalised access and reduced the cost of new entrants in joining these systems. The Reserve Bank has also worked with the Australian Payments Clearing Association to improve access to the other electronic payment systems. While some improvements have been made in these areas, the Reserve Bank's Payments System Board (PSB) has continued to draw attention to the difficulties that arise from the fact that a number of Australia's payments systems are built around bilateral links between financial institutions. These bilateral links mean that new entrants are required to reach agreement with existing participants – who are likely to be competitors – before they can enter the system. The PSB has asked the industry to consider, as a matter of priority, how access arrangements to these payment systems could be further improved.

## **5.2 Information and switching costs**

A second factor influencing competition is the ability of consumers to access information with which to compare financial products, and the ease of switching to products or institutions that offer a lower price or better service.

Over the past decade, access to information has been improved by two main developments, which have both helped to reduce search costs and improve competition. They are:

- *the availability of information on financial products and services on the internet.* In Australia, there are a number of websites that allow comparisons of the costs and features of retail financial products.



Some of these focus on particular products (for example mortgages), while others are more comprehensive in their coverage of different types of housing, credit card and other personal loans, as well as retail deposit/savings accounts. These websites are typically run by private-sector organisations, although there are a number of government-operated financial literacy sites.

- *the emergence of brokers*, offering a range of products from different lenders. Brokers allow borrowers to compare more easily the costs and features of different loans, and have allowed lenders to compete in geographical locations without the need to set up extensive branch networks. In aggregate, it is estimated that broker-originated loans currently account for around 30 per cent of new housing loans, though this figure varies considerably across lenders. It is worth noting, however, that brokers are paid by commission, which as the US experience illustrates, can sometimes lead to loans being made that are not in the best interest of the borrower.

A related issue that has recently attracted attention is the costs that a borrower incurs when switching to a different financial institution, with most lenders in the mortgage market charging a fee if the loan is repaid within a few years of it being taken out. Earlier this year, the Government requested that ASIC conduct a review into mortgage fees, with the review finding that early-exit fees are often in the range of around \$1 000 for authorised deposit-taking institutions (ADIs), and \$2 000 for non-ADIs. While these fees are often seen as an impediment to switching accounts, they sometimes substitute for loan establishment fees, being used by lenders to recoup the costs that they incur when loans are established. In comparison with a number of other countries, loan establishment fees in Australia are relatively low.

In other areas of retail banking, the recent focus has been on the difficulty that customers face in switching institutions when there are direct debit and credits linked to an account. For many customers the inconvenience associated with switching institutions may have increased over recent times, particularly given that many loan accounts are now ‘bundled’ with transaction accounts. While this bundling may have benefits in terms of convenience, the difficulty of switching accounts effectively increases the market power of the existing institutions. In February this year, the Treasurer announced a package of measures designed to make it easier for customers to switch their accounts between banks. A key element of this package is a listing and switching service whereby ADIs will provide customers wishing to switch institutions a list of all direct credits and debits made to the old account over the previous 13 months. The introduction of these new arrangements – which will be in place by 1 November this year – is being overseen by the Reserve Bank.

More generally, many consumers appear reluctant to switch accounts either because of a lack of information or an assessment that the benefits of doing so are not sufficient to outweigh the ‘hassle’ factor, the costs of switching, or the convenience of having a number of services ‘bundled’ with the one institution. This reluctance

to switch, even where competing institutions offer superior products, tends to dull competition in the system and confers benefits to the existing institutions. It is likely to best be addressed by a combination of further efforts to improve financial education, more widespread use of comparison services, and efforts, along the lines of those discussed above, to reduce switching costs. ✎

Reserve Bank of Australia  
SYDNEY

10 July 2008

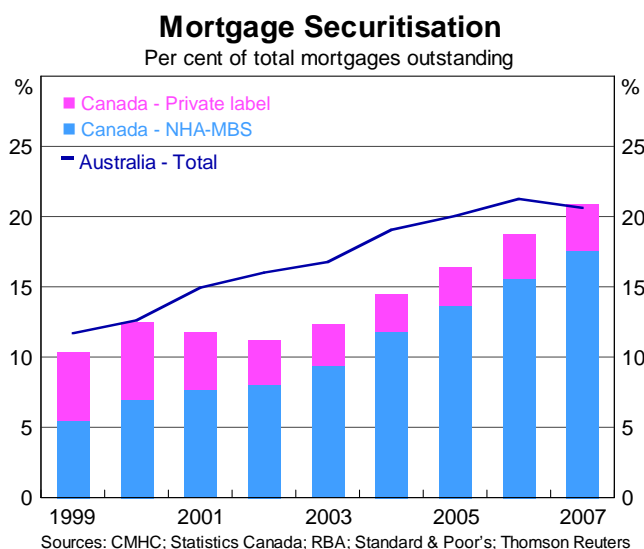
## Appendix A – The Canadian Securitisation Market

In Canada, there are two closely related government-owned entities that participate in the domestic mortgage market – the Canada Mortgage and Housing Corporation (CMHC) and Canada Housing Trust (CHT). Their roles are to increase liquidity in the domestic residential mortgage market, promote home ownership, and improve housing affordability. There are no equivalent institutions in Australia; all of the main participants in the housing finance market and the related RMBS markets are privately owned, yet the size of the RMBS market is very similar to that in Canada.

In Canada, CMHC:

- provides an unconditional guarantee on all RMBS issued under the National Housing Act (termed NHA-MBS), guaranteeing the full and timely payment of principal and interest in the case of default;<sup>9</sup>
- is the largest provider of lenders' mortgage insurance in Canada; and
- is a significant provider of social housing and housing research.

CHT was established in 2001 to further develop the RMBS market. Its main role is to issue CMHC guaranteed Canada Mortgage Bonds (CMBs) and use those funds to purchase NHA-MBS. Since the introduction of CHT, the share of outstanding mortgages in Canada that are funded by RMBS has doubled to 20 per cent, with NHA-MBS more than accounting for this growth. This share is similar to that in Australia, though Australia has achieved this growth without a government housing agency.

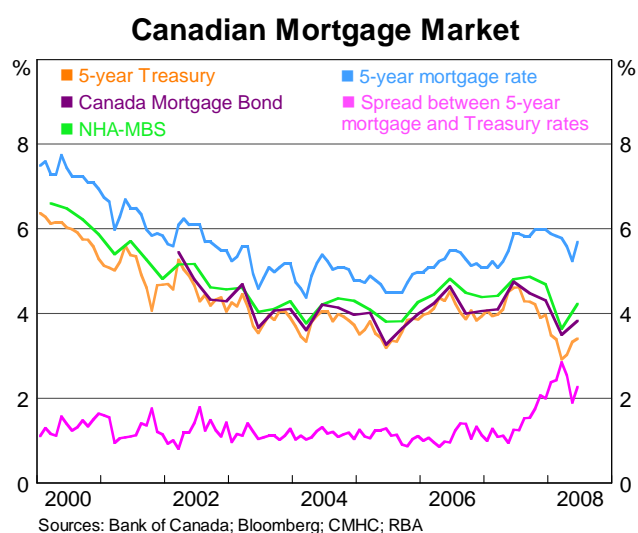


CMHC/CHT effectively provides subsidised funding to the smaller, fringe lenders. CMHC/CHT have a government imposed cap on the quantity of mortgages that they can fund. In normal conditions, they are usually able to fund all of the mortgages that are offered to them. This is because the larger lenders fund most of their

9. The National Housing Act (NHA) is legislation that was introduced in 1944 to improve housing and living conditions for Canadians.

loans directly, rather than through CMHC/CHT, and hence the cap is not a binding constraint.

The recent capital market turbulence has pushed up the cost of private capital market funding markedly, resulting in a significant increase in demand for CMHC/CHT finance from both large and small lenders. Because of its cap, CMHC/CHT was unable to fund all of the mortgages that were offered to them; in its December 2007 and March 2008 funding rounds, the agency funded a set value of mortgages offered by each lender, but only partially funded requests that were greater than this value. Large lenders were forced to raise most of their funds from higher-cost private sources, and set their mortgage rates accordingly. The smaller lenders, which are fully funded by CMHC/CHT, set their mortgage rates in line with the large lenders, thereby expanding their interest margins. The smaller lenders had little incentive to undercut the large lenders as they could not obtain additional funding from CMHC/CHT to accommodate any additional lending. Hence, even though CMB yields have declined by about 90 basis points (in comparison to a 120 basis point fall in Canadian 5-year Treasury bond yields), households' 5-year fixed mortgage rates have fallen by only 20 basis points. The government subsidy was retained by the smaller financial institutions, rather than passed on to households.



As discussed in the main text, the increases in variable and fixed mortgage rates in Canada have been similar to those seen in Australia, suggesting that the Canadian housing agencies have not had a significant impact on mortgage rates during the recent capital market turbulence.