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Inquiry into the Australian Banking Industry

RESERVE BANK OF AUSTRALIA

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A. INTRODUCTION

1. The Reserve Bank's relationship with the Australian banking industry is necessarily very close, given its direct responsibility for the prudential supervision of Australian banks and the protection of their depositors and, more generally, for the integrity of the payments system and overall stability of the financial system.

2. This submission focusses on three main areas:

(i) the evolution of the banking and financial system, with particular reference to the changing environment occasioned by deregulation;

(ii) the nature and extent of competition in the banking sector; and

(iii) the trade-off between ensuring effective competition and wide choice on the one hand, and maintaining prudential requirements appropriate for a stable financial system on the other.

The Bank would be happy to elaborate on any aspects of this submission, and to respond to any supplementary questions the Committee might wish to ask it.

B. EVOLUTION OF THE BANKING SYSTEM

3. Banks comprise the largest group of financial institutions in Australia. They provide the bulk of the credit extended to households and businesses and they are the major repositories for household savings. Banks employ about 167,000 people (about 2 per cent of the workforce) across a national network of some 6,600 branches. Their significance in public policy terms is that they:

- are a major channel for monetary policy;
- provide the low-risk end of the spectrum for household savings, given the "depositor protection" provisions of the Banking Act; and
- are at the centre of the payments system for the economy.

4. Government policy towards the banking industry, therefore, has been an important part of general economic policy. For most of the post-war period, policy towards the banking industry relied on widespread use of direct controls. In large measure, this approach can be traced to the recommendations in the Report of the Royal Commission on the Monetary and Banking Systems of Australia of 1937, as encapsulated in the Banking Act 1945. Many of these controls were designed for monetary policy purposes - that is, to help the Government, through the Reserve Bank, to influence the growth of money and credit in order to pursue its goals for inflation, economic growth and employment. They provided scope also to direct credit into particular sectors, and to assist with other objectives, such as reducing the cost of financing the budget deficit.

5. Prudential supervision was not mentioned specifically in the post-war legislation but it was implicit in the "Protection of Depositors" Division of the Banking Act. In any event, the Bank was able to keep itself well informed of banks' operations and the body of regulations was sufficiently restrictive that there was little incentive, or room, for banks to engage in excessively risky behaviour. It was not until 1989 that specific responsibility for prudential supervision was included in the Act, by which time the Reserve Bank had developed - and was applying - a range of prudential guidelines.

6. The main controls applied to banks during most of the post-war period were:

- interest rate ceilings on deposits and loans (including zero interest on normal cheque accounts);
- the Statutory Reserve Deposit (SRD) system, whereby a percentage of trading bank deposits was held at the Reserve Bank at below market interest rates;
- the Liquid Assets and Government Securities (LGS) Convention, under which a percentage of trading bank deposits was invested in cash or Commonwealth Government securities;
- asset restrictions on savings banks, which were required to invest a relatively high proportion of their deposits in prescribed assets mainly government securities issued by the Commonwealth and State Governments, with the remainder in housing loans; and
- quantitative lending guidelines, which required banks to limit growth in their lending and, at times, qualitative controls which required banks to prefer lending for certain purposes.

7. Over time, these controls were relaxed or removed. This occurred gradually during the 1970s, but accelerated sharply in the early 1980s, stimulated largely by the public discussion surrounding the Committee of Inquiry into the Australian Financial System (the Campbell Committee), which reported in September 1981, and the subsequent Report of the Review Group (the Martin Report) in December 1983.

8. The major deregulatory measures directly affecting banks were:

- in the early 1970s, the interest rate ceiling on one category of deposits - certificates of deposit - was removed, as was the ceiling on large overdrafts (the major category of non-housing lending);
- in 1971 banks were permitted to trade as principals in foreign exchange - previously they had traded as agents of the Reserve Bank;
- in several steps during the middle and late 1970s, the prescribed asset ratio of savings banks was reduced from 65 per cent to 40 per cent;
- in 1980, interest rate ceilings on all trading and savings bank deposits were removed;
- in 1982, quantitative lending guidance was discontinued;
- in 1985, sixteen foreign banks were invited to accept banking authorities;
- in 1988, the SRD arrangement was replaced with the much less-onerous system of non-callable deposits (NCDs). The successor to the LGS ratio - renamed the Prime Assets Ratio (PAR) - was also substantially reduced; and

- during this period, there were a number of other important changes which moved the financial sector in a more market-oriented direction. The most important were the introduction, in two stages in 1979 and 1982, of a tender system for issuing government securities, and the floating of the Australian dollar and ending of exchange controls in 1983.

A comprehensive listing of deregulatory measures is at Appendix 1.

Pressures Leading to Deregulation

9. The gradual reduction of direct controls reflected several factors, including moves towards financial deregulation overseas. More important was the growing disenchantment, within Australia, with the accumulating consequences of three decades of regulation. These consequences, which the Bank believes are pertinent to understanding and assessing the deregulation process, are elaborated in the following sections.

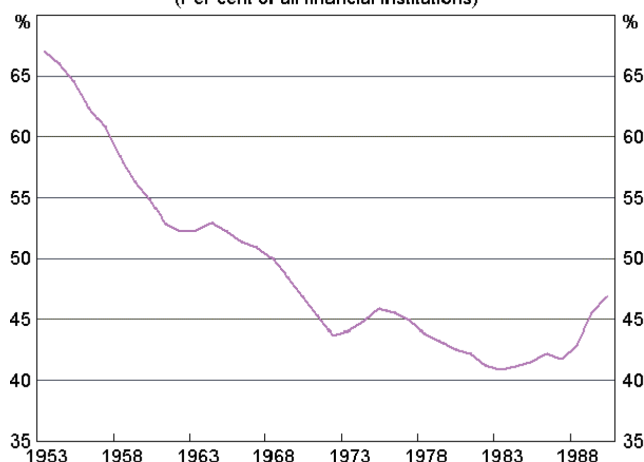
(a) The erosion of the regulated sector

10. Controls on banks reduced their capacity to adjust to changing conditions and imposed a cost disadvantage on them - through, for example, having to hold a large proportion of their portfolio in assets which earned below-market rates of interest. While it also gave them some measure of protection - for instance, a monopoly of foreign exchange transactions and protection from foreign bank entry - it cost them considerable market share as financial intermediaries not subject to the same controls grew at the banks' expense. In 1953, banks accounted for 67 per cent of the assets of all financial institutions but by 1981 this had fallen to about 42 per cent (Graph 1). One result of this was that the monetary authorities, by relying on direct controls, were exerting influence over a shrinking proportion of the financial system.

11. The major beneficiaries of the restrictions on banks were finance companies, which increased their market share from 2 per cent in 1953 to 9 per cent by 1960, and permanent building societies, which grew from 2 per cent in 1968 to 7 per cent by 1978. In the late 1970s and early 1980s, merchant banks also increased their share quite sharply, as did cash management trusts although their absolute size was a lot smaller. The growth of non-bank financial intermediaries is detailed in Table 1 (see page 3).

Graph 1

Bank Assets
(Per cent of all financial institutions)



12. In addition to the incursions of domestically owned non-banks, the increasing integration of Australia into world financial markets brought further incursions from overseas offices of foreign banks, their domestic representative offices, and from their partly-owned domestic merchant banks. Non-banks, not being constrained by the same controls, had more scope to be innovative than the banks (in, for example, currency hedging and cash management trusts, which helped attract customers away from banks).

13. The shrinkage of the controlled sector weakened the capacity of monetary policy to affect the economy (see next section). It also meant that many borrowers had to go outside the banking system to obtain credit even though this usually entailed higher rates of interest than banks were able to charge. Depositors too gradually moved more of their savings outside the banks in pursuit of higher interest rates, not always appreciating the loss of the depositor protection provisions of the Banking Act in the process. Other forms of investment - such as building society deposits, credit union deposits, bank-owned finance company debentures and cash management trust investments - were increasingly perceived by the public as offering virtually the same security as bank deposits, storing up problems for the future.

14. One possible reaction to the relative decline in the regulated sector would have been to apply the controls more widely. This possibility was debated in the 1950s and 1960s but was not adopted, in part because of uncertainty about the Commonwealth's power to legislate in this area. In the mid 1970s, a widening of the regulatory net in the form of the Financial Corporations Act of 1974 was contemplated, but in the end the Act was not used for that purpose. Once again it was recognised that as each new set of financial institutions was brought within the regulatory net, another set could be expected to emerge outside that net. As we had seen, the growth of finance companies was followed by building societies, which in turn were followed by merchant banks. Less formal forms of financial intermediation were waiting in the wings, including the inter-company market, the solicitors' funds market and, of course, the commercial bill market. Many of these were decentralised, "telephone" markets with a diverse set of participants which would be difficult, even in principle, to regulate.

(b) Problems with the implementation of monetary policy

15. With the original controls intended primarily to assist the implementation of monetary policy, it is not surprising that problems in effecting this purpose encouraged a re-assessment of the regulated system. It became increasingly apparent, particularly in the 1970s,

Table 1: Financial Institutions

Shares of Total Assets (a)

	BANKS (a)			Non-Bank Financial Corporations				Other Financial Institutions			
		(of which)									
		Trading	Savings	Permanent Building Societies	Finance Companies	Money Market Corporations	Other (b)	Cash Management Trusts	Life offices & Superannuation Funds	Public Unit Trusts	Other (c)
1953	66.9	(39.7)	(26.4)		2.3		3.4		21.1	0.2	6.0
1954	66.1	(39.5)	(25.8)		3.0		3.2		21.1	0.3	6.3
1955	64.4	(37.8)	(25.8)		3.9		3.2		21.7	0.4	6.4
1956	62.0	(35.2)	(26.0)		4.7	0.1	3.3		22.8	0.5	6.7
1957	60.9	(34.4)	(25.8)		5.0	0.1	3.3		23.3	0.6	6.8
1958	58.7	(32.6)	(25.4)		6.1	0.1	3.2		24.0	0.8	7.1
1959	56.5	(30.8)	(25.0)		7.1	0.1	3.8		24.4	0.9	7.2
1960	54.8	(29.6)	(24.4)		8.8	0.2	4.1		23.4	1.2	7.4
1961	52.5	(27.7)	(24.0)		9.2	0.2	4.5		24.5	1.2	7.9
1962	52.2	(27.2)	(24.2)		9.1	0.3	4.5		24.8	1.2	7.9
1963	52.3	(26.3)	(25.2)	1.2	7.8	0.3	4.5		25.3	1.2	7.4
1964	52.8	(26.5)	(25.5)	1.2	7.2	0.3	5.0		25.1	1.2	7.2
1965	52.5	(26.2)	(25.5)	1.4	7.4	0.3	4.6		25.4	1.1	7.2
1966	51.3	(25.3)	(25.1)	1.5	7.6	0.3	4.8		25.6	1.1	7.9
1967	50.7	(24.8)	(25.0)	1.7	8.1	0.3	5.0		25.5	1.0	7.8
1968	49.8	(24.4)	(24.4)	2.0	8.5	0.6	4.9		25.6	0.8	7.7
1969	48.6	(24.1)	(23.4)	2.5	9.5	0.8	4.9		25.4	0.7	7.6
1970	46.4	(23.2)	(21.9)	3.2	10.2	2.1	4.8		25.3	0.7	7.4
1971	45.2	(22.5)	(21.2)	3.8	10.8	2.3	4.7		25.2	0.7	7.3
1972	43.2	(21.7)	(20.0)	4.5	11.5	3.4	5.3		24.2	0.7	7.1
1973	43.9	(23.1)	(19.6)	5.3	13.0	3.9	4.7		22.1	0.6	6.5
1974	44.5	(24.5)	(18.8)	5.7	13.9	3.6	4.0		21.1	0.6	6.6
1975	45.9	(25.4)	(19.3)	5.8	13.0	3.4	4.3		20.5	0.5	6.5
1976	45.2	(24.8)	(19.0)	6.2	13.3	3.6	4.2		19.9	0.5	7.0
1977	44.6	(24.8)	(18.5)	6.6	13.7	3.6	3.5		19.6	0.5	7.9
1978	43.3	(23.8)	(18.3)	7.0	13.9	3.7	4.1		19.9	0.5	7.5
1979	43.0	(24.2)	(17.5)	7.2	13.2	4.1	4.2		19.2	0.7	8.5
1980	42.5	(24.8)	(16.5)	7.6	12.9	4.7	4.5		18.8	0.9	8.1
1981	41.6	(24.9)	(15.5)	7.6	13.6	5.4	4.4	0.1	18.6	1. 1	7.7
1982	40.9	(25.4)	(14.4)	7.1	13.4	6.3	4.3	0.9	18.0	1.3	7.9
1983	40.4	(24.6)	(14.8)	6.8	11.7	6.2	4.3	1.0	19.5	1.7	8.3
1994	41.1	(24.9)	(14.9)	7.0	9.0	7.0	5.1	0.6	20.0	2.2	8.1
1985	41.2	(25.5)	(14.5)	6.2	8.9	7.5	5.0	0.5	19.6	2.7	8.5
1986	41.8	(26.9)	(13.3)	5.6	8.2	8.3	5.2	0.9	20.1	3.0	7.1
1987	41.1	(25.9)	(13.4)	4.1	6.6	8.6	5.3	0.8	n.a.	3.6	6.6
1988	42.6	(27.4)	(13.5)	4.0	5.7	9.2	5.2	0.7	n.a.	4.0	7.0
1989	45.2	(29.0)	(13.7)	3.8	5.9	8.6	4.2	0.6	21.0	4.1	6.6
1990	46.3	n.a.	n.a.	3.3	5.9	7.7	4.0	0.6	20.8	3.9	7.5

(a) Excludes the Reserve Bank but includes development banks.

(b) Authorised money market dealers, Credit co-operatives, Pastoral finance companies and General financiers.

(c) General insurance offices, Intra-group financiers, Co-operative housing societies and Other financial institutions registered under the Financial Corporations Act.

that the regulated system was not delivering the expected results on monetary policy. The main weaknesses were:

(i) Over time, the erosion of the controlled sector limited the capacity of monetary authorities to control the growth of money and credit. Even when some success was achieved in slowing the activities of banks, non-bank financial intermediaries often continued to grow very strongly. In the 10 years to 1974, for example, banks' assets grew at an annual rate of 11 per cent, while non-banks grew by 21 per cent. As a result, total credit over this period expanded faster than the authorities wished.

(ii) Even when bank interest rate ceilings were lifted, serious difficulties remained in restraining the growth in money and credit. One reason for this was the failure to fully fund the budget deficit in the market i.e. part of the funding was provided by the central bank, which pushed cash into the banking system. Another factor was the ability of financial markets to obtain liquidity from the rest of the world through the fixed (or quasi-fixed) exchange rate mechanism. These technical aspects of monetary policy do not need to be pursued here, but they lay behind the decisions to move to a tender system for issuing government securities and to float the exchange rate.[1]

(iii) Over short periods of time, the authorities could implement changes in monetary policy, with immediate effects on financial markets. The concern here was more with the abruptness and dislocation associated with such changes in monetary policy, rather than their ineffectiveness. With interest rate ceilings on banks, a tightening of their liquidity position caused by a change in monetary policy meant that they could not cushion the squeeze by bidding for funds. Instead, their only response was to call in loans which could result in severe "credit squeeze" conditions, as occurred in 1961 and 1974. It is worth remembering also that during the period of regulation - but when some bank interest rates were free to vary - these conditions were often associated with sharp rises in interest rates. Rates on Certificates of Deposit and bank bills, for example, reached 25 per cent in June 1974 and 23 per cent in April 1982 - higher than comparable rates in the period since full deregulation.

(c) Inefficiencies in the allocation of credit

16. "Allocative efficiency" is jargon for the capacity of the banking system to direct credit to areas of greatest productivity and long-term benefit to the country. Under the regulated system, with interest rates on loans controlled, banks had little opportunity to innovate or incentive to lend for new or more risky activities. There was widespread acceptance in the community that bank credit was difficult to come by, for all but the safest borrowers.

17. With all banks offering similar interest rates, it was difficult for one bank to gain market share at the expense of others. Even if a bank were keen to expand its lending into what it believed was a new and profitable area, it could not be confident of being able to raise the deposits to finance that expansion. This tended to reduce competition among banks, except in less-productive ways such as the expansion of branch networks.

18. It is the essence of banking that if loans are to be made which involve higher risk, the bank should be compensated with a higher rate of return. If, however, all loans have to be made at the same interest rate, logic dictates that the bank allocate its funds to the lowest-risk borrowers. These are likely to be concentrated in established firms in traditional industries. Other prospective borrowers, such as small firms and those seeking to expand into newer and less-familiar industries, do not get much of a look-in under such conditions. Moreover, with interest rate ceilings on both the deposit and the lending sides, it was not essential for banks to develop expertise in pricing their products for risk - another shortcoming of the regulated era which has become apparent in recent years.

19. One response to the inherently conservative lending policies of banks and the inability of newer and/or riskier borrowers to obtain credit was for governments to establish new lending facilities in an attempt to fill the gap. The main examples were the establishment of the Commonwealth Development Bank in 1959, the Term Loan Fund in 1962, the Farm Development Loan Fund in 1966, the Australian Resources Development Bank in 1968 (owned by the private banks) and the Australian Industries Development Corporation in 1971.

20. The regulated system also involved allocative inefficiencies in the form of cross-subsidization. The role of the Reserve Bank in clearing the foreign exchange market daily at fixed exchange rates, and the provision of set margins to banks in respect of foreign currency transactions gave banks assured and substantial profits. This, and the interest margins applying with official approval at the time, relieved banks of the need to look too closely at the profitability of particular types of savings bank and trading bank accounts. Transaction fees were not generally charged. One consequence was that some groups of customers - for example, those with many transactions but low balances - benefited at the expense of others - for example, longer-term savers with few transactions.

C. COMPETITION IN BANKING

The Results of Deregulation

21. Any evaluation of the results of deregulation should bear in mind the recentness of those changes - we have little more than half a decade of experience with the present system, after more than three decades with a tightly controlled financial environment. Furthermore, the period of the present system has involved a substantial "learning phase" as decision making by participants has had to adjust to more market driven influences and less official direction. The past half decade or so has also witnessed

1. For a detailed explanation of this point, see Australian Financial System Inquiry: Final Report, September 1981: Money Formation and Interest Rates in Australia, T.J. Valentine, Australian Professional Publications, 1984; and Methods of Monetary Control in Australia, I.J. Macfarlane, in Economics and Management of Financial Institutions, eds Valentine and Juttner, Longman Cheshire, 1987.

other significant economic developments which, while not related directly to financial deregulation, have affected the behaviour of banks and their customers.

22. What was expected from financial deregulation at the time? Different groups no doubt expected different things but it was widely expected that:

(a) banks would regain market share;

(b) interest rates would be less volatile;

(c) bank credit would be more readily available and bank depositors would be better compensated for the use of their savings;

(d) banking would become more competitive and innovative, probably involving some reduction in profitability; and

(e) because banks would have more freedom and competitive pressures would be greater, they would be exposed to more risks.

23. Much of the remainder of this submission comments on the extent to which these expectations have been fulfilled; many of the issues here would appear to fall directly within the Terms of Reference of the Committee. The overall conclusion must be that there has been a significant increase in banking competition during the second half of the 1980s.

(a) Market share

24. The expectation that banks would regain market share has been fulfilled. From a low-point in 1983, when banks accounted for only about 40 per cent of the assets of all financial institutions, their share has risen to a little over 46 per cent. This has not returned them to anywhere near the degree of dominance they enjoyed in the immediate post-war period but no such return was expected. A large part of the increase in the banks' share has reflected the bringing back onto banks' own books of business that was formerly written by bank-owned finance companies and merchant banks. An additional factor has been the conversion of a number of permanent building societies into banks. Merchant banks gained market share in the early years of deregulation but lost much of these gains subsequently as imposts on the banks were reduced and some merchant banks chalked up substantial corporate losses.

(b) Interest rate volatility

25. Interest rates have fluctuated within wide limits (cash rates, for example, have ranged between 10 and 18 per cent since 1983) but in terms of day-to-day movements in interest rates, there has been a reduction in volatility.[2] Sharp "credit crunches", of the 1961 and 1974 variety, have been avoided as more of the work of monetary policy has been done by rising interest rates and less by credit rationing. For a variety of reasons, however, interest rates have probably acted more slowly in countering excess domestic demand pressures than was expected. Interest rates had to be kept at high levels for a considerable time in 1985/86 and again in 1989 before domestic demand slowed appreciably. Other factors - including expectations of sustained asset price rises - appear to have contributed to that situation. Notwithstanding the lags involved, however, monetary policy pursued through market operations has proved effective.

26. It is sometimes argued that the process of deregulation caused real interest rates to rise over the last decade. It is true that real interest rates have been significantly higher in the 1980s than in the 1970s, but this has been true for all major countries (see Table 2). The widespread use of controls in the 1970s meant that interest rates were slow to adjust to rising inflation; in fact, the catch-up did not occur until the 1980s. In addition, the demand for funds for private investment was much stronger in the 1980s for most countries while in many countries private savings rates declined.

Table 2: Real Interest Rates
(short-term interest rates deflated by the change in CPI)

	1970s	1980s
United States	-0.8	3.3
Japan	-1.8	3.6
Germany	1.9	3.8
France	-0.5	3.5
United Kingdom	-3.7	3.8
Italy	-1.9	3.6
Canada	-0.3	4.7
Australia	-1.0	5.8
Netherlands	-0.4	4.3
Belgium	0.4	5.7

(c) Availability of bank credit

27. Bank credit has been more freely available since direct controls over banks' interest rates and lending volumes, were removed. Table 3 shows the strong growth that occurred through the 1980s, with bank credit growing at an average rate of over 20 per cent. The fastest rate of growth was in the period from 1985 to 1989. During this time, non-bank credit did not slow by much, so that the net effect was to speed up the growth in the total provision of credit during these years. By sector, the fastest rate of growth occurred in the provision of credit to businesses.

28. In contrast to the regulated period, when the non-availability of credit was a common charge, many complaints during the deregulated phase have been to the effect that banks have provided too much credit. Certainly the growth of credit has far exceeded the rate of growth of nominal GDP, and the outstanding stock of debt as a ratio of GDP has risen, as has corporate leverage. It is fair to say that the increase in the availability of credit was greater than was foreseen - and banks would concede that they made many loans that they now regret. This is

2. R.G. Trevor and S.G. Donald, "Exchange Rate Regimes and the Volatility of Financial Prices: The Australian Case", *Economic Record Supplement*, 1986, pp 58-68.

Table 3: Growth in Credit by Sector
(year to June)

	Bank				NBFI	Total
	Housing	Personal	Business	Total	Credit	Credit
1981	10.2	33.4	15.7	15.7	22.6	18.7
1982	8.9	27.2	18.2	20.9	17.0	17.6
1983	12.9	24.4	13.9	14.9	6.1	11.1
1984	13.9	27.9	16.2	14.8	10.4	13.7
1985	27.3	26.6	23.2	20.8	21.0	22.3
1986	19.4	11.8	26.1	32.3	15.7	21.9
1987	28.8	3.6	26.3	29.3	5.9	18.5
1988	18.1	-0.7	28.2	36.1	17.5	24.5
1989	28.2	23.1	26.2	25.8	10.5	21.1
1990	14.6	8.5	14.6	16.0	1.1	10.6
Average	18.2	18.6	20.9	22.6	12.8	18.0

part of the learning phase for banks (and others) which is still underway.

29. Other factors, however, have been at work in generating this exceptionally high rate of growth of credit.[3] In Australia, as in a number of other countries, business adapted to the inflationary pressures of the 1970s by pursuing strategies based increasingly on leveraged asset acquisition. Australian banks, to a large extent, accommodated this, but it is unlikely that they were the main initiating factor, nor were they the only credit providers to companies engaged in leveraged asset speculation; overseas banks and overseas holders of high-yielding ("junk") bonds were also prominent in many instances.

(d) Competition and profitability

30. Deregulation was expected to lead to an increase in competition in the banking industry, and probably involve some reduction in profitability in the process. There are many aspects to be examined here. This section of the submission examines competition in banking by considering, in turn, the concentration of the industry, trends in profitability, changes in interest rate margins and range of services.

(1) Concentration

31. A common starting point for studies of competition within an industry is to look at its degree of concentration - for example, the proportion of industry turnover accounted for by, say, the four or five largest firms. Industry turnover can be defined to include all banks, or it can be widened to include all financial intermediaries. The wider definition recognises that banks compete with building societies, finance companies, credit unions, and other institutions. In Australia, there has been a number of studies of industry concentration, but none specifically directed at the banking industry. Table 4 shows concentration ratios for a number of major Australian industries derived from a recent study by the Australian Bureau of Statistics; we have added figures for banks, which show the proportion of assets of all banks accounted for by the four largest banks.

Table 4: Concentration Ratios in Selected Australian Industries: 1987-88

(proportion of total turnover accounted for by largest four firms)

Industry	Ratio
Tobacco	1.00
Pulp & Paper	.93
Beer	.91
Glass	.87
Butter	.85
Motor vehicles	.81
Iron & Steel	.80
Banks	.69
Poultry	.65
Bread	.60
Cotton	.56
Household appliances	.49
Cosmetics	.40
Footwear	.40
Knitwear	.33
Pharmaceuticals	.25

Source: Manufacturing Industry Concentration Statistics: 1987-88. Cat. No. 8207.

32. Many industries in Australia have concentration ratios that are high by international standards; indeed, some major industries are near-monopolies. On the data shown in Table 4, banking comes roughly in the middle of the field. The concentration ratio in Australian banking, measured on this basis, rose from 66.9 per cent in 1978 to 79.1 per cent in 1983, following the mergers between the Bank of New South Wales and the Commercial Bank

3. See I.J. Macfarlane, "Money, Credit and the Demand for Debt," *Reserve Bank Bulletin*, May 1989 and "Credit and Debt: Part II," ibid., May 1990.

of Australia to form Westpac, and between the National Bank of Australia and the Commercial Banking Company of Sydney, and the absorption into ANZ of the Bank of Adelaide. The ratio has since fallen - to 68.5 per cent in 1988 and 66.9 per cent in 1990 - but will rise again when the State Bank of Victoria/Commonwealth Bank merger starts to reflect in the figures.

33. By international standards, the concentration of banking in Australia is not unusual. Apart from the United States, which has an extremely fragmented banking system of around 14,000 separate banks, virtually all other countries show a fair degree of concentration. For example, in the United Kingdom, Canada, Australia, New Zealand, the Netherlands and Sweden, the bulk of domestic banking business is accounted for by four or five large banks. Table 5 shows concentration ratios for 9 countries, where concentration is measured by the percentage of assets of all financial intermediaries held by the largest 3, 5 and 10 firms. Again Australia is in the middle of the field. (This ratio is lower than the one shown in Table 4 because its denominator is all financial intermediaries, rather than all banks.)

Table 5: Concentration Ratios in 1983
(percentages of total assets)

Country	All financial intermediaries		
	3	5	10
Germany	16.6	24.0	38.2
Italy	17.5	25.5	40.4
Spain	17.6	26.3	35.7
Japan	22.9	29.6	41.5
Australia	30.4	46.4	65.5
France	33.1	47.3	60.9
Belgium	35.8	52.1	67.7
Switzerland	44.8	51.8	59.3
Sweden	52.0	60.4	67.5

Source: J. Revell, "Comparative Concentration of Banks", *Research Papers in Banking and Finance,* Institute of European Finance, Bangor, United Kingdom.

(2) Bank profitability

Recent trends

34. One guide to whether an industry is competitive is the profitability of firms in that industry. Abnormally-high profits usually indicate a lack of competition, while normal or below-normal profits may indicate (assuming firms are efficient) that the industry is competitive.

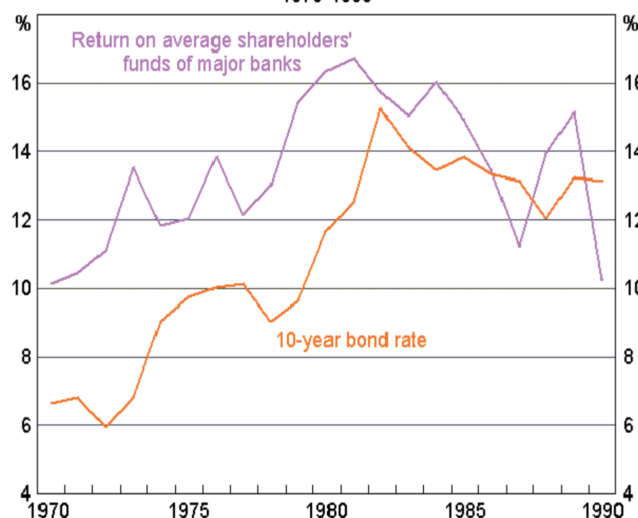
35. Determining what is a "normal", or appropriate, level of profits in an industry is a matter of judgment. A comparison often drawn, however, is with rates of return available on alternative investments. A widely-used benchmark is the interest rate on government bonds, which provides a measure of the risk-free rate of return on capital. Investors in shares look for a return above that because of the greater risk; the higher the risk, the greater the expected return needs to be to attract capital. Another benchmark is rates of return in other industries, although such comparisons need to take account of differences in risk across industries.

36. Bank profitability can be measured in a variety of ways. The most widely-accepted measure, and the one that can be compared most readily with other industries, is return on shareholders' funds. This is usually measured as net profit after tax as a percentage of shareholders' funds. Another measure is return on assets - i.e. net profits after tax as a percentage of total assets - but this measure can be affected by changes in the composition of banks' balance sheets and is also more difficult to compare with other industries.

37. Returns on shareholders' funds for the four major banks and yields on 10-year Commonwealth Government bonds are shown in Graph 2 for the period covering the 1970s and 1980s.[4] The year-to-year variability in profits means that not too much emphasis should be placed on profits in any particular year, but conclusions can be drawn by looking at a run of years. The graph shows that:

- average returns rose gradually over the 1970s, from a little over 10 per cent to about 16 per cent - this rise was more or less in line with movements in government bond yields but, on average, returns exceeded bond yields by 4 percentage points in the 1970s;
- through the first half of the 1980s, returns on shareholders' funds were fairly steady, averaging 16 per cent - over this period bond yields rose and the margins of bank returns over bond yields fell to 2.5 percentage points on average;
- returns fell sharply over 1985, 1986 and 1987 - both in absolute terms and relative to bond yields - following the progressive moves towards deregulation, including the licensing of new banks. Profitability rose in 1988

Graph 2



4. Figures for all banks show similar movements, although the average level is lower.

and 1989 due largely to the reduction in banks' costs of funds resulting from the "flight to quality" by investors after the sharemarket crash of 1987. However, it again fell in 1990, as these effects passed and banks were burdened with large volumes of bad and non-performing loans. This followed the sharp expansion in their loan portfolios in earlier years.

38. On average in the second half of the 1980s, banks' profitability fell to a rate which was not very different from the government bond yield. The fact that banks were not able to earn a premium on the risk-free rate of return suggests strong competitive pressures. In the Bank's view, deregulation and foreign bank entry were major sources of the increased competitive pressure.

Factors affecting banks' profits

39. Profits reflect the difference between revenues and costs. The two main sources of revenue for banks are net interest income and non-interest income (e.g. fees for service). Costs can be divided into operating costs and costs of credit risk. Movements over the 1980s in these various components for the major banks are discussed below.

Net interest income

40. Net interest income of the major banks - the difference between interest charged on loans and interest paid on deposits - averaged 3.7 per cent of assets in the first half of the 1980s, but fell to 3.3 per cent in the second half. Several factors contributed to this fall (discussed in more detail below) but, importantly, over this period the margin between interest rates on loans and those on deposits narrowed.

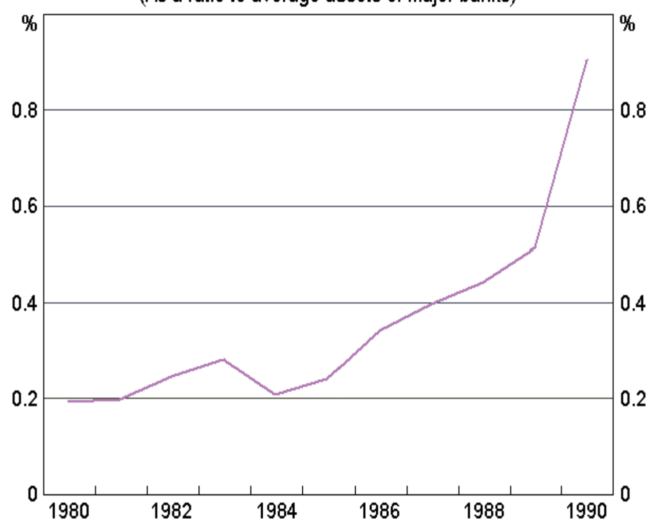
Non-interest income

41. Non-interest income of banks (again measured in relation to assets) was slightly lower in the second half of the 1980s than in the first half (1.7 per cent and 1.8 per cent respectively). Although banks widened the range of services they provided to customers over the period, and greatly expanded the volume of some (such as bill finance), competition brought about significant reductions in the fees for many of these services. This was particularly noticeable, for example, in the fees banks charge for bill finance. Typically, acceptance fees for larger companies were 1.5 per cent in the early 1980s, but fell to 0.5 per cent by 1987.

Operating costs

42. This is another area where competition appears to have had a major impact, raising the level of banks' operational efficiency. Operating costs of the major banks averaged 3.9 per cent of assets in the first half of the decade, but declined to 3.2 per cent in the second half. This reduction was achieved by more efficient use of personnel (assets per employee have risen strongly) and by the introduction of new technology. It is reflected also in a fall in the ratio of operating costs to total income - this fell from 0.7 in the first half of the 1980s to 0.6 in the second half. The reduction in these ratios suggests that banks are now operating more efficiently than in the early 1980s.

Graph 3



Credit risk

43. In the first half of the 1980s, costs of bad debts averaged only about 0.2 per cent of assets. (The cost of non-performing loans - i.e. interest forgone - is taken into account in the measure of net interest income discussed above.) In recent years, however, and particularly over the past year, these costs have risen sharply; charges against profit for bad debts accounted for 0.5 per cent of assets per year over the period from 1986 to 1990, peaking at 0.9 per cent in 1990 - see Graph 3.

44. Some of the increase in bad debts over the past year or so results from the contraction in economic activity, and should be partly reversed as the economy picks up. However, a further large part of the increase reflects the recent fall in asset prices, after their rapid growth during most of the 1980s. Had these bad debts been foreseen, they should have been charged against profits in earlier years, in which case the apparent pick-up in profitability in 1988 and 1989 (see Graph 2) would not have occurred. In other words, there would have been a steady decline in the return on shareholders' funds in the second half of the 1980s, rather than the variations shown in the actual figures. Part of the rise in bad debt expenses above that prevailing in the first half of the 1980s might also reflect a structural shift by banks into higher-risk forms of lending.

45. Table 7 summarises the net impact on banks' profit margins of the various factors discussed above. Profits, measured as a percentage of assets, fell between the first and second half of the 1980s, from 0.8 per cent to 0.7 per cent. This fall occurred despite a substantial increase in the efficiency of banks, as indicated by the reduction in their operating costs. Part of the reduction in operating costs was absorbed by higher bad debt expenses,

but most of it was passed on to customers through lower interest margins and fees - suggesting the operation of substantial competitive forces.

Table 7: Components of Profit for Major Banks
(as a proportion of total assets)

	1980-85 (%)	1986-90 (%)
Net interest income	3.7	3.3
Non-interest income	1.8	1.7
Operating expenses	3.9	3.2
Bad debt expense	0.2	0.5
Tax	0.6	0.6
Profit after tax	0.8	0.7

Comparison of bank profits with other rates of return

46. The decline in bank profits following deregulation occurred against the background of a slight increase in the general level of profitability of companies in Australia. As a result, while returns on shareholders' funds for all banks exceeded the average of other companies in the first half of the 1980s by an average of 6 percentage points, in the second half of the 1980s the margin was only 1 percentage point (and was negative on average in 1989 and 1990). For the major banks, the margin recently has averaged 3 percentage points, well down on that in the first half of the 1980s - see Table 8

Table 8: Return on Shareholders' Funds
(per cent)

Average for	Major Banks	All Banks	All companies
1982-1985	16	15	9
1986-1990	13	11	10

47. Graph 4 shows rates of return of companies listed on the Stock Exchange, classified by industry. In the first half of the decade, banks were among the most profitable companies listed on the Stock Exchange but, in the second half, they fell in the middle of the field.

(3) Banks' interest rates

48. Following deregulation, there have been two major developments in banks' interest rates:

(i) with the lifting of controls the average interest rate paid to depositors has risen substantially. In 1980, about 45 per cent of banks' deposits attracted an interest rate of less than 6 per cent. Today, despite a lower rate of inflation, about 13 per cent receive less than 6 per cent. In other words, depositors - other than those who, because of inertia or for other reasons, have elected to retain their savings in low interest accounts - now receive higher, more market-related, interest rates on their savings; and

(ii) banks' interest margins have declined - i.e. the full extent of the increase in deposit rates has *not* been passed on to borrowers.

49. There are various ways of measuring changes in bank interest margins. One is to take the difference between a selected deposit rate and a selected loan rate. This approach, however, takes no account of changes in the relative shares of deposits raised at different rates or of changes in the mix of loans and other assets held by the banks. It does not allow, for instance, for the shift to higher cost deposits noted above, or for the fact that interest is now paid on a much higher proportion of bank deposits, including cheque accounts.

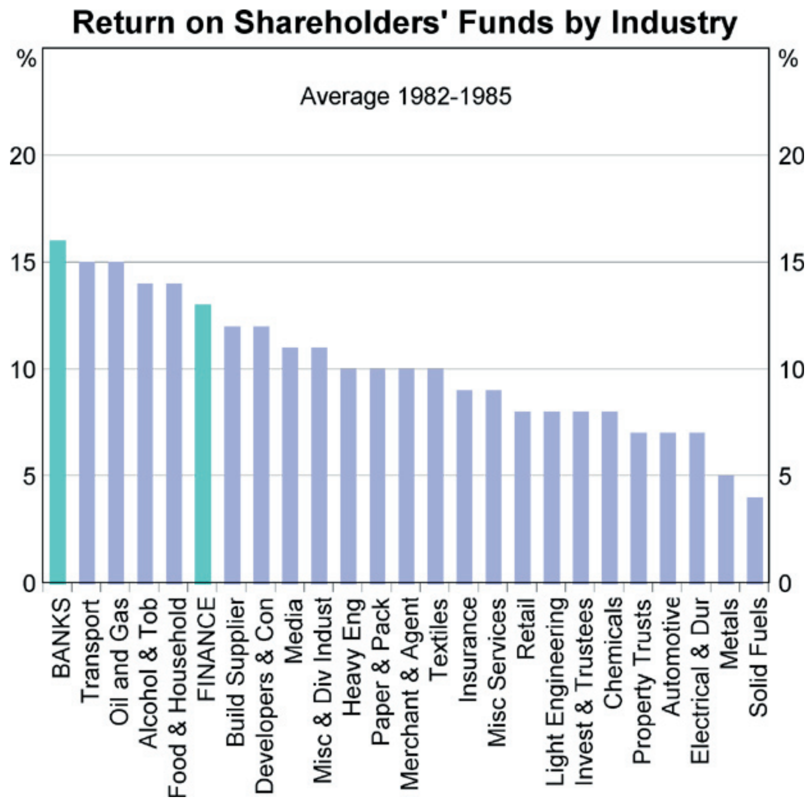
50. A better approach is to measure the net interest income of banks as a proportion of their assets. The figures shown in Table 7 are on this basis. As noted earlier, this ratio has declined in the post-deregulation period, reflecting the net result of several factors:

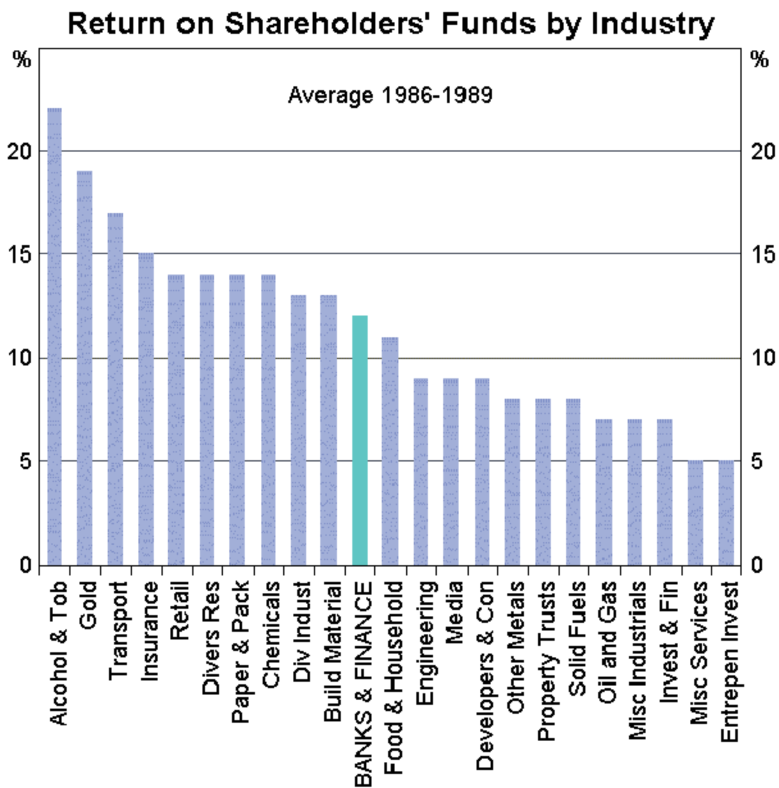
- the removal of interest rate controls and competition among banks for deposits have tended to raise average interest rates paid by banks, while competition for lending business has limited the scope for banks to pass on these higher costs of funds to borrowers. Taken together, these factors have tended to produce a lower interest margin;
- the growth of offshore business, where net interest earnings have been narrower than on domestic assets has worked in the same direction. Banks in most countries earn higher rates of return on their domestic business than on their overseas business, reflecting their greater competitive advantage at home;
- also tending to depress the ratio has been the growth of *non-interest bearing* assets, such as bill acceptances, on which the banks earn a once-off return as acceptance fees rather than as interest; and
- working in the opposite direction has been the reduction in the severity of regulations, particularly the Prime Assets Ratio and the Statutory Reserve Deposit arrangements, which required banks to hold low-interest assets. The replacement of these assets with assets earning higher interest rates - mainly loans - has tended to push up the ratio.

51. If we put aside offshore business and non-interest bearing assets, and look only at the difference between average interest rates paid on *domestic deposits* and average interest rates charged on *domestic loans*, a similar picture emerges. Information available to the Bank indicates that the average interest spread measured on this basis has declined by 0.4 percentage point in the second half of the 1980s, from 5.0 per cent to 4.6 per cent.

52. This does not mean that interest margins have been uniformly lower in the second half of the 1980s. At times, especially after the stockmarket crash in 1987, when the banks gained large inflows of low-interest deposits in a "flight to quality", and again for a time in 1990 when banks were slow to reduce loan interest rates at a time of large bad debt losses, margins widened temporarily to around the average levels of the early 1980s. Those wider margins, however, were not sustained. suggesting that

Graph 4





Source: Australian Stock Exchange

community pressures and competitive forces were strong enough to prevent a permanent return to earlier levels.

53. Nor do the lower average margins in the second half of the 1980s mean that all depositors and borrowers have benefited equally. Some depositors - for example, those who, for whatever reasons, choose to hold deposits in low interest bearing accounts may not have benefited at all. It might be argued that competition for corporate lending was stronger in the period 1987-1989, leading to a presumption that corporate borrowers fared better than retail borrowers. This presumption is difficult to test because of the controlled interest rate loans remaining in banks' housing loan portfolios and the lack of data on which to make accurate comparisons. It seems clear, however, that margins narrowed for most, if not all, borrowers during the second half of the 1980s - by a greater degree for some than for others.

(4) Range of services

54. Under deregulation there has been a proliferation of products and services, with "new" banks and non-banks prominent in this development. In addition, the number of alternative types of deposit account offered by most banks has expanded, allowing customers a wide choice of combinations of interest return, fee structure, and access to payments services.

55. Table 9 lists the main product innovations since 1985, and tentatively identifies categories of potential beneficiaries. In some cases, the innovations reflect the "unbundling" of products and services which had formerly been combined; in other cases, they reflect services not available because of interest rate and exchange controls. More generally, they represent responses to perceived customer demand in a highly-competitive environment.

(5) Availability of Information

56. For bank customers to gain the benefits that flow from greater competition, they need to be properly informed about the services available, the interest rates to be paid or received, and all other fees and costs involved.

57. Banks were probably slower in responding in this regard than in most of their other responses to competition. In part this reflected the rapid expansion of services, the problems faced by their own officers in comprehending the various features of new products before being able to explain them to customers, and the costs involved in communicating with customers. For their part, customers were sometimes slow in seeking adequate detail in advance of signing up, and perhaps unwilling at times to admit that they did not fully understand the fine print.

58. After a slow start, a good deal of progress has been made in the past couple of years in setting standards of conduct, in the disclosure of information, and in the handling of customer complaints and disputes. Two specific developments have been:

- implementation of the Code of Conduct for electronic funds transfer (EFT) transactions which details the rights and obligations of users and providers of EFT services - institutional compliance with the Code is now being monitored by the Australian Payments System Council; and
- establishment of the Banking Industry Ombudsman in mid 1990.

59. The Bank believes there is scope for further improvement in standards of disclosure which it would like to see made in ways consistent with the flexible, adaptive operation of financial markets. Both directly and through its involvement with the Australian Payments System Council, the Bank is supporting initiatives to improve standards of services and protection for consumers. It is mindful that the costs of such initiatives be balanced against the benefits to be achieved given that, ultimately, the costs of customer protection are borne not by the banks but by the customers seeking to be protected.

(e) Entry to Banking

60. One test of competition is the extent to which new entrants are able to enter an industry. At present, entry to banking is restricted in a number of ways:

- The Banks (Shareholdings) Act limits the degree of ownership by a single person, or company or associated group. A dominant shareholder poses the risk that a bank's deposits might be used for the benefit of such a shareholder (not itself subject to central bank supervision) or that public confidence in the bank would be compromised by business problems experienced by the dominant shareholder.
- An applicant for a banking authority must satisfy the Bank and the Treasurer of the viability of the proposed bank in terms of capital availability, management competence, and other requirements.
- Applicants must be joint stock companies. The main short-comings seen in co-operative or mutual organisations relate to the problems in establishing and maintaining a strong sense of ownership among members; the potential lack of effective discipline on management; and limited access to new capital.

61. Additional foreign banks are not envisaged under current policy. The most recent foreign bank entrants were the fifteen authorised over 1985 and 1986. Since then, foreign banks have been able to establish non-bank financial subsidiaries in Australia and a substantial number have done so. It is arguable whether a more open approach to foreign bank entry would add significantly to competition in the banking sector, or merely add to surplus capacity. The entry of additional foreign banks would hardly reduce competition in the banking sector but would probably not enhance it significantly either, unless foreign banks were permitted to take over or merge with a significant domestic bank. A non-competition argument in favour of more open entry is that such a policy change could make it easier for domestic banks to establish operations overseas, particularly in countries where reciprocal treatment is part of official policy.

62. Foreign banks, with a small number of "grandfathered" exceptions, have been required to establish in Australia as locally incorporated subsidiaries,

Table 9: Major Innovations in Bank Products and Services Since 1985

Deposit Products	**Beneficiaries**
Cash Management Accounts	Customers who wish to earn 'money market' interest rates, without the need for constant monitoring of the market and with the convenience of having the money available at call.
Comprehensive Transaction Accounts	For customers wanting one account which includes cheque book, ATM access, daily crediting of interest, links to credit cards, regular payment of bills, and an overdraft facility. May also include a telephone banking option.
Transaction Account with Sweep Facility	For customers who do not wish to regularly monitor the balance in their transaction account. The balance above a certain amount is moved into a higher-yielding deposit account, such as a cash management account. Generally aimed at high-net-worth customers.
Incentive Savings Accounts	Accounts with interest rate structures which reward consistent savings records.
Interest Offset Facility	For customers with both a loan account (usually a home loan) and a deposit account. The savings act to reduce interest commitments which tends to shorten the term of the loan.
Minimising Bank Charges	Customers may choose from a combination of high/low transaction fees and high/low rates of interest, depending on their particular needs.
Interest Receipt Options	Monthly receipts, or deferred receipt of interest earned on deposit accounts, including term deposits. Customers can choose which suits best.
Foreign Currency Deposits	For customers who wish to hold foreign currency deposits for transaction, hedging or speculative purposes.
Facilities for Special Groups	Promotional sets of products for special groups, e.g. retirees, young people.
Lending Products	
Flexible Repayment Arrangements e.g. low-start loans	For customers whose capacity to meet mortgage commitments is expected to change over the period of the loan.
Fixed-Interest Rate Housing and Business Loans, Also Capped Rate Loans	Customers who wish to fix, in dollar terms, their interest payments stream, and/or customers who wish to avoid interest rate risk.
Residential Property Investment Loans	Customers who wish to purchase real estate for investment purposes.
Home Equity Loans/Secured Lines of Credit	Customers with significant equity in their residential property (or in some other asset) who wish to borrow, for any purpose, against that equity.
Foreign Currency Loans	Customers who wish to borrow in a foreign currency to meet a foreign currency commitment, or in order to speculate on the exchange rate.

Services

Some banks have developed into "financial supermarkets" with services including investment and business management advice, insurance, superannuation, property and equity trusts, and risk management.

rather than as branches of the parent bank. Some foreign banks argue that this adds to their costs and limits their capacity to compete effectively. They argue that branches would be able to operate on the basis of the parent's total capital base, giving more effective access to wholesale banking opportunities. The contrary arguments, which helped to determine the present policy, relate to the capacity of the Australian authorities to supervise a bank that is not established under, and controlled by a board of directors subject to, local legislation; and to the capacity of authorities in other countries to determine the behaviour of a bank operating as a branch in Australia. The task of protecting local depositors might also be more complex if a branch is involved. This issue is under discussion within the Bank, and between the Bank and the Government. Some foreign banks have argued that their non-bank financial subsidiaries in Australia should also be able to operate as a branch of the parent bank. The Reserve Bank does not favour this course, basically because any such institution, bearing the name of the parent bank, would itself be seen as a bank, although legally and in other ways this would not be the case.

(f) Increase in risk

63. An increase in risk was an expected feature of a deregulated banking market, for a number of reasons, including:

- a reduction in the previous incentive to lend only to the lowest-risk borrowers after interest rate ceilings were removed;
- increased competition encouraged banks to expand their activities into newer areas in an effort to maintain or increase their market share;
- greater pressure on banks' managements to make decisions previously made or heavily influenced by the government, e.g. how to price deposits and loans, how to assess and price risk;
- a reduction in the proportion of banks' funds held compulsorily in government securities or deposits at the Reserve Bank, with more held as loans to the public; and
- the spread of operations to other countries in a variety of currencies.

64. Coming to terms with this increase in risk is at the centre of the on-going learning phase of deregulation for the banks. The Reserve Bank's response can be seen in the introduction of formal prudential controls; these are detailed in Part D of the Submission.

D. PRUDENTIAL SUPERVISION

65. Prior to the 1980s the Bank's prudential supervision of Australian banks was largely informal although, on the face of it, effective. The problems of the Bank of Adelaide in 1979 were identified promptly and the merger of that bank with the ANZ Bank was organised smoothly without loss to depositors and with minimal disruption to banking system stability.

66. During the 1980s, a number of factors persuaded the Bank that greater formality, based on publicly available guidelines, was needed in pursuing its supervisory role. A Bank Supervision Unit was established by the Bank in 1980, which has subsequently developed into the Bank Supervision Department. The reasons for this change in approach included:

- recognition that the process of deregulation would involve banks in greater operating risks, increasing the importance of adequate capital and liquidity and effective management controls;
- the growth in banks' overseas operations gave risk management an added dimension and meant that overseas banking supervisors would be looking for evidence of effective supervision in Australia;
- a strong move internationally towards consistent minimum standards of banking supervision in all major banking centres; and the close contacts needed to underpin an informal supervisory system became more difficult as the number of banks increased and there was greater devolution of authority within banks.

(a) Trade-offs in bank supervision

67. Settling on the right amount and intensity of prudential supervision involves some important trade-offs. Arrangements are required that bolster community confidence and support the reliability and viability of the banking system and the payments system. The framework needs to be simple, logical and practicable on the one hand and, on the other, it needs to minimise artificial distortions in financing.

68. Banks should practice prudent risk management but we also need a dynamic innovative financial system. It would be inappropriate to bear down excessively on the former at the risk of damaging the latter. Risk is an essential part of financial markets just as it is an essential part of the economic development process. It should be managed sensibly but it would be a delusion to believe it can, or indeed should, be removed altogether.

69. The Bank has been very aware of these trade-offs in developing its approach to banking supervision. Its primary concerns are to protect the depositors of banks and to maintain stability in the banking and financial system. Underpinning its approach is a belief that the main responsibility for the prudent conduct of a bank's operations rests with the board and management of that bank. It has developed a set of general guidelines against which to assess a bank's operations and, through statistical collections, consultations and continuous assessment of banks' risk management systems, it monitors each bank's performance. Banks' external auditors report to the Bank on each bank's observance of the prudential guidelines, and on whether its management systems are effective, its statistical reports are reliable, and statutory requirements have been met.

(b) The supervisory framework

70. Specific elements of the bank supervision framework relate to:

- minimum capital requirements;
- liquidity management;
- large credit exposures;
- associations with non-bank financial institutions;
- ownership of banks.

These are detailed in a set of publicly available Prudential Statements, a copy of which is being supplied to the Committee together with this Submission.

(c) Protection of depositors

71. An element of the Reserve Bank's role which is not always well understood relates to the protection of bank depositors. Some see this as a guarantee that a bank will never fail or that a depositor will never lose money kept in a bank account. That is not the case. The Reserve Bank does not guarantee bank deposits[5]; the Bank uses its powers to protect the interests of depositors, i.e. to minimise the risk that they could be subject to loss.

72. In most countries, it is usually the case that bank deposits rank towards the lowest-risk end of the risk spectrum. That is also the case in Australia and banks pay certain costs for being in that position. They are required to hold at least 1 per cent of their total Australian dollar assets in Australia in low-interest deposits with the Reserve Bank; they must hold another 6 per cent in "prime assets", i.e. cash and Commonwealth Government securities; and they must meet the capital requirements and other prudential guidelines mentioned earlier.

73. These various arrangements do not save banks from making bad loans or suffering losses. Rather, they are designed to minimise the possibility that such bad loans or losses will put the banks themselves or their depositors' funds at risk.

74. If a bank authorised under the Banking Act were to get into serious difficulty, the Reserve Bank has very wide powers which go beyond the provision of liquidity support and the conduct of a thorough investigation of the bank's position: if necessary, it could assume control of the bank and manage it in the interests of the depositors, perhaps pending a merger with another, stronger bank. If a bank was unable to meet its obligations, the Banking Act stipulates that its assets within Australia should be used first to "meet that bank's deposit liabilities in Australia in priority to all other liabilities of the bank". This preferred position of their depositors makes banks unique among Australian financial institutions.

75. It is the total package of arrangements - the supervisory oversight of the Reserve Bank, the access to the Reserve Bank for liquidity support and the protective provisions of the Banking Act - that gives bank deposits their status as an especially low risk haven for savings.

76. Every efficient financial system requires that a spectrum of risk be available to savers and investors, with expected returns broadly consistent with the degree of risk involved. To seek to offset those risks by official intervention, e.g. through officially sponsored deposit insurance arrangements, involves a degree of moral hazard and some aspects of the S&L problems in the USA illustrate the potential dangers in this. Such schemes risk reducing the onus on managers and directors to act prudently, and on depositors and investors to weigh risk sensibly. They can also encourage governments to accept responsibilities which rightly should be shared between depositors and the managers of their funds.

77. Nonetheless, it is appropriate that there should be a safety haven for small investors, a role traditionally filled by banks. The need to maintain a stable and dependable position in domestic and international payments arrangements gives further support to the case for putting banks in a special category for prudential policy and for depositor protection.

5. The Commonwealth Bank's liabilities are guaranteed by the Commonwealth Government, while State banks carry a State Government guarantee.

APPENDIX 1

CHANGES TO BANK REGULATIONS

This appendix outlines:

(1) major regulations affecting banks in 1968;
(2) subsequent significant changes to these regulations.

Regulations in 1968

The powers given to the Reserve Bank (RBA) under the Banking Act (1959) were extensively used to control the activities of the trading and savings banks.

Savings Banks

Savings banks were required to invest:

- 100 per cent of depositors' funds in cash, deposits with the Reserve Bank, deposits with and loans to other banks, securities issued or loans guaranteed by the Commonwealth or a State, securities issued or guaranteed by an authority constituted by or under an Act, housing loans or other loans on the security of land and secured loans to authorised money market dealers ("specified" assets);
- at least 65 per cent of depositors' funds in cash, Reserve Bank deposits, Commonwealth or State Government securities and securities issued or guaranteed by Commonwealth or State Government authorities ("prescribed"assets); and
- at least 10 per cent of depositors' funds in deposits with the Reserve Bank, Treasury notes and Treasury bills ("liquid" assets).

Savings bank deposit rates were fixed, personal loan rates were subject to the same maximum as trading bank personal loans, and housing loan rates were subject to the maximum rate on trading bank overdrafts. There was a restriction of $10,000 on the maximum interest-bearing amount in any single deposit, and no deposits could be accepted from trading or profit-making bodies.

Trading Banks

Trading banks were subject to the SRD ratio, which required a percentage of Australian dollar deposits to be kept in SRD accounts with the Reserve Bank. The percentage could be varied as a monetary policy tool. The interest payable on these accounts was generally substantially below market rates (and was 0.75 per cent in 1968).[1]

The major trading banks were parties to the LGS convention, which provided for 18 per cent[2] of depositors' balances to be kept in liquid assets, comprising notes and coin and deposits with the Reserve Bank (excluding SRDs), and/or Treasury notes and other Commonwealth Government securities. The other trading banks also had agreements with the RBA to hold certain minimum liquid assets.

Deposits and loans were subject to maximum interest rates and fixed deposits were subject to minimum maturities of 3 months and maximum maturities of 2 years. Banks could accept large fixed deposits (of $100,000 and over) for periods of 30 days to 3 months, subject to a maximum rate.

Term and farm loan funds were set up, partly funded by the banks and partly from the SRD accounts. Term loan funds could be used for fixed-term lending to the rural, industrial and commercial fields, and to finance exports. The loans were subject to a minimum term of 3 years and a maximum term of 8 years. Farm development loans were made for development purposes to rural producers and were subject to a maximum term of 15 years.

Quantitative Controls

Since the early 1960s, the RBA had used quantitative controls on bank lending in its monetary policy. Initially, gross new trading bank approvals were subject to RBA guidelines, with net new approvals being subject to controls in later periods. In the late 1970s and early 1980s, growth in trading bank total advances was subject to control.

1. The SRD ratio was adjusted frequently over the period 1968 to 1981 and ranged between 3 and 10 per cent. The ratio was last used as a tool of monetary policy on 6 January 1981, when it was increased to 7 per cent. Changes to the SRD ratio are set out in Table C.5 in the Reserve Bank Bulletin.
2. Except between February 1976 and April 1977, when it was 23 per cent.

Major changes since 1968

1968

May	Banks were given approval to undertake lease financing outside the maximum overdraft arrangements.

1969

March	Approval was given for banks to issue certificates of deposit over terms of three months to two years, for amounts over $50,000, subject to a maximum interest rate. Savings banks were allowed to introduce progressive savings accounts at interest rates up to 1 per cent higher than ordinary deposit accounts. The maximum amount on which interest could be paid was set at $10,000.
December	Savings banks were allowed to offer investment accounts, subject to a minimum balance of $500, minimum transactions of $100, three months notice of withdrawal, and a maximum interest rate.

1970

March	Savings bank deposit rates could be varied subject to the maximum rate set by the Reserve Bank.
April	The maximum interest-bearing amount in any single savings bank account was increased from $10,000 to $20,000.
October	The savings bank prescribed asset ratio was reduced from 65 per cent to 60 per cent.
December	The maximum term on trading bank fixed deposits was increased from two to four years.

1971

August	The minimum balance on savings bank investment accounts was reduced from $500 to $100 and the minimum transaction requirement was dropped. Banks were permitted to trade as principals in foreign exchange, subject to the requirement that they clear their net positions with the Reserve Bank each day (previously, they had traded as agents for the Reserve Bank).

1972

February	The maximum interest rate on overdrafts and housing loans over $50,000 was removed, and interest rates on these larger loans became a matter for negotiation between banks and their customers. Trading banks were given increased freedom to negotiate interest rates on deposits greater than $50,000, subject to a maximum rate, for terms between 30 days and four years.

1973

April	The interest-bearing limit on savings bank investment accounts was lifted from $20,000 to $50,000.
September	The interest rate ceiling on certificates of deposit was removed, and the maximum term was extended from two to four years.

1974	
March	The interest-bearing limit on savings bank ordinary and investment accounts was lifted, and the 3-month notice requirement replaced by one month's notice, after a 3-month minimum term.
September	The savings bank prescribed asset ratio was reduced to 50 per cent, and the liquid assets ratio cut to 7.5 per cent.
1975	
January	The agreement between banks to maintain a uniform fee structure was discontinued, as it was contrary to the Trade Practices Act.
1976	
February	The maximum overdraft and housing loan interest rates were extended to loans drawn under limits of less than $100,000.
November	The interest rate payable on SRDs was increased to 2.5 per cent.
1977	
May	The savings bank prescribed asset ratio was reduced to 45 per cent.
1978	
August	The savings bank prescribed asset ratio was reduced to 40 per cent.
October	The three-month initial notice requirement on savings bank investment accounts was reduced to one month, and the minimum balance requirement was removed.
1979	
June	The trading banks began operating a foreign currency hedge market.
1980	
May	Banks could apply to the Reserve Bank to increase their equity in money market corporations to a maximum of 60 per cent.
December	Interest rate ceilings on all trading bank and savings bank deposits were removed.
1981	
August	The minimum term on certificates of deposit was reduced to 30 days.
November	Trading banks could offer line of credit facilities, comprising a limit to be drawn down at any time with a minimum monthly amount to be repaid; the interest rate to be subject to the maximum applying to personal loans for limits of less than $100,000.
1982	
March	The minimum term on trading bank fixed deposits was reduced from 30 to 14 days for amounts greater than $50,000, and from three months to 30 days for amounts less than $50,000. The minimum term for certificates of deposit was also reduced to 14 days.

Savings banks were allowed to accept fixed deposits less than $50,000 for terms between 30 days and 48 months.

The requirement of one month's notice of withdrawal on savings bank investment accounts was removed.

May — The interest rate payable on SRDs was increased to 5 per cent.

June — The Reserve Bank announced the ending of quantitative bank lending guidance.

August — Savings bank specified assets requirement was reduced to 94 per cent to allow a "free choice" tranche of 6 per cent.

The 40 per cent prescribed asset ratio and the 7.5 per cent liquid assets ratio for savings banks were replaced by the Reserve Assets Ratio (RAR). This ratio required 15 per cent of depositors' balances be held in RBA deposits, CGS and cash.

Savings banks were allowed to accept deposits of up to $100,000 from trading or profit making bodies.

1983

October — Changes to Australia's foreign exchange arrangements were announced:

- Settlement by the Reserve Bank of the net spot foreign exchange positions of banks would be on the basis of a $A/$US mid-rate announced at the end of each working day.
- The Reserve Bank removed outer limits on margins which apply to banks' dealings in spot foreign exchange in $US with their customers.
- The Reserve Bank withdrew from underwriting the official forward exchange market, and ceased quoting forward exchange rates.
- The Reserve Bank ceased to absorb the trading banks' net positions in forward exchange at the end of each working day.
- Greater freedom was given to trading banks to hold foreign exchange balances abroad and to borrow abroad for the purpose of matching their forward transactions and permission to hold limited "open" spot positions in foreign exchange.

December — The Australian dollar was floated, and most foreign exchange controls were removed. Banks were no longer required to clear their spot foreign exchange positions with the Reserve Bank each day.

1984

April — The Treasurer announced that the number of foreign exchange dealers would be increased by authorising non-bank financial institutions that met certain criteria.

June — Controls precluding banks from buying or selling forward exchange to cover non-trade-related risks were removed.

August — All remaining controls on bank deposits removed. This included the removal of minimum and maximum terms on trading and savings bank deposits, and removal of restrictions on the size of savings bank fixed deposits. This allowed banks to compete for overnight funds in the short-term money market.

	Savings banks were permitted to offer chequeing facilities on all accounts, and the $100,000 limit on deposits by a trading or profit making body was removed.
	The 60 per cent limit on banks' equity in merchant banks was lifted.
September	The Treasurer called for applications for new banking authorities.
1985	
February	Sixteen foreign banks were invited to accept banking authorities.
	The Reserve Bank published its general approach to prudential supervision and its framework for the supervision of the capital adequacy of banks.
April	The remaining ceilings on bank interest rates were removed, with the exception of owner-occupied housing loans under $100,000.
May	The Prime Assets Ratio (PAR) replaced the LGS convention. Twelve per cent of each bank's total liabilities in Australian dollars, (excluding shareholders' funds), within Australia, had to be held in prime assets, comprising notes and coin, balances with the Reserve Bank, Treasury notes and other Commonwealth Government securities, and loans to authorised money market dealers secured against CGS. Funds in SRDs up to 3 per cent of total deposits could also be included as prime assets.
November	Definition of PAR denominator extended.
1986	
April	The interest rate ceiling on new housing loans was removed. Existing loans remained subject to the previous maximum interest rate of 13.5 per cent.
	The Reserve Bank announced plans to establish links with banks' external auditors on prudential issues.
June	The Reserve Bank announced a more formal approach to supervision of banks' large credit exposures. This included regular reporting to the Reserve Bank of exposures to individual clients or groups of related clients above 10 per cent of shareholders' funds.
September	The Reserve Bank announced new guidelines for measurement of banks' capital adequacy. The definition of the capital base was widened and banks established before 1981 were asked to maintain minimum capital ratios in the vicinity of 6 per cent of total assets. Trading banks established in 1981 and afterwards continued to be required to observe a minimum capital ratio of 6.5 per cent during their formative years.
1987	
January	The Reserve Bank announced revised arrangements for the supervision of banks' large credit exposures. It asked each bank to give it prior notification of any intention to enter into exceptionally large exposures to an individual client or group of related clients.
April	The savings bank Reserve Asset Ratio was reduced to 13 per cent.

1988

August

The Reserve Bank issued guidelines for a risk-based measurement of banks' capital adequacy, broadly consistent with the proposals developed by the Basle Committee of Banking Supervisors.

The Treasurer foreshadowed the abolition of the SRD requirement and the removal of the distinction between trading and savings banks.

September

From 27 September the SRD ratio was reduced to zero, and the funds in SRD accounts transferred to "non-callable deposits". Subject to some transitional arrangements, all banks (trading and savings banks) would be required to hold in the form of non-callable deposits 1 per cent of their liabilities (excluding capital) which are invested in Australian dollar assets within Australia. The excess of the non-callable deposits over the minimum requirement would be returned to banks over a three-year period.

The distinction between savings and trading banks being unable to be totally removed without amendments to legislation, as an interim step, the "free choice" tranche of savings banks was increased from 6 to 40 per cent effective from 30 September.

PAR reduced from 12 to 10 per cent. Banking (Savings Banks) Regulations amended to permit PAR as it applies to trading banks to replace the savings bank Reserve Asset Ratio.

1989

August

The Reserve Bank issued revised guidelines for the supervision of banks' large credit exposures. Each bank was asked to report large exposures in terms of the consolidated group, rather than on a banking group basis.

September

The interest rate paid on non-callable deposits would be set monthly at 5 percentage points below the average yield at tender in the previous month on 13-week Treasury notes.

December

Changes to Banking Act gave the Reserve Bank explicit powers in respect of prudential supervision of banks; removed the distinction between trading and savings banks and formally replaced the Statutory Reserve Deposit requirement on trading banks with a non-callable deposit requirement applicable to all banks.

1990

February

The definition of PAR assets was amended to exclude the non-callable deposits of banks with the Reserve Bank. PAR reduced further, to 6 per cent by May 1990.

May

The Treasurer announced that the Government was not opposed, in principle, to a non-mutual life office owning a bank provided various criteria were satisfied.

June

From 30 June 1990, banks were required, for the purposes of assessing capital adequacy, to deduct from total capital their equity and other capital investments in non-consolidated subsidiaries or associates effectively controlled by the bank.

September

The Reserve Bank announced (with effect from September 1991) that, for the purposes of assessing capital adequacy, a bank's holdings of other banks' capital instruments (other than trading stock) should be deducted from the investing bank's total capital (and assets).

APPENDIX 2

AUSTRALIAN BANKS - 1980 to 1990

Banks Operating January 1980

Australia and New Zealand Banking Group
Australia and New Zealand Savings Bank

Australian Resources Development Bank

Bank of Adelaide
Bank of Adelaide Savings Bank

Bank of New South Wales
Bank of New South Wales Savings Bank

Bank of New Zealand
Bank of New Zealand Savings Bank

Bank of Queensland

Banque Nationale de Paris

Commercial Bank of Australia
Commercial Savings Bank of Australia

Commercial Banking Company of Sydney
CBC Savings Bank

Commonwealth Trading Bank of Australia (June 1984 renamed Commonwealth Bank of Australia)
Commonwealth Savings Bank of Australia
Commonwealth Development Bank of Australia

Hobart Savings Bank (trading as The Savings Bank of Tasmania)

Launceston Bank for Savings

National Bank of Australasia
National Bank Savings Bank

Primary Industry Bank of Australia

Rural Bank of New South Wales (November 1981 renamed State Bank of New South Wales)

The Rural and Industries Bank of Western Australia

Savings Bank of South Australia

The State Bank of South Australia

State Savings Bank of Victoria (December 1980 renamed State Bank of Victoria)

Changes In Bank Participants Since 1980

Year	Bank (a) Entry	Bank Merger, Takeover
October 1980		Bank of Adelaide merged with Australia and New Zealand Banking Group.
February 1981	Australian Bank.	
October 1981		Bank of New South Wales merged with Commercial Bank of Australia to form Westpac Banking Corporation (fully integrated October 1982). National Bank of Australasia merged with Commercial Banking Company of Sydney (name subsequently changed to National Australia Bank). (Fully integrated January 1983).
September 1983	Bank of Queensland Savings Bank.	
July 1984		The State Bank of South Australia merged with the Savings Bank of South Australia to become State Bank of South Australia.
February 1985	Macquarie Bank.	
June 1985	Advance Bank (formerly NSW Permanent Building Society).	
September 1985	CHASE AMP Bank.	
October 1985	Lloyds Bank NZA.	
November 1985	Bank of Tokyo Australia, Barclays Bank Australia.	
December 1985	IBJ Australia Bank, Citibank and Citibank Savings, Bank of China.	
January 1986	Mitsubishi Bank of Australia.	
February 1986	Deutsche Bank Australia, NatWest Australia Bank, Hongkong Bank of Australia, Bankers Trust Australia, National Mutual Royal Bank and National Mutual Royal Savings Bank.	

April 1986	Standard Chartered Bank Australia.	
May 1986	Bank of America Australia, Bank of Singapore (Australia).	
June 1986	Civic Advance Bank (formerly Civic Co-operative Permanent Building Society (ACT)).	
March 1987	National Mutual Royal Savings Bank (NSW) (formerly United Permanent Building Society).	
April 1987	Challenge Bank (formed from Perth Building Society and Hotham Permanent Building Society).	
June 1987		Primary Industry Bank of Australia became a subsidiary of The Rural and Industries Bank of Western Australia.
September 1987	Tasmania Bank (established under State legislation by merger of Launceston Bank for Savings and Tasmanian Permanent Building Society).	
December 1987		National Mutual Royal Savings Bank (NSW) merged with National Mutual Royal Savings Bank.
July 1988	Metway Bank (formerly Metropolitan Permanent Building Society).	
February 1989		State Bank of Victoria acquired Australian Bank.
July 1989	Bank of Melbourne (formerly RESI Statewide Building Society).	
October 1989		Australian Resources Development Bank acquired by National Australia Bank.
April 1990		Australia and New Zealand Banking Group acquired National Mutual Royal Bank.
August 1990		Civic Advance Bank changed its name to Canberra Advance Bank following acquisition of Canberra Building Society.

(a) Commenced operations.

January 1991	Commonwealth Bank of Australia merged with State Bank of Victoria. Commonwealth Development Bank converted by legislation to a subsidiary of Commonwealth Bank of Australia.

BANKS OPERATING 30 JUNE 1990: TOTAL ASSETS (a)
$ million

Bank	
Advance Bank Australia	5654
Civic Advance Bank	673
Australia and New Zealand Banking Group	42437
Australia and New Zealand Savings Bank	6669
National Mutual Royal Bank	2387
National Mutual Royal Savings Bank	2446
Bank of America Australia	815
Bank of China	172
Bank of Melbourne	3695
Bank of New Zealand	2398
Bank of New Zealand Savings Bank	78
Bank of Queensland	405
Bank of Queensland Savings Bank	453
Bank of Singapore (Australia)	543
Bank of Tokyo Australia	825
Bankers Trust Australia	1980
Banque Nationale de Paris	1964
Barclays Bank Australia	2288
Challenge Bank	3299
CHASE AMP Bank	3414
Citibank	4810
Citibank Savings	2961
Commonwealth Bank of Australia	31032
Commonwealth Savings Bank	20059
Commonwealth Development Bank (b)	2399
State Bank of Victoria (c)	20048
Australian Bank	278
Deutsche Bank Australia	1655
Hongkong Bank of Australia	2980
IBJ Australia Bank	1057
Lloyds Bank NZA	1018
Macquarie Bank	1726
Metway Bank	2037
Mitsubishi Bank of Australia	1120

National Australia Bank	40839
National Australia Savings Bank	9912
Australian Resources Development Bank	194
NatWest Australia Bank	2812
The Rural and Industries Bank of Western Australia	6855
Primary Industry Bank of Australia	1206
S.B.T. Bank(d)	656
Standard Chartered Bank Australia	764
State Bank of New South Wales	14743
State Bank of South Australia	12273
Tasmania Bank	878
Westpac Banking Corporation	45629
Westpac Savings Bank	13314
TOTAL	325850

(a) Average weekly figures for assets on Australian books.
(b) Converted under legislation to a subsidiary of Commonwealth Bank of Australia from 1 January 1991.
(c) Merged with Commonwealth Bank of Australia from 1 January 1991.
(d) Formerly trading as Savings Bank of Tasmania.

APPENDIX 3

FOREIGN BANK PARTICIPATION IN AUSTRALIAN BANKING AND FINANCE, DECEMBER 1990

Foreign Bank Owners of Australian Bank Subsidiaries*

BankAmerica Corporation
Bank of China (branch)
Bank of New Zealand (branch)
Oversea - Chinese Banking Corporation
The Bank of Tokyo
Bankers Trust New York Corporation
Banque Nationale de Paris (branch)
Barclays
The Chase Manhattan Bank (50% owner of Chase AMP Bank Ltd)
Citicorp
Deutsche Bank
The HongKong and Shanghai Banking Corporation
The Industrial Bank of Japan
Lloyds Bank
The Mitsubishi Bank
National Westminster Bank
Standard Chartered

* Three banks (indicated) operate as branches.

Foreign Banks that Fully and Directly Own Companies Registered Under the Financial Corporations Act*

Allied Irish Banks
Algemene Bank Nederland
Amsterdam-Rotterdam Bank
Arab Bank
Bank Brussels Lambert
Bank of Credit and Commerce International
The Bank of New York
Banque Indosuez
Canadian Imperial Bank of Commerce
CoreStates Bank
Credit Commercial de France
Credit Lyonnais
Credit Suisse
The Dai-Ichi Kangyo Bank
The Daiwa Bank
Dresdner Bank
The First National Bank of Chicago
The Fuji Bank
Habib Bank
Hambros
Hanil Bank
The Hokkaido Takushoku Bank
The International Commercial Bank of China
Korea Exchange Bank
Kuwait Asia Bank
The Kyowa Bank
The Long-Term Credit Bank of Japan
Manufacturers Hanover Trust Company
Midland Bank
The Mitsubishi Trust & Banking Corporation
The Mitsui Taiyo Kobe Bank
The Mitsui Trust & Banking Company
Monte dei Paschi di Siena
Morgan Guaranty Trust Company of New York
NCNB National Bank of North Carolina
The Nippon Credit Bank
NM Rothschild & Sons
NZI Bank
Overseas Union Bank
Pittsburgh National Bank
The Saitama Bank
The Sanwa Bank
Schroders
Security Pacific National Bank
Skandinaviska Enskilda Banken
Societe Generale
The Sumitomo Bank
The Sumitomo Trust & Banking Company
Svenska Handelsbanken
Swiss Bank Corporation
The Tokai Bank
The Toronto-Dominion Bank
The Toyo Trust & Banking Company
Union Bank of Switzerland
United Overseas Bank
The Yasuda Trust & Banking Company

* Some other registered financial corporations are partly owned by foreign banks. Some other financial institutions e.g. stock brokers, funds managers, etc. are also wholly or partly owned by foreign banks.

Foreign Banks with Representative Offices in Australia*

Agricultural Bank of Greece
Banca Commerciale Italiana
Banca Nazionale del Lavoro
Banco di Roma
Banco Espanol de Credito
Banco Santander
Banco Santander Argentina

Banco Santander Chile
Banco Santander Uruguay
Bankinvest
Bank Leumi Le-Israel
Bank of Credit and Commerce International
Bank of Cyprus
Bank of Montreal
The Bank of Nova Scotia
Bank of New York
The Bank of Tokyo
Bank of Valletta
Banque Francaise du Commerce Exterieur
Banque Indosuez
Banque Worms
Berliner Handels-und Frankfurter Bank
Chase Manhattan Overseas Corporation
Christiania Bank og Kreditkasse
The Chuo Trust and Banking Company
CIC - Union Europeenne International et Cie
Commerzbank
CoreStates Bank (operating in Australia as Philadelphia National Bank)
Credito Italiano
Credit Suisse
Credit Suisse First Boston
Cyprus Popular Bank
The Dai-Ichi Kangyo Bank
The Daiwa Bank
DG Bank (Switzerland)
Deutsche Bank Asia (Singapore branch)
Dresdner Bank
The Export-Import Bank of Japan
First Austrian Bank
First Interstate Bank of California
The First National Bank of Chicago
The Fuji Bank
Girozentrale und Bank der Osterreichischen Sparkassen
Habib Bank
The Hokkaido Takushoku Bank
The Industrial Bank of Japan
Korea First Bank
Kredietbank
Kredietbank Luxembourgeoise
The Kyowa Bank
Lippo Bank
The Long-Term Credit Bank of Japan
Manufacturers Hanover
Manufacturers Hanover Trust Company
Mellon Bank
The Mitsubishi Bank
The Mitsubishi Trust and Banking Corporation
The Mitsui Taiyo Kobe Bank
The Mitsui Trust and Banking Company
Monte dei Paschi di Siena
National Bank of Abu Dhabi
National Bank of Greece
National Mortgage Bank of Greece
NCNB National Bank of North Carolina
The Nippon Credit Bank
Overseas Union Bank
Rabobank Nederland
Royal Bank of Canada
Royal Bank of Scotland
The Saitama Bank
San Paolo Bank (Istituto Bancario San Paolo Di Torino)
The Sanwa Bank
Stopanska Banka Skopje
The Sumitomo Bank
The Sumitomo Trust & Banking Company
Swiss Bank Corporation
Swiss Bank Corporation International
The Tokai Bank
The Toyo Trust and Banking Company
Westdeutsche Landesbank Girozentrale
The Yasuda Trust and Banking Company

* Of the banks with representative offices in Australia -

51 have offices in Sydney only;
10 have offices in Melbourne only;
19 have offices in Sydney and Melbourne; and
1 has offices in Sydney, Melbourne and Adelaide.
Some banks operate joint representative offices.