

Deloitte Access Economics

# Competition in retail banking

Australian Bankers'  
Association Inc.

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# Glossary

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ABA	Australian Bankers' Association
ABACUS	Association of Building Societies and Credit Unions
ACCC	Australian Competition and Consumer Commission
ADI	Authorised deposit-taking institution
AFR	Australian Financial Review
APRA	Australian Prudential Regulation Authority
ATM	Automatic Teller Machine
BBSW	Bank Bill Swap Rate
BIS	Bank for International Settlements
CIE	Centre for International Economics
COBA	Customer Owned Banking Association
CR	Concentration ratio
CUBS	Credit unions and building societies
DAE	Deloitte Access Economics
GDP	Gross Domestic Product
GFC	Global Financial Crisis
HHI	Herfindahl-Hirschman Index
NFC	Near-Field Communications
NIM	Net interest margin
OECD	Organisation for Economic Co-operation and Development
RBA	Reserve Bank of Australia
RMBS	Residential mortgage backed securities
SMH	Sydney Morning Herald

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# Executive Summary

The Australian economy has prospered over the last quarter of a century. In part, this can be attributed to the robustness and competitiveness of its financial system. Both of these factors have contributed towards improving consumer welfare.

The Global Financial Crisis (GFC) recently has disrupted the financial system, including retail banking. In particular, it has led to changes in the dynamics that influence the competitive environment arising from two main areas:

- international institutions adopting less aggressive strategies or withdrawing from the Australian banking industry as a result of developments overseas; and
- deterioration of securitisation markets, both in price and volume.

The GFC led to:

- a more risk-averse approach by investors, bankers and regulators; and
- some consolidation in retail banking through withdrawals, mergers and acquisitions.

Against this background, the Australian Bankers' Association (ABA) has commissioned Deloitte Access Economics (DAE) to undertake an independent review of the state of competition in the Australian retail banking sector (defined in this report as individual consumer's banking, excluding small business and farmers). If competition is operating well, this will deliver benefits to consumers and the economy more broadly, as it will drive efficiencies, lower prices and encourage innovation and choice.

There can be a trade-off between efficiency and stability. Policy makers have focused on supporting stability in recent years. There is now an opportunity for policy makers to consider whether competition could be improved further without undermining stability or creating distortions which have an adverse impact on the efficient functioning of the system.

Competition can take many forms. Financial institutions compete through many different means. Different business models will prevail in the market at various times, reflecting their strengths and weaknesses. As long as conditions allow different models to proliferate, there will be a competitive environment. For example, financial institutions of different sizes will have different advantages that allow them to compete effectively against each other.

The **cost of funds** is an important determinant of an organisation's ability to price competitively. Large banks have an advantage in securing funds in a cost effective manner as their credit ratings are higher than small banks on a stand-alone basis, and their ratings also benefit because they are deemed 'systemically important' and, as such, are believed to be more likely to receive government support in times of stress (Standard & Poors, 2012). However, there are differing views as to whether a systemically important bank would receive government support.

The reported **profits** of the major domestic banks have raised concerns about the effectiveness of competition in the sector. The performance of Australian banks since the GFC and global economic downturn has highlighted that they are well managed, and not excessively profitable.

*“Our assessment is that, if you look at the rates of return on equity in our banks over a lengthy period of time, say 20 years, they are good but they are actually broadly in line with the listed company sector in general in Australia. I do not think it is obvious from that comparison that they are in some sense excessively profitable.”*

- RBA Governor Glenn Stevens, 2012

There are a range of measures of competition. Guided by the Australian Competition and Consumer Commission (ACCC) merger assessment guidelines, we consider:

**Market concentration:** In transaction accounts, interest-bearing accounts, mortgages, personal loans and credit cards, the concentration ratios do not exceed ACCC thresholds. Thus, the level of concentration does not indicate any problems with competition despite the increase in concentration since the GFC.

**Barriers to entry:** Technology and globalisation have worked together to reduce the barriers to entry in all areas of retail banking in recent years, and are set to continue to do so in the future. Technology has reduced distribution costs, allowing low cost players to enter. Globalisation and policy changes have allowed overseas banks and non-banks to enter and compete aggressively.

However, some submissions to recent government inquiries have cited concerns that regulatory barriers could limit the level of competition in the market.

**Availability of substitutes:** There is a wide variety of products and suppliers in the Australian retail banking market. Recent policy changes and technology have made it easier to switch, both for individual products or bundles of products.

*“In the more subdued post-GFC credit environment, competition remains keen and considerable switching is occurring.”*

- Fraser, 2011

**Innovation and product differentiation:** Innovation in retail banking has taken a number of forms including using different distribution channels, different sources of funds and product innovation. Innovation has come from all parts of the markets. Along with the main incumbents, this has included, for example, innovation from non-ADI home lenders using capital markets to source funds, global banks using online distribution channels or non-financial institutions using technology to provide customers with new ways to access financial services (such as brokers or co-branding credit cards).

### **Implications for consumers**

Compared to overseas, Australians are well served by their retail banking system. Australians have some of the highest levels of access to banking services and customer satisfaction in the world:

- over 99% of Australians have an account at a formal financial institution;
- Australia’s banking system is one of the five least-risky in the world (Liondis, 2014); and

- Australian banks rank fourth in the world in providing a positive customer experience (Capgemini and Efma, 2013)

### **Looking to the future**

Based on the assessments of the level of concentration and market dynamics surveyed in this report, it can be concluded that there is no basis for serious concern about the level of competition in retail banking markets.

There will however be more benefits for consumers if more competition returns to the market. This can be expected as global markets and suppliers of funding continue to recover from the GFC. To date, the pace of this has been slower than expected and the extent of the recovery remains unclear. This has made it difficult for some participants, including those that have made extensive use of capital markets to fund their lending, to innovate and compete.

Yet, overall, the Australian banking system remains stable and competitive. Consequently, while it is appropriate for policy makers to review the competitive landscape, Australian consumers still have a very robust banking system by world standards, which continue to add to consumer welfare. This is illustrated by the ability of participants throughout the industry to develop and promptly adopt solutions using new technologies across the suite of retail banking products.



# 1 Introduction

Australia has prospered economically over the last quarter of a century. In a large part, this can be attributed to its robust and competitive financial system. Both of these factors have increased consumer welfare through improved efficiency and innovative products.

The retail banking industry in Australia is characterised by close competition between the major banks. Since the 1980s, competition has been further bolstered by smaller firms exerting significant competitive pressures.

Barriers to entry decreased following the financial deregulation of the 1980s and technological growth through the 1990s. This process allowed other authorised deposit-taking institutions (ADIs), foreign banks and niche players to more readily enter the retail market. Their competitiveness was also supported by the introduction and growth of new sources of funding – in particular, securitisation – through the 1980s and early 1990s (Australian Prudential Regulation Authority (APRA), 2000).

Competition within the sector led to positive outcomes for customers, including:

- more innovative product offerings and delivery channels;
- better value for money, as evidenced by decreasing net-interest margins from the 1980s through to the mid-2000s;
- improved access to credit, especially for groups such as first-home buyers and the self-employed;
- provision of no-cost and low-cost basic bank accounts; and
- extensive choice of products and providers.

The Global Financial Crisis (GFC) has disrupted the financial system, including retail banking. In particular, it has led to changes in the dynamics that influence the competitive environment arising from two main areas:

- international institutions adopting less aggressive strategies or withdrawing from the Australian banking industry as a result of developments overseas; and
- deterioration of securitisation markets, both in price and volume.

The GFC led to:

- a more risk-averse approach by investors, bankers and regulators; and
- some consolidation in retail banking through withdrawals, mergers and acquisitions.

Issues in global markets continue to have significant effects. Australian banks have been faced with some sources of funding being less available, and being offered at higher costs. In addition to intensified risk management, this has forced banks to restructure their funding arrangements and increased competition for deposits (Senate Economics References Committee, 2012). Higher funding costs have made it more difficult for players without sizeable balance sheets and/or strong reputations to compete as vigorously as before. These tightened conditions have led to consolidation within the market and the withdrawal of some players.

There is still close competition between the major banks. This is evident through the speed of their competitive response to price changes and technological developments (see Section 3.1). Other product markets and suppliers of funding have begun the process of recovery from the GFC. However, the pace of this has been slower than expected and the extent of the recovery remains unclear. This has led to discussion of whether regulatory intervention should be considered to enhance competition across the industry. In response to public concerns, the Government introduced the *Competitive and Sustainable Banking System Package*.

To assist public understanding of the level of competition that currently exists, the ABA has asked DAE to prepare a report examining the level of competition in retail banking in Australia. This report is not intended to serve as a comprehensive analysis. Rather, it considers key issues at a high level.

The report proceeds as follows. Chapter 2 discusses competition in the primary product markets in retail banking, as well as trends in competition in the retail banking sector more generally. It also explains that competitiveness is not the only important consideration for a financial system. It briefly discusses the importance of stability, and evidence on the trade-off between the two factors.

Chapter 3 explores the context of the retail banking sector in Australia. It considers some of the key trends which have shaped the industry in recent years. This includes discussion of changes in the cost of funds, and the extent to which this impacted on different parts of the industry. It discusses the profitability of Australian banks relative to those overseas and to other domestic industries.

Chapter 4 outlines the approach used by the Australian Competition and Consumer Commission (ACCC) to assess competition. It defines the relevant markets for retail banking products, and calculates concentration ratios, which are used as an initial indicator of the level of competition in the market. These are compared with other jurisdictions.

Chapter 5 contains a more detailed analysis of the most significant factors which contribute to the level of competition in retail banking. It concludes by discussing the value that the current system creates for consumers. Finally, it considers how competitive dynamics are likely to evolve in the future.

## 2 The role of competition

Competition is an important characteristic of a market, and drives better outcomes for consumers, such as lower prices and more choice. Competition for market share in retail banking, including from non-banks, improves consumer welfare through lower prices, more choice, better products and improved quality and access to services.

In the long term, consumer benefits are also crucially dependent on a stable and robust financial system.

### 2.1 Consumer welfare

Competition between suppliers is important to outcomes for consumers. The more competitive a market is, the more value producers must offer in order to attract consumers. These offerings can take a range of forms. In retail banking, this leads to a range of benefits:

*“The Committee believes competition is good. It should result in intermediation services being provided at low cost, finance being directed to where it can be best used and consumers and small business being able to access it on fair terms.”*

- Senate Economics Committee, 2011.

One of the ways in which producers seek to attract customers in a competitive market is through **lower prices**. By offering a similar product for a lower price, suppliers entice consumers to switch away from their existing provider. The ability to purchase the same goods for less has clear benefits for consumers. For example, in interest-bearing savings accounts, a depositor would benefit from being offered higher interest rates.

However, the willingness of customers to switch will depend on how sensitive they are to changes in price. In banking, consumers might be less willing to move to capture any gains because of the inconvenience of changing institutions. Their decision will also be influenced by switching costs. These issues are discussed in more detail in Section 5.2.

A competitive market offers consumers **more choices**. There are more suppliers and/or products available, allowing individuals to be more discerning and choose the products which are most appropriate to their needs. This is important in retail banking where some features are more important to some consumers than others. For instance, branch networks are important to some consumers, while others value comprehensive digital offerings more highly.

Competition also encourages **innovation** to retail existing customers and attract new ones. In a more competitive market, producers have more incentive to innovate. It provides them with the opportunity to differentiate their products, thus attracting a greater market share. This has benefits for consumers. Innovative products could be more convenient, cheaper and/or easier to use, thus creating more value. For example, recent competition in the

industry has led to the development of products such as mobile banking which increase accessibility and convenience for customers.

In retail banking, competition has also facilitated consumer **access to financial services**. In modern society, access to services can be very important. It can affect an individual's ability to purchase goods and services, access credit and even obtain employment. However, given the risks associated with some retail banking products, institutions may prefer not to provide products to all potential customers. Those who are least likely to be granted access to products are often the ones who are most disadvantaged.

Competition can drive wider accessibility, as well as industry and individual institutions' financial literacy initiatives. Institutions may seek to increase their market share by offering their services to a broader group of individuals. This can benefit those who are given access which they would not have otherwise been granted. For example, competition and innovation led to the creation of low-doc loans. This enabled more self-employed would-be homeowners to procure mortgages.

Competition is important. Ultimately, however, a market should be assessed by the level of benefits which flow to its users and consumers.

## 2.2 The stability/efficiency trade-off

As part of the broader financial system, stability is another desirable feature of retail banking. Ensuring the industry's overall stability is a key social and policy objective. The adverse consequences of financial instability to the wider economy were demonstrated through the GFC. As a result, stability has become a focal point for regulation at the expense of competition. However, there can be a trade-off between stability and competition.

*There is broad agreement among competition agencies from OECD countries that the purpose of competition policy is to protect competition, not competitors.*

- Organisation for Economic Co-operation and Development (OECD), 2011

Financial stability also is a key consideration for policy makers, especially in the wake of the GFC. Ian MacFarlane explained:

*"To some, the word 'stability' sounds unexciting, and probably more so if I use the term 'economic stability'. But stability is not just an economic concept; it has a profound impact on the lives of people. Instability can create havoc, damage institutions, and leave a legacy from which some families and nations will take many years to recover."*

- MacFarlane, 2006

Australia experienced considerably less financial instability than many countries in the GFC. Other factors – such as the Asian boom – played a part in this. The costs of financial instability ranged from triggering recessions to undermining confidence in the financial system. In the United States, for example, the GFC triggered a recession in which gross domestic product (GDP) fell 6%, and the unemployment rate almost doubled to 10.1%

during the crisis. The Federal Reserve Bank of Dallas estimated that the GFC cost the American economy between \$6-\$14 trillion and 40-90% of 2007 US output (Sheng, 2013). In 2013, despite economic recovery, actual GDP still was 4.6% lower than potential GDP (Center on Budget and Policy Priorities, 2014).

The research on the trade-off between these two characteristics can be distilled to:

- too much competition “reduces bank charter values and may increase incentives to take risks”. This does not imply, however, that low levels of competition are necessarily ideal – it “leads to inefficiencies and may add to the too-big-to-fail problem” (Ratnovski, 2013).

These two effects are reconciled at an “optimal” level of competition from a stability perspective. This occurs at a point where market concentration is neither too high nor too low.

The trade-off between competition and stability was summarised by the OECD:

*“Competition and stability can co-exist in the financial sector... the results of empirical studies linking competition and stability are ambiguous, however. Structural and non-structural measures of competition are found to be both positively and negatively associated with financial stability, depending on the country and the sample analysed and the measure of financial stability used.”*

- OECD, 2011

The retail banking industry in Australia has been subject to several shocks over recent years – in particular, the Asian Financial Crisis, GFC and the post-GFC effects. Despite this, the system has been praised for its overall resilience. This can be attributed to a number of factors: Australian banks are well managed, however, banking policy and strict prudential regulation have clearly played an important part.

There is general consensus that the regulatory focus on stability during the GFC was well founded and in the interests of the general population. However, with the crisis having passed (even if some of the effects linger), it is appropriate that this focus should be re-evaluated.

According to the Senate Economics Committee’s Inquiry in to Competition within the Australian banking sector:

*The Australian Government, like those overseas, placed greater emphasis on stability than competition during this period. As the effects of the GFC pass, and regulators respond to the lessons learned from it, competition has heated up for deposits but not yet for loans. The Committee believes the time has come to again place more emphasis on boosting competition... allowing the benefits of competition to emerge without such a loss of stability is the role of the authorities.”*

- Senate Economics Reference Committee, 2011

The OECD's report on Competition in Retail Banking and Financial Stability had this to say:

*Encouraging new entry may therefore be better achieved in the longer run by reducing regulatory barriers: for example, by removing unnecessarily anti-competitive regulation and making the entry process as easy and inexpensive as possible, especially in markets where mega mergers have been allowed as an emergency measure.*

- OECD, 2011

There can be a trade-off between efficiency and stability. Policy makers have focused on supporting stability in recent years. Post-GFC, there is an opportunity for policy makers to consider how to support competition. The challenge is to improve competition without undermining stability or creating distortions which have an adverse impact on the efficient functioning of the system.

# 3 Competition in retail banking in Australia

This chapter places the analysis of the current level of competition in retail banking in Australia in context.

Competition within an industry can take a number of forms. At a base level, firms compete in two ways – product and price. However, the exact nature and focus of this competition varies between industries. In retail banking, context is provided by examining business models, cost of funds and profitability.

## 3.1 Differing business models

In retail banking, competition to attract customers occurs through a number of means:

- price;
- product features;
- quality and access to services;
- innovative product offerings; and
- branding.

Between the larger banks, prices (i.e. interest rates, fees and charges) tend to be closely matched, with rate changes by one major quickly responded to by others (including smaller players). Over the last two years, for example, Reserve Bank of Australia (RBA) rate changes have been at least partly passed through by the four major banks in an average of nine days (DAE calculations based on media releases). This reflects how closely the competitors monitor each other and suggests competitive pricing. Given that the products tend to be matched on price, the major banks compete with each other by differentiating their products through other means (e.g. innovative products and quality of service).

Most small players price at a margin to majors and try to differentiate by service. Some smaller players may only focus on one product, as discussed below. Where this is the case, they tend to have lower overhead costs, e.g. because they have a less extensive physical presence to maintain. This is particularly true in some products which lend themselves well to online models, such as online savings accounts. Where institutions do operate these lower cost models, they may compete with the major banks on price. The major banks react to these competitive pressures by lowering their own prices to be in line with those charged by their competitors. The Wallis Committee noted that:

*“Regional banks have been an increasingly important competitive force in recent years. In particular, along with credit unions and building societies, they have led the way on service, innovation and pricing on some products.”*

- Wallis et al (1997)

Competition can take many forms. Financial institutions compete through many different means. Different business models will prevail in the market at various times, reflecting their strengths and weaknesses. As long as conditions allow different models to proliferate, there will be a competitive environment.

### 3.1.1 Price competition

As discussed above, retail banks in Australia compete on prices, with quick competitive responses between major banking competitors, and pressure exerted by niche players.

Analysis of competition tends to focus on price factors. This is partly because prices often are more easily observable and quantifiable than other indicators. In a more competitive market, prices charged to customers will be closer to the costs incurred by firms. The speed with which a firm reacts to price changes by competitors can also be an indicator of the level of competition. Depending on data availability, these dynamics can be formally tested using econometric or other modelling.

Price competition in financial services is clearly important to consumers, and a key element of competition between producers. However, in practice, measuring prices in banking – and thus, the level of price competition – is complicated:

- **products are bundled.** Many of the services offered by retail banking are complementary. Customers often value the convenience of centralised service. As such, individual institutions often offer bundled services to customers. This is generally coupled with bundled pricing. This can make it difficult to determine prices for single products within the bundle.
- **there are two-sided markets.** Banks are intermediaries between borrowers and depositors. Individual institutions have different models, under which costs may be recovered from depositors, borrowers, or a mixture of the two. On the other hand, some institutions only act on one side of the market, such as acquirers of credit card payments. Net interest margins are often used as a price measure which accounts for these factors. However, in practice, competition in retail banking is often assessed on a product market basis, where only a single rate applies. As such, higher prices in a given market might not, in and of itself, reflect less competition.

Even when banks and other lenders compete on price in a pure product, it can be difficult to determine the actual price charged. Standard published rates and fees can differ from those actually charged. Banks typically discount advertised standard variable mortgage rates by 50-70 bps for preferred (lower risk) customers. Similarly, promotions or differing non-price terms may not be captured in data.

Australian banks compete on price terms, quickly reacting to movements by competitors. In practice, it is difficult to assess price competition in individual product markets due to bundling and the two-sided nature of banking products.



### 3.1.2 Non-price competition

The retail banking industry in Australia competes on a number of non-price factors, including:

- product features;
- quality and access to services;
- innovative product offerings; and
- branding.

#### 3.1.2.1 Product features

The features of product or sets of products on offer can attract customers to a specific institution. Product differentiation can also allow financial intermediaries to charge a premium to reflect the additional value customers gain.

Traditionally, one method that Australian banks have used to differentiate their products is through **bundling**. Many banking products are complementary. For example, a consumer will tend to get more value from a transaction account if it is linked with an interest-bearing savings account. By providing bundled goods, banks are able to provide more value to consumers by reducing their internal duplication and administration costs.

Many of the major banks offer bundled products to their clients. This is in keeping with their business models, which focus on comprehensive service offerings. The business rationale for selling bundled goods in retail banking has three main elements:

- customers value the complementary products;
- where customers have differing or diverging valuations for various products (for example, households who have mortgages are likely to value interest-bearing savings accounts less), bundling allows firms to gain more of the customer's business; and
- it allows for cross-subsidisation between products.

Other institutions have focused on selling individual products. Of the more recent entrants to the market, many have initially sold only one or two retail banking products, for example interest-bearing savings accounts and mortgages, such as NAB's UBank. The new entrants begin by making the features of one of these products attractive (either on price or non-price terms) relative to other players. This is sustainable in the long term if these players operate at a lower cost than full-service banks and other competitors.

#### 3.1.2.2 Quality and access to services

Banks compete on service. This is particularly the case for smaller ADIs and non-banks that are not able to compete on price. Customer satisfaction surveys, such as Roy Morgan's monthly report *Customer Satisfaction – Consumer Banking in Australia* show that credit unions and building societies (CUBS) and smaller banks consistently outperform their major bank competitors in customer satisfaction. However, the surveys also show that banks are responding, raising the quality of their service, resulting in steadily increasing their satisfaction rating from around 60% to 80% in the decade to 2012, while the CUBS have maintained a 90% satisfaction rating.

For some retail banking products – particularly transaction accounts – consumers value the ability to conveniently interact with their financial institutions. This interaction may take many forms, such as via mobile apps, telephone, internet banking and face-to-face branch interaction. Consumer preferences over these are idiosyncratic. As such, institutions may compete by offering multiple platforms for interaction or prioritising one mode over others.

In transaction accounts in particular, physical presence, including ATM access is particularly important to consumers (ACCC, 2008). This is because consumers currently can only access cash in person and the use of other bank facilities, e.g. credit cards, for this purpose often incurs an additional cost. Banks compete with each other by providing these facilities in locations which are convenient to their customers. However, the importance of this has declined in recent times, due to technological advances. This is discussed in greater detail in Section 5.1.

A second element of providing access to services is producer willingness to supply. In most products, suppliers are indifferent as to the nature of their customers. Firms tend to sell indiscriminately to all willing customers so as to maximize revenues, and ultimately profits.

Retail banking products are unusual in that this is not the case. Most banking products involve the banks taking on risks. The levels of risk involved vary according to the characteristics of a particular customer. As such, banks may choose not to provide services in some cases.

Given the importance of retail banking products to facilitating purchases and financial inclusion, access to finance can be very important to individuals. This could be particularly true for those who might be considered high risk. For example, lower income individuals could value credit cards or personal loans very highly.

One means of competing in retail banking products is the level of access provided. Some institutions differentiate themselves by focusing on providing more exclusive products to higher net-worth customers with minimal risk. For example, this could include discounted mortgages. Others may differentiate themselves by offering their products to those who may not otherwise be able to access credit. Innovations in this field include, for example, low-deposit mortgages. These offerings are supported by products such as lenders mortgage insurance and funding from securitisation. This is explored in more detail in Section 5.3.

### **3.1.2.3 Innovative product offerings**

Product differentiation can be an important method for producers of largely homogenous products to make themselves “different from the pack”, thus enticing more consumers. In recent years, innovation – particularly in technological offerings – has been a key aspect of this in retail banking.

Some institutions’ business models revolve around competing for consumers by seeking to be innovation leaders in the market place. The aim of this strategy is to create products and/or services which are valuable to consumers and sufficiently differentiated. In doing so, innovation leaders seek to capture new customers from competitors who do not offer the same products.

These leaders may obtain a “first-mover advantage”. Successful innovation may be attractive to customers, and it may be difficult for competitors to quickly develop similar offerings. This allows an innovative firm to quickly capture increased market share.

However, over time, innovations will be diffused, as other institutions leverage the available knowledge to meet the new consumer expectations. In order to retain their advantage, financial institutions operating under this model may need to:

- develop means of deploying these innovations at a lower cost;
- continually innovate; and/or
- put other measures in place to encourage retention of their customers.

As noted above, a key source of innovative models in retail banking in recent years has revolved around technological advances. This is because digital offerings have intrinsic value to consumers, as well as the potential to reduce bank operating costs. Consumers of retail banking products value the “anytime, anywhere” convenience offered by digital technologies. For financial institutions, it can mean a reduced reliance on labour and physical presence, as well as greater efficiencies.

Some institutions compete for consumers by seeking to be digital leaders in the market place, offering customers early access to new technologies. Historically in Australia, these players have tended to be foreign banks or niche players. For example, ING Direct, a foreign pure-play internet bank, was credited as being the first to allow customers to establish an account without the need to attend a branch or fill out physical paper-work in Australia. As noted in the House of Representatives report on competition in the banking and non-banking sectors:

*“The Australian Bankers’ Association (ABA) agreed that foreign banks and the non-banking sector forced the banks to ‘accept reduced margins and to roll out new technology and new products, and to otherwise respond to competitive pressures.’”*

*- House of Representatives Standing Committee on Economics, 2008*

However, major domestic banks are also sources of innovation. Examples include:

- the CBA’s recent developments of Facebook-based banking and NFC-based POS payments;
- The announcement of mobile contactless payment by Westpac in December 2013;
- ANZ have also unveiled several such services, this includes Fastpay™ and goMoney™;
- NAB’s first ‘smart store’ in Docklands, incorporating a number of intelligent self-service machines that interact with customers and their mobile devices to deliver the next-gen banking experience.

Innovation as a source of competition is discussed in more detail in Section 5.3.

However, initially establishing these offerings can be challenging and expensive, especially in retail banking products, where there is a high degree of regulation, extensive networks are often required and information security is particularly important. There is also a degree of risk which is inherently imbedded in designing and selling innovative products, given that

they may not have been commercially tested and consumer appetite cannot be guaranteed.

#### 3.1.2.4 Branding

Another method which has been widely used to differentiate competing products in the Australian retail banking market is branding and marketing. This is an important means of attracting and retaining customers.

Trust in their bank is important to customers. Hence, a key aspect of branding is developing a reputation for stability, security and reliability. Well-known incumbents tend to have an advantage in this field.

Financial institutions can also use innovative marketing and branding to compete with others. This can include:

- discounting (e.g. ING Direct);
- re-branding or establishing a new brand (e.g. a “no-frills” subsidiary such as NAB’s UBank);
- campaigns in non-traditional mediums (e.g. CBA’s “Can” campaign); and
- targeted marketing through the use of data analytics (e.g. Wesfarmers credit cards).

Retail banking products have also been characterised by differing levels of disaggregation. Some institutions have integrated models, where the bank itself conducts end-to-end sales (i.e. product origination, distribution and management is all contained internally). The major banks are primary examples of this. Other organisations, such as credit unions, have adapted segregated models, under which parts of the process are contracted externally. For example, in mortgage products, mortgage brokers can be used for distribution, while aggregators and security dealers can be involved in packaging and managing risks off the originator’s balance sheet.

The availability of these different forms of models allows financial institutions of various sizes to compete, by providing a means for mitigating the importance of scale. It also creates more areas for competition; e.g. there could be competition between brokers, and competition between institutions for alliances with brokers.

#### 3.1.3 Impact of regulation

Regulation affects bank structure and the activities banks can undertake. For example, responsible lending obligations prevent lending to some individuals who request loans, and prudential regulation (higher capital requirements) limits the attractiveness of more risky loans.

There is competition between APRA-regulated entities and other financial intermediaries (so-called shadow banking); regulation influences the level of shadow banking activity.

*“Increased capital and liquidity standards for depository institutions and insurance companies will likely heighten the returns to shadow banking activity.”*

- Pozsar et al, 2010

## 3.2 The cost of funds

Supply costs – in particular, the cost of funds – can be a significant determinant of the ability of any given player to compete effectively. If an institution faces relatively higher costs, they may not be able to price their products attractively.

There are several different sources of funds. The relative costs vary over time, according to factors such as:

- fluctuations in the business cycle;
- risk appetites;
- the availability of credit; and
- international developments.

Given that funding arrangements differ between institutions, variations in costs over time can influence the competitiveness of any given business model. It is important to consider the composition of funding sources – how these have changed over time, and how they vary between institution types and the causes of this variation.

Chart 3.1 shows how sources of funding have changed over time – particularly following the GFC. One of the key trends over the period has been an increased reliance on deposit funding.

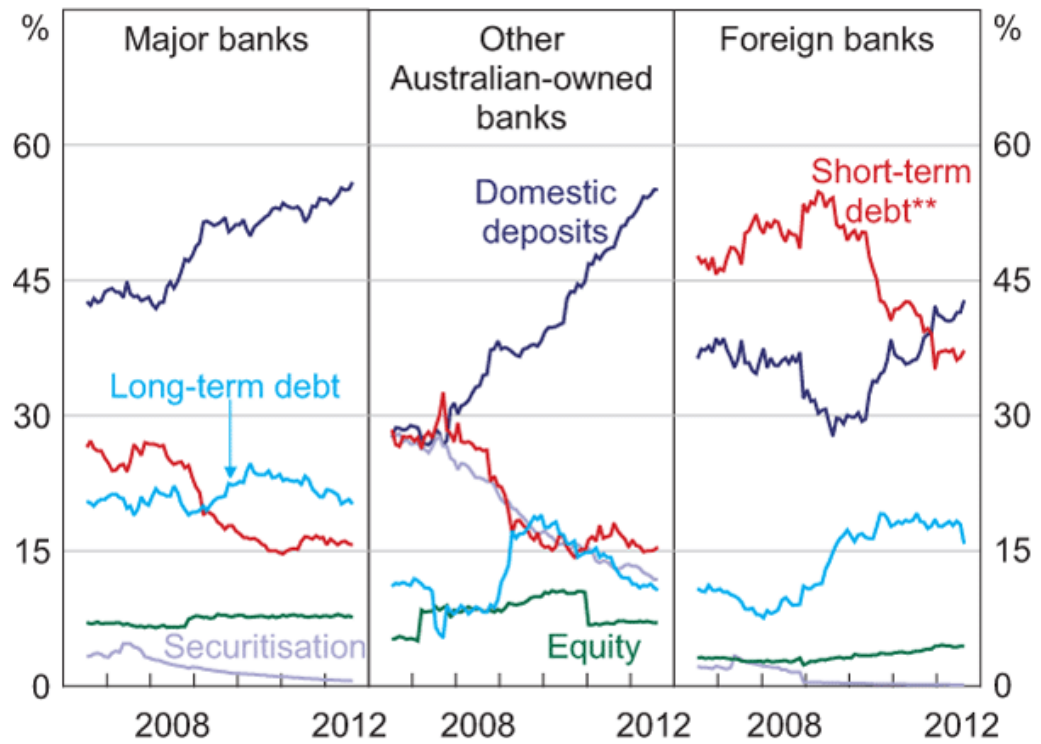
The greater importance of deposit funding has been reflected in a decline in the use of other sources – in particular, short-term debt and securitisation. This can be attributed to increased costs of obtaining some types of external funding, including through regulatory change. New regulatory standards such as the forthcoming Basel III liquidity requirements also have played a role in this shift.

Chart 3.1 illustrates how different types of institutions rely on different modes of funding. It illustrates that, whilst all banks operating in Australia are reliant on deposits, the extent of this reliance has changed in recent years:

- **non-major banks** have become much more dependent on domestic deposits. These are making up a larger portion of funding, as use of short-term debt and securitisation decreases. These institutions used securitisation to a greater extent than the major domestic banks. Since the GFC, however, securitisation issuance has diminished, and prices of issuing asset-backed securities have increased. More recently, conditions for non-major banks have improved, with securitisation market depth and pricing improving and banks being able to access unsecured term wholesale funding.
- **major banks'** sources of funding have also changed over the period. Securitisation funding decreased from an already low base to become a comparatively insignificant source of funding. Equity levels remained fairly steady. Long-term debt has become a more significant source of funds than short-term debt. Again, deposits have become more important over the period; however, the shift is less marked than it is for other Australian-owned banks.

- **foreign banks** have also shifted their primary source of funding towards deposits in recent years. This was a move away from short-term debt funding, including intra-group transfers.

**Chart 3.1: Funding composition of banks in Australia – share of total funding**



\* Adjusted for movements in foreign exchange rates; not adjusted for mergers and changes in capital structure

\*\* Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA

Source: RBA, 2012.

Ultimately, the ability of institutions to vary their funding composition is dependent on their ability to access various sources of funding at affordable costs, as well as regulatory and equity/credit stakeholder expectations. In practice, the major banks have an advantage on this front. This is because they can access wholesale markets – both domestically and overseas – at a lower cost as a result of broader and stronger franchises, larger capital bases and higher ratings. The Association of Building Societies and Credit Unions (Abacus) (now the Customer Owned Banking Association, or COBA), in its submission to the Senate Inquiry on the Post-GFC Banking Sector, noted that:

*“The only distinction I would make between us and the banks, and why the deposit cost is so critical for us, is that we do not have the same diversity of funding that the major banks have, for instance, and therefore we do not get to spread that cost—it is all largely in one bucket.”*

- Degotardi, 2012.

Larger banks have the following characteristics which facilitate access:

- issuing debt on a wholesale basis is affordable given the scale of their operations and balance sheets;
- large banks that have their own risk models approved by APRA (specifically, those designated ‘advanced’ banks) can hold relatively lower capital reserves than smaller ADIs (even accounting for the 1% “higher loss absorbency” ratio imposed by APRA on “systemically important financial institutions” (APRA, 2013a)); and<sup>1</sup>
- their credit ratings, which are higher than smaller banks on a stand-alone basis, and include an assessment of the level of government support resulting from their being deemed to be systemically important.

In Australia, securitisation developed largely as a means of funding for smaller non-bank lenders, notably non-ADIs, although covered bond issuance is effectively only practical for large banks. Since the GFC it has diminished in importance. Types include:

- **asset-backed securities**, under which loan originators package loans and sell them on to other parties, effectively taking them off balance sheet; and
- **covered bonds**, under which originators issue bonds against assets which are specifically quarantined so that, in the event of insolvency, they can only be used to meet the bond liability.

As shown in Chart 3.1, smaller lenders have tended to use asset-backed securities more heavily than major banks. Covered bonds, which were only permitted in Australia since October of 2011 (RBA, 2012a), have been issued by larger banks, with approximately \$50 billion of issuance since introduction. Robertson and Rush (2013) attribute this to “their higher credit ratings, given their dedicated collateral backing, and the expanded investor base to which [they] appeal”. However, the use of covered bonds as a source of funds is limited to 8% of Australian assets by legislation; as such, there is likely to be an upper limit on growth (Australian Prudential Standards 121-7).

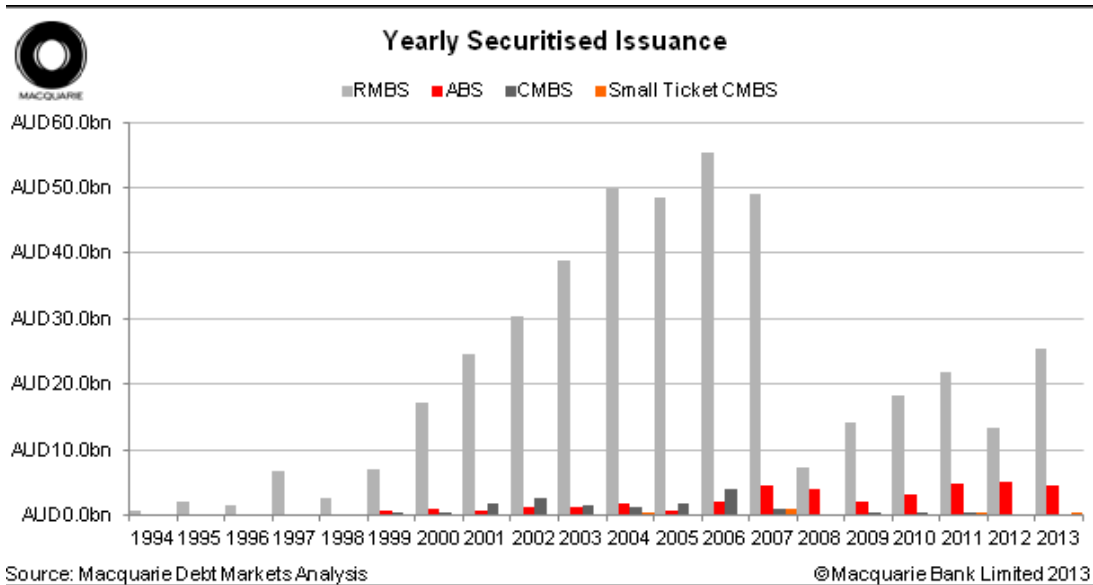
Asset-backed securities – in particular, residential mortgage backed securities (RMBS) – were widely used pre-GFC. However, issuance of RMBS collapsed in the GFC, as can be seen in Chart 3.2. While issuance has increased recently, with a temporary setback when covered bonds were introduced in 2012, it remains substantially below pre-GFC values according to the Reserve Bank of Australia (Robertson and Rush, 2013).

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<sup>1</sup> According to requirements first set out in Basel II, ADIs are able to determine capital reserve requirements held for regulatory purposes, that is, calculate their capital adequacy ratio, according to one of two methods:

1. a standardised (default) method (the *standardised method*) or;
2. an advanced, model based approach which is more aligned with the risk profile of individual ADIs (the *internal ratings based (IRB) or model-based approach*). APRA approval is required for ADIs utilising this method.

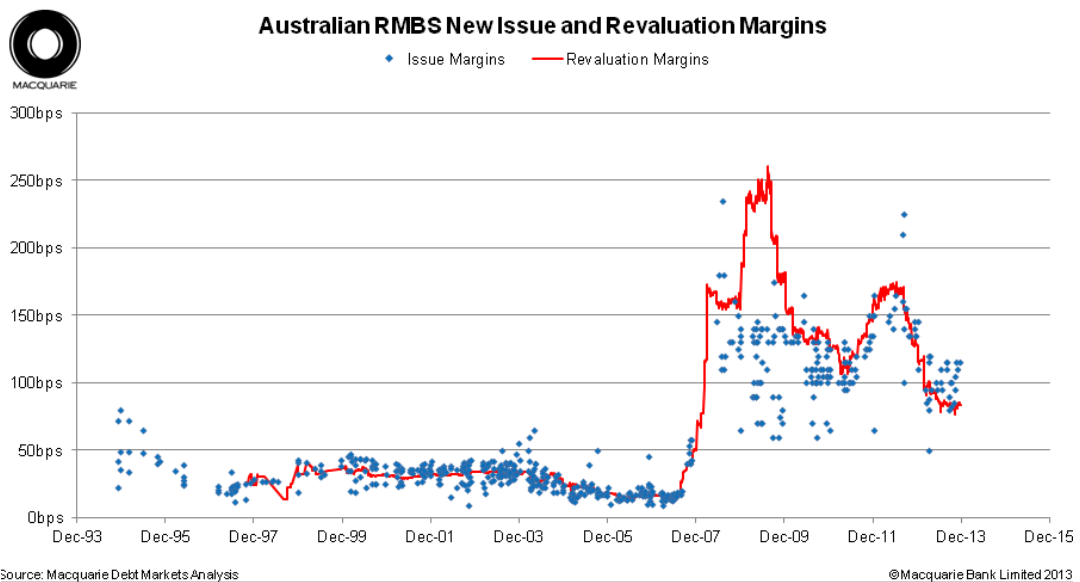
**Chart 3.2: Securitised issuance, Australia, 1994-2013**



Source: Australian Securitisation Forum, 2013

Issuance costs also rose, and this harmed the ability of financial institutions which were heavily reliant on these instruments to compete (Chart 3.3). Typically, RMBS were issued at around 20-30 basis points (bps) over the benchmark bank bill swap rate (BBSW) immediately prior to the GFC. Currently, even the highest-rated issues are yielding around 85bps over swap.

**Chart 3.3: Australian RMBS new issue and revaluation margins**

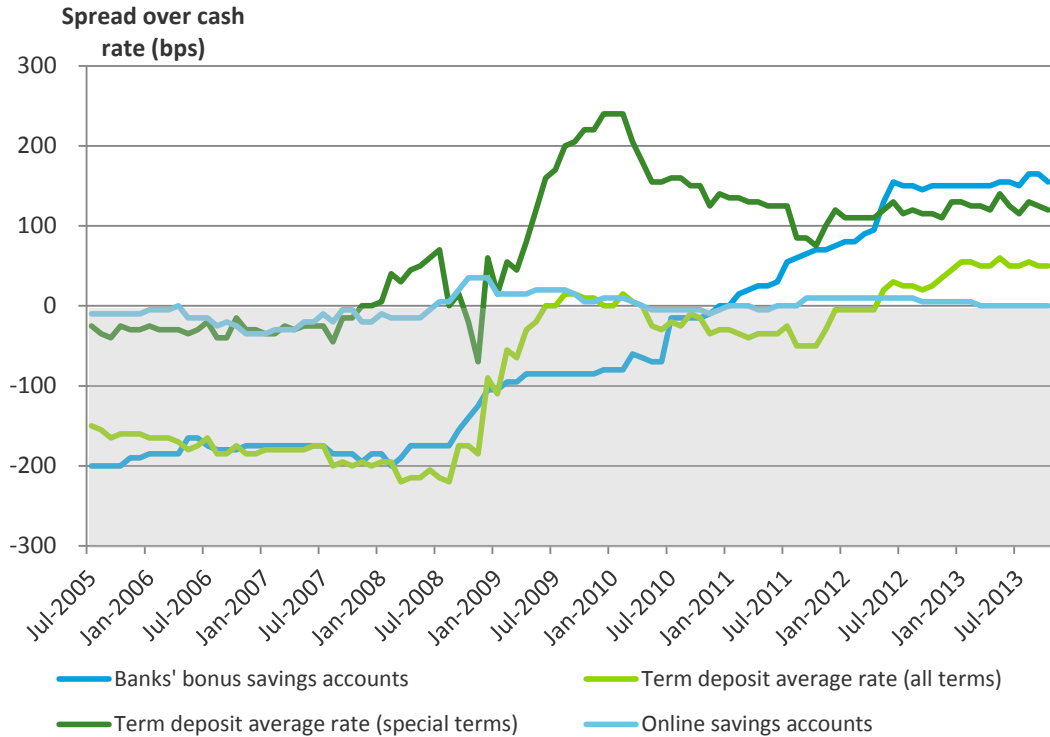


Source: Australian Securitisation Forum, 2013

The increasing reliance on deposits as a source of funding has intensified competition for deposits, resulting in a rise in deposit rates. This has led to an increase in the average cost of new deposits relative to the cash rate (Chart 3.4).



**Chart 3.4: Interest rate spreads on savings accounts and term deposits**

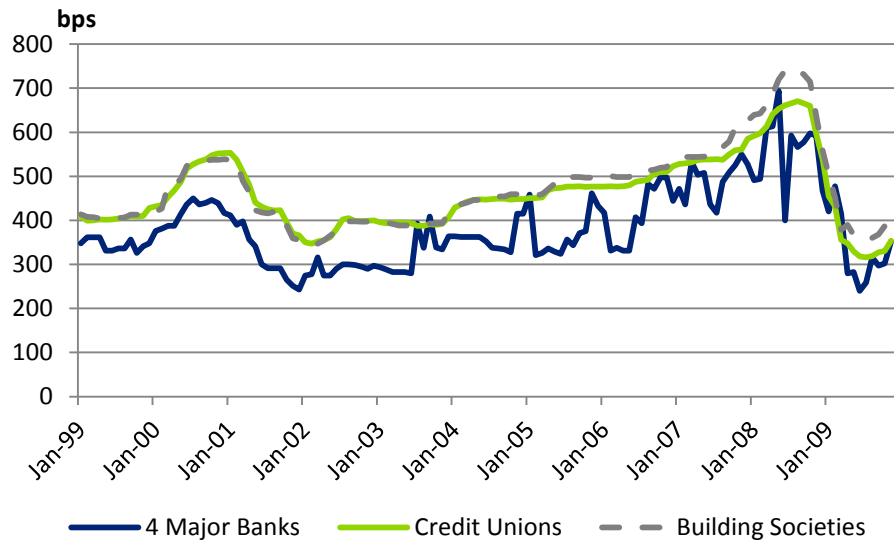


Source: RBA, 2013; DAE calculations

The average rate on banks' term deposit specials is more than 100 bps above market rates for debt of equivalent terms, compared with an average rate 60 bps below before the GFC. Bonus savings accounts are more than 150 bps above the cash rate. This reflects increased competition for funds forcing ADIs to pay customers more for deposits.

Chart 3.5 illustrates the average interest rate for 30-day term deposits over \$10,000. The interest rates offered by credit unions and building societies were typically higher than those offered by the major banks. However, the major banks are now offering rates comparable to those offered by credit unions.

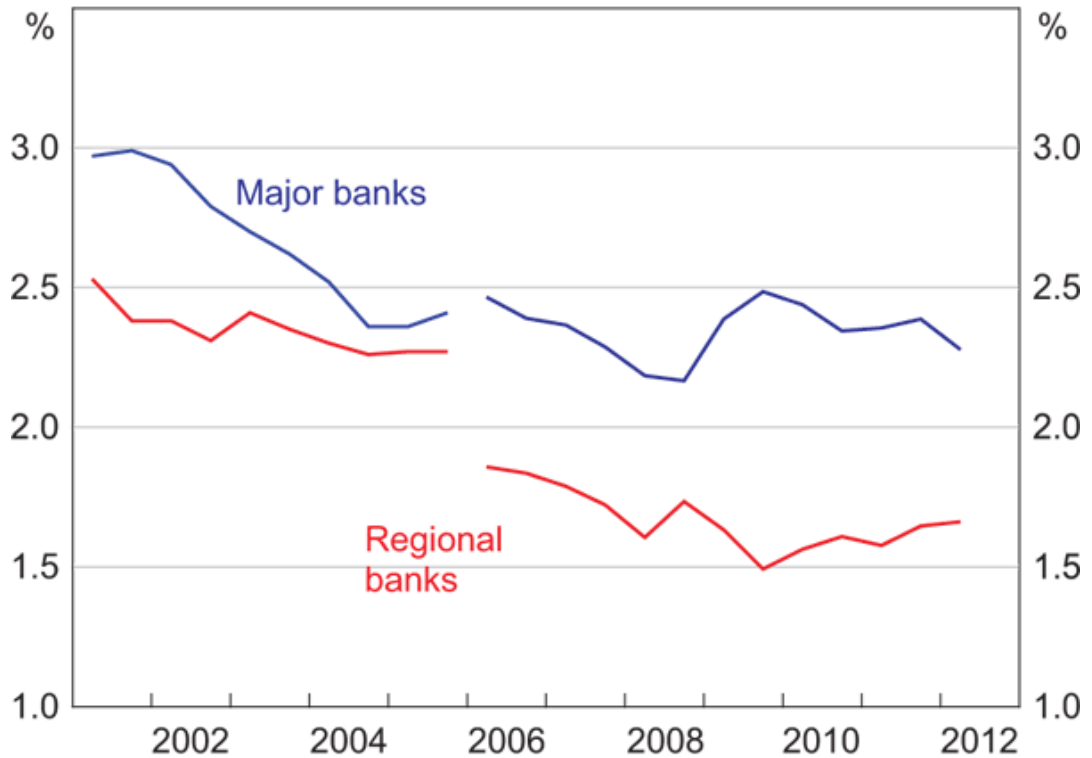
**Chart 3.5: Average term deposit rates (\$10,000 for 30 days)**



Source: CANSTAR CANNEX as cited in Deloitte Access Economics (2012).

Ultimately, increased competition for funding combined with price competition has led to net interest margins (NIMs) reducing significantly over time. A differential of over 450 bps percentage points at the start of the 1980s has almost halved, with NIMs under 250 bps since 2005. However, the gap between the major banks and other banks has widened in recent years, as can be seen in Chart 3.6. Between 2010 and 2012, major bank NIMs decreased to around 225 bps, and they remain at this level in 2013.

**Chart 3.6: Banks' net interest margins (domestic operations; half-yearly)**



\* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis  
Sources: RBA; banks' annual and interim reports

Source: RBA, 2012.

In conclusion, the cost of funds has risen disproportionately for smaller players relative to major banks. This is a result of multiple factors, including:

- smaller players' reliance on securitisation and subsequent shift in their funding mix towards deposits;
- a market view that small players are more vulnerable to shocks due to their smaller balance sheets;
- implied government support for major banks, based on systemic importance;
- difficulties in accessing wholesale markets at a competitive cost of funds; and
- increased competition for deposits.

As noted by the RBA,

*"The available evidence suggests that, in aggregate, the increase in the regional banks' funding costs since the onset of the financial crisis has been larger than that experienced by the major banks. This reflects the fact that smaller banks have experienced a larger increase in funding costs and have made a larger shift in their funding mix towards deposits."*

- RBA, 2012

Regulations which discriminate between banks also have a role to play in the differential between players.

- For example, in mortgage markets, “standardised” banks (generally smaller institutions) are required to hold larger capital reserves against loans than “advanced” banks. This effectively means that they are required to fund the same asset at a higher rate, thus incurring additional costs.
- A 1% “higher loss absorbency” ratio imposed by APRA on “systemically important financial institutions” (i.e. larger institutions), which will be introduced in 2016 will reduce the difference.

The cost of funds is an important determinant of an organisation’s ability to price competitively. Large banks have an advantage in securing funds in a cost effective manner, as major banks’ credit ratings, which are higher than small banks on a stand-alone basis, benefit further because they are deemed “systematically important” and are believed to be likely to receive government support in a stress (Standard and Poors, 2012). This can be offset by, for example, their higher distribution costs compared to some other providers. This advantage in the cost of funds has been exacerbated by the GFC.

### 3.3 Bank profits

Australian major banks are relatively profitable compared to other banks in the developed world. The report of the Senate Inquiry into competition in the Australian banking sector noted that “even during the period of the GFC, when the real economy slowed down markedly, the profits of the major banks held up well... their very high profits are ultimately paid for by households and small businesses. They are also a reflection that competition is not as keen as it should be” (Senate Economic References Committee, 2011). This raises the question of whether increased financial stability may come at a cost to consumers.

#### 3.3.1 Bank profitability

High profitability does not, in and of itself, equate to low levels of competition and contestability within a market – indeed, it should attract new players. Similarly, it does not necessarily lead to worse outcomes for consumers. As effectively run financial institutions operating within a resilient financial sector in a growing economy, it can be expected that Australian banks should be profitable. Sustained high profitability could be the result of factors which are not detrimental to consumers. For example, it could be the result of productivity gains from technological advances being captured for shareholders.

#### 3.3.2 Comparisons of profitability

Comparisons with returns on equity internationally are difficult and can be flawed. Returns on equity are reported for an entire institution, rather than one of the sectors it operates in. The returns arising from retail banking arms cannot be separated from other parts of bank activities, such as commercial and investment banking and non-banking activities.

Regardless, on a pre-crisis basis, the RBA considered that major Australian banks’ returns on equity were comparable to those in other countries. Following the GFC, it is difficult to directly compare profits between Australia and these other countries. As noted by then

Treasury official, Jim Murphy, in response to questioning by the Senate Economics Committee:

*“The traumas that other countries have had with their banking systems, to me, probably reflects the market and that they are being reasonably well run. We have had strong prudential regulation. The banks came through the GFC in a very strong position and that means that the whole ADI sector— I am not saying just the majors. One would think that you have got to get some benefit out of that.”*

- Murphy, 2012

In the period leading up to the GFC, Australian banks’ returns on equity and assets, as illustrated in Table 3.1 and Chart 3.2 respectively, were towards the upper end of the range. Since the GFC, bank failures, lending losses and recessions in other countries in many cases have reduced the profitability of overseas banks. This is largely attributable to much lower lending losses incurred by banks in Australia compared to countries that experienced significant declines in profitability.

**Table 3.1: After-tax return on equity (%)**

Country	2007	2008	2009	2010	2011
Australia	17.8	13.7	9.5	13.1	14.1
Brazil	26.6	8.5	14.3	13.0	13.3
Canada	9.7	10.4	8.1	18.1	25.3
China	20.4	18.2	18.6	19.7	13.0
France	5.8	-12	6.4	9.1	3.4
Germany	16.1	-11.6	-4.3	2.3	0.7
India	17.1	14.1	15.7	15.4	14.0
Italy	9.7	5.6	2.5	3.1	-11.3
Japan	5.7	-3.3	5.1	6.2	5.6
Russia	14.7	8.9	3.7	8.3	10.0
Spain	15.9	12.1	9.9	7.7	-0.3
Sweden	22.6	15.5	14.9	7.1	11.0
Switzerland	1.9	-42.7	-4.0	5.9	8.6
United Kingdom	22.2	1.4	-1.6	-0.6	3.8
United States	8.6	1.4	1.4	5.9	7.3

Source: World Bank, 2013

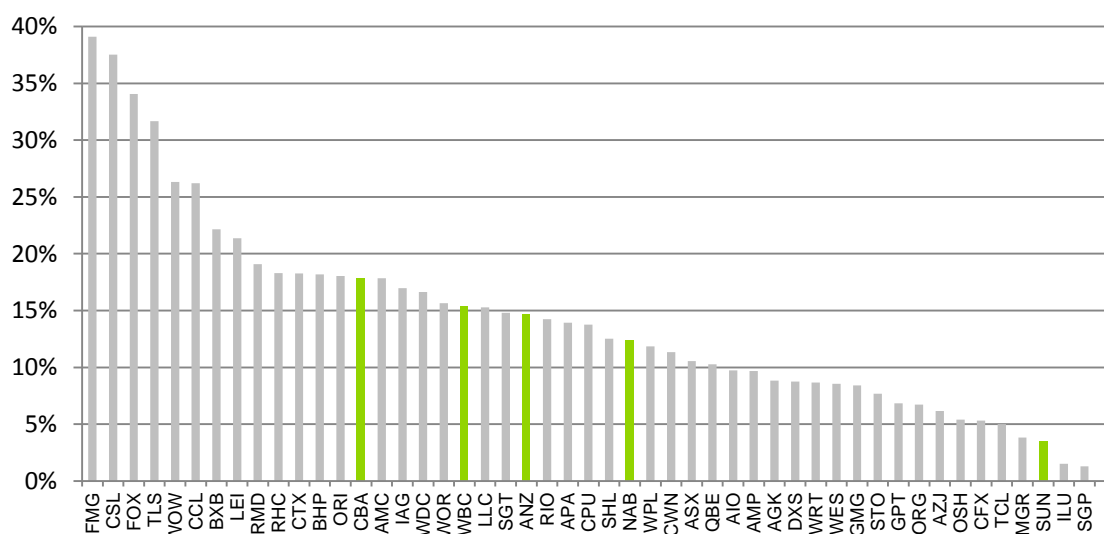
**Table 3.2: Pre-tax profitability of major banks (% of total assets)**

Country	Average (2000-07)	Average (2008-11)	2012
Australia	1.58	1.07	1.18
Brazil	2.23	1.61	1.50
Canada	1.03	0.80	1.07
China	1.62	1.56	1.83
France	0.66	0.29	0.19
Germany	0.26	0.06	0.09
India	1.26	1.34	1.45
Italy	0.83	-0.03	-0.06
Japan	0.21	0.36	0.56
Russia	3.03	1.46	2.39
Spain	1.29	0.94	0.08
Sweden	0.92	0.56	0.68
Switzerland	0.52	-0.05	0.03
United Kingdom	1.09	0.19	0.20
United States	1.74	0.42	0.96

Source: BIS, 2013

Ranking the top 50 companies in Australia (based on market capitalisation) by their return on equity shows that the four major banks are mid-ranked: CBA ranks 14<sup>th</sup>, Westpac 19<sup>th</sup>, ANZ 22<sup>nd</sup> and NAB 27<sup>th</sup>, with Suncorp ranking 48<sup>th</sup>.

**Chart 3.7: The top 50 companies (by market capitalisation) RoE for 2013**



Source: ABA, 2014

The reported profits of the major domestic banks have raised concerns about the effectiveness of competition in the sector. The performance of Australian banks since the GFC and global economic downturn have highlighted that they are well managed, and not excessively profitable.

*“Our assessment is that, if you look at the rates of return on equity in our banks over a lengthy period of time, say 20 years, they are good but they are actually broadly in line with the listed company sector in general in Australia. I do not think it is obvious from that comparison that they are in some sense excessively profitable.”*

- RBA Governor Glenn Stevens, 2012

Australian retail banks are amongst the most profitable in the developed world. In part, this reflects other foreign banking industries moving down the league ladder due to bank failures in the GFC and the recessions that followed, a supportive financial system and stronger economic conditions than other countries in recent years and institutions that did not have to absorb the costs of significant impaired loans and bad lending practices.

However, profits by themselves do not provide a useful measure of competition. Competition needs to be assessed directly, by, for example, seeing how easy it is for others to enter into the market to compete with the incumbents.

## 4 Preliminary evidence of competition in retail banking

Competition within a market can take many forms. At a base level, it can be broken down into two categories – competition between existing players, and potential competition from new entrants.

There are several methods and metrics which can be used to assess the level of competition in an industry. In Australia, the most commonly used is the ACCC approach, as outlined in the Merger Guidelines (ACCC, 2008b) (Appendix B).

Under this approach, assessments of competition begin by defining the relevant market. Once markets have been defined, initial concentration ratios are calculated. The purpose of this calculation is to assess whether further competition analysis is warranted; if concentration ratios fall below a pre-defined cut-off, then the ACCC is less likely to analyse the situation further. However, if further assessment is warranted, it then considers a series of other factors which are indicative of the level of competition in the market. These are based on the *Competition and Consumer Act*. This report examines the elements of this approach that are relevant to retail banking markets.

### 4.1 Defining markets

Defining the relevant market is a key element of analysing competition. As noted in the ACCC's Merger Guidelines:

*“Section 50 of the Act requires that a substantial lessening of competition occur in a substantial market for goods and services in Australia, or a state, territory, or region of Australia. Accordingly, in assessing [the level of competition], the ACCC will examine the competitive impact of the transaction in the context of the markets relevant...”*

- ACCC, 2008b

How a market is defined can determine the outcome of a competition analysis. Narrower markets are more likely to be assessed as being less competitive.

The competitiveness of any given financial institution will differ between products, reflecting varying business strategies and historical incumbencies. Given these variations within the sector, it is prudent to assess the level of competition in each individual product category. This can then inform an overall discussion of the level of competition in the retail banking market in Australia.

In recent analyses, the ACCC has defined retail banking markets as including personal banking markets and business banking markets. This analysis focuses on personal banking, which, according to the ACCC, has the following product dimensions (ACCC, 2008):

- transaction accounts;
- deposit/term products;



- credit cards;
- home loans;
- personal loans; and
- hybrid personal loans (margin loans).

As noted above, the dimensions of a market may vary geographically. For example, hairdressers only compete within a suburb or local region, whereas online retailers compete with each other nationally.

To assess whether there was a geographic element to these markets, the ACCC considered the importance of physical presence (including branch and Automatic Teller Machine (ATM) networks) to consumer choices of provider and the geographic scope of decision making. They found that – with the exception of transaction accounts – competition for all of the products above occurred on a national scale. While competition for transaction accounts was assessed as local, the ACCC noted that price competition in the market was national.

Following from these assessments, this report will look at competition in the following markets:

- transaction accounts;
- interest-bearing savings accounts (including term deposits);
- mortgages;
- personal loans; and
- credit cards.

Retail banking markets provide a range of products. Competition occurs on a product-by-product basis in a national market. Some firms compete in all markets, while others specialise.

## 4.2 Concentration ratios

A starting point in analysing competition in any industry is looking at concentration ratios. This is a useful indicator of the level of market power which can be exerted in the industry. A more concentrated market is likely to be less competitive.

Many different measures of concentration can be used. Some examples include basic CR(n) ratios, such as Four-Firm Concentration Ratio and Eight-Firm Concentration Ratio, which measure the market share of the four and eight largest firms in a market respectively.

The measure preferred by the ACCC is the Herfindahl-Hirschman Index (HHI). This calculates market concentration in an industry by summing the squared market shares of all (or the top 50) firms in the market. Mathematically, this is defined as:

$$HHI = \sum_{i=1}^{i=50} (\text{market share}_i)^2$$

The significance of using an HHI is that it provides greater weight to bigger firms, meaning that the measure becomes larger if some firms are substantially larger than others.<sup>1</sup>

#### 4.2.1 Concentration in Australian retail banking

Table 4.1 below shows the HHIs which have been calculated for the retail banking products mentioned above, on a national basis, using APRA's *Monthly Banking Statistics* data. They only include banks, due to a lack of disaggregated data for non-bank ADIs and other financial institutions. However, the calculations cover over 90% of the market.<sup>2</sup> As it is on an institutional basis, it does not account for potential capital market competition.

**Table 4.1: Concentration ratios (banks only)**

Market	HHI - 2007		HHI - 2013	
	Score	Flag? <sup>3</sup>	Score	Flag?
Transactions <sup>4</sup>	1505	✘	1828	✘
Interest-bearing savings <sup>5</sup>	1505	✘	1828	✘
Mortgages <sup>6</sup>	1535	✘	1908	✘
Other personal loans <sup>7</sup>	1428	✘	1904	✘
Credit cards <sup>8</sup>	1750	✘	1962	✘

Source: APRA data, DAE estimates

The HHI cut-off of 2000 is provided in the 2008 Guidelines. Table 4.1 shows that concentration levels in retail banking have increased since the onset of the GFC. This is due to a number of factors, including acquisitions and withdrawals from the market. Given that APRA's statistics are provided at an institutional level, it does not account for intra-brand

<sup>1</sup> The HHI is computed by taking the market shares of the firms in the market, squaring them, and then summing the squares. Thus, the HHI measure of pure monopoly is 100<sup>2</sup>, or 10,000.

<sup>2</sup> Estimated upper bounds for HHIs for the entire market are also provided in footnotes.

<sup>3</sup> The ACCC benchmark criteria for further analysis, or a "flag", is HHIs over 2000, as set out in the ACCC Merger Guidelines (2008)

<sup>4</sup> This covers 94% at the market (measured by 2013 "call/on demand" deposits on Quarterly ADI Performance). If all of the market was included, the maximum that the HHI could be using available data is 1843

(Bank HHI + Market share<sub>all building societies</sub><sup>2</sup> + Market share<sub>all credit unions</sub><sup>2</sup> + Market share<sub>all mutuals</sub><sup>2</sup>).

<sup>5</sup> This covers 92% at the market (measured by 2013 term deposits on Quarterly ADI Performance). If all of the market was included, the maximum that the HHI could be using available data is 1851 (calculated as above).

<sup>6</sup> This covers 93% at the market (measured by 2013 total outstanding housing loans on Quarterly ADI Performance). If all of the market was included, the maximum that the HHI could be using available data is 1929 (calculated as above).

<sup>7</sup> This covers 99% at the market (measured by 2013 "other loans" outstanding on Quarterly ADI Performance). If all of the market was included, the maximum that the HHI could be using available data is 1905 (calculated as above).

<sup>8</sup> Calculated using outstanding balances on banks' books only. This covers 99% at the market (measured by 2013 "other loans" outstanding on Quarterly ADI Performance). If all of the market was included, the maximum that the HHI could be using available data is 1963 (calculated as above).

competition. As such, concentration ratios are likely to be overstated to the extent that brands within the same institution compete with each other. However, using the currently preferred HHI metric, none of the products have concentration ratios which are sufficiently high to warrant further assessment, as they are all under the ACCC threshold of 2000.

This suggests that the retail banking market is fairly competitive. Regardless, concentration ratios should only ever be considered as indicative. A robust assessment of competition requires a more complete analysis. As such, Chapter 5 considers particular factors which are influencing the dynamics of competition in retail banking.

Concentration ratios are used as an initial indicator of the level of competition in a market. In transaction accounts, interest-bearing accounts, mortgages, personal loans and credit cards, the concentration ratios calculated do not exceed ACCC thresholds. This suggests that these markets are competitive, if less so than before the GFC.

#### 4.2.2 International comparisons

Table 4.2 presents measures of bank concentration (HHIs) for credit institutions in European jurisdictions. Declines in concentration over time are consistent with major institutions losing market share. “Credit institutions” are defined by the European Central Bank as “an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account” (European Central Bank, n.d). These statistics do not separate out the retail banking sector, or retail banking product markets more specifically. Thus, the HHIs in Table 4.2 are calculated differently to those calculated for Australia in Section 4.2. Notwithstanding the qualifications set out above, concentration ratios in Australian retail banking are higher than those in most European countries.

**Table 4.2: Bank concentration in the European Union (HHIs), 2007-2011**

Country	2007	2008	2009	2010	2011
Austria	527	454	414	383	423
Belgium	2,079	1,881	1,622	1,439	1,294
Denmark	1,120	1,229	1,042	1,077	1,192
Finland	2,540	3,160	3,120	3,550	3,700
France	679	681	605	610	601
Germany	183	191	206	298	317
Greece	1,096	1,172	1,184	1,214	1,278
Ireland	700	800	900	900	800
Italy	328	307	298	410	407
Luxembourg	316	309	310	343	346
Netherlands	1,928	2,168	2,032	2,052	2,061
Portugal	1,098	1,114	1,150	1,207	1,208
Spain	459	497	507	528	596
Sweden	934	953	899	860	863
United Kingdom	509	370	360	424	523

Source: ECB, 2012.

### 4.2.3 Implications for competition

Since the GFC, ex-ACCC head Graeme Samuels had publicly stated that some of the mergers that took place may not have been allowed if policy makers had not elevated financial stability above competition (ABC, 2009).

However, as noted above, the level of concentration in retail banking in Australia, while relatively high still is below the ACCC threshold and, therefore, is not prima facie a cause for concern about the level of competition.

The level of concentration is also partially the result of intentional policy design. The “four pillars policy”, for example, is intended to prevent rationalisation amongst the largest players, which limits the potential for market concentration to increase.

# 5 Dynamics of competition

As discussed in Chapter 4, concentration ratios should only be considered as an initial indicator of whether further analysis of the level of competition is required. The ratios calculated suggest that the industry is relatively concentrated by global standards, but not overly concentrated, as measured by the ACCC benchmarks.

Nevertheless, market competition is more dynamic and complex than concentration ratios alone can explain. This chapter contains a more nuanced analysis of the relevant factors which determine and contribute to the level of competition in retail banking, drawn from the ACCC's 2008 *Merger Guidelines*.

Based on these indicators of effective competition, the chapter assesses competition overall at a high level. It then looks to the benefits that the system creates for consumers. The chapter concludes with a discussion of how competitive forces are likely to evolve over coming years.

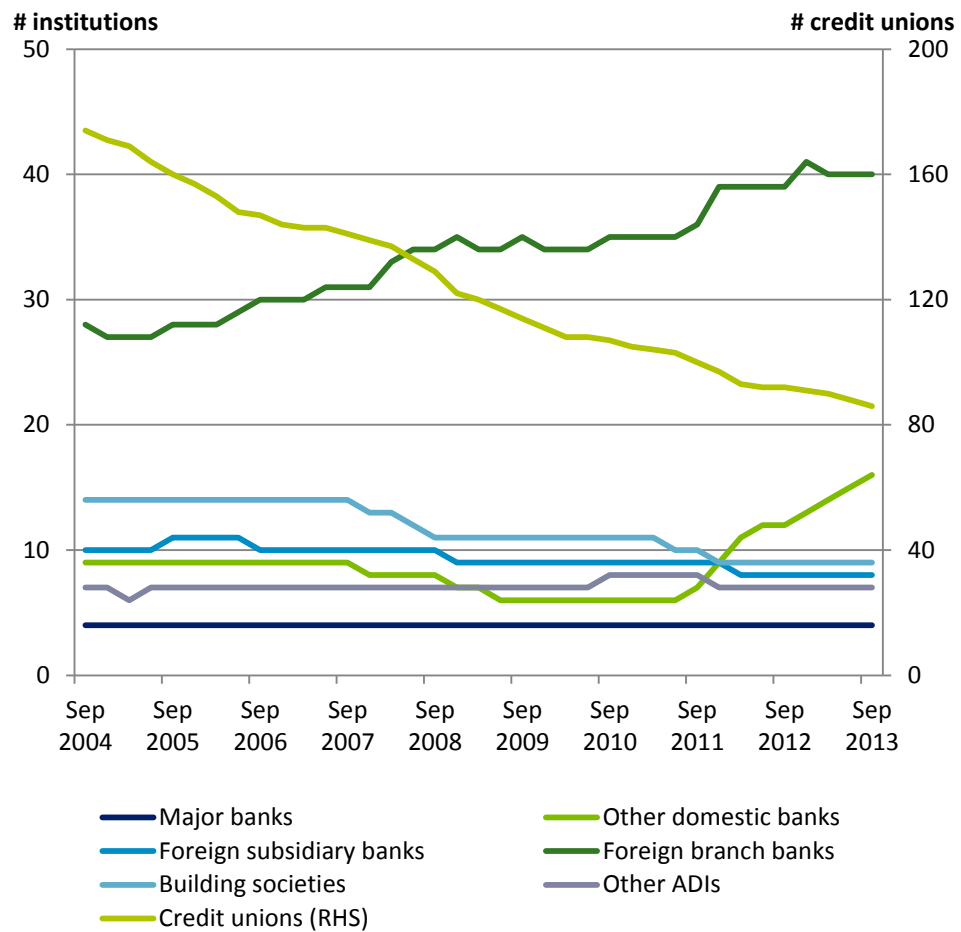
## 5.1 Barriers to entry

The height of barriers to entry – and exit – is an important factor which can affect levels of competition over time. The entry of new firms increases the level of competition in an industry. If there is a credible threat of new entrants, existing firms are less likely to exercise any market power which they might have. This is because, e.g. if they raise prices, they may be faced with a new competitor who sells at a lower cost, thus attracting existing customers away.

However, if there are significant barriers to overcome before a new player can enter the market, potential new entrants will be discouraged. This will slow and/or prevent these players from entering the market. Similarly, if it is costly or difficult to leave the market, the risks of entry increase, which will discourage players from joining in the first place. Thus, high barriers to entry or exit, by changing incentives for new players, enable existing institutions to exercise market power.

There have been a number of entries to, and exits from, the market in recent years. Chart 5.1 shows there are a large number of players in the industry, but consolidation continues, particularly between credit unions. However, new banking licenses are still being issued, with seven new entrants over the last 8 years. This suggests that, while barriers to entry and exit may exist, they are not insurmountable. While some European banks have exited the market, Asian banks are expanding their presence in commercial and investment spheres, and may consider a move to retail in the future.

Chart 5.1: Number of ADIs, 2004-2013



Source: APRA, 2013

Even in concentrated markets, low barriers to entry and ease of exit can ensure robust competition. In Australian retail banking, technology and globalisation has reduced these barriers in recent years and will continue to do so. However, due to its important role in the economy, retail banking is more regulated than other industries. This favours the incumbents.

### 5.1.1 Scale

Entry to retail banking markets could occur at three different levels:

- entry of existing players to new sub-markets (e.g. a savings-only institution who moves into mortgage markets);
- entry of players with an existing banking presence into the retail banking market (e.g. foreign banks or non-ADIs with existing asset bases entering the Australian market); and
- entry of new players without existing banking presence into the market.

Providing retail banking services at any level tends to require access to a substantial balance sheet. Establishing this from scratch can be difficult. Historically, Australian ADIs

were built on equity, such as customer ownership and mutualisation. However, recent rationalisation in the mutual sector suggests that this path may be difficult to follow in current circumstances.

As such, scale can be a significant barrier to entry for “fresh” new players. In practice, it appears that new entrants are more likely to have established balance sheets. This could be from non-financial operations, or from existing financial operations overseas. One particular strategy which has been successful in recent years is staged entry. For example, Virgin Money began by offering credit card products in 2003. They then moved into mortgage products in 2008 (FirstFolio, 2014).

### 5.1.2 Regulatory barriers

Retail banks – and the institutions that provide these services – underpin the financial system. Maintaining the stability of these institutions is thus an ongoing high-order objective for regulators and governments.

To maintain stability and confidence, the Australian system has established barriers to entry into the system. These are aimed at ensuring that the market participants are prudentially sound and have the skills, expertise and incentive to manage their institutions appropriately.

These barriers were relaxed in the 1980s and 1990s, with the most notable change being allowing foreign banks to enter the market. However, significant barriers still exist, including but not limited to:

- costs and requirements associated with **licensing** and related conditions;
- ongoing regulatory burdens and **compliance costs**;
- increasing **prudential standards**, such as Basel III; and
- the need to obtain approval from the Treasurer for **ownership** in excess of 15%.

Some submissions to recent government inquiries have cited these factors as limiting the level of competition in the market. One potential new entrant, FirstMac, a non-ADI operating as a specialised home loan lender and servicer, claimed that it wished to enter retail banking, but had been prevented from doing so by regulatory barriers:

*“Over the past three years FirstMac has actively sought access to an ADI license either through establishment of a new start-up license or alternatively through strategic alliance and equity investment in an existing ADI licensed entity.*

*A significant barrier to entry has been the ownership of FirstMac Group which is 100% held by private family interests. Legislation prevents an individual from owning greater than 15% of an ADI. It is understood that this requirement is in place to facilitate capital raising if required by that ADI. This appears inconsistent with the licensing of Mutuals which by their membership design have numerous owners but limited capital raising capability. In contrast FirstMac Group has limited owners but far greater capital raising capacity.”*

*- FirstMac, 2010.*

Similarly, the Commonwealth Bank noted regulatory barriers relating to ownership which could dis-incentivise both entry and exit:

*“The key barriers to exit are the legislative requirements that a shareholding in an Australian financial sector company in excess of 15% requires the approval of the Treasurer under the Financial Sector (Shareholdings) Act. If the sale involves a foreign purchaser then the purchase (if over certain thresholds) must also be considered by the Treasurer under the Foreign Acquisitions and Takeovers Act. Under that Act “the Treasurer can block certain proposals that are contrary to the national interest or apply certain conditions to the way proposals are implemented to ensure they are not contrary to the national interest”. In addition, an acquisition of a substantial interest in an ADI would require the approval of APRA under the Banking Act.”*

- Commonwealth Bank, 2012.

Regulation can be a barrier to entry and exit. Rules are generally designed with incumbent products and players in mind. This can make the introduction of new business models challenging. However, this reflects policy choices about societal desire for a stable financial system, as discussed in Section 2.2. Policy makers must consider the impact that these decisions can have on the ability of new players to enter the market.

### 5.1.3 Geographical footprint

Traditional banking was founded in physical networks. To access bank products, customers had to attend a branch or – later – automatic teller machine in person. As such, the extent of a financial institution’s geographical presence was important to its ability to compete with others.

For many retail banking products, this need has reduced substantially over time. Technological advances and innovations in banking mean that individuals are increasingly willing and able to access banking services remotely. For example, one can apply for a new personal loan online, or manage transactions between an interest-bearing online savings account and a transaction account on a mobile app. This has reduced barriers to entry, as the costs of establishing these technological offerings is often lower than establishing an extensive physical presence. In the proposed merger between Westpac and St. George Bank, the ACCC noted that:



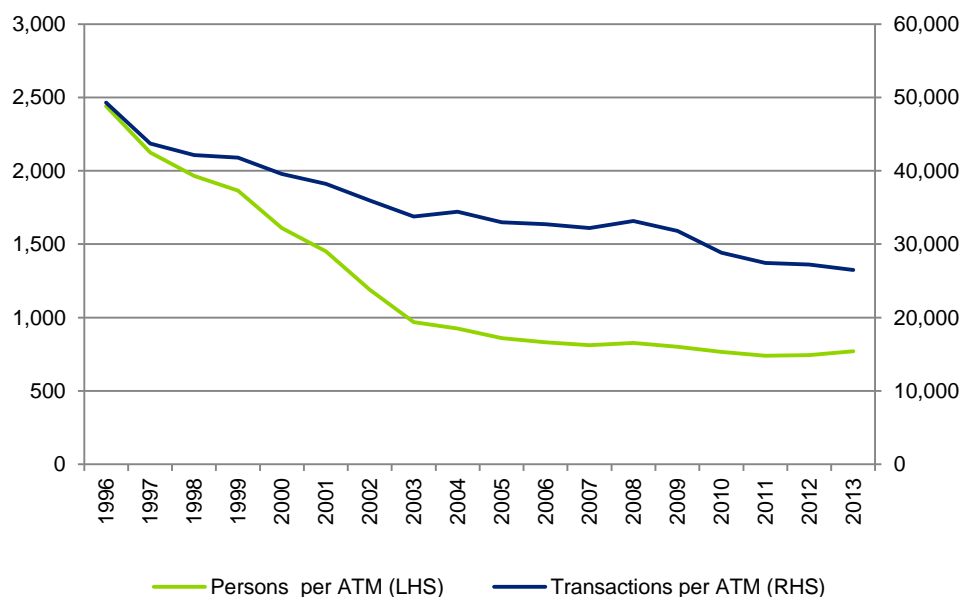
*“evidence... illustrates that branch usage for these [non-transaction account] products is very low... service levels, fees and interest rates, and the availability of internet banking are more important to customers of these products than the location of branches and ATM availability.*

*Changes in the modes of distribution for each of these products in particular greater reliance on the internet, telephone and broker channels, has meant that a customer can obtain one of these products, transact and manage their relationship with their financial institution without visiting a branch. This trend has allowed institutions to compete in regions where they do not have a physical presence – for example, ING Direct has attracted a significant share of the Australian savings account market by distributing its products solely through the internet.”*

- ACCC, 2008.

Convenient access to services for Australian consumers is also demonstrated through the availability of ATMs, as shown in Chart 5.2. Decreasing numbers of individuals per ATM suggest that availability has increased over the last decade. This has occurred despite the decline in transactions per ATM caused by the convenience of online transactions.

**Chart 5.2: ATM access**



Source: ABA, 2014

As such, the need for an expansive physical presence is no longer a significant barrier to entry in most retail banking products. However, as discussed in Section 4.1, the exception to this is transaction accounts, which are still associated with a need for physical presence.

The need to withdraw and deposit cash – a physical product – means that the location, spread and number of points of presence can be a significant factor in customer choice of transaction account provider. The continued preference for cash in low-value transactions suggests that this is likely to persist in the near future. However, potential new entrants to the market may leverage existing distribution networks for this purpose. For example,

supermarkets have substantive geographical presence that could be used to deliver retail banking products in the future.

#### 5.1.4 Incumbency

In mature markets which are served by large players, it may be more difficult for new entrants to join the market and compete effectively. Pre-existing players will have established intangibles which are important for capturing and maintaining customers, such as reputation, branding, and networks. This can make it difficult for new entrants to build customer awareness and attract clients.

This is especially true in retail banking, where trust and reputation can be very important to a consumer's choice of institution. In a 2011 Ernst & Young global survey, 22% of individuals who switched their main bank attributed this move to a lack of trust (Ernst & Young, 2011).

There is evidence of the importance of incumbency both in Australia and worldwide. The market share of the major banks in Australia has held up over time. New entrants thus face more difficulties in gaining substantive market share, given that the market is mature and the major banks have tended to maintain their positions.

Incumbency tends to govern product choices globally. This is partially as a result of the convenience of bundling services, as discussed in Section 3.1.2.1. New entrants may perceive that it will be difficult to attract consumers away from their existing banking arrangements.

## 5.2 Availability of substitutes

The existence and availability of alternative products is important to competition. Even in a concentrated market, there may be a high level of rivalry or contestability between firms. If the products on offer by rival firms are similar (the degree of product differentiation is low), customers can more easily switch between providers. This would stimulate competition between suppliers to attract customers.

Overall, retail banking products offered by different institutions tend to be fairly similar. While the specific features of these products may vary, they tend to achieve the same purposes to a great degree. For example, while a transaction account may be attached to different levels of ATM access and fees may differ, customers would find that many of the products on offer would meet their needs.

Despite relative product homogeneity, there is a proliferation of services on offer from a wide variety of institutions. For example, as at December 2013, Canstar listed over 500 variable rate owner-occupier mortgage products on offer from over 100 companies. This suggests that there is a wide array of fairly close substitutes in the market. A broader definition of the industry suggests even more players:

*“Australian banking customers are currently served by a wide range of providers. These include 12 Australian-owned banks; 9 foreign-owned bank subsidiaries; 35 foreign bank branches; 11 building societies and more than 100 credit unions. Further, there are currently around 111 providers of over 2,200*

*mortgage products; 66 providers of over 420 different credit cards; and 114 providers of over 992 different types of deposit account.”*

- Treasury, 2010

In practice, however, the accessibility or validity of these external options can be limited by a number of factors. One of these is **switching costs**. If consumers perceive that they will have to incur significant costs in order to change products or providers, they will be less likely to change. This is because higher costs may outweigh the benefits of moving to another provider.

Some level of switching costs may be naturally occurring as a result of the nature of the product or service on offer in a market. These are evident in retail banking. Customers may be unwilling to swap because of resistance to change. They value having all of their products with one provider because this is more convenient, and they may also get a sense of familiarity resulting in greater comfort in staying with an existing provider.

However, switching costs can also be imposed, either by individual institutions or by the overall structure of the market. In retail banking, these include:

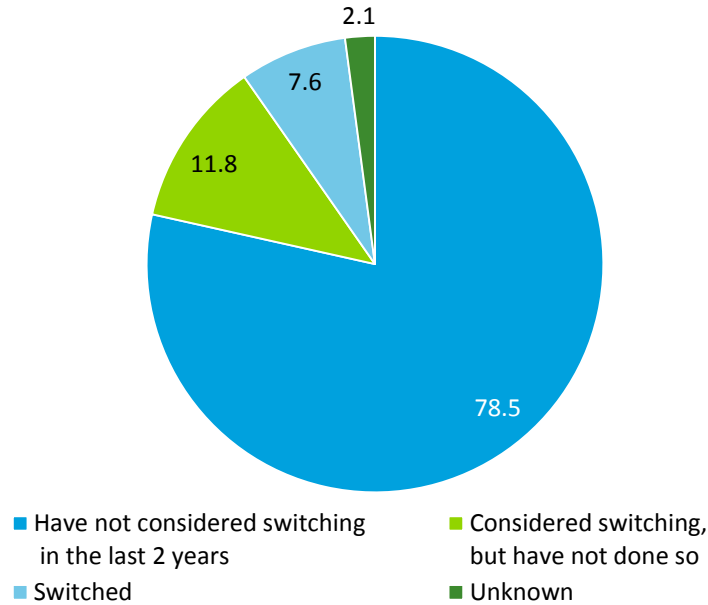
- **bundling** behaviour, as discussed in Section 3.1.1, can impose additional switching costs. Buying bundles makes it more difficult for consumers to readily compare products, because they might have different features and inclusions;
- difficulties associated with **porting**, such as the inconvenience of setting up a new account and communicating new account details to relevant parties; and
- **exit/establishment fees**, where institutions charge customers for changing providers.

This behaviour has, in part, been curtailed by regulatory changes, in particular the ban of mortgage exit fees introduced by the *National Consumer Credit Protection Amendment Regulations* (2011).

Evidence suggests that, overall, the level of switching in retail banking products in Australia is indicative of a fairly competitive market. *The Banking Services: Switching Arrangements* report, published in 2011, noted that there was a considerable amount of switching in mortgages. It cited ABS data that indicated that fully one third of new housing loan approvals in the first half of 2011 were refinances of existing mortgages (ABS, 2012). While this does not necessarily mean that these mortgages moved to other providers, it nevertheless suggests that there is the potential for mobility in mortgages. The report also found that while there were greater barriers to switching in the transaction accounts market, significant quantities of switching activity still occurs.

Chart 5.3 further supports this assessment. While only 7.6% of consumers surveyed by Choice magazine in 2011 switched banking providers, the vast majority – over three quarters – had not considered switching at all. This suggests that most consumers are either comfortable with their current provider, are experiencing inertia, and/or do not perceive that there would be substantive gains from switching.

**Chart 5.3: Transaction account switching (%), Australia**



Source: Choice Magazine, 2011.

The *Banking Services: Switching Arrangements* report also suggested that switching behaviour in mortgages had increased in recent years:

*“not all existing mortgage holders are likely switchers; many will be quite content with their present provider. Some may have considered switching only to be discouraged by exit fee imposts. Others again will have been persuaded by their existing provider’s retention team (and the offer of better terms) to stay, rather than switch. The bottom line, however, is that the housing mortgage market over the past couple of decades has seen significant switching by borrowers who have been motivated to change providers to gain a better deal.”*

- Fraser, 2011.

Elsewhere in retail banking, where switching costs are low, banks respond promptly to competition.

*“In the online account world, the transactions costs of switching are very low, and the evidence is that the response rate to small interest rate differentials is rapid.”*

- RBA Assistant Governor Guy Debelle, 2013

“There is a wide variety of products and suppliers in the Australian retail banking market. Recent policy changes and technology have made it easier to switch, either for individual products or bundles of products” (RBA Assistant Governor Guy Debelle, 2013). Moreover, the threat or possibility of losing existing customers will prompt lenders to respond promptly when gaps to their competitors emerge.

## 5.3 Innovation and product differentiation

Industries with high levels of innovation could compete for customers based on product features by providing new products or services which consumers value. This is particularly relevant in retail banking, which, worldwide, has been a source of innovation through digital technologies, globalisation and business model changes in recent years.

Traditional retail banking models are associated with fairly high overhead costs, as a result of the need to maintain branch networks. This is because the traditional model is centred on building and maintaining customer relationships. Major players underwent a process of branch rationalisation in the 1990s. However, this process has since slowed significantly, as a minimum level of presence is required for relationships to be maintained and thus to avoid customer attrition.

One of the key innovations in recent years has been the evolution of business models based on other factors. New players evolved who targeted only certain product types – such as savings accounts and mortgages – which rely less heavily on relationships and physical presence. By utilising new platforms and technologies, new players were able to distribute and manage these products at lower costs, e.g. ING Direct.

One of the advantages of traditional banking models is scale. As discussed in Section 3.2 and Section 5.1.1, larger sizes allowed these institutions to develop a significant balance sheet, which had the advantage of increasing customer awareness and brand exposure, as well as providing access to lower cost funds.

Dis-intermediation and the “unpacking” of some retail banking products has been an important innovation to business models in recent years. This trend has allowed smaller players to compete more effectively by granting them access to funding and wider distribution networks without the need to build scale. As noted in Section 4.1, this relates in particular to mortgage products and credit cards.

Essentially, this process involved disaggregating the supply chain for these financial services. Instead of a single player providing end-to-end services, the value chain could have multiple players, including, for example:

- **brokers**, who are responsible for distributing and “selling” products to final customers;
- **originators**, who create the loan products and provide them to brokers; and
- **balance sheet owners**, who buy packages of loans through the process of securitisation.

This process was facilitated by and spurred the entry of a range of new market participants, many of whom were not ADIs. New brokerage groups such as Aussie Homeloans and RAMS emerged as significant competitors in the market, attracting significant client bases and putting competitive pressure on major banks.

Brokers provide additional value to consumers by helping them to make informed choices. It can be difficult for individuals to identify the products on offer, understand their features and compare products. This placed competitive pressure on lenders by lessening information asymmetries.

Competition in capital markets has also spurred innovation. In particular, the emergence of securitisation as a major funding source was key to the process of dis-intermediation. It allowed smaller originators to sign loans but keep the liabilities off balance-sheet, instead focusing on other aspects of the value chain. Section 3.2 details the importance of these funding sources to mortgage originators in the pre-GFC environment.

Treasury, in a submission to the *Inquiry into Competition within the Banking Sector* refers to a list of innovations that have occurred in the 10-15 years prior to 2010 including:

- High Interest Online Savings accounts
- “All you can eat” transaction accounts with a simplified fee structure and unlimited transactions (of certain types) for a fixed monthly account fee
- “Basic bank accounts” targeted at low income consumers
- “no frills” credit cards
- Mobile phone banking
- Low-doc and no-doc loans
- Zero or low deposit home loans
- Reverse mortgages
- Shared equity mortgages
- “capped rate” variable mortgages

The influence of one source of innovation - dis-intermediated business models - declined during the GFC. This can be attributed to a range of factors, in particular:

- a decline in RMBS issuances as investor sentiment shifted due to the sub-prime crisis in the USA; and
- anxiety around system stability leading to a move towards major banks which were perceived as being safer.

This change in sentiment has slowed the progress of disintermediated models and thus innovations coming from new business models and players. For example, securitised issuance has declined dramatically, however, this does not mean that innovation activities have ceased during this period.

Instead, innovation has continued, with competition for product differentiation persisting between existing players, in particular, major banks. Recent innovations have focused on improving convenience for customers. Some examples of this in Australia include online-only banking platforms and mobile banking services.

A lot of innovation has been focused in particular on payments systems. Competition in payments fuels competition in retail banking, with banks seeking to provide the best choices and most convenience for their consumers. The market in Australia is contested by numerous players with differing value propositions, from BPay to eftpos and international credit card schemes. Many of these are not direct participants in retail banking. Some retail banking service providers are partnering with these external payments systems to offer value to customers.

Others are developing their own innovative approaches. For example, the CBA has invested heavily in improving its internal systems to provide customers with same-day clearance and real time value.

A number of banks have developed mobile applications. The announcement of mobile contactless payment by Westpac in December 2013 puts Australia at the forefront of mobile phone enabled transaction technologies. The mobile platform builds upon the industry's already innovative mobile banking framework to deliver an enhanced customer experience (Westpac, 2013). The CBA has begun to roll out Facebook-based payments, claimed to be the first service of this nature in the world (ZDNet, 2012). ANZ's FastPay, launched in October 2012, offers small business owners with same day settlements of merchant payments processed using iPhones or iPads (ANZ, 2013).

In the wake of the GFC, the pace of innovation has accelerated, particularly in the digital space. A recent example is Defence Bank, which has opened a prototype digital-only "teller-free" bank in Canberra. Similarly, NAB's first "smart store" in Docklands will incorporate a number of intelligent self-service machines that interact with customers and their mobile devices to deliver next generation banking services.

As discussed in Section 3.1.2.3, financial institutions develop differentiated products with services which appeal to customers. Indeed, some business models focus on innovation as a source of competitive advantage in the market. Where this is successful, competitors have generally been fairly quick to adapt new offerings accordingly.

Innovation in retail banking has taken a number of forms including using different distribution channels, different sources of funds and product innovation. Innovation has come from all parts of the markets. Along with the main incumbents, this has included, for example, innovation from new entrants using capital markets to source funds (e.g. non-ADIs), global banks using online distribution channels or non-financial institutions using technology to provide customers with new ways to access financial services (such as brokers or co-branding credit cards). The GFC has disrupted the ability of some potential innovators to provide services that require capital markets to source funds (notably through securitisation). However, technological advances continue to drive product innovation as highlighted by banks' offerings in mobile banking.

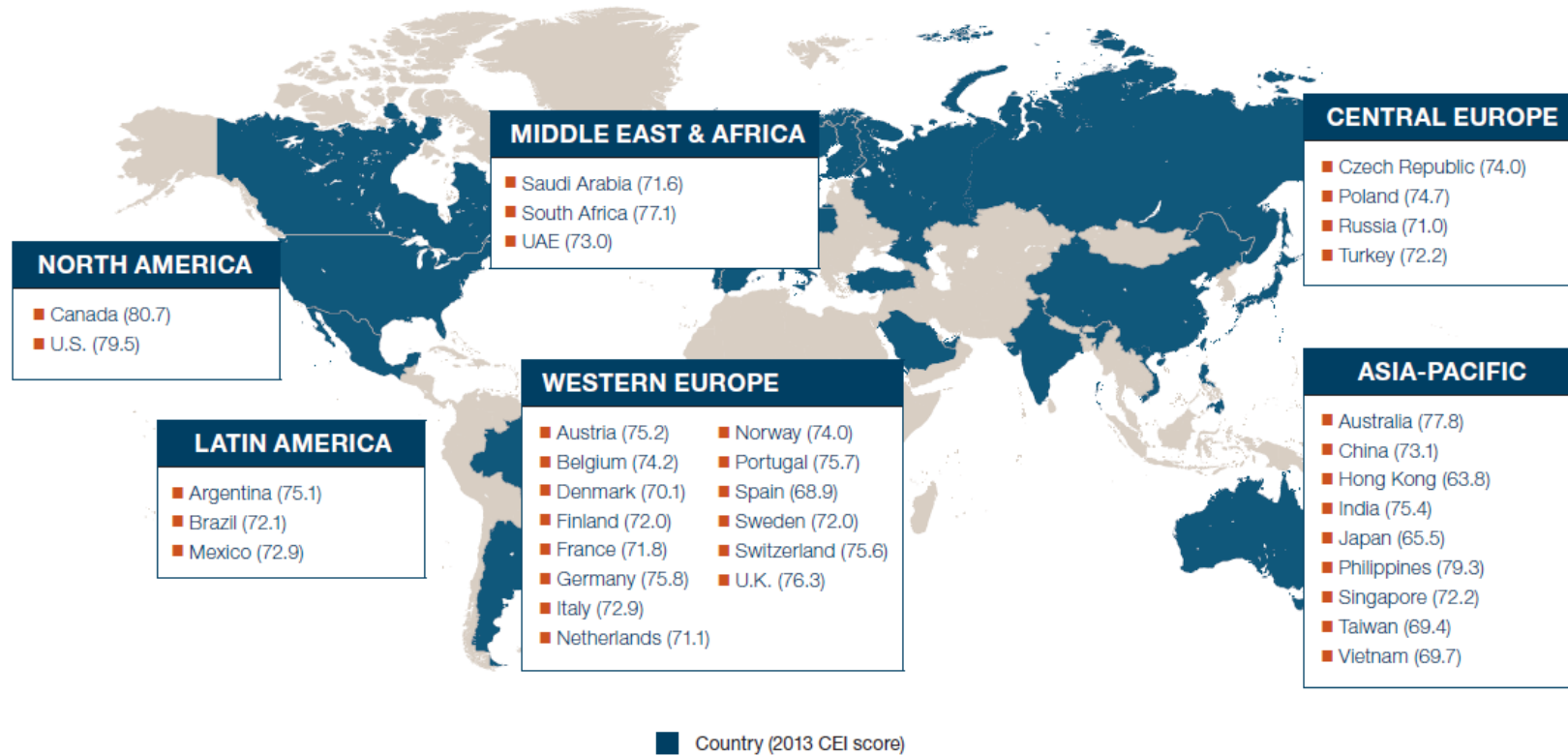
## 5.4 Implications for consumers

As discussed in Section 2.1, a competitive market can lead to great benefits for the welfare of individuals and households. This Section surveys the evidence for the Australian retail banking market.

One of the most commonly cited metrics for assessing banking systems is customer satisfaction and the customer experience. In a large-scale survey of over 18,000 retail banking customers in more than 30 countries, Capgemini found that Australians had one of the best customer experiences in the world – second in the Asia Pacific region and fourth in the world – as can be seen in Figure 5.1. This result was arrived at after surveying customers on a range of issues based around the perceived quality of their interactions with banks. It included 80 indicators encompassing product dimensions, different distribution channels and customer lifecycle (i.e. what the customer is seeking to achieve). Questions revolved around items such as quality of service, trust and customer perceptions that their financial institution understood their needs.



Figure 5.1: Customer experience index by country, 2013



Source: Capgemini and Efma, 2013

This supports the suggestion that building a positive customer experience and relationship is one of the ways through which banking product providers compete with each other in Australia. The fact that the market ranks so highly suggests that this is leading to positive outcomes for customers.

Further, banks compete to attract customers through improving their service offerings, leading to improved customer satisfaction, as discussed in Section 3.1.2.2.

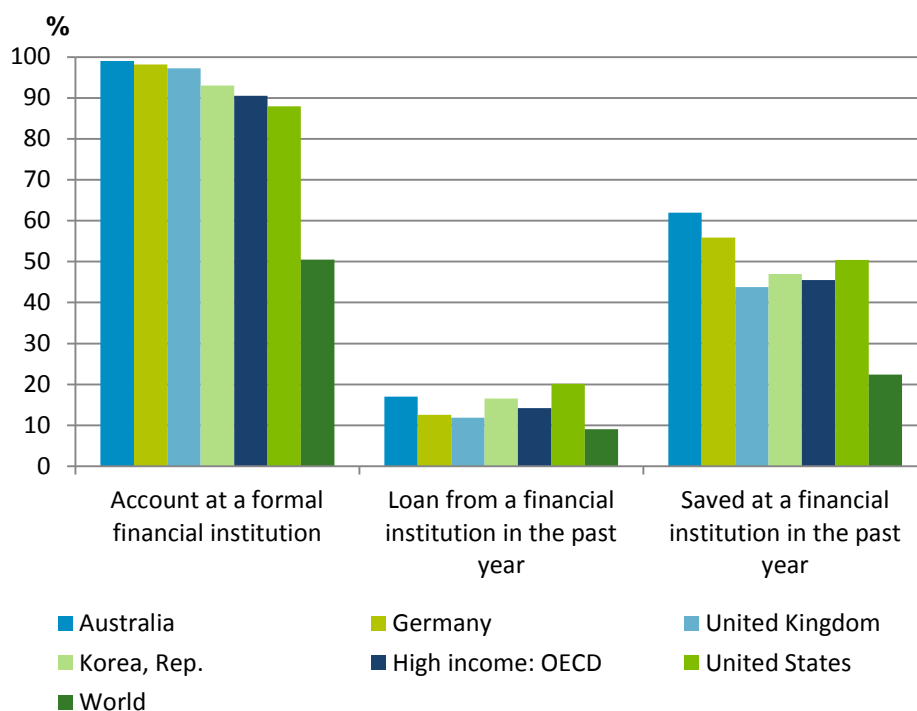
Australian consumers have also benefited from a less risky banking system – a characteristic which is expected to persist into the future. A recent assessment by Standard and Poors found:

*“Australia is currently one of the five least-risky banking systems of the 86 for which Standard & Poor’s has published banking industry country risk assessments”*  
 - Liondis, 2014

As detailed in Section 3.1.2.2, increased access to financial services has been another benefit of competition. The development of business models based on widening accessibility has meant that these services are available to individuals for whom retail banking products are especially important, but who might have otherwise been excluded from accessing these services.

As shown in Chart 5.4, Australians have some of the world’s highest rates of participation in the financial system, with over 99% of individuals aged over 15 having an account with a financial institution (World Bank, 2013).

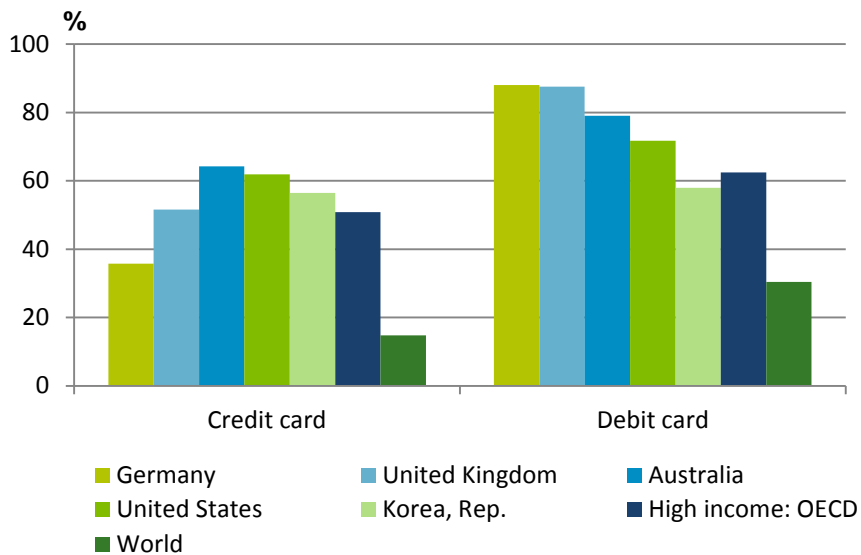
**Chart 5.4: Use of banking services, 2011 (population >15)**



Source: World Bank, 2013

An innovative and well-developed system has led to increased convenience for Australian consumers. This is illustrated through the availability and take-up of new channels, such as mobile and online banking. Similarly, Australians have comparatively high levels of credit and debit card usage, well over the high-income OECD country average, as can be seen in Chart 5.5.

**Chart 5.5: Use of cards, 2011 (population >15)**



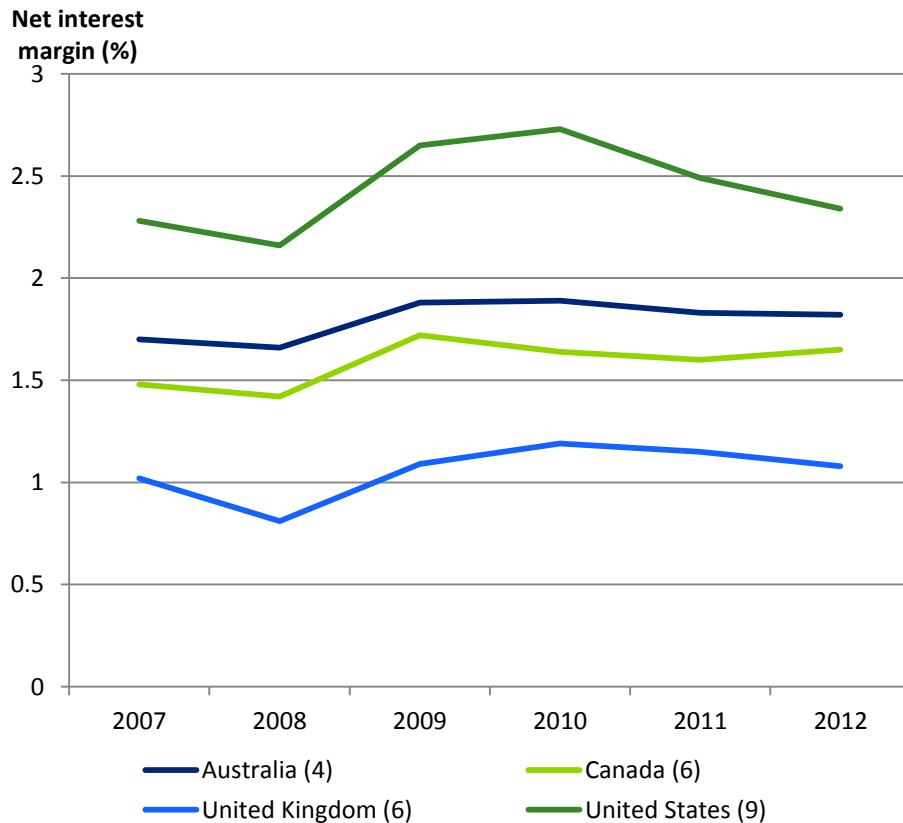
Source: World Bank, 2013

Competition within the market has also resulted in improving outcomes and “value for money” for consumers. This is evident through falling NIMs over the period, as shown in Chart 3.6. More specifically, competition for deposits as a means of funding has led to increasing deposit interest rates. Comparison rates for key products including term deposits and online savings accounts are now consistently exceed the cash rate, as can be seen in Chart 3.4.

NIMs are one a measure of value, because they represent the difference between deposit rates received by customers and lending rates paid by customers. Smaller margins represent better value to consumers, as they imply that a greater proportion of the interest being paid by lenders is being returned to borrowers in the form of interest income.

Prior to the GFC, these margins were in the middle of the range of comparative international banking systems, such as the USA, Canada, and the UK, as shown in Chart 5.6. Australian NIMs have overall remained fairly stable over the period, and have not grown significantly, up from 1.7% in 2007 to 1.82% on 2012 (BIS, various years). This would suggest that, on this indicator, the level of price competition in retail banking in Australia is comparable to pre-GFC levels.

Chart 5.6: Net interest margins of major banks, 2007-2012<sup>1</sup>



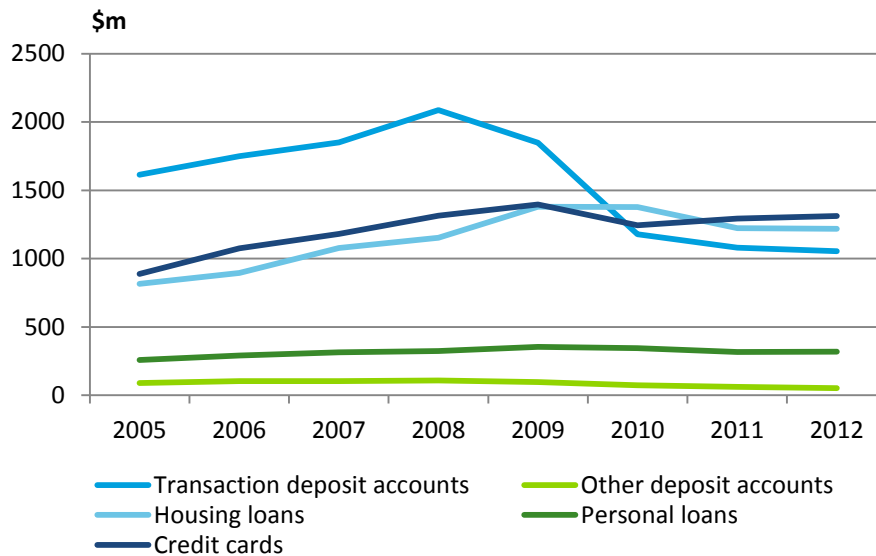
Numbers in brackets reflect the number of major banks included in the analysis.

Source: BIS Annual Report (various years)

Banks may also derive profits from non-interest revenues. In particular, under the “fee for service” model encouraged following the Campbell Inquiry, significant revenues might be gained from banking fees. Chart 5.7 shows that domestic banking fee income from most product types has declined in recent years, despite overall levels of service remaining high. Banks have continued to compete on fees, as shown by the provision of no-fee and low-fee bank accounts.

<sup>1</sup> This series only examines the average margins for major banks in selected countries. It does not encompass the entire sector. Further, it encapsulates bank activity in its entirety; that is, it includes commercial and investment banking as well as retail banking.

**Chart 5.7: Domestic banking fee income from households**



Source: RBA, 2013

Compared to overseas, Australians are well served by their retail banking system. Australians have some of the highest levels of customer satisfaction and access to banking services in the world.

While Australian consumers still receive a range of benefits, the distribution of these has changed. For example, greater competition in deposit markets has led to greater relative returns on deposits.

## 5.5 Looking to the future

Overall, the retail banking market in Australia is robust and competitive. As detailed in previous Sections, this has been supported by a range of factors, including:

- price matching and competitive pricing behaviours;
- narrowing net-interest margins in the long-term;
- dis-intermediation and the entry of new competitors and business models along the supply chain;
- falling barriers to entry as a result of new technologies;
- innovation activities within the market; and
- stability and robustness through the GFC.

Despite this, there could be further benefits which could arise from encouraging greater competition. This could be driven, as before, by international banks, smaller ADIs and non-ADIs, as well as the recovery of capital markets. It will also be supported by the general trends of innovation, technology and globalisation.

Technological change, business model innovation and capital markets have continued to be a driving force for innovation and competition in the sector despite the GFC. Consumer demand

and the rapid rate of digital improvement are the main motivators of adoption of new offerings within the industry. This trend can be expected to continue to have a material impact in coming years. For example, in payments systems, Near Fields Communication (NFC) technology, online payment security, digital wallets and contactless payments have all emerged recently. These new technologies continue to gain popularity while yet others are still being developed.

A range of market participants have played a role in creating and fostering this competition throughout the years. However, continuing to maintain a competitive but stable financial environment will require further recovery. Smaller banks and non-bank ADIs bring an agility which is important to the market and as broader market conditions and customer sentiment start to return to their pre-GFC states, this recovery process will be facilitated by enhanced competition from other participants, in particular those depending on securitisation markets, or being replaced by players with new business models. For example, in a sign of change within the foreign bank sector, Asian bank lending to non-financial corporations in Australia has recently exceeded lending by European banks (Australian Financial Review, 2013). While Asian banks have tended to focus on trade and project financing, this is beginning to change, with the Bank of China now offering retail products. Asian banks have a large presence globally, and are likely to be exerting more pressure in Australian retail banking markets.

Potential new players are also starting to express interest in the market. Supermarkets have issued credit cards, and are rumoured to be considering entry in to mortgage products (Sydney Morning Herald, 2013). Google has begun to offer payments services through products such as the Google Wallet. The threat of new entry will put competitive pressure on incumbents.

Despite the forces described above, there is ongoing debate as to whether levels of competition in retail banking are returning to pre-GFC levels quickly enough, and to what extent competition from niche players will return. While some elements of the financial system are likely to have changed permanently as a result of lessons from the GFC, it is important that other characteristics of the market ultimately return to their previous operating circumstances.

To the extent that the speed of recovery is sub-optimal, regulatory interventions may play a role in stimulating parts of the market. However, any regulatory response should be carefully thought out to avoid introducing distortions that undermine the efficiency of the system. There is a risk that inappropriate legislation may introduce adverse incentives for both consumers and financial institutions. Too high a regulatory burden could encourage shadow banking. It is clear that, while legislation could play an important part, any intervention needs to be appropriately nuanced and considerate of potential long-term effects as the global and domestic markets recovers.

# Conclusions

On a range of indicators, the Australian retail banking industry is competitive in both price and non-price terms. While the sector is concentrated, calculated concentration ratios are not high enough to warrant concern against ACCC criteria. The range of product offerings and industry participants suggests that the market is contestable and contested.

The onset of the GFC disrupted some of the drivers of competition. Increased funding costs and the decline of securitisation markets impacted more on smaller players. International developments also impacted on the ability of overseas banks to compete aggressively.

These developments have resulted in changes to the nature and extent of competition in the industry. The increasing differential in funding costs, mergers and acquisitions, as well as a shift in consumer preferences towards safety and certainty, has led to the major banks increasing their market share. Concentration is higher than it was prior to the GFC.

However, competitive forces continue to operate in the market. Technology advances and consumer demand have continued to drive innovation in product and service delivery. Increased reliance on deposit funding has intensified price competition for deposits.

Despite the impact of the GFC, the banking system continues to deliver value for its customers. This is evidenced by some of the highest levels of access to financial services in the world. Net interest margins are similar to those in comparative economies, such as the UK and New Zealand. Research also suggests that, by world standards, Australians are amongst the most satisfied with their banking experiences.

Overall, Australians are well served by their retail banks in comparison to other countries. However, there are still potential gains from encouraging further competition. Many of the drivers of competition – in particular, innovation and technology – have continued strongly through the GFC. Other factors, such as securitisation markets, have not fully recovered. However, they may revert to pre-GFC levels in coming years.

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# Appendix A: Concentration ratios

This Appendix details the concentration ratios calculated for every product market examined in this report:

- transaction accounts;
- interest-bearing savings accounts (including term deposits);
- mortgages;
- personal loans; and
- credit cards.

As discussed in Chapter 4, concentration ratios are calculated using the market share of various organisations. They are used as an initial indicator for the level of market power within an industry. In this report, they are derived using data from APRA's *Monthly Banking Statistics*. As such, they only include data about institutions which are registered as banks. These were annualised for the purpose of calculation. The benchmark cut-offs used are based on the ACCC's current or previous *Merger Guidelines*.

Market share graphs are also provided. These graphs have been compiled using different sources. The relative advantages of each of these sources is summarised in Appendix C.

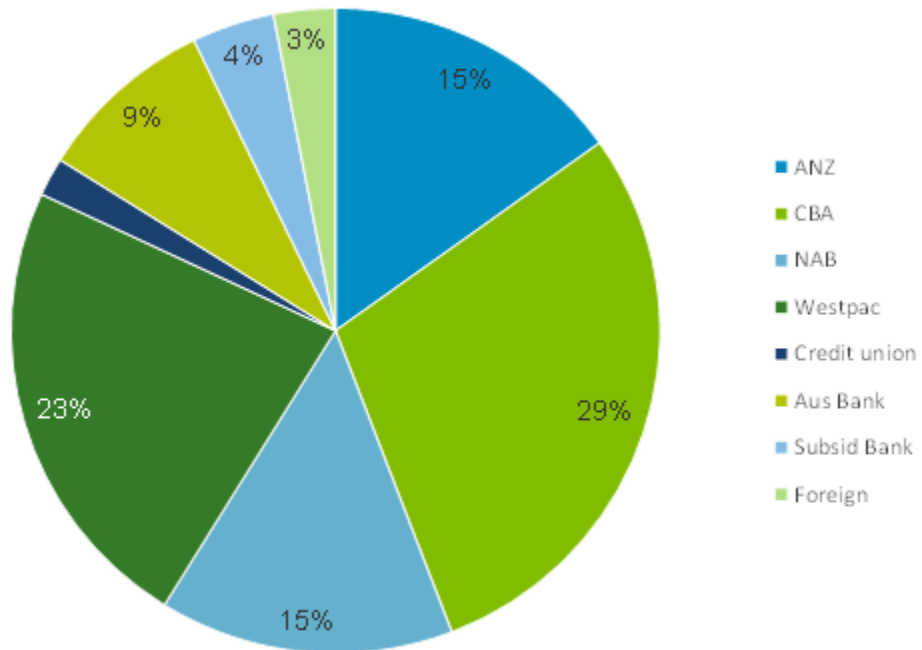
## Transaction accounts

**Table A.1: Transaction account concentration ratios (banks only)**

Metric	Criteria for flag	2013		2007	
		Score	Flag?	Score	Flag?
HHI	> 2000	1828	*	1505	*

Source: APRA; DAE

**Chart A.1: Market shares in transaction accounts based on value, 2013<sup>1</sup>**



Source: APRA, Quarterly ADI Performance

Aus Bank = other Australian banks

<sup>1</sup> Each of the major banks' market share was calculated using APRA's Monthly Banking Statistics. This was then multiplied by the total major banks market share to approximate individual institutions' market share.



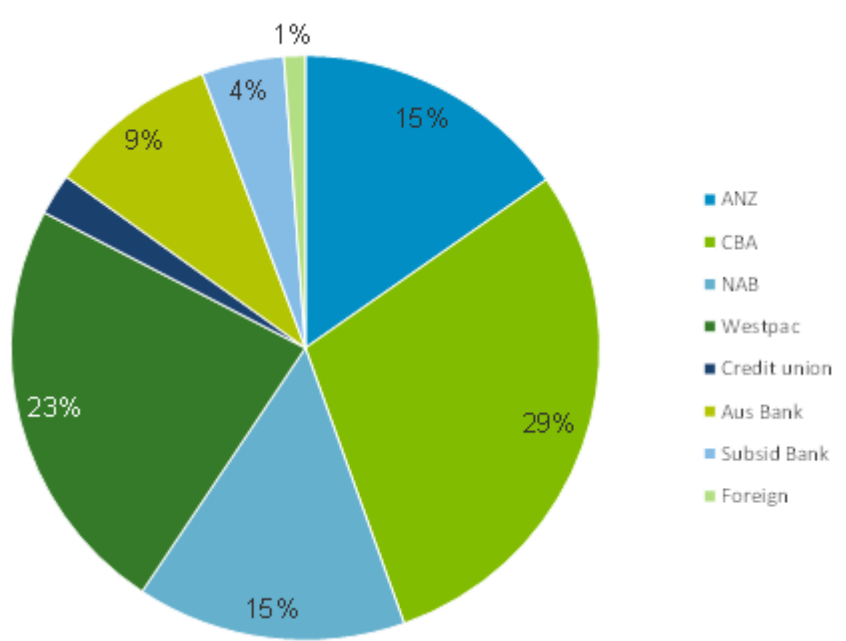
## Interest-bearing savings accounts

**Table A.2: Interest-bearing savings account concentration ratios (banks only)**

Metric	Criteria for flag	2013		2007	
		Score	Flag?	Score	Flag?
HHI	> 2000	1828	✘	1505	✘

Source: APRA; DAE

**Chart A.2: Market shares in interest-bearing accounts based on value, 2013<sup>1</sup>**



Source: APRA, Quarterly ADI Performance

Aus Bank = other Australian banks

<sup>1</sup> Each of the major banks' market share was calculated using APRA's Monthly Banking Statistics. This was then multiplied by the total major banks market share to approximate individual institutions' market share.

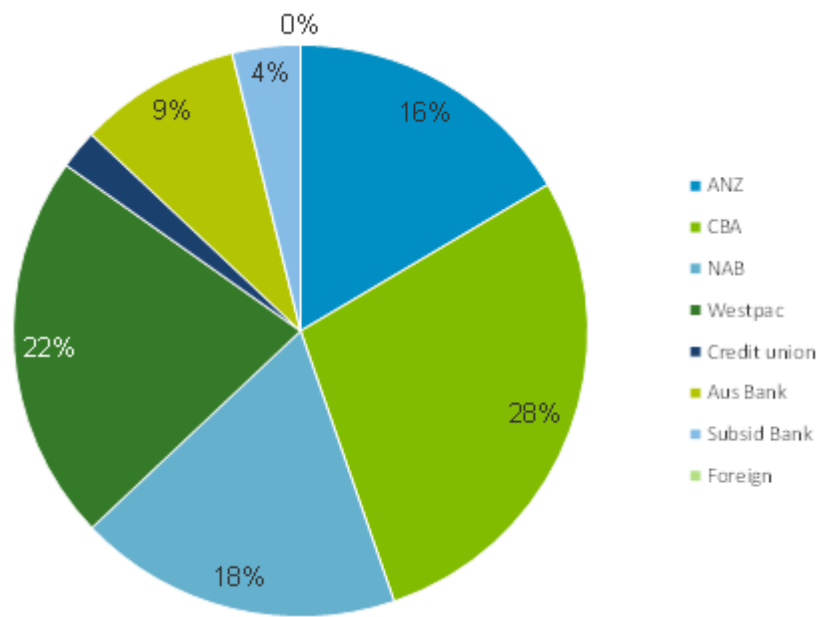
## Mortgages

**Table A.3: Mortgage concentration ratios (banks only)**

Metric	Criteria for flag	2013		2007	
		Score	Flag?	Score	Flag?
HHI	> 2000	1908	*	1535	*

Source: APRA; DAE

**Chart A.3: Market shares in housing loans based on value, 2013<sup>1</sup>**



Source: APRA, Quarterly ADI Performance

Aus Bank = other Australian banks

<sup>1</sup> Each of the major banks' market shares was calculated using APRA's Monthly Banking Statistics. This was then multiplied by the total major banks market share to approximate individual institutions' market share.

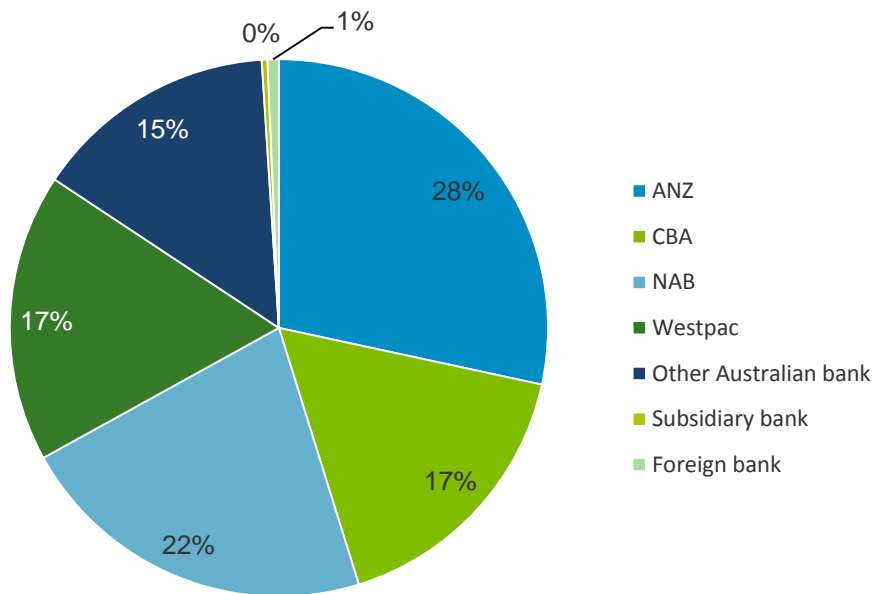
## Personal loans

Table A.4: Personal loan concentration ratios (banks only)

Metric	Criteria for flag	2013		2007	
		Score	Flag?	Score	Flag?
HHI	> 2000	1904	x	1428	x

Source: APRA; DAE

Chart A.4: Market shares in other household loans based on value, banks only, 2013



Source: APRA, Quarterly ADI Performance

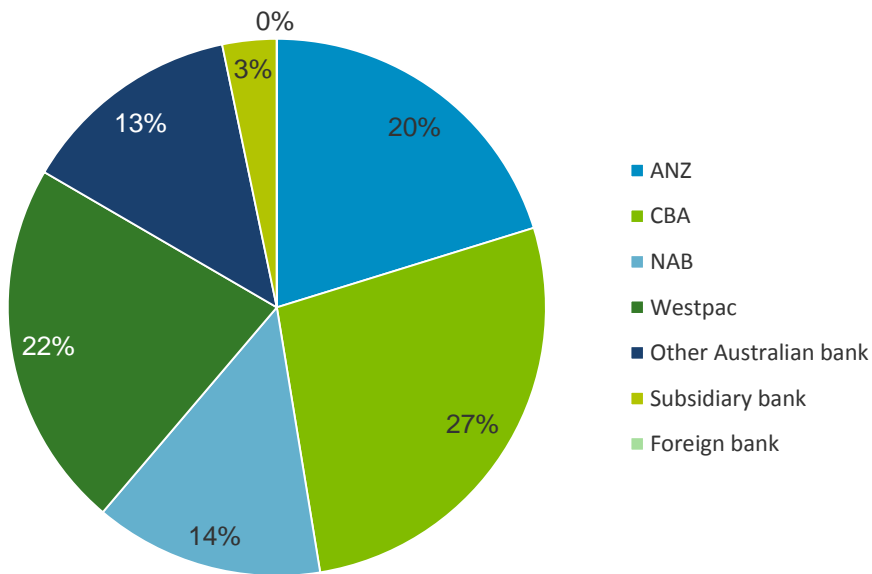
## Credit cards

Table A.5: Credit card concentration ratios (banks only)

Metric	Criteria for flag	2013		2007	
		Score	Flag?	Score	Flag?
HHI	> 2000	1962	*	1750	*

Source: APRA; DAE

Chart A.6: Market shares in other credit card loans based on value, banks only, 2013



Source: APRA, Quarterly ADI Performance

# Appendix B ACCC merger assessment criteria

Section 50(3) of the Competition and Consumer Act (2010) sets out a (non-exhaustive) list of matters which are taken into account by the ACCC when assessing competition matters:

- (a) the actual and potential level of import competition in the market;*
- (b) the height of barriers to entry to the market;*
- (c) the degree of countervailing power in the market;*
- (d) the likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices or profit margins;*
- (e) the extent to which substitutes are available in the market or are likely to be available in the market;*
- (f) the dynamic characteristics of the market, including growth, innovation and product differentiation;*
- (g) the likelihood that the acquisition would result in the removal from the market of a vigorous and effective competitor; and*
- (h) the nature and extent of vertical integration in the market.*

These are intended to be used in merger analysis; as such, not all of them are relevant. Further, some may not be as pertinent to the banking industry in particular. For example, in an analysis of retail banking, there is not likely to be a large degree of consumer power. This is because alternative industries which can fulfil the same needs are not readily available.

Those which could be applied to retail banking markets are briefly described below.

**Actual and potential level of import competition.** Where the domestic producers of a good are not very competitive, the market may also be supplied by overseas producers. This international presence could make the overall market more competitive. However, this is not a strong consideration in Australian banking markets. Many foreign banks, and subsidiaries of foreign banks, have a presence in Australia. However, they are not significant competitors, having a very small share of total retail banking. Further, given the need to obtain licenses from APRA and the low profitability of foreign banks in Australia, it is unlikely that further, significant competitors will emerge from overseas.

**Height of barriers to entry.** The entry of new firms can increase the level of competition in an industry. If there is a credible threat of new entrants, existing firms are less likely to exercise any market power which they might have. This is because if they raise prices, they may be

faced with a new competitor who sells at a lower cost, thus attracting existing customers away from their current supplier.

**Availability of substitutes.** The existence and availability of alternative products is important to competition. Even in a concentrated market, there may be a high level of rivalry or contestability between firms. If the products on offer by rival firms are similar (the degree of product differentiation is low), customers can more easily switch between providers. This would stimulate competition between suppliers to attract customers.

**Degree of countervailing power.** A producer's ability to leverage their market power may be curtailed by buyers. If a buyer is sufficiently large, they can threaten the producer by setting up rival operations (that is, integrating vertically so that the good/service does not have to be purchased externally). They could alternatively sponsor or support the entry of a new player into the market.

Customers in retail banking markets are, by definition, individuals, households, and small businesses. These do not generally have the resources available to establish a banking facility. As such, countervailing power is not likely to mitigate any competition concerns in this market.

**Dynamic characteristics, including growth, innovation and product differentiation.** The evolution of a market over time can affect the extent of competition. In a market or industry with historically high levels of growth which are expected to persist over time, it is likely that there will be higher levels of competition. Similarly, industries with high levels of innovation could compete for customers based on product features by providing new products or services which consumers value.

This is particularly relevant in retail banking, which, worldwide, has been a source of innovation through digital technologies in recent years. Financial institutions develop differentiated products with services which appeal to customers. Where this is successful, competitors have generally been fairly quick to adapt new offerings accordingly. Some examples of this in Australia include online-only banking platforms and mobile banking services.

**Nature and extent of vertical integration.** Where firms in an industry operate at more than one level – for instance, both as wholesalers and retailers – then they are said to be vertically integrated. Industries with a higher level of vertical integration could be less competitive, because firms which are integrated might have a cost advantage.

# Appendix C Data sources

Table C.1: Data sources

Source	Public Data?	Markets*						Frequency	Time series?	Disaggregate by institution?	Retail only?	Include non-banks?	Include non-ADIs?
		T	I	D	M	L	C						
APRA, <i>Monthly Banking Statistics</i>	✓			✓	✓	✓	✓	Monthly	✓	✓	✓		
APRA, <i>Quarterly ADI Performance</i>	✓	✓	✓	✓	✓	✓	✓	Quarterly	✓			✓	
ABS 5609.0, <i>Housing Finance Commitments</i>	✓				✓			Monthly	✓			✓	✓

Source: DAE

\* This category shows which markets (as defined above) the data source can be used for: T = transactions; I = interest-bearing savings accounts; D = deposits (not specified); M = mortgages; L = personal loans; C = credit cards; S = SME lending.

# Limitation of our work

## **General use restriction**

This report is prepared solely for the use of The Australian Bankers' Association. This report is not intended to and should not be used or relied upon by anyone else and we accept no duty of care to any other person or entity. The report has been prepared for the purpose of explaining the level of competition in retail banking in Australia. You should not refer to or use our name or the advice for any other purpose.



## Contact us

Deloitte Access Economics  
ACN: 149 633 116

Level 7  
225 George St  
Sydney NSW 2000

Tel: +61 2 9322 7000  
Fax: +61 2 9322 7001

[www.deloitteaccesseconomics.com.au](http://www.deloitteaccesseconomics.com.au)

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