Inquiry into Competition in the Banking and Non-Banking Sectors

Submission to the House of Representatives Standing Committee on Economics

July 2008

INTRODUCTION

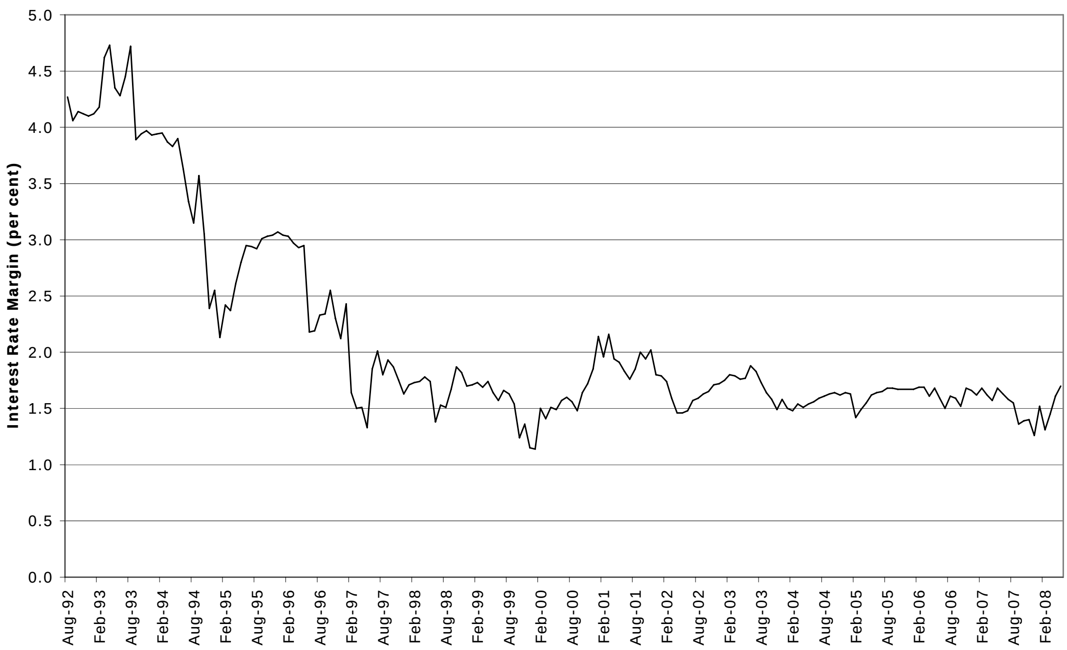
Australia and New Zealand Banking Group Limited (ANZ) is pleased to provide a submission to the House of Representatives Standing Committee on Economics *Inquiry into Competition in the Banking and Non-Banking Sectors* (the Inquiry).

ANZ notes that the Inquiry will pay particular attention to home mortgage products and linked facilities frequently offered to consumers such as credit cards and savings accounts, and this submission specifically addresses these areas.

ANZ believes that the mortgage market is highly competitive and this has been demonstrated by declining interest rate margins for major banks as a result of having to compete for market share against other major banks and as new specialist competitors emerged. While declining interest margins are the clearest outcome of competition, the home loan market has also delivered major innovation in products and their distribution – such as basic home loans, interest rate tracking home loans, portfolio accounts and innovation in services such as mobile lending and lending via the Internet.

The interest rate margin for major banks (comparing the standard variable rate to the Reserve Bank of Australia's 90 Day Bank Accepted Bill Rate) is shown in the Chart 1 below.

Chart 1 Interest Rate Margin for Major Banks

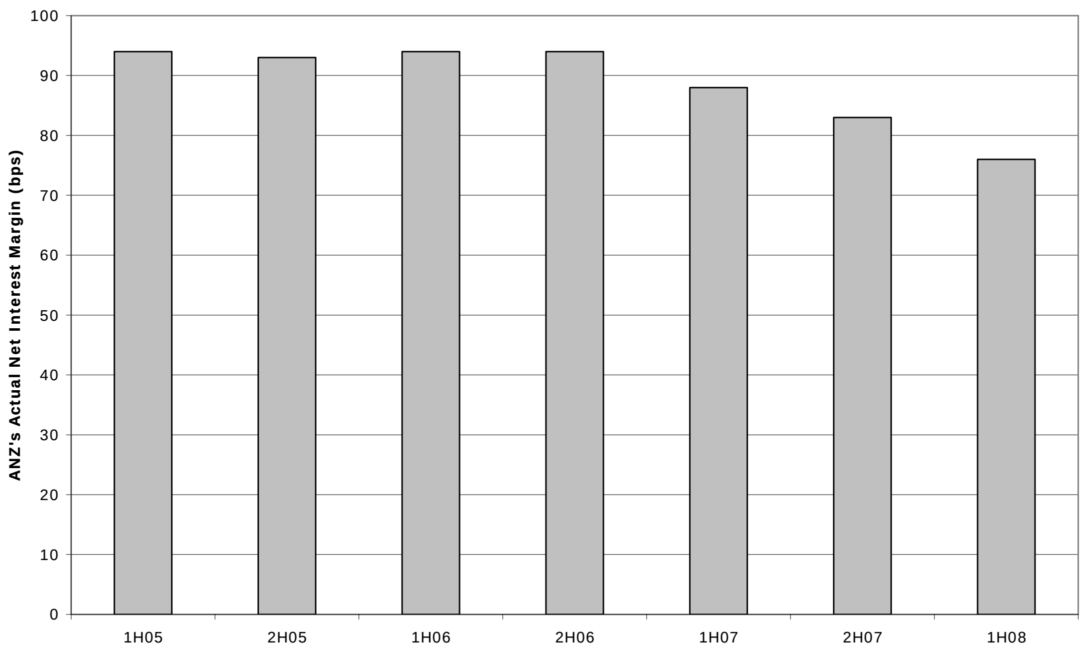


Source: RBA Statistical Table F01 (Bank Accepted Bills – 90 Day) and RBA Statistical Table F01 (Housing Loans—Banks Standard Variable Rate)

Chart 1 shows that since the early 1990s the interest rate margin for major banks fell significantly to a trough in the late 1990s. While interest rate margins did stabilise following this trough, the RBA data only examines the ‘headline’ interest rate and does not take into account further discounts given by lenders which are now standard across lenders. As a guide, the “standard” discount available to ANZ customers on standard variable home loans is 0.70% which reduces the interest rate to 8.92%. Discounts in excess of 0.70% are also prevalent in the market as major banks, non banks and non major or other bank lenders compete for market share. Notwithstanding the impact of the credit crisis since mid 2007, intense competition on rate, service and loan features remains prevalent in the market, particularly amongst the major banks.

Chart 2 below shows ANZ’s net interest rate margin which takes into account our actual cost of funding compared to the actual rates at which we lend.

Chart 2 ANZ’s Net Interest Rate Margin

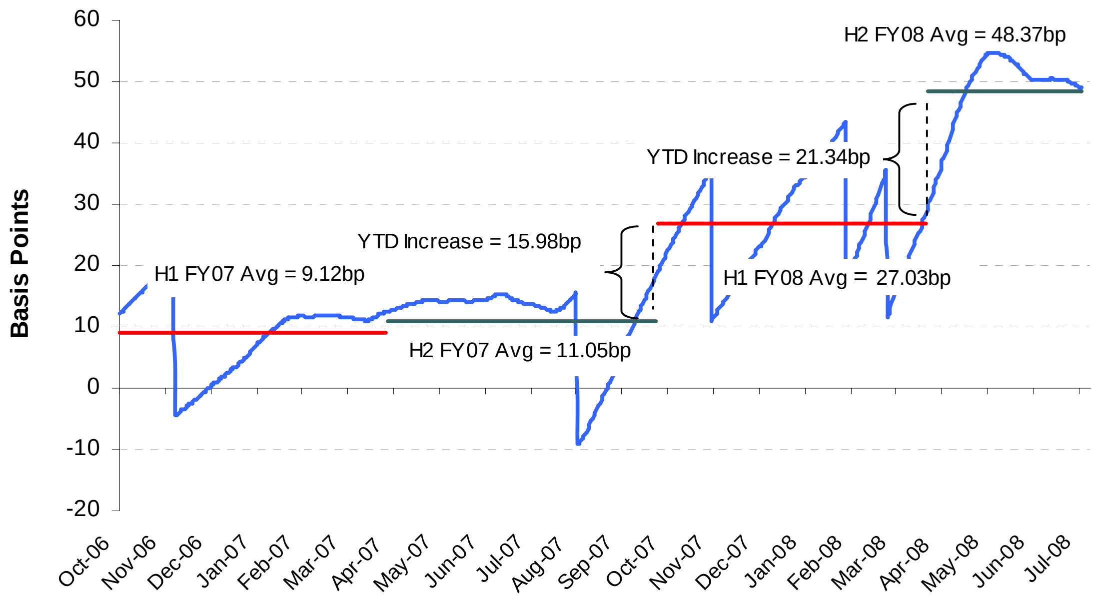


As can be seen the actual net interest margin ANZ makes on its mortgage book is significantly lower than that shown by the RBA data due to the prevalence of discounting. We have also seen a deterioration of the interest rate margin from the second half of 2006, largely due to strong competition in the mortgage market.

Concern has been expressed that recent “out of cycle” rate rises by major banks could indicate a lack of competition in the industry. The banks’ cost of funding is not, however, tied solely to the official cash rate (OCR) set by the Reserve Bank of Australia. The banking industry, like the household sector and the overall Australian economy is a net borrower of funds. In the context of the mortgage market, and major banks, while customer deposits provide a source of funding, these are not sufficient to meet the demands of home loan borrowers. All major banks therefore rely to a greater or lesser extent on global markets for funding. Since mid 2007 the cost of short and longer term funding used by banks to fund their home loan portfolios has increased materially. While it has been the convention over the last 10 years or so that variable home loan rates move in line with movements in the OCR, there is no one-for-one connection and with recent global turmoil the cost of funding mortgages has increased by significantly more than the rises in OCRs and the costs have become far more volatile.

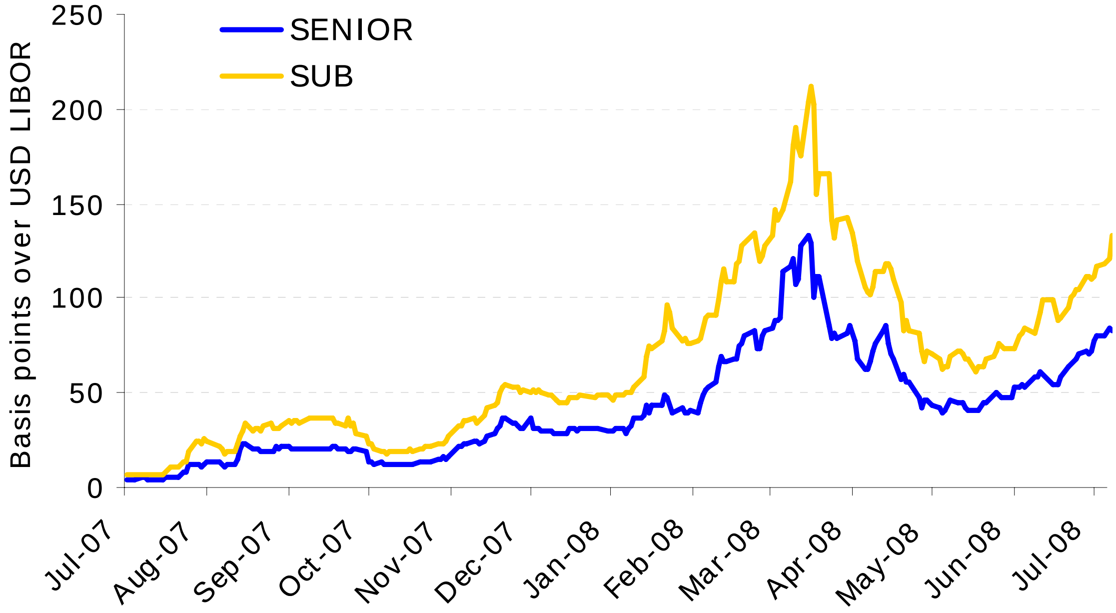
Charts 3 and 4 below show how ANZ's short and long-term funding costs have increased as a result of the sub prime crisis.

Chart 3 Rolling 90 Day 3mth BBSW Less RBA Cash Rate



Source: Reuters and ANZ

Chart 4 ANZ 3 Year Credit Default Swap



Source: Reuters and ANZ

Banks were initially reluctant to pass on the increased costs of funding to customers but with sustained higher funding costs have been forced to increase rates to achieve minimum acceptable returns and a sustainable retail banking business. Achieving acceptable returns are fundamental to the future stability of the Australian mortgage market.

1. RECENT DRIVERS OF COMPETITION IN THE MORTGAGE MARKET

There have been a number of developments that have facilitated enhanced competition in the mortgage market, including the increased prevalence of:

- Competition for market share between major banks, foreign banks and non-Authorised Deposit Taking Institutions (non-ADIs);
- Brokers as a key distribution channel; and
- Customers' use of the Internet for information gathering and mortgage applications.

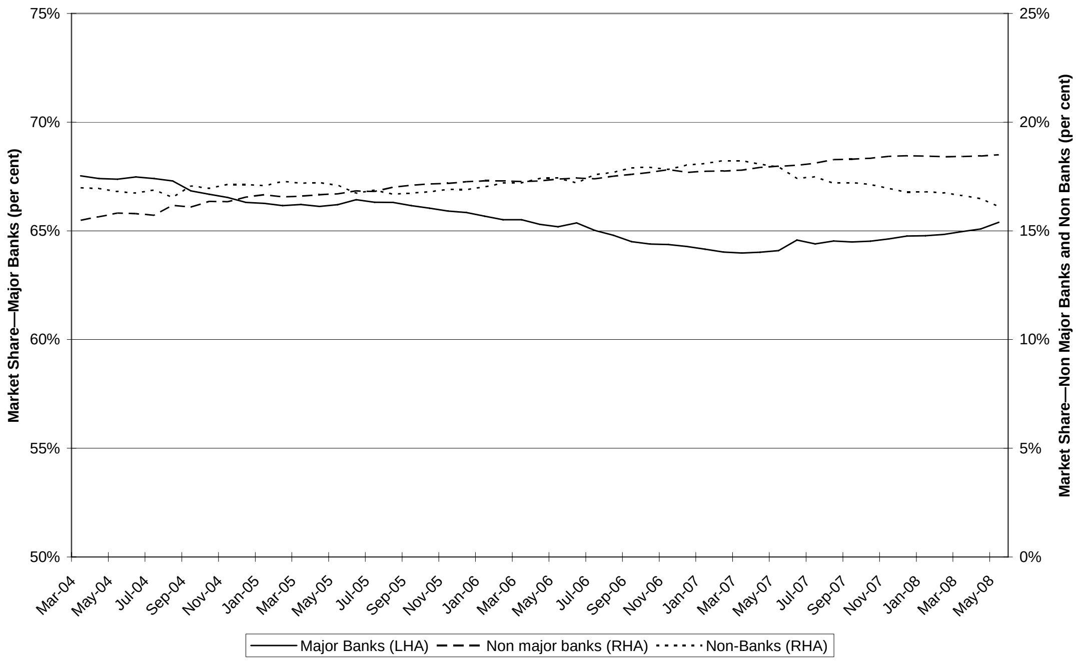
Each of these developments is discussed in more detail below.

Competition for market share between major banks, foreign banks and non-ADIs

Financial market deregulation over the past two decades has led to a significant increase in the number of credit providers in the market, including foreign banks and non-ADIs, and this in turn has led to greater competition for mortgage customers.

These competitors have sought to expand their market share though aggressive pricing which, as outlined above, has led to a fall in interest rate margins across the industry. The increased prevalence of foreign banks and non-bank lenders in the mortgage market is demonstrated in Chart 5 below.

Chart 5 Market Share of Major Banks, Non-Major Banks and Non-Banks



Source: Derived from data in the APRA ARF 320.0 Statement of Financial Position (Domestic Books) and RBA Bulletin Statistics

Note: While Members Equity was reclassified as a non-major bank from July 2007 it has been included in the data for non-banks to ensure consistency across the time series

As can be seen from the chart above, non-major banks and non-banks have been steadily gaining market share in the mortgage market at the expense of major banks up until June 2007. However, in March 2007 the chart shows that the market share of non-banks began to decrease. This change in market share resulted from the liquidity crisis in the capital markets which was triggered by the US sub-prime crisis.

Following the significant turmoil in the US sub-prime market, confidence in the capital markets around the world diminished and this has meant that investors demanded a higher premium for their funds. As a result the wholesale costs of funding have increased significantly and securitisation markets have closed to new funding.

The US and UK governments have provided significant financial support to some institutions that have been severely financially destabilized by their exposure to defaults in the US sub-prime markets and flow-on pressures on funding costs. Examples include:

- In February 2008 the UK Government was forced to nationalise the Northern Rock building society to avoid it failing which had been struggling with its exposure to sub-prime investments in the US
- In March 2008 the Federal Reserve extended JPMorgan Chase a US$30 billion line of credit to buy rival Bear Stearns that was on the verge of collapsing due to losses on investments in mortgage backed securities
- In July 2008 US regulators took control of the assets of the Californian IndyMac Bank after the mortgage lender succumbed to the pressures of tighter credit, falling house values and rising foreclosures
- The US Treasury is currently seeking the agreement of Congress to increase its line of credit to Freddie Mac and Fannie Mae (who together hold more than half of the value of outstanding home loans in the US), and is also seeking authority to buy stakes in each company if necessary. This assistance package is thought to be worth approximately US$300 billion.

The liquidity crisis has impacted on all funding markets around the world and as a result, all lenders in Australia have suffered, including major and non-major banks. However, as Australian banks have access to more diverse funding sources they have been able to continue to lend at competitive margins to support home loan borrowers.

The closure of securitisation markets and higher costs however, have meant that lenders that rely on the securitisation market, the primary source of funding for non-bank lenders, have slowed their lending materially. In some cases this has meant that lenders are effectively in hibernation, that is, they are not originating new loans or they are only replacing those loans that they have discharged. As a result we have seen the market share of non-bank lenders fall. While major banks did observe an increase in market share as a result of the ‘flight to quality’, the non-major banks have also been beneficiaries with a continued increase in their market share.

It is important to note that Residential Backed Mortgage Securities (RMBS) remain an attractive asset class for institutional investors. However, at present the risk of changes in credit spread due to volatility in the capital markets prevents new investment (rather than any concern around the performance of residential mortgages).

ANZ believes that the increase in wholesale costs for banks and non-bank lenders is a short-term challenge and these costs will fall over the medium-term. In the interim non-bank lenders typically have large portfolios which, combined with warehousing facilities from major banks, allow them to continue lending, albeit at a slower rate. Once these costs have fallen and securitisation markets reopen, we expect that these non-bank lenders will return to the securitisation market which will provide them with the funding volume to return to their previous competitive position.

We note that a proposal has been put forward by economists Joshua Gans and Christopher Joye for the Australian Government to sponsor an enterprise, the so called "AussieMac" proposal, similar to Fannie Mae in the United States, and use its AAA rating to issue low cost bonds and acquire high quality mortgage backed securities to add liquidity to the market.

While the proposal would provide additional liquidity to the market and assist those non-bank lenders reliant on securitisation, ANZ would question whether this type of intervention in the market is necessary. The proposal would introduce a permanent solution to address a temporary problem. As noted above, ANZ believes the securitisation market will recover in the medium-term. The proposal would also require the Australian Government to take on a contingent liability.

Offshore models, such as Fannie Mae, have also introduced inequities in terms of access between lenders. This is because they operate on a tender basis and do not consider the aggregate volume originated by each lender. This means that a small lender may be put on the same footing as a major lender and permitted to access equal absolute amounts, rather than amounts proportional to the size of their book. A small unregulated entity may be able therefore to fund its whole business through this channel, while a major lender could fund only a portion of its book, creating a competitive advantage for the smaller lender. This also creates a reputational risk for the Australian Government in the event that one of these smaller unregulated originators collapses.

Further, as noted above even in the current environment competition in the mortgage market remains robust. This is demonstrated by the fierce competition for new business from the major banks where interest margins remain at historically low levels.

The emergence of brokers as a distribution channel

Financial intermediaries, such as brokers, are perceived by customers as an important alternative channel to direct distribution, especially in mortgage lending. Brokers play an advisory role in the lending market by providing the customer with access to information and introductions to third party loans from their panel of lenders, which can include both banks and non-bank lenders, without the customer having to physically visit each lender.

ANZ continues to utilise and actively compete for business through this distribution channel. This is demonstrated by the fact that brokers have consistently represented approximately 38 per cent of all of ANZ's mortgage Funds Under Management (FUM) over the past two years.

The increased use of the Internet

The Internet has helped to further empower the consumer as well as act as a new distribution channel. ANZ's 2008 Survey of Adult Financial Literacy in Australia[1] found that 72 per cent of survey respondents usually accessed the internet from their home.

The Internet has made more information available to customers, both through individual lender websites as well as comparative websites. Comparative websites, such as Cannex's www.ratecity.com.au, provide customers with instant access to information and comparisons of banking products across financial services providers which helps to ensure they are well informed as to the lenders that offer products that best meet their needs.

Further, the Internet has provided another low-cost distribution channel for banks to offer their products. ANZ customers can apply for home and investment loans online reducing the need to visit our physical branch network. The 2008 Survey of Adult Financial Literacy in Australia found that of those respondents that had applied for a financial product online, 10 per cent had applied for a mortgage through this channel.

Indeed this is why in July 2006 ANZ launched 'one direct', which offers customers home and investment loans through direct channels, phone and online. As a direct provider, one direct has no branches and lower operating costs and these savings are passed on to our customers through lower interest rates.

2. POTENTIAL BARRIERS TO COMPETITION IN THE MORTGAGE MARKET

As demonstrated above, changes in the financial services market have enhanced competition, and further innovation in distribution channels will mean this market is likely to become more competitive into the future. However, ANZ understands that there are concerns surrounding some perceived barriers to competition in the mortgage market, including:

- Early termination fees;
- The complexity of some mortgage products making it difficult for consumers to compare; and
- 'Bundled' products meaning that switching providers is more difficult due to the need to switch multiple financial products.

Each of these concerns, as well as ANZ's response is discussed in detail below.

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1 To be released in October 2008

Early Termination Fees

Early termination fees have been criticised as a potential barrier to switching mortgages. On ANZ's Standard Variable Rate Loan and Simplicity PLUS loan we charge a Deferred Establishment Fee (DEF) of $700 which is payable when the customer refinances with another financial institution or repays their loan in full in the first four years.

ANZ does not recover the full cost of originating a loan from our customers through the loan approval fee of $500 (which in many cases are waived[2]) and valuation fee of $150. As a result ANZ introduced the DEF in January 2006 to recover the set-up costs that would normally be anticipated to be recovered through interest income over an anticipated minimum five year life of a loan.

The April 2008 Australian Securities and Investments Commission (ASIC) *Review of Mortgage Entry and Exit Fees* shows that ANZ's flat rate DEF of $700 is one of the lowest in the industry, with the Review showing the average DEF for variable loans was:

- $1944.62 for Large Non-ADI lenders
- $1081.25 for Big Banks
- $703.33 for Other Banks
- $400.91 for Credit Unions and Building Societies

The Review also compared the average entry and exit fees in Australia with those in the US and UK. While the DEF for ANZ is higher than the average early termination fees in these countries, it is important to note that our fees are offset by lower up-front fees. Indeed the total fees for an ANZ customer who pays out their variable rate loan within three years would be a maximum[3] amount of $1890, lower than the average fees paid in the US of AUD $1943 and significantly lower than the average fees paid in the US of $2461.[4]

I would also note that the prevalence of DEFs in the mortgage market has not restricted the ability of customers to refinance to other providers. This has been shown in data from the Australian Bureau of Statistics which suggests that the proportion of all loans advanced accounted for by refinancing has remained around 30 per cent each month since August 2003.

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[2] For Simplicity PLUS customers who receive the First Home Owners Grant this fee is waived. Fees for Standard Variable Rate loans are waived as a part of the ANZ Breakfree package.

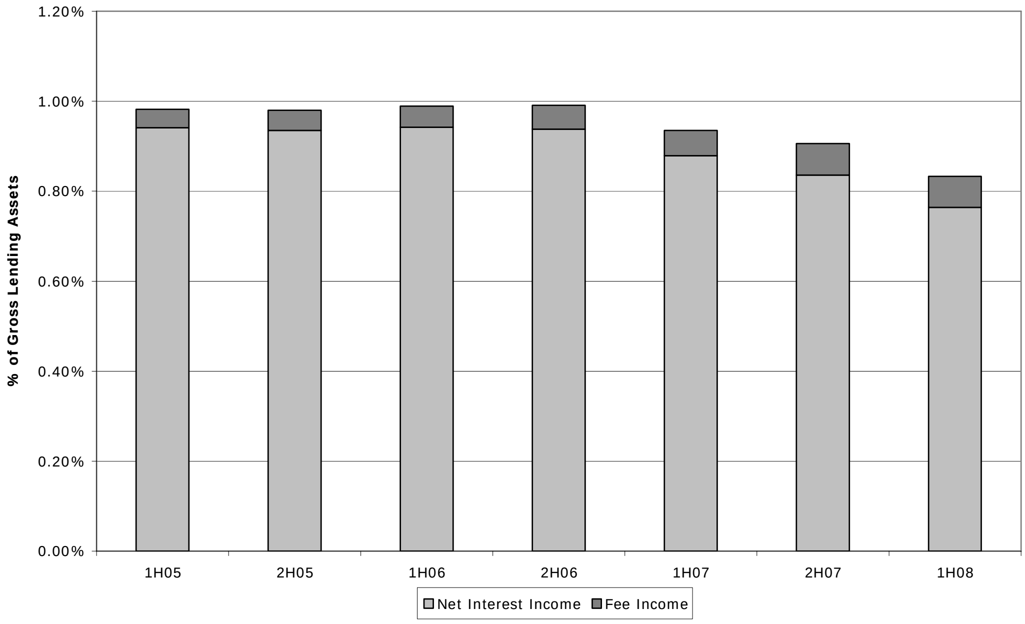
[3] Noting that ANZ can waive the loan approval fee for particular loans.

[4] ASIC, *Review of Mortgage Entry and Exit Fees*, April 2008, p. 10.

ANZ actively competes for new customers who may be charged these fees by offering rebates for the DEF they incur as well as waiving loan approval fees on a tactical basis. Also, ANZ customers who are charged a DEF can have this fee refunded if they return to ANZ within 12 months of leaving.

There has also been concern that while interest margins have fallen over recent years due to competitive factors, this has been offset by an increase in fee income, including from DEFs. However, this is not the case for ANZ with Chart 6 below showing that ANZ's net interest and fee income as a percentage of our gross lending assets on an annualized basis for the past three and a half years.

Chart 6 ANZ's Net Interest and Fee Income (As a Percentage of our Gross Lending Assets)



Source: ANZ
Note: 6 months income is annualised as a percentage of gross lending assets at the end of the period.

As you can see, while mortgage fee income has increased from 0.041 per cent of gross lending assets in the first half of 2005 to 0.069 per cent in the first half of 2008, this has not offset the fall in net interest income over the same period which fell from 0.941 per cent to 0.764 per cent of gross lending assets.

This is supported by the Reserve Bank May 2008 Bulletin on Banking Fees in Australia which suggests that "*Fee income from housing loans grew by 8 per cent in 2007, a little faster than the growth in the number of housing loans. This partly reflects the wider take-up of housing loan packages, which have a sizeable annual fee but give households a lower interest rate on their home loans and other benefits such as fee-free deposit and credit card accounts*".

Complexity of Mortgage Products

There is also some concern that the complexity and disclosure surrounding some mortgage products mean that it is difficult to compare between lenders. As noted above the increased prevalence of brokers as well as comparative websites have helped consumers better understand the mortgage products that are available to them.

However, ANZ has also made moves to simplify the choice for our customers, and we recently restructured our home loan product offering to make it easier for our customers to select the right home loan product to suit their individual needs. Our simpler range of home loans now has four key products which the customer can select from, including:

- Simplicity PLUS—a simple home loan with low fees and a low ongoing variable rate with the loan approval fee waived for customers receiving the First Home Owners Grant

- Standard Variable Rate—a fully featured loan designed to give customers full control and flexibility at a variable rate of interest

- Fixed Rate—a loan that allows customers to lock-in an interest rate and repayments over a pre-determined period

- Equity Manager—an all-in-one home loan and everyday banking solution which offers a line of credit

We also ensure that our fees and charges are clearly disclosed to our customers. In 2005 ANZ introduced a responsible lending commitment into our Customer Charter which, amongst other things, specifies that we will "*explain in clear and simple terms how interest on your credit card or loan is calculated, what fees may apply and when, and the consequences of paying late on your credit*".

To fulfill this commitment we have a comprehensive Letter of Offer, our Fees and Charges booklet (www.anz.com/aus/ratefee/default.asp) and readily available information at www.anz.com. All of these documents clearly outline the DEF and what circumstances it will be payable by the customer, as well as all other fees and charges and applicable interest rates.

Later this year we will introduce changes to our Home Loan Statements to further improve clarity for our customers about the fees they have incurred on their accounts in each statement cycle.

Product Bundling

There has also been concern that the inclusion of transaction accounts and credit cards into a 'bundled' mortgage product may pose a potential barrier to competition between the individual products.

ANZ's core mortgage package is the 'Breakfree Package' which offers, amongst other things, our mortgage customers:

- A discount off the standard variable rate on applicable ANZ home loans[5]
- No annual fee on a linked ANZ credit card account
- No monthly fee on either the ANZ Access Advantage or ANZ One offset facility transaction accounts

In the event that a customer wants to access the benefits of the Breakfree Package but wants to use a transaction account or credit card from another financial provider they can still do so as both of these additional products are provided free as a part of the package and will not incur fees in the event that they are not used.

ANZ is also able to assist customers move their transaction account to a new provider with our listing service. ANZ implemented our listing service on 10 March 2008 which allows customers to request a list of their direct debit and direct credit payments, recurring payments and periodic payments on their ANZ account[6] for the past 13 months.

Customers can request this list by visiting a branch or phoning our call centre. This list will then be mailed to the customer within 5 working days. A sample of the letter which will be sent to the customer can be found at Attachment A.

At this stage the production of this list is largely a manual process and until an automated process is implemented the cost of providing the service is significant. However, in the interests of facilitating a competitive market ANZ has chosen to absorb a substantial portion of the cost and charge a fee of $7 for the service.

ANZ would be pleased to provide any further information about this submission as required, and can be contacted as follows:

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Head of Government & Regulatory Affairs
ANZ
Level 22, 100 Queen Street
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jane.nash@anz.com

[5] ANZ's Fixed Rate and Simplicity PLUS loans are not eligible for the Breakfree Package

[6] This includes personal transaction accounts (Access, Progress Saver, V2 PLUS), Visa Debit and Visa Paycards, Mortgage Offset accounts and Equity Manager Accounts and Wholesale Banking transaction accounts.

Attachment A

[DATE[

Customer & Transaction Services
2/570 Church Street
Richmond VIC 3121

<Customer name>
<Customer address 1>
<Customer address 2>

Reference: <Carbe no>

Dear Sir/Madam,

Re: Listing of direct entry items for your account(s)

<ANZ Access Advantage 1234-56789>
<ANZ V2 PLUS 987654321>

In accordance with your request, we set out below the direct debits and direct credits for your account between (month and year) and (month and year).

Please note that this does not include information relating to ANZ Internet Banking debits and credits manually set up by you, for example Pay Anyone, BPAY® and transfers between accounts.

Account number	**Account Name**	**Most recent transaction**	**Amount**	**Details**
1234-56789		06/02/2008	$75.00 Dr	Transfer to Progress Saver 9876-54321
		07/02/2008	$244.05 Dr	Payment to Esanda Finance 111122356
		13/02/2008	$2042.10 Cr	Payment from Woodcroft College
		02/02/2008	$45.00 Dr	Payment to Independent Education Union
		07/02/2008	$554.88 Dr	Payment to Home Loan 5432-12345
		02/07/2007	$1733.08 Cr	Anz Dividend
9876-54321		06/02/2008	$75.00 Cr	Automatic payment from 1234-56789
5432-12345		07/02/2008	$554.88 Cr	Payment from 1234-56789

Regards,

For the Manager

Please note that the information may not be completely accurate and you should check your records to ensure its accuracy.