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SUMMARY

Following the deregulation of the Australian financial system, bank fees and charges have become part of the Australian retail banking landscape. This development has not been without controversy. Concerns have been expressed that fees and charges are unwarranted (resulting from exploitation of market power), or that they impact disproportionately on certain groups within society. This submission examines whether fees and charges are set in a competitive environment, looks at their incidence on different groups within society and assesses the case for government intervention.

From a number of perspectives, it is apparent that there is now significant competition in the retail banking industry in Australia. For one thing, no bank has significant market power on its own. Moreover, given the number of sellers of banking services, the diversity of banking products sold, and the demonstrated capacity for entry to and exit from the banking industry, the pre-conditions for collusion among banks are not present. Similarly, the high number of sellers means that oligopoly pricing models are inappropriate. Increased competition since deregulation is supported by evidence of a reduction in the interest rate margin received by Australian banks, as well as other indicators such as reduced profitability and increased cost efficiency.

An indication of the competitiveness of the retail banking industry in Australia is that consumers in most parts of Australia can choose between many different banks and the competitive fringe of operators providing banking services. Although some areas (eg country towns) may have a more limited choice, the advent of technology based services (eg telephone banking) enhances consumer options even in poorly serviced areas.

Prior to deregulation, the Australian retail banking system was characterised by a high number of cross-subsidies amongst different categories of consumers. Income was derived largely from interest rate margins; there were few specific fees. This was inefficient and penalised some consumers. Since deregulation, fees and charges have increasingly been applied on transaction accounts, and the proportion of income from interest rate margins has declined.

The Office of Regulation Review (ORR) considers that this development is a desirable consequence of the competitive pressures faced by banks, which have made it difficult for them to sustain cross-subsidies and avoid user pays pricing.

While enhancing economic efficiency, the introduction of bank fees and charges can potentially impose a disproportionate burden on those with low incomes, such as social security beneficiaries and students.

At this stage, however, the ORR cannot find a compelling case for government intervention on equity grounds. This is because banks currently exempt from fees and charges most potentially disadvantaged groups within the community. In addition, there are several avenues open to consumers to minimise or eliminate the impact of the current structure of fees and charges. Apart from its impact on efficiency, government intervention would also reduce the incentive for banks to provide exemptions from fees and charges.

The structure of bank fees and charges could change in the future. In that case, the argument for government intervention on equity grounds may become stronger. If the government chose to intervene, the ORR considers that on balance the most efficient approach would take the form of a “community service obligation” on banks to provide specific groups of customers with fee-free basic banking services, with the Commonwealth Government reimbursing the banks for the costs of doing so.

1. INTRODUCTION

The last 10 to 15 years have seen significant microeconomic reform within the Australian economy. These reforms have had the effect of opening the economy internationally, and of addressing regulatory impediments to competition in many previously sheltered markets. A key element of microeconomic reform has been the deregulation of the financial system.

Financial deregulation has brought a wider range of products and services offered by all financial institutions, especially banks. The banks also have rationalised their branch networks and their staffing, expanded into new fields including stockbroking and insurance, and acquired substantial subsidiary interests overseas.

There have been, however, some downsides associated with financial deregulation. The spate of high profile corporate failures in the late 1980s and associated loan losses by banks have both been linked, fairly or unfairly, with financial deregulation. Perhaps the most controversial change to be associated with deregulation has been the introduction of a range of fees and charges on retail transaction accounts. There are concerns within the community that many of these fees and charges impact disproportionately on disadvantaged groups.

The concern expressed by many groups over increased fees and charges led the Assistant Treasurer to instigate a public inquiry by the Prices Surveillance Authority (PSA) into fees and charges imposed on retail transaction accounts by banks and other financial institutions. (In 1992 the PSA conducted an inquiry into a related matter, credit card interest rates.)

This submission considers whether retail banking fees and charges are likely to be set as outcomes of a competitive marketplace, and what their impact might be. Section 2 outlines the structure of retail banking in Australia and describes some of the fees and charges which might apply to certain transactions. Section 3 examines various statistical measures of the degree of competition, loosely referred to as competitiveness, and their usefulness. Section 4 assesses the competitiveness of the retail banking services sector. Section 5 discusses how explicit fees and charges for specific banking products and services are a consequence of a competitive marketplace. Section 6 considers which groups in society are most disadvantaged by bank fees and charges, and evaluates several possible methods of government intervention to assist them.

2. STRUCTURE OF AUSTRALIAN RETAIL BANKING

Australia's financial system can be divided into five main categories:

- Australia's central bank (the Reserve Bank of Australia (RBA));
- the banks;
- non-bank financial institutions;
- the insurance and superannuation industry; and
- the securities industry.

Competition for the provision of retail banking services comes from banks and non-bank financial institutions. The category of non-bank financial institutions includes the building society and credit union movements.

The banks can be classified into four main categories:

- nationally operating banks (commonly referred to as the major banks);
- State banks;
- regionally operating banks; and
- foreign banks.

The major banks have extensive branch and agency networks and operate throughout Australia. State banks operate principally within each State, although some are now extending their operations to other states. The regionally operating banks are commonly building societies which have converted to banks, and tend to focus their activities in a niche market.

In 1994, there were 44 banks operating in Australia. This included the four major banks, three State banks and twenty one foreign banks (RBA 1994a).

There are numerous types of non-bank financial institutions, such as building societies, credit unions, cooperative housing societies, authorised money market dealers, finance companies and general financiers.

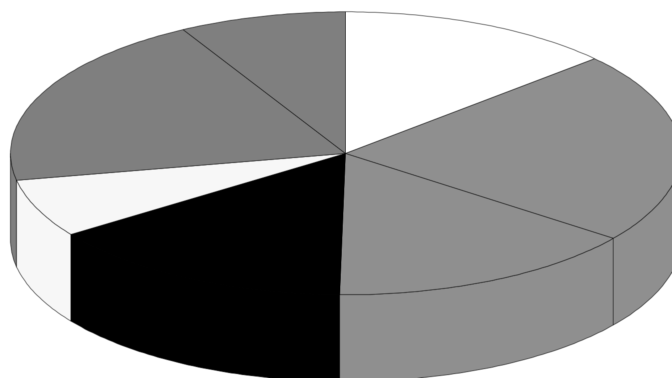
While all forms of non-bank financial intermediary provide some retail banking services, only building societies and credit unions provide the range of services provided by banks. In June 1994, there were 28 building societies and 308 credit unions operating in Australia.

2.1 Market shares and access

There is no single accepted measure of the size of, or the market shares within, the Australian banking industry. This section presents two different measures: value of deposits repayable by banks; and numbers of bank branches.

Total deposits repayable by banks in Australia amounted to $246 000 million as at October 1994. Figure 2.1 presents the market share of the different banks in terms of deposits repayable. As expected, the largest banks (measured in these terms) are the four major banks.

Figure 2.1: Bank market share in terms of deposits repayable



Source: RBA 1994b.

Building societies and credit unions provide a sufficiently diverse range of retail banking products and services for them to be regarded as substitutes for banks. Incorporating building societies and credit unions, total deposits repayable by the banking industry amounted to $267 000 million as at October 1994[1,2]. Figure 2.2 presents the market shares of the different institutions in terms of deposits. The largest market shares also are held by the four major banks.

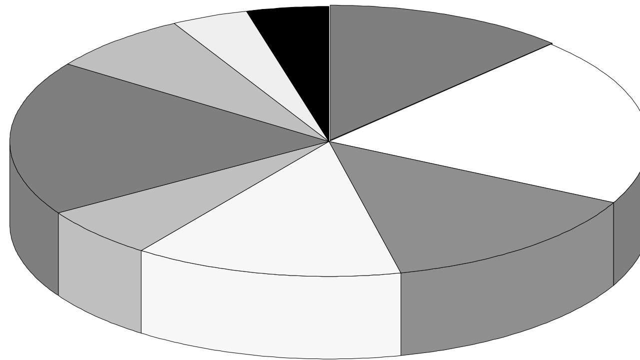
Deposits repayable are not necessarily an accurate reflection of market shares in retail banking because commercial customers also hold deposits, and building societies and credit unions concentrate on retail banking services. Branch

1 Data for the building societies and the credit unions was as at June 1994.

2 There may be some double counting in this amount because building societies and credit unions hold deposits with banks.

numbers are in many ways a better measure of market share because branch networks are basically designed to cater for retail customers.

Figure 2.2: Market share of financial institutions in terms of deposits repayable



Source: RBA 1994b.

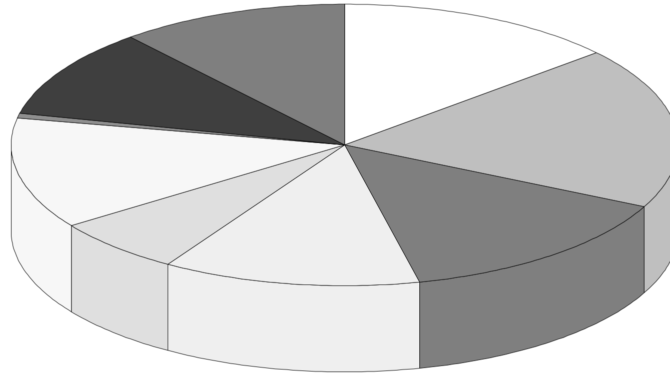
As at June 1994, there were 6790 bank and 950 credit union branches in Australia. Figure 2.3 disaggregates the number of branches by institution across Australia. The building society and credit union movements clearly have a level of market access equivalent to each of the major banks.

The national market shares do not necessarily reflect the market shares in each state. For example, in South Australia the State Bank has over 20 per cent of the retail banking branches, yet State Banks nationally have only a 7 per cent market share.

For many consumers, however, the issue is the degree of access they have to their savings. A very different story emerges when electronic access is measured. Each of the major banks has an extensive telling machine network. In June 1994, there were 5724 automatic teller machines (ATMs) in Australia.

Many State and regional banks, building societies and credit unions have access to similar size or even larger networks of telling machines than the major banks. In most cases, the State and regional banks, building societies and credit unions not only have their own telling machines, but their customers also have access to the networks of the National Australia and ANZ Banks for many transactions.

Figure 2.3: Market share of financial institutions measured in terms of branch numbers



Source: RBA 1994b.

For example, credit union members can use Redicard to access about 3350 ATMs[3], while Westpac and Commonwealth Bank customers can access approximately 2350 ATMs. Hence, from an access stand-point, most financial institutions have telling networks that are viable substitutes for each other.

All domestic financial institutions and some foreign banks have access to the EFTPOS[4] and Poscash[5] systems. There were 42 371 EFTPOS outlets[6] in June 1994. When these products are included in computations of market shares, most financial institutions have approximately the same number of access points. Most card holders can access almost 50 000 transaction outlets.

While branch networks have been reduced over recent years, the growth of the autobank and EFTPOS networks has resulted in a considerable increase in the number of retail banking outlets accessible by customers.

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[3] Of the 308 credit unions in Australia, 170 issue Redicard to their members.

[4] EFTPOS: electronic funds transfer at point of sale.

[5] Poscash: cash dispensing terminals located at clubs and hotels.

[6] The estimates of EFTPOS terminal numbers includes point of banking (EFTPOB) terminals located in post offices and in the premises of retailers acting as agents for financial institutions.

2.2 Breadth of banking products

Banks, building societies and credit unions all offer a vast range of banking products and services. They all offer basic deposit accounts. These can include card accounts, cheque accounts, passbook accounts and special purpose accounts (eg accounts for children and pensioners).

Most financial institutions also offer variations on these basic accounts. For example, the Elliott Committee surveyed the types of accounts offered by 15 banks in Australia, and found 56 card accounts, 41 cheque accounts, 55 passbook accounts and 18 pension accounts (Elliott 1992). These numbers would be much greater if all banks, building societies and credit unions were included in the survey.

Other examples of retail banking products include personal loans, fixed term deposit accounts, credit and debit cards, home loans and investment accounts. It is difficult to summarise the range of accounts offered by financial institutions across Australia.

This breadth of products is due in part to technological innovation, best illustrated by the growth of electronic teller networks in the last decade. In addition, advances in data processing and telecommunications have enabled banks to offer home banking (for personal customers) and cash management systems (for corporate customers) which allow customers to undertake banking activities from their home or office.

Banks have also diversified their operations into other areas of financial activity beyond traditional boundaries, including superannuation, funds management, financial planning and advice, life insurance, stockbroking, trust services and travel.

2.3 Types of bank fees and charges

Table 2.1 summarises some basic accounts offered by a selected group of financial institutions.

Excluding government taxes and charges, there are basically three types of fees and charges on basic deposit accounts:

- first, there are account keeping fees imposed when a balance of less than a specified fee-free threshold is maintained;
- second, there are charges on electronic transactions. Only a few institutions impose such charges, with most offering unlimited access to the electronic network; and

- third, there are charges on paper withdrawals - that is, across-the-counter withdrawals or cheques. Most institutions permit customers to make 2 or more such transactions each week before charging customers. Deposits do not incur charges.

All of the selected financial institutions offered exemptions from fees and charges to specified groups within society. In most cases, aged pensioners, under 18s and full time students do not incur fees and charges.

Table 2.1: Fees and charges on typical small accounts

	ANZ	*Commonwealth*	*NAB*	*Westpac*	*Bank of Melbourne*
Account-keeping fee	**$2 per month (if balance less than $300)**	**$2 per month (if balance less than $500)**	**$2 per month (if balance less than $500)**	**$2 per month (if balance less than $500)**	**$2 per month (if balance less than $300)**
Electronic transactions	15 per month, then 50c each	Unlimited	Unlimited	Unlimited	Unlimited
Paper withdrawals[a]	**15 per month, then 50c each**	**6 per month, then $1.50 each**	**8 per month, then $1.00 each**	**8 per month, then $1.00 each**	**Unlimited**
Exemptions	Under 18; trustee accounts for minors; home borrowers; students; gold card holders	Aged and war veteran pensioners; under 21; home borrowers; students	Aged and war veteran pensioners; under 21; home borrowers; existing customers before Jan 1	Students under 21; trustee accounts for minors	Most pensioners; under 18; students

	Bank SA	*Advance*	*Challenge*	*Metway*
Account-keeping fee	**$2 per month (if balance less than $300)**	**$2 per month (if balance less than $500)**	**$7 per month (if balance less than $100)**	**$5 per quarter (if balance less than $500)**
Electronic transactions	Unlimited	7 per month, then 50c each except through Advance ATMs	Unlimited	10 per month, then 30c each
Paper withdrawals[a]	**5 per month, then 50c each**	**7 per month, then 50c each**	**Unlimited**	**10 per month, then 30c each**
Exemptions	Students; pre-schoolers; most pensioners; retirees	Aged and war veteran pensioners; students under 16; home borrowers	Aged and war veteran pensioners; students under 25	Trustee accounts for minors; under 18; Target account

a. Some institutions define withdrawals to include cheques. Deposits incur no charges.

Sources: Bulletin, 7 February 1995; and information provided by the financial institutions.

3. MEASURING THE PERFORMANCE OF BANKS

A common approach to assessing the degree of competition in the retail banking services sector is to analyse various statistical measures. This section examines a variety of such statistical measures. The primary statistic used in banking is the difference between interest rates levied and interest rates paid (the 'margin'), but other useful measures relate to market share, profitability and cost efficiency.

Such statistical measures provide useful indicators of the competitiveness of the market, but cannot be taken as conclusive evidence. Movements in these measures, even over a long term period, can be a reflection of factors other than the competitiveness of the market.

3.1 Net interest rate margin

The Australian financial system has undergone substantial regulatory change throughout the past 20 years. The major changes occurred in the 1980s. Box 3.1 outlines the most important elements of deregulation from a competition perspective.

One benefit of deregulation is that it should have been associated with decreases in interest rate margins due to increased competition. Has this been borne out in practice?

There is a perception in the community that the net interest rate margin has increased in recent years. For example, the ACT Consumer Affairs Bureau has claimed to "see margins between savings and borrowings increasing"[7].

In contrast, analysis undertaken by the RBA and others indicates a decline in the net interest rate margin since deregulation.

This gap between perception and reality can be simply explained. Statements about behaviour of interest rate margins are often made with reference to a comparison of one lending rate and one deposit rate. For example, the difference between the housing indicator lending rate and a savings account deposit rate.

Such comparisons are misleading. Comparing particular deposit and loan rates does not provide a reliable indicator of the overall interest rate margin. Banks have many different types of loans and these are drawn from the pool of funds built up from a variety of deposits and other liabilities. In other words, money is

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7 ACT Consumer Affairs Bureau, *ACT Alert*, December 1994, p. 1.

'fungible'. Interpretation must therefore be based on a bank's overall interest rate margin, and not on simple rate comparisons.

Box 3.1: Regulatory changes to the Australian financial system

Financial deregulation has been a gradual process, not a one-off event. The major elements from a competition perspective (other elements directed at prudential issues are not addressed here) were:

- in December 1980, interest rate ceilings on deposits with trading and savings banks were removed;
- in December 1983, the Australian dollar was floated and all substantive exchange rate controls were removed;
- in August 1984, all remaining restrictions on bank deposits were lifted;
- in September 1984, invitations were called for foreign bank entrants. Sixteen applications were accepted, and the new banks commenced their operations between September 1985 and May 1986;
- in April 1985, all bank interest rate ceilings were lifted, except for housing loans of under $100 000;
- in April 1986, interest rate ceilings on new bank housing loans under $100 000 were removed; and
- in December 1993, further applications from foreign banks for banking authorities were considered, and foreign banks were given the option of operating as branches, rather than as (or in addition to) locally-incorporated subsidiaries.

The RBA has identified other flaws in using simple interest rate comparisons to evaluate competition in banking. These include that:

- no allowance is made for lags between changes in interest rates quoted on new deposits and loans and average rates paid and received by banks on outstanding deposits and loans;
- shifts in the proportions of low interest and high interest deposits can affect the average cost of funds to banks even if cash rates remain unchanged; and
- although the banks' various loan indicator rates generally move together, significant differences can persist even over the longer term (RBA 1991).

Net interest spread

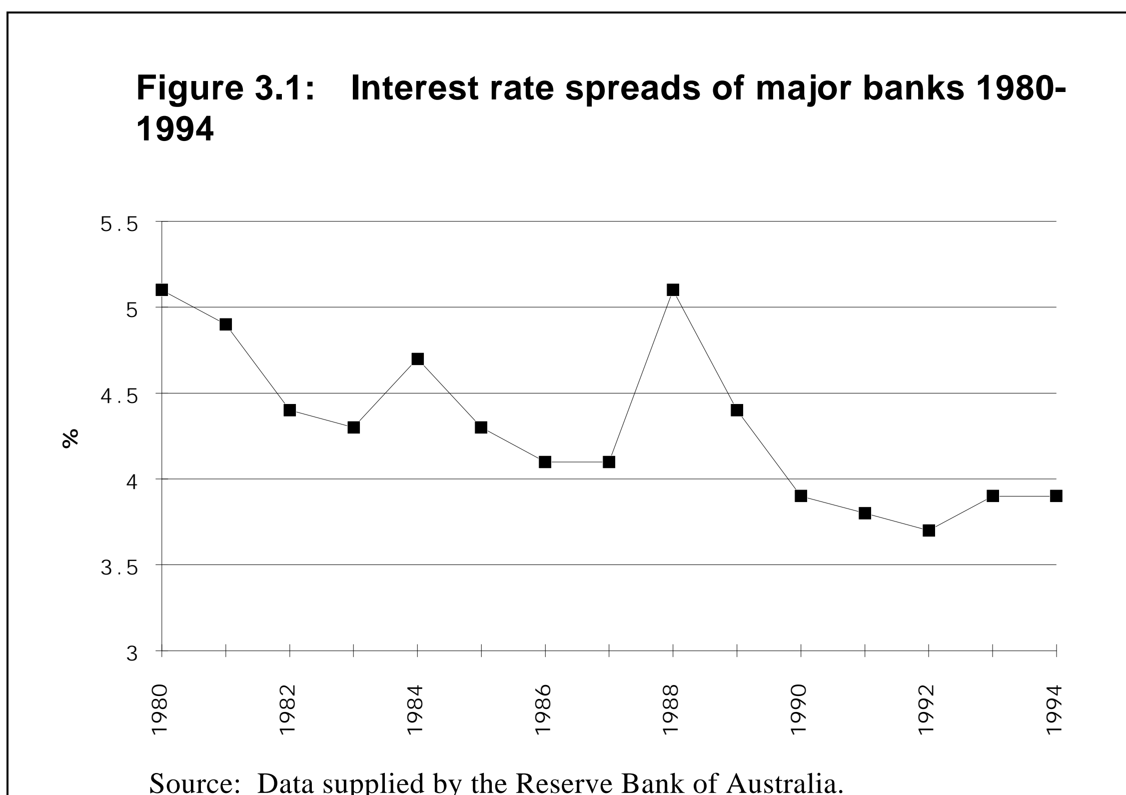
A more appropriate measure of the net interest rate margin is the *net interest spread*. This is equivalent to the difference between the average rate of interest

earned on a bank's portfolio of interest-bearing assets and the average rate of interest paid to its depositors.

As might be expected, the net interest spread does not fluctuate as sharply as some indicator interest rates, and certainly by much less than some of the common measures used in the simple comparisons.

The RBA has found that the net interest spread has followed a downward trend since deregulation. Figure 3.1 shows the net interest spreads for the major banks since 1980[8]. For the major banks, the average interest spread was about 5 percentage points in the first half of the 1980s, and between 4.5 and 5 percentage points in the second half (RBA 1992). In 1990 and 1991, the net interest spread is estimated to have declined to just under 4 percentage points, and has since stabilised at about that level (RBA 1994a).

Figure 3.1: Interest rate spreads of major banks 1980-1994



Source: Data supplied by the Reserve Bank of Australia.

While spreads have been lower on average since deregulation, this result is not uniform. For example, spreads increased markedly in 1988 — following the share market crash in October 1987 — when there were large inflows of low-interest deposits to banks as investors sought security for their savings.

8 The calculation of net spreads includes non-accrual loans on which no interest is being earned by banks. The spread on banks' other loans and investments - the average gross spread - is higher.

International comparisons

The RBA has also attempted international comparisons of interest rate margins. Given the structural and institutional differences across countries, however, the RBA has expressed scepticism about the value of the data underlying such comparisons and about the prospects of deriving any entirely satisfactory international comparisons.

The RBA has concluded that total income and profitability of Australian banks are in line with comparable banks in other countries. What is different in Australia is the mix of income - while interest margins tend to be higher than in other countries, this is offset by relatively low fees and charges (RBA 1994a).

The structure of the taxation system in Australia, which is characterised by relatively high marginal rates of tax at relatively low levels of income, could reduce the incentive to change the balance of these two sources of bank income. This is so because low fees and charges constitute a non-taxable benefit whereas higher paid interest rates (which would accompany higher fees) would be subject to relatively high marginal rates of income tax.

Distributional issues

There are some indications that the wholesale banking sector has benefited considerably more from deregulation than the retail sector. Milbourne and Cumberworth (1991) decomposed the aggregate net interest margin into its retail and wholesale components. They found that the net interest margin on retail activity increased steadily throughout the 1980s, whereas margins on wholesale (mainly commercial) banking were decreasing.

The results attained by Milbourne and Cumberworth hinge on the assumptions used to separate retail and commercial banking. They themselves acknowledge, in reaching their conclusion, that it is difficult to calculate separate margin series for retail and wholesale activities because the funds used are drawn from a common pool of assets, to which different contributions incur different costs.

If the gains from deregulation have been concentrated in the wholesale (commercial) sector, it need not follow that retail customers have cross-subsidised commercial customers. Indeed, under the previous regulated system it seems likely there would have been pressure on the banks to favour (cross-subsidise) the household sector (Milbourne and Cumberworth 1991). It is also likely that the wholesale sector has seen more intense additional competitive

pressures since deregulation than the retail sector. Most of the new foreign banks have concentrated on the wholesale sector.[9]

The RBA has also looked at distributional issues. Although finding that the average net interest margin had fallen since deregulation, the RBA acknowledged that did not mean that every customer's experience had been the same - some are better off, some are worse off, and some are neither one nor the other (RBA 1992). Chapter 6 assesses which groups within the community are most likely to be disadvantaged.

The RBA found that, as a group, depositors have benefited in the past decade or so from a rise in the average interest rate paid by banks on their balances, especially after allowance is made for inflation. This is so for two reasons. First, interest rates on some categories of low-interest accounts have risen over the period. Second, the share of low-interest accounts has declined sharply — from 55 per cent of banks' liabilities in 1981, to about 20 per cent of liabilities in 1991 (RBA 1992).

The trend increase in average interest rates paid by banks has translated into a corresponding trend increase in the average interest rates sought by banks on their loans and other investments. On average therefore, borrowers are paying more for their loans than they did a decade or so ago. But the benefits are flowing to those people who lend money to or deposit money with the banks (RBA 1992).

Indeed, it is pertinent that the "household sector", as defined in the national accounts, is the major source of domestic saving in Australia (Fitzgerald 1993). It can therefore be argued that the household sector, overall, is better off as a result of higher average interest rates paid by banks.

3.2 Other indicators of competitiveness

Deregulation of the financial sector has had impacts in areas other than the net interest rate margin. It is worth looking at some of these impacts in order to determine whether the results are further indications of competitiveness.

Market share

Before deregulation, the restrictions placed on banks and the high cost of their operations induced substitution away from banks towards non-bank financial institutions. The result was a loss of market share by the banks to the non-banks.

[9] The largest foreign banks in terms of retail presence are Citibank, Chase Manhattan Bank, Hongkong Bank of Australia, and Bank of New Zealand.

Since deregulation, the combined market share of banks has consolidated, and the loss of market share to non-bank financial institutions has been stopped. Finance companies and building societies have lost considerable market share — many of the latter have become banks.

Profitability

The additional competition stimulated by financial deregulation was expected to reduce the profitability of banks. The recent large profits earned by the major banks are sometimes cited as evidence that deregulation has failed. The more systematic evidence, however, appears to confirm a general downward trend in bank profitability since deregulation.

Profitability of the finance industry as measured by the return on equity fell steadily from approximately double the all-industry average in 1981-82 to less than two percentage points higher than the all-industry average in 1985-86. Since then, profitability decreased due to corporate bad debts, but has since returned to approximately 1985-86 levels (ABA 1994). In a more complex study, Harper and Scheit found that the shareholders of banks generally, and of the three major private banks in particular, have not earned supra-competitive risk-adjusted rates of return on their shareholdings since deregulation (Harper and Scheit 1992).

However, data on bank profits cannot be relied on in drawing conclusions about the adequacy of competition. Profits studies have a notorious history as an indicator of the effectiveness of competition and are plagued with measurement problems to the point where they are now largely discredited.[10]

For example, several hundred studies published between 1950 and the early 1970s found that, in most cases, industry profits rose with seller concentration. This positive correlation was regarded as a consequence of monopolistic and oligopolistic market power. However, by the end of the 1970s, the interpretation of this correlation between profits and market concentration was viewed as ambiguous: the above-normal profits could be the result of superior efficiency, market power, or both. By the end of the 1980s, further more sophisticated studies demonstrated that most, if not all, of the correlation between profitability and market concentration was almost surely spurious (IC 1994).

[10] See Scherer and Ross (1990, pp-415-22) for a discussion of the measurement problems associated with profits studies.

Cost efficiency

A major goal of financial deregulation was enhancement of the efficiency of the financial system. This was to occur through competition forcing institutions, particularly banks, to operate at lower cost levels.

Bank operating costs as a percentage of average assets for the major banks have indeed fallen since deregulation (Ackland & Harper 1992). Real deposits per employee have increased, and unit labour costs have fallen (Milbourne & Cumberworth 1990). One manifestation of greater cost efficiency is the increased automation of routine procedures previously conducted manually by bank staff.

Service quality and product range

One of the most obvious effects of deregulation is the wider range of products and services offered by all financial institutions, especially banks. The introduction of electronic funds transfer, 24 hour/7 days per week automated teller machines, over-the-counter sales of shares and insurance products, the burgeoning array of financial products including swaps, futures and options, low-start and reverse mortgages, securitised loans - all are examples of new products and services introduced into retail and/or wholesale financial markets since deregulation.

3.3 Summing up

There are numerous statistical measures which have been used to show the competitiveness or otherwise of the retail banking services sector in Australia. These measures include the net interest rate margin and the rate of profitability. None of these measures is perfect, and all can be misused. Nevertheless, it is significant that all the available measures are consistent with the retail banking services sector having become more competitive since financial deregulation.

4. IS COMPETITION EFFECTIVE?

The PSA (1995) has identified competition as one of the key issues of its inquiry. In principle, competition should stimulate the banks, building societies and credit unions to provide, at least cost, the retail services desired by their customers. This section assesses the degree of competition in retail banking. It draws on more general work on competition issues published in *Pro-competitive Regulation* (IC 1992) and *What future for price surveillance?* (IC 1994).

4.1 Single bank market power

At one extreme, there could be ineffective competition if a single bank could unilaterally exercise market power. This possibility can be easily dismissed — no bank has a market share that is even close to the levels needed for unilateral market power. For example, the combined market share (in terms of Australian deposits) of the four major banks amounts to only around two-thirds of the market — the largest single bank has 21 per cent of the national market. Antitrust case law and recent econometric evidence suggest that a single firm would need to occupy at least two-thirds of a market to secure significant market power (IC 1994).

4.2 Collusion

Another reason for ineffective competition might be that there is collusion. The main avenue for collusion by the banks is tacit: the development of implicit understandings about fees and rates — there is no evidence of a cartel in the retail banking sector.

The prices of retail banking services are publicly known which aids tacit collusion. However, collusion over retail banking faces major hurdles — the existence of numerous competitors, the entry and expansion of new banks, the lack of a standard product and a rapidly changing business environment. For example, implicit understandings may break down owing to conflicts over the most suitable price, the complexities of co-ordinating pricing across a diverse range of products or the simple presence of a maverick institution. As time passes, destabilising pressures will build due to long-run substitution and the threat or actuality of entry by new competitors.

Any collusive arrangement in retail banking would call for the co-ordination of a plethora of existing products and services, as well as the regular introduction of new products and technologies across a range of established and new financial

institutions. For example, as noted in section 2, a survey of 15 banks found 56 card accounts, 41 cheque accounts, 55 passbook accounts and 18 pensioner accounts. Moreover, these numbers would be much greater if building societies and credit unions were included.

Nonetheless, the banks no doubt note carefully the actions of their rivals, including the costs of basic products, and a degree of copy-cat behaviour is likely. However, it is not easy to distinguish competitive from collusive pricing on this basis. A simultaneous price rise may reflect industry-wide cost changes or rising demand. Moreover, identical prices would be expected in any market where buyers have good information and the products of each seller are similar.

As a practical matter, any understandings to reduce competition in retail banking would have to be virtually market-wide in coverage. Otherwise collusion would be defeated by competition from non-participating institutions. Moreover, if there were some collusion in the fixing of account fees, that would only induce institutions to compete with greater intensity in other areas. Non-price competition is generally too subtle and widespread to be constrained by an informal agreement. For example, prior to financial deregulation, there is evidence that banks responded to interest rate controls by competing in the size and scope of their branch networks and other forms of non-price competition.

Collusion is especially unstable in dynamic markets — where the growth in demand or the pace of technological and product innovation are strong. The Martin Committee observed:

> In the past few years the way the average Australian has carried out daily banking has changed greatly. No longer is it usual to operate a stand-alone cheque account to pay bills and a passbook savings account for daily transactions and deposits for a particular purpose.
>
> Instead there are combinations of accounts to satisfy almost every banking need. Accounts can now be combined so that money from a cheque, savings or credit card account can be accessed by a single card through an Automatic Teller Machine 24 hours a day (pp. 366-7).

Electronic banking is marginalising the advantages of large branch networks and, more importantly, is making small or regionally based institutions almost indistinguishable from major banks because all offer similar card access.

The number of retail outlets has increased from about 7,000 branches to over 50,000 access points due to the emergence of telling and EFTPOS networks. Electronic transactions account for almost half of all transactions while EFTPOS and Poscash usage is growing an annual rate of 30 per cent. In such a market, collusion could not endure unless all or most institutions can agree on the rationalisation of their existing branch networks and their rates of expansion into new markets and technologies.

4.3 Oligopolistic pricing

Even if there is no collusion, there has been long-standing suspicion that competition is less than vigorous in concentrated markets. While each bank may act independently, its decisions must reflect the expected reactions of its rivals. A pattern of non-aggressive behaviour may emerge as a result.

Many factors beyond concentration bear on the ability to co-ordinate prices without collusion in the normal sense. They include the heterogeneity of products, buyer strength, the psychology of the players, and the relative uncertainty about how rivals are behaving or will behave (Areeda 1984). Hence, although there may be no need for formal agreements or tacit understandings, the weight of the evidence is that there is a need for clearly understood signals and patterns of leadership by one or two of the market's largest firms (Scherer 1987).

There is some anecdotal evidence that high concentration tends to dampen competition. But there is also anecdotal evidence to the contrary. For example, there is strong rivalry within the airline and long distance telephone duopolies. In addition, the PSA has examined seven different three-member oligopolies since 1991. It found enough signs of competition to justify the removal or replacement of prices surveillance in the majority of these inquiries.

The Industry Commission (1994) noted in its submission to the PSA's review of prices surveillance declarations that, on best empirical evidence:

- market power tends to be wielded not collusively, but by the largest seller and is often based on cost or price advantages;
- new competitors do move into markets with varying degrees of success;
- potential competition is important, although not as powerful as actual competition;
- competitive forces eliminate excess profits over time, although sometimes this process may be slow;
- the first firm in the market may charge a high price, but the entry of one or two other suppliers usually results in effective competition; and
- once there are three to five suppliers in a market, an additional entrant has little impact on pricing.

The ORR considers that Australia has a moderately concentrated retail banking sector. The declining significance of branch banking and ready access to electronic technology allows most banks, building societies and credit unions to win market share from under-performing rivals.

4.4 Consumer inertia and 'lock-in'

Effective competition in retail banking may be impeded if consumers are reluctant to shop around. Some consumers may be locked-in to their existing institution if retail banking is an ancillary feature of a long-term relationship premised on a mortgage. It is also possible that consumers may over-look retail banking fees and the costs of switching out of a long term arrangement when entering into a mortgage.

Gaps in the availability and quality of consumer information are common-place in real markets; this creates room for otherwise competitive suppliers to over-price their products without losing appreciable market share (Stigler 1961). Moreover, consumers are constrained by income, time and their capacity to process information when making decisions (Becker 1993).

For example, consumers select financial institutions not only on the basis of price, but rather their preferred mix of price, service, quality and other features. Their demands vary over time with economic conditions and requirements such as the need for a home mortgage. However, the Martin Committee (1991) expressed dissatisfaction with the amount of consumer information that is available about banks and noted the complex financial calculations required for detailed product comparisons.

The Governor of the Reserve Bank has observed that:

> If [consumers] shop around, they are likely to discover that they can get better deals on particular products from different banks. But in practice, many borrowers are reluctant to shop around for a number of reasons, including inertia and the convenience of the current 'packaged' service (comprising housing loan, cheque account, credit cards and so on), reluctance to try non-traditional sources of funds, and the actual and perceived costs of switching some or all transactions from one bank to another (Fraser 1994, p. 16).

Consumer inertia and switching costs appear to be less of a problem than in the past. For example, electronic funds transfer, telling machine and EFTPOS networks have made it easier to conduct business with more than one financial institution. Hence, the modest market power that flows from gaps in consumers' knowledge about their banking options should be in decline due to technological and product innovation and the intensification of marketing efforts following deregulation. Of course, interest in new products and technology, and the capacity to use them may be less in certain disadvantaged groups. Thus this feature of the benefits of deregulation and competition may not be evenly spread in the community. This issue is discussed in Section 6.

Consumers are often aware of the possibility of lock-in and act to protect themselves before an initial purchase is made (Klein 1993). For example, Australian adults already use an average of 1.92 financial institutions and 10 per

cent of customers change their main financial institution each year. Moreover, a 1989 survey revealed that only 30 per cent of borrowers chose their lender because they were banking with them at the time of deciding to seek a loan. The large majority of borrowers compared price, service and availability of different institutions (ABA 1991).

Most firms have an interest in attracting new business and retaining the goodwill and regular patronage of their existing customers (Arthur 1994). In addition, sellers are usually aware of the extra profits from locking-in customers and offer rebates to attract this type of buyer (Shapiro 1995). For example, the offer of discounts to regular customers is a common commercial practice.

Thus, in a market with several providers, each seller faces a choice: build a reputation for serving all customers well, or run down its goodwill by taking advantage of locked-in buyers. If the actions of a seller undermine customers' trust, or alter market expectations about future behaviour, the loss of goodwill may spread to the other products sold by the firm (Shapiro 1995). News of opportunistic behaviour by a financial institution can spread both by word of mouth and through the mass media.

For example, studies of the impact of automobile and drug recalls, and the detection of deceptive advertising, show that the share prices of the companies concerned fall by amounts far in excess of all plausible out-of-pocket expenses that may be incurred at the time and in any later litigation. The implication is that the share market anticipates a significant long term decline in sales and profits due to a general loss of goodwill (Peltzman 1981, Jarrell and Peltzman 1985).[11] Hence, opportunism regarding locked-in customers is most likely in settings where goodwill is not important — for example, when a firm is leaving an industry or it is operating in a sharply declining market (Shapiro 1995).

Some financial institutions already appear to be aware of the potential adverse reaction of consumers to retail banking fees in the context of long term relationships. For example, some institutions exempt home mortgagees from fees on their savings, passbook and card accounts (see Table 2.1).

Attempts by an institution to over-charge for retail banking services are likely to impact on new business and encourage enough existing customers to shop around that such a strategy should be unprofitable. Hence, the discipline exerted by mobile consumers, to the extent that they are informed about alternatives, offers some protection to customers who are poorly informed or locked-in.

[11] Numerous studies show that share price changes are very reliable indicators of changes in the value of companies; and that new information about a company is capitalised into its share price within the day that it is released (Easterbrook and Fischel 1991; ORR 1995).

There is evidence from the PSA's last inquiry into retail financial services that suggests that the introduction of fees may actually reduce consumer inertia. Consumers appear to be relatively insensitive to variations in credit card interest rates. However, evidence from overseas suggests that consumers are quite responsive to variations in the fees levied on credit cards (PSA 1992).

The PSA (1992) found that the removal of the prohibition on fees is likely to result in more diverse pricing of credit cards and lower interest margins and lead to a closer match of consumers' preferences and credit card products. A similar rationale applies to the introduction of fees on retail transaction accounts. Financial institutions can win more market share — and reduce their costs and interest rate margins — by better targeting of their product ranges to the usage patterns of different groups of consumers.

5. USER PAYS

The pricing regime used by financial institutions prior to the 1980s made relatively little use of fees based on costs of particular services (user pays). A large part of this was due to regulations which restricted price competition. It also reflected more conservative management in banks and less demanding customers. This meant there were a number of cross-subsidies, such as depositors subsidising borrowers, infrequent transactors subsidising heavy transactors, and urban customers subsidising geographically isolated customers. These cross-subsidies were funded by the net interest margin, and were largely hidden and possibly unintentional.

5.1 Impact of deregulation

Deregulation meant that additional competition was introduced into the domestic banking sector. Competitive forces placed increased pressure on banks to justify the use of resources in given activities. The more substantial cross-subsidies ceased to be sustainable because competitors could always avoid providing the underpriced services, and undercut where services were overpriced.

The effect of strengthening competitive pressures has been summarised by the Commonwealth Bank:

> If you try to avoid user pays and others are using it or coming in to compete with you in areas where they do not have the same burden of transactions to service, then they can pay interest rates which will woo your customers away and leave you stuck like the proverbial shag on a rock with all the business that is costly (Martin, 1991, p. 104).

The principle of ‘user pays’ pricing is the simplest way to avoid cross-subsidies. It also increases overall economic efficiency as customers face prices based on the costs of their use of different services, rather than being encouraged to over-consume some apparently ‘free’ services and under-consume others. Indeed, to encourage the provision of innovative and cost-effective banking services, it may not be in the long term interests of many customers to offer them some cross-subsidised services.

User pays is manifested by the imposition of explicit charges for identifiably separate services - sometimes referred to as ‘product unbundling’. It was anticipated that:

> Institutions which cut their net interest margins and introduced fees and charges would expand their borrowing and lending and eliminate profit haemorrhage through overuse of underpriced ancillary services (Ackland & Harper, 1992, p. 58).

The PSA itself has noted the process by which increased competition is changing the way that banks do business, stating that competitive forces have:

> led banks to pay closer attention to individual product costing and pricing. The shift in focus away from intricate structures of product cross-subsidisation to "user pay" pricing principles ushered in the era of bank product "unbundling". This involved identifying as far as possible distinct products and services to achieve a more satisfactory connection between the costs of producing and delivering those particular products and services and the revenue they generated (PSA 1992, p. 11).

Deregulation has thus seen a move by banks towards user pays pricing. Banks have introduced transaction charges for deposit accounts, establishment fees for loans, together with an increased range of other charges. The proportion of total income received by the major banks from sources other than the net interest margin has increased since deregulation of the financial sector. An additional factor spurring the adoption of user pays by the major banks is the reduction in the proportion of low-cost deposits held by them.

5.2 One step at a time

While both banks and non-banks have made some moves in the direction of user pays pricing, consumer resistance has been strong. There has also been concern that fees and charges have had a disproportionate impact upon disadvantaged groups within society.

It would appear that consumers have become accustomed to using cards as a transaction device without fees and consequently are resisting fees (PSA 1992). Credit unions have made a concerted effort to accustom their clientele to fees and charges as a means of controlling costs in the face of stiffer competition from banks (Ackland & Harper 1992).

Some commentators believe that the move to user pays has been too slow, thereby imposing avoidable costs upon the community. Harper is one such critic:

> the incomplete use of user pays is sub-optimal because the fear of any one bank being pilloried, especially by the political mechanism, has made them naturally reluctant. The awkward thing is that they pass that higher cost back to the community in forms which are not easily perceived and which, frankly, are inequitable (Martin, 1991, p. 106).

The political dimension is illustrated by the inquiries, including the current PSA inquiry, which have resulted from the introduction of fees and charges.

5.3 Charges can be further refined

The structures of fees and charges is yet to accurately reflect the cost structure of retail banking, so that some cross-subsidies remain. For example, electronic transactions involve significantly lower costs than manual paper-based transactions (the banks have estimated that the cost of an ATM withdrawal is between 30 and 60 per cent of that of a withdrawal over the counter (Martin 1991)). While banks sometimes charge differently for manual and electronic transactions, the difference is rarely as large as the difference in costs and so does not yet provide adequate incentive for consumers to make efficient use of electronic facilities.

As consumers become more used to 'user pays', and as banking technology advances further, fees and charges are likely to be applied more broadly and in a manner which more accurately reflects the cost structure of retail banking. As this will take some pressure off interest margins as a source of profitability, margins could be expected to narrow further.

6. FINANCIAL INSTITUTIONS AND COMMUNITY SERVICE OBLIGATIONS

The evidence presented in this submission indicates that banking fees and charges are set in a relatively competitive market. Consequently, they are likely to promote efficiency in the sense that resources are allocated in response to the costs of and demand for services.

Any move away from explicit fees and charges for identifiably separate services would result in the re-emergence of cross-subsidies and lead to wasted resources, in the form of the types and levels of banking services available. Increased interest rate margins would likely emerge.

But it should be recognised that explicit fees and charges can impose a relatively heavy burden on some groups in our society. Who they are and what might be done are addressed in this section.

6.1 Who are the disadvantaged groups?

Table 2.1 shows the fees and charges relevant to basic banking accounts with a range of financial institutions. It shows that fees and charges have tended to be imposed on low balance accounts, and on high frequency transactions. Consequently, it can be argued that fees and charges impact disproportionately on people with low levels of income. Also, because some fees and charges are imposed on over-the-counter withdrawals but not on automatic teller machine transactions, aged persons and those with physical or intellectual disabilities tend to be disadvantaged.

A large group likely to be disadvantaged by fees and charges are those dependent on Department of Social Security payments. The Commonwealth Government requires that all social security and family payments be credited to banking accounts, which makes banking services essential to most of those who are in need of financial assistance. In addition, social security beneficiaries are more likely to have relatively low balances in their accounts. Bank fees and charges therefore have a disproportionate impact on this group because their bank balances are often low enough to attract charges, and because the fees and charges may be perceived as large relative to their income.

A second group likely to be disadvantaged by explicit fees and charges is low income earners. Like social security beneficiaries, many low-income earners maintain bank accounts with low balances. Unlike social security beneficiaries,

however, some low-income earners are at least not compelled to maintain a banking account.

A third group who might be disadvantaged by explicit fees and charges is children and full-time students, who often have low account balances.

Exemptions from paying fees

Banks have voluntarily provided exemptions from fees and charges to many customers who might be disadvantaged.

Table 2.1 shows that many financial institutions currently exempt some social security beneficiaries from paying bank fees and charges. For example, most institutions do not require aged and war veteran pensioners to pay any fees and charges. Some financial institutions do not levy bank fees and charges on people under 21 years of age. This means that the 20 per cent of unemployment beneficiaries who are under 21 could avoid paying bank fees and charges (DSS 1993, p. 272).

Table 2.1 also shows that many financial institutions provide exemptions from fees and charges for children and for full-time students. These exemptions are not offered by as many institutions as for aged pensioners, but are offered by enough institutions to give those consumers a choice.

Avoidance of fees

There are several ways in which consumers who are not exempt can avoid or minimise paying bank fees and charges. These methods have all been given some publicity by the banks themselves. For consumers with a sufficient level of funds, the easiest way is to maintain account balances above the fee-free threshold, which may involve the consumer consolidating several different low balance accounts. Of course, for many social security beneficiaries and low-income earners, maintaining even a single account balance above the threshold may not be possible. But even those persons, by ensuring that across-the-counter withdrawals are limited to some 6 to 8 per month, will be able to minimise bank fees.

Conclusion

After taking into account the exemptions currently offered by most banks, the groups most likely to be disadvantaged by bank fees and charges are those social security beneficiaries not exempted as under 21 years or in receipt of aged (and war veterans) pensions, and employed low-income earners. To incur fees and charges, the individuals must maintain low account balances (below $100-$500) and rely on over-the-counter withdrawals.

Box 6.1: Illustrative example of the impact of banking fees and charges on a family[a] solely dependent on social security benefits

	Transaction	Amount	Balance	Fee
Week 1	Opening balance		$100	
	Social security benefit (adults)	$536	$636	
	Withdrawal (counter)	$300	$336	
	Withdrawal (counter)	$100	$236	
Week 2	Deposit	$50	$286	
	Withdrawal (ATM)	$100	$186	
	Family payment (children)	$178	$364	
	Withdrawal (counter)	$100	$264	
Week 3	Withdrawal (ATM)	$200	$64	
	Social security benefit (adults)	$536	$600	
	Withdrawal (counter)	$300	$300	
	Withdrawal (counter)	$100	$200	
Week 4	Withdrawal (counter)	$100	$100	
	Family payment (children)	$178	$278	
	Withdrawal (counter)	$200	$78	$1.50
	Withdrawal (ATM)	$50	$28	
	Monthly fee as balance went below $500			$2.00
	Total fees and charges for the month[b]			**$3.50**
	Annual fees and charges on equivalent transactions			$42.00
	Annual flow through account			$18 564
	Fees as a percentage of flow			0.25%

a. The example assumes a family of 2 adults with 2 dependent children under the age of 13. The family uses only one account which can be accessed both by card (with an ATM) and over-the-counter.

b. There would also be some government fees. Financial institutions duty levied by the States at 6 cents per $100 of credits would amount to 90 cents each month. In this example, there would be no bank account debits tax because the account is assumed not to have a cheque facility.

Box 6.1 illustrates how fees and charges could affect a family solely dependent on social security payments. In this illustrative example, the family receives a social security payment each fortnight of $536 credited to their bank account, and a family payment (for two children under 13 years of age) each fortnight. These payments are staggered so that the family receives some money each week —

this suggests a minimum requirement might be four withdrawals per month. The example makes provision for 10 withdrawals during the month, of which 3 are by automatic teller machine and incur no fee. Of the other 7 withdrawals which are conducted over-the-counter at the bank, the first six are free of charge — only the seventh (and any subsequent withdrawals) in the month incurs a fee, in this case $1.50. In addition, there is a $2.00 account keeping fee because the balance in the account fell below the $500 threshold set by this bank. If the account were operated in this way throughout the year, fees would amount to $42 for the whole year — equivalent to a quarter of one per cent of the money flowing through the account.

If the family could manage with just one less over-the-counter transaction, or make more use of ATM withdrawals, total fees could be reduced to $2 each month, or $24 each year — a negligible sum relative to the transactions involved.

Given the number of exemptions currently available and the methods available for avoidance of fees, the number of people adversely affected to a significant extent would be low.

Nevertheless, bank fees and charges are a relatively new phenomenon in Australia. As noted, it is likely that they might be increased progressively and their incidence widened over time as banks gather better information on what it costs them to provide particular services. In this regard, it is noted that fees and charges are significantly higher in some other countries than they are in Australia.

A significant increase in the extent and impact of fees on disadvantaged groups may prompt government to intervene on equity grounds. Some options are briefly discussed below.

6.2 Options for government

Governments generally recognise the need to provide for persons who are genuinely in need of assistance, due to low levels of income, or physical or mental limitations. This section considers the merits of different possible forms of government intervention.

6.2.1 Social security payments by cheque

If social security beneficiaries were given the option of receiving payments by cheque, then they would have greater flexibility in managing their funds to minimise fees and charges. Such people would no longer be compelled to maintain a banking account, but realistically most people would see it as

desirable to have a banking account for reasons of security and good management.

Payment by cheque would not be costless to the Commonwealth Government. The introduction some years ago of electronic payment of social security benefits provided considerable savings to the Government, which would be partly lost as people opted to receive cheques. Problems with fraud control could be encountered. In addition, the introduction by banks of charges for the cashing of such cheques could not be ruled out.

The fiscal cost of making social security payments by cheque could be mitigated by limiting this option to selected beneficiaries. For example, of Australia's 889 000 unemployment beneficiaries in 1993, about 280 000 received an additional allowance for rental assistance (DSS 1993, p. 272) and they appear to be in particularly pressing financial circumstances. Such targeting, however, runs the risk of discriminating against people in even more difficult circumstances.

The PSA would have to give close consideration to the cost and relative merit of paying social security by cheque to particular groups before making any such recommendations. The principal difficulty would be to target those not already exempted from fees and charges by the banks.

6.2.2 Further options

There are other options available to the Commonwealth Government for assisting social security beneficiaries and low-income earners to cope with bank fees and charges. These include income compensation, banking vouchers and general subsidies to bank consumers.

Compensation via social security payments

Access to banking services among the financially disadvantaged in the community could adequately be provided for by increases in social security payments designed to compensate for increases in fees and charges. (Current indexation arrangements are unlikely to provide more than partial compensation). Such a system would also not restrict consumer choice.

The difficulty would be to avoid compensating those already exempted by the banks. Nor does this approach assist low-income earners not in receipt of a social security benefit. Further, the banks would face an incentive to cease or narrow exemptions with the expectation that the government would pick up the tab.

In-kind vouchers

Voucher systems could be used to implement in-kind transfers while incorporating some of the desirable features of cash transfers such as retaining an element of consumption choice, transparency and non-interference in the commercial activities of enterprises. As consumers retain an element of choice between providers of banking services, competition between banks would not be impaired.

Vouchers may not be a practicable option for retail banking, because the frequency with which retail banking services are used is likely to make the administration of a voucher system far too costly.

General subsidies to all bank consumers

A general subsidy would ensure that on some basic banking products no fees or charges would be levied. The program could be paid for by the banks through cross-subsidies or by the Commonwealth Government. But such general subsidies are an ineffective means of income support for those genuinely in need because they do not distinguish between different users of banking services. Those who could afford to pay for banking services would also receive the subsidy.

6.2.3 A "community service obligation" on banks?

Another option would be for government to introduce regulatory requirements on the banks to provide services at reduced fees or free of charge to disadvantaged groups.

If the banks were required to bear the costs of operating such accounts, that would be a form of taxation on them. There would also be efficiency losses resulting from cross-subsidies, and increased net interest rate margins are likely to emerge (see Section 5.1).

An alternative would be for the Commonwealth Government to fund the program, via contracts with banks to provide fee-free or concessional accounts to specified groups of low-income earners (equivalent to a "community service obligation"). Banks could tender for the right to operate such accounts.

There are clear benefits associated with Commonwealth funding, as opposed to bank funding, of such a program:

- the bidding process would ensure that the cost of the program would be minimised;

- banks would be free to carry on their business operations as normal, without having to worry about cross-subsidising underpriced accounts. Distortions due to inefficient resource allocation would be minimised;
- it would serve to improve the transparency of governments' decisions and encourage more thorough assessment of the policies, because taxpayers and policy makers could clearly identify and assess the cost of such a social policy; and
- it would ensure that accountability for policy remains with the contracting government department and that the bank is accountable only for operations.

There are, however, some problems associated with the provision of fee-free basic banking services:

- the removal of the price mechanism would diminish market discipline and encourage overuse of basic banking facilities by some consumers; and
- banks currently provide numerous exemptions from fees and charges, but the imposition of a "community service obligation" would provide them with an incentive to phase out their voluntary exemptions and pressure government to extend its subsidy to those persons affected. This might result ultimately in government subsidising the provision of basic banking services for **all** social security recipients and low-income earners.

6.3 Summing up

At this stage, the ORR cannot find a compelling case for government intervention on equity grounds. This is because banks currently exempt from fees and charges most potentially disadvantaged groups within the community. In addition, there are several avenues open to consumers to minimise or eliminate the impact of the current structure of fees and charges. Apart from its impact on efficiency, government intervention would also reduce the incentive for banks to provide exemptions from fees and charges.

The structure of bank fees and charges could change in the future. In that case, the argument for government intervention may become stronger. However, any such intervention would not be without cost. On balance, the ORR considers that, if the government chose to intervene, the most efficient approach would take the form of a "community service obligation" on banks to provide specific groups of customers with fee-free basic banking services, with the Commonwealth Government reimbursing the banks for the costs of doing so.

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