

## COMMENTARY



### **Will the removal of exit fees increase bank competition?**

#### **Not likely**

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The recent debate over the lack of competition in Australia's banking sector is nothing new. Indeed, a major objective of the Campbell Inquiry which reported in the early 1980s and led to deregulation of the financial sector was to increase competition in banking through lowering barriers to entry and issuing more banking licences.

The suggestion however that the removal of exit fees could be even a partial solution to this deep-seated and complex problem, raises serious questions about how well the issue is understood.

A recent survey by leading mortgage broker Mortgage Choice of 1,028 Australians who had refinanced their home loan during the previous 12 months, suggests that exit fees had little influence on a borrower's decision to change financiers. In this survey primary motivations for refinancing were to switch to a cheaper loan, to consolidate debts, fund a renovation, or buy an investment property.

More than four out of every five respondents who switched providers reported that refinancing was either a very easy or relatively easy process, with 46 % paying no exit fees at all and another 21% paying less than \$500. On the down side, almost a quarter of all respondents had delayed refinancing to avoid higher charges, and overall around 16% paid over \$1,000 to refinance. Although this is obviously a biased sample in that it does not include those who chose not to refinance, it suggests that the issue of exit fees may not be significant as we are being led to believe.

It is undoubtedly true, however, as reflected in the reduced number of financial service providers and increasing consolidation of market share amongst the major banks that the banking sector has become less competitive over the past decade as a consequence of both market forces and the unintended consequences of government intervention.

In the GFC, possibly for the first time, Australian really learnt the advantages of having a strong and robust banking system. Australia stood out not only as a country with no bank failures or bail outs, but in being able to retain four of the few remaining AA banks globally. Due to the long derided "four pillars policy" and the banks' focus on raising funds rather than creating complex financial products, Australia had an environment that was protected from the worse excesses of bank competition. Australian banks were largely immune to the falling credit standards and risky practices that dominated banking in the United States and Europe.

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Indeed, the major banks grew from strength to strength through the GFC just as the position of their competitors, the second tier banks, building societies, credit unions and mortgage companies, weakened. As is usually the case in uncertain times, consumers flocked to the perceived strength of the major banks so that their market share in retail deposits and loans grew significantly. This is most evident in the home loan market where the major banks share of owner-occupied approvals has increased from around 60 % in mid-2007 to around 82 % by the end of 2009.

The unintended consequences of government and regulatory intervention such as the differential pricing in bank guarantees, interventions to support the collapse of the securitisation market and a change to the RBA's interchange policy for ATMs further disadvantaged smaller institutions.

While the bank guarantee introduced in November 2008 strengthened the position of Australian banks globally, it put the smaller regional banks, building societies and credit unions at a cost disadvantage. On an international basis Australia stood out by way of the significant differential in fees charged on the guarantee. While AA-rated major banks could raise funds at a fee of 70 basis points over the cost of funds, BBB-rated banks such second tier building societies and credit unions paid a fee of 150 basis points. As a consequence few BBB-rated institutions engaged in guaranteed senior debt-raising under the guarantee.

Unfortunately this funding disadvantage hit the smaller institutions just in time to coincide with the collapse of the securitisation market, another critical source of funding. Some smaller institutions had become so reliant on the RMBS market to fund lending that this precipitated consolidation as in the case of St George which merged with Westpac and the demise of some non-bank originators such as RAMS, which had contributed so much to increased competition in the late 1990s.

The Federal government's intervention to support the securitisation market through the AOFM, unfortunately once again did not work to the advantage of smaller institutions which had difficulties accessing this funding in the right size tranches. While there are some signs that this market is regenerating, its been a long time coming.

In March 2009 the RBA moved to reform the payments system by replacing interchange fees with direct charges to customers on ATM transactions. By making ATM interchange fees transparent, flexible, and reflective of the true cost of transactions the RBA was seeking to increase competition and profitability in ATM provision, expand the ATM network and make it easier for new players to compete and become part of the system.

While this reform has been largely successful in achieving its objectives it has to some extent further eroded the competitive position of smaller institutions. As the cost of transacting went up substantially for customers using "foreign" ATMs outside their own institution's network, a clear incentive was provided to move to a larger institution with a more widely dispersed ATM network.



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If the government is serious about improving competition it needs to reconsider policies directed at the financial services sector. Removing exit fees is not the whole answer. The principal of “the level playing field” that underpinned the Campbell recommendations ensures that policies encourage a wider diversity and equivalent treatment of all financial services providers. Over recent times that has not always been the case.

*This Commentary is written by Professor Deborah Ralston, Director of the Australian Centre for Financial Studies. Deborah is also a Professor of Finance at Monash University, and a Director of Mortgage Choice.*

[deborah.ralston@australiancentre.com.au](mailto:deborah.ralston@australiancentre.com.au)