WHAT PRICE STABILITY?

Market design in the Australian banking sector

David Hetherington

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About the author

David Hetherington is the Executive Director of Per Capita. He has previously worked at the Institute for Public Policy Research, as a consultant to the OECD and for L.E.K. Consulting in Sydney, Munich and Auckland. He has authored or co-authored numerous reports on economic and social policy including After the Party (2012), Towards a Fair Go: Design Challenges for an NDIS (2011), The Per Capita Tax Survey (2010 & 2011), Employee Share Ownership and the Progressive Economic Agenda (2009), The Full-Cost Economics of Climate Change (2008), Unlocking the Value of a Job (2008), The InvestingSociety (2007), Disability 2020 (2007) and Would You Live Here? (2006). His articles have appeared in the Sydney Morning Herald, the Australian Financial Review, the Age and The Australian and he is a regular commentator on Radio National and ABC24. David holds a BA with First Class Honours from UNSW and an MPA with Distinction from the London School of Economics where he won the George W. Jones Prize for Academic Achievement.

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About Per Capita

Per Capita is an independent progressive think tank which generates and promotes transformational ideas for Australia. Our research is rigorous, evidence-based and long-term in its outlook, considering the national challenges of the next decade rather than the next election cycle. We seek to ask fresh questions and offer fresh answers, drawing on new thinking in science, economics and public policy. Our audience is the interested public, not just experts and practitioners.

Graphic Design by Design Clarity

Executive Summary

Few subjects in the public debate are more emotive than banking. Bankers' actions, pay and profits have been ferociously dissected in the wake of the Global Financial Crisis (GFC). In Australia, we were fortunate that our banking system and broader economy survived the crisis in good health. But banks' behaviour here continues to attract scrutiny.

This report examines our banking debate through the prism of market design. It analyses the major faultlines, identifies enduring market failures and proposes a policy response.

There are three main points of tension: 1) whether the banks should follow the Reserve Bank of Australia (RBA) in setting interest rates; 2) whether rising funding costs have necessitated the banks' rate increases; and 3) whether banks are too profitable relative to the risk they face.

On the first two points, the report finds in favour of the banks – they are rightly the arbiters of their own rate settings, and rising funding costs have indeed led banks to raise rates. On the third point, we find that the Big Four banks *are* more profitable than the risk attached to their equity would justify, thanks to implicit insurance provided by the state and a market structure which makes their operations more capital intensive than necessary.

The report identifies three market failures which contribute to this mismatch between profitability and risk. The first is a lack of competition brought about by 'stickiness' in customer behaviour. The second is the familiar moral hazard problem, in this case created by the implicit public guarantee provided to the banks by government. The final failure is the perceived need amongst policymakers to accept a trade-off between competition and banking system stability, underpinned by the fear that some banks are too big to fail.

The recent announcement by Mark Bouris's Yellow Brick Road of a new venture to take on the Big Four banks in residential mortgages in a welcome development. This report argues that a comparable policy initiative can complement Yellow Brick Road's market-based initiative in the deposit and transaction segment.

The principal recommendation of the report is a new publicly owned bank, YourBank, which offers 'vanilla' deposit and transaction products. It is intended to address the lack of competition by offering lower-cost, no-frills banking services. Any Australian could open an online account with YourBank, and students would be offered new accounts at school in the way that the Commonwealth Bank once did when it was in public ownership. YourBank would not possess a bricks-and-mortar branch network; it would offer online services only. This would enable it to deliver services cost-effectively and would underpin its ongoing commercial viability.

The YourBank proposal does involve public costs, including the set-up investment in systems and infrastructure, and the reduced tax take from the banking sector. However, these costs will be outweighed by the commercial profits of the new venture and, even more significantly, by the lower banking costs available to consumers and businesses.

In addition to YourBank, the report recommends mandatory mortgage default insurance for banks to remove the moral hazard of the implicit guarantee by making explicit the costs of insurance.

Section 1
Introduction

In October 2012 the Reserve Bank cut interest rates yet again, and yet again the Big Four banks vacillated. Few issues are more vexed in our public debate than the role of banking. Banks announce ever larger profits and politicians reliably line up to indulge in a spot of 'bank-bashing'. For the wider public, it's hard to make head or tail of this debate, with its jargon of spreads, leverage and capital ratios.

An exploration of the Australian banking sector is useful for two reasons. First, if couched in lay terms, it helps explain many of the contested claims from both banks and politicians, and allows interested observers to make up their own minds. Secondly, it helps us to understand how market design can be applied by policymakers to resolve these tensions. In this context, market design involves government setting the 'rules of the game' of market competition to enable private, public and third-sector providers to compete in a way which redresses market failure and advances social welfare. As we will see, while some market design tools have already been deployed through the course of the Global Financial Crisis (GFC), there remains scope for further initiatives to address ongoing market failures.

There are two discrete banking sectors in Australia which operate almost independently of one another. On the one hand, there are the Lehmans, Goldmans and Macquaries of high finance and on the other, the Big Four banks that most Australians deal with every day. The high financiers of the investment banking sector provide investors with various capital products, including commodities, currencies, bonds, equities and derivatives based on each of these. It was the activities of these banks that largely created the GFC.

The familiar names of the retail banking sector provide consumers and businesses with deposit, transaction and credit products. These retail banks are the subject of Australia's heated banking debate, and form the focus of this report. At the outset, it's important to note that Australia's banks performed creditably during the GFC, thanks to a combination of good management, good regulation and good luck. Yet this does not detract from the importance of the debate about banking in Australia today. If anything, the global economic damage wrought by irresponsible banking practices (setting aside illegal practices) means this debate is as urgent as ever.

The recent announcement by Yellow Brick Road that it will establish a new provider of mortgage products highlights a perceived lack of competition in the residential loans sector. Mark Bouris and his partners at Macquarie Bank intend to challenge directly the market power of the Big Four, and clearly believe there are commercial payoffs for doing so. The credibility, experience and deep pockets of the new entrants suggests they have a real chance of success.

Yet the Yellow Brick Road proposal only addresses the dearth of competition in the loans segment; it does not tackle competition issues in the deposit and transaction sector. This is a particular area of focus of this report.

The report is structured as follows. In Section II, I consider the three dominant points of contention in the banking debate, and evaluate the arguments of each side. In the following sections, I examine distinct market failures – stickiness in Section III, and moral hazard in implicit guarantees in Section IV – and propose market design responses. Section V concludes with some thoughts on the future for the market design of Australian banking.

Section II
Competing claims in the banking debate

The debate over banking is marked by deep disagreement on almost all of the salient points. Let's examine briefly what each side of the debate says about its position on the most important issues of contention. These are:

i) Pricing control
ii) Funding costs
iii) Profitability relative to risk

i) Pricing Control

The first bone of contention has been the banks' decision to move away from the Reserve Bank of Australia (RBA) cash rate as the anchor point of their mortgage pricing. For two decades, the retail banks had moved in lockstep with the RBA, moving their standard variable mortgage rates by the same increment that the RBA moved its cash rate, with only occasional exceptions .

The banks began to deviate from the RBA cash rate benchmark when they chose not to pass on the full rate cut as the Reserve slashed interest rates in the immediate aftermath of the GFC. In January 2012, the ANZ Bank explicitly severed the link between mortgage rates and the cash rate, announcing it would no longer be guided by the RBA and would decide its rates independently on the second Friday of each month, 10 days after the RBA decision. When the Reserve cut rates in February, ANZ lifted its mortgage rate and the other big banks soon followed.

In justifying the move, ANZ's head of retail banking, Phil Chronican, highlighted pressure on profit margins due to rising funding costs and argued that this should have more influence over the bank's pricing than the RBA board. "We just wanted to get out of being part of this exercise where the RBA announces and we are expected to move the next instant", Chronican stated (2011).

The move prompted anger amongst politicians and many in the community. Treasurer Wayne Swan opined (2012) that "the decision from the ANZ ... is one which I think their customers will rightly be angry about" and noted that "from time to time [the banks] decide that they want to give priority to their shareholders over their customers and their staff".

Yet Swan acknowledged, as he'd done previously, that the banks were the final arbiters of their own pricing. This is as it should be. The link to the RBA cash rate was only ever an unofficial convention and, as agents of their shareholders, it is incumbent on the management and boards of the banks to maximize shareholder value however they can, within existing regulatory frameworks. Given this, it was only to be expected that they would eventually break the RBA link when it was felt to be constraining profit growth.

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Several observers, including the RBA's Philip Lowe (2012) and Ross Gittins of the *Sydney Morning Herald* (2012), have commented that the increased gap between mortgage rates and official rates offers an important upside: higher returns for depositors, resulting in a safer banking system, since higher deposit levels improve capital adequacy and liquidity. However, I would argue that this upside is questionable, given the behaviour of depositors around the world during the GFC who proved all too willing to withdraw funds in response to rapid losses on confidence in national banking systems.

ii) Funding costs

Let's accept then that the banks have the right to set their own pricing and turn to the second part of Chronican's argument: that funding costs have been increasing, which in turn has placed pressure on profits.

The debate over funding costs requires a brief detour through the recent history of Australian finance. Before financial deregulation in the 1980's, the bulk of Australian banks' core capital came from depositors' funds, which allowed them to fund loans using fractional reserve banking, where only a fraction of deposits were retained as capital buffer with the remainder lent out. This was fairly straightforward. As the saying ran, bankers could take deposits at three percent, lend at six percent (with a three percent margin) and be on the golf course by three in the afternoon - the 3-6-3 rule.

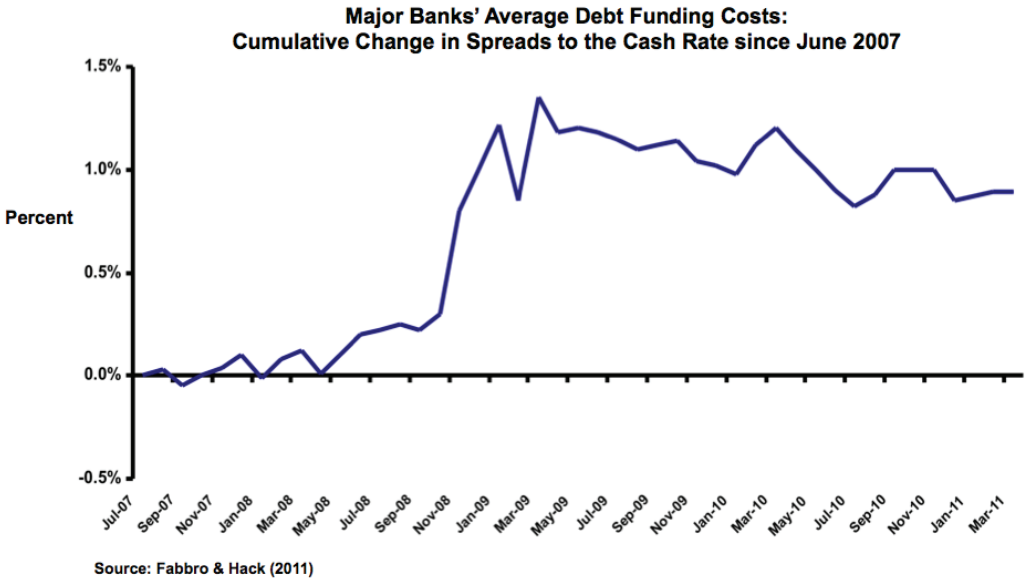
When finance was deregulated, a new source of funds opened up offshore. Australian banks were able to borrow from overseas capital markets to fund their loans, and the rise of loan syndication - where bundles of loans were packaged and onsold - allowed Australia's banks to write new loans and then sell them to foreign buyers. Importantly, this enabled banks to grow rapidly at a time when deposit growth was sluggish and demand for consumer credit was rising fast.

The upshot was a change in the mix of funding sources. The banks went from being fully funded by domestic deposits (on which they controlled costs by setting depositor rates) to being significantly funded by offshore capital markets (where they had little control over costs) with the balance provided by local depositors.

The banks' current claims regarding margin pressures are driven by their exposure to that foreign funding, the costs of which have increased faster than the RBA cash rate since the GFC.

Analysis by the RBA shows that the major banks' funding costs did increase significantly above the cash rate from 2007-09 and remained constantly at around 100 basis points above the cash rate between 2009 and mid-2011 (see Chart I, Fabbro & Hack, 2011).

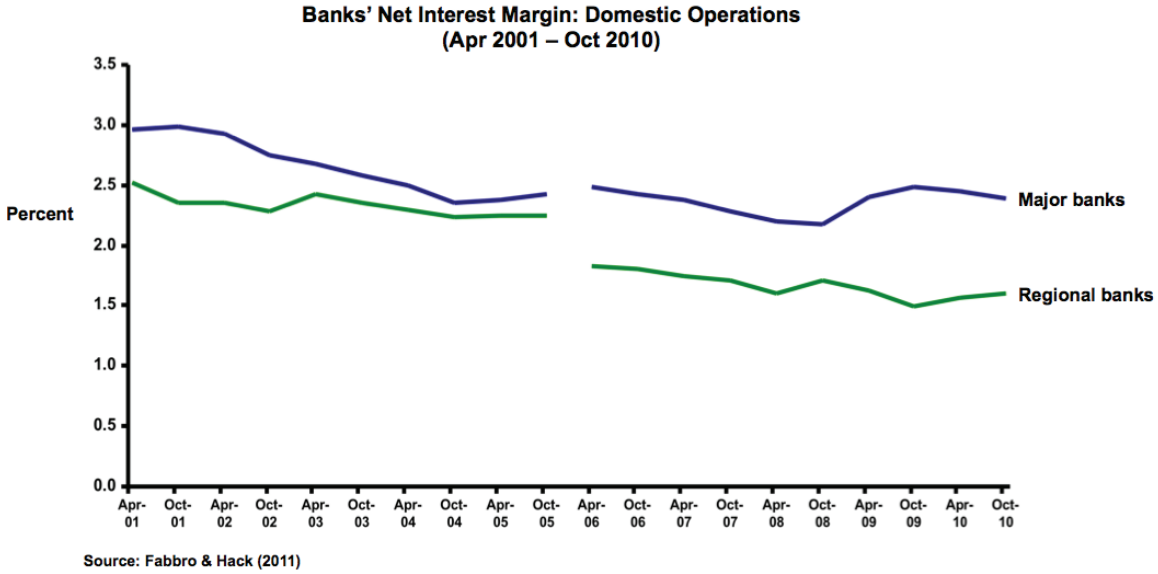
Chart I



According to a more recent speech by RBA Assistant Governor Guy Debelle (2012), the banks' costs have risen again since mid-2011 to around 140 basis points above the cash rate as a result of the European debt crisis, although they fell somewhat in the first half of 2012 as the crisis eased.

Additionally, the net interest margins enjoyed by the banks – the difference between their costs of funding and loan pricing – have fallen gradually over the last decade. For the major banks, this fall has been around 50 basis points, while for the smaller banks it has been closer to 100 points. The difference has further expanded the premium the Big Four enjoy over their competitors, and further entrenched their market power (see Chart II).

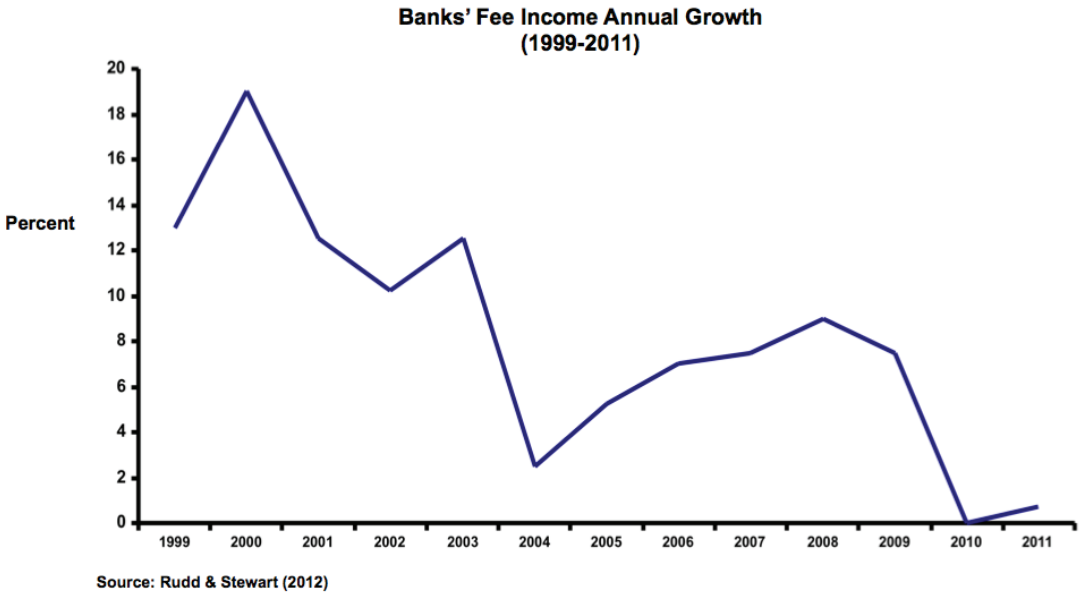
Chart II



So the banks appear to be correct when they argue that increased funding costs have led to a contraction in their net interest margins – but this tells only half the story. Over the same time period, banks have rapidly built their 'non-interest income': the fees and charges they levy on account holders. These include annual fees, overlimit fees, late payment fees, ATM fees, establishment fees and break fees.

Non-interest banking income grew steadily for the largest banks over the last 15 years, with fees and commisions rising from $4.1b in 1997 to $11.3b in 2011 (Rudd and Stewart, 2012), equivalent to 47% of post-tax profits. However, growth during that period has slowed steadily and was close to zero in 2010 and 2011.

Chart III



Source: Rudd & Stewart (2012)

Throughout this period, the banks have been able to offset decline in their net interest margins with growth in their non-interest income. One study found that the banks have managed to secure fee increases in advance of the decline in their interest margins but that these increases have been too small to offset the loss of margins (Williams & Rajaguru, 2009).

So the overall picture for bank profitability is that interest margins have been gradually squeezed over a decade but these have been offset by fast-growing fee income. The upshot is that the Big Four banks achieved record pre-tax profits of $33.0 billion in 2011-12, which represents a doubling of profitability over the last decade (KPMG, 2012). The banks argue that these headline numbers are not the right measure of profit to consider, but that profit margins are more important, specifically the return on their shareholders' equity. So let's now turn to returns on equity (ROE), and examine how these returns relate to the risks borne by bank shareholders.

iii) Profits and risk

One of the great shibboleths of the banking sector is that high profitability is the price we pay for stability: if we allow our banks to grow sufficiently big, then they'll be less likely to fall over in a crisis. This logic is routinely used to justify the scale and growth of Australian banking profits (see McCrann, 2012).

In the theoretical world of free markets, excessive profits should not exist because they are all competed away. In the real world, where they do exist, they should be aligned with risk. In more technical terms, capital investors require returns commensurate with the risk of an investment.

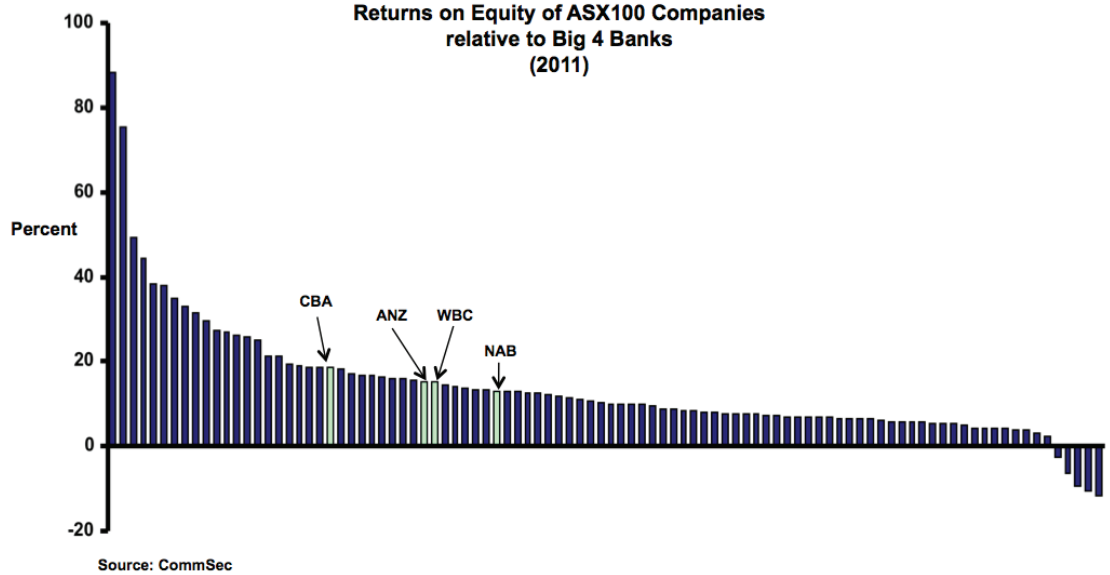
Another feature of business profits is that they are expected to rise. Investors enjoy capital growth as a result of expected profit growth, and this is part of the banks' challenge. Because profit growth has begun to slow, the banks are feeling jumpy.

Nonetheless, the banks enjoy healthy levels of profit as measured by ROE. In 2011-12, the major banks achieved average ROE of 15.4%. How does this compare to other Australian industries? The chief executive of the Australian Bankers' Association, Steve Munchenberg, says it is on par:

> "There is no evidence banks are making excessive profits. A standard measure of profitability – return on equity – shows banks are in the middle of the pack compared to other industries." (quoted in Kellerman, 2011)

Does this claim stack up? The data suggest Munchenberg is not right to claim that the banks' return on equity is mid-ranking relative to large Australian companies: all four banks are in the top 40 of the ASX100 (CommSec, 2012). In 2011, the CBA ranked 22nd amongst ASX 100 companies with ROE of 18.5%. ANZ was 31st with 15.2%, Westpac was 32nd with 15.1% while NAB was 38th at 13.1%. The average of the Big Four banks' ROE was 1.5% higher than the ASX100 average.

Chart IV



So the banks are clearly making healthy profits, better than most big public companies, but are these profits excessive, or merely reasonable as claimed by Munchenberg?

Here's where it gets interesting. Banks' risk profiles are very different from other businesses'. Unlike most businesses, banks in Australia receive regulatory protection and support which means that some of their biggest risks are effectively insured by taxpayers. The greatest risks to a retail bank are a liquidity crunch, a run on deposits and non-performing loans. Any of these things can sink a bank, and since the collapse of a bank hurts both depositors and creditors, they entail dire consequences for the entire economy. The collapse of Northern Rock signalled the beginning of the financial crisis in Britain while the collapse of a series of banks, some investment and some retail, did the same thing in the United States.

To protect against such scenarios, Australian authorities took a series of measures in the lead-up to and during the GFC (see Barrett, 2011). For the purposes of this paper, the most important of these were:

- An injection of $55b of liquidity into banks by the RBA
- Government guarantee of depositors funds up to $1m per person
- Access to the Federal Government's borrowing capacity

It's difficult to estimate the combined value of these interventions, but despite this, it's clear that interventions like these dramatically reduce the risk of any bank collapsing. In turn, this reduces the risk that shareholders lose their capital. Certainly, if a bank were to collapse, the shareholders would lose their investments but state intervention makes this far less likely, thus increasing the value of their stakes.

Recently global banking regulators have been making loud noises about their renewed willingness to let collapsing banks fail, a course which would wipe out shareholders' equity. At the G20 Summit in Cannes in November 2011, rich-country leaders asked the Basel Committee on Banking Supervision to develop a new framework for the 'resolution' of domestic 'systemically important banks'. Under this framework, national 'resolution authorities' are supposed to ensure that no bank is too big to fail, and that shareholders rather than taxpayers wear banking losses. In Australia, the Australian Prudential Regulatory Authority (APRA) will play this role.

These are promising steps, but to date, they remain worthy objectives rather than detailed and credible policies. For this reason, bank managers and shareholders may still believe that, if push comes to shove, governments will be there to shore them up.

This is why the banks' arguments about return on equity are misplaced. They compare themselves to their ASX100 peers when they face far lower risks than those peers, given the taxpayer support they enjoy.

The margins that the banks generate are disconnected from their position on risk/return profile of capital investment opportunities. So even though they've been falling slowly, the margins they earn *are* excessive.

Let's put excess profitability aside for a moment, though, and look at profits another way. What are the banks actually doing to earn those profits? Much of their activity is undifferentiated 'vanilla' banking where they provide basic deposit and transaction services. As we've seen, their income from these services is a combination of account fees and the interest margin they make when lending out funds on deposit. In addition to the costs of funds, their biggest costs are the customer service network (including branches), IT systems and marketing required to support these accounts. Between them the Big Four Australian banks sustain a combined cost base of $33b, equivalent to over 2% of GDP.

But here's the catch. Apart from the usual vagaries of customer service, there is nothing distinctive about these services. BPay, Eftpos, ATM services, online payments, electronic funds receipts – apart from some cosmetic branding, they are exactly the same service no matter which bank provides them. In this respect, they are utilities much like electricity, gas and water.

The question that society needs to ask is whether we should be spending so much on duplicating services that provide little additional value. Because all these services could be sustained by one set of infrastructure with enormous economies of scale, huge savings could be made if we were to remove this duplication. In productivity terms, this is a regrettable waste of resources as it makes each transaction considerably more expensive than necessary. What's more, it's unfair on consumers because it forces them to pay bank fees higher than the true minimum possible cost of provision. Earlier this year, the RBA (2012) proposed the development of a common-user payments and settlements hub which, if developed comprehensively, offers the potential to reduce much of this duplication (see Section IV below).

The banks will no doubt counter on two fronts. First, they'll say that maintaining their own IT and branch infrastructures allows them to compete on service by tailoring their offering. This might be true in business banking where service levels are more differentiated. For consumer deposits and transactions, which are increasingly electronic, such differentiation is minimal at best.

The second objection will be that their returns on equity show that they're not making super-profits from excessive fees (notwithstanding the diminished risk associated with that equity). At face value this is true, but the catch is that they have invested far more capital than necessary to support the total volume of transactions in the market. So while their profits are reasonable in relation to their costs, there is too much cost. Competition does not drive down costs sufficiently because each player is obliged to maintain its own infrastructure, implying high industry fixed costs in aggregate.

This overcapitalization resembles the state of play in Australia's electricity sector where a regulated rate of return on capital leads to 'goldplating' – producers ploughing in more capital because they know they'll get a decent return, no matter what the spend. Like in electricity, the market design of banking in Australia leads inevitably to a high cost system.

What are we to do? To begin, let's consider some of the market failures peculiar to retail banking that enable inflated costs and profits.

Section III
Market failure: Stickiness and its impact on competition

As with so many other things, banking is something of an anomaly when it comes to market failure. Take excess market power, where lack of competition means there's no pressure to offer consumers lower prices. The size of the Australian market means many industrial sectors operate as an oligopoly, but usually these are dominated by two or occasionally three players: aviation, construction materials, supermarkets, telecoms, the list goes on.

Banking is different and does not fail the conventional tests of too much market power. The market is not dominated by two or three players. The top four players are of similar size, and the largest two make up less than half the market, a level not considered "excessive" under normal circumstances.

What makes banking different? It's that we customers are what's called 'sticky'. We cling to our banking providers like a newborn baby to its mother; we find it hard to leave one provider for another. There are only a handful of occasions in life we make an active decision to buy a banking product: the savings account at school, the cheque account and credit cards with the first job, the mortgage once or twice in a lifetime, the term deposit, maybe the business loan. But even if we only make a dozen banking purchases in our life, we don't simply pay for these purchases upfront. Instead we pay a trailing series of fees and/or interest charges for the life of the account.

The catch is that we only rarely close these accounts, even if it's in our economic interest to do so. If you doubt this, ask yourself if you still have the first bank account you ever opened, or the last time you closed a bank account.

Why do we act against our own self-interest like this, costing us thousands over a lifetime in fees and charges? It's due to a combination of complex information and 'bounded rationality'. Let's start with the information part.

The neoclassical model of the free market assumes us to be perfectly rational individuals, capable of making choices that 'maximise our welfare' on the condition that we're given perfect information. So the policy response has been to ply us with more and more information. All of us have felt our eyes glaze when presented with a weighty product disclosure statement or an updated terms and conditions document.

Not only does this information arrive in a torrent, but for the average person it's incredibly complex: legal definitions, calculation formulae, detailed eventualities which trigger fees and charges. But people are not great calculators – we can't absorb this complex information to evaluate all the possible courses of action and choose the optimal one.

And there's a second problem beyond the information complexity: bounded rationality. The neoclassical model is based on a false premise – we're not perfectly rational, we're predictably irrational (see Fuller, 2009). We experience loss aversion – we'd rather not lose what we have than gain something else so we fear changing course. Taken together, all this makes it just too hard to shop around in banking.

This is wonderful news for the banks. It means that the rules of competition don't work as effectively as they do in other markets – a distinctive form of market failure. Market share thresholds that constitute excess market power in other sectors are lower in banking. It's not necessary for the top two players to have 80% market share; in banking, having four equal players with over 80% share is enough to create anti-competitive pressure.

Admittedly, the gradual compression of banking margins has meant that this pressure has eased, but when you add an average ROE of over 15% combined with the dramatically reduced risk enjoyed by the banks, consumers are losing out badly. What are policymakers to do?

Stickiness: The market design response

In the wake of the GFC and the subsequent disquiet about banking profits, the Federal Government has already made several market design interventions.

Some have been designed to address customer stickiness and impulse buying. The ban on exit fees for all new mortgages aims to remove barriers to exit and make it easier for customers to switch providers. The ban on unsolicited offers for credit limit increases is intended to avoid indebtedness that's not the product of careful consideration by the customer.

Other measures have been intended to shore up the stability of the overall banking system - so-called 'macroprudential regulation'. These include the requirement for the banks to hold increased levels of capital against their liabilities under the new Basel III accords, the federal guarantee of depositors' funds, the temporary extension of the government's borrowing capacity to the banks and the injection of liquidity into the banks by the RBA.

These measures have undoubtedly been effective in promoting stability of the banking system. Along with Canada, Australia has had the most stable system in the developed world in recent years. However, it has been less effective at reining in excess profits. Faced with a trade-off between stability and competition, we have opted for stability. This was certainly the right priority during the GFC, but now that the crisis has passed and our banks are extremely sound, it's time to think about returning some of those excess profits to the consumer.

YourBank: A new public bank

One idea with potential is the introduction of a public provider to compete with the private sector incumbents. A variation on old-fashioned public provision, this is known as the 'mixed oligopoly' approach. In a market that operates as an oligopoly (few providers with excess market power), the introduction of a public provider can act as an valuable source of new competitive pressure (see De Fraja, 2009).

To apply this approach to banking we should first distinguish between the provision of deposit and transaction products on the one hand, and loans on the other, as the risk profile of the two activities differs enormously. Deposits and transaction accounts are most closely analogous to utilities – essential services that are almost impossible to live without in today's society. All of us receive wages, transfer payments, interest or dividends; all of us pay bills. Deposits and transactions are also the simplest of the suite of banking products to provide. Admittedly they require large IT systems to underpin them, but do not carry the risk profile associated with lending.

Over the last two years, the RBA has conducted a 'Strategic Review of Innovation in the Payments System'. This review found that market failures in banking exist which may prevent innovation in the payments system which underpins deposit and transaction activity, largely because any innovation requires a collective effort to succeed and may divert business away from incumbents' profitable positions.

In its conclusions published in June 2012, the RBA sets out a model for what it calls a 'real-time retail payment and settlements hub' which it says would overcome such market failures. It would act as a conduit for real-time payments between banks by consumers and businesses. It would be open to all Authorised Deposit-taking Institutions offering retail transaction services, and would be facilitated by the instantaneous settlement of each transaction in central bank funds.

For consumers, this would mean the ability to make and receive real-time payments 24x7 (i.e. outside of normal banking hours) and to include much more detailed remittance information. The hub would be in place by the end of 2016, according to the RBA's timeline. Its ownership is still uncertain, but the RBA has stated that one option is for the central bank itself to provide the architecture of the hub.

In the context of this paper, such a system provides a valuable opportunity to increase competition and lower overall system costs. Conceptually, this system is analogous to the National Broadband Network - a common-user network platform on which various providers can compete, except in this case, they are banks, rather than telecoms companies.

The market design opportunity here is to take advantage of this new common-user infrastructure to establish a public provider of consumer deposit and transaction services, backed by the Commonwealth's balance sheet, which would operate on the new infrastructure. Ideally, this would be a stand-alone state-owned enterprise, although it might also be operated as a division of the national post office, as happens in New Zealand. Let's call the new venture YourBank.

The charter of YourBank would be to provide no-frills, low-cost deposit and transaction accounts. It would operate as a commercial enterprise with an expectation of a reasonable return on the government's equity (say 8-10%). Its deposit rates would be linked to the Commonwealth one-year bond rate and adjusted on a rolling basis.

Subject to strict minimum capital requirements (say 15%), YourBank would invest its funds in Australian government bonds and, potentially, highly rated corporate bonds. Any Australian resident could open an online account with YourBank, and students would be offered new accounts at school in the way that the Commonwealth Bank once did when it was in public ownership.

YourBank would not possess a bricks-and-mortar branch network; it would offer online services only. This would enable it to deliver services cost-effectively and would underpin its ongoing commercial viability. The corollary of this is that, at the outset, YourBank services would most likely appeal to younger low-income groups who are more comfortable with online services than their older peers. As penetration of online banking in older demographics increases, YourBank would increase its market share in these age groups.

This offering would suit many citizens who use only basic banking services. The reform would have the effect of introducing a low-cost provider into the retail deposit and transaction segment, stimulating competition and lowering average prices to the consumer. Ultimately, it is a design intervention that redresses the failure of excess market power in the 'utilities' segment of retail banking.

The establishment of a new public provider would take a considerable initial investment in systems and online infrastructure. However, several parallel opportunities exist which might reduce the size of the required investment.

The first is the RBA's proposed payment and settlements hub. If the Commonwealth were to both establish YourBank and, through the RBA, to fund the development of this new hub, it would make sense to integrate the build of the new hub with YourBank's new accounts system. While the two exercises are not wholly overlapping, a joint build would create economies of scale and cost less than each undertaken separately.

At the same time, the Commonwealth could introduce account number portability into the payments systems as proposed by the economist Joshua Gans (2008). Bank account numbers could be transferred between providers just like mobile phone numbers can be, reducing switching barriers and increasing competition. If YourBank is launched in parallel with this initiative, it would obviate the need to create a new unique account numbering system, and to integrate that system with those of other banks and payments systems.

If the Commonwealth chose not to integrate the design of YourBank with the creation of the new payments hub or to introduce account portability, another approach would be to build upon the ATO's existing accounts system. Each taxpayer and business currently has an individual Tax File Number which could readily serve as an YourBank account number. While the volume of transactions would likely be far greater than the ATO currently manages, the underlying account infrastructure would be a valuable base on which to build.

The system effects of a new public bank

The introduction of YourBank may set off a number of second-round effects which should be considered as part of the overall proposal. If YourBank does win market share in the deposit and transaction segment, it will inevitably draw some deposit funding from the Big Four.

The incumbent banks are already under pressure to find more capital. New APRA regulations require the incumbent banks to hold higher capital against their loan portfolios and derivatives like interest rate swaps. Furthermore, since Australian banks are designated 'swap clearers' under US law, they are subject to the full weight of the new Dodd-Frank legislation and its strict capital requirements.

The funding environment faced by the banks is undoubtedly tight. Because of low Federal Government debt, there are fewer risk-free domestic assets to hold as collateral. This means that greater competition for domestic depositor funds would have several knock-on effects.

Importantly, it would make Australian banks more dependent on offshore wholesale funding. This is a double-edged sword. In good times, it offers our banks access to deeper funding pools at the lowest cost. In tough times, it means liquidity is extremely hard to access. The optimum balance would be for Australian banks to have a significant share of short-term funding from offshore sources with a detailed fallback plan in the event that global liquidity dries up. One element of this plan would certainly be that the Commonwealth Government facilitates short-term liquidity by allowing the banks to use its sovereign rating for borrowing, as occurred during the GFC.

A second consideration is that tighter competition for domestic funds would increase political pressure for banks to be able to access pension savings with the same tax concessions as those enjoyed by superannuation funds and for the Future Funds to be allowed to invest in debt rather than exclusively in equities. At this stage, I believe this pressure should be resisted since the banks should have access to sufficient funding sources through their own deposits and offshore wholesale funding underpinned by occasional access to the Commonwealth's credit rating.

Another potential criticism of the YourBank model is that it provides an outlet for the incumbent major banks to offload older and low-income customers who comprise loss-making accounts for the banks. Because these customers hold low account balances, use bricks-and-mortar branches and receive postal statements, they're expensive for the majors to service but don't generate significant fees or interest income.

So, the argument goes, if these customers migrate to YourBank, the incumbents' margins will be even higher and the state will subsidise loss-making customers.

However, the goal of this market design intervention is to increase competition and lower costs for consumers, rather than to constrain directly the margins of incumbent banks. If older and lower-income customers migrate to YourBank, they will still be enjoying cheaper banking services and potentially more attractive deposit rates, irrespective of the margin effects on their former providers.

Under the proposed design, the YourBank concept does not involve the government becoming a lender. It's unlikely that governments have the capacity to judge borrower risk in the same way that private providers do. The state's entry into fully-fledged loan provision may well result in losses to the taxpayer, as well as disgruntled citizens who resent either being rejected for a loan or pursued for repayments.

However, while YourBank might not initially make loans, it's possible that a limited personal loan facility could be developed over time. YourBank might allow any adult citizen to borrow up to $2,000 for personal use slightly above the prevailing Commonwealth bond rate, which is much lower than existing personal credit rates. This would provide all citizens with universal access to a modest amount of credit throughout their adult lives, for use in life transitions, emergencies or investment.

Critics will say that this facility would shower money on less creditworthy people who'd waste the money and be unable, or unwilling, to pay it back. But the facility is only made feasible by the fact that individuals would effectively be borrowing from the Commonwealth, and the Commonwealth has the ultimate credit recovery capacity through the tax system: it's able to recover bad loans through an adjustment to an individual's tax return or welfare payment.

A low-cost public provider of utility banking infrastructure is not just an idea on the fringe of the banking debate; it has been canvassed by global banking leaders. Andrew Haldane, an Executive Director of the Bank of England, commented on the potential of a shared utility vehicle for banking in an October 2012 speech:

> "…I am attracted to recent proposals which would place some core banking services in the hands of a shared utility, storing customer account details. At present, this information is private which acts as a barrier to entry by new banks. It also acts as an impediment to consumers switching and searching between banks and their products.
>
> With customer information held in a network utility, like the electricity grid or railway network, banks could plug and play when offering deposits and loans to customers. The costs of entering the banking market would be lowered for new banks. And so too would the costs of searching and switching for customers, between banks and between products, rather as you might between gas or mobile phone suppliers..." (Haldane, 2012)

In Australia, the economist Nicholas Gruen has sketched the outlines of a new public savings and payments system based on RBA infrastructure (2008). Meanwhile, New Zealand's KiwiBank offers a contemporary example of a publicly owned bank that has managed to increase competition and reduce costs to consumers. Kiwibank was launched in 2002 and has grown rapidly and profitably since then, winning the Cannex Best Value Bank award in New Zealand five times. It offers depositors a guarantee through New Zealand Post, its publicly-owned parent, and implicitly through the New Zealand sovereign.

Kiwibank differs in important respects from the proposed YourBank model: it offers a wider range of banking products and maintains a physical branch presence through NZ PostShops. However, it demonstrates that a low-cost, publicly owned bank can compete and succeed in a market economy.

As discussed above, the recent proposal announced by Yellow Brick Road seeks to raise competition in the residential lending sector. YourBank is a complementary response to the corresponding failure in deposit and transactions. Together, these two initiatives might form a big picture shift for Australian banking: a combination of market-based and policy-based measures that offer a healthy evolution for the industry.

Instead of addressing the static efficiency of the banking sector (the return on capital which is the focus of the Big Four), they address its dynamic efficiency (the allocation of resources which increases welfare for society as a whole). While this provides an immediate competitive threat to the large incumbents, it might also force them into newer, greener markets to the benefit of both consumers and their own shareholders. One such market might involve the development of better loan products for service businesses who currently struggle for credit because they are unable to provide 'bricks and mortar' collateral.

The YourBank proposal involves costs to the taxpayer, both direct and indirect. The direct costs are the set-up of the required systems and infrastructure, while the larger indirect costs are the foregone tax payments on lower profits from the incumbent banks. Set against these costs are even bigger benefits to the community. The taxpayer enjoys the profit stream from YourBank, which will provide a commercial return on the upfront investment in set-up costs. Most importantly though, consumers and businesses benefit enormously through the lower banking fees provided by greater competition.

Inevitably, the incumbents will argue that you can't lower system costs by introducing a new infrastructure platform. But given its low cost of funds and the volume of transactions it would be handling, the new platform would provide banking services at considerably lower cost than the current market. By winning market share over time, it would drive down average banking costs in Australia, improving household budgets and business productivity.

Section IV
Market failure: The moral hazard of implicit public guarantees

While YourBank addresses important market failures, it does not resolve them completely. If the government limits itself to the provision of deposit and transaction products, important issues of system stability remain unaddressed. The most critical of these is the role of the state as implicit insurer of the banks against loan defaults. Clearly, some form of state backing is critical to public confidence in the banking system, and protection against wider economic instability.

Arguably, though, the implicit nature of this backing creates uncertainty which leads to moral hazard. Banks can be tempted to take on more risk because they believe the government will bail them out in the event of loans defaults. But the implicit nature of the state guarantee makes the precise contours of this safety net unclear.

What is clear is that, even with an ill-defined safety net, governments feel obliged to rescue failing banks of any significant scale. Amongst many others, the US government rescued Washington Mutual, the British government bailed out HBOS, the French and Belgians shored up Dexia. In September 2008, the Irish government extended a broad state guarantee to all Irish banks, leading to the collapse of Irish public finances and a subsequent EU/IMF bailout. As recently as July 2012, the EU's European Financial Stability Fund approved a US$122 billion bailout for Spanish banks.

Notably, all the banks listed here ran retail operations, and not investment banking ones, no different to Australia's Big Four except that they lent more recklessly in the lead-up to the crisis. All banks considered 'too big to fail' enjoy an implicit public guarantee of bailout in case of collapse, and this guarantee distorts risk appetite. How can we make the cost of the guarantee more explicit so that it can be integrated into bankers' decision making?

The market design response: Mandatory public mortgage default insurance

A better market design would make this government insurance explicit rather than implicit. Such an approach has been proposed by Gruen (2010). The Australian government would establish a bespoke entity to offer mortgage default insurance to Australian banks. This insurance would be offered on a commercial basis without subsidies, either implicit or explicit. To provide the level of system stability required while avoiding high-risk exposure, the government would insure up to a maximum loan-to-value ratio (LVR) of, say, 60%. The private insurance market would be available to provide additional cover at higher LVRs.

Gruen does not explore whether such insurance should be mandatory for those with Australian banking licences. The obvious benefit of mandatory insurance is that the cost of insurance is incorporated in the

On the other hand, if mortgage default insurance were optional rather than mandatory, it is possible that the capital markets would rate those banks with insurance higher than those without, providing a higher return for better insured banks. But the moral hazard point remains: it's likely that capital markets bet that governments will bail out a large failing bank even if it doesn't have insurance, and so will reward those banks who save on the cost of explicit insurance. Given this, I would argue that mandatory mortgage default insurance is the superior design approach.

Taken together, these design features – a public provider of 'vanilla' banking services and mandatory mortgage default insurance – address the most serious market failures in Australian retail banking. The question is whether our political leaders have the appetite for the task.

Section V
Conclusion

It turns out that both sides of the banking debate are half right. The banks are within their rights, as they claim, to set their interest rates as they see fit, independently of the Reserve Bank. They're also correct that their own funding costs have increased in recent years, and that the accepted response of any well-run business to this scenario is to lift prices where possible to sustain profits.

Critics argue that the banks shouldn't be able to get away with charging what they do in fees and interest. The critics are right to argue that bank profits are too high, but they often miss the key reason for this: that banks face lower risks because they're effectively underwritten by the taxpayer.

The standard argument in the face of excess profits amongst the banks has been to increase competition. In 1977, the then Shadow Finance Minister said that,

> "…perhaps the answer to this problem is the opening up of banking licences in Australia to world banking competition so that some of the smug executives in Australian banks will have to get out and compete instead of having their business given to them on a plate by the provisions of the Banking Act" (see Megalogenis, 2011: 164).

That man was Paul Keating and as Treasurer, he went on to do more than anyone else to introduce competition into Australian banking. This reform had the desired effects of increasing credit availability and stimulating innovation but came with challenges that were unrecognised at the time.

The first is that no matter how many banks compete in the market, customers will always be sticky: pricing and choice don't work effectively and punters tend to remain with their initial provider. Secondly, there is an inherent trade-off between competition and stability – regulators may be happier having fewer, well-capitalised banks even if they enjoy excess profits.

The market design initiatives proposed in this paper are a response to these challenges. A new public bank, YourBank, where school-age Australians can open their first deposit and transaction accounts will mean that stickiness works against excessive margins rather than supporting them.

Explicit compulsory default insurance will mean that the cost of insurance is directly borne by the banks and that their returns will be more closely aligned with the levels of risk they face.

The fact that we survived one crisis is no guarantee we'll survive the next. Market design in the banking sector can improve our chances of doing so, and benefit the Australian consumer into the bargain.

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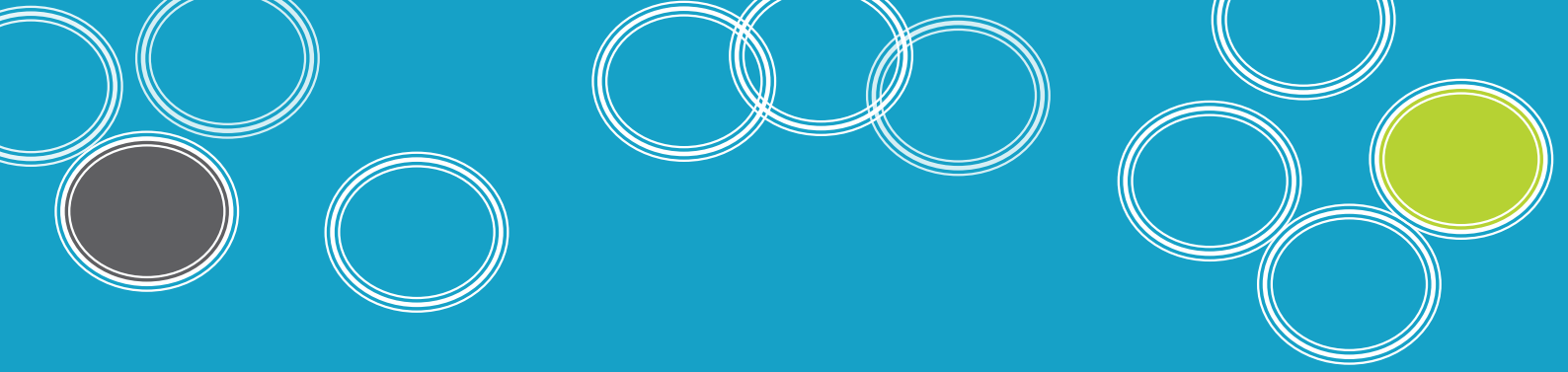

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