The Business Of Banking

By **Rachel Mules**,
Head Teacher HSIE,
Newtown High School of the Performing Arts

Introduction

Businesses deal with banks, directly or indirectly, every day.

In Australia, there are 58 banks, making them the major type of authorised deposit taking institution (ADI), followed by credit unions (129) and building societies (11). Banks in Australia are worth, in terms of the value of assets, $2,460bn, followed by credit unions ($44bn) and building societies ($20bn).

An authorised deposit taking institution (ADI) is a corporation which is authorised to take or accept deposits from savers, under the *Banking Act 1959*. These institutions come under the supervision of the Australian Prudential Regulation Authority (APRA) and are the safest place for savers to deposit their money.

There are three types of ADIs in Australia: banks, credit unions and building societies.

Banks are the major type of ADI. They are incorporated enterprises, meaning they are owned by shareholders and exist to make a profit. In addition to deposit taking, they offer a wide range of financial services such as loans and credit cards, funds management, foreign currency exchange, securities trading and insurance.

Credit unions accept deposits and provide personal loans and housing loans to their members. They can also provide other services such as bill payment and insurance. Credit unions are mutually owned institutions, meaning that they are a not for profit cooperative that exists to benefit its members.

The main activity of a building society, besides accepting deposits, is to provide mortgage finance to home-buyers. Building societies are also mutually owned, although there is an increasing tendency for these types of institutions to raise finance by issuing shares.

Other types of financial institutions in Australia, besides ADIs, include foreign banks, money market corporations (more commonly known as merchant banks) such as HSBC and Grant Samuel, and finance companies such as Esanda.

STUDENT ACTIVITIES

1. If the total asset value of all ADIs is $2524b, calculate the percentage of the total that is held by banks, credit unions and building societies. Comment on the size of the market share in this category.
2. List additional services that banks and credit unions provide as well as accepting deposits from its members.
3. What other financial institutions exist in the Australian market?

Regulation

The Banking Act 1959 regulates banking and ensures protection of the currency in the Australian financial system. It has been amended over time to adapt to the changing conditions of financial markets in the Australian and global economy.

ADIs are regulated and supervised by the Australian Prudential Regulation Authority (APRA), which also regulates insurance companies and superannuation providers. Non-ADIs are regulated and supervised by the Australian Securities and Investment Commission (ASIC).

Figure1: Beirut Hellenic Bank, a foreign owned bank run by Lebanese Australians, which has invested over $US420m in Australia, exists to provide banking services to Lebanese and Greek communities and facilitate international trade between Australia, New Zealand, the Middle East and Europe.

Source: R Mules

Role Of Banks And Other Financial Institutions

Banks and other financial institutions make funds available to people who need to use them. They provide a medium through which people with surplus funds (savers) can make that money available to people who do not have enough funds for their purposes (borrowers and investors).

The Australian financial system plays a crucial role for businesses and individuals:

- It provides financial products for Australian businesses to raise finance for investment
- It facilitates payments – for example, customers can pay cash which they have withdrawn from an ATM, use EFTPOS with a debit card or pay with a credit card online
- It provides financial products for Australian individuals to invest and save for retirement – this benefits individual households and provides access to investment funds for businesses

- It enables households to save for and purchase major items such as housing, cars and overseas travel – again this also benefits businesses when households purchase their products and services
- It provides business with financial products and services such as business overdrafts, investment advice and assistance with establishment and growth.

Banks As Businesses

As you know, businesses exist to provide a good or service for payment to customers with the goal of making a profit. Banks are in the business of providing financial services to their customers in order to make a profit.

How do banks make profits?

The main way a bank makes a profit is the difference between the interest it pays to savers on their deposits and the interest it charges to borrowers for lending them money. For example, a bank might charge 10 per cent on a business overdraft and pay 0.01 per cent on an everyday savings account. Banks also make profits through fees and charges such as ATM usage fees and credit card account charges.

The difference between what a bank charges in interest and what it pays in interest is called the ***net interest margin****.*

Interest rates

Interest refers to the price of loanable funds. Interest is a cost to borrowers and a form of income to savers/lenders. Interest is usually expressed in terms of an interest rate, which is the per cent charged to a borrower on a loan or the per cent return on the savings of a depositor.

Interest rates are affected by a range of factors. Generally, the more demand there is in an economy, where the spending of consumers and businesses is rising, the greater the demand for funds, leading to an increase in interest rates. Conversely, if there is a downturn in an economy, with consumers and businesses spending less, then there will be less demand for funds and so interest rates should fall.

A major impact on interest rates in Australia is the activities of Reserve Bank of Australia (RBA) which is Australia's central bank. The RBA uses its domestic market operations in buying and selling Commonwealth Government Securities (CGS), to determine the rate of interest between itself and the banks, known as the cash rate.

If, for example, the RBA is concerned about rising inflation, it will take action to increase the cash rate on CGS. The higher cash rate will encourage banks to purchase the CGS to take advantage of the higher return. This means the banks have less money left over to lend out, so other interest rates in the economy will increase, for example mortgage rates and business loan rates. This will make the cost of borrowing higher, therefore businesses are less likely to borrow for investment purposes and consumers are less likely to take out loans, leading to a fall in demand in the economy. This can lead to a decrease in sales and profits for businesses. However, in taking action to prevent inflation in the economy, the RBA is hoping to prevent inflation from getting out of control, which would have a much more detrimental impact upon businesses and the economy.

Banks And Stakeholders

Just like other businesses, banks have responsibilities to their stakeholders, including shareholders, household customers, business customers, employees, communities and society in general, government and the environment.

Banks have been criticised over the past 20 years for branch closures, especially in small rural towns. Banks have closed branches to reduce costs and increase efficiency, to satisfy the demands of shareholders for increasing profits. To a local community, however, branch closure means a loss of jobs, less spending in local businesses due to less customers coming into town to do their banking, and less service provision for local individual and business bank customers.

STUDENT ACTIVITIES

4. Outline the typical circumstances when interest rates rise or fall in an economy.
5. Describe the link between rising inflation and rising interest rates.
6. Explain the process whereby the Reserve Bank of Australia causes interest rates to rise (or fall).
7. List a variety of stakeholders in the banking industry.

Community Banks

In response to branch closures by major banks there has been a rise in community banking, such as the Bendigo Bank which establishes banks which serve local communities, with members of the community being shareholders of the bank along with the Bendigo Bank. Community banks create a number of benefits, including banking services to the local community, the opportunity for individuals and businesses to invest in their local bank and receive income in the form of dividends, increased investment funds and stimulation of the local economy whereby local people can borrow funds to invest in new projects, creating jobs and economic activity, profits to owners, increased spending in the local economy and so the process continues.

Examples of the social role played by major banks include Westpac's Indigenous Capital Assistance Scheme; ANZ's urban sustainability targets in Australia as well as the Asia-Pacific; the Commonwealth Bank's free financial literacy curriculum resource; and the NAB's community investment programs such as the Ovarian Cancer Research Foundation.

Figure 2: ANZ bank

Source: R Mules

Banks, Competition And Market Power

The competitive situation of the financial market in Australia can be categorised as an oligopoly. An oligopoly is a market situation in which there are few sellers who dominate the market with a significant proportion of market share – at least one third.

The four largest banks in terms of market share are the National Australia Bank (NAB), the Commonwealth Bank, Westpac, and Australia and New Zealand Banking Group (ANZ). Note that St George Bank is a subsidiary of Westpac. The market share of the four major banks in Australia is 78 per cent of deposits and 87 per cent of home loans, which as you can see in Table 1, has increased over time.

Table 1: Market share of the four largest banks in Australia, 1970 to 2011

Year	Deposits	Home loans
1970	68%	77%
1990	65%	65%
Oct 2008 pre-mergers	65%	74%
Oct 2008 post-mergers	75%	86%
Feb 2011	78%	87%

Recent Trends In Competition In The Banking Sector

While deregulation of Australia's financial system in the 1980s opened up competition in financial markets, placing downward pressure on interest margins, the Australian Government's Senate Committee on Competition within the Australian Banking Sector's report, released in May 2011, found increasing concerns about declining competition in banking in Australia, particularly since the Global Financial Crisis (GFC). The Committee found that during the GFC all banks suffered profit losses but losses were greater in the smaller financial institutions, partly due to their regional nature, being more vulnerable to downturns in particular regions, forcing them to reduce their interest margins relative to larger banks. Net interest margins for the major banks actually increased since the beginning of the GFC, and the banking sector has now become more concentrated.

For example, in the housing market, the market share of the big four banks increased from 60 per cent mid 1997 to 82 per cent by 2010.

Why Did Market Share Concentrate?

- Some Australian firms exited the market (for example, RAMS) or scaled back operations ;
- Some foreign banks exited the market or scaled back operations;
- The Commonwealth Bank takeover of BankWest and the Westpac takeover of St George.

STUDENT ACTIVITIES

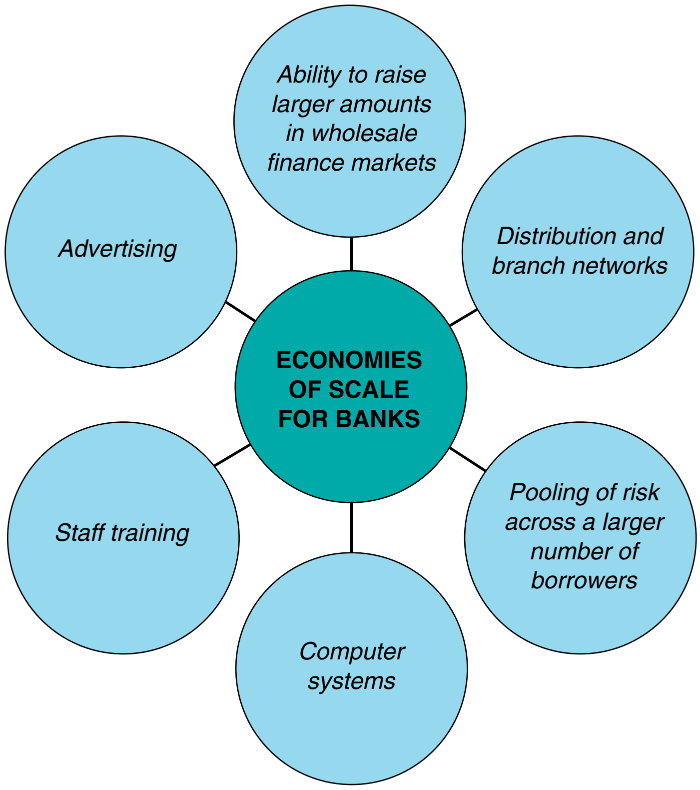
8. How did the Global Financial Crisis contribute to the decline in home loan market share on non bank home lenders (such as Aussie Home Loans and RAMS)?
9. Compile a list of points for and against a high degree of market concentration in the banking system.

Impact of GFC on interest margins was that by the end of 2009 margins for major banks increased to around 25 per cent higher than pre-crisis levels.

Economies Of Scale In Banking

While competition from smaller banks and institutions can put pressure on major banks in terms of interest rates and service provision, there are advantages of having large scale banks – known as 'economies of scale':

Figure 3: Economies of scale for banks – mind map



The benefits of economies of scale to consumer and business customers come in the form of greater access to finance and lower prices for financial products.

However, increasing market concentration and subsequent reduced competition could result in higher prices over the long term. Therefore government intervention is needed to protect consumer and business customers as well as the smaller financial institutions. Government legislation attempts to ensure contestable markets, which are markets in which new businesses are able to enter the market and compete with existing businesses. These markets don't necessarily have to have a large number of suppliers; competition can exist in markets with a small number of major suppliers as long as barriers to entry are low enough.

The Senate Committee's report made a number of recommendations in relation to increasing competition in the Australian banking sector. Some of these include:

- A broad ranging inquiry into the Australian financial system
- Requiring the RBA to publish information about banks' net interest margins and returns on equity
- Requiring the RBA and APRA to publish information about the cost of home loans

- Action to halt market concentration in the banking industry, with the maintenance of the four pillars policy to prevent any merger between the four major banks
- Reducing barriers to competition in the banking industry
- Development of a small business code on lending by the Australian Bankers' Association and small business representatives.

> *NAB Breakup*
> *In February 2011, the National Australia Bank (NAB) launched a marketing campaign to try to differentiate itself from the other major banks and change public perception of the bank. The marketing campaign focused on the idea of the NAB growing apart from the other banks and offering more customer-friendly services and lower interest rates on certain products. The campaign was successful in helping the NAB actually increase their market share: home loan market share increased by one per cent and business lending market share increased by three per cent to 23.8 per cent.*

Figure 4: National Australia Bank (NAB)

Source: R Mules

> *Small businesses in particular were hit hard by the reduced availability of finance as well as significant adjustment to existing loan arrangements made by banks in the aftermath of the GFC.*

Conclusion

While Australia has seen some market concentration in the financial sector, we still have a wide range of service providers including 54 banks, 108 credit unions, 11 building societies, a number of non-deposit-taking lenders, 110 providers of more than 2070 mortgage products; and non-Australian banks which account for 30 per cent of business credit.

Whatever we think of banks and their role in the economy and society, one thing is for certain; the business of banking will remain of vital importance to all businesses in Australia.

STUDENT ACTIVITIES

10. Economies of scale are savings that can be made simply by a business becoming larger and spreading costs over a larger output. Outline some of the savings that come from a smaller number of larger banks.
11. Suggest sound reasons why say Westpac decided to take over St George Bank.

Extension activities

1. Define these terms in their correct business use: incorporated enterprises, mortgage, overdraft, inflation, oligopoly, subsidiary, economies of scale, global financial crisis, takeover, merger, regulation, four pillars policy.
2. Google APRA and ASIC and briefly outline their role in regulating the Australian financial system.
3. Undertake an internet search on a major Australian bank. Find out the difference that it pays depositors on an ordinary savings deposit compared to what it charges on a standard variable housing loan.

References And Further Reading

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An interesting watch:

Hungry Beast episode on banks: <http://hungrybeast.abc.net.au/media/banks-suck>