2 May 2023

ACCC
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Submission to the Retail Deposits Inquiry

We appreciate the opportunity to make a submission to the Retail Deposits Inquiry.

We are investors in Australian equities, investing ~$9b directly and indirectly on behalf of Australian households who are mainly saving for retirement through their superannuation accounts. We invest for the long term in a broad range of listed Australian companies. Generally, we receive performance fees only if we outperform the ASX 300 benchmark in which Australian banks are a very large weight. It is therefore worth noting that we are making this submission when our weight in Australian banks is far lower than their overall benchmark weight (said differently, our firm stands to benefit from initiatives that will make Australia's banking system less profitable). Despite this, we see a strong need for sensible policy decisions in banking and financial services for the benefit of all Australians.

Looking at retail deposit pricing on its own tells only one side of the story. Return on (tangible) equity is the single most important metric for banks, bankers and their shareholders. Currently, and as has been the case for a number of years, return on equity for most Australian banks is not particularly high. We are not in an era of super-normal banking profits for the majority of domestic banks. Therefore, to ask for higher savings rates is to essentially also ask for higher mortgage and other lending rates, as that is the only near-term way for banks to keep their returns at reasonable levels.

An analysis of and inquiry into retail deposit rates with a focus on higher savings rates risks changes that will almost certainly have huge (we're assuming unintended?) consequences for all Australians. It would be akin to throwing stones in a vacuum glasshouse. Banks do not currently make unacceptably high returns (even before one adjusts for the risks they assume). Tinkering with the liability side of their balance sheet risks likely changes to the asset side of their balance sheet with potentially devastating effects on the economy. Already today, households are struggling with the rapidity of interest rate increases. Regulating retail deposit rates will almost certainly result in out of (RBA) cycle increases in borrowing costs for Australians.

The banking system in Australia is insanely competitive. The current (term) deposit war as banks scramble to replace their Term Funding Facility repayments is one example of this. Another is the front book economics for residential mortgages as banks compete for credit growth. A third, and as discussed below, is the relatively mediocre risk-adjusted returns our banks currently 'enjoy'.

The rest of this submission is structured around answering a subset of the questions posed by the issues paper.

2. What alternatives do consumers have to retail deposit products for earning a return on their funds? How close are these substitutes? How does this vary with consumers' risk preferences?

One alternative to term deposits is fixed term annuities. One company that offers these products is Challenger, though the fixed terms tend to be longer.

12. What is the relative importance of the various incentives and constraints that influence ADIs in setting retail deposit interest rates and interest rates for lending products?

To maximise shareholder returns, banks need to deliver a reasonable return on equity. This return is determined by net interest margin, the total loans outstanding, credit losses, and costs. It is also determined by the amount of equity that a bank needs to hold, which is heavily influenced by prudential regulations.

Retail deposit pricing does not happen in a vacuum. Sustainable profits come from the spread between lending rates and funding rates, of which retail deposits are a component. For banks to offer higher interest rates to savers, there would need to be an offset for a bank to maintain its return on equity. That offset can really only come in the form of higher rates for mortgage holders, much higher total loans outstanding or greater cost reduction efforts. None of these seem plausible today:

- In an environment where interest rates are rising, even higher rates for mortgages (to offset increases in savings interest rates) would be problematic, especially as it would also come with higher credit loss expectations.
- Higher interest rates also slow down credit demand, which means banks have to compete aggressively to maintain or incrementally grow their loan balances. We are seeing this today with front-book mortgage pricing at very low spreads to risk-free rates and often offered with additional one-off sweeteners.
- Banks have been on a cost-reduction journey for a while now with mixed success and so that is unlikely to be a source of profit preservation.

Aggressive new competitors would be one of the few ways to force banks to reduce their returns expectations which may manifest in higher offered rates for savings. Even that, however, is less likely now that interest rates are higher, and investors who might have equity funded these competitors are now demanding actual returns on their investments at levels higher than the risk-adjusted returns banks currently make.

It is also worth noting that policy settings have changed over the years. Higher capital requirements mean the equity required to be held by banks has risen and hence the absolute dollar returns have to be greater. That puts upward pressure on net interest margins (in the absence of credit growth), which can only come from a widening gap between mortgage rates and savings rates, all else equal.

15. What factors influence how closely and quickly retail deposit and lending interest rates are adjusted following a change in the cash rate target? How does this vary between different categories of retail deposit products.

It is unclear to us why these should all move in tandem. The cash rate is a short-term rate. Longer-term funding like longer-duration term deposits do not necessarily have costs that go up and down equally with cash rate movements.

We would suggest there are other factors that are taken into account when banks adjust retail deposit and lending rates (focusing here on the ones not already mentioned in the issues paper):

- The rate of credit growth. Higher credit growth may lead to bidding up savings deposit rates. Conversely, lower expected credit growth would reduce competition for savings as there is less incremental assets to fund.
- Changing capital requirements. Higher capital requirements would put pressure on banks to reduce funding costs, all else equal.

Yours sincerely,

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