Forum

The following address by the Chairman of the Commission, Professor Allan Fels, was given to the Australasian Banking Conference, organised by CS First Boston, on 29 September 1995.

Competition policy and banking

Recent activity in the banking industry

In the latter half of 1995 the Commission considered the proposed acquisition of Challenge Bank in Western Australia by Westpac. Following extensive market inquiries, the proposed acquisition was found not to be in breach of s. 50 of the Trade Practices Act which prohibits mergers or acquisitions which would have the effect, or be likely to have the effect, of substantially lessening competition in a substantial market for goods or services.

Media reporting of the decision was accurate. Naturally, however, interpretations and evaluations of the decision varied widely. One newspaper headlined the decision as 'Banks let off the leash'. At the same time the accompanying insert said the Commission had 'caused havoc at the regional bank takeover party'. In similar vein, some papers suggested that the Commission would permit a frenzy of bank takeovers whilst others said that it was imposing tight controls. Yet another variant was a headline suggesting that the Commission had softened its stance on bank mergers (although there seemed to be no basis for this particular interpretation in the reporter's story itself, and in fact this particular interpretation is not correct).

As to evaluation of the decision, at one extreme some commentators took the view that the advance of new technology meant that it would be too narrow to regard the relevant market as State-based retail banking and reached conclusions such as 'correct decision, wrong reasons'. On this view, no mergers in the banking sector would be of concern. At the other extreme, some commentators thought that the Commission was too permissive in allowing the Challenge acquisition. They implicitly would oppose all trading bank acquisitions of regionals.

Others considered that the Commission had struck the right balance at the present time and had built in a degree of flexibility if circumstances changed in the future or if conditions varied from one State market to another. Others saw the decision as a compromise.

Leaving the media aside, the decision generated considerable interest and the spectrum of views about the Commission approach is very wide, ranging from comments that it had taken too narrow an approach to market definition to comments suggesting that the decision will trigger a rash of acquisitions of regional banks and implying that the Westpac Challenge acquisition should have been opposed.

At one extreme is the view that in light of the changing nature of the financial services market, the Commission should have no concerns about bank mergers, that it should oppose no mergers even if:

(a) the major trading banks (MTBs) take over all regional banks — essentially leaving banking in their hands; and/or

(b) the MTBs themselves merge.

At the other extreme is the view that no mergers at all should occur. If one removes one of the logs, all the others will topple. Thus,

if there are, say, six major players in a market, the removal of the sixth player by a major trading bank will alter the competitive pressures on the fifth player which, freed from competition by another regional, instead of competing fiercely with the sixth player and the big four will settle into a quieter life of cooperation under the umbrella of the big four.

The issues faced by the Commission in this matter and the emergence of a number of factors in respect of the banking industry warrant further discussion here. These factors will be significant in light of possible attempts at further restructuring in the industry.

Market definition

The first major issue faced by the Commission was that of market definition.

Product dimension

A number of submissions to the Commission put the view that a financial services market that included life insurance offices, superannuation funds and other non-bank financial institutions should be adopted for analysis of the proposed acquisition. This approach implicitly says that four or perhaps fewer MTBs are sufficient for competition at the present time.

However, whilst taking due account of the changing role of these institutions for certain parts of its analysis, the Commission did not accept that at this time retail banking services were simply part of this wider financial services market, and indeed was concerned that in looking ahead it should not suffer at this time from the affliction many merchant bankers are believed to suffer from — a tendency to make premature extrapolations.

Banks have certain distinctive features. Were banks to raise rates or charges, many consumers could not, or would not, switch to other financial institutions, for example for transaction banking, for small business or many farm loans or farm business transactions, or, more generally, for the cluster of services provided by banks, especially through their branch network.

New developments in financial facilities, such as mortgage securitisation, were taken into account, but the view taken by the Commission was that the market should still be regarded as one for retail banking services rather than financial services as a whole.

The Commission has taken the approach that there is a cluster of banking-type functions (deposits, loans, transactions), and while parts of the cluster are subject to some non-bank intrusion (e.g. home loans), customers themselves do not exhibit such price-responsive fluidity of movement across the spectrum of suppliers of each type of financial service as to lead to the conclusion that they are separate markets.

In relation to this approach, the PSA commented in its inquiry into fees and charges in the banking industry that:

> It appears ... that by focussing on a customer's broad range of needs over time, rather than particular products at a point in time, institutions are able to reduce the impact of price competition from competitors who offer individual products.

The PSA also referred to the importance that financial institutions attached to developing a long-term relationship with their customers to cater to their needs over a lifetime and by so doing, 'capturing all of the banking business of the customer'.

There are a number of factors which suggest that there continues to be a competitive advantage in supplying a full range of banking services, notwithstanding partial and at times vigorous competition for particular banking products. These include the following.

- Branch networks continue to be important for a range of retail banking services, of which transaction banking forms a part and is seen as the basis of a relationship that generates other retail banking business.
- At the present time the transaction relationship appears to be capable of permitting 'cross-selling' of service products and 'price rises' (increases in loan interest rates and decreases in deposit rates) without significant movement of customers. Customers are reluctant to change banks or

go to a variety of suppliers of financial services for a number of reasons including:

- information and search costs;
- procedural requirements under the Financial Transaction Reports Act;
- the possibility of going to a more distant branch; and
- perception of financial security of banks.

- Various banking products are delivered through combined/linked accounts, such as the linking of transaction accounts with credit cards, the linking of personal loans with home loans and the linking of access to electronic transfer system with other banking products.
- The integration of banking products through electronic banking may significantly increase customer information and transaction costs in sourcing particular products from disparate suppliers.
- Customer surveys indicate that the overwhelming majority is unlikely to change their main financial institution.

So the Commission has adopted a cluster approach of retail banking services as the relevant market. This cluster approach has also been adopted in the US. In the leading case of *Philadelphia Bank*, the Supreme Court recognised that the cluster of products and services that full-service banks offer has economic significance well beyond the various products and services involved.

On the question of a broader 'financial services market', while superannuation funds and life offices are starting to participate in some areas of retail business, the banks have particular skills in credit assessment of borrowers and knowing their day-to-day financial needs. These are information-intensive functions and the skills are not easily acquired. Moreover, in the Westpac acquisition of Challenge, Challenge's primary focus was on retail banking, not the wider financial services area, so it was more appropriate to look at retail banking.

Geographic dimension

The view was put to the Commission that the relevant geographic area of the market was national. Again, if this approach were adopted, no acquisition of a regional bank would be likely to be opposed as individually they have very small national shares.

Retail customers, however, are unlikely to seek out potential suppliers of banking services interstate in response to a moderate price increase. Similarly, potential interstate suppliers of such services are unlikely to respond to a moderate price increase in another State. Any such decision to supply into another State would be a decision to enter that market as a longer term strategy.

Of greater relevance, perhaps, is the behaviour of participants. While MTBs broadly operate a national business decision-making structure, the Commission's inquiries indicated emerging regional approaches to retail banking with a degree of regional decision-making autonomy supported by national 'back office' operations. This is exemplified in Western Australia by Westpac's proposals for a regional label for its operations and ANZ's Town and Country Bank subsidiary operating in the same market area as its owner, ANZ, in its own right.

There is a view that electronic banking is increasingly making Australia a national market, not a regional one. The Commission took due account of the impact of technological developments such as ATMs and EFTPOS and concluded that at this point in time such developments have not had the effect of expanding the market that far.

- For example, it is still not possible generally to open an account or arrange a personal loan by means of electronic banking.
- A significant proportion of consumers (at least 50 per cent) do not use electronic facilities.
- In any case, the level of concentration of ownership of electronic facilities in the hands of the large banks in Western Australia effectively limits competition from interstate. For example, the two largest

providers of EFTPOS (NAB and BankWest) account for around 75 per cent of such facilities and the four largest players in ATMs account for around 77 per cent of such facilities.

The economies of scale and probable existing excess capacity of electronic infrastructure could just as easily limit new entry as encourage it. So one should be a little cautious in assuming automatically that the new technology *guarantees* a competitive future in banking.

The Commission considered, therefore, that the relevant geographic area of the market was regional.

Whether the new participants (mortgage securitisers, superannuation funds etc.) can establish themselves as viable contenders in the provision of the cluster of retail banking services and how long that takes are the unknowns. Customer acceptance will determine their success and will be taken into account by the Commission in its assessment of future proposals for acquisitions of regional banks. Similar considerations apply to the geographic scope of the market, i.e. whether customers switch to interstate suppliers in response to local price rises.

The Commission has not closed off these possibilities but their mere promise is not sufficient at this time to widen the geographic and product dimensions of the market. If the market evolves in the way suggested, the Commission will assess it accordingly in future bank acquisitions. Incidentally this point was made fairly clearly at the time of the Westpac/Challenge decision.

Barriers to entry

Another important issue considered by the Commission was barriers to entry. Low barriers mean that new entry or its potential are an effective constraint on the ability of incumbents to raise prices. Market inquiries revealed that there are significant barriers to entry and barriers to non-bank competition in the retail banking market. These include:

- the need to establish extensive branch and agency networks;
- the need to establish electronic banking facilities;
- customer inertia, the effects of 'relationship banking' (where customers tend to use one institution for all requirements), and information and transaction costs;
- the economies of scale and scope for key costs such as data processing;
- 'banking premium' (that is, the premium which banking derives from its prudential security and perception of government guarantee);
- advertising expenditure and brand awareness;
- significant sunk costs;
- historical factors such as access to the payments system and access to deposits; and
- the special skills in credit assessment in small scale lending which are not easy to acquire quickly.

It has been suggested that there is plenty of scope for entrants via the building society route. While it is true that many of the current regional banks evolved in this way, with Bendigo Bank in Victoria being the latest to take this option, there is a limited number of significant building societies remaining.

Contestability

It is sometimes claimed in trade practices cases that 'contestability' makes competition policy irrelevant — in the long run, competition will look after itself. In fact, the theory of contestability is somewhat like that of competitive equilibrium — it serves to remind us how stringent the conditions are under which first best outcomes will be achieved merely by the 'invisible hand'. Thus, 'perfect' contestability has very strict requirements:

- no sunk costs;
- potential entrants must only consider pre-entry prices (or incumbents must be prevented from changing prices in the event of competing entry);
- all firms face the same cost conditions and technological options; and
- consumers are indifferent between suppliers, and all firms have equal access to all customers.

It is obvious that these conditions are rarely, if ever, met in practice.

- There are always some sunk costs. Even if the entrant can hire equipment etc., it still has to employ staff and invest in stocks, do some advertising and promotion, the cost of which will not be fully recovered on exit.
- Potential entrants will only consider pre-entry prices if they are likely to reflect post-entry prices; where there are significant economies of scale, the addition to supply of minimum efficient scale (MES) entry will be likely to drive prices down and make entry unprofitable, unless pre-entry prices are above competitive levels or are fixed.
- Potential entrants will often face different cost conditions, e.g. access to scarce resources, investment in promotion to combat brand loyalty of incumbents.
- Where products are differentiated, consumers will not be indifferent and potential entrants are likely to face different demand conditions to those faced by incumbents.

Viewed as a whole, these facts imply that market performance will depart from the ideal of perfectly contestable markets. As a result, some firms will possess and be able to preserve market power, and they and others can collude knowing that market disciplines will often work poorly or only very slowly to undermine the high prices the colluding firms set.

To say this is not to suggest that the proper task of competition policy, and of regulation more broadly, is limitless. Although all real world markets depart from the textbook ideal, most do a far better job of delivering lower prices and better products than would regulators. The task of the economic regulator should not be to replace the market, but rather to make it function better — by deterring conduct which harms consumers and undermines the competitive process. Clearly, priorities need to be set in this task — and without suggesting that other responsibilities are unimportant, four suggest themselves:

- to prevent the kinds of conduct which are most harmful — for example, price fixing;
- to pay special attention to those markets where competitive disciplines are weakest — for example, the public utilities, formerly regulated industries and the non-traded goods sectors more generally;
- to prevent structural changes, such as mergers, which seriously weaken competitive conditions, and which, even if a power of divestiture were available, are difficult and costly to reverse; and
- to maximise the efficiency of markets by protecting and enhancing the power of consumers.

Taken together, these tasks do not make markets perfectly contestable — competition policy can no more do that than it can eliminate the entry barriers which sunk costs, product differentiation and transactions costs create. But it can help the competitive process yield outcomes which come closer to the competitive ideal, and hence allow for durably higher productivity and incomes.

Let us consider some aspects of contestability and banking.

Customers

Data from a number of sources indicate that the majority of customers (more than 70 per cent) say that they are unlikely to change their main bank. Information and search costs, procedural requirements under the Financial Transactions Reports Act, the possible inconvenience of going to a more distant branch, and the

perceived financial security of banks generally are contributory factors. In general, switching costs for borrowing can be high due to transfer fees, loan fees, etc.

The ability of banks to 'bundle' a group of services and the tendency of customers to accept such bundling is demonstrated by the increasing use of linked (usually electronic) account facilities combining statement, card, cheque accounts. Information provided to the Commission by a number of parties indicates that once the 'average accounts per customer' ratio exceeds 1.5, the prospect for selling other services by the institution to its customers (the cross-sell ratio) is high. All participants in the Western Australian market exceed this ratio.

Sunk costs

Viable entry without establishing a branch network appears unrealistic at this time. Customers cannot open an account with a new financial institution electronically. Further, the Commission's inquiries indicate that almost 50 per cent of customers never use electronic facilities. So accessible physical facilities (rather than a single representative office) is necessary if a new entrant wishes to access all customers. The likelihood of recovering branch establishment costs on exit must be low with the tendency to rationalisation by the incumbents.

A new entrant would also have to establish electronic banking facilities (EFTPOS, ATMs etc.) to access those customers who do use them. That is, 'bricks and mortar' and electronic facilities are not alternatives, they are complements. The electronic facilities are also unlikely to be easily saleable on exit.

The PSA said in its report that 'significant branch networks are likely to remain a feature of the industry' (p. 32). The House of Representatives Standing Committee on Finance and Public Administration (the Martin Committee) in its report 'A pocketful of change' said in respect of branch networks:

> Industry representatives acknowledged that the costs of establishing a large branch network are a significant barrier to entry. These costs were cited by foreign banks as being one of the major reasons for their failure to make an impact in the retail banking sector. As far as the Committee is aware, foreign banks have not managed to make significant inroads into the retail banking sector of any country, except where they have acquired an existing branch network (p. 144).

The Committee went on to conclude:

> The commercial advantages enjoyed by established domestic banks, particularly their branch network and their broad customer base, are a barrier to competition in the sense that they make it more difficult for new entrants to gain a share of the market. These advantages have been built up over a considerable period of time and reflect an extensive investment by the established banks.

As to electronic facilities, some 75 per cent of EFTPOS in WA is accounted for by NAB and BankWest and the leading four providers of ATMs account for 77 per cent of facilities. The concentration and probable excess capacity make it highly risky and unlikely for new entrants to break in.

Competition in the retail banking services market

It is clear that there is a degree of strong competition among the MTBs. On the other hand, the MTBs are 'look alikes' in terms of:

- size and scope of their domestic operations;
- geographic and risk spread of their loans;
- 'bricks and mortar' investments;
- electronic systems;
- borrowing costs;
- strategic outlook;
- evolutionary history; and
- customer relationships.

MTBs have similar cost advantages in terms of borrowing costs and scale and scope economies. MTBs also have similar cost disadvantages in terms of their inherited organisational structure and physical assets, which the regionals and new participants (home loan originators etc.) do not have.

MTBs can be contrasted with regionals, which have:

- a focused geographic operation;
- a niche customer range;

- a service oriented outlook;
- lower operational costs; and
- an innovative approach.

Regionals therefore impose a constraint of a different dimension to that imposed by intra-MTB competition.

In assessing the vigour and effectiveness of regional banks, the Commission looked at the performance of regionals generally according to a range of competition criteria and found that regionals:

- are generally highly efficient;
- are relatively highly profitable;
- compete vigorously on prices, leading and lagging competitively;
- have been a strong innovative influence in banking product development;
- achieve high levels of customer satisfaction; and
- have achieved good asset growth in recent years.

It has been suggested that the regionals are in fact not highly efficient. The first point here is that with the exception of National Australia Bank, with a cost-to-income ratio around 56 per cent, MTBs have a cost-to-income ratio above 60 per cent and rank behind the regionals as a class. The second point is that cost-to-income is just one of a number of measures of efficiency. The Commission considered other criteria such as the cost-to-assets ratio and operating income per employee and found that the regionals generally rated ahead of the MTBs.

Similar observations can be made about the profitability of regional banks notwithstanding the previous State Banks of Victoria and NSW (both now under new ownership). The remaining regionals, as a class, are highly profitable despite higher borrowing costs arising from their lower credit rating (due to their limited asset base and geographic spread). They content themselves with lower interest spreads and operate efficiently to compensate for higher borrowing costs. In terms of growth of assets, the performance of the regionals, as a class, has been significant and some of them have increased their market share as well.

Regional banks

Addressing the wider issue of regional bank acquisitions, the approach of the Commission is to examine each case individually on its merits in the circumstances prevailing at the time of the acquisition in the relevant market. The principles and method of the Commission's analysis are based on the draft merger guidelines that were issued in 1993.

In the Westpac/Challenge matter, the Commission undertook extensive inquiries, obtaining views from a number of experts, including bankers, economists and senior legal counsel, on the structural and behavioural characteristics of the participants in that market. Serious consideration was given to these views in formulating an approach to issues of regional bank acquisitions.

Based on the Western Australian study, the Commission considers the retail banking market to be regional or State in character, although it is accepted that the major banks operating in State markets include the four national banks. It is not appropriate to view most consumers as having national choices. Rather, they must choose basically between banks and other relevant financial institutions operating within their State.

It should be noted that a distinguishing feature of the Western Australian market was the role of BankWest, which the Commission found to be a strong competitor against the MTBs on price and a range of services, with a market share of 24 per cent of both loans and deposits, and a strong presence in both EFTPOS and ATMs. Its asset growth has also been significant. The Commission views the sale of BankWest to the Bank of Scotland as a pro-competitive step.

Although there has been an increase in the amount of competition between the MTBs in recent years, they retain a 'look alike' image to many customers. Regional banks, by adding diversity, innovation, closeness to customers and price competition play a key role in promoting competition and consumer choice in the market.

While regional brands (operated by MTBs) have the potential to be pro-competitive, they do not guarantee competition. Decisions on price are ultimately in the hands of the controlling MTB. Whether the local brand will initiate price cuts or merely respond to market pricing is, consequently, at the discretion of the MTB. Therefore, the Commission will be looking to see what independent regional bank constraint exists on the level of prices.

Any MTB acquisitions of regional banks would be scrutinised very carefully. In any State with only one major regional bank the Commission would be especially concerned. The concern is that such an acquisition at this time would be likely to substantially lessen competition. The Commission would need some highly persuasive evidence to be convinced otherwise. Even in States with more than one substantial regional bank, the Commission would still examine any MTB acquisition of a regional very closely.

Because of the smaller size and higher borrowing costs of regionals, they need to take smaller spreads of interest, be more efficient and contain their costs by focusing on core businesses in order to compete with the majors. This adds a strong dimension to competition. If the regionals were to be 'taken out', the MTBs are likely then to have less incentive to compete vigorously.

Both the PSA and the Martin Inquiry have commented on the competitive significance of regional banks. The Martin Inquiry noted:

> Particular reference was made by industry representatives to competition in State markets. They pointed to the strong support for locally owned institutions in their home states. This translates into significant market share ratios for local institutions within particular sub-markets, and, according to industry representatives is one indicator of effective competition in the industry.

Price is at the very heart of competition and the PSA has pointed out the relationship between product differentiation, pricing and relationship banking. It pointed to relationship banking as a means of product differentiation which:

> ... allows banks to retain business they may otherwise be losing even faster to more specialised competitors and to camouflage fees and charges through packaged product design and pricing. Relationship banking essentially makes a homogeneous product different in the eyes of the customer. This approach by banks is intended to undermine the price-attractiveness of competitors' offerings on a product-specific basis, while also highlighting the advantages of purchasing a range of services from the one institution.

This competition-focused approach to mergers and acquisitions is dictated by the provisions of the Trade Practices Act and does not take into account any possible increases in business efficiency or other public benefits (unless they directly affect competition), as public benefits are only available for consideration by the Commission when an authorisation is sought for a merger.