CHAPTER SIX - OTHER ISSUES: MERGERS AMONGST FINANCIAL MAJORS AND ELECTRONIC COMMERCE

6.1 MERGERS AMONGST FINANCIAL MAJORS

As the financial supervisor of the insurance and superannuation industries, the ISC has a keen interest in the level of competition in those industries. Although the ISC has a minimal role in regulating competition per se (the ACCC being the regulator in this area), we nonetheless wish to contribute - from our particular experience and specialised perspective - to the debate on competition in those industries, particularly in relation to mergers amongst the larger players in the industry.

In this part of Chapter Six, discussion will focus on the life insurance and banking industries, since it is in these industries that mega-mergers have the greatest potential to impact on competitiveness in the relevant markets. Although the banking industry per se is outside the ISC bailiwick, there is some discussion on it in this chapter because of the impact that increased concentration in the banking industry would have on the financial system generally (eg. the largest financial conglomerates are banking groups). Comment on the general insurance and superannuation industries is more limited because those markets are generally less concentrated in terms of numbers of players and dispersion of assets than the life insurance and banking markets.

The structure of the financial system in Australia

The overall picture

The financial system, according to RBA and ISC figures as at December 1995, comprises some $1,041 billion in assets. It is, however, difficult to be precise because of some cross-investment between financial sectors (ie. ‘double counting’). For example, it is estimated that around 4 per cent of superannuation and insurance assets are deposited with banks and other financial institutions, while a further 7 per cent is invested in other managed funds.

The four major banks dominate the financial system with some $305 billion or 29 per cent of total financial system assets between them. The life insurance sector is smaller but also significant, with some $124 billion or 12 per cent of total financial system assets.

There is not, however, a neat division between the banking and life insurance industries. As pointed out in Chapters Two and Three, a substantial amount of financial system assets are controlled by financial conglomerates, whereby banks have life office and funds management subsidiaries, while life offices in turn have bank or building society and funds management subsidiaries. Of the top ten financial groups, which collectively manage around $490 billion or 55 per cent of total financial system assets, five are primarily banking groups (Commonwealth Bank, Westpac, NAB, ANZ and Advance Bank/State Bank of SA), two are life office groups (AMP, National Mutual), two are more generally known as financial services or funds management groups (Bankers Trust and Lend Lease), and one is a hybrid insurance/banking entity (Colonial Mutual/State Bank of NSW). The Colonial group is the only example where a life office owns a bank; however, this group is expected to have a holding company structure following demutualisation of the life office.

The structure of the financial system is summarised at Appendix A (financial system report card). At Appendix D is a descriptive list of financial conglomerates by industry type.

Concentration

A measure of the competitiveness in any industry is the degree of concentration in that industry. Viewed separately, there is a significant degree of concentration in the banking and insurance industries, as illustrated in the table below.

Table 6.1 Concentration in Australian Financial Industries

Industry	**Industry Share** (% share of total industry assets)
Banks:	
- Top 4	67%
Life Offices:	
- Top 3	52%
- Top 10	80%
General Insurance Companies:	
- Top 3	32%
- Top 5	53%
- Top 10	75%
Superannuation Funds:	
- Top 10	25%
- Top 100	62%

Sources: Reserve Bank Bulletin June 1996, ISC Life Insurance Quarterly Statistical Bulletin, 31 December 1995, ISC Selected Statistics on the General Insurance Industry, 30 June 1995, ISC Bulletin.

If a view is taken of the entire financial system, the levels of concentration are somewhat smaller. According to the Council of Financial Supervisors 1995 Annual

Report, the top four financial groups (headed by the top four bank majors) account for **34.5 per cent** of total financial system assets. The top 10 financial groups account for **52 per cent** of financial system assets.

Both the Campbell and Martin[1] Committees highlighted two principal concerns about the trend towards increased concentration of ownership and control in the financial system, and the potential effect of financial deregulation on this trend. These were:

- that a particular group or category of institutions (eg. banks or life insurance companies) may assume a position of undue dominance in the financial system (group dominance); and

- that a small number of large institutions may dominate the financial system (individual firm dominance).

The Martin Committee noted at the time of its inquiry that the top four banks had approximately 72 per cent of market share. As at June 1996, the assets of the top four banks constituted approximately 67 per cent of assets of all banks in Australia, not including the Reserve Bank. On this basis, concerns about a small number of institutions dominating the retail market in particular would have eased only marginally.

It is evident, however, that the view one takes on what exactly is the relevant 'industry' or market is critical to the question of whether there is undue concentration in that industry. In assessing bank mergers, we understand the ACCC takes a case-by-case approach having regard to market conditions at the time, but in at least one or two instances, has defined the market as the retail banking market in the relevant State[2]. The major banks, however, would no doubt argue that the market is much wider than that, particularly given new technology. Whatever view one takes, there is no doubt that the question of concentration is of more relevance to the **retail** deposit, investment and lending sectors, than the corporate/wholesale sector.

Despite the increased number of market players following deregulation in 1983, the level of concentration in the retail banking industry has remained relatively high. The entry of new banks in the wake of deregulation resulted in an initial drop in market share for the incumbent nationally operating banks, but more recent consolidation of market share by the major banks following a series of mergers and acquisitions has restored a relatively high level of retail industry concentration.

Foreign bank entry following deregulation did lead to fierce competition in the mid to late 80's, but such competitive pressure tended to deliver customer benefits only in the

[1], Report of the House of Representatives Standing Committee on Finance and Public Administration, *A Pocket Full of Change* November 1991, AGPS, Canberra, p 118-121.
[2]In the USA, the market is defined for antitrust law purposes in terms of both product type and geographical region (US Government economists use the Herfindahl-Hirschman index to measure concentration, ie. the sum of the squares of the market shares of each competitor).

corporate/wholesale sector; the benefits of competition were far less apparent in the retail sector.

It is evident, however, that deregulation has led to a significantly more open and competitive environment within the banking industry and the financial system taken as a whole. There are a far greater number of institutions competing for market share than was the case prior to deregulation. Also, the partial erosion of traditional lines of demarcation has allowed banks and other financial institutions to compete across a broader range of activities for a more varied spread of business (although the entrenched power of the traditional retail banking base through an extensive branch network and a high degree of customer loyalty and inertia should not be underestimated).

Reasons for mergers

A principal aim of financial deregulation has been the attainment of increased efficiency of the financial system through the promotion of effective competition (ie. involving price restraint and improved service, not merely product differentiation and marketing effort). The premise underlying financial deregulation has been that the most efficient way to organise economic activity is through a competitive market system which is subject to a minimum of regulation and Government intervention. The development of a more competitive structure within the banking industry and the wider financial system should not be regarded as an end in itself, but rather a means to an end.

On this basis, it could be argued that Government and regulators should not interfere with market forces that would be likely to generate efficiency gains and provide a net benefit to consumers. Some of the reasons advanced for mergers include the scope for economies of scale, reaching a sufficient size (‘critical mass’) to be internationally competitive, and in the case of mergers of different types of institutions, diversification and access to new markets.

Economies of scale

There is limited empirical evidence on whether there is scope for economies of scale from mergers in the banking and insurance industries in Australia. One study by Walker[3] concluded that there was little evidence of economies of scale in the banking sector. Similarly, a study of Victorian Credit Unions[4] found that economies of scale were not significant in that industry and should not be relied upon to justify mergers among the credit unions. However, a study of Australian permanent building societies[5]

[3] Greg Walker, Faculty of Commerce, Charles Sturt University - Mitchell, *Evidence on the Economies of Scale Debate in Australian Banking*, Paper presented at the Australian Institute of Bankers “Banking and Finance Conference” 10-11 July 1995.
[4] Rayna Brown and Ian O’Connor, *Measurement of Economies of Scale in Victorian Credit Unions*, Australian Journal of Management, June 1995.
[5] Neil Esho and Ian Sharpe, *Long-run estimates of technological change and scale economies in a dynamic framework: Australian permanent building societies, 1974-1990*, Journal of Banking and Finance, Vol 19, 1995

found evidence of scale economies for small societies and diseconomies for large societies. There is little or no support in the international literature for economies of scale in very large banks (eg. this is made clear by Stephen Rhoades[6] and other experts in the field). However, there may be some potential for efficiency gains where a more cost efficient bank takes over one that is less cost efficient, and successfully lifts the latter's internal x-efficiency or productivity; however, there is no clear evidence to indicate that this commonly occurs in practice[7].

Overall, the literature does not support the general existence of economies of scale from bank mergers - rather, anecdotal evidence and casual observation would seem to suggest that, from a prudential perspective, banks should neither be too small (thereby lacking the benefits of regional and product diversification) nor too large (creating internal management difficulties between branches and head office and becoming an unwieldy bureaucracy).

Although there is no definitive empirical evidence available in relation to insurance companies (both life and general), there is no prior reason for assuming that economies of scale would not exist. In the managed fund sector, and in global investment banking more generally, there is wide agreement that there are significant potential economies of scale to be derived from size. However, if there is any lesson to be derived from the literature, it is that any claims of economies of scale as a consequence of mergers amongst financial majors in banking and insurance delivering consumer benefits should be treated with considerable scepticism.

International competitiveness

There is no doubt that in world terms Australian financial institutions are relatively small (Australia's largest bank, National Australia Bank is ranked 41 in terms of capitalisation, with the remaining three major banks being in the top 100) compared to some of the larger European, Japanese and US institutions. It is often argued that financial institutions need to be of sufficient size to be internationally competitive - large Australian financial institutions cannot simply rely on the domestic market for growth, and must increasingly compete in international markets, as world economies continue to 'globalise'. This is the 'critical mass' or 'national champion' argument. It is interesting to note that the largest US commercial bank (Chase Manhatten/Chemical Bank) accounts for less than 5 per cent of the US commercial banking market, by both assets and deposits.

However, there are already options available to major Australian financial institutions wishing to diversify internationally other than through domestic mergers. For example, takeovers of (or mergers with) local companies in foreign markets may be a more efficient method of growth, giving an Australian company an insight into local customs and traditions, and a foreign 'brand name' which may be better able to compete than an

[6] Numerous papers, eg. Stephen Rhoades, *Competition and bank mergers: directions for analysis from available evidence*, *The Antitrust Bulletin*, Summer 1996.
[7] Allen Berger and David Humphrey, *Megamergers in banking and the use of cost efficiency as an antitrust defense*, The Antitrust Bulletin, Fall 1992.

Australian brand. This is more likely to be true in retail markets rather than wholesale markets, since retail customers tend to show considerable resistance to unfamiliar foreign brand names and commercial practices.

It may also be that the 'critical mass' that is supposedly needed before an institution can become an internationally competitive 'national champion' is exaggerated. Again, there is scant evidence or rigorous reasoning to support the view that sheer size and dominance of financial institutions in their home market is the main determinant of their international competitiveness, unless it is assumed that profitable domestic business (based on market power) is used to cross-subsidise international expansion.

Diversification

Mergers between different financial institutions can often be complementary, whether they are operating in the same sector or not, leading to potential (but not always realised) economies of scope (or synergies) which could benefit consumers and shareholders. For example, if two general insurance companies were to merge, one being strong in domestic lines (eg. car, household insurance), the other being strong in commercial lines (eg. workers compensation, public liability), there exists significant potential for diversification gains. On the other hand, market players often favour overlapping mergers in order to reap the potential gains of closing duplicate offices, without automatically losing business to a competitor further down the street.

Mergers that seem to be complementary may not necessarily lead to the gains expected, however. For example, a merger between a bank and a life insurance company, while seemingly offering scope for cross selling in distribution of products, may lead to a clash of cultures and skill sets (or core competencies) because of the inherently different nature of banking and life insurance business. In fact, there are numerous examples of mergers resulting in unexpected administrative trauma as managers struggle to integrate incompatible cultures and systems, and to relocate or retrench staff.

The role and the views of the ISC in takeover/merger regulation

Insurance Acquisition and Takeovers Act 1991

As mentioned at the start of this chapter, the ISC has a keen interest in the subject of mega-mergers, and consequently levels of concentration and competitiveness in the industries it supervises. The ISC also has a prudential role to play in takeover regulation through its administration of the *Insurance Acquisition and Takeovers Act 1991* (IATA).

IATA came into operation in March 1992 and provides for the prior screening of changes in the ownership and control of Australian life and general insurance companies. This prior screening takes the form of notification to, and approval by, the Treasurer, or the Commissioner as his delegate. It applies to any proposal to acquire a significant shareholding - 15 per cent or more - in an insurance company, or any proposal which would result in a person being able to control the directorate of an Australian insurance company.

The purpose of IATA (as stated in section 3 of the Act) is to protect the public interest by:

- ensuring that the affairs of Australian insurance companies are likely to be carried out in a prudential manner;

- preventing unsuitable persons from being in a position of influence over Australian insurance companies;

- preventing the undue concentration of economic power in the Australian insurance industries, or in the Australian financial system; and

- preventing proposals that would be contrary to the national interest.

IATA therefore has primarily a prudential, rather than competition, focus. However, there is the scope for the Treasurer to regulate competition in the insurance industries using IATA if he has a concern that 'an undue concentration of power' may be contrary to the public interest in the circumstances at the time. This complements the more general power in section 50 of the *Trade Practices Act 1974* (TPA) which is administered by the ACCC.

To date, no-one has complained of proposals for acquisitions of substantial shareholdings put to the Treasurer or the Commissioner under IATA being refused (decisions under IATA are not necessarily announced, although it is unlikely that a rejection of a major proposal would not be announced). Most of the proposals, as the table below shows, involve some rationalisation in the general insurance industry, although there has also been some activity in the life insurance industry.

Table 6.2 Activity under the Insurance Acquisitions and Takeovers Act 1991

Year	General Insurance requests and approvals	Life Insurance requests and approvals
1991-92	5	5
1992-93	29	6
1993-94	16	3
1994-95	13	8

ISC views on mergers

In the ISC's view, proposals for mergers between financial majors need to be evaluated on a case-by-case basis, having regard to the circumstances at the time. For example, there would be a strong prudential case for approving the takeover of a troubled financial major, particularly if it could continue to operate autonomously because the buyer was foreign. More generally, for financial majors, there could be public interest grounds to approve a merger in order to avoid a company failing, even at the risk of a reduction in competition, and despite the obvious moral hazard.

In the absence of a prudential concern, however, mergers between domestic financial majors may be problematic because of the potential for a reduction in effective competition and flow on effects to retail consumers. As alluded to above, there is no Australian or international empirical evidence to clearly support the view that mergers between large financial institutions would unambiguously generate efficiency gains or benefit shareholders, or that only a domestically dominant 'national champion' will have the 'critical mass' to be internationally competitive.

On the other hand, there are strong anecdotal and intuitive grounds for suspecting that merger proposals are commonly motivated by empire-building per se, and that very large institutions can be in danger of becoming more imperious and less consumer-oriented. It is also possible that a very large institution would become 'too big to fail' (the moral hazard referred to above), and become arrogant and remote in dealing with governments and customers.

There is also a very strong possibility that a merger between financial majors would lead to irresistible pressure for successive rounds of catch-up mergers among the remaining majors, until the local retail banking market was dominated by only two very large banks. This prospect is of major concern, because mergers are not typically isolated events, but tend to occur in tandem.

Appropriate regulatory structures

At present, the Treasurer has powers to regulate mergers in the financial industry under IATA, the *Banks (Shareholdings) Act 1972* and (in the case of foreign bids) foreign investment policy, on top of the role of the ACCC under the TPA. Although this appears to involve duplication, the primary objective of IATA is stability in the general and life insurance industries rather than competition, which is the preserve of the TPA in this context. Similar to IATA, the *Banks (Shareholdings) Act* has a prudential focus, designed to protect depositors rather than preserve competition, and foreign investment policy is largely attuned to community expectations and sensitivities.

On this basis, it is the view of the ISC that all these additional powers have a legitimate place in the regulation of the financial system, because they give the Treasurer the discretion to reject a proposal having regard to special public interest considerations which may apply on a particular occasion, but not more generally. Regarding regulation of competition generally, it is the ISC's view that the appropriate regulator of competition is the ACCC, and that body should continue to have the powers it currently has under the TPA in respect of vetting mergers and takeovers. The ISC has a concern that extremely powerful corporations may be difficult to deal with in the broader public interest, and is not convinced that mergers between major banks and life insurance companies would unambiguously and significantly benefit domestic consumers.

6.2 ELECTRONIC COMMERCE

The ISC's interests in technological and market developments in electronic commerce are two-fold. First, the ISC as a user of electronic commerce (defined broadly) is keen to keep abreast of such developments to ensure that its supervision of life and general insurance companies and superannuation entities is as efficient and cost effective as possible. Second, the ISC is concerned to ensure that the regulatory framework continues to be relevant and that legitimate market developments are not unduly hindered by outmoded legislative requirements. Concomitant with this, the ISC is also concerned to ensure that such technological and market developments do not result in activities - which would otherwise be supervised by the ISC - falling outside of the regulatory framework. The ISC does not 'crystal ball gaze' and is not proposing to comment on the implications of new technology for the regulation of the payments system.

ISC regulation and electronic media

The ISC makes significant use of electronic media in its supervisory activities. In the general insurance area, both quarterly and annual returns - which are the basis for both prudential regulation (assessment of solvency) and compilation of important statistical information - are provided by means of diskette, and are input directly into the Commission's database. The advantage of this system is that pre-lodgement edit checks can be built into the diskette program, minimising administrative errors upon lodgement and thereby speeding up the processes of assessing solvency and compiling statistics.

In the life insurance area, work is proceeding to implement electronic lodgement; it is expected that a system will be in place early in 1997. Already certain unclaimed moneys information is provided to the Commission electronically. Similarly, in its supervision of superannuation entities, the ISC encourages superannuation funds to lodge their annual returns by means of diskette, although this is not mandatory and a paper annual return is still accepted. However, the take up rate of lodging by diskette is around 90 per cent.

In the superannuation field, the ISC is participating in discussions with the Australian Taxation Office (ATO) and the superannuation industry to examine ways in which electronic commerce can be used to reduce compliance costs, increase levels of service delivery and improve the quality of data collected from industry. In particular, the superannuation industry is interested in using electronic commerce to process employer and employee superannuation contributions and to transfer members' benefits between superannuation funds. The possibility of eventually developing a single superannuation fund return which could serve the needs of the ISC and the ATO is also being examined.

Market developments in electronic commerce

In recent years there have been significant technological advances with the potential to unleash major market developments in the insurance and superannuation fields, particularly with the growth of the Internet. Most of these potential developments have centred around the prospect of new and cheaper ways of selling and distributing financial products, such as general and life insurance policies, and interests in retail superannuation funds.

For example, telephone sales of life insurance and general insurance policies are on the increase. Although little hard data is available, in the United Kingdom it is estimated that 30 per cent of personal motor and 10 per cent of household insurance policies are now sold over the telephone. In Australia, anecdotal evidence on direct selling suggests that the results could be similar.

Beyond telephone sales, developments in electronic selling and distribution of financial products is in its infancy, but could conceivably grow rapidly. For example, the ISC has been approached about a proposal to sell an insurance product on the Internet. This has not yet occurred to our knowledge, but work in this area is proceeding. In addition, information provided to the ISC indicates that some 30 per cent of authorised life insurance companies currently have an Internet 'homepage', while a further 23 per cent have indicated that an Internet homepage is planned within the next 12 months. Such homepages are used primarily as a billboard for advertising and marketing.

As with life insurance companies, it is understood that the Internet is extensively used by general insurers for advertising and brandname marketing. In addition, commercial developments, such as individual consumer identification numbers, may mean that the Internet will be soon be secure enough to be conveniently used for commercial transactions such as the sale of insurance policies.

In relation to superannuation, as referred to above, the industry through ASFA and LISA is actively working on developing a system to allow contributions and transfers between funds to be made electronically. Some advantages of such a proposed system would include reduced costs for employers to comply with Superannuation Guarantee requirements, an integration of employer payroll systems which should lead to improved information quality, fewer duplicated accounts, and fewer lost members.

Other market developments in this area include the use of electronic prospectuses for sale of investment products. The first electronic prospectus for a managed fund was recently approved by the ASC.

Regulatory issues for the ISC

There are a number of regulatory issues raised by developments in electronic commerce. Such issues include:

- reliable and user friendly identification and verification procedures in electronic transactions for security purposes;

- the extent to which issuers can reduce the regulatory (paperwork) burden through the use of technology, including interactive software, to disseminate information and gain informed consent from customers;

- whether electronic transactions may make evidence gathering, both in relation to disputes between parties and breaches of prudential requirements, more difficult because there is less paperflow, or easier, because there is an automatic electronic ‘trail’; and

- the extent to which existing regulatory requirements are inhibiting market developments (provided these are not unfair or anti-competitive).

Clearly, one of the most significant issues for the ISC is the appropriate form and level of product disclosure in respect of electronic transactions. Current requirements under superannuation legislation and Life Insurance Circulars require the pre-sale disclosure of certain information in order to assist consumers to make informed choices. Central to this is the Key Features Statement which briefly outlines how the product works, how the costs are structured and what risks are involved. Current life insurance requirements also govern the conduct of advisers in the sales process to some extent. While direct selling in the past has generally involved simple or commoditised products distributed on an ‘execution only’ basis (ie. without personalised advice), the challenge for the ISC is to ensure that electronic transactions do not cause consumers using 'interactive' software for advice, to be at a comparative disadvantage to those receiving advice and buying financial products in a more traditional manner.

In relation to the last of the above dot points above, an example where the ISC and the Government have acted to ease regulatory requirements in the light of technological developments occurred recently in the superannuation industry. The superannuation industry developed and commenced using in 1995 a 'transfer protocol' to facilitate the electronic transfer of superannuation benefits between funds. The main purpose of the transfer protocol is to allow members to consolidate a multitude of (commonly small) accounts into their current fund. To assist the efficient working of the transfer protocol, the Government agreed to relax certain provisions which require member consent before the member's benefit can be transferred out of a fund.

Another issue is the possibility that enforcement of existing requirements may be made more problematic by technological developments. It has always been open to unauthorised overseas insurers to offer products locally, for example by way of advertisements in newspapers and magazines. However, the incidence of this has not been large, and it may not have been cost-effective. This could change with the Internet. As an example, in Canada recently, the Ontario Insurance Commissioner's attention was drawn to the offer of a general insurance policy on the Internet. Investigations revealed that sales were being attempted by an unauthorised insurer based in the West Indies.

In Australia, it is not illegal for a consumer to purchase a life or general insurance product directly from an unauthorised overseas insurer. However, under the *Life Insurance Act*, local intermediaries are prevented from arranging life policies with unauthorised overseas insurers. Under the *Insurance Act*, certain intermediaries can supply general insurance policies underwritten by unauthorised overseas insurers, provided certain requirements are met, including an acknowledgment from the insured that the insurer is not authorised to conduct insurance business in Australia.

This situation has the potential to be a significant regulatory issue for the ISC. Obviously if a substantial percentage of the Australian insuring public were insured with unauthorised overseas insurers, this would be a matter of concern not only for the industry, but also for the ISC from the point of view of effective consumer protection. While the Internet per se does not create this circumstance, it makes it much easier for unauthorised companies to sell policies in Australia, and therefore makes it far more likely that it will happen. Regulatory responses to such circumstances will depend on the size and nature of such market penetration (data on this is not currently available), while effective regulation will no doubt rely on co-operation between countries, perhaps through the development of standards by bodies such as the International Association of Insurance Supervisors (described in Chapter Three).

Conclusion

The above points are only a sample of the many issues that are thrown up by technological and market developments. Such issues are not yet resolved, but as indicated above, the ISC is active in pursuing with the industries it supervises, reasonable outcomes in relation to fine-tuning the regulatory framework to take account of developments in electronic commerce.

Crystal ball gazing is a hazardous activity, and the ISC has reservations about adjusting the regulatory framework in anticipation of market developments which may or may not eventuate, or which may occur later rather than sooner.

The ISC believes that the challenge for the Government, the ISC and other regulators is not to forecast or pre-empt the take-up of technological change, but to ensure that the regulatory framework does not unduly inhibit reasonable market developments, and that regulatory responses do not occur in a 'knee jerk' manner which would weaken important prudential or consumer protections already in place.