Chapter 4

CURRENT ENVIRONMENT AND TRENDS

4.1 Introduction

Over the past decade or so the financial services industry has seen significant change, however, the pace of change is bound to accelerate in the next decade. A range of demographic, technological and globalisation forces are at work that do and will continue to influence the structure and characteristics of the financial services market and the way products and services are delivered. In turn, such changes will affect the way financial services participants operate and compete. It is against this background that regulation needs to be framed.

4.2 The Forces Driving Change

4.2.1 Demographics

A recent report by the Economist Intelligence Unit[1] highlighted demographic and related trends which will affect customers' needs internationally over the next decade. These include:

- An ageing population;
- More single parents and dual income families, reflecting the tendency for a higher proportion of women to work;
- The diminishing availability of a pension "safety net";
- Greater labour market flexibility, including career changes, job sharing, part time employment;
- Greater customer acceptance of new technology;
- Better educated consumers;
- More wealthy consumers, but a more uneven distribution of wealth; and
- An increasingly active small business sector due to increasing reliance on outsourcing and franchising.

These demographic trends will be as relevant to Australia as to the OECD more generally:

- By the year 2005, 30% of the Australian population will be over the age of 50 versus 26% in 1995;
- Today 53% of Australian women are working versus 46% ten years ago;
- The introduction of compulsory superannuation in 1992 reflects the government's desire to reduce the dependence of the over sixties on the age pension;
- Today 14% of school leavers go on to higher education versus 7% 10 years ago; and
- Today small business accounts for 51% of all private sector employment, up from 48% 10 years ago.

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[1] *Building Tomorrow's Leading Retail Bank,* The Economist Intelligence Unit and Coopers & Lybrand, 1996, pages 2-7.

As a consequence of these trends, customers' needs will become increasingly varied and more complex. In particular, these demographic trends are driving consumers to demand greater value, convenience and diversity of choice in the provision of financial services as will be discussed in section 4.3.7. The trends are also associated with the development of a more sophisticated market for financial products and services.

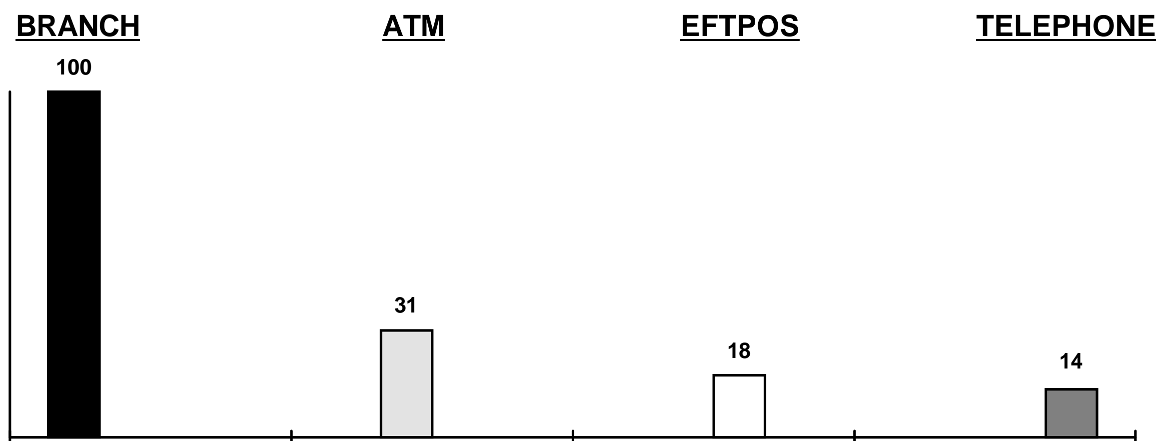
4.2.2 Technological developments

Significant advances are taking place in technology, information processing and telecommunications allowing financial service providers to dramatically improve service levels. At the core of these developments are the massive reductions which have been achieved in the costs associated with processing, storing and transmitting data. It has been estimated that "Between 1987 and 1993 the real cost of processing in a PC dropped by no less than a factor of 100. The cost of storing data in the same time interval dropped approximately 20 fold. Finally, the cost of moving data has again in the same time period dropped in real terms by a factor of 100."[2]

Technology is reducing the cost of doing banking business and moving transactions out of branches

Since the early 1980s, financial institutions have increasingly turned to technology to enhance service delivery. The main driver has been cost reduction, and particularly the desire to reduce the cost of transactions through reduced human intervention. Technology, in association with its ability to facilitate the construction and integration of powerful data bases, will also become increasingly important for bringing down the cost and increasing the effectiveness of sales. The economics of the new delivery channels compared with the use of branches can be seen in Figure 4.1.

Figure 4.1
RELATIVE DELIVERY COSTS
(Index: Branch = 100)



Note: Data is based on a cash withdrawal at a branch, Westpac ATM, EFTPOS machine, and a self service balance enquiry by telephone.

Source: Westpac

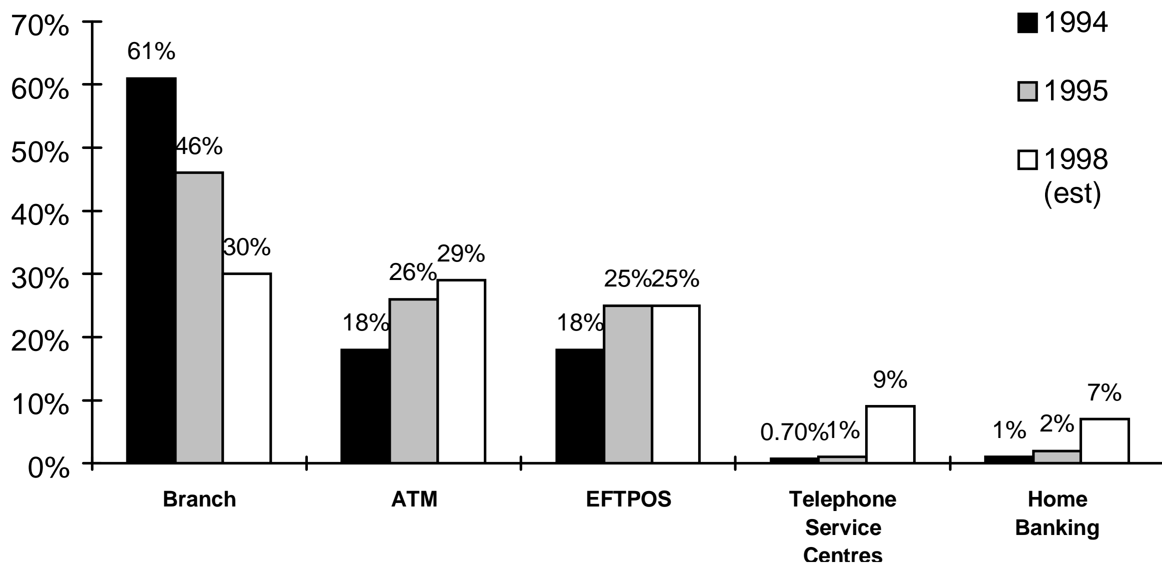
[2] *The Future of Retail Banking, A Global Perspective*, Deloitte Touche Tohmatsu International, 1995, page 13.

Initially, transaction cost reduction via the use of new technology was achieved through the promotion of ATMs and, more recently, EFTPOS in the place of over the counter transactions. Direct crediting of salaries and social security payments and, to a lesser extent, the direct debiting of accounts have also reduced human involvement in transactions and reduced costs.

More recently, with the declining cost of information technology and communications, banks and other financial institutions globally are turning to increasingly multi-functional ATMs[3] and to telephone banking, including the use of interactive voice response systems, as an even more cost-effective way of handling transactions. Currently Westpac's telephone banking service receives 1.8 million calls a month. Telephone banking services will evolve further with the introduction of additional value added services and with investments in sophisticated computer integrated telephony.

Customer usage of non-bank delivery channels has been such that in 1994 almost 40% of bank transactions in Australia were carried out other than in the branch[4]. The continued relatively large decline in the use of branches for banking services is encapsulated in Ernst & Young's [5] predictions for the usage of the various transaction delivery channels. Figure 4.2 shows that non-branch transactions are likely to account for 70% of total transactions by 1998.

Figure 4.2
TRANSACTIONS BY DISTRIBUTION CHANNEL



Source: *Fifth Annual International 1996 Technology in Banking,* Ernst & Young.

[3] For example, Westpac kiosk banking centres permit customers to open accounts, pay bills, order cheque books, find out account balances, withdraw cash, apply for credit card or home loan and receive investment and insurance advice. Multifunctional ATM's, for example, permit the issue on the spot bank cheques.

[4] *Fifth Annual International 1996 Technology in Banking,* Ernst & Young, Australian Edition

[5] *Fifth Annual International 1996 Technology in Banking,* Ernst & Young, Australian Edition

It is important to note that, while the new technologies for delivering financial services are dramatically decreasing the per transaction cost of each service, the ease of using the new delivery channels has meant that there has been a dramatic increase in the number of transactions undertaken by consumers. In particular, the convenience of using ATMs and EFTPOS has meant that customers make many more small withdrawals, while ATMs and telephone banking have encouraged a proliferation of account balance enquires. This increased transaction incidence, has retarded the degree to which banks have been able to reduce costs.

The next wave of technological innovation, whose main impact may not be felt in the consumer market before 2000, will take the form of transactions via stored value cards and home banking, involving PCs and interactive TV, using both proprietary networks and the Internet. Screen phones and the ability to transfer funds from home using reloadable stored value cards and electronic purses in connection with a modem will further reduce the use made by customers of branches for transactions. This is discussed further below.

Technology is also freeing managers from their branches. Mobile sales forces with sophisticated PC-based sales support tools can now use wireless technology, such as lap top PCs which can send and receive faxes, to produce documentation at remote sites. Westpac has 52 home finance/personal banking mobile managers and 466 business banking managers on the road.

Technology is expanding access to the information necessary to provide financial services

Financial institutions are essentially in the information business. For example, in acting as intermediaries between those who want to borrow and those who want to lend, banks take on risks associated with lending and use their control over information to manage these risks. Information is central to the development of new financial instruments and to the participation in financial markets. Banks transfer information, in the form of payments instructions, among households, businesses, governments and the like. In short, information is central to the role of financial institutions in the economy.

Computerisation enabled the development of powerful information-based tools for use in financial services and as a result institutions are using information to more effectively manage their business. Examples include sophisticated risk management systems, business process automation (involving work-flow management and document imaging), the use of management information systems to measure and monitor product and customer profitability and the use of technology to deliver products in remote locations. The use of technology to manipulate data in more meaningful ways is enabling those institutions with large customer bases to unlock the value of this asset through database marketing.

Computerisation has also resulted in greater access to information, fostering greater competition in the process:

- The development of sophisticated computer-based credit assessment programs has meant that institutions such as mortgage originators do not need to accumulate information on borrowers to engage in housing lending - they can access software programs based on the historical experience of traditional housing lenders.

- Specialist bodies, such as rating agencies and credit bureaux, are sources of information which other lenders (not necessarily banks) can use as a basis for their decisions about risk-taking.

- By disclosing information, companies enhance their ability to access capital markets directly for funds. As more companies do this, capital markets become increasingly efficient and represent a viable alternative to bank finance for a larger range of companies.

- Households can acquire the information necessary to make comparisons of products offered by competitors, using agencies such as Cannex and Moneylink. The electronic version of this will be intelligent program navigators on proprietary networks or the Internet.

Technology is driving the convergence of different industries

"Convergence is the transformation and integration of communications, entertainment, information and computing. ... The convergence phenomenon is not one change but a set of related changes that are occurring today. The complexity of these simultaneous changes makes them difficult to understand and even more difficult to generalise." [6] Its relevance to the provision of financial services lies in the fact that information can now be transformed through the process of digitisation. With advances in computing (such as microprocessors) and communications (such as fibre optics), once information is digitised, it can be instantly manipulated, stored and transmitted at very low cost.

Due to the broad range of parties actively working on and looking to exploit the convergence phenomenon (computer software and hardware developers and telecommunication companies, in particular), it is not something that can be controlled in terms of roll-out timetables. Further, while financial institutions and their service and product delivery will be affected by technological developments, the institutions themselves will not necessarily be able to control the rate at which the developments affect the delivery channels. This is contrary to past experience when product delivery channel development was very much under the control of the financial institutions.

While currently having only a marginal impact on financial institutions, the convergence of computer technology, communications and information is likely to have a significant direct impact in the future through the provision of on-line financial services.

<u>On-line financial services</u>[7]

These services are provided on wide area networks, which take three generic forms:

- the Internet - a public network, which is accessible through service providers;

- commercial on-line networks, which are accessible by the public through subscription services and generally link in to the Internet; and

[6] *The Information Superhighway and Retail Banking* Bank Administration Institute, Vol.1 page 9

[7] This section draws extensively on *The Information Superhighway and Retail Banking*, a Report by the Bank Administration Institute, 1996.

- proprietary on-line networks, such as those provided by some banks for use by their own customers. For example, Westpac offers the Desk Bank suite of products to over 5,000 sites. Unlike the other two forms of on-line services, with a proprietary network the customer dials in (via modem) directly to the bank rather than accessing the bank's services via the Internet.

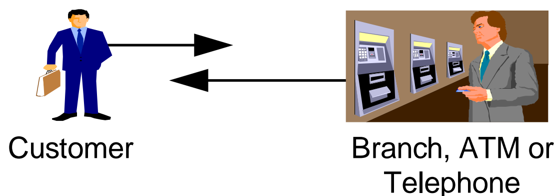
It is unclear how strong the demand for financial services on the Internet will be in Australia as reliable statistics are difficult to come by. However, the clear signs are that it will become an important new delivery channel.

Trends in computer, modem and Internet usage suggest that there is considerable potential for growth in on-line banking services in Australia. How fast this occurs will depend on such developments as the resolution of security problems to the satisfaction of financial service providers and customers, the development of faster modems, more user-friendly systems and better voice/data transmission on broadband networks.

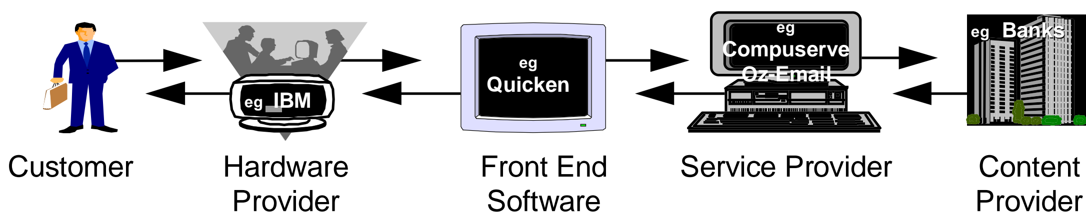
On-line financial services are likely to take the form of the electronic delivery of financial products[8], services and information as well as the provision of secure on-line payments systems. In the case of non-proprietary on-line services the issue for financial institutions, particularly banks, is about access to, and influence over, the customer's purchases of financial services. Whereas with traditional delivery channels, banks "own" their customer relationships, with non-proprietary on-line services a number of different institutions potentially come between banks and their customers, including telecommunication companies, software companies and third party processors. This is illustrated in Figure 4.3.

Figure 4.3
TRADITIONAL VERSUS ON-LINE DELIVERY SYSTEMS

Traditional Bank Delivery Channel



On-line Delivery Channel



Source: Based on McKinsey presentation to Virtual Banking Conference, September 1995.

[8] In line with developments in the US and Canada, the Australian Securities Commission has recently given regulatory approval to Advance Funds Management and Norwich Insurance to put managed fund prospectuses on the Internet. The growth of Internet prospectus distribution could potentially result in very large printing and distribution cost savings to the funds management industry.

Each participant in the delivery chain will seek to extract some form of value for their contribution to the overall service. This may be in the form of payment for service or use of software, or in the less direct form of seeking to use the identified financial service customer base for other marketing purposes.

Potential new financial service providers include network providers (such as Telstra), access providers to the on-line services (such as Microsoft), third party processors (such as Digicash) and non-financial institutions (such as Australia Post).

Global payments on the Internet and on commercial networks most likely will be made using credit cards and digital cash systems. The latter may take two forms:

- Stored value cards (see below for more detailed discussion) such as Mondex, which permit the transfer of funds from card to card in multiple currencies. The institution which issues such cards may manage the float, but will have no on-going role in payment transfers where the transfer is between two stored value cards.

- Electronic cash issued in exchange for currency or debits against a credit card, and "stored" by a specialist non financial organisation, which transfers funds between buyers and sellers on receipt of coded instructions. The issuers of electronic cash may not necessarily have any formal links with regulated financial institutions.

There is still great uncertainty about how the on-line services environment will unfold, but it is expected the new technology will offer better customer service and lower transaction costs. Financial institutions, and banks in particular, are closely monitoring developments and looking at forming alliances with non-financial service providers. They are also making selective investments in the application of developing technologies for alternate service delivery in order to try to ensure that when a clearer picture unfolds they will be well-positioned to take advantage of the new technology.

Stored value cards

Another example of the application of the convergence phenomenon is stored value cards. These have an embedded microprocessor capable of storing monetary value. Cardholders can use the value in the cards to buy goods and services simply by inserting the card into an electronic reader that records the transaction taking place and deducts funds from the card. Mastercard and VISA are both trialing these cards now in Australia as well as in other parts of the world. Loss of the card means loss of the embedded value, in the same way as if cash is lost.

A particular version of the stored value card, the Mondex smart card, developed by BT (formally called British Telecom) and National Westminster Bank, has extra features. The Mondex card can store value in five different currencies simultaneously and allows holders of the cards to transfer value between themselves via the use of the electronic wallets into which two cards can be inserted simultaneously. Value can be added to these cards via ATMs and specially modified public phones. The cards will eventually be able to expedite telephone transactions such as ticket purchases and bill payments simply by the owner inserting the card into a smart card reader in their home phone and switching the phone from voice to data mode. The Mondex system will also facilitate electronic cash transactions over the Internet. The card is being trialed in the UK. Local Australian banks have recently jointly purchased Australian and New Zealand rights to its use.

Technology is driving changes in corporate and wholesale financial markets

The same technological developments that are impacting the consumer market for financial services have also affected the corporate and wholesale markets. In particular, corporates increasingly have communication linkages with their banks to conduct their cash management and transaction business on-line. Further, financial innovation in this sector of the market has been enhanced through the use of computerised information, including screen-based trading systems, securitisation to convert cash flows from specific assets into marketable securities and the proliferation of derivative products for risk management purposes.

In summary ...Technology is opening up the financial services market to many new participants

A diverse range of technological developments and the phenomenon of convergence are having an affect on the way services are provided, on who provides them and on customer expectations of what constitutes efficient and convenient financial services. The way such forces are playing themselves out will be discussed in Section 4.3. Suffice it to say that "new technologies" permit much lower cost delivery of financial services and also allow new niche competitors to participate in the market.

Without having to bear the cost burdens of the "old" delivery technologies (branches), new competitors using new technology have greater capacity to price products competitively and "cherry pick" the market. Niche competitors also are unlikely to provide widely available transactions services and the reliable exchange of value via the payments system. Existing financial services providers will need to find ways to balance the ongoing equitable and reliable supply of services necessary for a healthy economy against the pressure to reduce the costs of their infrastructure so they can compete head on with niche players.

4.2.3 Globalisation of financial markets

International capital markets have become substantially more integrated over the past 15 years or so. The impact of the application of new technology on screen-based trading systems and the rapid decline in communication costs have been mentioned above. In addition, a number of other forces have been at work, including the abolition of exchange controls, the development of new derivative and other marketable securities, the increased availability of information about foreign securities, and a greater focus by institutional investors on portfolio diversification.

Cross border funds flows

It has been estimated that, at the end of 1994, the stock of cross-border assets was more than 4 1/2 times its level of 15 years earlier, having risen from 20% of the combined GDP of OECD countries in 1980 to around 35%.[9]

The significance of these trends is that globalisation may increasingly provide borrowers with greater access to overseas institutional investors. Market boundaries are changing. To date, the tendency for the domestic corporate sector to access international markets has not been great, with borrowings by Australian companies from overseas as a proportion of their total borrowings remaining static at 24% throughout the 1990s[10].

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[9] *Regulating the new financial markets,* R. Dale 1996, page 8
[10] *Recent trends in the structure of the financial system*; L. Austin, RBA Bulletin, April 1996

However, as rating agencies and other information sources enhance the ability of a wider range of companies to access international capital markets, it is likely that more companies will finance themselves in these markets. Banks will earn fees from arranging and underwriting corporate debt and facilitating its placement rather than from funding it on balance sheet. The likelihood of such a trend eventuating has been increased with the recent decision by the RBA to allow Australian banks to hold certain high grade corporate securities on their balance sheets at risk weightings less than those which would apply if the same corporate loans were held directly on balance sheets.

Apart from creating underwriting opportunities, globalisation of markets has meant that Australian banks are now major borrowers in their own right on international capital markets. As at June 1995, 11% of their private sector borrowing was from overseas, compared with only 1% a decade earlier. Non-bank financial intermediaries lifted their share from 8% to 30% over the same period.[11]

At the same time, offshore financial institutions are accessing the Australian capital market and have recently started to launch bond issues here. Although the issues to date have been small, they are again indicative of the globalisation of the markets.

A final dimension of the trend towards greater globalisation is the development of improved cross-border payments systems, which parallel the globalisation of capital markets.[12]

Cross border administration and processing

There has been a shift towards a more international approach to financial services processing. Financial and non-financial organisations are increasingly taking advantage of the convergence of information, technology and communications to transfer important areas of their processing activities to areas where they are more cost-effective. Some recent examples of relevance to Australia include:

- Westpac is centralising the processing of all its offshore branch financial markets transactions in Australia.
- American Express has established a Regional Servicing Centre in Sydney to service card member complaints, collections activity, merchant servicing and fraud for all card member accounts throughout Asia.
- Bank of Scotland has established in Australia a regional headquarters of its subsidiary, Capital Finance Australia Limited, to provide marketing, finance, accounting, information processing and support for its regional operations.
- Bankers Trust Co. has established in Sydney a regional headquarters for its global custody and regional processing operations. Even more significantly, the Australian funds management arm of Bankers Trust last year took over responsibility for all Bankers Trust international funds management activities, including those run out of New York.

There are opportunities for Australian banks and other financial institutions to take advantage of the diminishing cost of communications and processing to support and facilitate moves, particularly by non-financial companies, to establish regional treasury and processing operations in Australia (see chapter 13).

[11] *Recent trends in the structure of the financial system*, L. Austin 1996, RBA Bulletin, April 1996.
[12] Indicative of cross-border payments system fund flows is the growth in foreign currency liabilities from $9.5 billion in 1986 to $47.1 billion in 1995.

Globalisation of ideas

The final dimension of the trend towards globalisation is the globalisation of ideas. The convergence of technology, information and communications is changing the speed at which new ideas and practices are taken up internationally. Whether or not a bank operates in the international arena or only in a domestic market, international ideas, standards and practices will increasingly have a major bearing on their efficiency and thus their competitive success.

The free flow of ideas and "financial technologies" in the international financial services arena will continue to impact on the Australian market. Two, very visible, recent examples are mortgage originator home loans and co-branded credit cards. The successful development of the mortgage originator home loan market is dependent on the financial engineering tools of securitisation and derivatives, the combined use of which was well-developed internationally prior to importation of the home loan securitisation idea into the Australian market. Similarly, the co-branded credit card idea[13] was in prolific use in the US many years before its importation to Australia. The adoption of such international financial innovations will continue and technology will ensure that the speed of adoption will increase.

As long ago as 1962, Marshall McLuhan expressed the view that "The new electronic interdependence recreates the world in the image of a global village". More than ever this is now becoming true. Market boundaries already under threat will continue to diminish in importance in the years to come. Financial service providers and their regulators which ignore this trend will put their ultimate viability at risk.

4.3 The Impact of the Forces on the Structure and Characteristics of Financial Services Markets

The demographic, technological, and global forces that are at work are having a significant influence on the structure of the financial services market and will have an even greater impact in future years. Distinct trends are already emerging in the savings and credit markets, both as a result of demographic and technology changes.

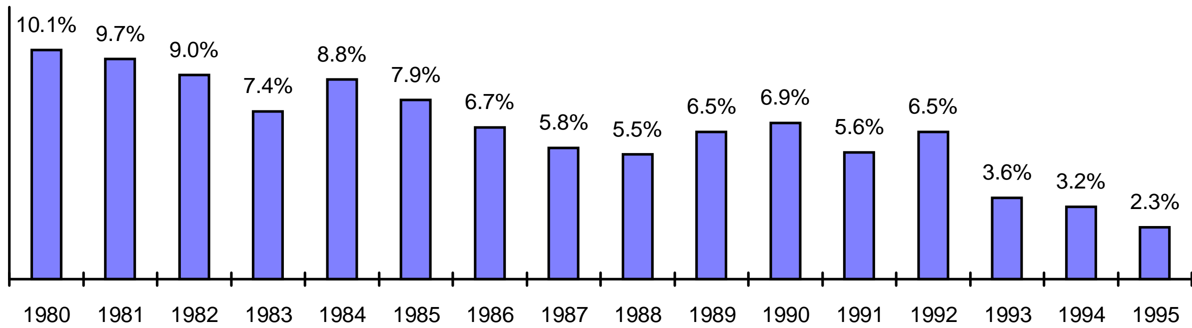
4.3.1 Trends in savings

The need to increase Australia's domestic savings rate has long been recognised in public policy. It is driven currently by our unsustainable high current account deficit and prospectively by the ageing of the population, and the need to reduce the dependence by the elderly on the government financed aged pensions.

Australia's domestic savings record is not good. The ratio of saving to household disposable income has declined from its peak of 15% in the mid-1970s to a 1995 level of 2.3% (see Figure 4.4). This level does not compare at all favourably with Australia's OECD counterparts. Household savings as a percent of disposable income are currently 13.4% in Japan, 11.6% in Germany, 10.2% in the UK, 8.2% in Sweden, 7.4% in Canada and 4.7% in the USA.

[13] Such as the Westpac/General Motors Mastercard, the NAB/Coles Myer card and the ANZ/Telstra Visa card.

Figure 4.4
HOUSEHOLD SAVINGS RATIO

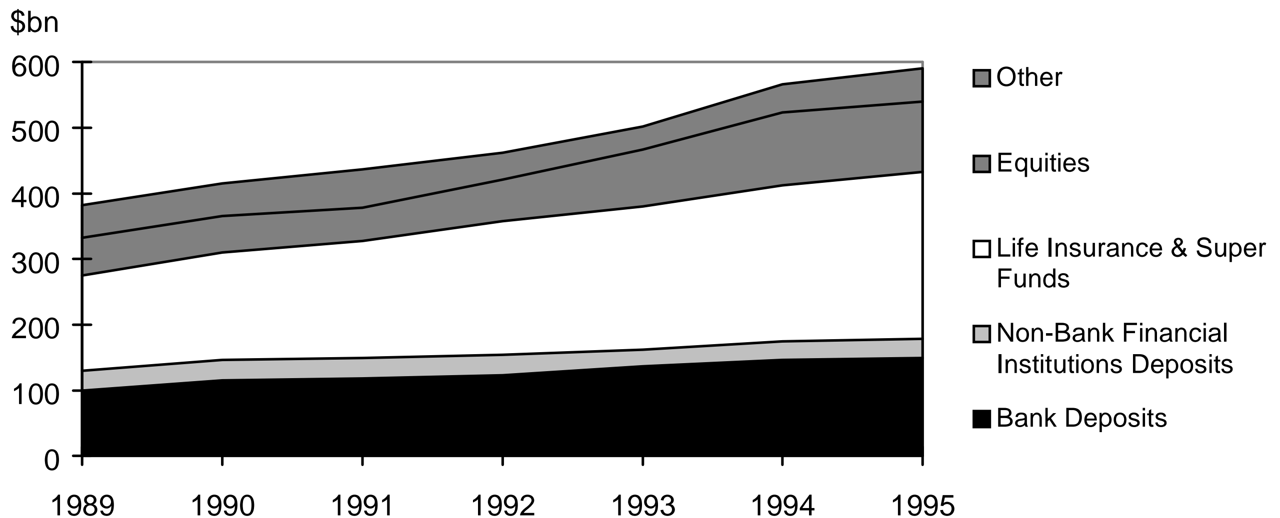


Note: Household savings rates is defined as the ratio of savings to current receipts.

Source: RBA Occasional Paper No.8 and Budget Statement No.2 August 1996.

There has also been a significant change in the mix of private, or more particularly, household savings. An increasing proportion of new household savings has been channelled into superannuation, non-superannuation managed funds (collectively referred to hereafter as managed funds) and, more recently, into direct equity investments. Figure 4.5 graphs the total assets in each category of savings over the last 7 years.

Figure 4.5
TOTAL FINANCIAL ASSETS - HOUSEHOLDS



Note: Other includes notes and coins, Commonwealth Government Securities and all other financial assets.

Source: RBA Occasional Paper No.8.

Deposits

While the overall share of funds that are going into bank and other deposits as a proportion of total funds has diminished, the importance of deposits as a minimal risk savings alternative is still great. Household deposits with banks, building societies and credit unions are primarily related to short term savings and transaction needs and have risen as a percentage of GDP from 34% in 1980 to 39% in 1995. Approximately 85% of these household funds, $150 billion, are in bank deposits.

Consumers clearly differentiate between deposits and other categories of savings, choosing to hold a relatively stable proportion of their funds in more liquid, capital guaranteed assets. It seems unlikely that this trend will change in the future. Deposits will continue to form the bedrock of consumer savings.

As was discussed in 3.1.2, there has been a significant change in the mix of deposits, with a growing proportion of customer funds placed in higher interest current and term deposits. This is consistent with the increased sophistication amongst users of financial services and this trend will not be reversed.

Managed Funds

Superannuation funds' assets have grown strongly over the past few years to $228 billion in December 1995, as can be seen in Figure 4.5.

Managed funds, in total, now represent around 30% of total financial system assets, compared with around 20% in 1980.[14] This growth reflects such factors as the Government's retirement income initiatives, taxation concessions, the trend for investors to look for higher returns when interest rates declined in the early 1990s, rising asset prices and the compounding of fund earnings.

Research by the Reserve Bank, however, suggests that "almost all of the variation in the growth of superannuation funds' assets in recent decades is attributable to changes in the funds' earning rates, combined with the fact that the long term nature of superannuation accounts tends to mean that earnings are locked in and automatically reinvested".[15]

Nevertheless, there can be little doubt that the Government's policies designed to promote superannuation will divert a significant proportion of household savings away from more traditional forms of saving, including deposits. Indeed, the Government's 1995 Budget Paper on "Saving for Our Future" assumed that 30% of the projected increase in compulsory superannuation contributions will be offset by reductions in other forms of saving.[16]

While not matching the massive growth seen in the last decades in the US, Australia has also seen significant growth in the assets of non-superannuation and non-life company managed funds from $47.5 billion to $62.8 billion between June 1990 and December 1995.

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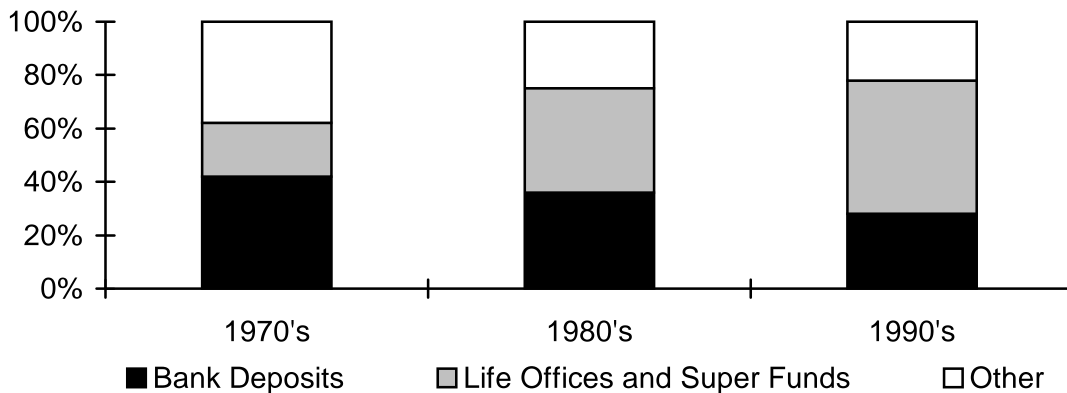
[14] Council of Financial Supervisors 1995, Annual Report, page 13

[15] The Evolving Structure of the Australian Financial System, M. Edey and B.Gray, 1996, forthcoming page 29

[16] Saving for our Future, statement by the Treasurer, May 1995, page 7

Around half of households' net new investments in financial assets now flow to life offices and superannuation funds, including those managed by banks[17], compared with 20% in the 1970s.[18] This can be seen in Figure 4.6.

Figure 4.6
NET ACQUISITION OF FINANCIAL ASSETS



Source: *Recent Trends in the Structure of the Financial System,* Les Austin, RBA Bulletin, April 1996.

There can be little doubt that the funds management industry will grow rapidly over the next few years. Socio-demographic factors, particularly the movement of the post-war 'baby boomers' into their peak saving period, and a massive increase in superannuation will underpin this growth. The previous Government estimated that the pool of superannuation savings will increase 10 fold by 2020.[19]

Other Savings

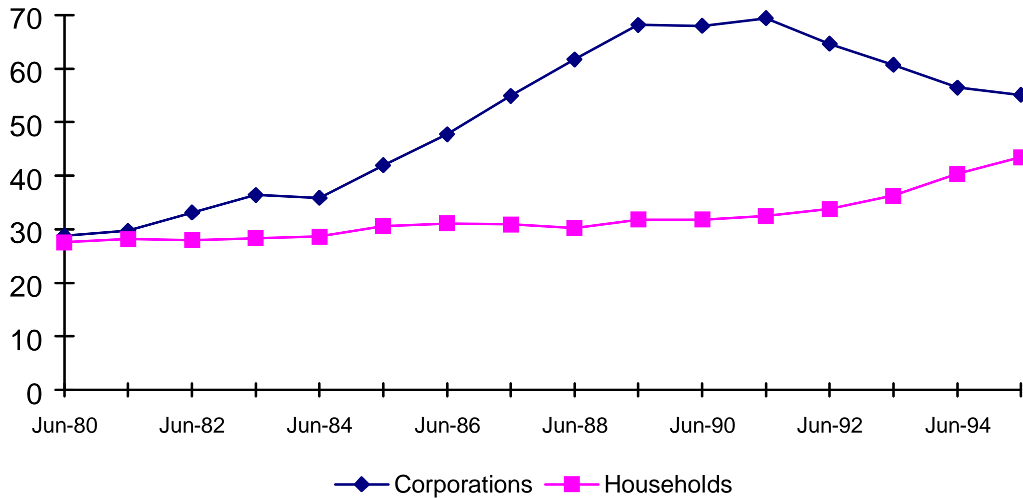
The float of a number of major companies and government enterprises has stimulated greater direct household investment in shares. In the period from 1991 to 1994, the number of Australians with shares increased by 50% to 2.5 million, or 21% of all adults. Households acquired a net $3 billion in equities in 1994-95. Both trends for direct and indirect investment in equities and unit trusts point to Australians increasingly becoming more adventurous, engaging in investment portfolio diversification and being prepared to take on greater risk in search of higher returns.

4.3.2 Trends in Indebtedness and Credit Provision

For a variety of economic and demographic reasons, there has been a significant increase in the ratio of household debt to GDP and a decline in corporate debt levels in recent years. This can be seen in Figure 4.7

[17] See Figure 2.4 re trends in the structure of funds management industry.
[18] *Recent trends in the structure of the financial system,* address by L. Austin, RBA, 1996, page 2
[19] *Saving for our Future,* statement by the Treasurer, May 1995, pages 2 and 6

Figure 4.7
DEBT AS A % OF GDP



Source: RBA Annual report 1995.

Household debt

After a gradual increase from 25% to 32% between 1977 and 1990, the ratio of household debt to GDP increased sharply to 44% in the next five years. This primarily reflected higher levels of housing purchases due to lower interest rates, higher levels of consumer spending and modest growth in incomes.

Supply side factors have also been important, with vigorous competition for housing loans among banks (and other institutions) due to their profitable nature. Institutions other than banks and building societies (i.e. mortgage managers, insurance companies and credit unions) have steadily increased their level of housing lending over the past few years, despite the downturn in the housing finance market. In the past five years, non-bank and non-building society mortgage providers have made rapid inroads into the mortgage market with their combined market share of new commitments[20] having risen to current levels of 9%.

Demographic trends and low inflation suggest that a return to the rapid increases in housing prices during the late 1980s is unlikely over the next few years. Thus, despite the Reserve Bank observing that "Australian households remain less highly geared than households in a number of comparable industrial countries"[21], the rate of growth in household debt, as a percent of GDP, is likely to slow. This, in association with the almost daily emergence of new competitors in the provision of household credit, should ensure a highly competitive household debt market into the future.

[20] New commitments reflect the flow of funds from the various housing lenders rather than the stock of housing assets of which 86% are still on bank balance sheets. In the last 6 months other lenders share of the flow of mortgages has been 11%.

[21] *Reserve Bank 1995 Annual Report*, page 34

Corporate debt

Corporate debt has declined from a peak of around 70% of GDP in the early 1990s to 55%, a level which is still well above the 25-30% of the early 1980s. The current level of indebtedness reflects greater dependence on financing investment from retained earnings, with only a modest growth in borrowing.

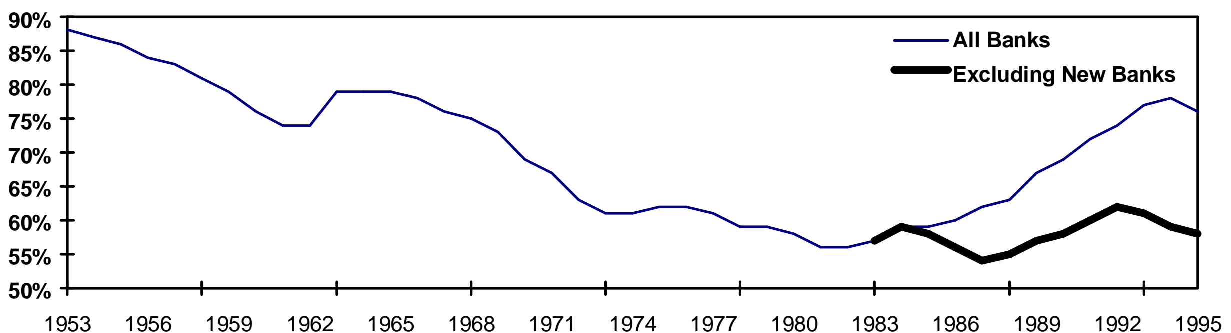
As has been pointed out, an important characteristic of the debt component of Australian corporate financing is the limited use that has been made to date of direct borrowing through the issue of corporate securities. Currently only about 13% of aggregate corporate balance sheets is financed by debt securities.

Given the trend internationally for corporates to borrow from securities markets, this figure will grow. Part and parcel of the globalisation trend is the phenomenon of financial markets taking over the credit provision role from institutions. It is more efficient and less costly for large corporates to borrow from capital markets, largely due to the fact that banks have to hold capital against corporate loans. In the corporate debt market, information asymmetry is shrinking, and technological and globalisation forces are driving large borrowers to make direct market placements.

Banks' share of intermediaries' assets

As Figure 4.8 below illustrates, there have been massive shifts in banks' share of financial intermediaries assets over the last 40 years, with a large decline between the 1950s and early 1980s, followed by a resurgence in share over the last decade. As Edey and Gray [22] observe, the pattern of decline and recovery has been exaggerated by the growth and subsequent reabsorption by banks of their finance company subsidiaries, and by the conversion of building societies to banks in the late 80s and early 90s. "When new and pre-existing banks are shown separately, it is apparent that banks already existing in the mid 80s largely did not recover the market share lost in earlier decades. This may be one indicator of the increasingly competitive environment faced by banks."

Figure 4.8
BANKS' SHARE INTERMEDIARIES' ASSETS



Source: *The Evolving Structure of the Australian Financial System,* M. Edey and B. Gray, 1996, forthcoming.

[22] *The Evolving Structure of the Australian Financial System*, M. Edey and B. Gray, 1996, forthcoming

While demographic and technological developments have impacted on the household debt market in particular, their greatest impact (and that of the globalisation of the financial services markets) has been on the core structure of the financial services market. This market is undergoing a process of disaggregation which, in turn, is resulting in a blurring in the distinctions between the various category participants and in new participants entering the market. The market will also be characterised by an increasingly sophisticated customer base, one which demands ever greater convenience in its use of products and services.

4.3.3 Disaggregation

Traditionally, financial institutions have engaged in all aspects of what they broadly defined as their core businesses. For example, banks originated mortgages, arranged the funding necessary to support the loans on balance sheet and serviced the loans on an on-going basis. Insurance companies developed insurance and investment products, distributed them, managed the risk and the funds received and undertook the servicing of policy holders or investors.

However, a number of forces have been at play causing the disaggregation of what historically may have been considered inseparable core functions:

- The rapidly declining technology costs and increased functionality of non-branch distribution channels allowed the entry of non-bank product suppliers into the mortgage markets in particular.
- The improved availability of information and greatly enhanced technological capacity to store and manipulate information for management, risk management, or marketing purposes.
- The increased financial sophistication of both personal and business customers resulting in the demand for and development of greater product diversity, this demand being met by both traditional market participants and new entrants.
- The growth in funds flow into superannuation and other managed funds (both domestically and internationally) with the resulting increased market appetite for highly-rated debt securities.

These developments are providing the impetus for existing players to assess where their real competitive strengths lie, and to change the focus of their activities, as well as for new players to become highly effective niche competitors.

As a result, banks and other financial service players are increasingly viewing their businesses according to their component functions: credit, savings, payments, and risk management, and in turn these functions are being further assessed on a disaggregated sub-business basis in order to identify where competitive advantages can be applied and where they cannot.

Credit

The credit business comprises origination, funding and servicing. Banks are examining their competitive advantages in each of these areas to determine what role they should play.

- *Originating loans* requires selling skills and cost-effective delivery channels, both of which banks have developed. Their large customer bases provide them with a distinct competitive advantage in terms of marketing. Origination also involves the use of

expert credit risk assessment skills, including a capacity to structure the credit (pricing, length of loan, variable/fixed rate) so as to ensure repayment. The experience which banks have in handling large volumes of credit business and the databases built to capture the statistical outcome of that experience means that banks are less likely to incur bad debts and can apply cost reducing technology to the credit assessment process. This is done via computerised credit scoring of standard credit applications such as for mortgages and credit cards.

- The *servicing* side of the credit business is also one where costs can be lowered through the effective use of expensive data processing systems to achieve economies of scale. Servicing credit involves monitoring and processing repayments and systematic debtor management. These are functions where technology provides the capacity to achieve processing efficiencies if large scale can be achieved. Processing functions need not be undertaken by the institutions which originate the mortgages, as they will not necessarily be able to achieve the processing volumes sufficient to justify the capital investment necessary to minimise costs.

  Given the trends in this area in the US[23], Australia is likely to witness a developing phenomenon whereby banks and non-bank processing specialists provide processing services on behalf of others. Westpac's new mortgage loan processing centre in Adelaide has the capacity to undertake processing for other lending institutions. Australia Post engages in agency and processing activities for a variety of financial institutions.

- In the current taxation and regulatory environment banks are, however, less well-suited to *funding* all credit business. The most efficient sources of funds are institutions which pay little or no tax on their earnings and/or which do not have to put up their own capital when providing funds for credit. Unlike superannuation funds, banks have to set aside capital for any loans they keep on their balance sheet and then have to pay a higher level of tax on interest earned. With the new found capacity of banks and others to securitise mortgages and other standardised forms of consumer and commercial credit with predictable repayment schedules, the basis has been established for banks and non-bank originators to look to others to provide the ultimate funding of loans.

Similarly, many large corporates with good credit ratings have been reducing the cost of their standard borrowings by directly accessing securities markets without resorting to banks for intermediary services, other than as arrangers.

However, despite the reduction in banks' on-balance sheet funding of some forms of credit, borrowers with unique, non-standard credit needs will continue to rely on and finance companies for their funding requirements. Rural enterprises, the self-employed, and small and medium sized businesses which do not have access to the securities markets and whose credit requirements are not easy to standardise for securitisation, will all continue to look to such institutions for credit[24]. These loans will be financed in the same way as they are now: on intermediaries' balance sheets, not by the securities markets. Similarly, even large corporates will still need to deal with banks for some tailored, non-standardised credit such as a bridging loan, or even short term working capital.

[23] MCI Telecommunications, the second largest telecommunications firm in the US, has recently entered the card processing business in that country. It has a transaction processing platform which handles credit card authorisations, debit card processing, claims processing and billing.

[24] See 2.2.1 for details.

Savings

Prior to deregulation, there was a close relationship between savings and credit. Households saved with banks[25] not only for transactions purposes and to meet short term savings needs, but because a lengthy and substantial savings record was often required as a pre-condition for a housing loan. Deregulation broke this link, ensuring that the two businesses would be managed separately.

Savers have become more sensitive to yield, a trend which has driven up bank deposit rates and increased the attraction of funds management. The savings market has, in turn, become more disaggregated, between products where the principal and interest are guaranteed and products where the underlying risk is borne by the investor.

Differences between the two types of savings businesses relate more to the dimensions underlying the savings process, and the differing regulatory and taxation treatment which apply, than to a disaggregation of the underlying processes. Historically, and within a framework of providing a guarantee to return both the principal and interest to depositors, either on demand or at maturity, banks have intermediated on three dimensions: size, credit risk and time:

- The savings of many small investors are pooled so that banks can lend larger volumes of funds to borrowers than those investors could provide in their own right.
- In the process of lending, they transform the maturity of these funds from short term deposits (whether at call or for fixed term) into longer term loans. The risk of managing this timing mismatch is borne by banks.
- When banks do offer a fixed rate for deposits, they - not investors - also bear the risk of interest rate variability.

Apart from the cost of managing the market risk, banks also bear regulatory compliance costs, such as the requirements to maintain 1% of Australian dollar liabilities (excluding capital) in NCDs at a penalty interest rate with the Reserve Bank, the 6% PAR liquidity requirement and the requirement to maintain a minimum 8% capital to risk asset ratio. This level of capital does not necessarily reflect the true underlying risks involved (see Section 7.7) and consequently can impair banks' ability to compete with other institutions which are not required to maintain capital.

Superannuation funds and other fund managers also pool the savings of small investors, thereby intermediating on size. They do not explicitly intermediate on time, but as savings in funds are generally longer term and the funds are largely invested in tradeable securities, the degree of any maturity mismatch is limited. (This risk is, however, greater to the extent that funds are invested directly in long term or illiquid investments such as property). As well, they generally do not guarantee either the principal sum or a return on those savings. i.e. they do not intermediate on credit risk.

As all risks relating to the underlying investments are ultimately borne by investors, funds managers do not have to carry the significant prudential regulatory costs borne by banks. (Life insurance companies are required to meet various prudential requirements, but these relate more to the guarantee they provide to policy-holders about payments on death and disability).

[25] This refers to banks, but applies equally to other licensed deposit taking intermediaries, namely building societies and credit unions.

In addition to being free of many regulatory imposts and their associated costs, fund managers also do not have to carry the overhead costs of the banks' branch networks. The costs of the branch networks have traditionally been absorbed by banks in their pricing of savings and credit products, but in today's competitive environment there is much less capacity to do so. Finally, superannuation funds receive preferential tax treatment compared with interest-bearing deposits.

Together, these regulatory and structural differences give rise to fund investments being associated with higher yield prospects, which are attractive to most consumers. However, the increased level of risk in non-bank savings products is not necessarily fully recognised or acknowledged by the customer.

So long as they continue to guarantee depositors their principal and interest, banks will continue to intermediate on all three risk dimensions in the savings business. Banks have a comparative advantage in developing deposit products and delivering them to their customers, as well as the skills necessary to manage the risks required to underpin the guarantee to repay deposits. Their main focus will be on redressing the balance of regulatory and taxation disadvantages, improving their overall cost-efficiency and ensuring that customers have a clear understanding of the relationship between risk and return. The regulatory policy issue is to ensure that non-bank savers have adequate disclosure about the credit risk and interest rate risk they are bearing.

Payments

The payments business is about individuals, companies and governments moving money and exchanging value. It is made up of two components: one element comprises the various means by which the many different forms of payments are physically transacted (cheques, credit cards, ATMs, electronic transfers, direct debits and credits, etc) and the other comprises the means by which all the transactions are cleared and settled.

Until the early 1980s, both parts of the payments business were effectively the sole province of banks. Banks had access to the centralised clearing system, allowing for the settlement of all payments, and they had an exclusive ability to be able to offer cheque accounts (which once were virtually the only means by which companies and individuals could participate in the payments system). Because the only participants in the payments system pre-deregulation were banks, and they were subject to interest rate and maturity restrictions, two things resulted: they could not pay interest on cheque accounts, and they maintained large branch networks to make it convenient for their customers to open cheque accounts.

A variety of developments have had an impact on this once simple, bank-run payments system. First, banks lost their exclusive franchise, in as much as other institutions such as building societies and credit unions were allowed to become participants in the transactions part of the payments business. Banks were no longer the only organisations to offer cheque accounts or credit cards. Next, the capacity of banks to subsidise their transactions business through deposit and loan pricing was greatly diminished when deregulation and increased competitive intensity brought about more market-oriented interest rates. The desirability of completely eliminating cross subsidies became even more important following the entrance of single product or single market suppliers, such as mortgage originators, who could deliver and price their products without having expensive branch networks.

Banks have sought to treat payments as a standalone business by unbundling transactions from deposits and loans and pricing each separately - a move which has attracted criticism. While the impact on the community is recognised, charging for transactions is an inevitable outcome of vigorous competition. Maintaining capital in branch networks while at the same time investing in new technology, and not being able to adequately charge for the use of either, has considerably restricted banks in their ability to price other financial products (such as mortgages) more competitively.

Banks are seeking to separately manage the business of payments from their other financial services businesses because it is a critical component and one in which they have a comparative advantage. Banks are good at facilitating value exchange via both the transactions and settlement portions of the payments system and have a record of innovation and unquestioned reliability in this area.

Risk management

As noted earlier, risk management is an area where banks also have a comparative advantage. Not only are they expert in credit risk management, but they have internal risk management policies and activities which are designed to ensure adequate liquidity, an appropriate balance in the maturity of their assets and liabilities and in the value of their loan portfolios, while preserving the integrity of deposits and payments flows and ensuring that their overall operations are run efficiently. As a result of their own capabilities, banks are well placed to offer their corporate customers risk management products and services. These include a wide range of treasury products that help customers manage their interest rate, foreign exchange and commodity price risks.

It is a natural development for banks to offer personal customers risk management products. Life insurance, home and contents and car insurance are all logical adjuncts to banks' savings and credit products. However, this does not mean that banks need to undertake all the functions involved in providing these products.

Risk management products of these kinds involve an underwriting and distribution function. Specialist insurance companies have the expertise necessary to undertake the actuarial valuations which underpin insurance products and thus their pricing, and may be better placed than banks to do this. On the other hand, banks have the benefit of large customer bases and efficient delivery channels, giving them an advantage in marketing insurance products.

The wide variety of delivery channels that banks have in place will also continue to provide the means for banks to cross-sell funds management products, which they may develop themselves or outsource so as to provide a more attractive range of products. Retirement savings accounts will also be an important addition to banks’ product range that can be sold efficiently through the extensive delivery networks.

In the same way as banking is becoming disaggregated, so too is the insurance industry. Insurance companies have increasingly found that consumers prefer unbundled insurance and savings products, acquiring term life insurance or disability insurance and managed funds products separately.

The same is broadly true of the funds management industry. Three principal businesses have emerged: one which develops new products and manages the funds which are raised; another which distributes the products to customers; and a third which is a custodial service which deals with much of the processing work entailed with servicing clients.

Concluding comments on disaggregation

The trend to disaggregation is one of the most fundamental changes affecting the future structure of the financial system and the role of the different players in it.

The challenge is for financial institutions to rigorously assess the economics and comparative advantages of the various businesses they are in and the opportunities for future growth and profitability, and to concentrate their efforts on those which offer the best potential for maximising the return to shareholders over time.

Any assessment inevitably will lead to decisions not to undertake certain activities, usually because other institutions can do them more cost effectively. Out of this process of adjustment and the increased efficiency it generates, customers and shareholders will both benefit.

4.3.4 Entry of new competitors

The forces that are leading to the disaggregation of the credit, savings, payments and risk management businesses are equally responsible for the entry of new competitors.

The three areas where such competition is becoming most obvious is in credit, savings, and the transactions end of payments, although in the last case, the process is still embryonic.

Credit

To date, pressures from new competitors have been most marked in the credit business and typically involve a degree of specialisation. Some of the newer activities include:

- The emergence of mortgage originators as a force in housing finance, funded by domestic bond issues to institutional investors, or by banks, particularly regional banks. Currently mortgage originators have between 4 and 6% of the flow of new housing mortgage commitments.

- The increasingly active role of life and general insurance companies in housing finance, funded either by securitisation or policy holder funds. Currently life and general insurance companies are responsible for between 2 and 4% of the overall 15% of the flow of funds to non-bank housing lenders.

- The emergence of various forms of affinity lending eg. housing loans to superannuation fund members under the ACTU - National Mutual Home Loans Scheme and loans arranged by specific purpose bodies to their members, such as the RACV.

- American Express marketing a new credit card which has a revolving facility with interest paid on any unpaid outstanding (debit) balances.

- The US owned, GE Capital's purchase of the $850 million of credit card receivables of Coles Myer, equivalent to 15% of bank credit card outstandings.

- Initial moves by industry superannuation funds into business lending through the establishment of the Super Business Loans Trust.

Mortgage managers have been able to establish a significant presence so quickly because of:

- their ability to concentrate on loan origination with the funding being done by other institutions;
- the impact of technology on their ability to assess credit risk and monitor loans;
- their ability to use low cost, flexible delivery channels, such as phone marketing and mobile lending; and
- the existence of wide margins in home mortgage lending, driven by the cross-subsidisation of other banking services like transaction accounts and corporate lending.

The same external developments plus the cost of funding mortgage loans on the balance sheet have resulted in banks examining housing loan securitisation for their own purposes and have encouraged the development of centralised mortgage processing centres such as Westpac's centre in Adelaide.

Savings

In the area of savings the proliferation of products with various risk dimensions have been discussed and this trend has clearly been accompanied by a proliferation of product suppliers. This is particularly so in the case of savings via funds management products, be they superannuation or unit trusts where there are now some 93 participants.

The diversity of backgrounds for participants in this sector of the savings market has changed considerably. The traditional focus of life insurance companies on providing death and disability cover has shifted to funds management, particularly as it relates to superannuation, to the point where, in the words of the Insurance and Superannuation Commission, they "play a pivotal role in offering Australians savings products"[26]. Banks have also become very active in providing funds management products (usually through subsidiaries), with an estimated current market share of 25%. And there are a variety of other funds managers, including many internationally owned funds managers, all vigorously competing for household savings. The changes which have occurred to the structure of the funds management industry were previously illustrated in Figure 2.4.

Other New Competitors

The entry of new players into the payments system is more embryonic, although local developments are mirroring more established trends overseas:

- Australia Post has established itself as a European style GiroPost. It acts as an agency for a number of banks, American Express and other institutions by handling such transactions as deposits and withdrawals, account balance enquires, new account openings and credit card bill payments. The significance of this development lies in the fact that institutions with limited branch structures can provide reasonably broad service banking with a low cost infrastructure by making use of mortgage managers or brokers to originate loans, GiroPost to handle transactions and telephone banking for both transactions and sales.

[26] *Insurance and Superannuation Commission* ,1994-95 Annual Report, page 39

- Ongoing developments in computer and communications technology and the trend for non-banks to participate in various forms of the transactions part of the payments business will result in more non-bank competitors seeking to earn revenues from this portion of the payments system. Taxi companies and government transport organisations are issuing prepaid cards, retailers are setting up their own EFTPOS networks and Australia Post and Digicash are providing registration and verification systems for secure Internet payments. These developments are indicative of the change and diversification the transactions part of the payments business is undergoing.

Potential competitors and their strengths can no longer be confidently identified. Software companies such as Microsoft, may well offer their own financial services to customers in future, perhaps through their own banking channels. In the UK, for example, Virgin, Tesco, and Marks and Spencer are expanding their financial services to individuals, building on their brand names and marketing skills.

4.3.5 The formation of diversified financial service[27] providers and the blurring of boundaries among existing players

Australia has not had the institutionalised barriers between different types of financial service providers that have existed in many other countries where the one institution has been prevented from operating across the banking, life office and securities businesses. As a result, most larger Australian institutions have, for some years, operated with different financial service entities within the same group undertaking several or all of these activities. However, until the mid to late 80s, banks and life insurance companies tended to keep to their own traditional territories.

In recent years, however, this dichotomy has broken down, blurring boundaries between financial institutions which were previously quite distinct. This trend is very much related to the disaggregation issue discussed above and has involved diversification into new activities as competitive pressures and advances in technology, information and telecommunications have changed the way these institutions see their role in the financial system.

The largest 10 diversified financial service providers now account for 50% of Australian financial system assets, the largest 20 for 65% and the largest 30 for 75%[28]. As the Council of Financial Supervisors has noted, this trend to greater blurring of traditional boundaries within the financial system has been associated with an intensification of competition, with customers generally benefiting in terms of convenience and better pricing[29].

As banks recognised the need to make more effective use of their branch networks and to leverage off their large customer bases, they turned to life insurance or, more specifically, to funds management activities to generate additional revenue. Their decision to grow this area of business was reinforced by socio-demographic factors, particularly the ageing of the population, and by taxation incentives designed to promote superannuation as the main form of saving for retirement. (Their success was discussed in 4.3.1). Not surprisingly, life insurance companies are responding to this threat by moving (in some cases back) into various areas of banking business - most notably the provision of housing finance.

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[27] Regulators often refer to diversified financial services providers as “Financial conglomerates”

[28] *Recent trends in the structure of the financial system,* address by L. Austin, RBA, 1996, page 9

[29] *Council of Financial Supervisors, 1995 Annual Report,* page 26

Thus far, the bancassurance or allfinanz phenomenon which has been significant in Europe, and which involves the integration of banking and insurance activities, has been slower to take a hold in Australia. This reflects the difficulty of integrating the very different banking and life insurance sales cultures.

4.3.6 Capital and financial market development

The dynamic nature of the finance industry can be seen in the extent of innovation which has occurred in financial and capital markets in recent years. The 1980s saw the development of new techniques for raising funds through international capital markets, including securitisation, and for managing risk, including interest rate and foreign exchange swaps, options, futures and index funds. In recent years, the pace of innovation appears to have eased but application of these new instruments has broadened. As the OECD has noted:

> "The main feature of recent developments in this field has been a rapid spreading of the recourse by both customers and intermediaries to the new instruments and financing techniques that had been created in earlier years.... Visible signs of this process have been the breath-taking growth of the markets for swaps, financial futures and options.... Traditional activities such as foreign exchange trading and payments services, notably across borders, have reached dimensions which a few years ago had been inconceivable. A special characteristic of these latter developments is that the bulk of these transactions has been largely unrelated to the 'real world' of goods and (non-financial) services."[30]

Australian financial markets have been well to the forefront of these developments. A recent research paper has highlighted the positive impact of deregulation in the 1970s and 1980s on the growth of financial market activity, while noting that the growth of the funds management sector and its associated demand for risk management and financial trading services has also been an important factor.[31] It also pointed to the size of the Australian market, its primary focus on risk management, and the active role of banks in its development[32]. In particular, it is worth noting that:

- Australia has the ninth largest foreign exchange market and the sixth largest futures market in the world.

- Issuance and trading of corporate bonds remain relatively small, underlining the point that the growth of financial markets to date has been primarily related to their risk management function rather than to any shift to securitisation of financial flows to the business sector. However, this is likely to change.

- Innovation and trading in the new financial markets has been dominated by banks. For example, they account for almost 90% of foreign exchange dealing and around 80% of over-the-counter (privately negotiated) interest rate derivatives.

[30] *Banks under Stress*, OECD, 1992, page 20
[31] *The Evolving Structure of the Australian Financial System*, M. Edey and B.Gray, 1996, page 20
[32] *The Evolving Structure of the Australian Financial System*, M. Edey and B.Gray, 1996, page 20

The growth of the funds management industry is likely to contribute to the future growth of the domestic capital market. The strong take-up of securitised mortgages over the past two years is indicative of possible future trends. The volume of funds likely to flow into funds managers over the next decade also suggests that the demand for such securities may increase, particularly if reduced government budget deficits (or surpluses) lead to a contraction in the volume of government securities on issue.

Apart from the greater potential availability of debt finance from funds managers, there are a number of other reasons why the Australian capital market is likely to develop rapidly over the next few years:

- Banks and other financial institutions will look to securitise an increasing proportion of their assets as they unbundle their businesses and concentrate on those activities where they have the greatest comparative advantage.

- This process of unbundling and the pressure on each business to perform will also ensure that, to the extent that banks have cross-subsidised their corporate lending activities in the past, this no longer happens. For some companies, the capital market may become a cheaper way of acquiring debt finance.

- As better information becomes available to capital markets, both from companies seeking to borrow and rating agencies, they become more efficient and attract companies which might otherwise have borrowed from banks.

Clearly, developments such as these have important implications for the future role of banks in the financial system. This is not to suggest that they will necessarily have a lesser role, just a different one. The implications for banks have been summed up by one observer in the following terms:

> "In general, a central role in the future evolution of national financial systems, and the international system, will be growing competition and tension between banks and markets: capital and money markets in particular. Financial innovation has enhanced the relative attractiveness of capital markets for large, corporate borrowers. This does not necessarily imply a loss of business for banks as banks are involved in the capital market operations of their corporate customers. However, it implies that the way banks earn profits from their corporate customers will shift more towards off-balance sheet business compared with the interest margin on on-balance sheet business."[33]

4.3.7 Increasing demand for convenience and decreasing reliance on branches

The increased propensity for women to work, the trend towards single parent families, Australians' willingness to be early adopters of new technology, and the increased availability of that technology will all drive the trend to "anytime, anywhere, anyhow banking".

[33] *Banking in the 21st Century: The Transformation of an Industry*, D.T. Llewellyn, 1996, page 22

Even now the proliferation of alternative delivery channels means customers have much greater flexibility in how they do their business. Customers can transact via their branch, at an ATM, over the telephone or with a mobile lender at their home or in their office or at their supermarket through EFTPOS. The proliferation in new delivery channels means customers have much greater flexibility in how they do their business.

In the future the trend to increased convenience is likely to continue. While the exact shape of how the future will unfold obviously is unclear, it is likely that the new technology developments outlined in 4.2.2, in the form of smart cards and on-line banking, whether over the Internet or proprietary on-line services, will eventually become a reality.

Whatever the eventual outcome in terms of the proportion of business conducted by means of various delivery systems, there is no doubt that bank branches will be less important in customer usage of banking services over time.

4.3.8 Greater customer sophistication

Reflecting better education, greater familiarity with a broader array of product and service offerings, and intense competition, customers today are far more sophisticated and less institutionally loyal than they were in the past. This trend is likely to become even more noticeable in the future.

Over the past decade, qualitative research indicates that there has been a significant shift in the balance of the bank-customer relationship. Whereas banks were in control in the days before deregulation when they rationed funds, customers are now in control and are far more likely to move institutions when they are dissatisfied. Customer loyalty has diminished and is continuing to do so.

Customers now shop around for the deal with best suits them and if an alternative institution provides a superior solution and/or superior service they will move. This trend has been magnified by the reduction in or elimination of establishment fees and duties payable on mortgages, which have reduced the cost of moving between institutions.

Business customers are also becoming more demanding of their banks and are showing an increased willingness to switch lenders. This is particularly so of smaller enterprises, whose business is more straight forward. Middle market companies are less inclined to shift their total business, preferring to open up secondary banking relationships and migrating their business at appropriate times. In the case of large corporates, their ability to take their business offshore and their level of sophistication has long meant that the balance of influence has rested with the corporate treasurer and chief finance officer.

Financial institutions have increasingly had to recognise the need to be flexible and innovative in meeting customer needs, and the need to recognise, reward and build on customer loyalty.

4.4 How Financial Institutions Compete and Operate

The changes that are occurring in the structure of the financial services industry are having a direct effect on the way the participants choose to compete and operate. There has been and there will be an increasing push to pursue more customer focused strategies, there will be diminishing scope for cross-subsidisation between the various businesses and the pressure to reduce costs will only accelerate in the future.

4.4.1 Customer focused strategies

Not only are technology, information and telecommunications transforming the economics of their businesses, but financial institutions are looking to use advances in these areas to strengthen customer relationships and reverse the trend towards bank products becoming commodities whose sole determinant of value is price.

It is often overlooked by observers that, in a competitive market, financial institutions are only successful if they meet the needs of their customers better than their competitors. While price is, and will always be important, customers also value other elements of their relationship. Customers needs are becoming more varied and complex. Strategies are increasingly being tailored to meet these needs more effectively and at a price which is determined competitively. The strategies include the following:

- the use of sophisticated customer segmentation, together with data base marketing, to identify the needs of particular groups of customers and meet these cost-effectively;

- the use of cross-selling and up-selling to achieve the same outcome;

- the adoption by banks of more flexible and innovative delivery channels which are intended to meet customer needs for convenience and control in a way which is cost-effective;

- the introduction of loyalty programs to strengthen ties with customers who have a close relationship with and thus contribute to the profitability of the institution;

- an emphasis on branding so as to strengthen customer relationships at a time when the level of customer contact through branches is diminishing; and

- improving the quality of customer service to reinforce efforts to develop and maintain close relationships with customers, and to improve productivity.

4.4.2 Diminished scope for cross-subsidisation

The phenomenon of disaggregation in association with the intensity of competition which already prevails in the market for financial services is such that banks are finding it impossible to continue cross-subsidising products and services. Ongoing competitive pressures on the interest margins that banks can earn will increasingly result in banking products and services being offered in a way that eliminates cross-subsidies.

Reduced growth potential in net interest income

It is inevitable that competition will continue to put pressure on the growth in banks' net interest income. There will be limited, if any, ability to increase margins on lending or to reduce deposit interest margins, and overall deposit and on-balance sheet loan growth has been predicted to be modest.

Competition in the origination of housing loans has already intensified dramatically and is likely to continue, while banks will increasingly use securitisation to reduce their holdings of such on-balance sheet assets. This is not to be confused with the faster run-off in banks' existing loan portfolios which is occurring, due to the effectiveness with which they have educated customers about the benefits of making higher repayments on existing housing loans.

While there is some cause for optimism concerning demand for credit by the business sector over the next decade, this may not be fully reflected in the demand for bank finance. In particular, there is reason to suggest that disintermediation by corporate borrowers will continue to become more extensive as the ratings agencies and markets develop a greater understanding of smaller corporate risks and how to price them.

Greater emphasis on non-interest income

In the light of reducing net interest income generating possibilities, banks are looking to restructure their business so as to earn more significant levels of fee income for the services they provide. While net interest income still provides the bulk of the aggregate revenues of Australian banks, the proportion of fees to total income has been growing. The proportion of non-interest income to total income for the four major banks has grown from 17% in 1981 to 34% in 1995. This is broadly consistent with trends in most OECD countries, as can be seen in the Figure 4.9.

Figure 4.9
NON-INTEREST INCOME/TOTAL INCOME - SELECTED COUNTRIES (%)

	1979-1984	1985-1989	1990-1992
UK	31	37	41
US	24	30	34
Germany	19	21	25
Japan	18	32	20
Canada	22	27	31
France	15	16	26
Italy	27	29	24

Source: E.P.Davis, European Monetary Institute, Frankfurt; July 1996

Off balance sheet financing is likely to be a source of growth in non-interest income, particularly as banks move more extensively into arranging and managing securitised loans and engage more extensively in arranging debt raisings by Australian companies on domestic and international capital markets.

Funds management by banks will clearly grow in importance as a source of income, as will income from trading activities, given the growing importance of Australian financial markets.

The remaining area where growth can be expected is in relation to payments. As noted elsewhere, banks have little choice but to recoup the cost of transactions if they are to remain competitive in other areas of their business.

Justifying each component business on a standalone basis

Financial institutions are increasingly looking to separately manage their businesses so they can compete effectively with each other as well as with niche competitors in new and existing product markets. This may lead to getting out of particular businesses altogether as has happened, for example, in the US, where Bankers Trust ceased to be a retail bank, or where Wells Fargo Bank ceased to provide housing mortgages themselves[34], preferring to concentrate on other areas where it has a comparative advantage.

In addition, disaggregation and competition will lead institutions to price their services in a way which reflects the underlying cost of providing those unbundled services. This is an important issue for Australian banks at the present time.

In a competitive deregulated market, where the lending and deposits businesses have been separated, cross-subsidisation of one part of the business by another is no longer tenable as efficient third party providers will swiftly appear and offer better value to whichever customer or product segment is paying for the cross-subsidy. For example, customers with housing loans have been among the more profitable customers since 1989. To the extent that banks are forced to look to them to subsidise unprofitable transaction customers, the ability of mortgage managers to compete for this more profitable business is enhanced.

It is no longer practicable for banks to use margins on deposits and loans to recover the costs associated with providing transaction services. Each product market is unbundled and highly competitive and there is no room for cross-subsidisation.

This analysis is supported by the conclusions of the 1995 Prices Surveillance Authority report on the pricing of transaction accounts which recommended, in general, a shift to more transparent, activity based pricing.

4.4.3 Accelerating pressure to reduce costs

Banks have made significant reductions in costs in the past few years through the re-engineering of processes within branches and the centralisation of various processing operations. Staff numbers have been reduced, while the substantial proportion of transactions which are now undertaken electronically or by telephone has enabled banks, particularly the major banks, to reduce the number of branches[35]. However, the need for banks to further reduce costs is increasing.

Increased efficiency through achieving international best practice

The technology that is emerging has no national boundaries, therefore future efficiency standards will be set by whatever is international best practice in each unbundled area of the business. Whether or not a bank is operating in the international arena or in the domestic marketplace, international standards will apply to the provision of competitive banking services. The globalization of ideas across national bodies will equally ensure that this occurs.

[34] While Wells Fargo does not engage in origination, funding or servicing commodity types of lousing loans, they have an arrangement whereby their customers can conveniently access a low-cost mortgage. Wells Fargo still provides equity lines of credit, non-standard mortgages and the like.

[35] Retail bank staff numbers were reduced by 5% between 1983 and 1994. Over the same period the number of major bank branches was reduced by 15%.

Each bank, or financial services provider, will need to carefully identify where the competitive dynamics sit for its particular circumstances, identify its strengths and develop these to world standards. In the areas of business where a bank or other financial institution cannot match international best practice, it will need to look for solutions in outsourcing and/or the formation of operational and financial alliances, or consider withdrawing altogether.

Achieving economies of scale

A central challenge for financial institutions will be to determine how they can best reduce their costs, while adding value to their relationships with customers. Achieving economies of scale is a critical element. Different institutions will seek to do this in different ways over the next few years, leading to significant changes in the nature and structure of the finance industry:

- Some may do so by being big. However, scale economies typically relate to bank processes rather than to the size of an institution itself. As Westpac proposes with its mortgage processing centre in Adelaide, a bank can invest in the processing technology to achieve the scale economies and bring down costs by making the service available to its market competitors.

- A second way is through outsourcing and alliances. Large scale investment by companies specialising in specific activities or processes may deliver significantly greater economies of scale than a bank can achieve, even a large one, doing this itself. In particular, by using outsourcing, small financial institutions are likely to remain cost-effective competitors with large institutions. Alternatively, by outsourcing or through alliances, a financial institution may be able to access expertise which it could not afford in its own right. In practice, there are very few activities which cannot be handled through outsourcing to specialist providers.

Using mergers to reduce overall system costs and increase efficiency

As noted in Section 3.1.3, McKinsey & Co point out that one way of significantly reducing the over-capacity that exists in Australia is through mergers[36]. A merger of existing banking entities would facilitate significant reductions in branch numbers and corporate overhead costs and thus achieve significant rationalisation benefits. Ultimately, the only source of real consumer benefit is for Australia to have a lower cost banking system that permits lower margins and lower prices. (See Chapter 9 for a discussion of competition policy.)

4.5 Implications for Regulation

The regulatory framework that can deal with a financial services environment such as that described in this chapter will need to have a new more flexible approach and be adaptable in the face of constant change.

The trends that have already been identified suggest a variety of issues that any new regulatory framework will need to address:

[36] *Growth Platforms for a Competitive Australia*, McKinsey & Company Australia and the McKinsey Global Institute, p. 102-106.

- The regulatory framework should encourage rather than inhibit institutional adaptability to ensure the efficient allocation of resources. It should:

  - allow for the significant lowering of costs by participants through measures such as mergers, while ensuring ongoing vigorous competition and diversity of choice;
  - permit the rationalisation of costs through branch consolidations, but be mindful of the community need to be adequately serviced through the lowest cost channels; and
  - allow institutions to price their products and services according to economic criteria, without requirements for cross-subsidisation, provided the pricing is fair and adequate access for all consumers is assured.

- The regulatory framework needs to be able to cater to the changing corporate structures of financial services participants and to the new categories of participants by:

  - allowing for institutional diversification into new activities while ensuring the appropriate prudential controls are maintained and system stability is not put at risk;
  - allowing for the formation of strategic alliances between financial and non-financial participants in the provision of financial services and for the entry of new competitors while maintaining system integrity; and
  - ensuring the various participants can operate on a level playing field without compromising prudential regulatory concerns and system integrity.

- The regulatory framework needs to provide for the fair and equitable treatment of consumers of financial services in a manner that :

  - solves the information asymmetry problem by encouraging meaningful disclosure rather than maximising disclosure without regard to costs and benefits;
  - ensures consumer rights are dealt with cost effectively in a way that does not stifle product innovation;
  - ensures consumers have a choice of products with various risk profiles, at the same time as ensuring that the risks are adequately disclosed; and
  - allows for the efficient utilisation of information without encroaching on the privacy of financial service users.

- Finally, the ongoing focus on efficiency and cost reduction should also be adopted by the regulators, who should seek to lower and make their costs transparent.