Chapter 9

MARKET STRUCTURE AND COMPETITION POLICY

9.1 Application of Competition Policy to Banks

Competition policy is a vital component of the regulatory framework within which financial institutions operate. Like all other Australian firms, participants in the financial services market which want to undertake acquisitions or mergers are governed by Section 50 of the Trade Practices Act, as administered by the Australian Competition and Consumer Commission (ACCC).

However, banks have two additional competition policy hurdles to clear:

- They need to gain the prior approval of the Treasurer under Section 63 of the Banking Act 1959 for any mergers or reconstructions they wish to effect; and
- the general understanding (as a result of previous Federal Government policy, first enunciated in 1990) that the four major banks and the two largest life offices should not contemplate any mergers amongst themselves, as they will not receive the Treasurer's approval under Section 63.

The issue of bank mergers raises the possibility of significant potential efficiency benefits for the Australian economy (see discussion below), although the case for any specific merger proposal needs to be considered on its own merits. However, it is important that the banking and financial sector should not be subject to more demanding regulatory hurdles or tests than those which apply in other sectors of the economy. The determination and administration of competition policy needs to be relevant, efficient and transparent if markets are to be contestable.

Recommendation 9.1: **Competition policy should be applied to the banking and financial sector in an identical manner to its application to other industry sectors.**

9.2 Federal Treasurer's Approval of Bank Mergers

9.2.1 Application of section 63 of the Banking Act

Section 63 of the Banking Act 1959 requires the Treasurer to approve any disposal of a bank's business, bank amalgamations and reconstructions. This requirement creates a second regulatory hurdle involving the possibility that a proposed bank merger which has been approved by the ACCC may be rejected by the Treasurer on unspecified grounds. This lacks transparency and creates uncertainty, which is inconsistent with an efficient financial system.

In a deregulatory environment where the trend has been for decreasing government interference in, or regulation of, the operation of market forces, such a requirement also appears anachronistic.

Nevertheless, due to the banking sector's crucial involvement with the nation's payments system, particularly with clearing and settling, prudential issues may arise in relation to bank mergers. As a result, it is therefore appropriate for any proposal for a bank merger to be referred to the RBA for approval, from a strict prudential supervisory perspective, prior to its implementation.

Recommendation 9.2: **Treasurer approval for bank mergers should be removed from the Banking Act. The Reserve Bank should be responsible for approving all mergers from a prudential perspective and the ACCC should administer competition policy.**

9.2.2 The "Six Pillars" policy

In 1990, the Federal Government instituted a policy under which mergers between the four major banks and between any of the four majors and either of the two largest life insurance companies would not be permitted. This policy was formulated at a time when the trends towards disaggregation within the financial services sector were still embryonic, rather than in full swing and as well understood as they are now.

In view of the increasingly competitive marketplace and the two preceding recommendations, it is not appropriate for there to be a further regulatory hurdle involving competition policy for the banking and financial services sector. Any concern with the possible impact of such a merger on the level of effective competition should be dealt with under Section 50 of the Trade Practices Act.

***Recommendation 9.3*:** **The "Six Pillars" policy should be abolished.**

9.3 Section 50 of the Trade Practices Act and Draft Merger Guidelines

9.3.1 The application of competition policy

When Section 50 of the Trade Practices Act was amended in 1992 to change the mergers test from "dominance" to a "substantial lessening of competition", the Trade Practices Commission (now the ACCC) issued a set of draft guidelines which would help it interpret and administer the new test. The draft guidelines established a procedural framework which governs the way in which the ACCC evaluates mergers, with the framework including a range of interconnected threshold criteria which determine whether or not the ACCC will even investigate the proposed merger.

The Draft Guidelines require the ACCC to establish a definition of the market in which the proposed merger is to take place. The market share of the firms and the level of industry concentration are then measured according to the definition. If the firms proposing to merge have shares that are above the 'safe haven' threshold level and the industry structure following the proposed merger would be in excess of the threshold concentration levels, then the ACCC reviews whether or not the merger should proceed. Its review focuses on whether or not the proposed merger will substantially lessen competition in the industry, and what compensating countervailing public benefits may result from the merger. If a review process is instituted, factors such as import competition and barriers to entry are examined.

9.3.2 Market definition

How the ACCC defines the market has a major bearing on whether the proposed merger undergoes the ACCC review process. Further, if the proposed merger does undergo a review, the review body's understanding of the market and its dynamics will greatly influence its assessment of whether or not there will be a substantial lessening of competition.

In its recent review of the Draft Merger Guidelines and how they were administered by the ACCC, the Industry Commission also looked at the importance of the appropriate market definition being used by the ACCC. After discussing the acknowledged difficulties of defining markets due to the judgements required in determining what are substitutable goods, the Industry Commission concluded that "generally speaking, broad, rather than narrow, definitions of markets would appear to be the most appropriate for ensuring that all effective substitution possibilities be included."[1]

The market in which banks operate

As demonstrated in detail in Chapter 4, the financial services market, which includes activities traditionally classified as banking activities, has been undergoing a metamorphosis in which the components are being disaggregated and the boundaries between the various product and services providers have greatly blurred. The forces which have caused this will not be turned back. Rather, due to the rapid pace of technological innovation, the process of disaggregation and market transformation will accelerate in the future.

Similarly, technological innovation, the convergence phenomenon and the resulting development of new product delivery channels will go a long way to completely obliterating the notion of geographic boundaries for markets. As the Deputy Governor of the Reserve Bank has observed:

> "Technological innovations are rendering obsolete judgements about market competitiveness which are based on numbers of branches in a particular geographic area, or even market shares for deposits or loans. This is because the new delivery systems are making regional markets more readily contestable by institutions - whether banks or others - without a strong physical presence in those areas."[2]

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1 *Merger Regulation: A review of the draft merger guidelines administered by the Australian Competition and Consumer Commission,* Information Paper, June 1996

2 *Retail banking, Technology and Prudential Supervision,* speech given by Graham Thompson, Deputy Governor of the RBA, to AAPBS 1996 Information Exchange Seminar, Gold Coast, 16-19 April, 1996

Suggested approach to defining the market for banking and financial services

Section 50 of the Trade Practices Act is concerned with mergers that may substantially lessen competition. The legitimate concern is that participants in a market with inadequate competition could engage in anti-competitive conduct that is not in the greater public interest. The main observable evidence for anti-competitive behaviour comes in the form of restricted availability of the services normally provided by the firms and/or in product pricing that does not reflect vigorous competition. Simplistically, mergers policy is concerned with ensuring fair product/service pricing and reasonable access or availability.

To this end, the market definition adopted in relation to finance industry acquisitions should reflect the broad spectrum of financial services and product suppliers and the resulting multiplicity of sources of price competition, as well as the great variety of distribution channels available for consumers to access those products.

The ACCC's approach to the market definition should concentrate on the major products and their near substitutes, rather than on the category of institution which acts as a product supplier. This is particularly important given the amount of blurring that has already occurred between the various supplier categories. Banks are no longer the only organisations which supply a whole range of what were traditionally known as banking products, just as life insurance companies are no longer the only institutions with which consumers can save for their retirement. Consumers and businesses shop around for the best deal or the most suitable product, and in the process form relationships with a variety of financial service suppliers. *The market should therefore be treated on a product basis rather than on an institutional basis.* To adopt an alternative approach is to deny the existence of the disaggregation and category-blurring trends currently taking place within the banking and finance industry.

Westpac recognises that it is institutions, not products, which merge. However, it is market share and competition in the core products of the merging institutions which is important, irrespective of where that competition comes from. If it can be demonstrated that competition is not lessened in the major products, then Westpac would suggest that it is reasonable to conclude that overall, a substantial lessening of competition is unlikely to occur.

***Recommendation 9.4*: When examining a potential merger among diversified financial organisations whose prime business is banking, the ACCC should adopt a broad functional approach to determining who are the market participants, with the focus on the major products and services that are supplied.**

Further, the geographic boundaries for defining the market for financial services should, at a minimum, be national. The financial services industry is characterised by a broad range of alternative delivery channels for its goods, far more than most other industry sectors. The ongoing emphasis in the financial services industry will be on the development of cost efficient electronic delivery channels which do not require the supplier to be located in a particular geographic area. These electronic and remote delivery channels are the ones which consumers already favour utilising over the physical branch,[3] and the forecasts are for the physical branch to become less and less important as a delivery point.

[3] Refer *Fifth Annual International 1996 Technology in Banking Survey*, Ernst & Young, in which only 46% of banking transactions currently take place in the branch. Further, while loan products may be migrating to alternative delivery channels more slowly than transactions, trends to do increasing amounts of business, including small business loans, via telephone banking and with the use of mobile lenders will increase in the future.

Customer usage of remote accessing and transfer devices for cash withdrawals and bill payments very clearly demonstrate the reduced requirement for any institution to be located in any particular geographic area for the activities to take place. Cash can be withdrawn at supermarket checkouts, service stations, bottle shops and a broad range of other retailers; it can be withdrawn from the institution's ATM or from the one of the ATMs in the network to which the institution belongs; and bills can paid by setting up instructions for automatic bill paying via electronic fund transfer or via credit cards over the telephone.

***Recommendation 9.5*: The market definition should reflect the dynamic, increasingly fragmented nature of the market and its growing reliance on remotely administered technology for the delivery of products and services. The geographic boundary for the market for financial services should be national.**

9.3.3 Market share thresholds for review

The ACCC investigates a proposed merger if it would result in the *four* largest firms supplying 75% or more of the market (with the merged firm having at least 15% of the market) or if the merged firm would have market share greater than 40%.

In its recent report on the merger guidelines, the Industry Commission expressed concern that the current ACCC merger review threshold levels were too low. It expressed the view that:

> "the emergence of a less regulated Australian economy, increasingly open to international competition, has enhanced the dynamism of market forces and significantly reduced the scope for firms to price above competitive levels for sustained periods."

The Industry Commission was of the view that an increase in the threshold levels at which mergers undergo review would result in less uncertainty, lower compliance costs for firms and would give the ACCC increased ability to concentrate on those merger proposals which are most likely to matter for competition.

It therefore proposed that the threshold market share for an individual merged firm should be increased from the present 40% to 50% and that the post merger concentration ratio of 75% or more should apply to the *three* largest firms (with the merged firm having at least 20% of the market).

The ACCC has indicated that it will adopt the Industry Commission's suggestion *to consider* the implications of liberalising the market share threshold figures by reviewing mergers for 12 months against the old figures and the Industry Commission's proposals.

Westpac supports the Industry Commission's recommendation to liberalise thresholds. It does not argue for thresholds to apply to the financial sector which are any different to those for other Australian industries. Instead, Westpac takes the view that the dynamic and rapidly changing nature of the financial services market and the scope for non-bank financial services companies to proliferate and become robust competitors in different segments of the market mean that the higher concentration ratios proposed will not mean a substantial lessening of competition in the industry.[4]

[4] For example: non-bank mortgage originators in the case of Australian housing finance; GE Finance and American Express initiatives with consumer debit and credit cards both in Australia and overseas; and UK retailers, Marks & Spencer, marketing financial services to their customers.

***Recommendation 9.6*: The ACCC should adopt the Industry Commission's suggested review threshold levels beyond which proposed mergers would be subject to review, namely:**

- **raising the threshold market share for an individual merged firm from the present 40% to 50%; and**

- **replacing the threshold test in which the post merger concentration ratio for the *four* firms is 75% or more (with the merged firm having at least 15% of the market) with one in which the *three* firm concentration ratio is 75% or more (with the merged firm having at least 20% of the market).**

9.3.4 Import Competition and Barriers to Entry

Once the ACCC has settled on a market definition, it establishes if the market shares of the merged firms and resultant market structure are above or below the threshold tests and whether an ACCC review of the merger is required. When a review is required, the ACCC examines a range of factors to establish whether or not the merger would result in a substantial lessening of competition. Clearly, in such a review it is of the utmost importance that the industry and developments within it are well understood.

Import competition

The level of import competition is one factor that is looked at. This needs to be considered on two levels: competition which arises from *new players* and that which arises from *new ideas*.

In the banking and finance sector, import competition from *new players* can come from interstate suppliers (where a regional merger is involved) or even overseas-based suppliers such as international banks operating via branch offices and subsidiaries, and from multinational conglomerates such as General Electric who, amongst other things, provide a range of financial services. Import competition will increasingly also take place without any requirement for the provider to have offices physically in the State or in Australia as products will be offered over the Internet. The fact that the provision of financial services over the Internet at the moment is still at the embryonic stage does not detract from the likely importance this form of competition may eventually assume.[5]

International capital markets also provide effective import competition in the case of business finance as companies have the option of borrowing by means of bank loans or by means of debt securities issued in local and international capital markets.

The import of powerful *new ideas*, such as securitisation and mortgage banking, is also an important source of new competition. The disaggregation process discussed in chapter 4, which involves the splitting of traditional banking business into its component parts, means that new players can take these new ideas, along with new technology, and quickly become very effective competitors. This is exactly what has occurred in the case of mortgage originators.

[5] Note that Advance Funds Management and Norwich Insurance have received ASC approval to release prospectuses over the Internet. This is in keeping with the established practice in the US and Canada for publishing prospectuses on the Internet. Further, managed funds products are only one form of financial service that will be marketable on the Internet: deposit products, credit cards and standard loan products will all be marketable via this medium.

Barriers to Entry

The ACCC also looks at the barriers to entry to a market to establish whether or not effective entry from new competitors is likely. While there is a range of necessary regulatory and prudential requirements to be met in becoming a bank, there are far fewer and less onerous requirements to being a niche provider of many of the products and services that banks provide. The disaggregation of the sector has lead to fragmentation in the provision of products and services and to concomitant large increases in effective new competition.

As has been recommended above, the ACCC generally should not adopt an institutional approach to merger policy administration in the financial services sector. Nevertheless, it is worthwhile noting that the biggest barrier to entry to becoming a bank at the moment are the regulatory requirements that any new bank must meet, not the level of existing banks' sunk costs.

The significant sunk costs of the banks, the need to establish an extensive branch network and the economies of scale and scope for key costs such as data processing have all been identified as barriers to entry in past ACCC reviews of banking mergers. Historically these were barriers to entry. But now they are either irrelevant or actually provide positive openings to new entrants. A large portion of banks' sunk costs are in the extensive branch networks that they are seeking to rationalise. Banks want to minimise the costs of the branch networks to be able to compete more effectively with the niche competitors whose product pricing does not need to absorb such costs. The capital invested in branch networks is more an Achilles heel for the banking sector, inhibiting banks from competing more effectively, rather than a barrier new entrants have to get over.

Similarly, it has already been discussed that a bank does not need its own data processing capability to gain the benefits of scale required to bring down costs - servicing and processing activities can be outsourced.

Recommendation 9.7**: When assessing the extent to which there are any barriers to effective new competition within the financial services market, the ACCC should take full account of emerging trends in the competitive environment.**

9.4 Scope for Mergers to Increase the Efficiency of the Banking and Financial Services Sector

9.4.1 The nature of efficiency benefits

Westpac believes that each merger proposal should be considered on its merits, and does not seek in this submission to argue the case for a merger between two major banks, a major bank and a life office or a major bank and a regional bank. However, it believes it would be useful to explore some of the ways efficiency gains may be achieved as a result of a merger.

A vibrant and healthy Australian economy needs a highly efficient and low cost financial services sector. The more efficient the financial system, the more individual customers will benefit, and the more the economy as a whole benefits.

With the globalisation of markets and the increasing importance of trade flows to the Australian economy, Australian companies need the support of an efficient economic infrastructure to be internationally competitive on price. This includes competitive low cost financial services. As discussed in Section 2.2.3, a 5% average improvement in operating efficiency across the financial sector would result in cost savings of roughly $1 billion per annum. Branch productivity is low and there are too many branches relative to market size.

As noted in chapter 4, the major banks have been reducing their branch structures as part of a restructuring of their delivery channels to take advantage of new technology to increase the efficiency with which products and services are delivered to customers. However, there is a limit to the speed and the extent to which banks can reduce their cost structures in this way without disrupting service to their customers.

Mergers between financial institutions, particularly those with overlapping operations, can lead to faster rationalisation while maintaining service levels. They also can allow for a more systematic and significant reduction in costs than can be achieved by the individual institutions acting alone. For example, in addition to branch rationalisations, 'in-market' mergers may allow the combined head office costs and corporate overheads of the two banks to be reduced substantially and for economies of scale to be achieved in processing (see discussion in Chapter 4).

Such quantum cost rationalisation may create increased opportunities for improved competition and efficiency, as recognised in the recently issued revised merger guidelines by the ACCC. Specific steps taken by the ACCC include "greater emphasis on the relevance of efficiency considerations under section 50....The Guidelines now recognise that in certain circumstances a merger that reduces costs may contribute to improved competition ..."[6]

There are also dynamic benefits. In particular, a merger enables economies of scale and scope to be achieved by the merged entity, particularly in the processing of transactions, where advances in technology is delivering significant economies, as discussed in Chapter 4. With the disaggregation of banking, individual businesses are becoming profit centres in their own right. Some of these will have the capacity to achieve economies of scale, while others may not. A merger may be the catalyst for these to be sold off to other institutions which are more readily able to derive efficiency gains. In this way, mergers can lead to significant efficiency gains.

Nor need the merging institution gain all the efficiency benefits from the merger. These may accrue in other ways. A merger will often lead to a loss of customers to competing institutions. Other things being equal, this will lead to these institutions achieving efficiency gains, so that efficiency gains are distributed more widely throughout the economy. An example is the CBA acquisition of the State Bank of Victoria, which precipitated a significant movement of customers to other banks, particularly the Bank of Melbourne. The latter bank achieved substantial improvements in its efficiency ratios as the direct result of this development. Most importantly, this example demonstrates that it is the customers that largely determine where the efficiency benefits accrue.

[6] *Competition Policy Recent Developments,* Professor Fels, Chairman, Australian Competition & Consumer Commission, Address to the Rotary Club of Melbourne, 28 August 1996

9.4.2 The magnitude of efficiency benefits

The magnitude of efficiency benefits will obviously vary from merger to merger. However, it is useful to note some overseas views about the benefits which can be achieved.

The extent of market overlap between merging institutions, and the degree of planning and management skill, will obviously have a major impact on the efficiency of a merged entity. The Federal Reserve Bank of Atlanta, in an analysis of merger performance studies, reported select studies as concluding that "acquirers that purchase several banks in the same year and where there is no overlap would experience a significant increase in non-interest expenses. Conversely, the results suggest that an acquirer that purchases only one bank, where the banks operate in the same markets, may experience cost savings of around 15 to 35 % of the target's pre-merger expenses."[7]

These merger consolidation benefits are confirmed from public releases relating to recent US and UK major bank mergers[8]. The estimated merger savings justifying these mergers ranged from 8 to 16% of the combined institutions' non-interest expenses, which are in line with the above when looked at as a percentage of the acquired bank's expenses.

On the surface, these results appear to be at odds with an analysis of published studies of pre-1989 mergers in the United States[9]. This study concluded that "findings from cross-sectional statistical studies such as those examined here allow us to conclude that, in general, bank mergers do not lead to improvements in efficiency or profitability. However, this does not mean that mergers never yield such improvements". The vast majority of the mergers examined were small and the competitive dynamics of the marketplace have changed dramatically since the 1980s, for the reasons discussed in depth in Chapter 4. As recognised by the paper, "almost all the mergers analysed in these studies were undertaken before 1989, and mergers after that time might yield different results".

9.5 Conclusion

Australia will best be served by an approach to competition policy where efficiency benefits are allowed to be achieved, while ensuring adequate competition and effective safeguards for the community. As recognised by the ACCC, the approach should take full account of changes in the competitive environment. A policy based on a static and historical view of the market place will prevent banks and other financial institutions from lowering their costs and becoming more efficient.

The maintenance of artificial constraints outside of the ACCC guidelines, will result in the community being disadvantaged in several ways:

- personal and business users of financial services will be denied the benefits of lower cost financial services;
- the Australian banking sector may not be able to maintain international competitiveness; and

7 *Federal Reserve Bank of Atlanta*, Working Paper 2/92

8 Analysis conducted by McKinsey & Company Australia. Mergers examined include: BankAmerica / Security Pacific: Chemical / Manufacturers Hanover: NCNB / C&S Sovran; Lloyds / TSB; Chase / Chemical; and Wells Fargo / First Interstate.

9 *A Summary of Merger Performance Studies in Banking, 1980-93*, Board of Governors of the Federal Reserve System, Staff Paper 167, July 1994

- resources in the Australian economy may be mobilised and allocated in a way which is considerably less efficient, lowering national productivity and the welfare of the community as a whole.

Consequently, discriminatory merger constraints should be removed and the financial sector's merger and acquisition activities should be subject to ACCC regulation in the same way as other industries.

In addition, the ACCC is encouraged to recognise fully the competitive dynamics of the increasingly global marketplace, and to adopt formally the recent proposals by the Industry Commission to change the threshold levels which determine whether or not a merger will be subject to review by the ACCC.