CHAPTER 1: CAMPBELL REVISITED

1.0 BACKGROUND

Financial deregulation flowing from the Campbell Report[1] has combined with technological change and consumer preferences to transform the Australian financial system. From a system that was subject to a variety of direct and rigid regulations, it is now more vigorous and effective, allocating scarce financial resources within the domestic economy in a manner that increasingly reflects Australia's participation in a global financial system. Indeed, this deregulation is considered by many commentators to be one of Australia's most significant acts of reform. It is, therefore, appropriate and timely that the current Inquiry review and assess this transformation to ensure that regulatory arrangements continue to underpin a competitive and flexible financial system, capable of fulfilling the needs of the Australian economy into the next millennium.

A fundamental philosophy underlying the Campbell Report was that the most desirable outcomes for the community are best produced by a financial system that is competitive, efficient and subject to minimum regulations. While the Campbell Report was understandably unclear about the institutional structure likely to evolve following its recommendations, it suggested the following objectives:

- an easily accessible and secure domestic and international payments system;
- healthy competition between a range of institutions for the borrowing and lending business of both the relatively small retail customers and the relatively large wholesale customers; and
- a spectrum of risk opportunities facing investors within an overall financial system which is stable in the sense of being capable of absorbing the failure of some institutions, without prejudice to the rest.[2]

Although the Campbell Report was well aware of the likely microeconomic benefits from deregulation, it was primarily concerned with macroeconomic considerations [3]- in particular, how regulations were impeding the flow of funds into the heavily regulated banking sector and impacting on the efficacy of monetary policy. The current Inquiry terms of reference cover both macro and micro issues. For the purposes of this submission, the National has divided financial developments into these two categories:

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[1] Australian Financial System Inquiry - Final Report of the Committee (1981).
[2] Op Cit, page 531.
[3] Ackland R. and Harper I. (1990), "Financial Deregulation in Australia: Boon or Bane?", Paper presented to the Joint Conference on Microeconomic Reform in Australia, Canberra, September.

- the economic effects on growth, employment, savings and the flow of funds (the macro level); and
- the static and dynamic efficiency of the system including issues of availability, choice, quality and cost of service to consumers (the micro level).

Accordingly, this chapter is organised into two main sections. Key macroeconomic trends in the financial system are examined in Section 1.1, while the impact of financial deregulation on the efficiency of the financial system is assessed in Section 1.2. Some conclusions are summarised in Section 1.3.

1.1 MACROECONOMIC TRENDS

In broad macroeconomic terms, Australia has a well-developed financial system characterised by fairly deep capital markets and a high degree of international openness. With a share of just over 40% of financial assets, banks are an important, albeit not the dominant, participant in the Australian system - especially when compared to Europe. There is a great deal of variety in the structure of financial systems amongst industrialised countries. Some of the salient features of the Australian financial system, compared with other industrialised countries, are shown in the table below.

Table 1.1: Financial Structure

	Size Indicator 1.			Financial Intermediation Ratio 2.			Bank Intermediation Ratio 3.			Internationalisation Ratio 4.		
	1980	1990	1994*	1980	1990	1994*	1980	1990	1994*	1980	1990	1994*
USA	4.43	5.54	5.95	0.37	0.44	0.46	0.49	0.36	0.28	0.05	0.04	0.04
Germany	3.38	4.54	4.70	0.50	0.51	0.53	0.82	0.79	0.80	0.10	0.15	0.15
Japan	4.88	7.55	7.86	0.44	0.47	0.47	0.35	0.38	0.34	0.03	0.09	0.07
France	5.20	7.38	8.88	0.49	0.45	0.42	0.86	0.78	0.74	0.12	0.11	0.13
Italy	3.12	3.75	4.46	0.50	0.40	0.39	0.65	0.55	0.54	0.11	0.08	0.11
Canada	1.09	1.19	1.37	0.41	0.41	0.43	0.53	0.48	0.44	0.08	0.08	0.09
Spain	4.08	5.22	5.90	0.35	0.37	0.40	0.78	0.70	0.71	0.04	0.05	0.08
Sweden	3.62	5.41	5.54	0.44	0.51	0.50	0.49	0.41	0.33	0.05	0.06	0.08
Finland	1.43	4.07	3.81	0.75	0.52	0.61	0.61	0.66	0.60	0.03	0.13	0.14
Australia	n.a.	3.89	4.22	n.a.	0.46	0.48	n.a.	0.62	0.56	n.a.	0.20	0.22

Source: OECD, Financial Accounts of OECD Countries (Various), ABS Financial Accounts 5232, Tables 2 to 13.
1994*: All values are as at December 1994 except: Finland (93), Sweden (93), France (95), Australia (95), Germany (95).

Definitions:
1. The scale indicator is the ratio of the amount of total financial assets outstanding to GDP.
2. The financial intermediation ratio is the ratio of the assets of all financial institutions to total financial assets.
3. The bank intermediation ratio is the ratio of banks and other deposit-taking institutions to the total assets of all financial institutions.
4. The internationalisation ratio is the ratio of outstanding external assets to total financial assets.

Since the start of the 1980s, some of the main features include the:

- substantial deepening of financial markets across countries. Australia, where the ratio of financial assets to GDP stood at about 4¼ in the mid 1990s appears in the middle of OECD economies;

- increasing importance of capital markets in most countries, except for France, Italy and Finland. Australia has an average degree of institutionalised intermediation, with about half of all financial assets on the balance sheets of financial institutions;

- significant fall in the bank and other deposit-taking credit institutions' share of intermediation, except for Germany, Japan and Finland. Banks and other deposit institutions are still by far the main participants in the financial systems of Germany, France, Spain and, a lesser extent, Finland. In terms of this measure, Australia is also in the middle of the range for major industrialised countries;

- fairly stable and relatively low openness of most countries, although the Australian system exhibits, by far, the highest internationalisation ratio.

Changes in Market Share

Prior to financial deregulation, the regulatory framework in Australia made it difficult for banks to be fully competitive and innovative in the financial system. There were significant restrictions on their borrowing and lending activities.

On the liability side, for example, banks were restrained from raising funds by controls on interest rates and maturity limits. Similarly, on the asset side, banks were prevented from lending on the terms sought by borrowers. Credit rationing, cross-subsidies of certain customers and a lack of innovation were significant features of the heavily regulated banking sector. Consumers unable to borrow through banks obtained higher cost loans from the non-bank sector.

This led to the expansion of non-bank financial institutions outside the regulatory net to serve the needs of borrowers and savers. As a result, the market share of finance companies, merchant banks, building societies and other non-bank financial intermediaries increased rapidly from around 10% in the early 1950s to around 30% by the late 1970s. Over the same time, the banking sector share of financial sector assets fell by around 30% to about 40%.

Banks reacted by channelling resources into non-bank subsidiaries and turning to less regulated activities, such as bill acceptances and endorsements. This was partly to reduce the impact of the regulation on their trading and savings bank operations and partly to establish a foothold in these new areas of operation.

Financial Sector Assets*

Chart 1.1

As a per cent of GDP

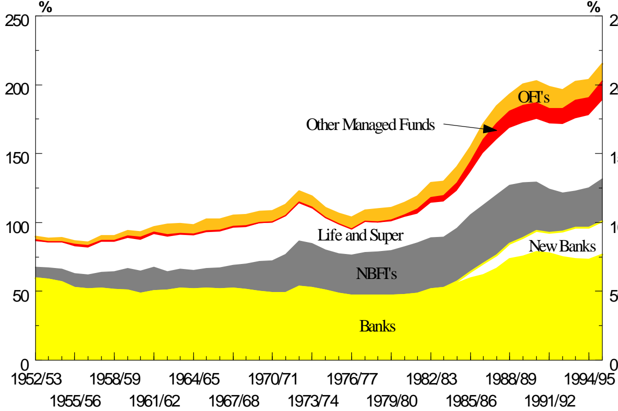
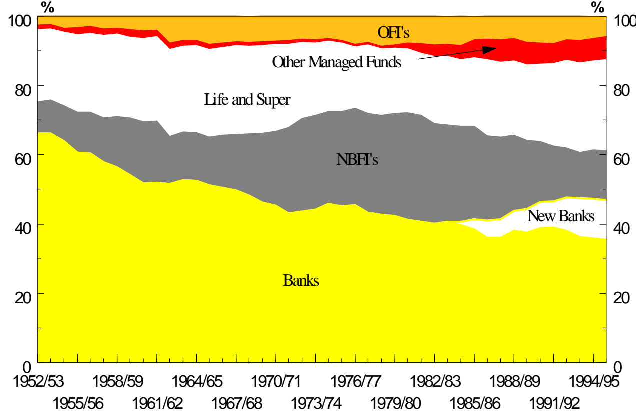


Chart 1.2

As a per cent of total financial assets



*OFIs are 'Other Financial Institutions', and include economic development corporations; general, health and export insurance companies; common funds; issuers of assets-backed securities; mortgage, fixed interest and equity unit trusts; cooperative housing societies; and credit union leagues.
Source: RBA Bulletin, Table D5.

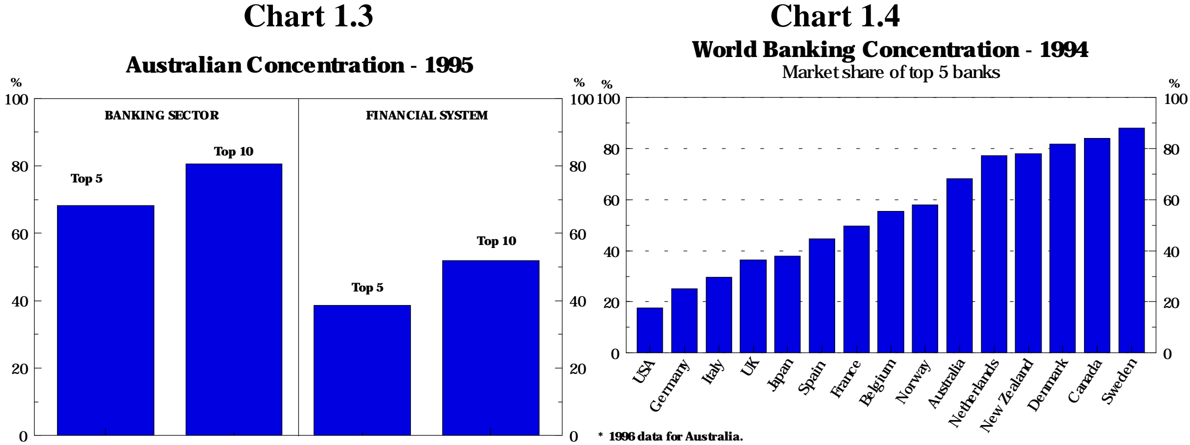
As is evident in the above charts, the structural decline in the market share of banks was arrested by the removal of regulations impeding the ability of banks to compete with non-bank financial intermediaries. Since the early 1980s, banks' share of financial sector assets has increased mainly at the expense of non-bank financial intermediaries, particularly building societies and finance companies, reflecting:

- the entry of new banks;
- the mergers and conversions of a number of non-bank financial intermediaries to bank status; and
- the absorption of non-bank subsidiaries into the general banking business of their parent companies.

Nevertheless, pre-existing banks have not recovered the market share lost since 1952, after adjusting for the impact of conversions and the entry of new banks.[4]

[4] Malcolm Edey and Brian Gray, "The Evolving Structure of the Australian Financial System", Reserve Bank of Australia 1996, pp. 2-3.

In terms of concentration ratios, the largest ("top") 5 banks currently account for about two-thirds of banking assets on Australian books - about the middle of international experience - but less than 40% when taking into account the whole of the Australian financial system (see charts below).



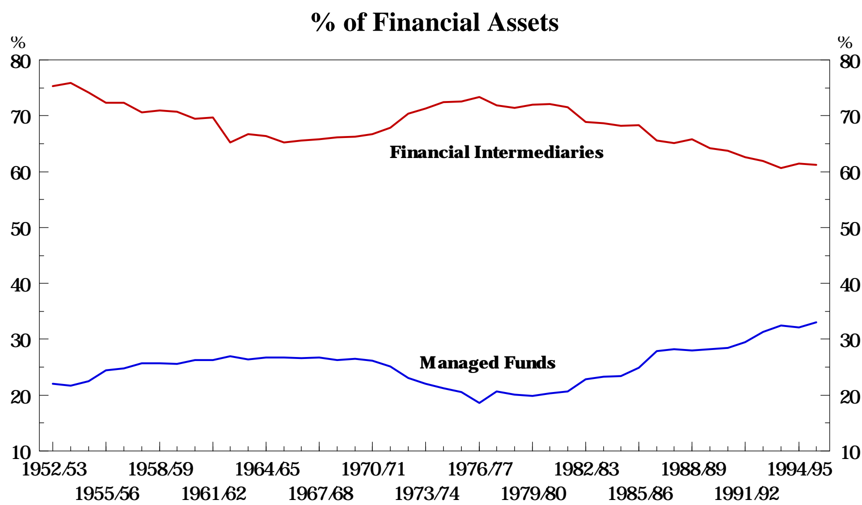
Source: RBA Bulletin Table B10, Council of Financial Supervisors Annual Report 1995, BIS Annual Report 1996, The Bankers' Almanac, OECD Bank Profitability.

Life and Super Funds

Another significant macroeconomic trend in the flow of funds has been the rapid growth of assets under funds management relative to financial intermediaries, largely due to regulatory arrangements favouring private superannuation and the asset inflation of the 1980s.

In terms of financial assets, the share of the total managed funds sector (defined generally as assets of Life Insurance & Superannuation Companies and "Other" Managed Funds) has increased from around 20% in the early 1980s to over 30% currently (see chart below) - the "other" non-life and superannuation sub-component increased from near zero to around 7% over the same period .

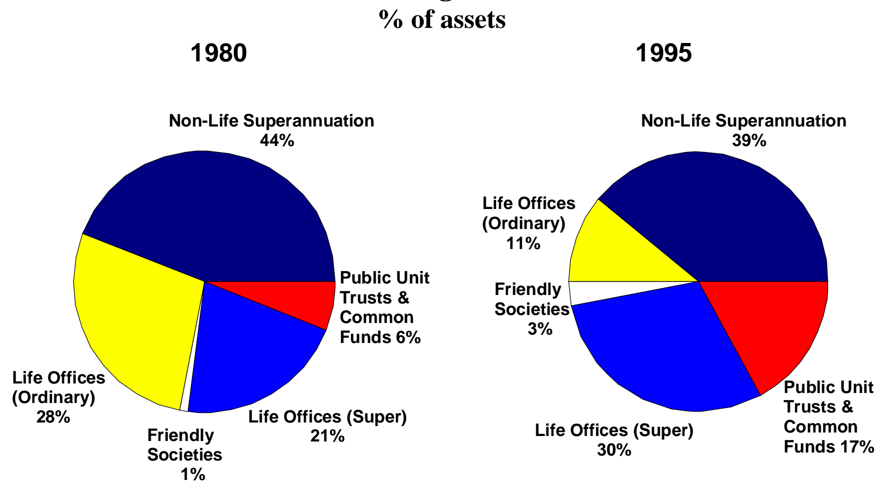
Chart 1.5: Financial Intermediaries v Managed Funds



Source: RBA Bulletin, Table D5, various issues.

While public unit trusts and common funds have benefited from the growing sophistication of investors and their preparedness to trade-off higher returns for risk, life and superannuation funds have captured the majority of longer-term savings. In contrast, life insurance ordinary business has lost market share (see chart below).

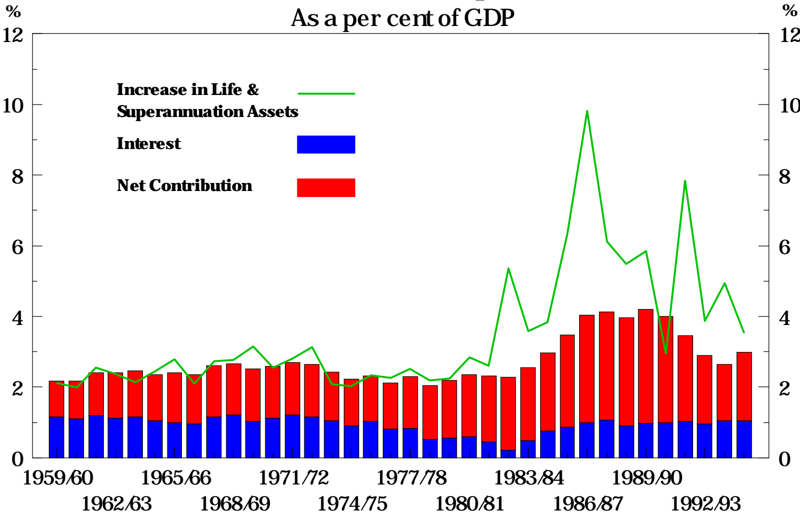
Chart 1.6: Managed Funds Sector



Source: Council of Financial Supervisors, 1995 Annual Report.

The strong growth in the managed funds sector mainly reflects the interaction of Government policies to encourage the spread of self-funded savings for retirement (including disparities in the tax treatment of fund contributions, compared with other forms of savings) and the compound nature of superannuation fund earnings.

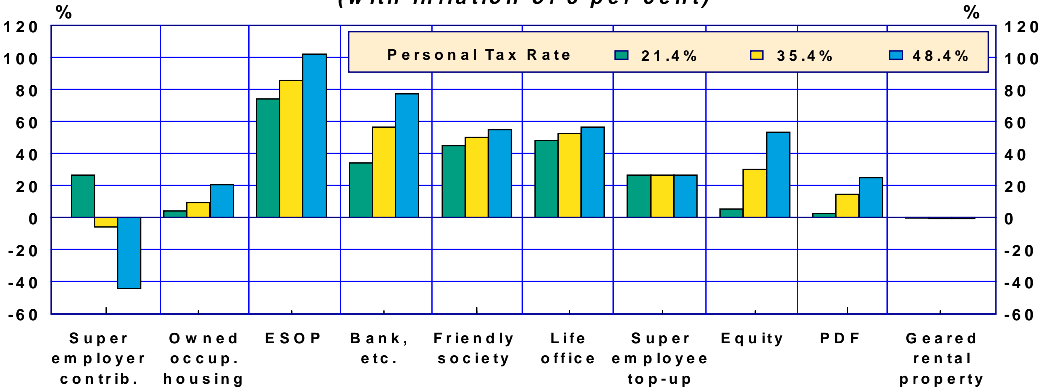
Indeed, despite the increased coverage of employees by superannuation - up from 35% in the mid 1980s to almost 90% currently - and higher compulsory contributions, there has been no significant increase in the proportion of net (compulsory and voluntary) contributions relative to GDP. Cyclical factors associated with the recession in the early 1990s (such as an increase in outflows associated with retirement and redundancy payments) and the fact that many employers were already satisfying the requirements of the compulsory scheme under pre-existing voluntary arrangements appear to have had a countervailing impact on contributions. Nevertheless, superannuation funds have benefited from asset prices and higher interest income (see chart below).



Source: RBA Bulletin, Table D5. ABS National Accounts 5204.0, Table 50.

Taxation

In the area of taxation, the discriminatory tax treatment of various forms of savings clearly benefits superannuation. The real effective tax rates on different forms of savings are highlighted in the following chart.



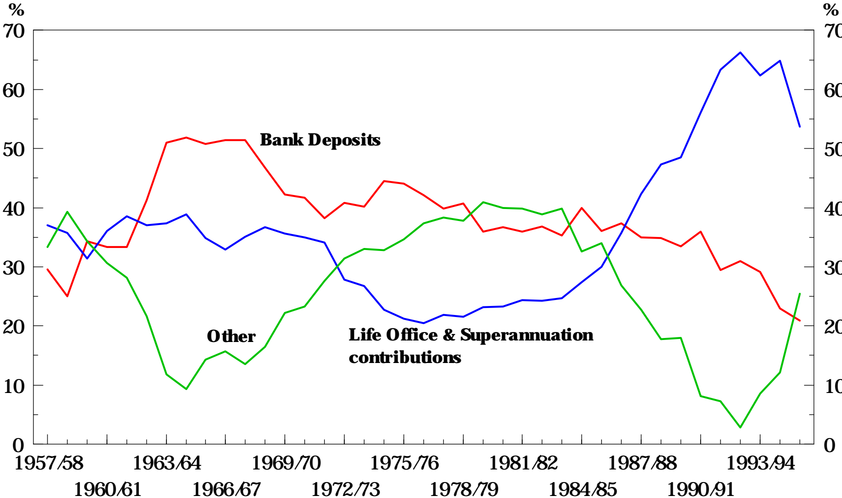
Source: Howard Pender and Steven Ross, EPAC Background Paper No.36 - 1994, p.25.

Some key features are that:

- placing money in an interest bearing account at a bank, building society, credit union, cash management trust or common fund faces a greater real effective tax rate than applies to direct investment in equities, an insurance policy with a life office or friendly society or making top-up contributions to a superannuation fund;
- receiving income in the form of superannuation contributions is the most tax attractive form of saving for the majority of income levels - because rather than paying the full personal tax on earnings, contributions tax at 15% is taken from the amount paid into the fund; and
- with the exception of superannuation contributions, the taxation system generally treats housing investments more favourably than investment in financial assets.

As a result, there has been a fundamental change in the destination of savings by households and unincorporated enterprises. The share of households' net new investments (savings) directed to banks has continued to decline, with a corresponding increase in the share of savings flows directed to superannuation (see chart below).

Chart 1.9: Households - Net Acquisition of Financial Assets



Other is mainly equities, but also includes deposits/placements with non-bank financial intermediaries, government securities, debentures and other securities.

Source: ABS Financial Accounts 5232.0, Table 25.

Looking to the future, these trends can be expected to increase buoyed by the increase in compulsory SGL contributions to 9% of earnings over the five years to mid 2001 as well as the favourable tax treatment of superannuation.

1.1.1 MACROECONOMIC IMPLICATIONS

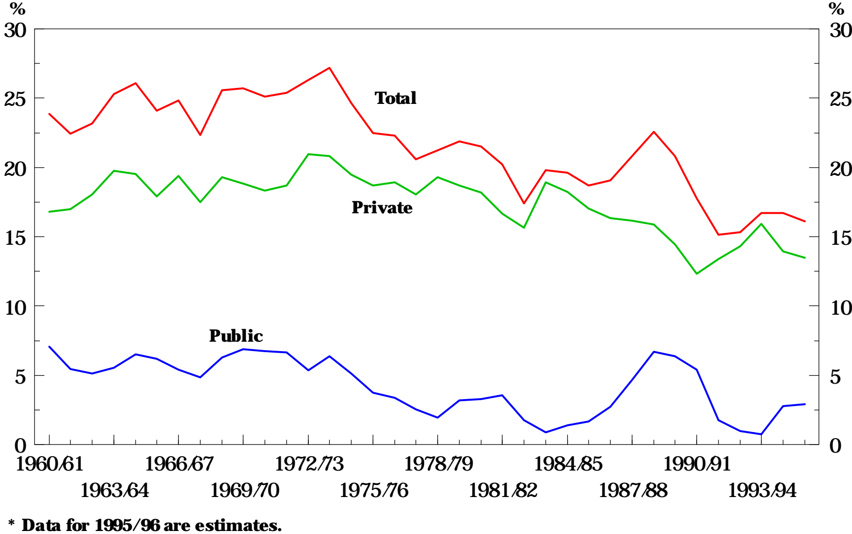
It is virtually impossible to distinguish the macroeconomic impact of financial deregulation, technological change and globalisation on the Australian economy. The simple point being that there are dynamic and interdependent factors at play. The following section examines some macroeconomic indicators.

1.1.1(a) National (Aggregate) Savings

In brief, Australia's national savings remain too low. While the fall in the level of national savings since the mid 1970s mainly reflects lower savings by the public sector, the level of private savings has also recorded a smaller structural decline over the same period (see chart below).

Chart 1.10: Gross National Savings

% of GDP



Source: ABS, Australian National Accounts, 5204 - Gross Accumulations.

The Government's objective of returning the Commonwealth Budget to surplus over the next few years will go a substantial way towards meeting the minimum requirement consistent with stabilising Australia's external indebtedness. The maintenance of low inflation is also an essential to promote private savings.

Further improvements in the efficiency of public trading enterprises will help by reducing the need for new investment in both the private and public sectors. Here, both the Hilmer Report and the recent stocktake by the new Productivity Commission have also recognised more generally the need to make economic and social institutions more effective and productive and

so provide the micro foundations for an adaptable, innovative economy, capable of flourishing amid inevitable and unpredictable global change.[5]

That said, an appropriate pro-saving environment is required to increase voluntary savings by households. Voluntary saving will remain a sizeable part of private savings, notwithstanding the positive impact of compulsory superannuation on private savings over the medium term. In this regard, the introduction of the Retirement Savings Account - a simple, low cost superannuation product - will help to enhance competition and choice in superannuation.

While the National Australia Bank is supportive of any saving initiatives that will boost national savings, those initiatives should satisfy the competitive neutrality test. That is, saving initiatives should not favour certain groups of participants - such as superannuation funds - or instruments. A major problem with the current arrangements is that they limit the extent of competition in a rapidly growing sector of the financial market (superannuation funds). This has also contributed to higher costs and a lack of choice for consumers.

1.1.1(b) Growth and Employment

Growth

At a simple aggregate level, it is not readily apparent that financial deregulation has had a significant impact on growth. For many reasons, GDP growth in the 1980s and 1990s to date has been lower than in the 1950s and 1960s. That outcome, however, was very much a shared experience across OECD economies. Another point not often recognised is that Australian growth in the latter period has been higher than that recorded in the pre-1950 era.

However, it can be argued that financial deregulation complicated economic management during the late 1980s. During this period, financial deregulation combined with inflationary expectations and the favourable tax treatment of debt, leading to a surge in credit and reduced credit standards. Ultimately, shareholders of banks and other financial institutions were the main losers from the financial distress that followed the return to more normal macroeconomic and financial conditions.[6]

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[5] Hilmer, F.G. (1993), "National Competition Policy" - Report by the Independent Committee of Inquiry; August. Productivity Commission (1996), "Stocktake of Progress in Microeconomic Reform", June.
[6] See Macfarlane, I. (1991) "The Lessons for Monetary Policy", Reserve Bank of Australia Conference Paper, for a discussion of the lessons from this episode.

Employment

The substantial deepening of financial markets during the past decade or so has not been accompanied by sustained gains in employment in the finance sector. In the finance sector, employment rose from about 265,00 (or almost 3% of total wage and salary earners) in 1984 to a peak of around 365,000 (or 4½%) in 1990, before falling to below 300,000 (or 3½%) in mid 1995. Within the finance sector, all major sub-sectors - banks, non-bank financial intermediaries, insurance and investment services - have reduced their workforce over the past five years (see chart below).

Put another way, a substantial rise in financial assets relative to employment - a broad indicator of a better performing finance sector - has contributed substantial efficiency gains and indirectly contributed to growth. (The microeconomic effects of a more efficient and competitive finance sector are discussed later in this chapter.)

In contrast to a loss in jobs across all parts of the finance sector since 1990, National Australia Bank has increased its workforce to meet the demands associated with its significant gains in market share. Furthermore by maximising re-deployment opportunities, voluntary severance and effective recruitment policies, there have been less than 500 compulsory redundancies over the past five years.

Chart 1.11
Employment in the Finance Sector

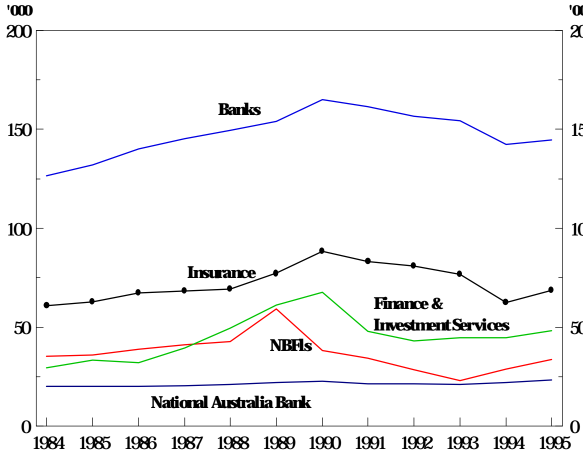
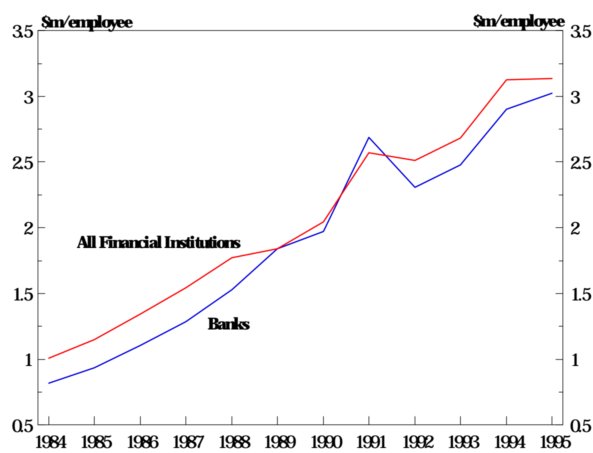


Chart 1.12
Ratio of Assets to Employment



Source: ABS Cat. No. 6248.0, RBA Table D5, National Australia Bank.

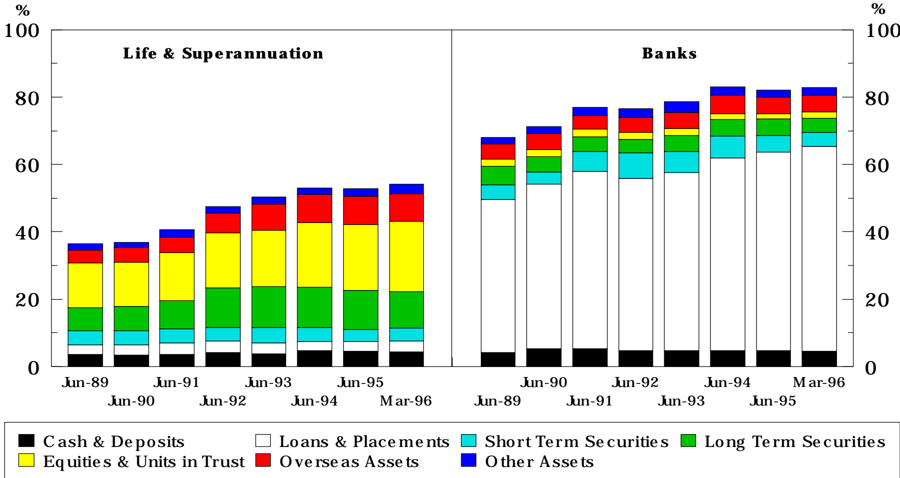
1.1.2 FLOW OF FUNDS

The shift in household savings flows towards managed funds has increased competition for savings between financial institutions. This trend is expected to continue and will have major implications for the allocation of funds within the Australian economy.

To better understand these effects, it is worth considering differences in the asset allocation decisions of the main financial participants. In that context, a comparison of the recent asset allocation of life and superannuation funds and the banking sector is summarised below.

Chart 1.13: Financial Assets

As a per cent of GDP



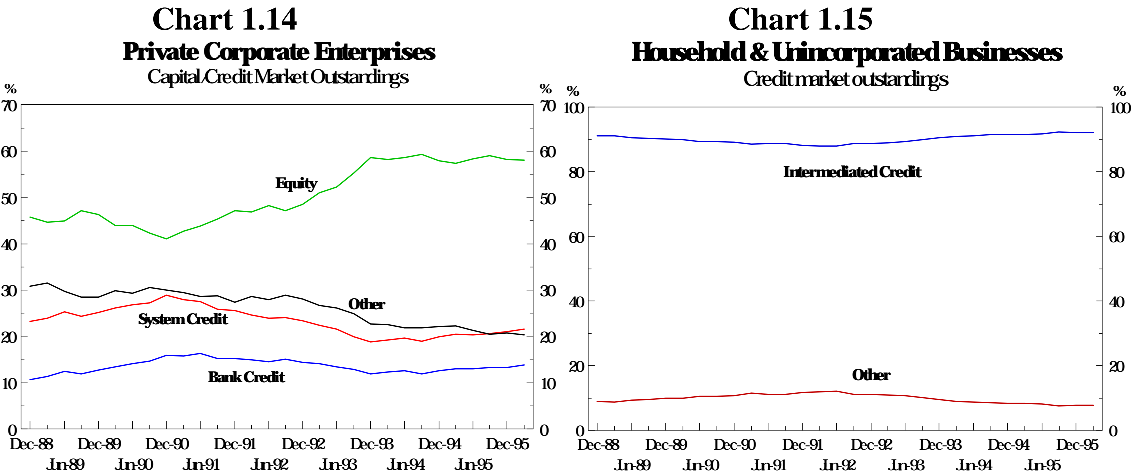
Source: ABS, Financial Accounts, 5232, Tables 6, 8.

Over the past seven years, the main features are:

- total intermediated lending (loans and placements) by life and superannuation funds has been maintained at around only 5% of GDP, but declined from about 9% to 5½% of assets. Over this period, equities and overseas assets have largely absorbed an increasing share of financial assets; and
- in contrast, loans and placements by banks have increased from about 45% to 61% of GDP, taking the share of bank assets accounted for by household and business loans from 69% to 73%.

These changes in the macroeconomic flow of funds are impacting significantly on the household, corporate and small business sectors. Both the household and small business sectors are highly dependent upon intermediated finance. In contrast, the corporate sector has a more diverse funding base, relying more heavily on equity markets, although more recently,

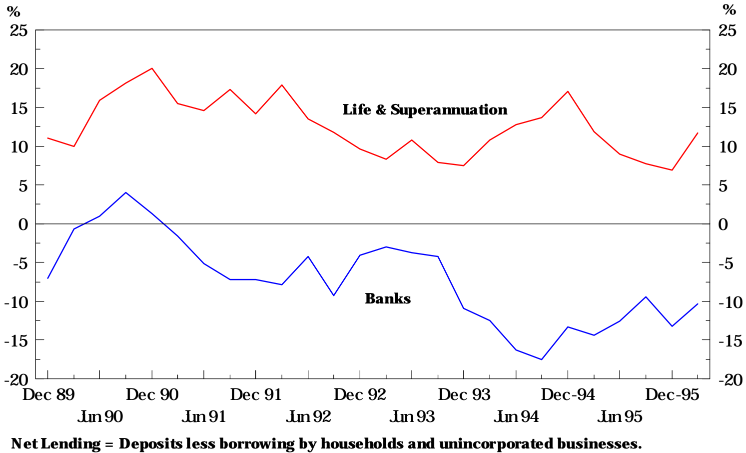
there has been an increase in their demand for credit mainly due to a recovery in investment and some moderation in internal funds (see charts below).



Source: ABS, Financial Accounts, 5232, Table 1.

The heavy reliance on intermediated credit for housing and "small" business loans and the decline in the share of household savings flowing directly to banks has meant that banks have increasingly been net lenders to this sector. The widening of this "funding" gap - measured by the (net) flow of loans less deposits - is evident in the next chart.

Chart 1.16
Household & Unincorporated Businesses: Net Lending to Financial Institutions
4-quarter moving average

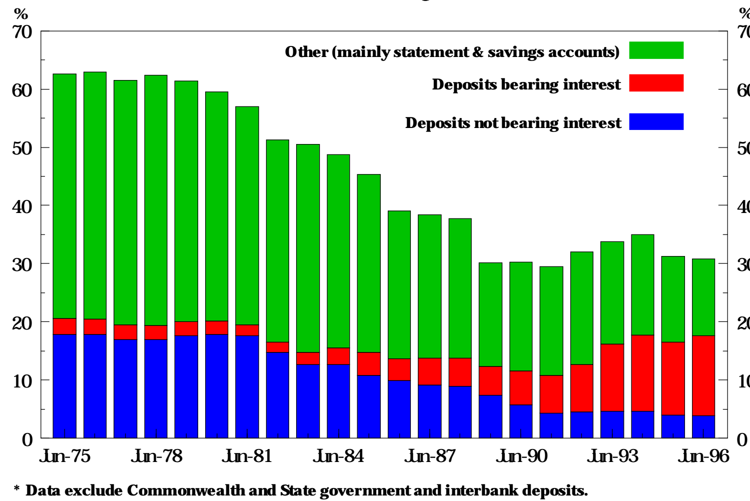


Source: ABS, Financial Accounts, 5232, Tables 19, 21& 25.

Furthermore, the increased competition for household deposits and greater investor sensitivity to rates of return in a relatively low inflationary environment has resulted in a higher cost of "retail" bank deposits (see Chart 1.37 later) and increased reliance on "wholesale" funding by banks (see chart below).

Chart 1.17: "Retail" Bank Deposits

% of $A Liabilities (Excluding Shareholders' Funds)



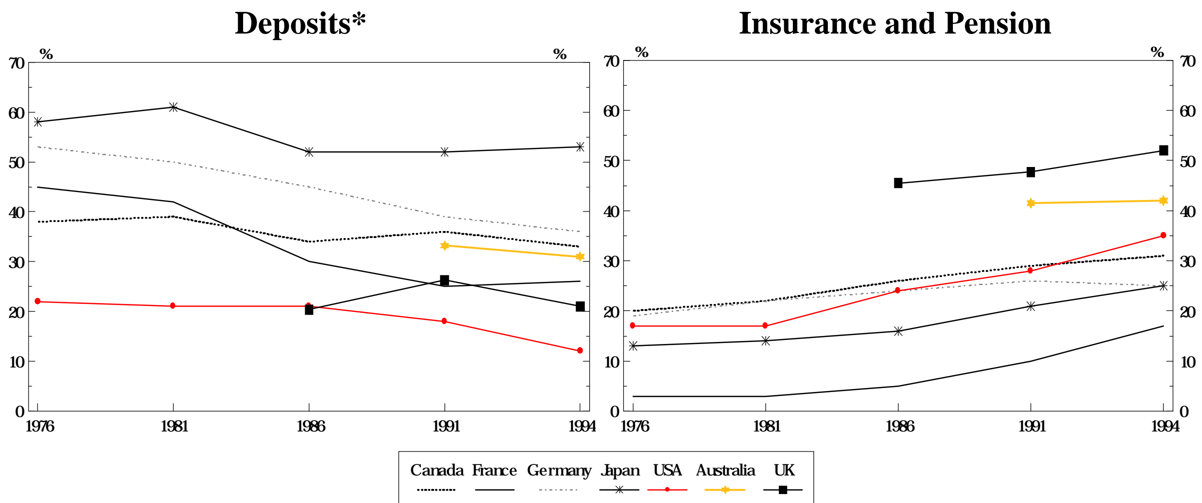
Source: RBA Bulletin, Table B2, various issues.

The increased competition for funds within the financial system implies that some element of the additional cost of funds will be borne by financial intermediaries in the form of lower margins and reduced profits. On the other hand, it is inevitable that part of the higher funding costs will be passed on to borrowers, particularly in areas where superannuation funds are not significant providers of funds (such as, small business and personal lending).

The shift in household savings patterns from financial intermediaries towards the life insurance and superannuation sector is by no means a uniquely Australian phenomenon. In a number of OECD countries, the share of household financial assets held in the form of liquid (bank) deposits has declined, while the share of household savings held in illiquid longer term insurance and investment assets is increasing.

Chart 1.18: Financial Assets of the Household Sector

% of total financial assets



* For Canada, also includes cash.

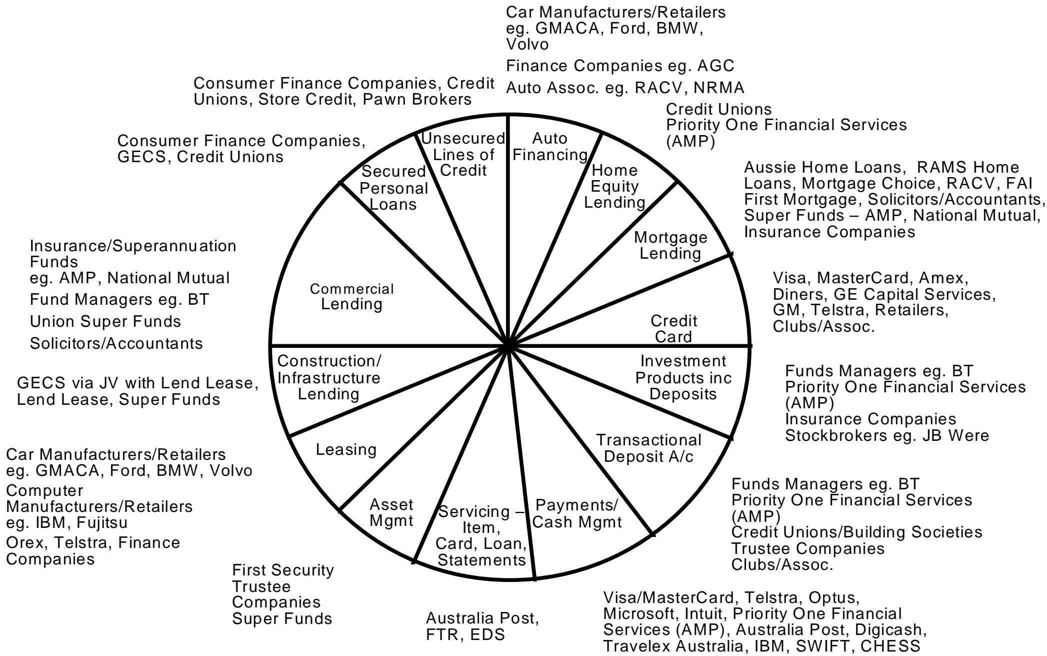
Source: Financial Accounts of OECD Countries, Bank of England Monetary Statistics for UK.

Financial intermediaries have responded by increasing their involvement in the insurance and funds management sectors. More generally, competition has increased among categories of institutions which were formerly not direct competitors. As a result, the traditional demarcation between the different types of financial institutions has become increasingly blurred.

Apart from financial deregulation, technology has helped to increase competition to the extent that non-traditional (niche market) participants have been able to offer services without having to develop a full branch network. For example, mortgage originators - unencumbered by branch network - have achieved a share of the home loan market. The increasing non-bank participation in traditional banking markets in Australia and the United States is evident in the following charts.

Chart 1.19

Non Bank Participation into Australian Banking Market

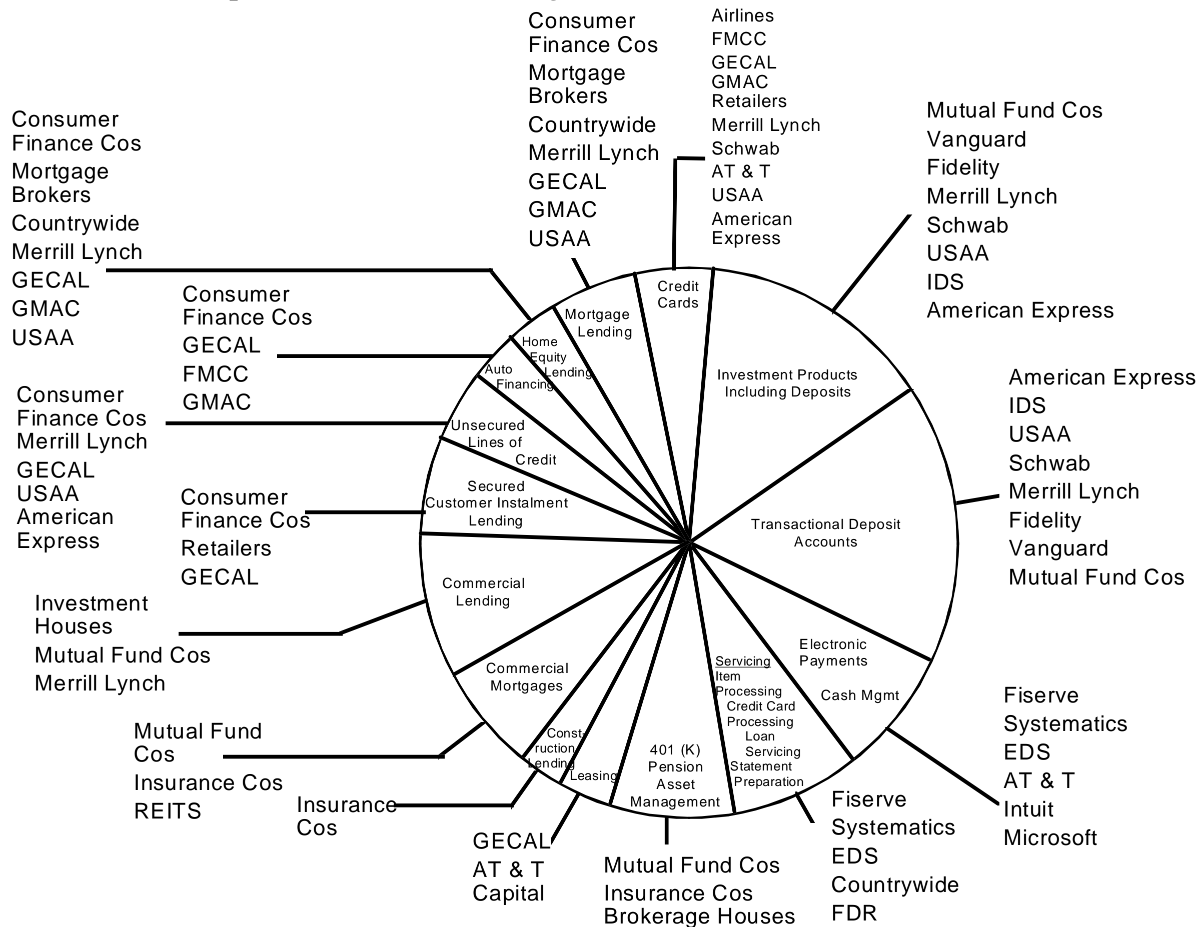


(1) Superannuation/Insurance have not been included in this analysis.

Source: National Australia Bank

Chart 1.20

Non Bank Participation into U.S. Banking Market



Source: National Australia Bank

Financial Conglomerates

A recent OECD study also highlighted that in a number of countries financial conglomerates (combining banking, insurance, superannuation and securities operations) have emerged to offer a full range of financial services. The OECD noted that financial assets can be close substitutes and the need for institutions to be able to provide a diversified product mix to meet the shifting needs of clients.[7]

These trends are also evident in a recent study by McKinsey & Co. of Europe and the US.[8] In the US, banks have been indirectly increasing their involvement in the managed funds sector to supplement a decline in their traditional base. In Europe, "universal" banks have maintained a significant share of managed funds by directly offering stock, bond and mutual funds.

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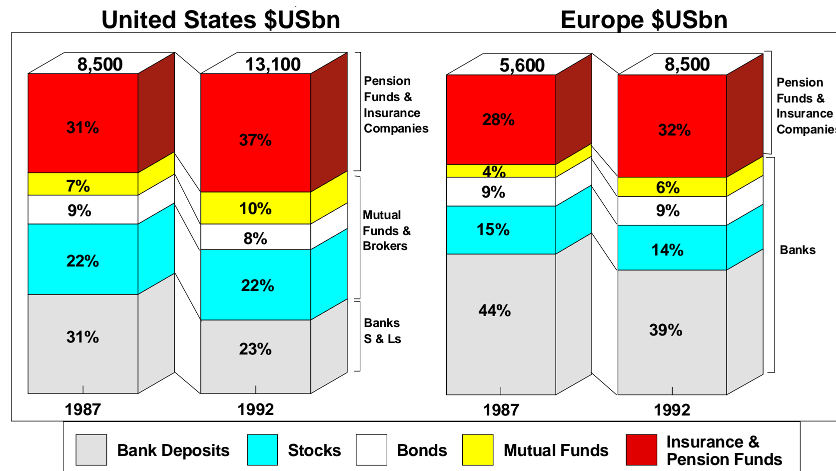
[7] Koguchi K. and Forestieri G. (1993), "Financial Conglomerates", OECD.

[8] McKinsey study published in the Australian Financial Review, 3 May, 1995, p.31.

Chart 1.21: Share of Household Assets

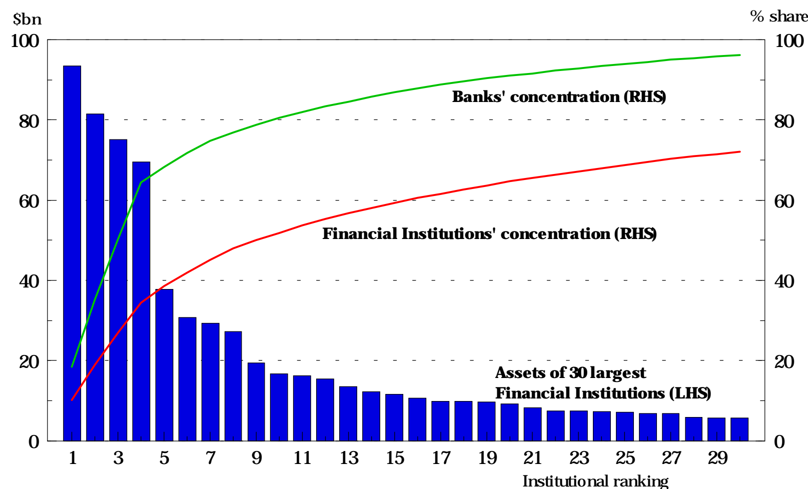


Source: McKinsey Study, Australian Financial Review, 3 May, 1995, p.31.

In Australia, conglomerates are also a major feature of the financial system, with many institutions increasingly expanding their operations beyond "traditional" areas. To illustrate the extent of these developments, the Council of Financial Supervisors estimates that about two-thirds of the total assets of the financial sector are controlled by the 30 largest groups - consisting of 16 banks and 10 insurance companies/other managed funds controlled institutions. The four major banking groups collectively account for more than 40% of Australian financial assets, compared with over 60% of the assets of the banking sector.[9]

Chart 1.22: 30 Largest Australian Financial Institutions

Assets on Australian Books



Source: Council of Financial Supervisors Annual Report 1995 and RBA Bulletin.

While comprehensive statistics on the extent of conglomeration are difficult to obtain, an indication of the extent of these trends can be gauged from the banking groups' increasing involvement in the management of managed funds assets. Unofficial ABS statistics indicate

[9] Council of Financial Supervisors, Annual Report, 1996, p.26.

that of the $292 billion of funds under management in March 1996, 41% were controlled by bank subsidiaries, up from around 28% in 1988.

Banks are now offering unit trusts and superannuation products in subsidiaries (or off-balance sheet) and some life insurance companies have established or acquired bank or building society subsidiaries. The Council of Financial Supervisors has reported that banks have increased their share of life office assets from 1% in 1980 to around 13% in 1995.[10] Unit trusts are also offering a range of products, some of which offer chequing facilities via agency agreements, closely resembling bank products. The diversification of financial institutions activities into "non-core" activities is highlighted in the table below.

Table 1.2

ASSETS OF FINANCIAL CONGLOMERATES BY INDUSTRY TYPE - 1994/95

At date of most recent annual report
(Per cent of assets managed on Australian books)

Group led by:	Financial Intermediaries			Insurers			Friendly	Other	Stock-	Futures	Non-
	Banks	Building societies	Other	Life	General	Health	societies	Managed Funds (a)	brokers	brokers	financial enterprises
Banks											
Advance Bank	>75%		0–5%	0–5%	0–5%			5–25%		0–5%	
ANZ Bank	>75%		5–25%	0–5%				5–25%	0–5%	0–5%	0–5%
Bank of Melbourne	>75%		0–5%								
Bankers Trust Australia	5–25%		0–5%	0–5%				>75%	0–5%	0–5%	
Bank West	>75%		0–5%					0–5%		0–5%	0–5%
Barclays Bank Australia	25–50%		5–25%					50–75%	0–5%	0–5%	
Citibank	>75%		0–5%	5–25%	0–5%			5–25%		0–5%	
Commonwealth Bank	>75%		0–5%	5–25%				5–25%		0–5%	0–5%
Hongkong Bank	50–75%		0–5%					25–50%	0–5%	0–5%	
Macquarie Bank	25–50%		5–25%	5–25%				50–75%	0–5%	0–5%	
Morgan Guaranty	5–25%		0–5%					>75%		0–5%	
National Australia Bank	>75%		0–5%	0–5%				0–5%		0–5%	0–5%
NatWest Markets Australia	5–25%		0–5%					50–75%	0–5%	0–5%	
St George Bank	>75%		5–25%					0–5%		0–5%	
State Bank SA	>75%		0–5%							0–5%	
Westpac Banking Corp	>75%		5–25%		0–5%			5–25%		0–5%	
Other Financial Intermediaries											
NM Rothschild Australia			5–25%					>75%		0–5%	0–5%
SBC Australia			5–25%					>75%	0–5%	0–5%	
Schroders Australia			50–75%					25–50%		0–5%	
Insurance Companies / Other Funds Managers											
AMP				>75%	0–5%			5–25%		0–5%	0–5%
Colonial Group	50–75%		5–25%	5–25%	0–5%		0–5%	5–25%	0–5%	0–5%	0–5%
GIO Australia		0–5%	5–25%	25–50%	25–50%	0–5%	>75%	5–25%		0–5%	0–5%
IOOF Friendly Society		5–25%						5–25%			0–5%
Lend Lease Corporation		0–5%		>75%				5–25%		0–5%	0–5%
Mercantile Mutual			5–25%	50–75%	5–25%			0–5%			
National Mutual			0–5%	50–75%	0–5%	0–5%		5–25%		0–5%	0–5%
NRMA			0–5%	5–25%	50–75%			0–5%			5–25%
Prudential Assurance				>75%				5–25%			0–5%
Suncorp		25–50%	5–25%	25–50%	25–50%			0–5%			0–5%

- More than 75% of assets managed on Australian books
- 50% to 75% of assets managed on Australian books
- 25% to 50% of assets managed on Australian books
- 5% to 25% of assets managed on Australian books
- More than 0%, but less than 5% of assets managed on Australian books
- Not active in this area

Notes:
(a) Includes non-life superannuation.
(b) Colonial Mutual and SBNSW have subsequently merged.

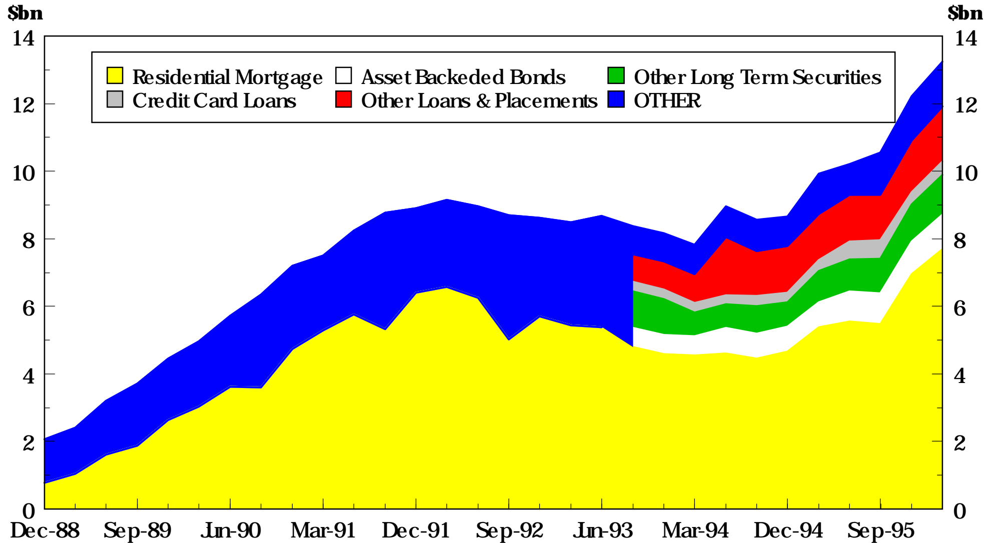
Source: Council of Financial Supervisors, Annual Report, 1995.

[10] Council of Financial Supervisors, Annual Report, 1996, p.14.

Finally, virtually every OECD country has also experienced a surge in securities market-related activities - including bonds, equities and derivatives - and associated advisory services. Many sovereign and corporate borrowers have partially redirected funding strategies towards direct recourse to capital markets from financial intermediaries. Under some supervisory regimes, large industrial groups have established their own financial operations to facilitate direct access to capital markets.

Increasingly, financial assets of households (such as mortgages and credit card receivables) are also being “unbundled” from balance sheets of financial institutions and “commoditised” into markets. By funding themselves in wholesale markets, securitisers face a higher average cost of funds, but have the advantage of lower operating costs. In the case of Australia, the value of mortgage backed securities on issue stood at almost $8bn in mid 1996 or around 4½% of total housing loans outstanding (see chart below).

Chart 1.23
Assets of Australian Securitisers
(Issuers of asset-backed securities)



Source: ABS Flow of Funds (unpublished) data.

1.2 MICROECONOMIC TRENDS

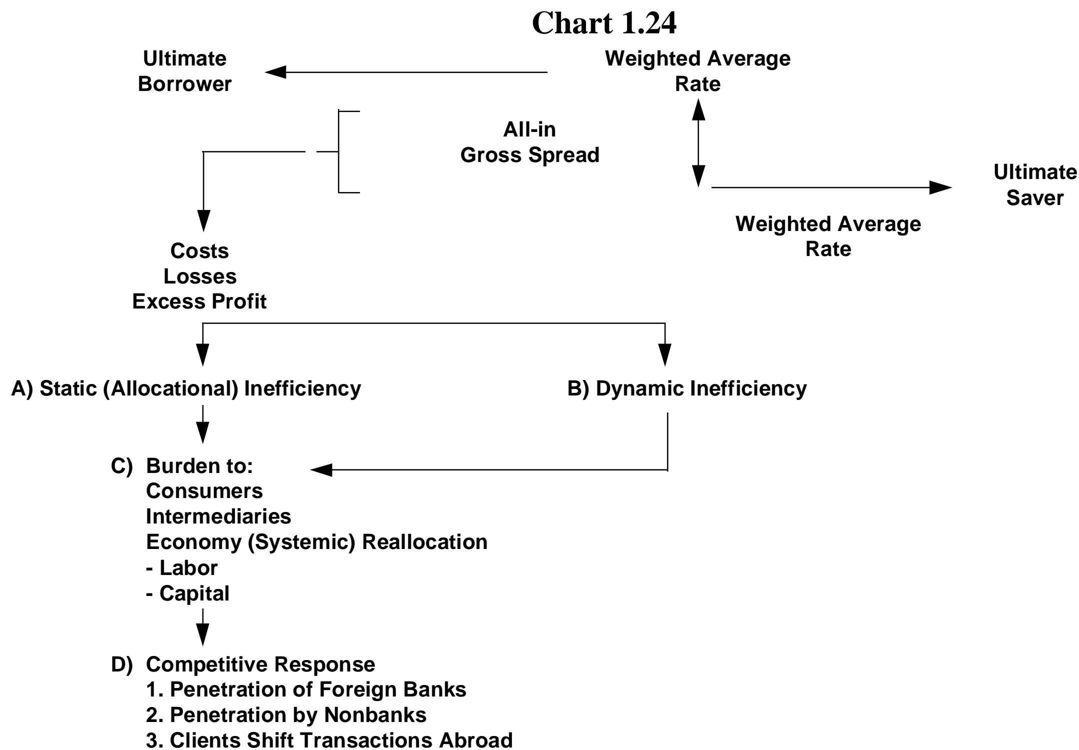
In the previous section, it was argued that deregulation of the financial system has increased competition, not just among banks, but increasingly with other financial institutions and indeed, with markets. These developments - over the past decade - have put pressure on banks to reduce costs, both directly through reduced levels of non-interest bearing deposits and indirectly through changes in saving patterns resulting in increased reliance on wholesale funding. To remain competitive, banks and other financial institutions have increasingly looked to re-engineer processes. In short, financial deregulation has encouraged greater efficiency.

In this regard, measures of both static and dynamic efficiency are used to help judge the microeconomic performance of the financial system.

- **Static efficiency** is depicted in the diagram below as the all-in gross spreads - the weighted average spread between the cost of funds and lending rates. This margin captures the overall cost of providing intermediated services - including operating and administrative costs, the cost of capital, profit/losses earned and liquidity premia. A financial system is generally considered to be inefficient, if these spreads are generally high, due to high overhead costs, losses and barriers to entry.
- **Dynamic efficiency**, on the other hand, promotes the development and introduction of product and process innovation through time. Successful innovation broadens the choice and quality of financial services.

Hence, an efficient financial systems minimises "spread" and, at the same time, produces a constant flow of innovations across the entire risk and return spectrum.

Chart 1.24



Source: Saunders and Walter (1994), "Universal Banking in the United States", p.18.

1.2.1 STATIC EFFICIENCY OF THE FINANCIAL SYSTEM

1.2.1(a) Financial Measures of Efficiency

Given the number of conceptual and data problems, it is perhaps not surprising that any analysis tends to focus more on performance, rather than efficiency measures. (It is worth noting that performance measures for all participants in the financial sector are conspicuous by their absence. Indeed, the available data tends to relate to the banking sector only.)[11]

Underpinning these measures is the view that if deregulation has encouraged competition, then bank profitability, interest rate margins and costs should generally fall (in comparison to the period prior to deregulation). Accordingly, in this section we turn to efficiency measures of the Australian banking sector and, where possible comparisons with offshore banking sectors.

Traditionally, analysis often focuses on "cost to income" ratios - measured in terms of "non-interest" or "operational costs" to total (interest and fee) income. While potentially indicative of efficiency, this measure can be misleading. For example, a low cost income ratio could well be indicative of good efficiency or equally the result of monopolistic rents on the income side. Further, with profitability typically highly cyclical, movements in the cost income ratio could

[11]See Oster and Antioch. (1995) "Measuring Productivity in the Banking Sector", RBA Conference Paper.

say as much about the current state of economic activity as improved efficiency levels - especially international comparisons of cost income ratios.

Nevertheless, a measure of cost income ratios of the Australian banking sector over the past decade and some indication of where Australian banks stood internationally in 1994 are shown in the next charts.

Chart 1.25

Australia - Cost Income Ratio*

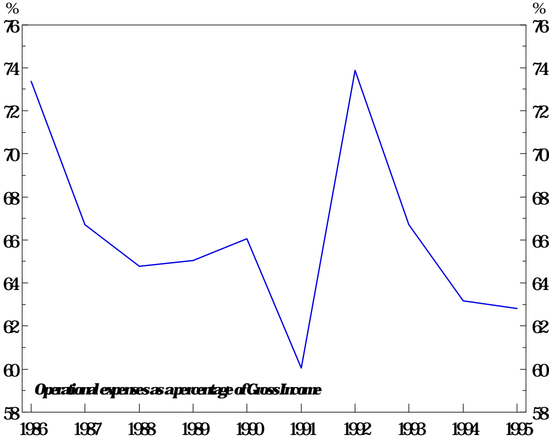
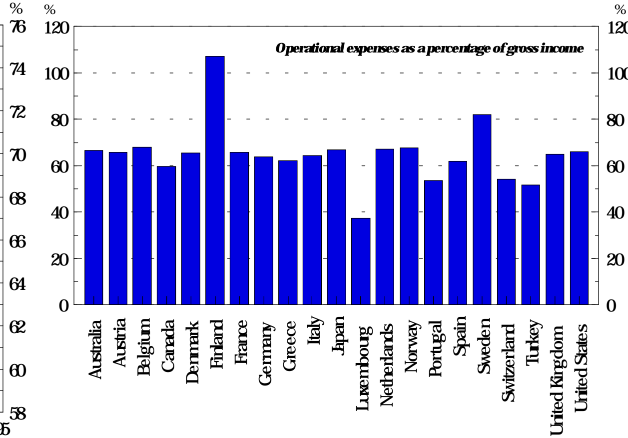


Chart 1.26

Cost Income Ratios for OECD - 1994



* National Australia Bank estimate for 1995.
Source: OECD, “Bank Profitability - Financial Statements of OECD Countries” (1995).

The cost to income ratio for Australia does exhibit a downward trend through the 1980’s - although the impact of the recession in the early 1990s significantly affected income streams and hence the ratio. On average, it also appears that the cost income ratio of Australian banks are towards the top end of the range vis-à-vis OECD economies (over the past decade). In part, it appears that the latter result reflects a relatively high operating cost to assets ratio - although more encouraging, there is a downward trend in this ratio over the past decade (see chart below).

Chart 1.27

Australia - Cost Asset Ratio*

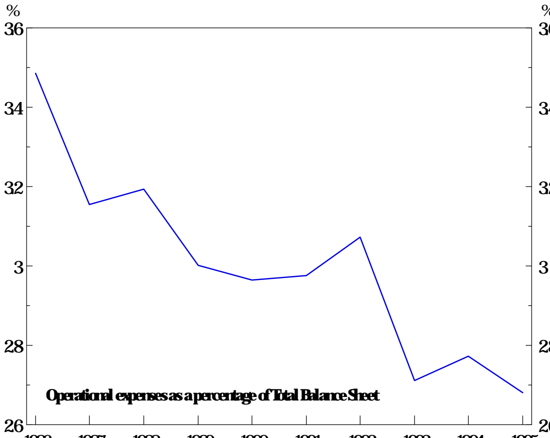
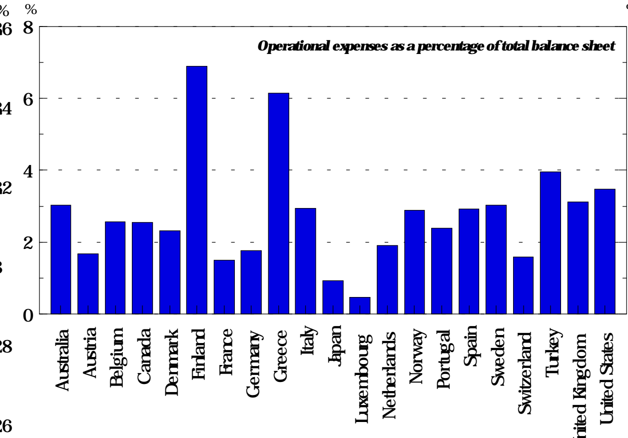


Chart 1.28

Cost Asset Ratios for OECD - 1994

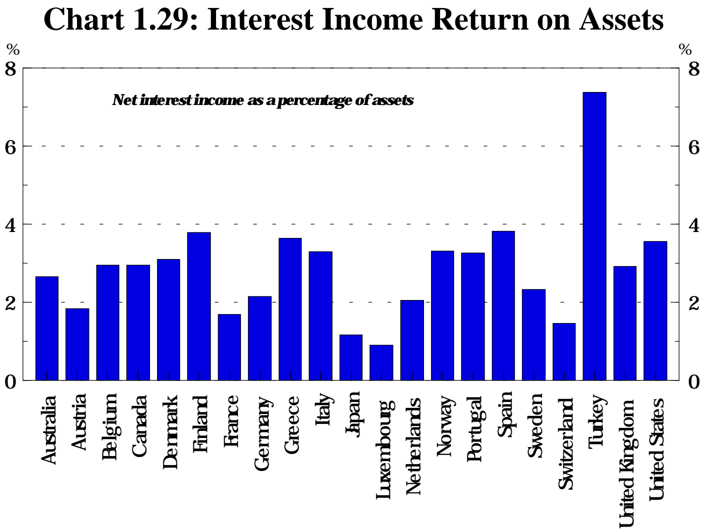


* National Australia Bank estimate for 1995.
Source: OECD, “Bank Profitability - Financial Statements of OECD Countries” (1995).

Of course, as with cost income ratios, cost to asset ratios need to be interpreted with caution. In particular, this ratio can be significantly affected within a financial market by the nature of the financial institution and the mix of its business and across jurisdictions given different taxation and regulatory regimes (e.g. Luxembourg).

One general measure of interest spreads is interest income to total assets (i.e. a ratio which when multiplied by the costs to asset ratio produces the cost income ratio). On this measure, Australian banks (based on international comparisons with OECD economies) tend to be towards the middle of the range.

Chart 1.29: Interest Income Return on Assets



Source: OECD, "Bank Profitability - Financial Statements of OECD Countries" (1995).

Two important qualifiers also need to be noted:

- Australian net interest income tends to be biased up by the treatment of bills (as highlighted by the Reserve Bank submission to the recent Parliamentary Inquiry on Bank Margins[12]); and
- Australian financial institutions typically tend to rely more on interest income and less on fees.

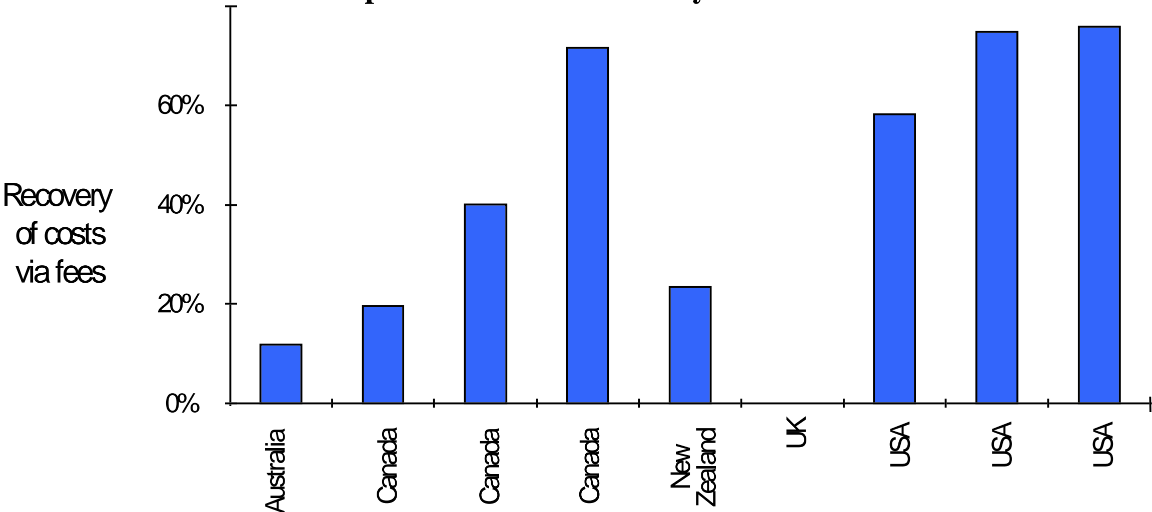
Support for relatively low banking fee structures in Australia can be examined more closely by reference to the cost of providing a given set of consumer transaction services, using fee structures across a number of major countries.

[12] Reserve Bank of Australia (1994), 'International Comparisons of Bank Margins' Submission to the House of Representatives Standing Committee on Banking, Finance, and Public Administration, August..

Some key findings of National's research presented to the recent PSA Inquiry into Fees and Charges on Retail Bank Accounts is summarised in the following couple of charts. Australian banks typically recover much less of the cost of running a transaction banking network through fees than banks in other countries.[13] The only exception is found in the UK, where transaction fees are not charged and, the cost is recovered by much wider interest rate spreads on transaction products.

Chart 1.30

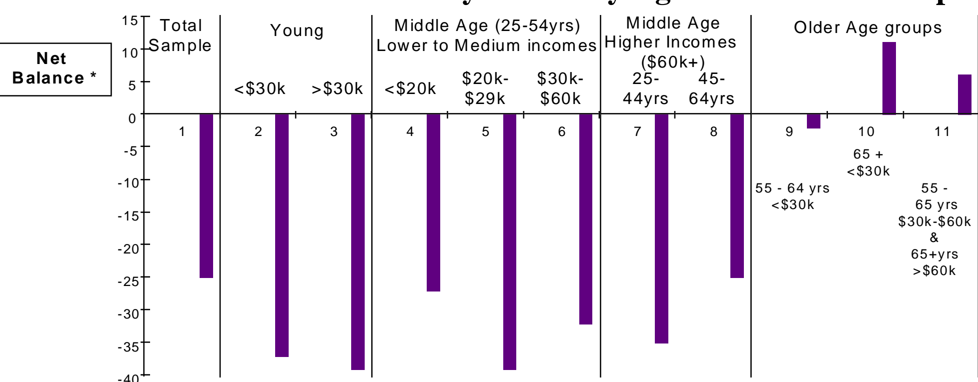
International Comparison of Cost Recovery in Transaction Accounts *



* Canada and the USA have 3 transaction accounts with similar characteristics to Australia's Flexiaccount.
Source: National (1995), "Submission to the PSA Inquiry into Fees and Charges", Appendix U.

A relatively low fee structure in Australia largely reflects consumer preferences - as witnessed by the very adverse responses to bank fees highlighted below.

Chart 1.31: Sensitivity to Fees by Age and Income Grouping*



* Defined by the difference between those disagreeing and agreeing with the statement that "I would shift institution to avoid fees".
Source: National (1995), "Submission to the PSA Inquiry into Fees and Charges", Appendix G.

Although the above analysis is drawn from consumer market research, similar fee aversion is evident in business markets.

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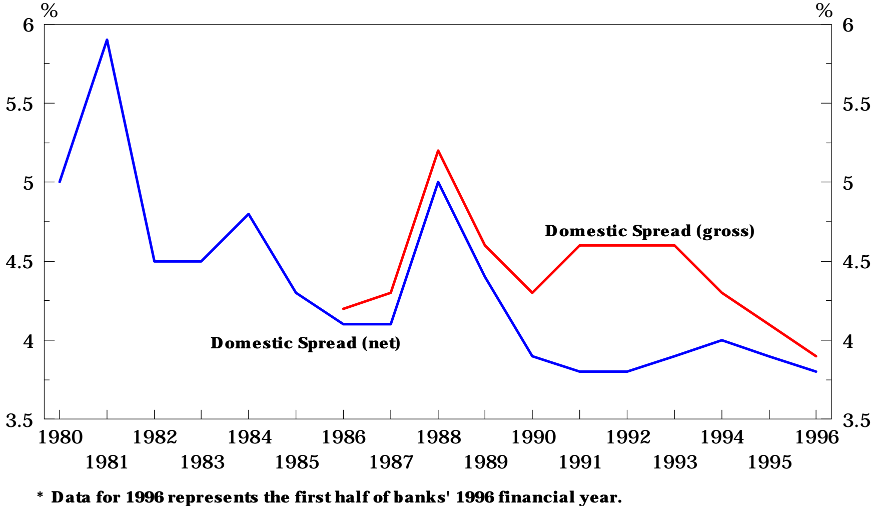
[13] National (1995), Submission to The Prices Surveillance Authority Inquiry into Fees and Charges.

Arguably, the best definition of bank interest spreads at the aggregate level is the average net interest spread; that is, the difference between the average interest rate received on all loans and investments and the average interest rate paid on all deposits and other interest bearing liabilities. In net (including non-accrual loans) terms, spreads are now significantly lower than the average rate of the 1980s. Excluding the impact of non-performing loans, the gross average spread on the performing loans of the major banks stood at 3.9% in the six months to March 1996 - significantly lower than in the early 1990s.[14]

Chart 1.32: Major Banks' Domestic Interest Spreads

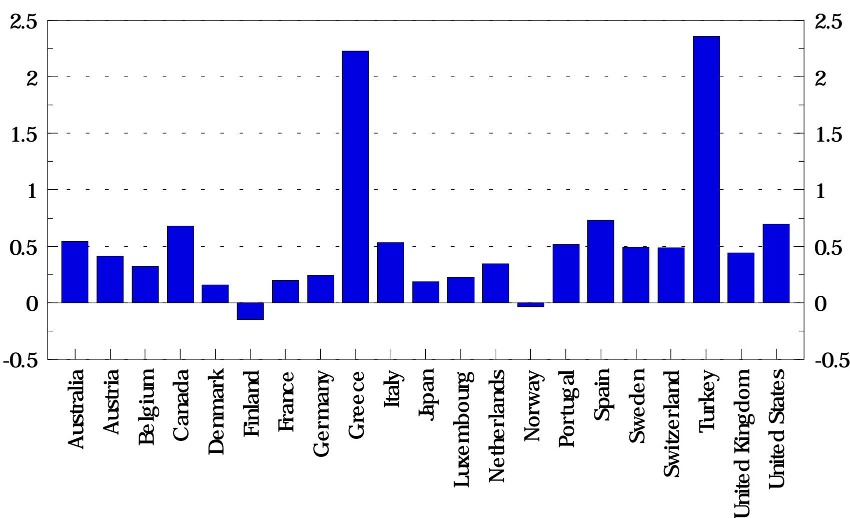


Source: RBA Annual Report 1996.

When fee and interest income are combined and expenses taken into account, Australian bank profitability sits around average levels in terms of international comparisons.

Chart 1.33: Profitability of OECD Banks - 1994

Profit after tax as a percentage of total balance sheet



Source: OECD, "Bank Profitability - Financial Statements of OECD Countries" (1995).

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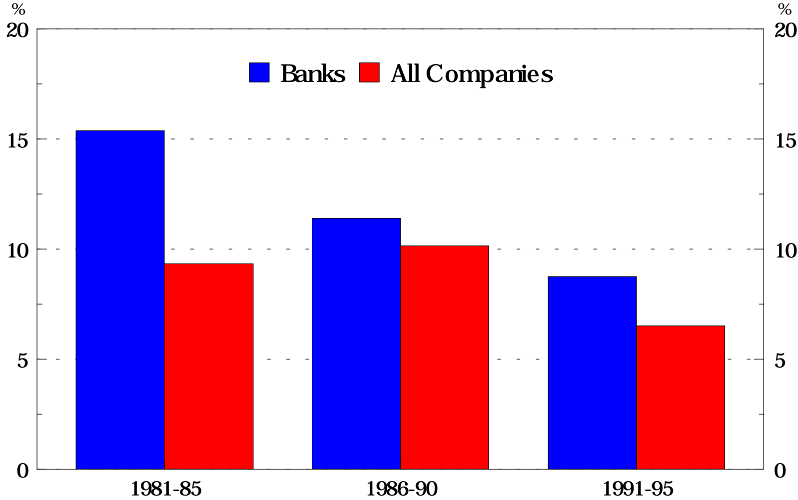
[14] Note that this data does not take into account the impact of the contraction of spreads on housing loans that has flowed from increased competition over recent months.

Perhaps more to the point, bank profitability (as measured by the rate of return on shareholders' funds) has fallen relative to other Australian industries over the past decade or so (see chart below).

Chart 1.34
Return on Shareholders' Funds



Source: STATEX Database (1995).

Assessing the return to shareholders also requires a measure of the riskiness of bank shares. A recent study by Harper and Scheit found that returns earned by major Australian banks were not excessive (relative to the degree of risk) as well as less variable than a diversified portfolio of shares - in part due to Reserve bank supervision.[15]

As noted above, there is a lack of publicly available data to examine static efficiency across major non-bank financial institutions. That said, the average return on shareholders' equity and the ratio of operating expenses to operating income for a range non-bank financial intermediaries as well as banks are shown below.

The main features are the relative stability of bank and non-bank operating costs; and the decline in the profitability of banks, money market corporations and finance companies relative to building societies and credit unions.

[15] Harper and Scheit (1992), "The Effects of Financial Market Deregulation on Bank Risk and Profitability", Australian Economic Papers, December, pp. 260-271.

Chart 1.35

Return on Shareholders' Equity

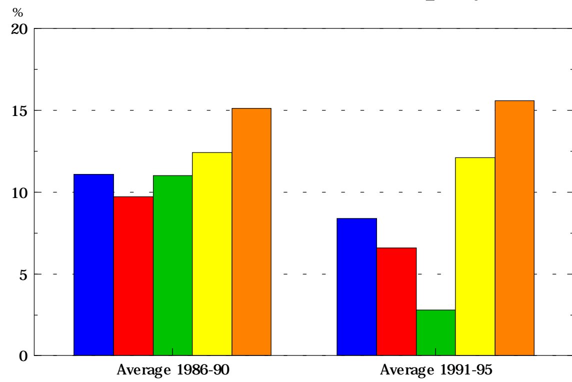
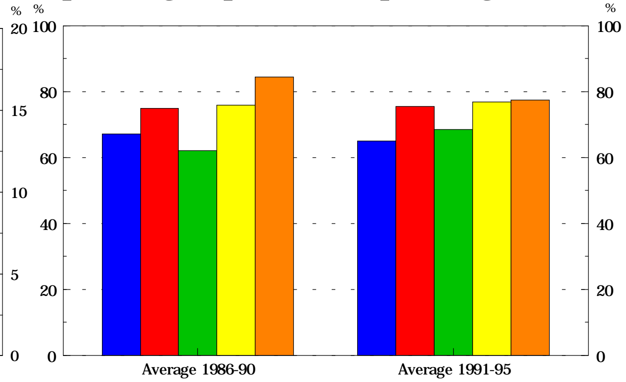


Chart 1.36

Operating Expenses to Operating Income



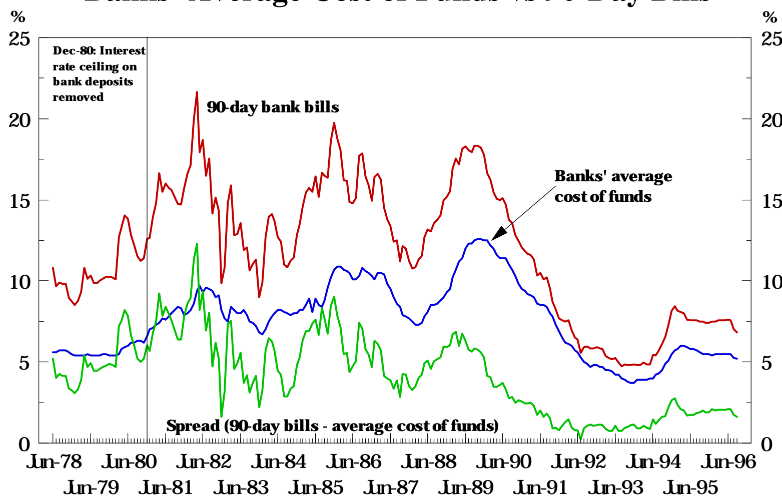
Source: KPMG Financial Institutions Survey (1995), STATEX Database.

Taking a closer look at spreads on particular assets and customer segments is also potentially useful in the assessment of the static efficiency gains.

Prior to deregulation, banks were able to raise the bulk of their deposits at interest rates well below market rates and, as a result, there was a very profitable spread between the average cost of funds and market rates, say the bank bill rate. By the early 1990s, however, the removal of interest rate ceilings, the change in household savings patterns and increased competition amongst financial institutions for a smaller pool of retail deposits has markedly reduced the gap between market rates and the average rate paid on bank deposits (see chart below).

Chart 1.37

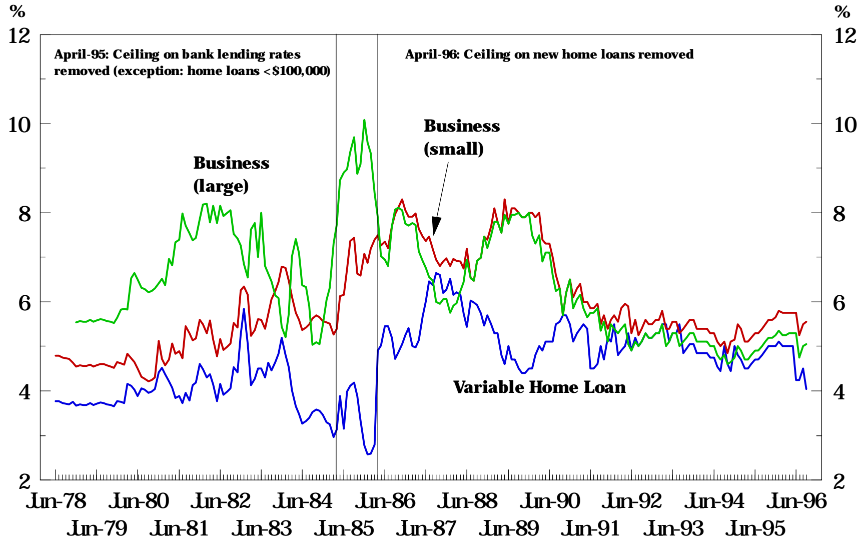
Banks' Average Cost of Funds vs 90-Day Bills



Source: RBA Bulletin Table F4, RBA Bulletin June 1996 "The Evolution of the Housing Loan Market in Australia", June 1996.

At the same time, bank spreads on key variable rate products - including mortgages and overdrafts - have also narrowed with the removal of interest rate ceilings and increased competition from non-deposit-taking institutions. It is also noteworthy that "base" spreads, before any allowance for risk, have narrowed across key variable rate products since the latter part of the 1980s.

Chart 1.38
Key Variable Product Spreads
(Base Variable Rate less Average Cost of Bank Funds)



Source: RBA Bulletin Table F4, RBA Bulletin June 1996 "The Evolution of the Housing Loan Market in Australia", June 1996.

1.2.2 DYNAMIC EFFICIENCY: CHANGES IN CHOICE, QUALITY AND AVAILABILITY OF SERVICES

Although the focus of public debate - over the past decade - has been mainly on price (interest rates and fees) competition, there has also been keen competition at the product and process level (i.e. dynamic efficiency) - involving financial institutions offering wider choices and differentiating their products and services. These developments are a direct response to the more competitive environment; there is greater general awareness that being responsiveness to customers' needs is as important as the need to be price and cost competitive.

1.2.2(a) Product Competition and Innovation

While there are proxy measures - as discussed in the previous section - that can measure the extent of price and cost competition, there is no easy way to measure the overall extent to which product competition has benefited consumers. What is unquestioned, however, is the

significant improvement in the range of choices confronting consumers - both as per financial products and alternative distribution systems.

A chronology of selected product innovations is shown in the table below.

Table 1.3

SUMMARY OF MAJOR PRODUCT INNOVATIONS BY BANKS

Year	Innovation
1980	Automatic Teller machines
1981	Monthly income term deposits
	Card (rather than passbook) savings accounts
1982	Variable repayment home loans
	Visa card for domestic & international use
	Reduced terms & minimum balances for term deposits
	PIN for credit & debit card access
1983	Mastercard
	Compounding term deposits
1984	Automatic sweep facilities
	Daily interest cheque account
1985	EFTPOS
	Mastercard ATM linkage
	ATM network links
	Packaged statement account
	Specialised agri-business & rural budgeting centres
	Telephone Banking
	Cash management accounts
1986	Housing bonds
	Equity mortgage loans
1987	Life insurance
	Fixed-rate mortgage lending
	Home banking
1988	Bankcard debit/credit card
	Enhanced retirement services
1989	Payroll system
	Business credit cards
1990	Mortgage Offset account
1993	Credit cards with pricing/features tailored to consumer needs
	(Following the deregulation of the consumer credit card market)
	Financial EDI (Electronic Data Interchange)
1994	Expanded purpose housing loans & redraw facilities on home loans
1995	Smart card trials
	Securitised home loans
	'No frills' home loans
	Cash flow lending to SMEs
	Equity participation in SMEs
	Export finance packages
	World wide ATM access (via Maestro & Cirrus)
1996	Internet banking
	Mobile EFTPOS (in taxis)

Sources: Australian Bankers' Association

Apart from the impact of financial deregulation, technology is helping to integrate and deliver new product and services to an increasingly segmented customer base. Greater customer segmentation has allowed banks to better tailor their products and services and has also increased the scope for cross selling of related products. There has been an increasing emphasis by banks to provide customers with a full range of financial services.

The need to maximise customer satisfaction and develop customer relationships has seen increased competition on both sides of the balance sheet - asset and liability products. The market for savings - as highlighted in previous sections of this chapter - is extremely competitive and increasingly product features are playing an important role (witnessed by the rapid proliferation of EFTPOS, ATM, phone-banking and fee charges). The emphasis on product differentiation has translated into a range of fee structures - for example, account keeping, ATM usage and over the counter transactions - designed to reduce cross-subsidisation and promote greater diversity and choice in the design of accounts.

Although the standard variable-rate home loan is broadly similar across lending institutions, there has been a significant increase in product features and services - such as mobile lenders, seven days-a-week home loan centres, in-principle approvals as well as a range of new products, such as a wider range of fixed rate loans, heavily discounted "honeymoon" loans and "basic no-frills" loans. This widening range of loans is encouraging borrowers to shop around and switch lenders. Over 25 percent of new loans for established dwellings during the first half of 1996 were for refinancing, compared with less than 10% in mid 1991.

In the credit card area, competition has seen more selected targeting of customers with the introduction of "gold" and "affinity" cards, for examples. In addition, technological innovation has also made available the use of credit cards for transactions purposes and bill paying.

Consumers to be able to choose need to be aware of the choices before them, the financial impact of those choices and to be willing and able to change their habits. Indeed, some consumers and/or their advocates argue that too much choice and a loss of standardised products is confusing. An important counter is that each bank has incentives to make its product well understood and acceptable. More generally, consumer advocates and financial advisers also often provide their comparisons and recommendations on more complex financial services.

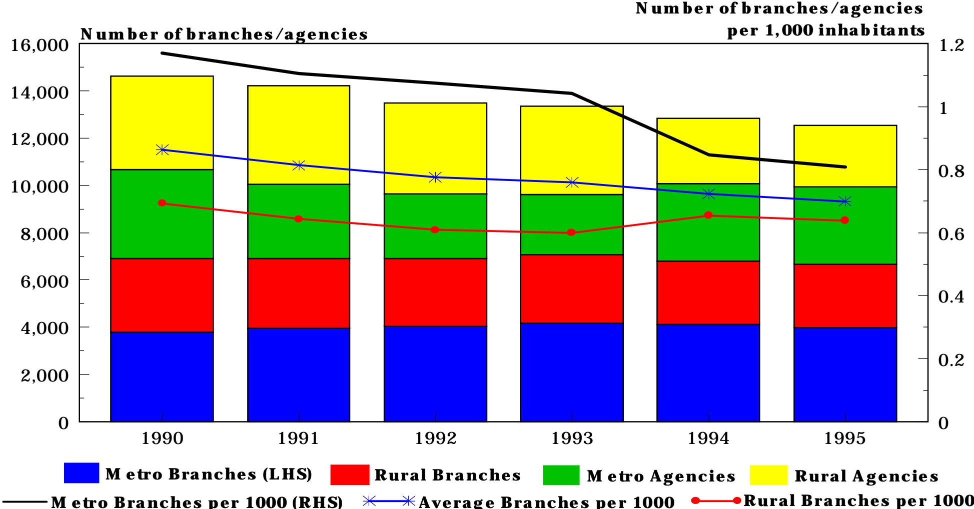
1.2.2(b) Access and Delivery

While consumers as a whole have gained from the greater choice and diversity associated with deregulation, some customers have lost due to the cessation of cross subsidies and gains to the former "taxpayers". Amongst others, these include small businesses and rural investors that no longer have access to finance at controlled rates. In addition, isolated communities have also been forced to face more of the economic cost of their isolation as banks consolidate rural branches.[16]

Nevertheless, bank representation in rural communities remains quite extensive today and, relatively favourable, in per capita terms compared with metropolitan areas (see chart below).

Chart 1.39

Branch and Agency Numbers - All Australian Banks



Source: RBA Bulletin Tables B21 & B22, ABS Demographic Statistics.

Looking forward, electronic delivery (including home banking via the phone and/or the Internet) and a new generation of more advanced ATM's will do much to solve any remaining access problems. (National's forecasts of future trends in alternative delivery platforms for consumer and business markets are discussed in Chapter 2.)

Phone banking provides a wide range of services to both metropolitan and remote regions. At National Australia Bank, FlexiPhone - an interactive voice response system - provides general information about the bank and its products, transaction services (such as account balances,

[16] See Harper (1991), "Competition: Choice and Diversity, Gainers and Losers", Reserve Bank Of Australia Conference Paper, for a more detailed discussion.

credit card payments, funds transfers, bill payment) and other services (such as ordering statements, reporting lost cards and stop payments). National's Telephone Centres also provide customers the ability to obtain housing and other personal loans as well as deposit products over the phone.

It should also be noted that charges for phone banking are generally at or below the cost of using an ATM, over the counter services or cheques, without the time and effort of visiting a branch or an ATM.

Table 1.4
National's Flexiaccount - Comparison of Costs of Various Access Methods

	Phone Banking	ATM	Over the Counter	Cheque	EFTPOS
Cash Withdrawals [1]	N/A	$0.25 [3]	$1.00	$1.00	Nil
Funds transfers between accounts	Call cost [2]	$0.25 [3]	$1.00	N/A	N/A
Bill payments	Call cost[2] + $0.30	N/A	N/A	$1.00 (+ postage $0.45)	$0.25
Account balance	Call cost [2]	Nil [3]	Nil	N/A	N/A

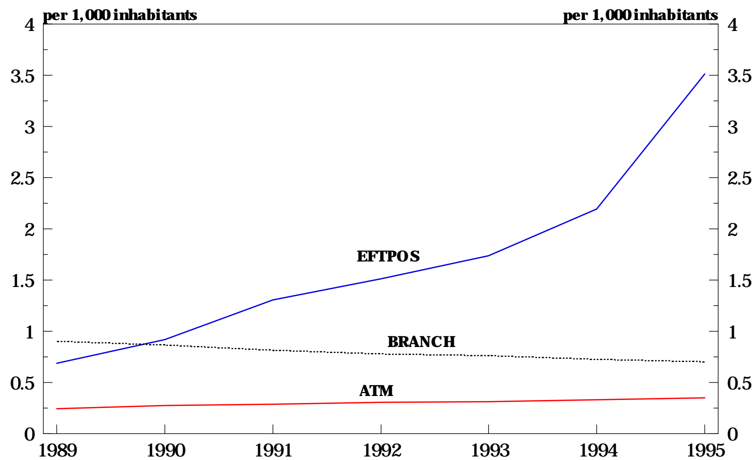
1. First eight withdrawals per month are free, with a maximum of four via cheque/over the counter.
2. The cost of a local call, excludes mobile phone charges.
3. All non-National ATM withdrawals and balance enquiries incur a fee of $0.75 (no free transactions).

Source: National Australia Bank

To sum up, the expansion of electronic networks constitutes a major change in the delivery of the most often demanded transactional services, such as cash withdrawals, balance transfers, account deposits and bill payment. To date, customer benefits include:

- an increase in the number of points of service;
- 24 hour access to financial services;
- lower transaction costs - the opportunity cost of time, vis-à-vis a branch visit; and
- higher interest earnings. Increased use of ATM and EFTPOS enables customers to reduce their holdings of cash balances, transferring surplus funds into savings deposits or other assets earning higher yields.

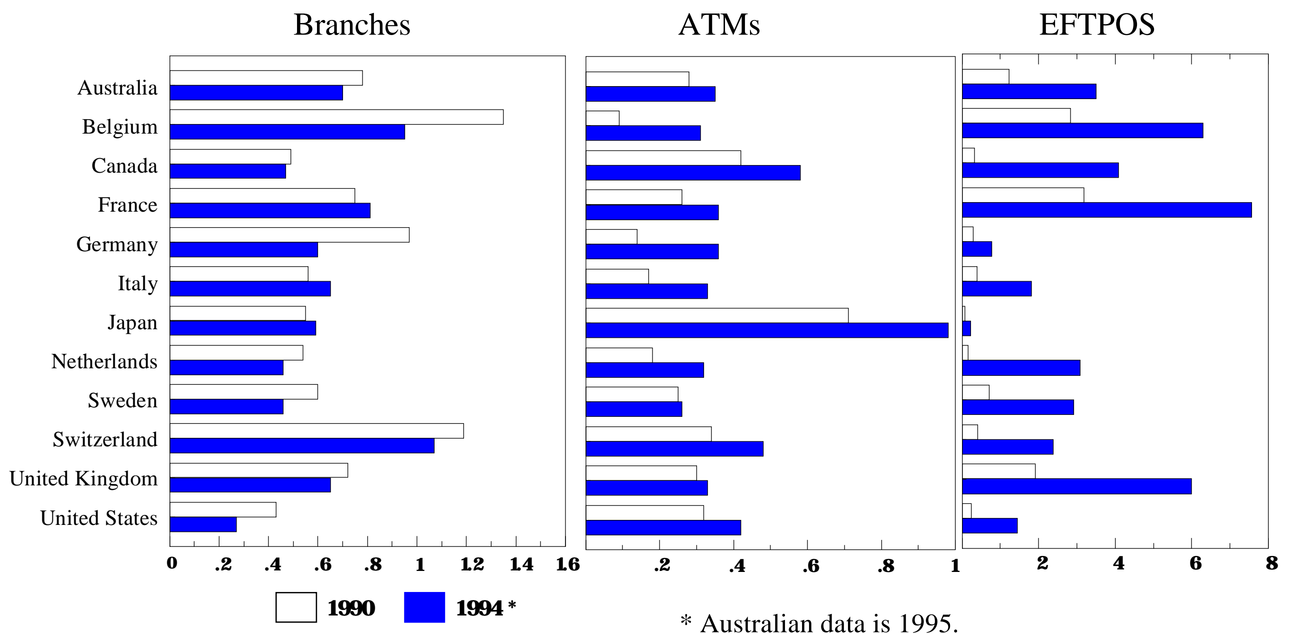
Chart 1.40
Distribution Channels - Australia



Source: Australian Payments System Council Annual Reports, Reserve Bank of Australia Bulletin.

These developments are broadly consistent with those abroad, particularly the consolidation of branch banking in favour of electronic delivery channels, especially in Belgium, Germany, the US and UK. That said, Australia still remains at the relatively high end of the scale of "branches" (per capita).

Chart 1.41
Distribution Channels - OECD
per 1,000 Inhabitants



Source: "Payment Systems in the Group of Ten Countries", Bank for International Settlements (1995).

Consumer Satisfaction

The performance of banks can also be gleaned from surveys of consumer satisfaction. A recent survey of both small metropolitan and rural business reported by the Reserve Bank of Australia suggests that the majority of small business are broadly satisfied with their bank relationship.[17]

Table 1.5

Satisfaction with Banks : Proportion of businesses satisfied

Metropolitan Businesses	%	Rural Businesses	%
Honesty and trustworthiness	78	Helpful branch staff	88
Branch service	76	Access to manager	86
Account management	73	Good relationships	82
Support of the company	67	Phone account access	82
Competency and efficiency	66	Efficiency	80
Believing what banks say	64	Good rural knowledge	76
Responsiveness and flexibility	61	Understand business	76
Acting in the company's interest	57	Flexible	76
Innovation	46	Sees problems	76
		Product range	72
		Financial reports	72
		Problem solving	72
		Advice	72
		Interest rates	70
		Farm visits	64
		Fees & charges	62

Source: RBA Bulletin, April 1994.

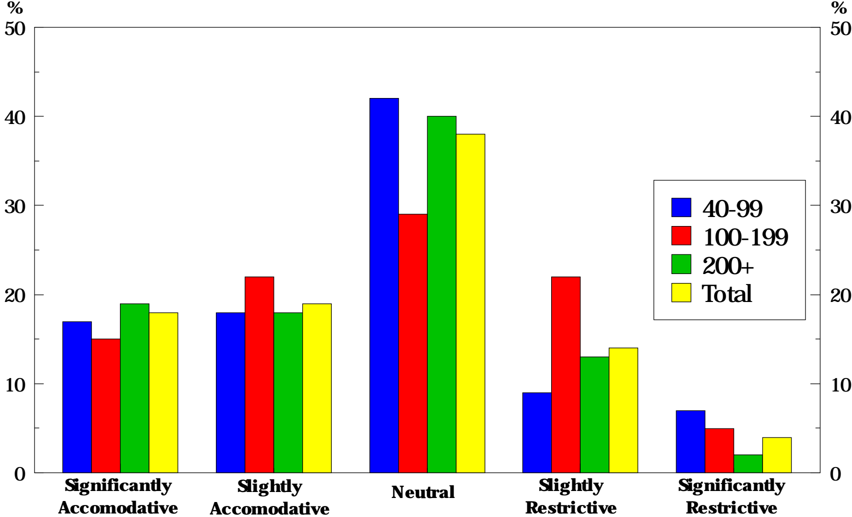
The Reserve Bank of Australia concluded its investigation of matters affecting small business by commenting that there is scope for improving relationships, but, at the same time, things that are essentially irritants to many small business stemming from poor relationships (aggravated by the recent recession) should not be mistaken for major problems in the availability or cost of bank finance for the bulk of small business.

In an attempt to monitor this latter issue, respondents to the National's Quarterly Survey of the non-farm business sector are asked to assess the availability/cost of finance (both debt and equity). In the latest survey, 75% of respondents assessed the availability and cost of finance to be either accommodative or neutral in the June quarter 1996 - much the same as the outcome of the survey in the June quarter 1993. 14% considered that the availability/cost of finance was slightly restricting their operation and only 4% rated it a significant restraint. Of the latter,

[17] Reserve Bank of Australia Bulletin (1994), "Bank Lending to Small Business", April, p.35.

respondents report more difficult conditions as firm size declines, although only 7% of small business assess the cost/availability of finance as a significant restraint on their business (see chart below).

Chart 1.42
Assessment of Cost/ Availability of Finance - June 1996



Source: National Australia Bank, Quarterly Business Survey, June 1996.

Another survey of small business conducted by Marsden Jacob Associates Pty for Yellow Pages found similar results. With almost four out of five small businesses conducting their financial relationship with the major four banks, 78% of small businesses were reportedly satisfied with the service they receive from their main bank in September 1995 - unchanged from the corresponding response in September 1993. This survey also found evidence supportive of successful differentiation, with the gap between the “best” and “worst” banks widening by 5% to 12% over the previous two years. Finally, 14% of business switched financial institutions during the past year.

1.3 CONCLUSIONS

Financial deregulation combined with technology, globalisation and consumer preferences have lead to significant advances in the performance of the Australian financial system since the Campbell Report. This includes:

- heightened competition, albeit somewhat slower than anticipated, amongst a range of institutions with the emergence of niche participants and full service providers, as well as market based instruments;

- increased innovation and a greater choice and quality of financial products and services; and

- the development of greater consumer awareness of alternative sources of financing and investment opportunities in the economy at home and abroad.

Notwithstanding this, there remains a (false) perception in some sectors that deregulation of the financial system has mainly benefited producers of financial services - and in particular, banks - and not the general community.

In this regard, these concerns led to a recent report by the House of Representative Standing Committee on Banking, Finance and Public Administration. A major objective of the Committee was to assess these concerns and to determine whether financial deregulation has resulted in increased competition and to what extent competition has benefited consumers. The findings of the Martin Report were summarised as:[18]

> "The Committee's assessment is that much of what was envisaged of deregulation has occurred. The efficiency of banks has increased and they have taken market share from other financial intermediaries that had benefited from regulation. Finance has become more widely available, though customers have had to pay a market price for it, including a component to reflect risk. Product range has increased and banks have increased their responsiveness to customers".

The National's view is that this quotation remains relevant and accurate today.

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[18] House of Representatives Standing Committee on Finance and Public Administration, 1991, "A Pocket Full of Change: Banking and Deregulation", AGPS, p. 457.