CHAPTER 5: DEFINITION OF THE MARKET & COMPETITION POLICY

5.0 INTRODUCTION

It is an integral part of the National's submission that the combination of financial deregulation, technology and globalisation has already set in train fundamental change in the market for financial services. There is evidence of: a structural change in the flow of funds (including savings) within the economy; the emergence of new providers of financial services; alternative technology driven distribution systems for financial services; greater use of market- based financial solutions; a blurring of the positioning and offerings of traditional financial institutions; and greater integration with world financial systems.

A fundamental tenet of our submission is that, in recognising these changes, the regulatory environment needs to exhibit a greater level of flexibility in order to promote increased competition. By doing this, Australian institutions - both financial and non-financial - will be better placed, not only to face new competition in the domestic market, but also to export their services into world markets.

Competitive forces are already having important influences by way of adding new elements of "contestability" to all areas of the financial services industry, and creating the need to look for new definitions of what constitutes **"the market"** (and associated sub-markets, such as "banking") from a public policy perspective. Thus, the Industry Commission recently noted:

> "While banks clearly retain a high profile in the community, it is also true that technological change has transformed the financial sector and heightened the substitution possibilities within it and across regional boundaries. As the Deputy Governor of the Reserve Bank of Australia 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 existing 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 (Thompson 1996, p 6).

The Commission considers that such changes justify a reassessment by the ACCC of the markets in which banks now operate."[1]

The National welcomes the flexibility that has already been displayed by the ACCC in its recently released Merger Guidelines. However, it believes that additional flexibility is required. Some of these issues are discussed in this chapter and Appendix 4.

5.1 BOOSTING THE COMPETITIVE PROCESS

Looking to the future, as set out in Chapter 2, we can expect to see continued change due to the impact of technology and globalisation. In particular, entry and exit costs will continue to fall, processing costs will reduce and the variety of choices for consumers will increase, as will the process of "unbundling". These trends, in conjunction with the changes advocated by the National in Chapter 4, will provide a new competitive paradigm - with any financial institution able to compete in any sector of the industry (or alternatively, be a full service provider) provided some common standards are adhered to by the relevant participants. In these circumstances, previous interpretations of what constitutes a "market" will no longer be appropriate. Whilst changes to the Act may be unnecessary, the Wallis Committee should give serious consideration to the issue of market definition.

If Australia is to fully tap the potential efficiency and innovation gains, it is critical that the regulatory regime that is in place to oversee this process over the next ten years recognise the changing dynamics of the market. More than most areas of public policy, this has particular force for the administration of "competition policy".

Before moving into these issues in more detail, it is important to understand what is involved in these concepts. As the Hilmer Report[2] noted:

[1]Industry Commission Draft Report "Implications for Australia of Firms Locating Offshore", May 1996, p. 243. These sentiments were repeated in the Industry Commission Information Paper on Merger Regulation, June 1996.

> "[C]ompetition policy is not about the pursuit of competition for its own sake. Rather it seeks to *facilitate effective competition in the interests of economic efficiency* while accommodating situations where competition does not achieve economic efficiency or conflicts with other social objectives." (Our emphasis)

Competition is not defined in the Trade Practices Act. It has, however, been "defined" by the Trade Practices Tribunal (now replaced by the Australian Competition Tribunal) which reviews the decisions of the ACCC and previously the Trade Practices Commission.

In a leading decision of the Tribunal dealing with mergers, Re QCMA Limited ((1975) 1 ATPR 40-012) the Tribunal made this observations about competition (amongst others):

> "Competition is a process rather than a situation" (at 40,925).

This description has been accepted in later decisions and in court cases. A leading commentator on the operation of the Trade Practices Act, Dr Maureen Brunt (who is a member of the Tribunal) has also described competition as a process[3] - it is not necessarily something to be measured by the number of participants in a particular industry. Indeed, the contention that the degree of competition can be inferred from structural measures of concentration (for example, concentration ratios or the Herfindahl index) relies heavily on the hypothesis that an increase in market concentration will increase the collusive opportunities between firms and the consequent abuse of that market power will generate higher prices and profits and/or be used to hide or protect inefficient practices (the so-called "Structure - Conduct - Performance" (SCP) relationship). That hypothesis can, however, be challenged both at the theoretical and empirical level.

At the theoretical level, the theory of contestable markets[4] significantly questions this hypothesis and implies, in the extreme, "that even monopoly can produce a socially optimal

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[2]Hilmer Report (1993), Chapter 1, part 5, p.6.
[3]See Brunt, M. (1990) "Market Definition Issues in Australia and New Zealand Trade Practices Litigation", *Australian Business Law Review*.
[4]See Baumol, W., Panzar, J. And Willig, R. (1982) Contestable Markets and the Theory of Industry Structure, HBJ New York.

result if its behaviour is constrained by effective potential competition."[5] In that context it is worth re-emphasising the point that the forces outlined in Chapters 1, 2 and 4 of this submission are all about generating more "contestable" markets.

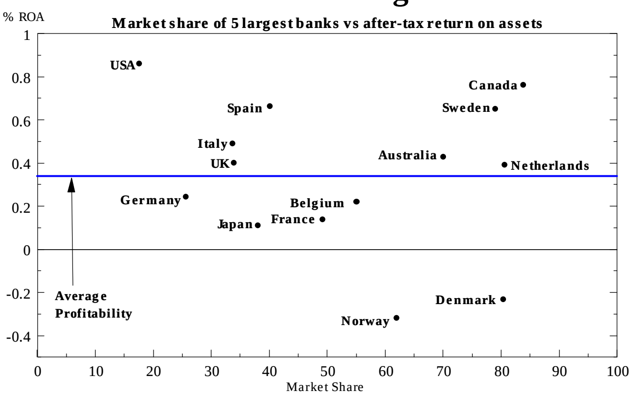
At the empirical level, for the banking industry at least[6], there is little evidence of a correlation between market concentration, excess profitability and/or inefficiency.

Figures 5.1 and 5.2 give five and ten year perspectives on the relationship between concentration (measured by the proportion of banking sector assets accounted for by the five largest banks in selected OECD economies) and the rate of return on assets achieved by the banking sector of those countries. These charts show no sign of any systematic correlation between levels of concentration and profitability.

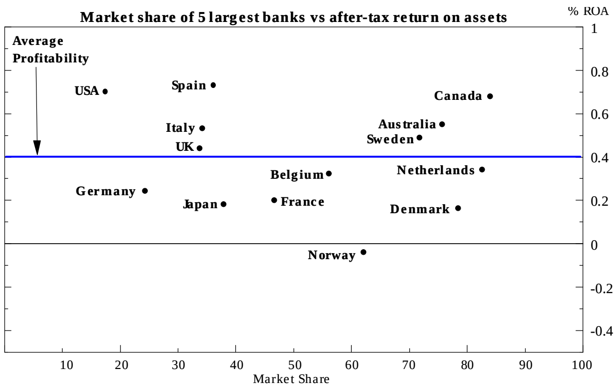
Figure 5.1 **Figure 5.2**

Concentration v Profitability

1990-94 Average



1985-94 Average



Source: OECD Bank Profitability - Financial Statements of OECD Countries (1995), Financial Accounts of OECD Countries (1995), Bankers' Almanac World Ranking (1995), BIS Annual Report 1996.

In the face of this evidence, some have argued that a lack of correlation between profitability and concentration could be marked by "slothful" behaviour or inefficiencies of larger banks. There is, however, little sign of such a correlation. Figures 5.3 and 5.4 contrast the same measures of concentration, against the non-interest cost to asset ratio (a proxy for efficiency in the banking industry) of the same OECD economies (again providing both a five and ten year

[5]See Vesala, J. (1995) "Banking Industry Performance in Europe: Trends and Issues", in The New Financial Landscape, OECD, p. 114.

[6]While the National will argue that in the future an appropriate view of the market will include the entire financial sector, past studies have tended to focus separately on banking, insurance and other financial sub-sectors (see below).

perspective). These figures also show little empirical evidence of increasing non-interest costs to assets ratio with concentration. One interesting finding in the above charts is the tendency it highlights for better efficiency results to be reported in countries where universal banks and/or conglomerates are operating. This result is strongly supportive of the type of changes advocated by the National in the previous chapter.

Figure 5.3

Concentration v Cost-Asset Ratio

1990-94 Average

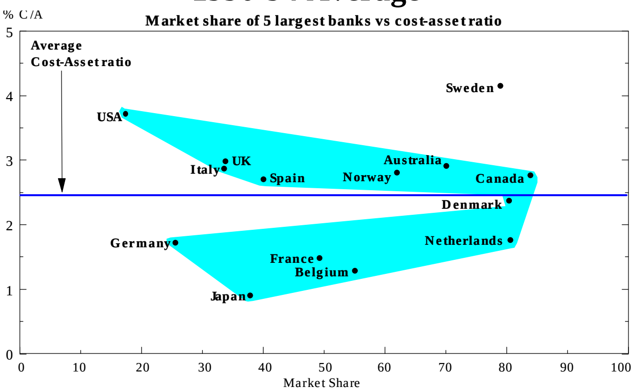
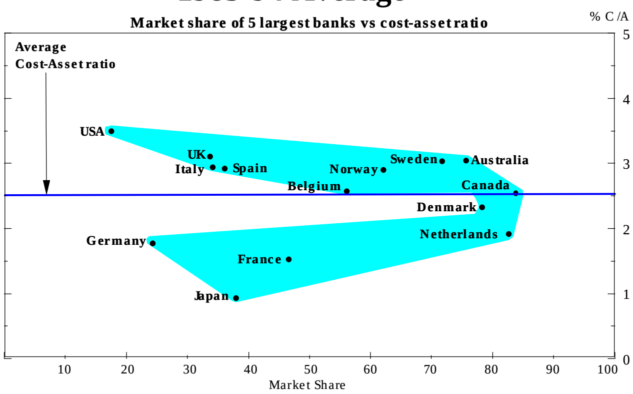


Figure 5.4

1985-94 Average



Source: OECD Bank Profitability - Financial Statements of OECD Countries (1995), Financial Accounts of OECD Countries (1995), Bankers' Almanac World Ranking (1995), BIS Annual Report 1996.

The above findings are also strongly supported by more detailed econometric testing, world-wide, of the 'structure - conduct - performance' (SCP) relationship in banking. Thus in 1995, in a comprehensive study of European banking, Vesala concluded, "the empirical econometric studies have not been able to establish reliably the existence of the SCP relationship in banking".[7] Similar results were also reported by a 1993 OECD sponsored study which exhaustively reviewed the literature on relationships between financial sector profitability, efficiency and concentration levels in OECD economies.[8]

These findings were also consistent with the views of the Hilmer Committee, when they noted:

> "Early economic work suggested that large numbers of competitors were important for the effective working of competitive forces. However, in some cases competition between a few large firms may provide more economic benefit than competition between a large number of small firms. This may occur due to economies of scale and

[7]See Vesala, Op. Cit., p.114.

[8] See Forestieri, G, "Economies of Scale and Scope in the Financial Services Industry: A Review of the Recent Literature", in the OECD's <u>Financial Conglomerates</u>, 1993.

scope, not only in production but also in marketing, technology and, increasingly, in management."[9]

As noted above, while there is little doubt that moves to increase the contestability of markets will significantly increase the competitiveness of markets - and technology will reduce entry and exit costs[10], some commentators have queried the extent of the efficiencies on offer - especially in the area of major bank mergers.

Further, there are perceptions, and indeed it was previously accepted Government policy, that mergers in the banking sector should not be allowed. The first of these perceptions or policies is the previous Government's "six pillars" policy which prevents mergers between the major four banks and the largest two life offices. The second is the assumption, which has been generated by press commentary, that the ACCC believes that mergers between major banks will be anti-competitive, no matter what happens.

It is the National's view that the previous Government's policy should be changed. It is also the National's strong view that, if correctly reported, the ACCC views on these issues need to be refined.

5.2 PUBLIC BENEFIT FROM MERGERS

On the basis that mergers do not effectively reduce the competitive process - and the previous section strongly suggests this is the situation in banking - a strong case can be made that mergers are primarily a risk for shareholders, not customers, and thus they should, a priori, be allowed.

Although much of the debate about potential public benefit is typically discussed in the context of potential scale economies in processing, this is not the only way that mergers can contribute to public benefit. This point has been made by Ginsberg:

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[9]Hilmer, Op. Cit., Chapter 1, para 2, p.3.

[10]David Llewellyn for example has argued that "competitive pressures intensify most powerfully when competition develops from outside the traditional industry as entry barriers decline". See "Banking in the 21st Century: The Transformation of an Industry", p.15, in a paper presented to the Reserve Bank of Australia Conference on the Future of the Financial System, Sydney, July 1996.

> " ...the efficiency-enhancing character of many mergers goes beyond simple economies of scale to exploit financial economies, economies of scope, and the complementarity of the unique resources in the particular firms involved. A merger may involve firms with well-developed distribution networks in different geographical areas or market segments, or firms with alternative research paths whose joint pursuit could lower risk. It may bring together firms with complementary product lines that could be manufactured, distributed, or marketed more efficiently in conjunction with one another. The internal growth of a single firm may never reproduce that configuration of resources, or it may take many years for a firm to accomplish unilaterally what it could have accomplished instantly by means of a merger."[11]

We now turn to a review of the potential size of benefits from economies of scale, scope, and from within bank process (technical or X) efficiencies.

First, it should be acknowledged that despite a significant (and accelerating) move towards mergers in a number of countries, the pre-1990 literature [12] is relatively "inconclusive" [13] - if not disappointing, at least as regards traditional studies of economies of scale **actually achieved** by merged banking entities.

There are, however, a number of grounds on which to treat these results with some caution. At the technical level, there has been some modification of the results of these studies when **the revenue side** and not just cost structures were examined. That is, evidence of gains resulted if and when merged entities successfully utilised their larger databases to "cross-sell".[14]

This underlines the importance of allowing banks, and especially conglomerates, to fully utilise their databases. As Llewellyn recently commented, banks these days are essentially in the "information business", and that their "overwhelming advantage is the information they have

[11] Ginsberg, D. " The Goals of Antitrust Revisited", *Journal of Institutional and Theoretical Economics*, 1991, p.27.

[12] For a comprehensive review of the literature in this regard, see Vesala, 1993, Op. Cit., and Berger, A.N., Hunter, W.C., and Timme, S.G., "The Efficiency of Financial Institutions", *Journal of Banking and Finance*, 1993, pp. 221-249.

[13] Llewellyn, Op. Cit., p.19.

on their customer base which is obtained through economies of scale, investment in information systems and expertise, and economies of scope or synergies".[15]

Another important contributing factor in these disappointing results was, a failure by management to carry through with the potential rationalisation savings and/or a pattern of paying an excessive take-over price.[16] Perhaps more than anything else, these results underline the importance of good management if a merger is to extract efficiencies and hence enable those efficiencies to be passed on to the public. Once again, the point made earlier about "shareholders taking the risk and not consumers" comes through.

It also needs to be acknowledged that technology (as noted in Chapters 1 and 2) is fundamentally changing the nature of bank processing. This, in turn, is changing some of the potential dynamics of mergers. That is:

- the potential size of the efficiencies on offer are likely to get larger through time (this will add to the uncertainty surrounding the reliability of previous study results as indicators of the future); and
- these results help explain why, in the face of an increasingly competitive global financial system, there has been a strong "merger" movement developing in the 1990s across the USA, the EC, Japan and into Scandinavia.

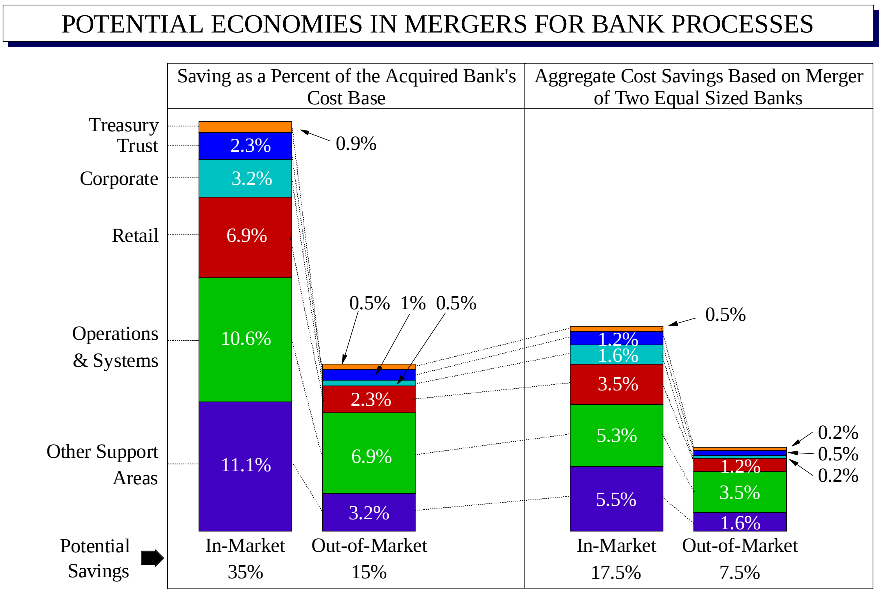
In that context, it is perhaps not surprising that the most compelling - and certainly the most robust empirical- finding to come out of the **recent** literature is confirmation of potentially large X-inefficiencies (or technical inefficiencies) within banking. This means that the success of a merger can be importantly influenced by the level of efficiency of the merger partners. Shaffer, for example, finds that if banks in the more efficient quartile acquire other banks, cost savings in excess of 20 per cent can be achieved, provided managerial efficiencies can be transformed to the acquired part of the bank. [17] Put simply, although the empirical evidence

[14]See, for example, Cornett, M., and Tehranias, H., "Changes in Corporate Performance Associated with Bank Acquisitions", *Journal of Financial Economics*, 1992, pp. 211-234.
[15] Llewellyn, Op. Cit., p.23
[16]See, for example, "Bank Consolidation Strategies for the Next Wave", a report prepared for the Bank Administration Institute (of America) by First Manhattan Consulting Group, 1995, Chapter 2.
[17]Shaffer, S., "Can Management Improve Bank Efficiency?", *Journal of Banking and Finance*, 1993, pp. 423-436. See also Berger, Hunter and Timme, Op. Cit., pp.232-236, and Forestieri, Op. Cit., p.75.

with respect to economies of scale in bank firms is inconclusive, there are clear economies of scale in "bank processes".

The role of technology also has important implications for where the technical inefficiencies are likely to be found in successful bank mergers. Figure 5.5 sets out estimates of potential cost savings.[18] Although these estimates are based on US data they are, in the National's view, equally applicable to Australia.

Figure 5.5

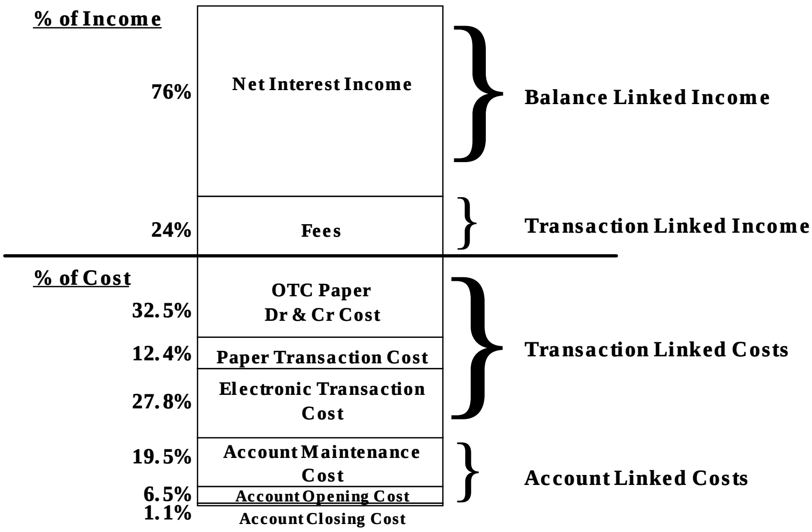


Source: First Manhattan Consulting Group and National Australia Bank

Some of the key points to note include:

- the difference in potential efficiencies from "within-market" mergers vis-à-vis "out of market" mergers (a point not sufficiently recognised in the literature);
- by far the largest proportion of the savings come in the areas of operations and systems and other support areas. Even with in-market mergers, the scope for savings through the rationalisation of branch networks are generally estimated as fairly minor;
  – To illustrate this point, the National estimates that currently around 40 per cent of the costs of providing a Flexiaccount (the main transaction account of the National) are taken up in either electronic and/or paper (cheque) processing (see Figure 5.6).

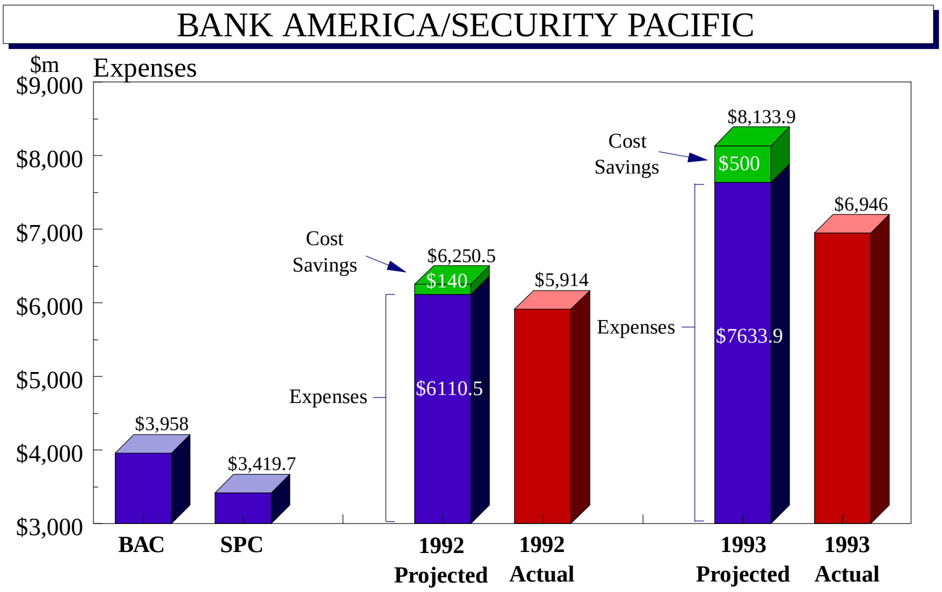
Figure 5.6: Cost and Income Associated with Flexiaccount



In the USA, examples of successful in-market mergers where these types of gains, noted above, are actually being achieved are becoming more common. Illustrative examples in the USA, include the Chemical/ Manufacturers' Hanover merger in 1992 and the Bank America/ Security Pacific merger in 1991. Figure 5.7 shows the savings actually achieved in the latter case.

[18] First Manhattan Consulting, Op. Cit.

Figure 5.7



Note: (1) Projected expenses are non-recurring expense base increased at 5% annually. Projected expenses and expense savings are pro-rated for 7 months of combined operation in 1992 (merger closing date 22/4/92)

(2) In 1994 Bank America acquired Continental Bank Corporation

Source: Morgan Stanley

More recently, another large US “in-market” merger - between Nations Bank and Boatmens Bancshares - announced anticipated cost savings of around 25 per cent to the Boatmens Bancshares cost base to be achieved over 3 years (or around 5 per cent total cost saving to the merged entity).

While merger activity in Australia over the past decade or so is much less common than in offshore markets (especially the USA) an example of a successful “in-market” in Australia is, of course, the National itself. Equally relevant, it should be noted that in a 1995 study[19], McKinsey & Co. found that “regulatory barriers such as restrictions on industry mergers” have limited the ability of retail banks in Australia to rationalise and “achieve substantial productivity gains”.[20] Indeed, the three measures advocated by McKinsey & Co.:

- allowing non-traditional participants wider access to the payments system;
- unifying financial sector regulation across banking, insurance and superannuation; and
- removing barriers to industry consolidation.

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[19] McKinsey & Co., “Growth Platforms for a Competitive Australia”, p.35. (See also the case study on retail banking, pp. 101-112).

[20] Op. Cit., pp. 111-112.

are all consistent with the National's submission.

Of course, while the potential gains from mergers, conglomerates and process re-engineering are likely to increase with the advance of technology, the difficulties in successfully tapping into these gains are likely to remain difficult - and depend critically on managerial skill. From a consumer's viewpoint, as pointed out by Benston, in a more contestable market environment there will always be a role for "niche" participants, and therefore consumers will continually be offered a wide diversity of choice.[21]

Drawing all of the above together it is clear that, given sufficiently skilled management, there are real potential benefits for the efficient operation of financial institutions from mergers in the Australian financial sector. The changes advocated by the National are aimed at improving contestability of markets (Chapter 4) and improving disclosure regimes (Chapter 7) will in turn ensure that there will be an appropriate flow-on of these benefits to Australian consumers and hence to the efficient operation of the broader economy.

5.3 AN APPROPRIATE DEFINITION OF THE MARKET

In any discussion of competition, a key consideration is defined as "the market".[22] Just as it is appropriate to view competition as a dynamic process, it is vital, if we are to tap the potential efficiencies of the change processes triggered by globalisation and technology, as well as the structural changes advocated by the National in Chapter 4 of this submission, that the concept of the market to be used in administering competition be continuously expanded to embrace the way in which the process of competition is evolving.

Attachment 3 to this submission sets out in more detail the current thinking underlying Australian competition policy as interpreted by the Australian Competition and Consumer Commission (ACCC). While covered in some detail in that Attachment, the National believes strongly that the current interpretation needs to be significantly expanded if it is to remain relevant. In particular:

[21] Benston, G., "Universal Banking" *Journal of Economic Perspectives*, 1995, pp. 121-136.
[22] See especially pp.16-24 of the Industry Commission's Merger Regulations information paper, June 1996.

- more attention needs to be placed on competitiveness as a process, rather than market structure;

- the current "cluster" approach to the definition of market illustrated in the recent *Westpac Challenge* decision of the Trade Practices Commission is out-dated, given its heavy emphasis on:
  - static markets (an approach that does not sit well with the comments of the Reserve Bank Deputy Governor or indeed Hilmer[23]); and
  - the provision of transactional services, which pays insufficient regard to the ability of technology combined with an injection of new contestability in the market to provide alternative service delivery platforms; and
- in keeping with the spirit of the changes advocated in Chapters 4, 6 and 7, the definition of market will need to be more flexible so that, where appropriate, it can encompass the provision of financial services.

In that respect, the National advocates an interpretation of the market that defines:

- the geographic dimension of the market as national;
- recognises the differences in the wholesale or retail areas of the finance industry;[24] and
- recognises that competition should not be seen in a short timeframe.

It follows from that interpretation that:

- the previous Government's "six pillars" policy preventing the mergers between any of the major four banks and the largest two life offices is outdated and should be abolished; and
- the present presumption in the ACCC that mergers between the major banks will be anti-competitive needs to be re-assessed.

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[23]See Thompson, Op. Cit. The Hilmer Report at p.14 noted "[t]here is increasing acknowledgement that Australia is for all practical purposes a single integrated market. The economic significance of State and Territory boundaries is diminishing rapidly as advances in transport and communications permit even the smallest firms to trade around the nation". This, in the National's view, is especially relevant to the finance industry.

Finally, as pointed out by the Hilmer Report:

> "If Australia is to prosper as a nation, and maintain and improve living standards and opportunities for its people, it has no choice but to improve the productivity and international competitiveness of its firms and institutions. Australian organisations, irrespective of their size, location or ownership, must become more efficient, more innovative and more flexible."[25]

The focus on maintaining international competitiveness in the above quote is also an important dimension that needs to be remembered in any discussion of competition policy. Indeed, a theme running through much of this chapter and Chapter 2, has been the opportunity and potential to achieve economies in financial services delivery and processing.

These potential benefits, as noted by the BIS, have been a driving force for bank mergers and conglomerates in the face of the new sources of competition "whether the competition stems from within the industry or outside it, from other financial intermediaries, open capital markets or even non-financial companies".[26]

A good example in this regard is the Netherlands, where bank mergers and conglomerates have been fostered, both to provide efficiency gains to the Dutch economy but also to enable that country's financial system to "play on the world stage". The Dutch example can be put in some context by noting that while their economy is broadly on a par with Australia's, ABN-Ambro (a merged banking entity) and Rabobank are both larger (in terms of assets) than a merger of the two biggest banks or financial conglomerates in Australia (ING, a Dutch financial conglomerate, is not that much smaller than Rabobank). Equally, as Llewellyn has pointed out, in Italy regulating authorities have been actively encouraging bank mergers "in order to create stronger and more competitive banking firms and in anticipation of a more competitive environment".[27]

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[24] In keeping with the disclosure requirements advocated in Chapter 7 of this submission, transactions above $500,000 could be treated as wholesale in consumer markets and above $1m in business markets.
[25] Hilmer Report, Op. Cit., Chapter 1, p.1.
[26] Bank of International Settlements, Annual Report 1992.
[27] Llewellyn, Op. Cit., p.22.

Ultimately, it is against world best practice and efficiency standards that the operation of our financial markets will be judged. Not to “match” these standards domestically will see more and more of our financing decisions sourced offshore.

5.4 Impact on Rural Communities; A Case Study

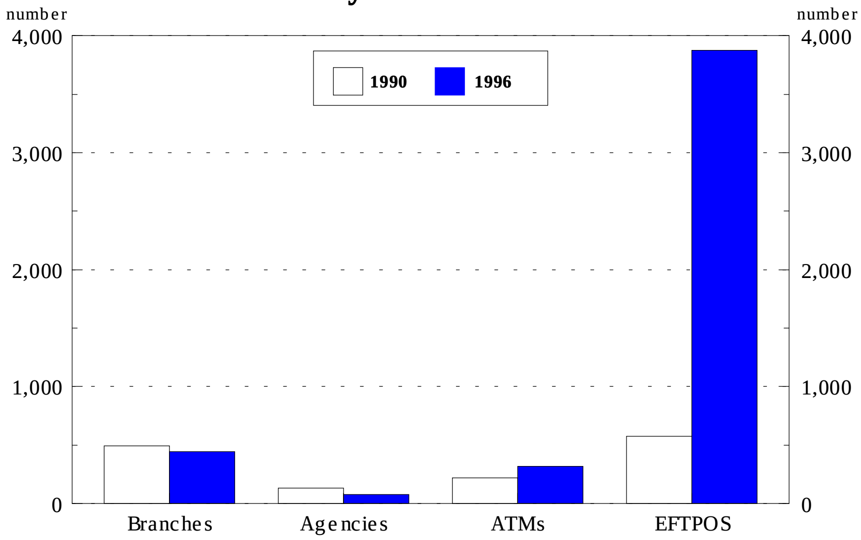
One of the arguments often put forward against the case for bank mergers (and by implication larger financial conglomerates) is the impact that branch closures might have on local rural economies. In that regard, a number of points can, and should, be made:

- in many ways, regardless of the outcome of the competition debate, the rural sector will continue to see change in the methods by which their financial services are delivered. The key issue is about delivery platforms. Indeed, the objective will be, like in non-rural areas, to maintain and improve on the current high levels of service already present in the rural community;

- there are already significant changes in transaction and payment service patterns in rural Australia. There is increasing use of direct transfers of funds such as EFTPOS, direct debits and periodic payments. For larger payments (over around $20) credit cards are replacing the use of cash and for smaller payments there are alternatives to branches, such as ATMs and EFTPOS merchants, for access to cash. An example of this change can be illustrated by Figure 5.8 which shows the changes that have occurred in the National’s delivery system over the past six years;

Figure 5.8

Remote Delivery - National Australia Bank



Source: National Australia Bank

- equally, as demonstrated by Table 5.1 below, around 55 per cent of transactional banking in the rural community goes through electronic means - with only around 13 per cent of transactions carried out in the branch;

Table 5.1

Branch and Electronic Transactions - July 1996
Share of Total (%)

	Deposits		Withdrawal		Total	
	Metro	Rural	Metro	Rural	Metro	Rural
Branch	34.0%	34.5%	5.7%	6.6%	12.1%	13.2%
Cheque	n.a.	n.a.	34.2%	40.5%	26.6%	30.9%
Electronic	66.0%	65.5%	60.0%	52.9%	61.4%	55.9%
of which:						
ATM	2.0%	1.0%	42.0%	40.7%	32.4%	29.7%
EFTPOS	n.a.	n.a.	36.7%	35.9%	27.9%	26.0%
Direct Entry	98.0%	99.0%	21.3%	23.4%	39.8%	44.2%

* Results are based on a representative sample of the number of transactions of National customers.

Source: National Australia Bank

- these figures are expected to fall further with the introduction of a new generation of ATMs which will greatly facilitate the ability to deposit (see Chapter 2);
- similar developments are occurring on the lending side;
- excluding part-time farmers, the rural industry trend is to fewer and larger farms. In the process banks have been criticised for both lending too freely (on the basis of security with insufficient regard for cash flow) and not lending enough. Clearly the optimum level of

lending is an amount which a farm's cash flow can service factoring in the probability of adverse operating circumstances (poor seasons and falls in commodity prices). With the development of industry specialists the banks are improving such assessments. Skill levels are emerging as a far more important element of service than proximity, with mobile farm finance specialists, based in regional centres, providing better service than small town branch managers. The move towards mobile industry specialists based in regional centres, rather than relying solely on traditional branches in smaller country towns, is an important development; and

- it is inevitable that the process of further rationalisation of rural networks (see Figure 1.39) will continue. However, as pointed out previously, mergers per se will not add significantly to that underlying momentum - that is, most of the cost savings of mergers these days are associated with economies in systems and head office support. (see Figure 5.5) Indeed, merging current uneconomic rural customer bases may well provide better prospects of retention of rural branches, than if current forces are left to their own momentum.