Part 2. Future Development of the Financial Sector

1. Introduction

The Australian financial sector has been transformed since the Campbell Inquiry Final Report was released in September 1981. It now better services the needs of the domestic economy and has good potential to capture a reasonable share of the regional trade in financial services. As outlined in Part 1, competition generated by financial sector deregulation was an important instrument underpinning this change but the interrelated factors of technological development and globalisation of financial markets were equally important. The future of the financial sector, and the nature of the organisations that comprise it, will be shaped by these factors.

Financial deregulation has largely run its course, though some fine tuning needs to be done and the full impact of competition arising from it has yet to be felt. In contrast, the adaptation of technological developments, especially in information processing and communications, to the provision of financial services is far from complete. Combined with further globalisation of financial markets, this could fundamentally change the character of the financial sector, including its constituent service providers and the type of products on offer. This part of the submission briefly reviews the key factors likely to determine the strategic development of the financial sector and considers important issues that arise for financial institutions and their regulators. As this is forward looking, there is necessarily some element of conjecture in the discussion.

2. Domestic Competition

Vigorous competition was the prime means of delivering the benefits of deregulation to users of the financial sector. The emergence of a strong investment banking sector, through the entry of foreign banks, initially brought benefits to the corporate sector in the form of narrower margins for large commercial transactions. They also brought significant benefits to retail consumers; for example, depositors received market related returns and, more recently, securitisation reduced home loan interest rates and broadened the range of home loan facilities. Competition in the financial sector will continue in this fashion; existing players and new entrants will continuously search areas of traditional banking for new opportunities to capture business, by offering more competitive terms. Utilising new technology, all aspects of finance will be scrutinised for potential efficiency gains. For example, stored value cards and internet banking will test the mettle of banks' existing payments services.

As a consequence of these pressures, banks have been forced to examine each segment of their business on a stand-alone basis. Product cross-subsidisation is increasingly difficult to maintain in this environment, as banks lose business in areas where they charge higher prices than otherwise, to support the subsidy. For example, banks will have to charge economic rates on account transactions that were previously subsidised by interest receivers and payers, or they will lose deposit and loan business to more competitive providers. This is what happened with home loan securitisation; the excessive margin earned by banks was pared away by the home loan originators, backed by the investment banks.

Banks will focus on those areas of their business in which they have a comparative advantage. At the large corporate level some business has already been lost to the financial markets. For example, the emergence of a competitive commercial paper market has reduced corporate reliance on banks for short term funds. The commercial paper market better recognises company credit ratings and non-bank investors in commercial paper do not have to carry the same capital costs as banks. Thus, banks find it difficult to compete by lending off their balance sheet but, instead, they earn income as arrangers and distributors of the paper. This demonstrates the manner in which the different processes involved in credit intermediation can be split apart. More generally, banks are likely to participate as loan originators, because they are specialists in locating creditworthy customers, and in the servicing of loans, where they have processing efficiencies. However, other institutions are better placed to fund the loans, due to regulatory and tax reasons.

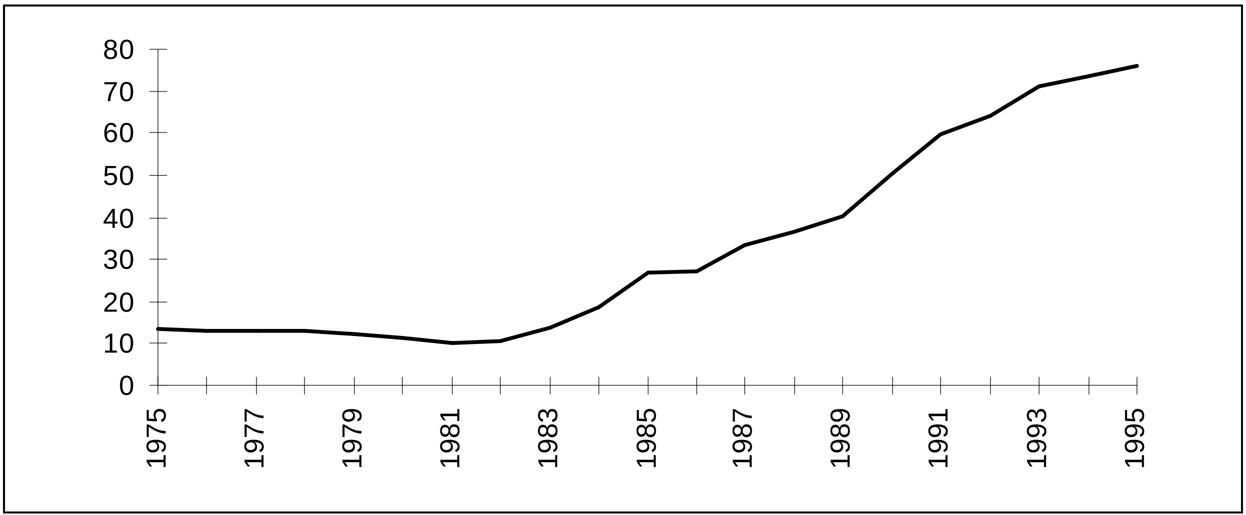
Banks are likely to retain certain types of lending on their balance sheet. In particular, small and medium size businesses are unable to access security markets at an economic cost, either domestically or overseas. Size factors matter here as much as anything; for example, these companies cannot afford the cost of a credit rating, which is required for debt issues, and would not issue in sufficient size to satisfy market liquidity requirements. In addition, the level of public disclosure required of these companies is relatively low and their business is often non-standard. Consequently, banks' specialist credit risk management skills will provide them with a comparative advantage in servicing these entities.

The liability side of banks' balance sheets is likely to be under the same pressure as the assets side. The proportion of household financial assets held in banks has declined steadily since the early 1980s. Consumer choice has been widened by the entry of non-bank providers of financial products. Banks deposits are only one product on a broad risk spectrum of investments. They have special qualities because they are low risk and, in some forms, can be used to facilitate payments. Consumers assess the worth of an investment by reference to a range of characteristics, including its returns, liquidity, counterparty risk and transactions costs. Deposits, unit trusts, shares and other financial instruments each offer the investor a matrix of benefits and costs. For example, fund managers offer investment products similar to bank deposits. However, a crucial difference is that deposits are capital backed but the investor carries full risk with unit trusts and, as a rule, the terms of bank deposits are more flexible. It is likely that products offered by banks will be subject to more rigorous comparison to their alternatives in the future.

There are opportunities emerging for banks to expand their business in this environment. For example, in general, banks are better placed than funds managers to distribute financial products, through their branch networks and established customer base. Thus, while banks may find it difficult to compete for the business of managing savings, they have natural advantages in distribution, which can be exploited through alliances and other commercial arrangements.

Banks are likely to face increasing pressure from non-bank providers of payments services; both from other financial institutions and from outside the financial system. Funds managers are gravitating towards the banking market and associations have been formed between banks and companies, like Telstra. In the USA, companies like General Electric Corporation have already developed to become major providers of payments services. Technological development seem likely to open the market to other players, like Microsoft, who already participate indirectly in the industry by servicing banks' needs.

Figure 1. Bank Current Accounts: Interest Bearing as a Percentage of the Total



Data sourced from Foster and Stewart (1996).

Retail consumers have become more sophisticated users of financial products; for example, bank current account holders now expect to earn interest on their balances, as a matter of course (see figure 1). However, it is not clear that retail investors always fully appreciate the differences between products. In the absence of strict controls on interest rates and the like, consumers have greater responsibility to manage their financial risk, whether it originates from investments or loans. Financial deregulation was just as great a cultural shock to retail consumers as it was to banks and corporates and it has taken them time to adjust to the new environment. The vulnerability of consumers to risk from this change has probably peaked. Over time, the intensity of regulation required to provide for consumer protection will need to be re-assessed from this perspective.

3. Technology

Technology has already had a dramatic impact on all segments of the market for financial services. It has been applied in financial innovation to develop new products, to improve the quality of existing services, to increase operational efficiency, to lower transactions costs and to increase returns to investors. The likelihood is that technology will have an even greater impact on the provision of banking and other financial services in the future.

From a retail consumer's perspective, technology has probably had the greatest impact on the channels of delivery for financial services. New payments mechanisms like ATMs, telephone banking, EFTPOS and electronic funds transfer have increased access to bank account services. New developments are likely to revolve around computer based media, like internet banking. 'Virtual banks' have already been launched in the USA. Credit intermediation has changed too, as banks apply complex information processing technology, like automated credit scoring systems, to more efficiently manage their credit risk and reduce operating costs. In a similar vein, consumers will be able to use electronic media to search for financial products that best meet their desired specifications. Prospectuses have already been authorised for release on the internet. The application of information technology in this manner should help reduce the information difference between financial institutions and individuals.

Active risk management, and the emergence of derivatives as the primary instrument with which to manage market risk, is partly due to technological development. The systems required to accurately price derivative products, measure exposures, design hedging strategies and manage portfolios with these products require a high level of computing capacity, that only emerged on an economic basis in the 1980s. This is significant in the context of financial sector deregulation, as risk management products reduce the cost of operating in markets with more volatile financial prices.[1] Banks have a comparative advantage in selling risk management products, as they carry substantial amounts of financial risk as a natural part of their business. The risk management instruments and processes that they develop internally can be sold into the market. Banks seem likely to retain their advantage in this area.

Looking towards the future, it seems certain that technology will act to increase competition in the financial sector. This will arise from the entry of new domestic non-bank providers and from providers from overseas. For example, in the first case, an enterprise may offer company payment netting services outside of the banking system. In the second case, a fund manager in Hong Kong could market investment units here through the internet. Thus, while financial products have been subject to greater scrutiny by alternative domestic providers in the past decade, it is likely that they will be subject to similar treatment by foreign enterprises, as they search for new business.

In addition, domestic financial service providers will be subject to competition from new products developed overseas that are sold here directly, or indirectly through arrangements like franchise agreements. For example, a number of European banks have developed stored value card payments systems, that are being tested here and elsewhere. It is likely that at least some of these will be offered on a commercial basis in Australia. Domestic banks can develop their own products (assuming scale factors allow for this), purchase a franchise or enter an international syndicate to develop similar products. Either way, external competition will help shape the development of the market.

4. Globalisation

The wholesale financial markets are largely global and have been so for some years. Financial institutions and large corporates typically trade foreign currency in a range of financial centres across the world. Companies list on foreign exchanges, borrow debt through foreign security markets and international banks and conduct their payments through a range of global facilities. In addition, World Bank data show an enormous rise in global international portfolio and direct investment over the last decade; a trend that has been matched in Australia and in the Asia-Pacific region. In consequence, market players are much better informed about the international alternatives to local financial products and assess the value to be had from the domestic financial sector in that light. When it comes to large size transactions, financial institutions that are uncompetitive and financial markets that are inefficient (for whatever reason; regulatory, tax, organisational or otherwise), will lose business to external competitors.

The competitive situation in the wholesale markets will tighten more, if anything, over the coming years. The position with regard to retail financial services, which are relatively untouched by direct foreign competition, is more uncertain but it does seem likely to yield to greater international competition. As noted above, the pace and nature of technological development strongly suggests that foreign financial organisations will offer their services in Australia through electronic media. For example, US fund managers may be more inclined to do business here, to take advantage of their lower management expense ratios in retail

[1] Volatility arises from price adjustment to take account of new economic information which, of itself, is a good thing from the perspective of economic efficiency.

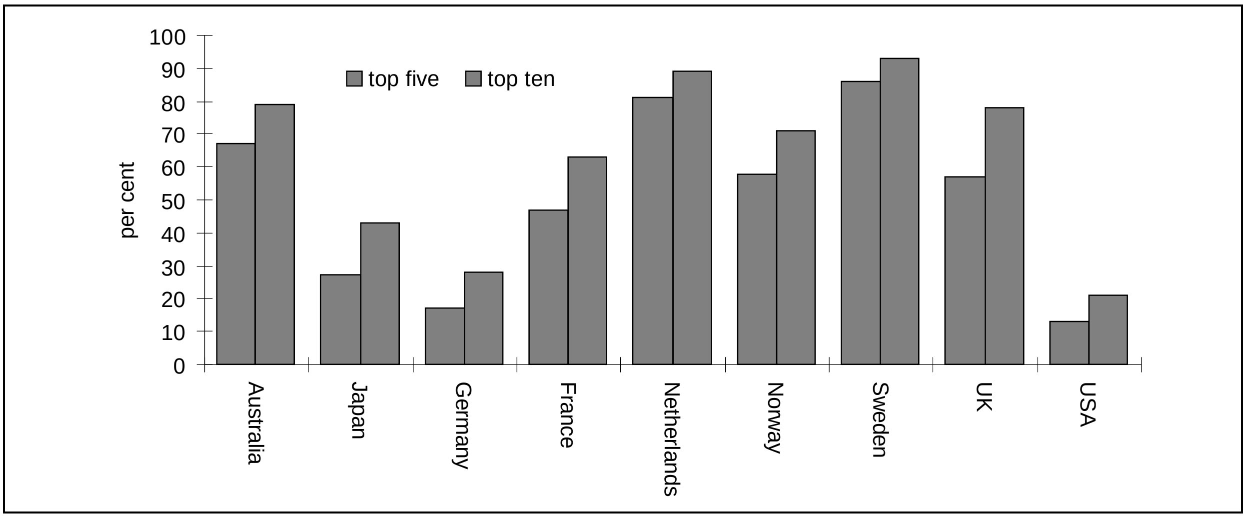
business. Much could depend on regulatory and tax arrangements. For example, financial institutions duty (FID) has the potential to drive some domestic banking transactions offshore in an environment with greater universal acceptance of emerging technology.

There are two sides to the globalisation story. Australia has comparative advantages in some aspects of international banking and attracts significant foreign business, as outlined in Part 1. Australian financial institutions also locate in other countries in the region and elsewhere, and conduct a range of wholesale and retail financial businesses through these operations. Thus, the likely increase in globalisation of financial markets will not only serve to increase competitive pressures on financial institutions here, but will also offer opportunities to these institutions to expand their offshore sales.

5. Mergers and Conglomerates

There are several trends in banking across the developed countries that are pertinent to Australian financial institutions. Banks in the industrial countries have undergone a period of consolidation and restructuring in the aftermath of financial deregulation, innovation and rapid technological development in the 1980s. There is a marked tendency for the number of financial institution to fall and concentration to rise (figure 2 illustrates concentration in banking across selected industrial countries in 1995). There is also evidence of a widespread decline in the number of bank branches and in the level of employment by banks. These trends also apply to Australian banks, though they have better recovered from the exceptional losses of the late 1980s than banks in some other countries.

Figure 2. Concentration in Banking 1995 - International Evidence



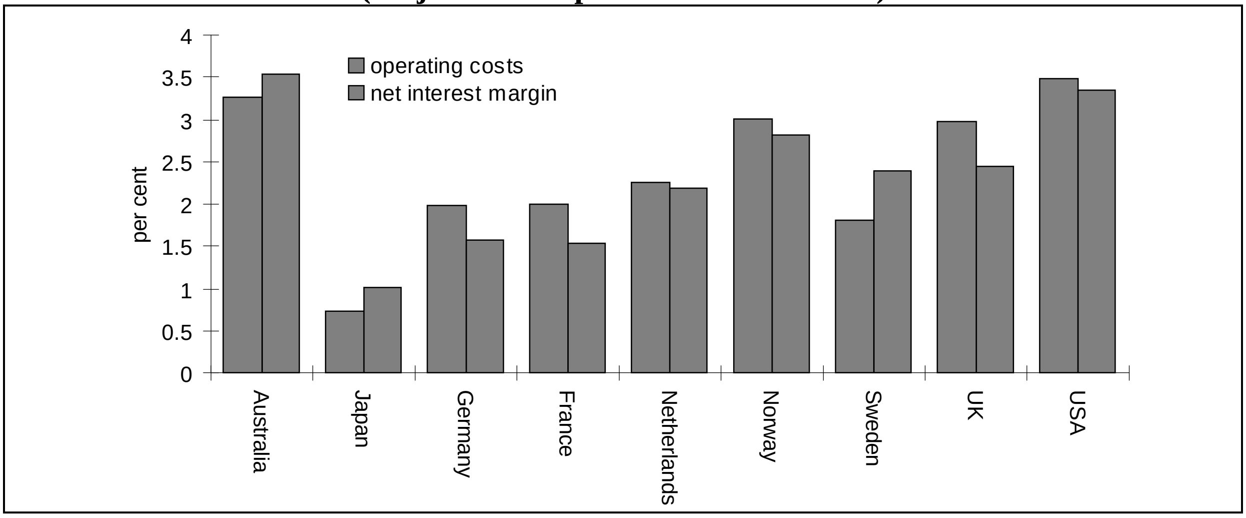
Source: Data are taken from the Bank for International Settlements *Annual Report 1995/96*.

Mergers and acquisitions have been a feature of the international adjustment process. As noted in Part 1, foreign banks operating in Australia have been merged following mergers between their parent organisations. Development in the international structure of banking will continue to be reflected in the operations of foreign banks in Australia. This is likely to increase their competitiveness in the local market.

There seems to be a growing consensus that mergers will increase the efficiency of domestic banks. The evidence is that, despite significant gains since deregulation, Australian banks' operating costs and net interest margins are high by international standards, as shown on figure

3. A recent study of labour productivity in Australian retail banks by McKinsey & Company found that productivity was 40% lower than it is in retail banks in the USA.[2] The study concluded that the major banks need to significantly reduce branch numbers, adopt lower cost distribution networks and adapt to innovation more quickly. Thus, the evidence is that there are inefficiencies in Australian retail banking that need to be addressed and mergers between the major banks provide an option of value in this regard.

Figure 3. Bank Operating Costs and Net Interest Margins - International Evidence (Major banks - per cent of total assets)



Source: Data for major banks IBCA Ltd. data taken from the Bank for International Settlements *Annual Report 1995/96.*

The issue to be resolved is the distribution of any benefits between bank customers and bank shareholders. This is best decided by market forces, *provided* that there is sufficient competition in the market. At the moment concentration in the industry is at the high end of the international spectrum (see figure 1). However, this does not capture the effect of competition from non-bank providers (like mortgage originators) and financial markets (like unit trusts), which has intensified in recent years. Nor does it capture the impact of competition from overseas financial institutions, that is likely to increase in the future. Nevertheless, it does emphasise the need to maintain competitiveness in the domestic market. The investment banks have played a critical role in this regard in the past. The tax and regulatory conditions that prevail must allow them continue in this role in the future.

A second international development of note that is likely to impact on Australian financial institutions is the trend towards financial conglomerates. It is argued that these give rise to technological and organisational efficiencies, primarily through economies of scale and scope. There is a risk that creation of these entities may result in monopolistic behaviour, to the detriment of consumers. The net outcome depends much on the initial structure of the financial sector. Financial conglomerates also pose new risks for financial regulators. In particular, there is a loss of transparency in intra-group dealings, significant contagion risk across group member companies, difficulty in establishing final capital attributable to the group and greater operational risk for management.

Financial conglomerates are a prominent feature of the financial sector in Australia, though they tend to be primarily bank or insurance company groups. To date, this distinction in

[2] This is summarised in *Improving Labour Productivity in Australian Retail Banking*, McKinsey & Co. Australia, with McKinsey Global Institute.

function has alleviated the supervisory problems faced by financial regulators of the component entities. However, the clarity is likely to diminish, as banks and insurance companies expand their ancillary businesses. If this occurs, as seems likely, a number of issues will need to be resolved. In particular, co-operation between the regulators of individual group entities and co-ordination of their supervisory activities must take a higher profile, if regulation is to be efficient, fair and not apply to high a compliance cost. There is a proposal in Part 3 to resolve these difficulties and put in place a framework to flexibly respond to future developments. This involves a strengthening of the Council of Financial Supervisors to guide regulators and the adoption of a lead regulator model to implement consistent supervisory standards.

6. Summary

Some important points arise from this short review of strategic trends in the financial sector. Firstly, there is commercial pressure for bank mergers and the formation of financial conglomerates. Secondly, competition is likely to increase from both within and outside the financial sector. This will, at least partly, counteract the effect of greater concentration of current providers of financial services. Nevertheless, there is a clear need to promote competition in the sector. Tax and regulatory impediments to competition in the financial sector must be eliminated to ensure that the market is adequately balanced from a competition perspective. Thirdly, there is an imperative to put in place a framework that will facilitate efficient and effective supervision of financial conglomerates in the future.