

Section Four: The need for a competition regulator

4.1 Overview

As “(t)he forces of unregulated competition eventually destroy true competition, a substantial network of regulation is necessary to maximise genuine fair and sustainable competition.”¹

The FSU has a strong interest in the development of a competitive and dynamic finance system as the means by which our members will be assured job opportunities and financial security.

In previous sections, we have presented evidence about the detrimental impact of mergers and takeovers on employees. In this section, we argue that the case for further concentration of the finance industry based on claims of scale economies and consumer benefit warrants careful scrutiny. A vital mechanism by which such scrutiny is applied, and should continue to be applied, is the regulatory framework provided by the application of the Trade Practices Act to financial services. The role played by the Australian Competition and Consumer Commission (ACCC) in assessing the effect on competition of mergers and takeovers is a pivotal part of this framework.

4.2 Competition and Efficiency

The FSU draws the following conclusions from available information about the levels of competition and efficiency gains in a deregulated financial system:

- The Australian banking industry post deregulation has a greater number of participants but remains highly concentrated by international standards.² The Martin Report found the emergence of four major banks with approximately 72% of national market share indicated a trend toward greater concentration in the banking industry. Commenting on the very different views presented by industry and consumer groups, the Committee noted the difficulties of drawing conclusions about competition based simply on market share.³ The subsequent PSA Inquiry looked at a number of indicators of concentration and found the four major banks’ share had grown and was in the high 70 per cent range on these indicators.⁴ In 1996, Australia wide, the four major banks have 65.8% of lending, 64.8% of deposits and 75.2% of branches. In Victoria, the four majors have 74.6% of lending, 76.2% of deposits and 87% of branches.⁵
- Bank profits remain sound. The latest Reserve Bank Report states that “notwithstanding the competitive pressures, bank profits improved further, albeit at a slower pace as the favourable impact of lower bad debt diminishes. Average after

¹ Disney J. “Globalisation issues: a community perspective” in Globalisation: Issues for Australia, EPAC, March 1995 p.210

² Davis, K, “Bigger is not better: you can bank on it” Australian Financial Review, 11 June, 1996

³ House of Representatives Standing Committee on Finance and Public Affairs, Banking and Deregulation, November 1991, p. 120

⁴ PSA, Inquiry into Fees and Charges, op cit, p. 118

⁵ McIntosh Baring, Bank Branches: To close or not to close?, April 1996

tax return on equity was again about 16 per cent, suggesting quite strong profitability by international standards.”⁶

- In 1995, the PSA Inquiry concluded that “since deregulation, there has been little change in the aggregate net interest rate spread of the four major banks. Since there has been little reduction in the spread, it can be concluded that bank customers as a group are no better or worse off since deregulation.”⁷ Contradictory evidence is available on the current situation. The latest Reserve Bank report concludes that the widening of spreads which occurred in the early 1990s has been fully reversed and the downward trend evident since deregulation has resumed.”^{8,9} However, recent media analysis suggests that the latest round of profit results show that “there is next to no pressure on interest spreads or interest margins. Analysts expect little contraction in the coming year”.¹⁰
- Increased competition and deregulation were intended to improve dynamic efficiency and the evidence suggests that it did to some extent. The 1980s and early 1990s have seen the development of “a wide range of innovative financial instruments”¹¹ in both the wholesale and retail areas.¹² This has created greater choice for business and domestic consumers.
- A component of the improvement in dynamic efficiency is significant advances in technology that have made possible new forms of money and altered the possible distribution channels. Alternative distribution channels include telephone banking, computer banking with E-cash, interactive television and video ‘counselling’ for appropriate financial products/advice. However, it is still not possible to open an account in Australia or to arrange a loan by electronic facilities.¹³ The advances have not created a situation in which people no longer want or need personal service and physical access. Alternative channels are embraced but as additions to existing services rather than replacements. The potential may exist for ‘borderless’ banking, but the average consumer still requires, and continues to want, physical access to a branch of a bank operating in their state for basic banking services.¹⁴
- After a review of a number of studies reviewing the gains in operational efficiency in a deregulated environment, one commentator concluded that the evidence was ambiguous and often conflicting.¹⁵ He tentatively concludes that in the early years

⁶ Reserve Bank of Australia, Report and Financial Statements, 1996, p.42

⁷ PSA, Inquiry into Fees and Charges imposed on Retail Accounts by Banks and Other Financial Institutions and by Retailers on EFTPOS Transactions, p. 115

⁸ Reserve Bank, op cit, p. 40

⁹ This difference between the two assessment would appear to be due to the PSA decision to include non interest bearing deposits in the calculation on the basis that such calculations are more representative of the true cost of funds. The RBA figures include only interest earning assets.

¹⁰ Ian Rogers, “Fat banks may be in for a trim” Australian Financial Review, 5 September, 1996

¹¹ Argy, F. Financial Deregulation: Past Promise and Future Realities, p. 16

¹² Another analysis of the increased innovation due to deregulation can be found in Harper, I. “Bank Deregulation in Australia: Choice and Diversity, Gainers and Losers” in The Deregulation of Financial Intermediaries, Reserve Bank, 1991

¹³ Fels, A. “Competition policy and banking” ACCC Journal No 1, p.17

¹⁴ ACA, Consuming Interest, No. 68, Winter 1996, p.10

¹⁵ Argy, op cit, p. 17

of deregulation any gains were small but that this “has been changing rapidly in more recent years” mainly driven by electronic payment devices and increased competition. The extent to which efficiency gains have been passed on to consumers is still unclear.

- Despite continuing developments in financial services, banks still have certain distinct features related to their prudential security, and cluster of services offered, which mean that there remains a discrete market for retail banking.¹⁶ The market is currently state based as consumers, because of the need for some form of physical access, effectively have a choice of financial institutions operating within their state. The fact that these institutions may be operating nationally or internationally does not make the market for consumers national or international.¹⁷

The FSU submits that difficulties inherent in market definition, let alone assessments of competitive structure, demonstrate the continuing need for a strong, well resourced and independent competition regulator for the finance sector. The importance of the role to be played by the (then) Trade Practices Commission was acknowledged in both the Campbell and Martin Inquiries. Our understanding of the rationale presented by these two Inquiries is detailed below.

4.3 The need for a competition regulator

The Campbell Committee of Inquiry explicitly started from “the view that the most efficient way to organise economic activity is through a competitive market system which is subject to a minimum of regulation and government intervention.”¹⁸ However the Committee was aware that economic neutrality achieved by an unfettered market may not always be compatible with the community’s social priorities and recognised the role that governments must play in working towards objectives other than economic efficiency. While it concluded that many forms of intervention had a detrimental effect on efficiency, there was identified a clear justification for government intervention where it is necessary to ensure free, fair and competitive markets.

The Committee commented on the difficulties and value judgments necessary to assess the competitiveness of the industry and saw an important role for the Trade Practices Commission in maintaining effective competition in financial markets.¹⁹ Concern about the impact on the competitive structure of then recently announced mergers was noted.²⁰

The Final Report of the Martin Inquiry noted the Committee’s concern that further concentration in the banking industry could have significant implications for

¹⁶ Ibid, p.16

¹⁷ Id

¹⁸ Australian Financial System, Committee of Inquiry into the Australian Financial System, Canberra, 1981, p. 1

¹⁹ Ibid, p. 533

²⁰ Ibid p.531. Interestingly a footnote comments that the banks expected the mergers to lead to greater operational efficiency and international competitiveness. The Committee did not feel able to assess this point.

competition and be counter to the aims of deregulation. The Committee considered that any arrangement or agreement which would lead to further concentration should be subject to “careful scrutiny and should be required to demonstrate substantial public benefit before being allowed to proceed.”²¹ The Committee saw considerable merit in having the Trade Practices Commission examine any proposed merger or acquisition.

Again, the concerns of consumer organisations about the apparent contradiction between deregulation as an inducement to greater competition and deregulation as an inducement to a wave of mergers in which the six largest private banks become three was reported. Some note is taken of the argument that greater concentration may lead to economies of scale and hence allow market participants to devote greater attention to research and innovation. However, the Report makes the important point that in the absence of competition, there is no guarantee that benefits would be passed on to consumers. This is particularly unlikely to be the case where market participants are focussed on short term profit outcomes rather than longer term strategies.

The FSU submits that the continued application of Trade Practices Act to the financial services sector and the current role played by Australian Competition and Consumer Commission (ACCC) in monitoring possible breaches of the Trade Practices Act²² are vital to the maintenance of competition in the sector. This will ensure that a clear focus on consumer protection is maintained, and enhance the likelihood that all Australians will gain equitably from any benefits of competition.

The dynamic processes of competition require that the impact of a particular merger on the competitive structure of the industry be subject to careful analysis. This is particularly so where new competitors are emerging and technological advances are driving change. It is important that assessments of the competitive structure are not made solely on the basis of future capacity. Only a case by case analysis will allow the industry to develop and change over time and new developments to be taken into account.

4.4 Mergers and Economies of Scale

The ACCC’s role in maintaining effective competition encompasses both a five stage analysis to determine if a proposed merger or takeover will substantially lessen competition, and a process of authorising anti-competitive mergers or acquisitions if they can be shown to be for the public benefit.²³ Public benefit has been interpreted as meaning “anything of value to the community generally, any contribution to the aims pursued by the society including as one of its principle aims the achievement of the economic goals of efficiency and progress”.²⁴

²¹ House of Representatives Standing Committee on Finance and Public Affairs, Banking and Deregulation, p.127

²² S. 50 which prohibits mergers or acquisitions which would or would be likely to substantially lessen competition in a substantial market for goods and services.

²³ Firms may apply for a merger to be authorised by the ACCC on public benefit grounds as per s. 88 of the TPA.

²⁴ Re QCMA and Defiance Holdings Ltd (1976) ATPR 40-012 at 17,242

The FSU submits that there is a need for careful scrutiny of arguments which are framed in terms of the need to build critical mass domestically to compete internationally. Studies commissioned as part of the Campbell Inquiry lead the Committee to conclude that there were moderate economies of scale in some aspects of banking, weaker evidence in building societies and credit unions and no convincing evidence regarding other forms of financial intermediation.²⁵ Any technical efficiency gains arising from the existence of scale economies would have to be weighed against any loss in competitive strength.

Less equivocal evidence can be found in a 1994 study by the US Board of Governors of the Federal Reserve System²⁶. An overview is provided of the evidence from 39 published studies undertaken between 1980 and 1993, with the intention of drawing a conclusion about the effects of bank mergers on profitability, efficiency or stock holder wealth. The overview divides the studies according to the methodology used.²⁷ For the operating performance studies the main finding is that despite the diversity among the studies, there is a strong evidence that there is a lack of improvement in efficiency or profitability as a result of the mergers.²⁸

Other evidence casts doubt on the potential efficiencies to be derived from the opportunity to close duplicate branches or offices. Seven of the operating performance studies analysed the effect on performance when merging firms have directly competing offices. These studies found that the elimination of overlap did not yield efficiency improvements. The study attributes this finding to the fact that either the offices closed were already operating on an efficient scale, or that while closing offices reduces costs, it also leads to a reduction in the number of customers.

The event studies were less consistent.²⁹ Nonetheless, the overall conclusion drawn is that while the stockholders of target firms had gains, the evidence showed that the returns to bidders, and to bidders and targets combined was too inconsistent to permit any clear conclusions to be drawn. This throws doubt on the conventional expectations of financial markets that mergers improve performance.

A 1995 report on the future of retail banking³⁰ found that banks grew less efficient as they grew larger. The conclusion drawn is that the retail banking industry is currently not susceptible to scale economies and that banks of very different sizes can co-exist and be profitable.

²⁵ Australian Financial System Inquiry, *op cit*, p. 537

²⁶ Stephen A Rhoades, Staff, Board of Governors, Federal Reserve, July 1994

²⁷ Nineteen of the studies used what is described as the “operating performance” approach which observes the financial performance of a firm following a merger. Twenty one used the “event study” methodology which measures the reaction of stock price of acquirers and targets to a merger announcement. (p.1)

²⁸ *Ibid*, p. 3

²⁹ For example, seven studies finding that mergers had a negative effect on returns to stockholders of the bidding firms, seven found no effect, three found positive effects and four found mixed effects. (p.6)

³⁰ Deloitte Touch Tohmatsu International, “The Future of Retail Banking: A Global Perspective” 1995

A Melbourne academic³¹ finds little hard evidence to demonstrate that bigger banks would achieve significant economies of scale and also little evidence that profitability increases with size. He argues that even if there was evidence to support such economies, any advantage would come about from greater ability to exploit market power.

This evidence combines to cast substantial doubt on the claims that scale economies are to be achieved from mergers. The complex analysis required to assess these issues demonstrates the need for an independent statutory body charged with responsibility for carefully assessing the effect of any mergers on competition and any claims for authorisation based on supposed public benefit.

4.5 Approval by the Treasurer

An additional control is provided by the requirement³² that the Treasurer approve any merger or takeover of a bank on the basis of a public interest test. It is submitted that this be retained. While the existence of an independent specialist competition regulator is a primary consumer protection mechanism, there may be public interest issues beyond the effect on competition. For this reason, it is important that ultimate political responsibility rests with the Government for a decision in which all citizens have a substantial social and economic interest.

4.6 Recommendations

The FSU recommends that:

- The prohibition on anti competitive mergers contained in Trade Practices Act should continue to apply to financial services;
- The role which the ACCC currently performs in assessing the affect of a proposed merger on competition and in granting authorisations of anti competitive mergers based on public benefit grounds should remain a key feature of the regulatory structure of the finance sector;
- The requirement that the Treasurer approve any merger or takeover of a bank should be retained; and
- The current ‘six pillars’ policy restricting mergers between major banks and major insurance companies should be retained.

³¹ Davis, K, “Bigger is not better: you can bank on it” Australian Financial Review, 11 June, 1996

³² s. 63 Banking Act 1959