

Mergers and Acquisitions

Introduction

6.1 This chapter discusses the regulatory arrangements for, and the implications of, mergers and acquisitions in the financial services sector.

6.2 The principal objective of merger regulation is to ensure that markets remain competitive. Effective or workable competition is a state in which:

no one seller, and no group of sellers acting in concert, has the power to choose its level of profits by giving less and charging more. Where there is workable competition, rival sellers, whether existing competitors or new potential entrants into the field, would keep this power in check by offering or threatening to offer effective inducements.¹

6.3 Governments have been concerned to foster effective competition because of the benefits which it can deliver to society. The Hilmer Committee on National Competition Policy observed:

Competition provides the spur for business to improve their performance, develop new products and respond to changing circumstances. Competition offers the promise of lower prices and improved choice for consumers and greater efficiency, higher economic growth and increased employment opportunities for the economy as a whole.²

1 Report of the United States Attorney-General's National Committee to Study the Antitrust Laws 1955, pp.245-6 as quoted in Corones, SG 1994, p.19.
2 Independent Committee of Inquiry (Hilmer Committee) 1993, p.1.

6.4 Among the potential benefits of competition in the financial sector are improved access to capital for business, cheaper credit and housing loans for consumers, better targeting of financial products to individual consumer needs, increased convenience in interacting with the system, improved ability to protect against risk, cheaper transaction and payment services and the possibility of improved returns on investments.

6.5 It is because competition can deliver such benefits that the Inquiry sees as one of its primary goals the further invigoration of competition in the financial services sector.

6.6 Market forces are the main determinants of competition. Public policy, however, in the form of competition policy, seek to ensure that these forces can operate effectively. Key elements of competition policy are:

- rules designed to deal with the structure of industries—in Australia these rules primarily take the form of merger regulations;
- rules designed to prevent anti-competitive conduct;
- ensuring that the regulatory environment is competitively neutral so that similar functions are subject to the same regulatory environment; and
- ensuring that the regulatory system does not create unnecessary barriers to entry or exit—that is, it facilitates the ‘contestability’³ of markets.

6.7 While this chapter focuses on the first of these approaches, the other issues are not ignored, and indeed they can influence attitudes taken to the assessment of mergers. Concerns over competitive neutrality and barriers to entry primarily arise in the context of other government regulations and are accordingly discussed in the chapters on prudential, consumer protection and financial markets regulation. Very few concerns with the current regulation of anti-competitive conduct have been brought before the Inquiry.

3 The term ‘contestability’ is used in this Discussion Paper to refer to the extent of barriers to entry to a market.

6.8 The structure of an industry is important because it can influence the ways in which firms behave in the market and the efficiency of an industry. As the Australian Government has not legislated for divestiture powers to break up existing institutions, (other than those resulting from illegal mergers), merger laws and ensuring a regulatory structure which does not discourage new entrants are the main means by which government can influence market structure.

6.9 Efficiency in a market or industry has a number of dimensions, all of which are important ultimate goals of merger policy. These include:

- technical efficiency, which is achieved where individual firms produce goods and services at least cost;
- allocative efficiency, which is achieved where resources used to produce a set of goods or services are allocated to their highest valued uses; and
- dynamic efficiency, which is achieved where industries make timely changes to technology and products in response to changes in consumer tastes and in productive opportunities.⁴

6.10 Mergers can be pro-competitive, anti-competitive or neutral. Thus, in setting out to regulate mergers, judgements have to be made on the facts of each case. What matters is the outcome for competition and the efficiency of industry, not the structure of the market per se.

6.11 Mergers in the financial sector are also regulated for a number of national interest reasons in addition to those relating to competition. Chief among these in the financial sector are prudential reasons where, for example, it might be believed that a merger could increase systemic risk, threaten the financial safety or soundness of the merging institutions or result in unsuitable persons being in positions of influence. Other reasons may be to prevent a concentration of economic power (other than market power) or to restrict foreign ownership or control.

4 Independent Committee of Inquiry (Hilmer Committee) 1993, p.4.

6.12 This chapter discusses:

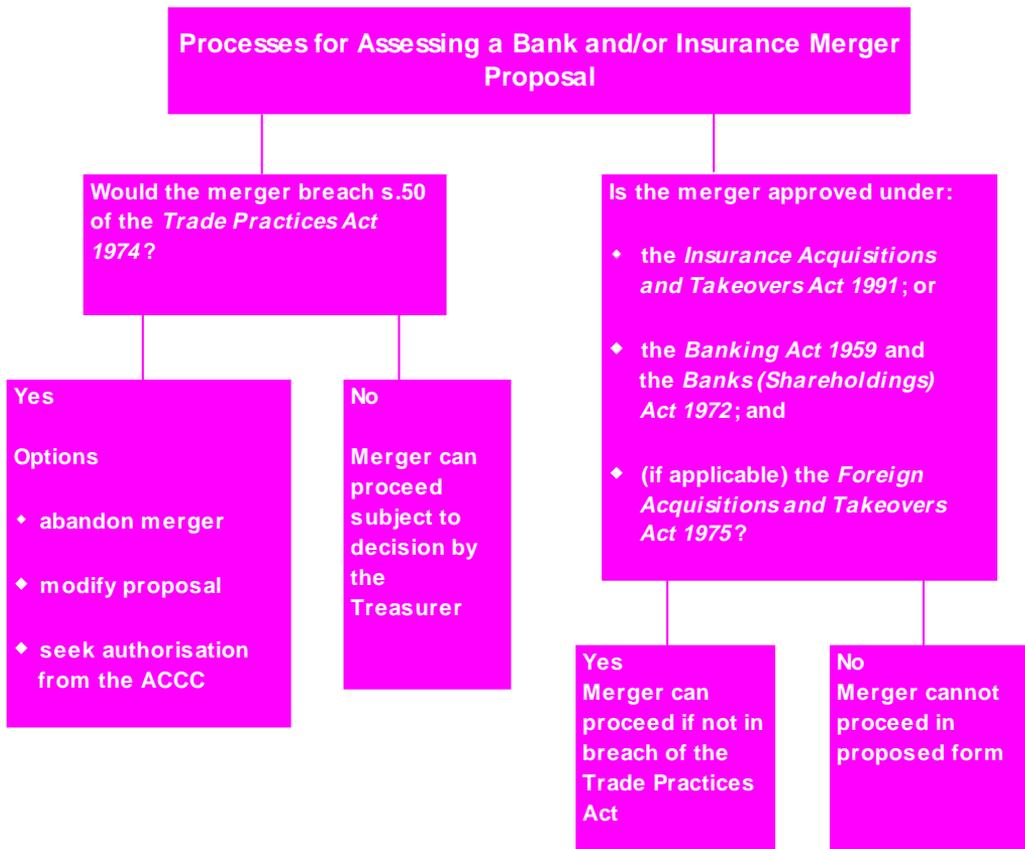
- the arrangements for merger regulation, having regard to its different regulatory purposes;
- the 'six pillars' policy;
- influences on competition in the financial sector and their relevance to mergers; and
- issues in foreign investment regulation of the financial sector.

Arrangements for Merger Regulation

Existing Arrangements

6.13 Under existing arrangements, there is a degree of regulatory duplication in the oversight of mergers involving banks and/or insurance companies. Mergers involving these institutions are required both to pass the test under the *Trade Practices Act 1974* and to receive the consent of the Treasurer under banking and insurance laws. Competition considerations are relevant under both. There is thus the potential for conflict as well as duplication.

Figure 6.1: Processes for Assessing a Bank and/or Insurance Merger Proposal



Trade Practices Law

6.14 The principal law governing mergers in Australia is contained in s.50 of the *Trade Practices Act 1974*. This provision prohibits mergers or acquisitions which would have the effect, or likely effect, of substantially lessening competition in a substantial market for goods or services.⁵ This law applies to all industries, including the financial services industry.

5 See also s.50A, which deals with acquisitions occurring outside Australia which would substantially lessen competition in a market within Australia.

6.15 Under trade practices law, whether or not a merger would breach the s.50 test is a matter for determination on the facts. In the first instance, the Australian Competition and Consumer Commission (ACCC) may form a view in relation to a particular merger and advise the parties accordingly. However, any view so formed does not of itself prevent the merger from proceeding. If a merger proceeds in circumstances where the ACCC has formed a view that it would breach s.50, the Commission may apply to the Federal Court to have the merger ruled in breach of the law — in which case penalties may be applied and the merger overturned.

6.16 The Trade Practices Act also provides a process whereby immunity can be granted, on public benefit grounds, for mergers which would otherwise breach the merger provisions of the Act. This process is known as ‘authorisation’.

6.17 Under s.90(9) of the Act, the ACCC can grant an authorisation if it is satisfied:

in all the circumstances that the proposed acquisition would result, or be likely to result, in such a benefit to the public that the acquisition should be allowed to take place.

Banking and Insurance Laws

6.18 Powers over bank and insurance company mergers are also provided in the banking and insurance laws.

6.19 The Treasurer has powers over bank mergers under prudential legislation, namely the *Banking Act 1959* and the *Banks (Shareholdings) Act 1972*. The Banking Act provides for the authorisation of banks and for the imposition of conditions on such authorities. It also requires authorised banks to seek the permission of the Treasurer to effect a sale, amalgamation or reconstruction, or to form a partnership or association (s.63). The Act provides no guidance on how the Treasurer is to exercise this discretion

beyond stating that the Treasurer's consent shall not be unreasonably withheld. In practice the Treasurer usually considers:

*any prudential considerations, the potential efficiency gains resulting from any rationalisation, and any potential losses resulting from reduced competition in the financial sector.*⁶

6.20 The Banks (Shareholdings) Act restricts individual shareholdings in banks to 10 per cent or less, subject to exemptions which may be granted by the Treasurer, for shareholdings of up to 15 per cent, or by the Governor-General, for shareholdings above 15 per cent. A national interest test is applied to determine whether or not an exemption should be granted.

6.21 The policy rationale for this legislation is prudential, namely, that such restrictions are needed to ensure a wide dispersal of ownership in order to minimise the likelihood of the stability of a bank being prejudiced by the influence or varying fortunes of a particular shareholder. While the legislation can be used to regulate mergers, that is not its intended purpose. The broader prudential issues relating to these ownership rules are discussed in Chapter 7.

6.22 There are analogous powers in the *Insurance Acquisitions and Takeovers Act 1991*. These give the Treasurer the power to stop the acquisition, or issue, of shares in Australian-registered insurance companies which would result in a person controlling 15 per cent or more of the shares. If an unauthorised action is carried out, the Treasurer can make a divestment order. This law states that its objectives are to protect the public interest in a number of ways, including protecting prudential standards, preventing unsuitable persons from being in a position of influence and preventing undue concentration of economic power. While the primary focus of these objectives is prudential, there is also scope for the Treasurer to regulate acquisitions in the insurance industry under this legislation on competition grounds.⁷

6 Department of the Treasury, Submission No. 143 to the Financial System Inquiry, p.143.

7 See Insurance and Superannuation Commission, Submission No. 53 to the Financial System Inquiry, p.99.

Views Presented in Submissions

6.23 Several themes relating to the role of the ACCC, the Treasurer and the shareholding restrictions emerged from submissions.

- Among those addressing the issue, there was widespread agreement that the banking and financial sectors should not be subject to more demanding merger hurdles or tests on competition grounds than those which apply to other sectors of the economy.
- There was also almost a consensus, in submissions which discussed the issue, that any merger or acquisition involving the banking or financial sector should be subject to the same competition test as is applied to other industries, namely, s.50 of the Trade Practices Act as administered by the ACCC. Submissions supporting this view included those from the four major banks, the major insurance companies (other than Legal and General), the regional banks, American Express, the consumer movement, the Finance Sector Union, and regulators.
- Almost no submissions argued that the existing mergers test under the Trade Practices Act (s.50) should be amended.
- The Treasurer's powers with respect to mergers under banking and insurance laws were criticised, for example by Westpac Banking Corporation, for lacking transparency and creating uncertainty and a double hurdle. These factors were argued to be inconsistent with an efficient financial system.
- The Australian Bankers' Association (ABA) and the Commonwealth Bank of Australia argued that the Treasurer should only exercise the veto power under s.63 of the Banking Act on prudential grounds following advice received from the Reserve Bank of Australia (RBA). The ACCC sought to have s.63 of the Banking Act amended to make it explicit that the Treasurer's consent should not be withheld on competition grounds. St George Bank sought to remove the Treasurer's powers under s.63 and instead vest them in the Governor of the RBA, to be exercised on prudential grounds. Others, however, such as the Bank of Melbourne and Advance Bank, supported the Treasurer retaining the present powers under the Act.

- Westpac supported amending the Banks (Shareholdings) Act so that the Governor of the RBA would approve shareholdings of between 10 per cent and 15 per cent and would make recommendations to the Treasurer where approval was sought for shareholdings over 15 per cent. Under their approach, the Treasurer could reject the proposal only where it was determined that it would not be in the national interest. Applications rejected by the RBA would not be subject to appeal to the Treasurer.
- The ACCC and National Mutual Holdings called for all restrictions on shareholdings to be removed because they constitute an unjustifiable barrier to entry. National Mutual's recommendation formed part of a package of recommendations on prudential issues.
- There was also support, however, for the retention of present powers over shareholdings because of their prudential value. Supporters of retaining the powers included ANZ Banking Group, St George Bank, Colonial Mutual Life Assurance Society and the RBA.

Approach of the Inquiry

6.24 A key issue for the Inquiry is the appropriate assignment of responsibility for the assessment of mergers. This involves determining:

- whether or not it is appropriate for both the Treasurer (as advised by the Treasury and the prudential regulators) and the ACCC to have a role in assessing the competition implications of mergers; and
- the scope of, and means for specifying in legislation, the non-competition issues which may justify the Treasurer, or some other entity, having a separate approval power over mergers.

6.25 In undertaking its assessment, the Inquiry notes its preference, in line with findings of the recent Hilmer Report on National Competition Policy, for all sectors of the economy to be subject to a uniform set of competition policy laws unless there is something special which justifies different treatment.

Options for Regulation of Mergers

6.26 Set out below are options for the regulation of mergers. These options are not mutually exclusive.

Continue Existing System of Dual Assessment

6.27 This option would involve both the Treasurer and the ACCC/courts continuing to have a role in assessing the competition implications of a merger. The Treasurer would also have a role in assessing prudential and other non-competition considerations. Such an approach would be justified if it were established that there are competition considerations in the banking or insurance sectors which are additional to those which would apply under the Trade Practices Act. This view was taken by the then Treasurer in 1990 when the proposed merger between a major bank and a major life office was disallowed, even though it would almost certainly have been approved by the then Trade Practices Commission (now the ACCC). In announcing his decision, the then Treasurer said that the merger would:

*detract more from effective and vigorous competition than is in the national interest.*⁸

Have the Treasurer Accept the Competition Assessment made under the Trade Practices Act

6.28 This could be done in two ways. The Treasurer could adopt a general policy position that, in future, the views of the ACCC or, where relevant, the courts, will be accepted for the purposes of assessing the competition implications of a merger under the banking and insurance laws. Alternatively, the legislation could be amended to reflect this position. The Treasurer's powers would then be restricted to consideration of prudential or other non-competition issues.

6.29 The advantage of either of these approaches is that they would remove an element of duplication and uncertainty as to the application of competition policy in this sector. An issue is whether in their respective

8 Keating, The Right Hon. PJ 1990.

forms the approaches could work reliably, noting the element of discretion in any remaining task of assessing the national interest.

Narrow or Remove Powers over Mergers in Either or Both the Banking and Insurance Laws

6.30 Whether or not this is an acceptable option will depend upon the assessment made of the importance of the non-competition reasons for having a separate power over mergers.

6.31 If a view were formed that these non-competition reasons could, or should, be restricted to a narrow range of objective tests, wholly or principally of a prudential nature, the exercise of these narrower powers, as suggested in some submissions, might be vested in the prudential regulator, under legislation which narrowly defines the matters to be taken into consideration.

6.32 Alternatively, the Governor-General and the Treasurer could retain the powers but again under more narrowly specified laws. An important issue is whether the appropriate considerations can be adequately anticipated and specified.

The ‘Six Pillars’ Policy

Existing Arrangements

6.33 The previous Government stated in May 1990 that mergers would not be permitted between any of the four major banks or two or three major life insurance institutions. This policy position was reiterated in subsequent years.⁹ The policy is known as both the ‘six pillars’ policy and the ‘majors’ policy. These policy pronouncements have been made under the terms of the banking and insurance laws—they have no application under trade practices law. The present Treasurer, the Hon. Peter Costello MP, has stated

9 Keating, The Right Hon. PJ 1990; and Dawkins, The Hon John 1993. The 1993 statement reiterates the 1990 position.

that the policy will remain in force at least until the Government receives and considers the Final Report of this Inquiry.

6.34 An issue for the Inquiry is whether the so-called ‘six pillars’ policy should remain, be abolished or be amended in some way. It is a relevant issue only if the powers to regulate acquisitions provided under the banking and insurance laws are retained and exercised by the Treasurer.

Views Presented in Submissions

6.35 Among those financial institutions addressing the issue, there was almost unanimous support that the ‘six pillars’ policy should be abolished. Supporters of its abolition included, Australian Mutual Provident Society (AMP), National Australia Bank (NAB), Commonwealth Bank, ANZ, Westpac and St George Bank. They argued that mergers between any of the pillars should be assessed in the normal way on the basis of the facts existing at the time of the proposal.

6.36 It was recognised, however, that mergers between one of the banking pillars and one of the insurance pillars could raise issues relating to the ownership of financial conglomerates. This is discussed further in Chapter 7.

6.37 Although not explicitly favouring retention of the policy, the RBA and Treasury submissions noted that there are several non-competition rationales for the policy. These include preventing the development of an undesirable degree of ‘economic power’ and avoiding the creation of an institution which is ‘too big to fail’.

6.38 The RBA did not think that the reduction of 4 banks to 3 would present particular prudential problems. However, it noted that, if this happened there may be pressures for a further move to 2 ‘major’ banks. It stated:

If this were to occur, it would give Australia the most concentrated banking industry in the industrialised world, and would take us into uncharted prudential waters.¹⁰

Bankers Trust Australia raised similar prudential concerns.

6.39 While not specifically referring to the ‘six pillars’ policy, some submissions, primarily from user groups, such as the National Farmers Federation, and individuals, expressed concern about mergers between the pillars — especially between the 4 major banks. The Finance Sector Union specifically called for the ‘six pillars’ policy to be retained.

Approach of the Inquiry

6.40 In its Final Report, the Inquiry will consider whether there remains a special competition or prudential case, over and above general case-by-case assessment processes, for specific policy restrictions on mergers among the financial sector majors. This will involve making recommendations on the future of the ‘six pillars’ policy after examining whether conditions in the financial services sector are such as to warrant special treatment. It will also be necessary to review developments in the market to establish whether the concept of ‘six pillars’ remains clear and relevant.

6.41 The retention of the existing policy, or a modified version of it, may be justified if factors special to the banking and insurance sectors are found to apply to the assessment of competition issues in these sectors or if non-competition (mainly prudential) considerations are found to be significant.

6.42 As noted earlier in this chapter, an example of the former concern is represented by the view expressed by the then Treasurer in 1990 that even a merger of a major life office with a major bank would lessen competition — implying perhaps an all-embracing view of the financial sector and the sources of competition within it.

10 Reserve Bank of Australia, Submission No. 111 to the Financial System Inquiry, p.76.

6.43 An example of the latter non-competition concerns may be that a merger among majors could produce an entity so large that it would compromise prudential regulation—that it may unacceptably concentrate risks to systemic stability.

Influences on the Assessment of Mergers

6.44 In its Final Report, the Inquiry will present its findings on the major new influences on competition in the financial sector, and draw from these any general implications for the assessment of mergers, whether under trade practices law or under banking and insurance laws. This section introduces these issues.

Existing Arrangements

6.45 As noted above, the ACCC has the role of assessing mergers for compliance with the Trade Practices Act. The methodology adopted by the ACCC to help it assess the likely impact of mergers on competition in a market involves a five-stage process:

- defining the market;
- establishing concentration thresholds to filter out mergers which are unlikely to result in a substantial lessening of competition;
- assessing the level of import competition;
- looking at barriers to entry; and
- considering other structural and behavioural market features.

6.46 This methodology was used by the Trade Practices Commission (now the ACCC) in its assessment of the Westpac/Challenge merger in September 1995. That merger was approved. In the course of approving it, however, the Trade Practices Commission made its position clear on three key issues:

- each merger must be assessed on its merits in accordance with the circumstances prevailing at the time;

- at that time, it considered that there was a regional, not a national, market for retail banking products, as opposed to financial services; and
- the presence of a regional bank in a region is important for competition and therefore the ACCC would closely scrutinise any merger involving the last major regional bank in a State or region. (This has become known as the ‘four plus one’ policy.)¹¹

Views Presented in Submissions

6.47 The views expressed by the Trade Practices Commission in its decision on the Westpac/Challenge merger have sparked controversy and collected supporters and detractors. Many of the comments made in the submissions were made against the backdrop of that decision.

6.48 Submissions which dealt with mergers assessment focused on 3 key areas:

- the extent to which the Australian banking sector is competitive;
- the criteria for assessing mergers under the Trade Practices Act; and
- the potential benefits from mergers.

How Competitive is Banking in Australia?

6.49 It was widely asserted that the financial system is more competitive now than it was at the time the Campbell Committee reported. In particular, there was broad agreement that the wholesale sector is competitive and that there is probably now a global wholesale market. Views were mixed, however, on the extent of competition in the retail sector, the degree to which such competition is entrenched and likely future trends. Arguments in submissions therefore focused on the retail sector. This sector is defined as covering the household sector and SMEs, including farms.

¹¹ Trade Practices Commission 1995, p.3.

6.50 The major financial institutions stressed the extent to which banking has become more competitive over the past 15 years. Their submissions pointed to a range of factors, including the impact of deregulation, the number of new entrants in the sector and the potential for more, the drop in interest rate margins, the increased choice in terms of providers and products and the increased convenience associated with banking. Table 6.1 illustrates some of these changes. Dynamic forces, such as technology, globalisation, product specialists and ‘cherry pickers’, consumer demands, disaggregation, outsourcing and joint ventures were identified as forces which will continue to make the sector more contestable and competitive.

Table 6.1: Some Changes in Competitive Conditions: 1980-1996

Number of Financial Institutions		
Type of Institution	1980	1995
Domestic Bank	17	16
Foreign Bank	2	28
Building Society and Credit Union	765	321
Finance Companies	117	103
Merchant Banks	59	83
Life Insurance Companies	45	51
Funds Managers	35	93
Mortgage Originators	0	26
Bank Points of Access		
Access Points	1980	1995
Bank Branches	5,859	6,655
ATMs	25	7,178
EFTPOS	—	107,702
Telephone	—	13 banks offering phone banking (mid 1996)
Internet	—	1 Australian bank allowing transactions (mid 1996)
Bank Hours of Access Per Week		
Access Point	1980	1995
Bank Branches	27	33.5 — 42.5
ATMs	112	168
EFTPOS, Telephone, Internet	-	168

Source: Westpac Banking Corporation, Submission No. 90 to the Financial System Inquiry; Reserve Bank of Australia and Insurance and Superannuation Commission data.

6.51 Submissions also pointed to United States and United Kingdom evidence of potential new non-bank sources of competition in the form of large retail chains, with their brand strength and large customer bases, along with telecommunications companies and software companies. These new entrants were argued to be playing an important role in stimulating competition in the financial sector overseas.

6.52 Regulators, the Treasury, regional banks, user groups and some individuals tended to be less sanguine about the extent of competition in the banking system. A number of submissions argued that until recently the banks had exercised oligopoly power and that, while there had been non-price ‘bells and whistles’ competition, there had been very little price competition. For example, Treasury claimed in its submission:

*Left to themselves, there is little evidence of any inclination among the four major banks, or indeed, even the larger regional retail banks, to engage in any serious price competition at the retail level, notwithstanding that significant differences exist in their cost structures.*¹²

6.53 However, these same submissions argued that in recent years there has been increasing competitive pressures on banks. Non-price competition was seen as being led by second tier regional banks. Similarly, the more recent price competition in the housing area was explained in terms of pressure from outside the banking system.

6.54 A subset of this latter group of submissions argued that levels of competition are not even across the retail sector. Included in this group of arguments was the view that, while there is now price competition in the home mortgage market, this is not the case for other financial products used by the household sector. It was also argued that SMEs only have access to limited sources of finance and that competition in this area is weak. The submission from the Australian Business Chamber, on the other hand, argued that it:

*is cautiously optimistic that in the past 12 to 24 months, the process of business loan competition has indeed begun occurring.*¹³

12 Department of the Treasury, Submission No. 143 to the Financial System Inquiry, p.48.

13 Australian Business Chamber, Submission No. 252 to the Financial System Inquiry, p.3.

6.55 Finally, a number of submissions, such as those from the NAB and National Mutual, recognised that the sector will become more competitive if there are significant changes to the regulatory system which reduce barriers to entry and increase the contestability of the market.

Factors Relevant to Assessing Merger Proposals

Market Definition

6.56 Before a merger can be assessed the relevant market must be defined. Markets have product, geographic, functional and time dimensions.

6.57 In respect to the market definition, many submissions, including the submission from the ACCC, recognised that the rapid changes taking place in the financial services sector—such as new delivery mechanisms, disaggregation and new market entrants—are likely to have implications for market definitions in the future and that market definitions must evolve to take account of this rapid change. There was disagreement, however, about the pace of such change and the appropriate definition of ‘the market’ as a result of changes to date.

Cluster of Services Approach

6.58 In the Westpac/Challenge decision, the Trade Practices Commission (now the ACCC) adopted a cluster of services approach to market definition. This meant it included within the market only those institutions which offered all of the products included in the cluster (deposits, loans, transactions).

6.59 Submissions were split as to whether or not this was an appropriate approach. Many major financial institutions opposed the approach and argued that substitutes should be identified for each of the relevant products. The NAB, for example, argued that the cluster of services methodology puts too much emphasis on static markets, while the Commonwealth Bank argued that the ACCC should give greater weight to the competitive dynamics of the industry and the contestability of the relevant market. Westpac argued that the ACCC should concentrate on the major products and their near

substitutes, rather than the category of institution which acts as a product supplier.

6.60 Submissions opposing the cluster approach also pointed to the emergence of product specialists and ‘cherry pickers’ selling tailored unbundled products. The submissions noted that there are now non-bank alternatives for almost all retail banking products, which has meant that banks have had to unbundle their products to a degree.

6.61 Other submissions, especially those from user groups and regional banks, supported the clustering of services approach at this time. They pointed to a ‘cycle of bundling’ and argued that banks are again bundling their products and emphasising relationship banking in response to these new forms of competition. It was also argued that, other than for major purchases, such as a home loan, consumers do not shop around for their financial services and prefer the convenience of having all services offered by a single institution. It was recognised in some of these submissions, however, that future changes in the market may render the cluster of services approach obsolete.

Product Dimension

6.62 The predominant view among the major banks was that the appropriate definition is of a market for financial services, not retail banking products. In support they pointed to such factors as the blurring in the distinction between both suppliers and product categories; the commoditisation of products; and the range of non-bank financial institutions and specialist providers (such as mortgage originators) offering products which provide substitutes for traditional retail banking services.

6.63 Other submissions, especially those from some regional banks and the ACCC, argued that the appropriate definition has been one focussing on retail banking products. It was recognised though that this too may change. Arguments given to support a retail banking products definition were similar to those supporting the cluster methodology. They included the argument that, other than for major loans, consumers do not shop around to find substitutes for bank products; that products offered by insurance companies are not seen by consumers as substitutes for banking products; and that banks bundle products to prevent consumers from shopping

around. It was also argued that there are no real alternatives to the banks for SMEs.

Geographic Dimension

6.64 Submissions were also split on whether or not the market definition should be regional or national. Indeed some, such as ANZ, argued that the market for retail financial services is becoming global although no submissions argued strongly that it has already become so. It was generally recognised that there is a lag between what is technically possible and what consumers choose to do.

6.65 Most of the major banks and insurance companies, as well as the RBA, argued that the market is now national. Among their arguments were the claims that technology is making possible new delivery systems which are reducing the importance of having a physical presence and that banks implement national policies and pricing structures. The advent of giroPost was cited as an example of how contracting out branch functions helps create a national market.

6.66 Particular emphasis was placed upon the first of these points — the development of new delivery mechanisms such as ATMs, EFTPOS, telephone banking and home banking. Trends in take-up rates for ATMs and EFTPOS, and predictions on take-up rates for telephone banking and computer-based home banking, were used to illustrate the further expected reduction in the importance of having a physical presence — although no submission predicted the total demise of branches.

6.67 The Inquiry is aware of several innovative examples of direct banking and direct insurance selling in the United States and United Kingdom which suggest that it may no longer be essential for a financial institution to have its own branch network. In those instances, however, backup branch services were contracted through an alternative supplier.

6.68 Others, including some regional banks and user groups argued that markets remain regional at this time. A large number of arguments were put in support of this view.

- The ACCC argued that at the time of the Westpac/Challenge merger retail customers were unlikely to seek out interstate suppliers of banking products in response to a moderate price rise and, similarly, potential interstate suppliers were unlikely to respond to a moderate price increase in another State.
- Several submissions, including those from St George and Bendigo Banks, argued that, while reducing in number and changing in form, branches will remain a key distribution platform, largely due to customer preference for institutions with a local presence.
- The Australian Consumers' Association (ACA), the ACCC and others made the point that the availability of new technologies must be balanced against their take-up rate, that is, that demand-side considerations must be taken into account as well as those on the supply-side.
- A number of submissions argued that there is an emerging trend towards regional management and pricing strategies among at least some multi-State banks.

Time Dimension

6.69 In the few submissions which addressed this issue, (such as NAB's), there was a strong view that a long-term time frame should be used for assessing the impact which a merger is likely to have on competition. This point was stressed because of the belief that there will continue to be widespread and rapid changes in the financial sector over the next 5 to 10 years. It was argued that such changes may have a significant impact on the appropriate market definition.

Concentration Levels

6.70 It was generally argued in submissions that concentration ratios alone do not determine whether or not a market will be competitive. For example, NAB argued that competition is a process and cannot be determined on the basis of concentration ratios.

6.71 Following on from such arguments, though, some submissions, such as that of the ACCC, put the view that high concentration rates suggest a

greater need for close scrutiny of a merger proposal. Several submissions noted that the Australian banking industry is among the most concentrated in the industrialised world — under one analysis, fourth behind Sweden, the Netherlands and Finland.¹⁴

6.72 Some submissions sought to draw inferences from concentration ratios and profitability. Bankers Trust, for instance, argued that there is evidence that higher concentration in banking is associated with higher profitability and that Australia lies towards the top in international comparisons of concentration and profitability. Alternatively, NAB presented OECD evidence to argue that there is no correlation between concentration and profitability.

Import Competition

6.73 In this context, imports refer to financial services and products provided from off-shore—they do not include products and services provided by a foreign institution with an Australian base. Submissions did not argue that there is any significant import substitution for retail financial services at the present time. Submissions were mixed on whether such a market would emerge and, if so, when. Several submissions provided examples of existing Internet sites¹⁵. These showed that most sites are still used only for promotional purposes. A minority offer online banking services. Most of these, however, are restricted to residents of the institution's home country.

Barriers to Entry and Exit

6.74 Views in submissions were split as to the extent to which barriers to entry and exit remain and the extent to which those remaining constitute an impediment to the contestability of the market.

6.75 Although there was general agreement that technology had reduced barriers to entry, there was disagreement about the extent. Contrary evidence

14 See Bank for International Settlements 1996, *66th Annual Report*, p.86.

15 See for example, Australian Mutual Provident Society, Submission No. 97 and National Mutual Holdings, Submission No. 32 to the Financial System Inquiry.

was provided about a number of possible barriers such as the need for, and cost of, establishing physical distribution networks and the ability of the major banks to use their brands and retaliatory price competition to respond effectively to new competitors. St George Bank, for example, argued that the major banks are able to respond to new competition by engaging in product differentiation and bundling a range of services for consumers. They concluded from this that the threat of new entry is not as credible a threat as the theory of contestability suggests.¹⁶ That is, the threat of new entry is not necessarily sufficient to ensure effective long-term competition.

6.76 In contrast, Westpac argued:

*While there is a range of necessary regulatory and prudential requirements to be met in becoming a bank, there are far fewer and less onerous requirements to becoming a niche provider of many of the products and services that banks provide.*¹⁷

6.77 Several submissions made recommendations concerning regulatory reforms which would assist with reducing barriers to entry. These included removing the ‘hundred points requirement’ for opening a bank account; changing laws in order to facilitate electronic commerce, for example, by making electronic signatures permissible; and expanding access to the payments system. This last issue is discussed further in Chapter 7, and removing bars to electronic commerce is discussed in Chapter 9.

6.78 It was also argued that regulatory barriers were partially responsible for discouraging new foreign entrants to the market. For example, a leading United States mutual fund manager, Fidelity Investments, argued it would not offer its existing products in Australia because of the tax rules on foreign investment funds (see Chapter 9).

6.79 Evidence of decomposition/disaggregation in the financial sector was also presented as proof of reduced barriers to entry. It was argued that the economies of scale available for certain functions, such as cheque processing, mean that there is an increasing trend towards contracting out functions which the institution does not have a competitive advantage in

16 St George Bank, Submission No. 212 to the Financial System Inquiry, p.5.

17 Westpac Banking Corporation, Submission No. 90 to the Financial System Inquiry, p.143.

performing itself. A similar trend noted is that towards joint ventures—especially in areas relating to technology. These trends were argued to make entry easier as new entrants will not be required to be skilled in, or perform, all aspects of the ‘value chain’.

Role of Regional Banks

6.80 This issue was addressed mainly in the submissions from the regional banks and the ACCC. Major banks concentrated on arguing for a national market—which, if accepted, would make the present ‘four plus one’ policy less relevant.

6.81 Evidence was put forward by those supporting the case that regional banks play an important role in ensuring competition in this sector. For example, the submissions from the Bank of Melbourne and Bendigo Bank showed that regional banks enjoy higher levels of customer satisfaction, while the submission from St George Bank argued that regionals price their lending products competitively with the majors and tend to be more responsive to market conditions. It also said that regional banks are more flexible in addressing customers’ requirements and expectations and are, on average, more efficient than the major banks.

6.82 The Australian Business Chamber argued that there is ‘overwhelming’ evidence that regional banks are ‘providing a much-needed challenge to the major banks which in turn is reflected in lower interest rates, wider product choice and better customer service’.¹⁸ Along a similar line, a survey commissioned by St George Bank, the Bank of Melbourne and Bendigo Bank concluded that 76 per cent of consumers believe the role of regional banks is to keep the major banks competitive and that consumers do not consider building societies and credit unions credible substitutes for banks.

6.83 The predominant view of those supporting the importance of regionals to competition can be summed up by the position of St George Bank that, without regional banks:

18 Australian Business Chamber, Submission No. 252 to the Financial System Inquiry, p.11.

*the Australian banking sector would return to the competitive hibernation that existed prior to deregulation.*¹⁹

Potential Benefits from Mergers

6.84 Submissions also considered the benefits which may or may not arise from mergers. Any such benefits may be relevant to assessing the impact of a merger on competition under s.50 of the Trade Practices Act if they can be shown to be pro-competitive. More commonly, they would be relevant to assessing public benefit considerations under the authorisations procedure.

Efficiencies from Bank Mergers

6.85 The only widely-accepted view on efficiencies to emerge from the submissions was that, while Australian banks have improved their efficiency in recent years, there is still scope for them to be more efficient.

6.86 There were differing views, however, as to whether or not mergers are an effective tool for increasing efficiencies in the Australian banking sector.

6.87 The submissions generally recognised that evidence from studies on bank mergers and efficiencies to date has, at best, been equivocal on whether or not there are efficiency gains to be had and, on the whole, points towards there being no correlation between bank mergers and improved efficiency. There was no consensus, however, as to the applicability of this evidence to future merger scenarios. Views put included those listed below.

- The RBA argued that there is no compelling Australian or overseas evidence that economies of scale exist in banking. The RBA stated that 'large banks do not typically have lower average costs than smaller banks, and both specialised and multi-product banks appear to be commercially viable.'²⁰

19 St George Bank, Submission No. 212 to the Financial System Inquiry, p.3.

20 Reserve Bank of Australia, Submission No. 111 to the Financial System Inquiry, p.75.

- The ANZ noted in its submission that its ‘own experience of the commercial reality is that the savings that appear possible on paper through, for example, removal of network and system duplication, are not always fully realisable’ and that ‘cost-cutting may be accompanied by revenue-cutting and a portion of the acquired market share lost.’²¹
- Some submissions, however, such as that of the Commonwealth Bank, criticised the methodology of many of the existing studies and sought to distinguish such studies from current circumstances in Australia or to argue that the situation will be different in the future. NAB argued that evidence from very recent United States mergers supports this position.
- A large number of submissions, including those of all of the major banks, argued that there are large cost savings to be made on the technology side through economies of scale in processing. Some of these same submissions noted that such efficiencies can be accessed in a number of ways, including outsourcing, joint ventures, foreign expansion and mergers. On this last point, Westpac also noted that there are many ways to achieve scale economies, although it argued that ‘scale economies typically relate to bank processes rather than to the size of an institution itself.’²²
- Others submissions, such as NAB’s, put the case that the most likely scenario for efficiency gains in bank mergers would be where a well-managed and efficient institution takes over an inefficient one.
- Westpac argued that a mergers policy based on a static view of the market will prevent financial institutions from lowering their costs and becoming more efficient. It argued that this will result in customers being denied the benefits of lower-cost financial services and mean that the Australian banking sector may not be able to maintain international competitiveness.
- St George Bank, on the other hand, argued that it is competitive pressure, not short-term merger-related cost savings, which ultimately generates economic efficiency and enhances community

21 ANZ Banking Group, Submission No. 94 to the Financial System Inquiry, p.51.

22 Westpac Banking Corporation, Submission No. 90 to the Financial System Inquiry, p.76.

welfare. It argued that if there is little competition, then it is likely that higher cost levels will be allowed to reappear.

- While speculating that mergers among the majors may achieve some efficiency gains, Bankers Trust posed the question of whether sufficient competition would remain so that any efficiency gains would pass through to consumers ‘and not just boost the remaining banks’ profits’²³. Similarly, the ACA argued that, in markets which are less competitive, efficiency gains are unlikely to be passed on to consumers.
- United States evidence provided to the Inquiry by the United States Federal Reserve suggested that, while cost savings can be attained from mergers, evidence collected by it about the most relevant United States bank mergers (those among relatively large banks) does not support a general conclusion that they have led to efficiency gains.

6.88 A particular focus of the submissions was on the impact of mergers on branch closures. While there was agreement on the institutional side that there is a need to reduce the number of bank branches in Australia, and evidence presented that this is happening and will continue to do so with or without mergers, there were divergent views on whether bank mergers which resulted in branch closures would result in improved efficiencies.

- Westpac argued:

One way of significantly reducing the over-capacity that exists in Australia is through mergers. A merger of existing banking entities would facilitate significant reductions in branch numbers and corporate overhead costs and thus achieve significant rationalisation benefits. Ultimately, the only source of real consumer benefit is for Australia to have a lower cost banking system that permits lower margins and lower prices.²⁴

- NAB noted:

By far the largest proportion of the savings (from mergers) come in the areas of operations and systems and other support areas. Even with

23 Bankers Trust Australia, Submission No. 136 to the Financial System Inquiry, p.46.

24 Westpac Banking Corporation, Submission No. 90 to the Financial System Inquiry, p.76.

*in-market mergers, the scope for savings through the rationalisation of branch networks are generally estimated as fairly minor.*²⁵

6.89 The ACCC stated that it did not question that cost savings could be achieved by closing branches and by reducing staff numbers. It argued, however, that such moves result in short-run cost savings which do not necessarily indicate any improvement in the internal efficiency of the merging banks as regards long-run costs. It stated that, as a general view, it believes that efficiency claims should form part of an application for authorisation.

National Champions

6.90 There have been claims that major bank mergers are necessary to create national financial sector champions—that is, firms with sufficient critical mass to compete successfully in global markets. This issue received modest attention in submissions.

6.91 Almost all of those submissions which addressed the issue did not support the case for national champions. Arguments against the case included the observation that several Australian financial institutions already successfully compete overseas; that takeovers in foreign markets may be a more efficient method of achieving international growth; that expertise in specialist areas is more important than overall institutional size for financial sector success; and that the most effective way to make a firm internationally competitive is to ensure that it is exposed to strong domestic competition. This last view was held by a disparate range of institutions including, the ANZ, the ACCC and the ACA.

6.92 Colonial Mutual put forward a range of arguments as to why the national champions argument may apply to the manufacturing industry but, why in its view, it does not apply to the financial sector. Advance Bank did not support the case for national champions, because of the relative scale of the Australian economy and currency. It also argued that the limits on generating franking credits in Australia would see any bank of world

25 National Australia Bank, Submission No. 131 to the Financial System Inquiry, pp.5-10.

significance inevitably transform so as to lose its characterisation as Australian.

6.93 A small number of submissions supported the case for national champions. NAB, for example, pointed to the Dutch experience in support of the thesis that a critical mass is necessary to compete successfully off-shore. (There are three major banks in the Netherlands — a country with a similar population size to Australia's.)

6.94 Views put to the Inquiry in discussions overseas suggested that size is helpful in efforts to expand internationally because of the depth of human resources and capital it provides and because stable and diverse income flows are important to maintaining high credit ratings. However, it is necessary to distinguish situations where domestic economies of scale allow a participant to obtain a cost advantage in an overseas market, as opposed to situations where foreign success is based on the transfer of technology and skills.

General Attitudes to Mergers

6.95 Views expressed in submissions ranged from suspicion of mergers to total support for them. Many submissions were somewhere in between these two extremes and concentrated on arguing that the dynamic aspects of the industry must be taken into account when assessing mergers. Those favouring mergers pointed primarily to the efficiency gains which could be achieved and increasing competitive pressures in the sector.

6.96 Those opposing increased merger activity primarily stressed possible reductions in competition. The Finance Sector Union (FSU) also raised concerns about job losses resulting from mergers. The FSU called for a transparent process for assessing the social impacts of mergers — especially with respect to access to services and employment effects. The Australian Business Chamber argued in its submission that 'a go-ahead for mergers would spell a return to a "credit squeeze" on SMEs'.²⁶

26 Australian Business Chamber, Submission No. 252 to the Financial System Inquiry, p.1.

6.97 Most submissions did not comment on individual merger scenarios and favoured leaving any proposals to be assessed under mergers law. No major concerns were expressed about mergers between banks and insurance companies.

Approach of the Inquiry

6.98 The main task of the Inquiry is to make recommendations on the overall regulatory framework of the financial services sector, including the appropriate framework for the determination of merger assessments.

6.99 The Inquiry will not comment on individual merger possibilities. This has not been sought in submissions and it is not appropriate for the Inquiry to comment on specific commercial matters. It is also recognised that merger proposals must be assessed on a case-by-case basis, taking account of the facts at the time. This is especially so in a sector undergoing rapid change.

6.100 As discussed above, however, there is a range of dimensions which form the basis for merger assessments. These include:

- market definitions, including:
 - the cluster of services approach
 - product, geographic and time dimensions;
- concentration levels;
- the level of import competition;
- barriers to entry; and
- other structural and behavioural market features such as the role of regional banks and other financial service providers.

6.101 There are also potential benefits from mergers, such as improved efficiency and the creation of national champions, which may be relevant to a merger assessment but which are more likely to be considered in the context of an application for authorisation.

6.102 It is not the intention of the Inquiry to make conclusive assessments of all of the factors listed above. However, the Inquiry will, to the extent that

it is relevant, report on the scale and nature of changes in the financial services industry. In many cases this may be relevant to any subsequent assessment by regulatory agencies of the above factors in the context of specific merger proposals.

6.103 The Inquiry will have particular regard to potential new sources of competition or other developments likely to have the effect of increasing competition. It will also draw attention to any changes to the regulatory schema, including any proposed by the Inquiry, that may have implications for the contestability of the sector.

Foreign Investment and Acquisitions

Existing Arrangements

6.104 Foreign investment in the banking and insurance sectors is required to be in accordance with the *Banking Act 1959*, the *Banks (Shareholdings) Act 1972*, the *Insurance Acquisitions and Takeovers Act 1991* and banking and insurance policy, including prudential requirements. In addition, any acquisition of a substantial interest in an Australian institution, including a financial institution, needs to be approved by the Treasurer under the *Foreign Acquisitions and Takeovers Act 1975*. Acquisitions will be approved if they are judged not to be contrary to the national interest.

6.105 The primary rationale for controls over foreign investment under the banking law is prudential. Government policy permits the issue of new banking authorities to foreign-owned banks where the RBA is satisfied the bank and its home supervisor are of sufficient standing, and where the bank agrees to comply with RBA prudential regulation. Specifically, to obtain an authority to operate either a locally incorporated bank or a branch in Australia, the ultimate parent entity must be a bank and supervised on a consolidated basis in its home jurisdiction in accordance with the Basle Concordat. Ownership issues are discussed in greater detail in Chapter 7.

6.106 Similarly, prudential considerations are relevant to foreign investment decisions under insurance law. For insurance, however, there are no pre-established criteria for assessing a foreign applicant. Rather, each is

considered on a case-by-case basis, taking into account such issues as the suitability of the parent company and its demonstrated expertise in insurance.

6.107 The national interest considerations under the Foreign Acquisitions and Takeovers Act are not spelt out. They are influenced by an array of matters, including prudential concerns and the social and political climate of the time.

6.108 Government policy in recent years has specified that foreign-owned banks will not be precluded from bidding for the smaller banks. The policy of the previous government, however, was that it would not approve the foreign takeover of any of the four major banks.²⁷

6.109 In addition to these specific rules on foreign investment, the current law effectively prohibits branches of foreign banks accepting retail deposits in Australia (see Chapter 7).

Views Presented in Submissions

6.110 The submissions expressed diverse views on the issue of foreign investment in the financial sector. Chief among them were those listed below.

- Treasury expressed the view that relaxing the restrictions on foreign takeovers and on foreign branches accepting retail deposits could enhance competitive pressures in the Australian market and facilitate major branch and overhead rationalisation among Australian banks.
- Treasury also put the view that it is questionable whether the policy prohibition on foreign takeovers of the 4 major banks should exist in addition to the Foreign Acquisitions and Takeovers Act.
- The ANZ raised concerns about foreign takeovers leading to the shifting of head offices and a consequent 'brain drain' of the best

27 See Department of the Treasury 1996. See also Keating, The Right Hon PJ 1992, p.69; and Dawkins, The Hon John 1993, p.4. for the policy statements setting out the ban on foreign takeover of the big four banks.

managers and most skilled staff. It was argued that future generations would not be trained in key management and technical skills, and that employment opportunities for allied professions, such as those in technology, diminish. The experience in New Zealand, where all major banks are now foreign controlled, was cited in support of this argument.

- Macquarie Bank and the ANZ also argued that there will be reduced interest in developing export markets for Australian-based institutions and reduced feedback from overseas branches to Australian companies about potential export opportunities.
- Colonial Mutual argued that it is in Australia's interests that ownership of financial institutions operating in Australia remain largely Australian, given the significance of the industry to Australia's financial stability and long-term economic well-being.
- The Australian Owned Companies' Association (ACOA), and a number of individuals such as Mr R. Donovan, supported this view. ACOA put the position that mergers of Australian institutions should be allowed if the alternative is foreign ownership.
- Westpac noted that, while foreign investment may not raise competition or efficiency concerns, there is likely to be community sensitivity if a foreign bank acquires an Australian bank of any size—this sensitivity, it stated, is shared throughout OECD countries. It thus supported the current process for assessing foreign investment proposals.
- Colonial Mutual also argued for a reciprocal approach, stating that Australia should not have an open-doors policy when many of its trading partners maintain restrictions on foreign entrants.
- At the other extreme, it was argued by others, such as the ACCC, St George Bank and Citibank, that there should be no specific restrictions on foreign investment and acquisitions in the financial sector. Included in this view was the opinion that the Foreign Acquisitions and Takeovers Act should not apply to the financial sector. It was argued that all such restrictions constitute an unjustified barrier to entry and consequently an impediment to the contestability of the sector. It was also argued that national interest concerns are adequately covered by the banking and insurance laws.

- The submission from the Department of Foreign Affairs and Trade noted that there are various international negotiations under way which aim at achieving non-discriminatory trade and investment in financial services. These include negotiations under the General Agreement on Trade in Services, World Trade Organisation negotiations and Asia-Pacific Economic Co-operation (APEC) developments. In such negotiations, Australia will be pressing for improved access to markets of commercial significance. This is likely to mean that Australia will come under pressure to liberalise barriers — such as the application of foreign investment policy in the financial services sector — to its own market.
- Finally, it was argued that, while reasons for foreign investment limitations will continue to exist, globalisation will render limitations less effective and more difficult to justify and enforce. For these reasons, National Mutual argued that foreign investment policy should change over time to reflect the globalisation of the financial services industry.
- No submission argued that there should be no prudential regulation of foreign investment although there was dissatisfaction with the content of some of the RBA's restrictions.

Approach of the Inquiry

6.111 In its Final Report, the Inquiry will address two issues associated with foreign investment in the financial sector.

- First, it will consider whether there is justification for a general policy against foreign acquisitions of major banks or life offices or whether there is justification for permitting more active foreign participation.
- Secondly, it will consider whether there are any special considerations relevant to financial sector mergers which should be taken into account in the assessment of the national interest under the Foreign Acquisitions and Takeovers Act. This may include consideration of the benefits which foreign investment in Australia may bring in access to new technologies and skills and the advantages for Australia and Australian consumers in encouraging

the full impact of global competition in financial markets. It may also include consideration of the arguments less supportive of foreign investment, such as whether there is a need for reciprocity in foreign investment policy.

6.112 As for other issues, the Inquiry's starting point is that there should be no special industry-specific rules or policies unless these can be clearly justified.