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The Nature of Competition in Australian Retail Banking

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The Nature of Competition in Australian Retail Banking

Rob Nicholls¹ and Carolyn Evans²

Abstract

Emerging rather less scarred than many from the most recent global financial crisis in 2008, Australia has a banking and finance industry evidencing long term stability, but moderate to high concentration as a result of long prevailing policy. In 2015, whether that level of concentration signifies less than desirable levels of competition is very much a current issue for policy makers.

If the Australian Government's 'four pillars' bank policy is the cornerstone of the banking industry structure as it now stands, it is hardly uncontested as a 'good thing'. As well, in a post-GFC climate of concerns over the public benefits of growth and prosperity that ride on private enterprise in banks, whether the public purse can or should support the mistakes or misjudgements of private enterprise banks renews the perennial governance challenge for elected government and regulators - setting clear policy objectives and then regulating effectively to those ends.

In common with other advanced economies, the size and influence of the financial services industry in Australia means that policy makers have their work cut out to remain independent in forming their opinions. Moreover, policy makers are with faced with the competing interests of an industry characterised by the fact of homogenous business models and highly domesticated risk profiles, and the possibility that diversification in the economy may be undermined by insufficient diversity in banking that, in turn, produces less than vibrant competition. Of course, there is also the effective certainty of a future financial crisis of some kind.

As a contribution to ongoing debate, this working paper discusses retail banking in Australia as a platform for Australia's long term prosperity from business and wellbeing in households.

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This working paper is published to promote comments and feedback.

Please do not quote without contacting the corresponding author.

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1 Introduction

This working paper examines the nature of competition in the retail banking sector in Australia in the context of Australia's regulatory framework for the financial services industry (OECD 2010b: 69). The principal agencies involved are three specific to financial services and one with a broad remit on competition. The entities within this governance structure are all national and independent, and have specified roles, responsibilities and relationships to other agencies (including the State and Federal Governments).

The first agency is the Reserve Bank of Australia (RBA) which is Australia's central bank. Its responsibilities include contributing to the stability of the currency, setting the cash rate to meet an agreed medium-term inflation target, issuing banknotes, managing Australia's gold and foreign exchange reserves and various banking services for the Australian Government.

The second agency is the Australia Securities and Investment Commission (ASIC), which, among other things, regulates financial dealing and advising (on investments, superannuation, insurance, deposit taking and credit, including related licensing and ensuring that licensees meet relevant standards). It supervises trading on Australia's domestic licensed equity, derivatives and futures markets (since 2010), and assesses how effectively authorised financial markets are complying with their legal obligations (including advising government on authorising new markets). More recently, ASIC implements the National Financial Literacy Strategy under the *National Consumer Credit Protection Act 2009* (Cth).

The third entity is the Australian Prudential Regulatory Authority (APRA), which is the prudential regulator of banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most of the superannuation industry.

The final body is the Australian Competition and Consumer Commission (ACCC), which is the competition regulator and has primary responsibility across all industries to ensure compliance with Australian competition, fair trading, and consumer protection laws under the *Competition and Consumer Act 2010* (Cth).

The key features of the financial services sector in Australia suggest that at least three overarching considerations should inform policy objectives that may arise. These include a nuanced understanding of the role played by banks in the ongoing economic prosperity of Australia, an independent, facts-based appreciation of the causal role of competition, and an evidence-based assessment of potential risk from policies that preference stability over competition.

This working paper puts focus on retail banking because of its importance in the structure of financial services in Australia. The scope of retail banking here includes:

- (a) for households/individuals: loans, credit cards, transaction accounts, deposits and term savings products and wealth management services, but excluding superannuation and recognising, as noted later in the working paper, that definitive data on wealth management is particularly problematic; and
- (b) for small-sized and medium-sized enterprises (SMEs): similarly, loans, credit cards, transaction accounts, deposits and term savings products, plus business banking products and services where identifiable (such as business loans and overdrafts), noting that (in relation to how the

ACCC may define markets) SME agribusiness is grouped with SMEs, while larger scale agribusiness conducted by corporations is grouped with wholesale banking and outside the scope of this discussion.

This working paper begins with an examination of the the environment of the Australian financial services sector. It does this by setting out the effects of the global financial crisis and painting a picture of the shape of the financial services sector, then defining markets in the financial services sector in a manner which is consistent with the prevailing policy and practice of the ACCC. The paper goes on to characterise markets in terms of market participants and conditions, such as barriers to entry and exit. It then examines evidence of market metrics as the basis for discussion of key issues arising in relation to competition policy generally or financial system policy specifically, before concluding that, given a concentrated market where competition is less than vigorous, policy makers face more nuanced choices than simply whether to accept conventional wisdom and continue preferencing stability over competition.

2 The environment

2.1 Life after the financial crisis

Australia emerged from the financial crisis not unscathed, but certainly with fewer scars than most in the short term. In part buoyed by the mining boom (for an estimate of the impact of the mining boom see Downes, Hanslow and Tulip 2014), Brown (2010) showed in her post-financial crisis comparison of the USA, the UK and Australia that there were two other distinguishing features of Australia's experience.

First, general conditions saw economic growth slow, but not to recession levels, meaning that there was a marginal increase, rather than a step function, in the risk of impaired loan assets.

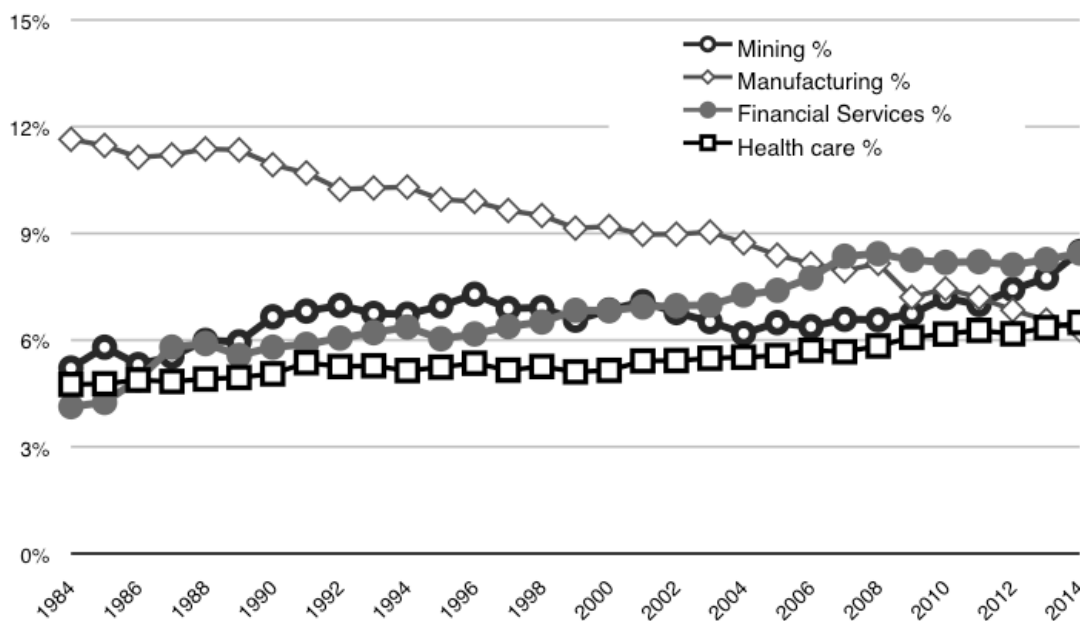
Second, housing markets were unsettled, but apparently without a 'bubble' waiting to burst. Importantly, the absence of a 'bubble' illustrates the fundamental differences in the manner and means of housing finance in Australia. They include the combination of an Australia-wide comprehensive and generally well-enforced consumer protection regime under the *National Consumer Credit Protection Act 2009* (Cth), balanced against a universal practice of mortgages being full-recourse loans. The latter entrenches the motivation to make repayments even in times of financial distress, since abandoning the mortgaged property will not necessarily discharge the debt as it would do in a limited recourse loan. Thus a strong social norm of paying the mortgage has been created by a long history of full recourse mortgages as the legal norm, which is balanced by a supportive net of effective consumer protection law, and together these militate against the development of a 'bubble'.

As Brown also showed, return on equity for Australian banks remained solid, and while realisation of nonperforming loans increased, the rise was quite modest and not above manageable levels. Rather than being pressed to respond to imminent or actual bank or financial institution failures, the Australian Government's bank deposit guarantee was instead a (well-timed) confidence-building gesture for the industry generally (for example, Laing 2011; OECD 2011; Perlich 2009; Rajapakse and Gardner 2014; Yates 2014).

The ongoing strong profit performance of Australian banks was confirmed in the annual report of the BIS for the year ended 31 March 2014. In examining the profitability of the world’s major banks, BIS compared the pre-tax profits of banks in 15 countries, which comprised 11 advanced economies (including the USA, the UK and Australia) and the four BRIC (Brazil, Russia, India and China) economies. Aggregated in three periods spanning before, during and after the financial crisis (being 2000-2007, 2008-2012 and 2013 respectively), Australia clearly led the advanced economies. The BRICs show more mixed, less stable results, although in some periods, specific results were better (Bank for International Settlements 2014).

Medium-term to longer-term, though, the picture is more debatable. As depicted in Figure 1 below, financial services are now equivalent to mining in terms of gross value added to the Australian economy, making them the top two industries on this measure. Figure 1 also illustrates the changing positions of the top four industries over the last three decades, reflecting a trend towards service industries in common with other advanced economies. The observable trends re-shaping the Australian economy take the debate beyond financial crisis-driven concerns over systemically important banks (SIBs) or financial institutions (SIFIs), to engage with the industry’s fundamental economic strength in supporting enduring prosperity for Australia.

Figure 1: Long term structural change in GDP composition in Australia (industry share of GDP by gross value added, chain volume measures)



Derived from Australian Bureau of Statistics (2014), Table 6 Gross Value Added by Industry, Chain volume measures. Financial services include insurance; health care includes social assistance services.

Palmer and Jeyaratnam (2014) find that household debt now comprises two thirds of banks’ collective loan assets, using data from APRA (2014) and excluding lending to government and financial corporations. Just four banks hold nearly 85% of \$A1.3 trillion which is the nation’s collective household debt. Despite the lack of a housing bubble noted above, an unprecedented run of economic growth in Australia has deflected attention from the fact that circumstances such as an

economic downturn are always a possible threat to the general capacity of householders to service their mortgages. That aside, more serious questions remain about whether the financial industry really is healthy and structurally sound when it is so exposed to house price fluctuations and that risk is concentrated in so few hands.

Put another way, if both mining and banking were to become troubled, how would Australia manage and how well placed are policy makers to respond? Did the mining boom just mask deeper problems from a 'two speed economy' with undetected recession risk, where the 'resource states' of Western Australia and Queensland register stronger growth than 'non-resource States' of New South Wales and Victoria? (for example, Perlich 2009, 2013/2014). The wind down from the mining boom has led to the RBA having a policy to reduce the value of the Australian dollar. This is to avoid 'Dutch disease', where the currency trades at (prejudicially) high levels under pressure from the inflow of cash from mining exports (Critchlow and Curran 2012).

During 2014, two studies were conducted at the behest of the Australian Government. Echoing the regulatory approach to financial services in Australia, the Financial System Inquiry (Murray et al. 2014a) had a narrow industry focus with the option of a wide lens on policy issues. The Competition Policy Review, chaired by Professor Ian Harper (Harper et al. 2015) had a specific policy focus on competition, but with the discretion to range widely over various industries (not excluding financial services). The specific remits for these studies intersect in relation to identifying the health of financial markets and their soundness from a policy perspective.

Against the backdrop of such projects in the post-financial crisis climate, the character of financial markets in Australia is a pervasive consideration, including whether they are reasonably regarded as efficient, effective, innovative or competitive. Such considerations materially impact the selection and prioritisation of potential policy responses over time, not only in the light of lessons learned from the (most recent) financial crisis. Moreover, how financial markets measure up on these dimensions has ramifications for the challenges ahead in implementing policy recommendations that may be taken up from the Financial System Inquiry and the Competition Policy Review .

General concerns over being efficient, effective, innovative and/or competitive raise specific issues. These include the risks and costs of bank interconnectedness, whether within one country or around the world, which need to be assessed in the context of innovation risks. On the one hand, there is the risk of too much innovation leading to manipulation, such as the manipulation of currency mechanisms (The Economist 2012), or circumvention of, for example, prudential regulation and supervision (Brown 2010). On the other, there is the risk of too little innovation, where customer needs remain unanswered, as discussed later in this working paper.

As well, there are post-financial crisis debates in Australia, such as the latest iteration of the perennial policy dilemma of balancing private enterprise benefits, garnered in good times, against the cost of support expected from the public purse in bad. This time around, the form of that support also raised the question of whether the bank deposit guarantee made conditions more fertile for moral hazard.

In this context, it is as well to keep in mind the inevitability of some other financial/banking crisis in the future, noting that they have been fairly common in the past. Beck points to this reality in drawing on the pre-financial crisis work of Honohan and Laeven:

[According to their stated crisis parameters, they] found 116 systemic banking crises in 113 countries over the period 1974 to 2002, which illustrates how widespread financial crises have become across the globe [noting that the] 1980s and 1990s have been characterized by a relatively large number of banking crises. During this period, at least 20 countries were in a systemic crisis at the same time; ranging from such diverse countries as Japan and US to Argentina and West Africa. In addition to systemic crises, there were numerous non systemic banking crises, which disturbed the normal functioning of bank business (Beck 2008a: 4).

Australia has not been immune to these, but more importantly, took the opportunity to learn from its share of non-systemic crises in financial services. Significantly, consequent reforms were in place before 2008 and no doubt assisted in weathering that particular storm. Not least, earlier crises highlighted need for reform in three areas.

First, Government involvement in market operations. For example, when ‘in the 1990s several state-owned banks foundered and others were taken over’ (The Economist 2011). This included two of today's four major Australian banks which had significant problems at that time. As noted by Wu (2008: 143): ‘In the early 1990s, mergers involving virtually insolvent State banks have been conducted as a solution to bankruptcy, consistent with [other observations that] bank mergers are a substitute for bank failures.’

Second, good governance and independent regulation. For example, when Pyramid Building Society collapsed in 1990, involving around 200,000 depositors who collectively stood to lose \$1.3 billion. That collapse came after intrusion by government ministers who became directly involved in decisions to allow exemptions under relevant regulations, and by providing public backing to Pyramid. This later saw them implicated in the collapse, albeit for bad judgment rather than corruption (The Economist 1990).

Third, the effectiveness of regulation and/or supervision, especially after the 2001 collapse of HIH Insurance with a deficiency estimated at up to \$5.3 billion. This highlighted to industry regulators ‘the importance of using their full regulatory powers’ (Yates 2014: 375). Importantly, this is consistent with the points made by Brown (2010) about industry capture and presumptions about what level of supervision is required for larger or smaller industry players. HIH's collapse was of epic proportions in the Australian economy, but was also credited as ‘the first of several events [in 2001] (September 11 was another) that triggered a rise in global reinsurance premiums’ (The Economist 2002). As a cautionary tale for policy makers and regulators, it is one that spawned a public enquiry that ran for nearly two years (namely the HIH Royal Commission), but also ‘a rather pathetic tale in which, to the great cost of thousands of ordinary Australians, the unwary followed the inept further and further toward predictable demise’ (Allan 2006: 137).

Not unrelated to the earlier of these events was the emergence of the so-called ‘four pillars’ policy, which arguably has determined the shape of the financial services sector as it stands in Australia today, and the role that its signature tune of banking plays in the overall economy.

2.2 The Shape of Financial Services in Australia

Turning first to the superstructure within which financial services are conducted, in common with other advanced economies, Australia is experiencing the relentless shift away from manufacturing of goods to the manufacturing of services. Financial services are thus unsurprisingly one of the two

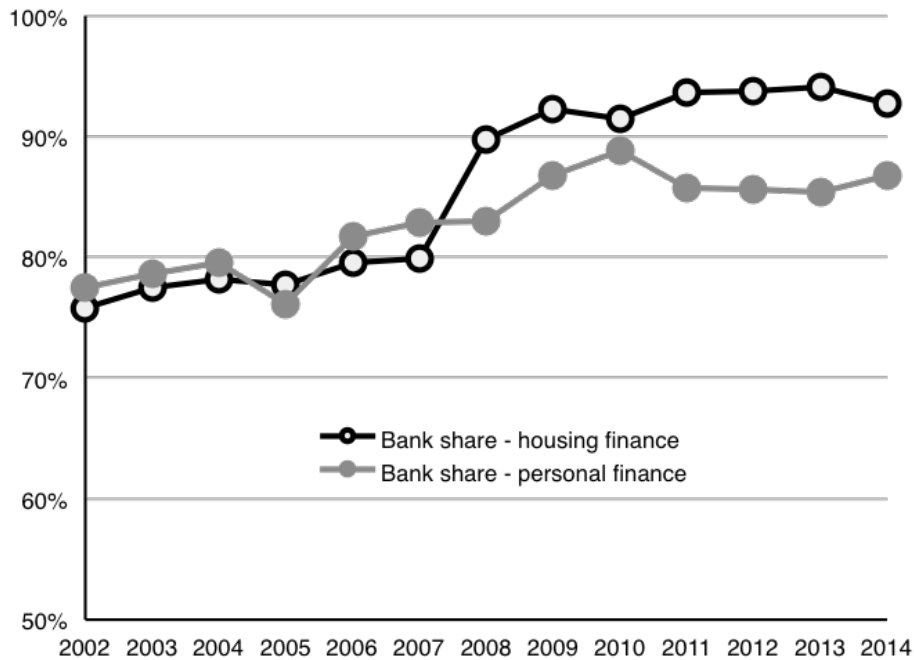
largest contributors of gross value added to GDP (as shown in Figure 1 above). Divergences from other advanced economies create idiosyncrasies in Australia, including that the mining sector matches financial services for scale, that sellers of financial services are concentrated, and that financialisation intertwines the 'real economy' (the buyers of financial services) with the sellers to no small degree.

As it turns out, the nature of institutions providing debt to households is crucial because of the weight that this carries as the definitive portion of financial services. 'Authorised Deposit-taking Institutions' (ADIs) in Australia encompasses banks, building societies and credit unions, which are corporations that become duly authorised institutions under the *Banking Act 1959* (Cth). Both ADIs and other lenders provide a variety of debt funding for non-business consumers. Data collected by the Australian Bureau of Statistics, for example, aggregates household and personal financial commitments held by banks, permanent building societies, credit unions/cooperative credit societies, life or general insurance companies, general government enterprises, superannuation funds, Registered Financial Corporations (RFCs) and securitisers of mortgage assets (wholesale lenders that provide funds to borrowers through a retail intermediary such as mortgage originators).

This is depicted in Figure 2 below, which shows that households in Australia source financing largely from banks. This is not a new development. The trend was well in place in 2002, which was the start of the time for which consistent data is available on the activities of banks. This start date is used for the majority of this working paper to ensure comparability of data sources. At this date, banks (rather than other retail credit providers) were the source of the significant majority of housing finance (then almost 76% and now over 90% by value) and personal finance (then over 77% and now over 85% by value).

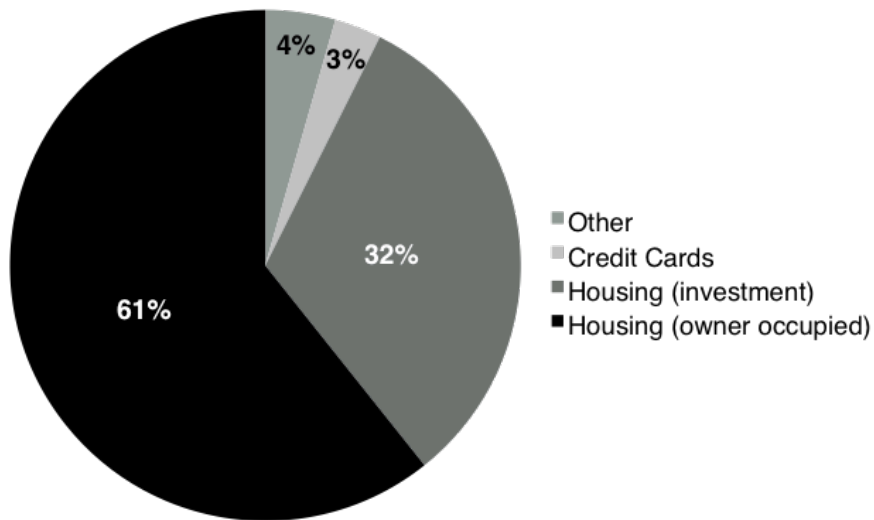
On the other hand, the effect of this increased concentration (of financial services providers as sellers) is that there is a tendency to domesticate risk in the supply of financial services. That is, lenders are oriented towards lending to households and to housing mortgages. These effects are shown in Figure 2 and Figure 3 below.

Figure 2: Household & personal finance commitments



Derived from Australian Bureau of Statistics (2015), Table 2 Housing and Personal Finance Commitments by Lender

Figure 3: All banks, loans to households as at June 2014



Derived from APRA (2014), banking statistics.

This self-perpetuating two-way homogeneity, of households principally seeking funds from banks, and banks being reliant on households for the majority of their profit-making business, adds a distinctive dimension of risk to policy making. Of immediate interest, not least is the contagion risk that could transmit rapidly through the industry in the event of a relevant crisis (whether the result of housing price fluctuation or some systemic challenge to householders' capacity to service their debt). As well, over time the systemic lack of diversification on the supply side entrenches demand

side behaviour in households as the majority customers, with important implications for barriers to entry and exit (discussed further below). But perhaps most importantly, the potentially negative implications for the overall economy are of concern, since as noted by Cetorelli and Strahan, there is 'robust empirical evidence that broader, deeper financial markets are strongly associated, causally, with better prospects for future economic growth' (Cetorelli and Strahan 2006: 437).

The overall picture outlined above flows from the 'four pillars' policy, the long-standing policy on banking in Australia, arising not from legislation but from executive decisions by the (Australian Government) Treasurer and perpetuated by subsequent Treasurers of both political hues.

Articulated formally in 1990, it was 'a reversal of a long standing policy whereby the Reserve Bank of Australia had consistently waved through mergers and encouraged consolidation in the financial sector' (Maddock 2014). Then-Treasurer Paul Keating famously blocked a merger proposed between the Australia and New Zealand Banking Group and the National Mutual Life Association on the basis that it would reduce the effectiveness of competition (Keating 1990). Thus, to support competition the 'pillars' policy was first aimed at maintaining separation of the six most significant financial services institutions in Australia, at that time being the four largest banks and two largest life insurance providers. Importantly, as noted in 1997 by the Wallis Inquiry (the immediate previous inquiry into the financial system), as well as likely receiving support from the Reserve Bank 'the merger would almost certainly have been approved by the then Trade Practices Commission (now the ACCC) (Australian Government 1997: 425).

In 1997, the 'pillars' policy was maintained contrary to the Wallis Inquiry recommendations (Australian Government 1997: 429). The abolition recommendation also had the unanimous support from the 'six pillars' at the time, although unions and consumer groups were against it (Wu 2008: 143). The government of the day did modify the policy, to focus on preventing mergers between the four largest banks, namely Westpac Banking Corporation (Westpac), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB) and Australia New Zealand Banking Group (ANZ).

Since then, successive governments on both sides of the political spectrum have maintained the policy and the status of the 'four pillars'. No specific merger proposals however, have arisen to test the policy, i.e. concerning two or more of the four pillars rather than other banks or financial services players, perhaps due to such bi-partisan consistency. This position has been maintained even against explicit urgings from the 'four pillars' and, implicitly, the wider financial industry. The opinions from the 'four pillars' are much quoted, for example Hepworth (2014) notes that 'Australian bank chiefs have long urged the abolition of the Four Pillars policy on the basis that it prevented them from competing more effectively on the global stage' and Durie and Gluvas (2009) express similar views. Williams (2008) states that Keating 'believed this would ensure a competitive banking market. But the policy soon became a favoured party piñata for bank CEOs, who have argued ever since that it restricts their growth and prevents them from becoming true global players'. In context of the intersecting Financial System Inquiry and Competition Policy Review in 2014, their views were consistent with a notable exception of CBA. As for the wider financial industry, maintaining the four pillars is often implicitly equated with a government guarantee for just these four banks and thus has an impact on bank credit ratings and so on (for example, Customer Owned Banking Association 2014). This has created an incumbency value for the 'four

pillars' that is hard to over-estimate, and entrenches their position as, for all practical purposes, defining the nature of financial services in Australia.

3 Market Definition

To depict retail banking markets in Australia, the purpose of this section is to define markets consistent with the prevailing policy and practice of the ACCC as Australia's competition regulator.

As articulated in 2008, the core approach of the ACCC is that a 'market is the product and geographic space in which rivalry and competition take place', but the approach is necessarily always purposive. That is, 'the definition of a relevant market cannot be separated from the particular merger under investigation' (ACCC 2008b: 16). Accordingly, substitution is key to market definitions (ACCC 2008b: 15), and to the extent that relevant behaviour evolves, so do market definitions.

In common with other advanced economies, over the last two decades Australia has seen substantive change in how markets for financial services operate. Not least are the consequences of the internet emerging as a distribution channel, first for market information and then for transactions, along with various iterations of card chip technology.

This is reflected in ACCC practice. In 1995, when reviewing the merger proposed between Westpac Banking Corporation (one of the four major Australian banks) and Challenge Bank (State-based, in Western Australia), the Trade Practices Commission (the predecessor to the ACCC) adopted the following view. It said that 'the banking market was best examined as a cluster of banking services which were delivered by banks to their customers as a bundle' (Jones, Nielsen and Trayler 2002: 25). In 1997, however, the ACCC (1997: 4) moved to a product-led approach which had regard to geographical and temporal considerations, finding that most retail banking was reliant on branches and therefore was State-based (including, for example, deposit and personal loan products), which is consistent with the Wallis Inquiry (Australian Government 1997).

At that time, a recognised exception was the market for home loans, which was already operating on a national basis. By 2000, the ACCC further acknowledged that 'providers of personal loans can also distribute their product through non-branch means' and that 'the geographic market for credit card issuing is likely to be approaching national' although deposits and transaction account markets were still viewed as State-based (ACCC 2000: 4 and 6).

That market view was reiterated regularly in regard to proposed mergers relating to financial services (including in ACCC 2008d, 2008c, 2009, 2013, 2008a). There was an underpinning view that in 'transaction accounts, SME and agribusiness banking [the] presence of a branch in a convenient location and the extent of the ATM network [are key considerations] in choosing between financial institutions for these products' (ACCC 2008c: 7).

The trend to finding national markets culminated in more recent ACCC decisions being based on the view that national markets in retail banking are the norm. In 2010, the ACCC used Table 1.

Table 1: Retail banking markets

Product dimension	Geographic dimension
Personal banking markets	
Transaction accounts	Local but price competition is national
Deposit/term products	National
Credit cards	National
Home loans	National
Personal loans	National
Hybrid personal loans (margin loans)	National
Business banking markets	
Small to medium enterprise banking	Local but price competition is national
Equipment finance	National
Agribusiness banking	Local but price competition is national

Extracted from ACCC public competition assessment (ACCC 2010: 16).

Analysing banking markets on a national basis is supported by the implications of results from large scale commercial research, for example that undertaken by Roy Morgan Research Ltd. The majority of statistics quoted herein are from the company’s publicly available materials that draw on its ‘single source’ omnibus survey of 50,000 people per annum, and/or their business research using about 12,000 business decision makers per annum. Highlighting the ‘national’ pattern of market behaviour, the shift to non-branch channels in retail banking is seen in the market behaviour of the majority of Australian consumers, as reported late in 2014:

The internet has become the channel most frequently used by [consumers] over the last few years to deal with their bank, largely replacing the branch. In an average four-week period nearly 60% of bank customers deal with their bank via the internet compared to only around one third visiting a branch (Roy Morgan Research Ltd 2014b: 2).

PricewaterhouseCoopers (2012: 5) has similarly reported customer preference for convenience over branch locations, including that ‘more than 60% of new home loans are already sold through mobile channels (brokers and mobile bankers)’. In other words, branch banking is no longer a majority norm, and trends to non-site-specific channels reinforce the ‘non-local’ nature of consumer banking choices by Australians.

There remains a portion of banking where physical presence cannot be avoided, even if the customer would wish it. In Australia, this is required occasionally for personal banking activities, such as when making any arrangement that requires identity to be proven, and similarly, for the broad run of SMEs, on occasions such as when making arrangements for business finance in loans, overdrafts etc. Branch attendance remains routine for SMEs in certain industries, for example where depositing cash takings is a regular requirement.

Of course, there are also still customers who conduct their banking business face-to-face in a branch by preference. On the available evidence, though, such consumers appear to be in a shrinking minority fairly considered to be tied to a locality in retail banking (rather than part of a national market). While their banking behaviour may differ from the majority it does not seem plausible that, for competition generally or this industry specifically, considering such differences would reveal widespread or fundamental departures relevant to policy formulation. Accordingly, in keeping with ACCC general practice and practical market considerations, this working paper proceeds by viewing all retail banking markets as effectively national.

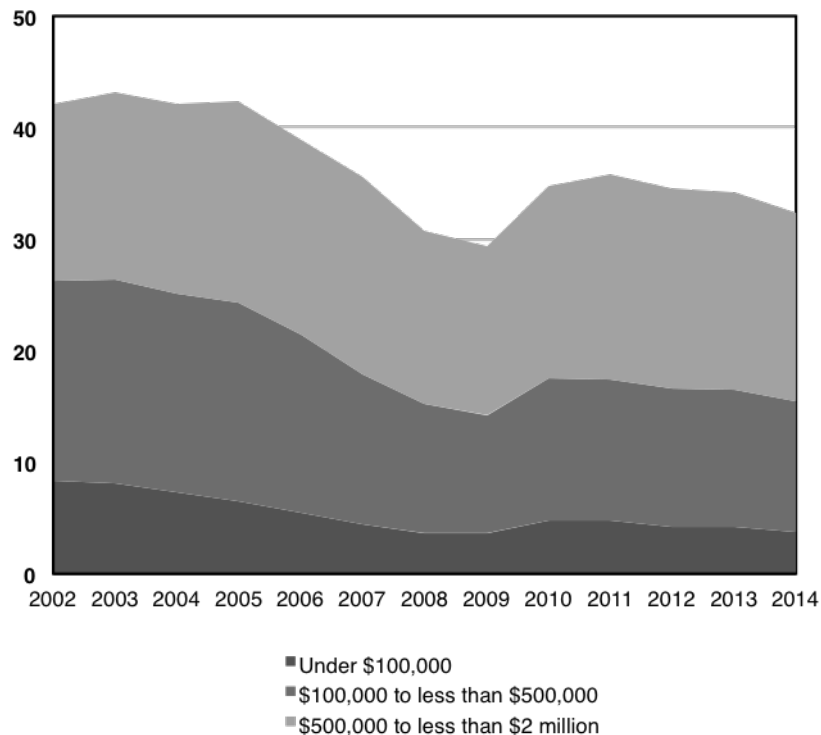
Markets for both deposits and loans are relevant, of which those related to wealth management could be a subset. However, inferring the purpose of an account from its type, such as detecting those potentially related to wealth management, could be unhelpfully error prone. As well, information asymmetries in retail banking are at their greatest in lending and, in turn, inadequacies of financial services policy or competition policy are more likely to be revealed in that context. Taking lending as the activity for analysis, based on available data sources, details on numbers of accounts (in aggregate or by lender) are not readily accessible on a consistent basis. Accordingly, analysis herein is generally limited to using the value of loan accounts as a proxy for the number of accounts (as it was for Figure 1 above).

As noted earlier, loans to government and financial corporations have been set aside, leaving loans to non-financial corporations as the measure for business loans. To exclude wholesale banking, the first issue would be to circumscribe what may be considered 'small to medium' sized business (and thus a retail banking client), a well-known definitional problem for analysts, statisticians, researchers and others alike (in relation to the finance industry, see: Beck 2013b, 2013a). Connolly, Norman and West (2012) provide an informative survey of the issues for the financial services industry in Australia. They show where contrasting definitions are used for widely applicable employment law, in general-use government statistical collections, and by the Australian Tax Office, as well as specifically in financial services where there are variations between APRA, ASIC and the RBA, and of course, lending institutions, which each have their own approach.

That said, since it 'is not possible to directly identify loans to small businesses from available data' (Reserve Bank of Australia 2010: 1), the most practical approach is to follow the RBA, since their collections provide the most consistent source of relevant data. There is no method to filter out 'large entities' seeking only modest loan principal amounts, although they are likely to be exceptional cases. Therefore, an appropriate method would be to use the loan principal amount as an indicator of the SME loan sector.

For all 'business' loans, the RBA reports in four size classes of loan principal amounts, based on data collected by APRA. The RBA usually categorises loans as being 'small business' loans if the loan principal is under \$2 million, meaning the sum of three size classes will encompass their classification of 'small business'. A borrowing business that is unincorporated may also be relevant, but has no discernible impact on the data used herein. Figure 4 below shows a time series analysis of the three size classes covering small businesses using the RBA approach, and including all 'businesses' whether incorporated or not.

Figure 4: Loans to business, credit outstanding by size of debt, % of credit balances as at 30 June each year



Derived from RBA reporting which uses APRA banking statistics (APRA 2014).

As shown in Figure 4, for over a decade, less than half of all business loans by value have been under \$2 million and there is a long-term downward trend in loans of this magnitude made by banks. While this is not definitive, it provides some sense of the market for loans to SMEs in Australia although it does not, *per se*, suggest whether or not there is an undue restriction of credit to SMEs. This decline is significant if small business lacks access to debt finance, and across various industries fails to thrive as a result.

Available data does not, however, provide further insight into this issue. Accordingly, the balance of this working paper uses consistent information from two APRA data streams. The first are the banking statistics for loans to households (all forms), which potentially includes some debt that in reality provides working capital for SMEs, in particular small/micro businesses. The second are the banking statistics for loans to non-financial corporations, which certainly includes SMEs along with all larger businesses. In the absence of specific data collection on a reasonably consistent basis, this is the necessary proxy for assessing the state of lending to SMEs.

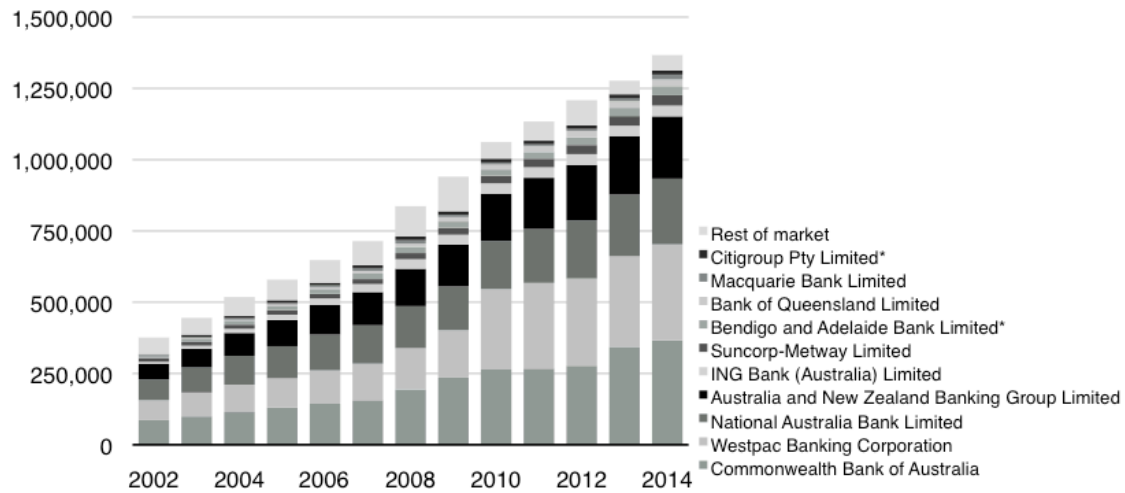
4 Market Characteristics

The core purpose of this section is to characterise Australian retail banking markets, primarily by reflecting on market participation over time and commenting on certain market conditions impacting participant behaviour.

4.1 Players

To identify the current players in retail banking, beginning with lending to households, Figure 5 below looks back over the period for which consistent data is available. This graph charts the progress of the 10 largest surviving banks in 2014, by volume of loans to households.

Figure 5: Loans to Households, market size (\$millions, as at 30 June each year)



Derived from APRA banking statistics (APRA 2014).

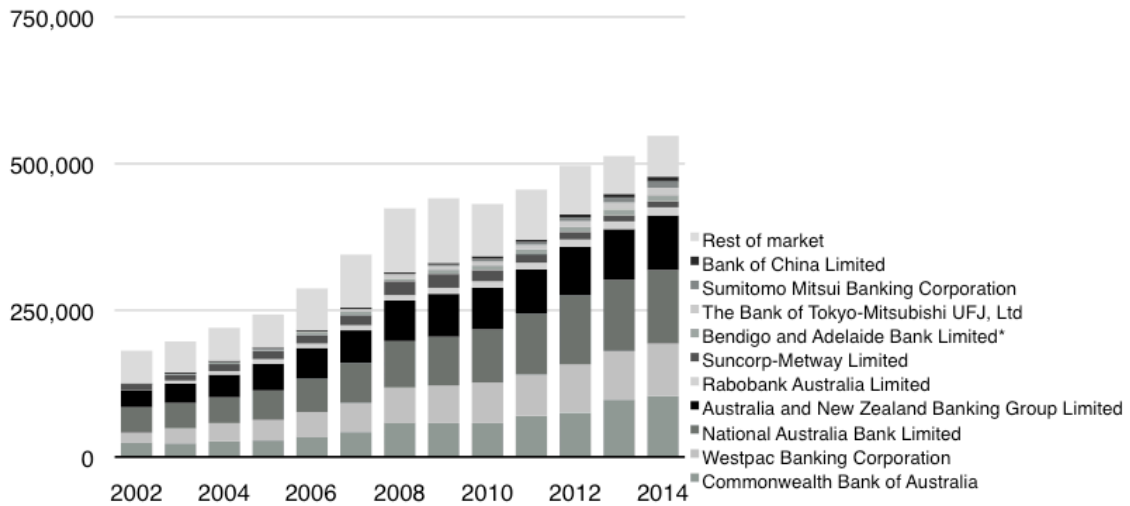
A quarter of a century after the Australian Government's 'pillars' policy was first articulated, CBA, Westpac, NAB and ANZ (that is, the 'four pillars') are very obviously the mainstays of the market and continue to provide the bulk of loans to households. As is also obvious from this data, growth in the market for bank loans to households has been quite significant. In fact, it has far exceeded growth in the Consumer Price Index (CPI). Since 2002, the market for loans to households has expanded more than five-fold as shown in Figure 6, while the CPI has risen by around one third (Australian Bureau of Statistics 2015). Growth on this scale offers contestable space that would readily accommodate other competitors.

In 2014, the next tier of six banks providing loans to households included four which are locally owned (Suncorp-Metway, Bendigo and Adelaide Bank, Bank of Queensland and Macquarie Bank) and two internationally owned (ING and Citigroup), each of which varies in the extent to which it is present in specific product and/or non-national geographic portions of the market. Cumulatively, this tier has held of the order of a 10% share nationally in recent years. In very broad terms, this tier has been the source of merger and takeover targets (including intra-tier, such as the merger of Bendigo Bank and Adelaide Bank in 2007), so its membership has not been as stable. Those shown in the graph reflect the six largest survivors as at November 2014, when the data was collated.

Taking a similar approach to the business lending market, available statistics on loans to non-financial corporations provides a gross measure of lending to business for productive purposes, including loans to corporations of a size otherwise termed SMEs. With that qualification in mind, Figure 6 below shows that the market is, in any case, very similar in make up to that for household lending. It is noteworthy that the volume of loans started smaller and has seen slower expansion

than the household market, although growth could still be regarded as quite healthy with the market being now three times its 2002 volume compared to CPI growth of one third.

Figure 6: Loans to non-financial corporations, market size (\$millions, as at 30 June each year)

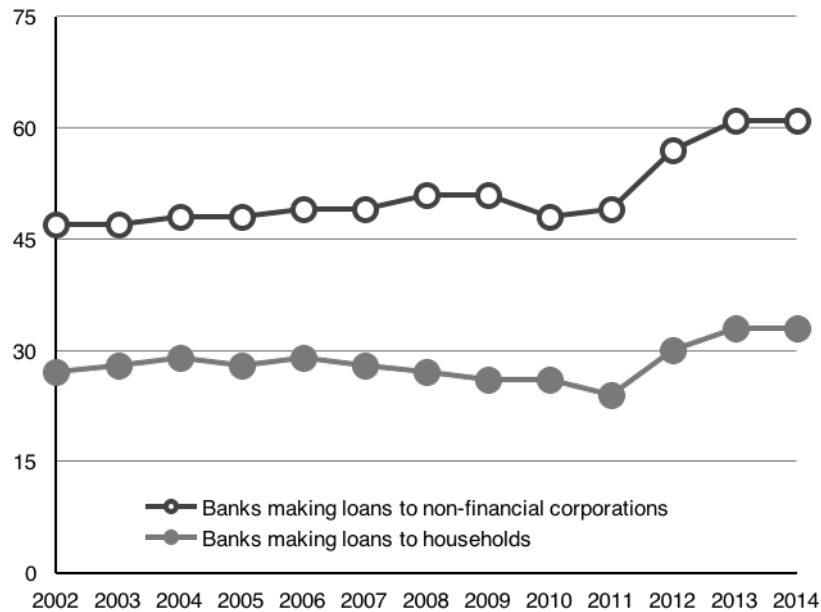


Derived from APRA banking statistics (APRA 2014).

The six non-major banks in this market in 2014 included two locally-owned (Bendigo and Adelaide, and Suncorp-Metway, both of whom also compete in loans to households), and four others (Bank of China which also competes in loans to households, plus Sumitomo-Mitsui, Tokyo-Mitsubishi and Rabobank which do not).

The total number of banks providing loans in either market is also interesting as an indicator of the state of the market. As shown in Figure 7 below, the number of competitors has grown in both markets over more recent years, but this has occurred to a lesser extent in the larger and more rapidly growing market place for loans to households. Banks making loans to households started at half the number of those providing loans to non-financial corporations, and continues to be of the same order. Moreover, in both markets, the greater number of banks active in 2014 has not had an impact on the combined share of the 'four pillars'. In fact, the opposite is observable in Figure 5 and Figure 6. The situation of the much larger market being much less contestable is discussed in more detail in the later section on market metrics.

Figure 7: Number of banks making loans to households and non-financial corporations (including SMEs)



Derived from APRA banking statistics (APRA 2014).

If competitiveness is limited, a lack of innovation may also impair consumer welfare. This effect can be exacerbated if policy focus on innovation is narrowed to ‘technology led’ innovation. Such a viewpoint tends to seek value solely in cost reduction and ignores the benefits of innovation which creates new value as perceived by a customer. This wider view of innovation is consistent with reports on Australian business thinking (Deloitte Access Economics 2014a).

5 Market Metrics

This section reviews the state of retail banking in terms of internationally recognized market metrics.

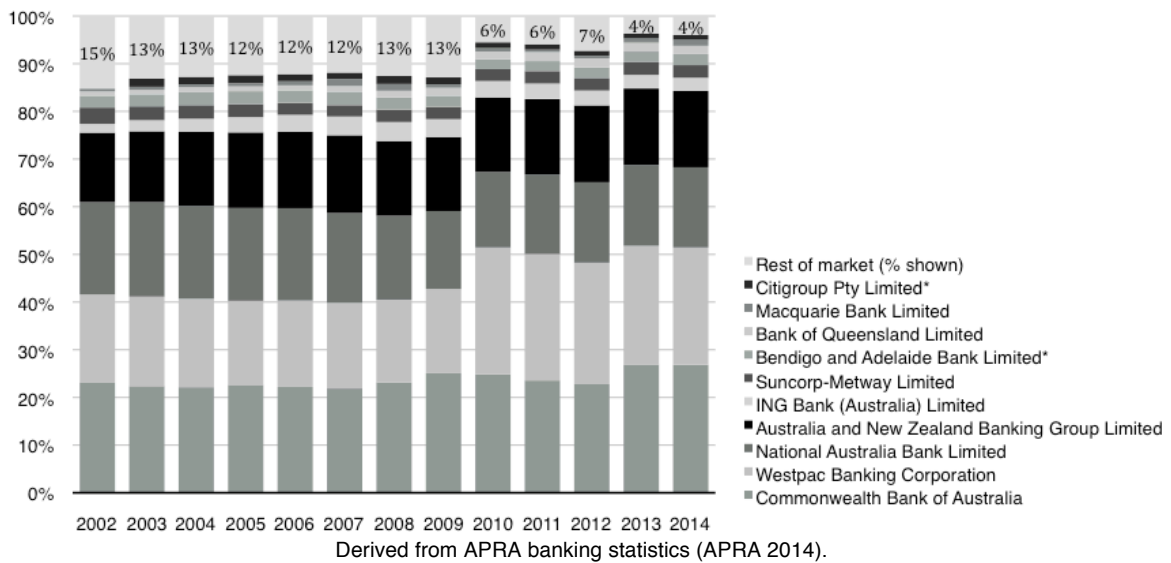
5.1 Indicators

5.1.1 Supply side: market share

As shown in Figure 7 above, the number of banks competing to make loans to households has grown since 2002. However, the extent to which they have gained a foothold in the market, shown in a meaningful market share, is quite a different matter.

To analyse this further as an indicator of the competitive state of the market, of those banks still standing in 2014, the largest ten have been tracked back over the period for which consistent data is available. The overall results are depicted in Figure 8 below.

Figure 8: Loans to Households, market share (as at 30 June each year)

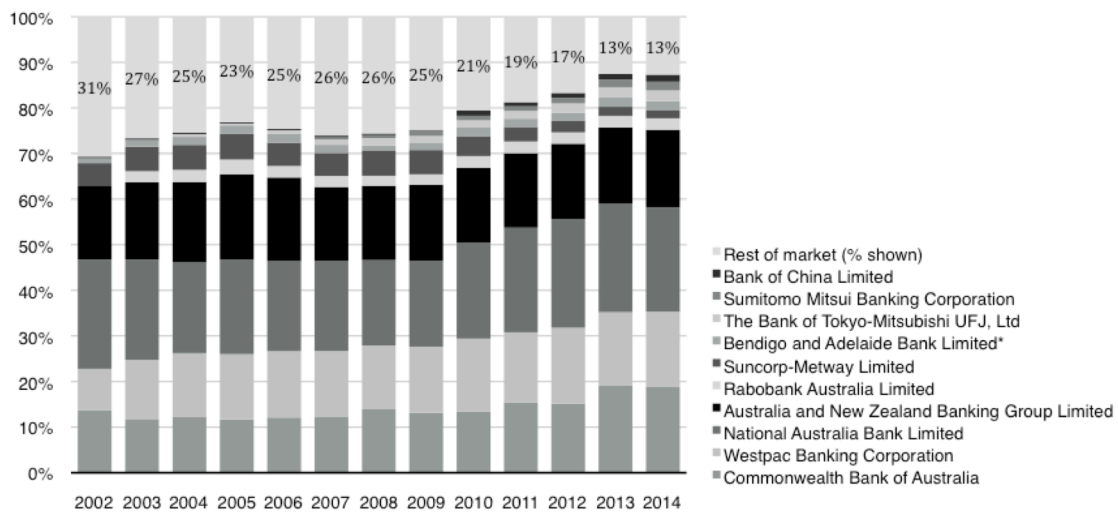


This highlights that the ‘four pillars’ have long made up the lion’s share of the market for loans to households. From being steady at around 70-75%, the acquisition of St George (a substantial regional competitor) by Westpac constituted a step change to the level of around 80-85% since. This was effective in 2009, following an ACCC decision not to oppose the move (ACCC 2008e). No major adjustments to market share have otherwise been observed, despite the contestable space created by significant expansion of the market (as described earlier, well beyond inflation).

In fact, Figure 7 demonstrates that the contestable segment of the market has shrunk, even though the market as a whole has expanded quite considerably. Rather than contestation resulting in wins for other lenders sufficient to see them expand into the space created, the contestable space has shrunk to the effect of the quantum previously held by St George, despite the presence of known and credible competitors (see further discussion below).

Mergers have also impacted the next tier through the merger of Bendigo Bank and Adelaide Bank to form the Bendigo and Adelaide Bank Limited, noting that, in Figure 8 above, their share is shown combined throughout the graph to better depict the impact of their presence as a competitive force. Shown in Figure 9, loans to non-financial corporations show a similar pattern, with a more marked tendency for the ‘pillars’ to crowd out smaller competitors over time. The ‘pillars’ have expanded from about two thirds to three quarters of loans to non-financial corporations over a decade.

Figure 9: Loans to non-financial corporations, market share (as at 30 June each year)

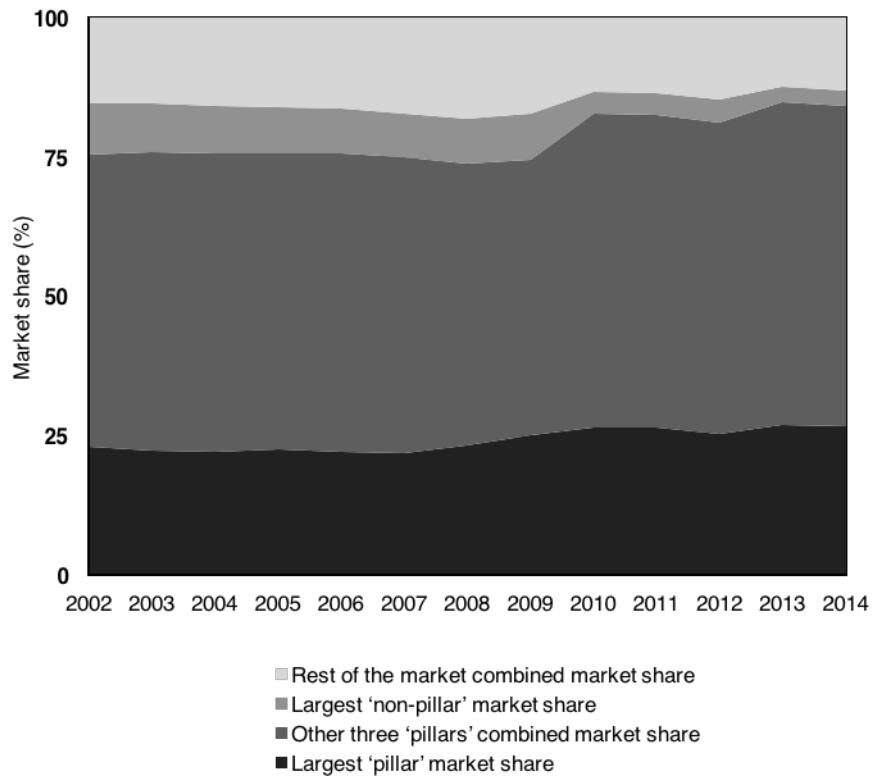


Derived from APRA banking statistics (APRA 2014).

If contestability of markets by smaller players is an indicator of healthy competition, revisiting the disaggregated data in each year from a different perspective more readily illustrates that contestable market space. It does so in terms of the smaller players' collective impact on the state of the market, rather than in terms of the success or otherwise of specific players.

First, by calculating individual firms' market shares, and then ranking them in order from largest to smallest, it is possible to produce the analysis of the household loans market shown in Figure 10 below. The individual firm market shares have been accumulated, beginning with the largest of the 'four pillars' as the base, followed by the aggregate of the other three 'pillars', then the largest 'non-pillar' competitor before the remainder of the market.

Figure 10: Market share, bank loans to households (all forms)

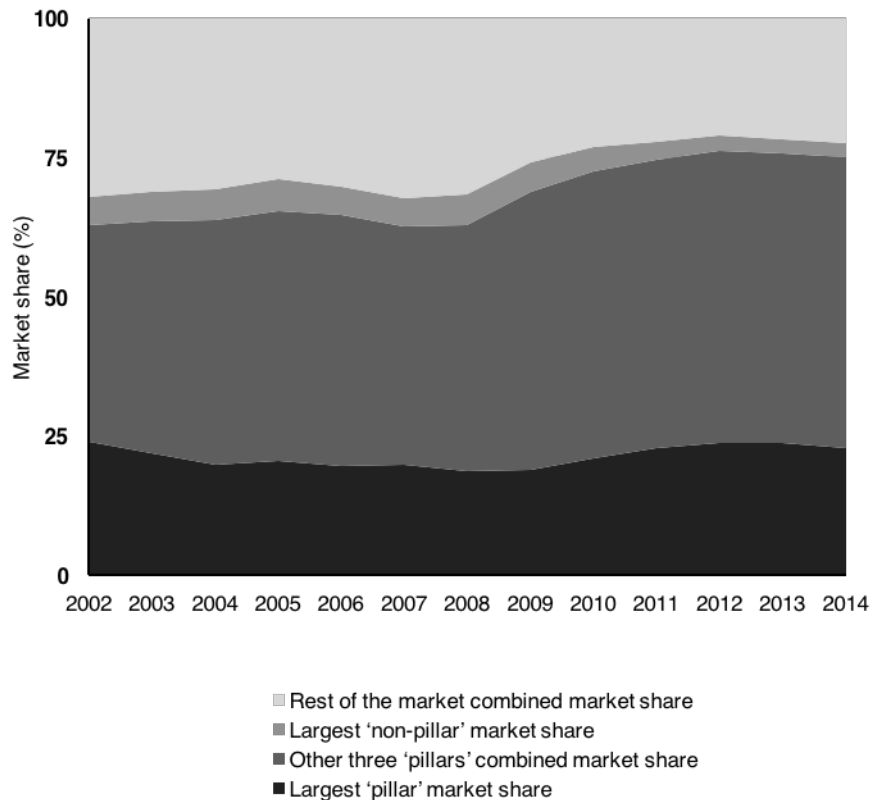


Derived from APRA banking statistics (APRA 2014).

It is clear from this that the retail banking sector has become more concentrated over the last decade. The '5th' competitor (largest after the 'pillars') has significantly diminished in footprint and new firms have been marginalised in a shrinking contested space. This is a direct result of the largest competitors outside the pillars being merger targets. By 2014, the 'rest of the market' was comprised of 24 other banks amounting to just a 4% share between them.

For business, the picture is not dissimilar, as depicted using the same methodology in Figure 11 below.

Figure 11: Market share, bank loans to non-financial corporations



Derived from APRA banking statistics (APRA 2014)

There is clearly more space for contestation, and perhaps this partly explains the systematic presence of a higher number of competitors (shown earlier in Figure 7). But the fact remains that most are tiny by comparison to the ‘pillars’, and even the largest of their number has a more marginal position than a decade ago.

Returning to households illustrates the point raised in the previous section in relation to inertia in customer switching. The ‘rest of the market’ group includes four banks that are interesting for having more than a token presence, being Members Equity Bank Limited, HSBC Bank Australia Limited, AMP Bank Limited and Heritage Bank Limited. Their market shares together amount to just around 2.5% in 2014.

Two of these are long-standing Australian organisations well-known in their previously established orbit as non-bank competitors against banks. Setting aside any barriers to entry from regulatory requirements etc., both should have had little to do in terms of gaining share when compared with a start up with no reputational stock on which to draw. One is Members Equity Bank (ME Bank). ME Bank is now a national bank, was originally ‘Super Member Home Loans’ and has been operating since 1994 to provide home loans to members of industry superannuation funds in Australia. The entity became Members Equity Bank in 1999 and received a banking license in 2001, to provide a wider range of banking products to clients. The parent company group now comprises 30 industry superannuation funds. The other is Heritage Bank, which is now a regional bank operating across south-east Queensland. This was previously Heritage Building Society, which was formed in 1981 by

the merger of two very long standing building societies. The name was changed to Heritage Bank in 2011.

The other two organisations also had substantial reputational stock on which to draw. Before it obtained a banking licence, AMP was already a megalith of insurance services in Australia and should have been very well placed to compete effectively and make inroads into household loans, and although HSBC is not as well known to households in Australia, it was by no means a start-up.

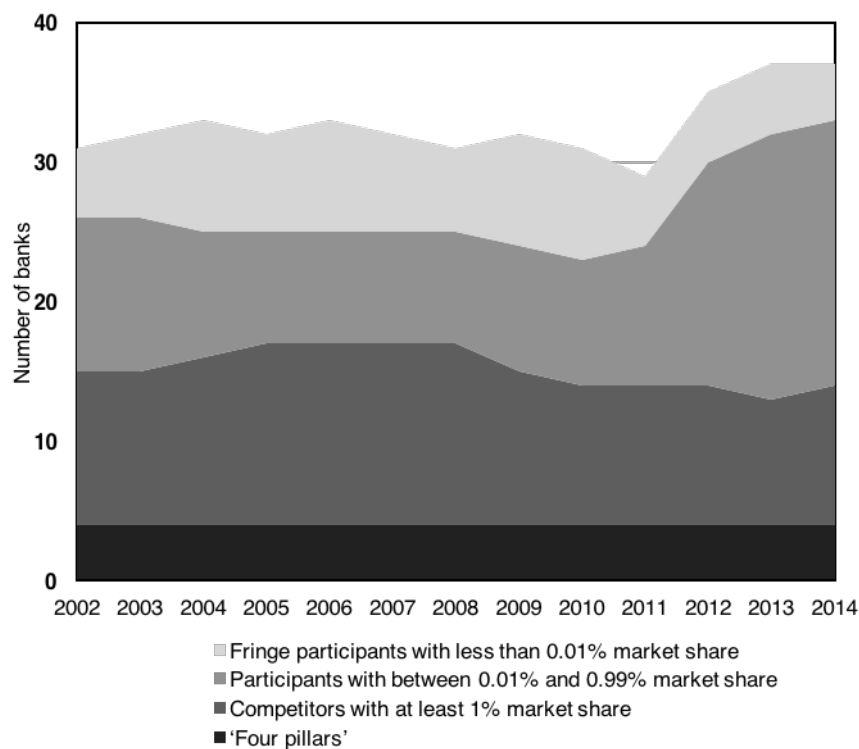
Looking at the graph above, it is clear that these four organisations have gained little traction as retail banks in Australia, raising questions about barriers to switching by consumers.

Seeking a lens on the scale differences between competitors in terms of their presence in the lending market again calls for revisiting the year by year market shares of each competitor. In this case, specific market shares in each year for every competitor were classified by the order of magnitude. The four pillars now having a combined share of around 85% of this market, other firms were divided in to three groups based on the order of magnitude of their market presence, where:

- (a) 'competitors' were defined as those banks having at least 1% market share;
- (b) 'participants' were defined as those having at least 0.01% (but less than 1%); and
- (c) 'fringe participants', being the remaining banks on the edges of the market with less than 0.01% share each.

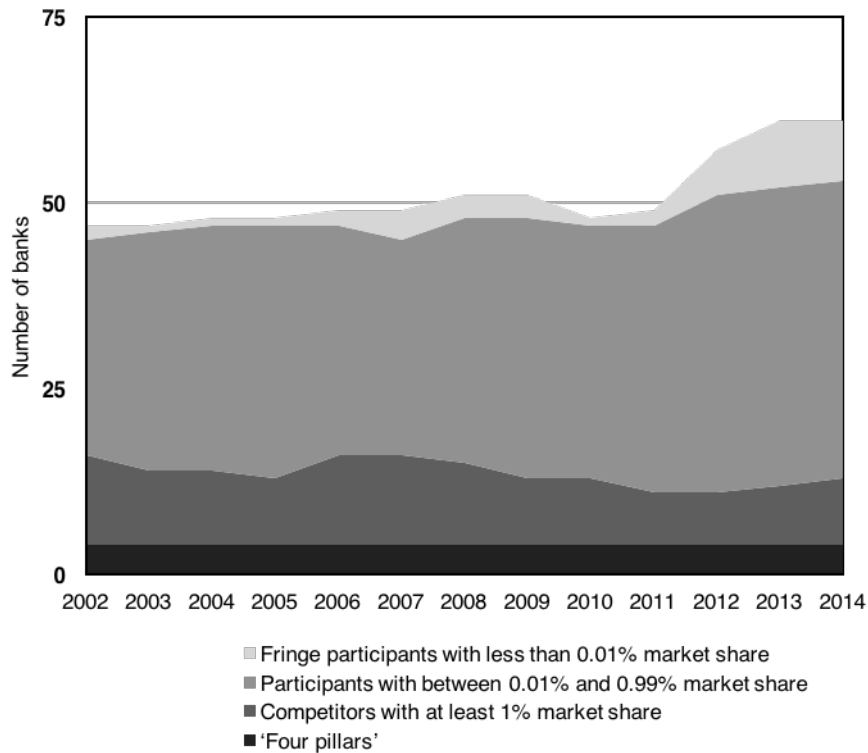
Re-aggregating these groups produces a stratified picture of the competitors in each market, depicted below in Figure 12 for loans to households and in Figure 13 following for loans to non-financial corporations (as before, including SMEs).

Figure 12: Banks making loans to households



Derived from APRA banking statistics (APRA 2014).

Figure 13: Banks making loans to non-financial corporations



Derived from APRA banking statistics (APRA 2014)

These graphs demonstrate that, on the whole, loans to non-financial corporations appear much more contestable than loans to households, but it has not stopped the ‘pillars’ from coming to dominate the market. Despite the non-trivial number of players meeting all regulatory and other statutory requirements for entry into either market, it is hard to find evidence of effective competition from a good majority of the firms in either market, particularly third and fourth tier banks, here classed as ‘participants’ and ‘fringe participants’. In 2014 there were 23 banks lending to households, and almost 50 banks lending to non-financial corporations, which are so far unable to gain a market share toehold of at least 1%. Given the diversity of firms and business models involved, this is more likely indicative of the value of incumbency and other barriers to switching, since any competitive inadequacy of firms being replicated across all those banks is hardly plausible. Also, it is certainly not plausible to suggest that high satisfaction rates make customers loyal. This is introduced in the first section and discussed further in the next section. Further, although there is a second tier of six banks, seen as ‘competitors’, which have gained a firmer footing, it remains that the largest of these has only gained a market share of 2.5% in household lending, or 2.8% in lending to non-financial corporations, and the same comments about their competitive performance apply.

In addition to negative impacts on consumer outcomes, the lack of progress by competitors is crucial in terms of the extent to which any, or all as a group, could step up to the challenge of assisting to ‘resolve’ a banking crisis. In such an exigency involving one of the ‘four pillars’, their capacity to absorb the shock and assist in replacing that institution must be considered very much an open question. This is an important perspective in terms of the capacity of the market to respond to

shocks, including ‘resolving’ a non-systemic banking crisis by absorbing the business of a larger competitor. Ceterolli’s (2002) analysis of entry and concentration in thousands of local markets in the USA serves to highlight a crucial point. That is, the importance of new entrants not only for competition *per se*, but as a buffer of alternative service providers to step in should one provider fail. Looking at this series of graphs gives pause on that score, given the lack of sizeable competitors for the ‘pillars’. Moreover, as discussed below, there is a significant observable similarity of their business models and, in many cases, a deal of any significance will involve two or more of the ‘four pillars’.

5.2 Stability: Assessment by the International Monetary Fund

While not an indicator in the sense of being an index or other measurement able to be replicated independently, the International Monetary Fund (IMF) Financial Sector Assessment Program (FSAP) is internationally recognised as an assessment protocol. In advanced economies such as Australia, the IMF team uses a systematic approach to consider a synthesis of data and observations, designed to assess systemic conditions in a country’s financial system. In developing economies, the responsibility is jointly held with the World Bank.

Post-financial crisis FSAP stability assessments consider vulnerabilities and resilience of the financial system, regulatory and supervisory frameworks, and financial safety nets, and the resulting report includes a Risk Assessment Matrix (International Monetary Fund 2014). In late 2012, the relevant risk assessment of Australia found that, overall (International Monetary Fund 2012b: 1):

Australia’s financial system is sound, resilient, and well-managed. Major banks are conservatively run, well capitalized and profitable, and they are likely to withstand severe shocks.

Importantly though, the assessment took note of the highly concentrated and interconnected banking system and also found that a medium probability of contagion risk from bank concentration would, if it eventuated, be likely to have a high (negative) impact on financial stability.

Comments included in the matrix observed that:

Dominated by four major banks, the Australian banking system is one of the most concentrated in the world. The four banks have similar business models, and such similarities may be a source of contagion risk.

The similarities in the big four banks’ lending and funding operations mean that stress in one bank could be quickly transmitted to others. A deposit guarantee from the Australian Government ‘seems inadequate to address such a contagion risk, meaning that other resolution options would be needed’ (International Monetary Fund 2012a).

This independent expert view about the business models of the ‘pillars’ is crucial. In the absence of demonstrated collusion or other anti-competitive behaviour, concentration is of less concern given resilience from diversity. However, the combination of concentration and homogeneity is of great concern, quite separately from the potential to dilute or limit the benefits to consumers from competition. Not the least issue is the capacity of the industry to respond to any large bank difficulty.

6 Evidence from Observation

As covered by extensive scholarship, the overall conditions prevailing in a market are an important basic indicator of the climate in which competition thrives or otherwise. Even if regulatory barriers to entry are well managed by competent firms, incumbency may become a sovereign barrier to new firm expansion if inconvenience is a significant barrier to customer switching. In turn, this creates highly concentrated markets. Ultimately (CMA and FCA 2014: 9):

There is no simple relationship between concentration and competition. However, more concentrated markets are in some cases less competitive. This is more likely to be the case where barriers to entry and expansion are significant.

That is, observation of the actions of competitors often forms a central feature of considerations about whether and when to exercise regulatory power. As one example, which is particularly on point, the UK's CMA has relevant powers (under the *Enterprise Act 2002*) to make a 'market investigation reference' and, in 2014, to such ends undertook a preliminary market study of personal current accounts (PCAs) and SME banking services (conducted jointly in respect of SME banking services, CMA and FCA 2014). In late 2014, the preliminary decision to go forward with a full investigation was confirmed (CMA 2014a: 62). In so doing, the CMA report noted:

- (a) the PCA market in terms of active accounts remains relatively concentrated, with the top four banks having a combined market share of over 77%;
- (b) other than the impact from mergers and acquisitions, market shares have been stable over time, suggesting that growth and expansion are difficult in the PCA market;
- (c) in terms of relevant harms from concentration, some evidence was found of poorer service but not of higher prices; and
- (d) low levels of switching despite evidence of poorer service, meaning that providers with higher customer satisfaction ratings have nonetheless not been able to gain significant market share, 'which is not what one would expect in a well-functioning market' (CMA 2014b: 8).

By the same token, parallel evidence from observation of prevailing market conditions provides a starting point in relation to markets in Australia. The retail banking market in Australia:

- (a) is relatively concentrated with the four major banks now having a combined market share of 80-85% in household lending and 70-75% in lending to non-financial corporations;
- (b) rather than being stable, in both parts of retail banking this share is well up on a decade ago, largely due to the consequences of mergers and acquisitions;
- (c) in terms of harms from concentration, commercial market research suggests that customers of other banks are markedly more satisfied than the customers of the 'pillars'; and
- (d) despite markedly lower consumer satisfaction, there is little evidence of customer switching away from the 'pillars' to one of many competitors demonstrating materially better customer satisfaction, leaving observers to wonder whether these are well-functioning markets.

These comparisons are stark in their similarity and worthy of attention in the context of the intersecting Financial System Inquiry and Competition Policy Review in 2014. Based on this cue from the UK CMA, policy considerations should include:

- Independent research on consumer banking satisfaction shows that ‘four pillars’ customers are noticeably less satisfied than those of other banks, and that this is not new. That overall result has hardly changed over the last four years (Aquilina 2015). As well, in a 2014 climate of very low home loan interest rates, home loan customers of the four major banks reported lower satisfaction levels than non-home loan customers (Roy Morgan Research Ltd 2014b: 4).
- The ten banks with the highest reported customer satisfaction ratings over years include five out of the six non-major banks identified in Figure 5 and Figure 6 above but, none of the ‘four pillar’ banks (Roy Morgan Research Ltd 2014a: 2).
- Commercial research noted a particular problem for the ‘pillars’, with ‘small business customers, who rate satisfaction with banks overall at only 67.5% compared to 82.3% for personal customers’ (Roy Morgan Research Ltd 2014a: 3). This suggests that customer outcomes are particularly poor in the SME market at a time when concentration has increased for several years in a row.
- As illustrated earlier in Figure 8 and Figure 9, non-major banks have not been able to gain market share while the major banks have preserved their combined share and grown it (albeit the latter largely through mergers/acquisitions), despite the relative performances on customer satisfaction.
- While reforms were initiated in 2010 to facilitate customer switching, akin to reforms to facilitate mobile number portability in telephony a decade ago, arguably these reforms were lost in the last change of federal government. Moreover, their home in ASIC is by no means a usual or familiar source of information for households.

In more detail on retail customer satisfaction, Roy Morgan Research Ltd recently found that the top ten performers for customer satisfaction in consumer banking ‘were well above the level of the best performer among the big four’ (Roy Morgan Research Ltd 2014b: 2). This was satisfaction for banks of any size, that is, the ‘four pillars’ did not rate in the top ten on customer satisfaction. In the six months to August 2014, the top ten performers ranged from 85.7% to 89.9% of customers giving a rating of ‘very satisfied’ or ‘fairly satisfied’, while the best result for any of the four major banks was 81%. While average satisfaction with consumer banking has been improving such that ‘the satisfaction level of the personal customers of banks reached an eighteen-year record high of 82.8%’ in November 2014, up from 81.3% 12 months earlier, all four major banks remained below that average (Roy Morgan Research Ltd 2014b: 1).

Note that all customer satisfaction results in this section are calculated on this basis – the quantum of customers said to be ‘very satisfied’ or ‘fairly satisfied’. However, ‘fairly satisfied’ is hardly a ringing endorsement of the service provider, and the best customer satisfaction performance among the ‘four pillars’ had at least one in five customers not even ‘fairly satisfied’. Such ratings would be more consistent with shifts in market share, rather than static or increasing market share. From an effectiveness of competition and consumer benefit perspective, this makes the growing concentration of markets even more concerning.

The performance of subsidiaries is also worth noting, even though these are not analysed separately here in terms of market share. In this particular commercial research, the ten largest banks are measured according to personal banking customer numbers and this includes:

- (a) St George Bank, a subsidiary of Westpac since the ACCC decided not to oppose that acquisition in 2008 (ACCC 2008e); and

- (b) Bank of Western Australia Ltd (BankWest), a subsidiary of the CBA since the ACCC decided not to oppose that acquisition also in 2008 (ACCC 2008c).

St George was ranked fifth at 84.1%, while its parent was ranked eighth at 81.2%. Similarly, BankWest was rated sixth with customer satisfaction of 83.8%, while its parent was rated seventh with 81.8%. As reported by the researchers, these are non-trivial differences and speak volumes about customer preferences.

In an interesting insight on the distinctiveness of banks other than the 'four pillars', the researchers also commented that (Roy Morgan Research Ltd 2014a: 3):

1.3% points now separate [the four major banks] compared to 12.6% points in 2005. This competition is good for customers but shows that it is difficult for the major banks to create and maintain a clear positioning advantage ... other competitors, including the smaller banks, building societies and credit unions ... remain well ahead of the big four for customer satisfaction and are seen as outperforming them ... on fees and charges, interest rates and treatment of customers.

So outside the 'pillars' group, banks and other financial institutions are creating distinctive positioning and service propositions which are met with customer approval shown in high levels of customer satisfaction ratings. Among the 'pillars', the same simply cannot be said, suggesting that customer outcomes are of a lower standard even if there is little price differential to find in these sectors.

7 Informing Policy Options

Evidence from around the world, not least as to how each country responded to and emerged from the most recent financial crisis, shows that there are many ways to succeed and fail in the regulation of financial services. As with many complex policy matters though, the issue is not only the means but the end. That is, the choice of policy should depend on the objective that government has in mind based on that society's needs. So for Australia at this time, it is not just a matter of 'four pillars' or some alternative, nor a simple question of the level of trust policymakers may be willing to place in the good governance of private enterprise (colloquially, 'if they were not hit by the financial crisis, they must be sound'). The fundamental issue is being quite specific about the broader economic purposes to be served, and to what extent any such policy will serve them.

In that vein, there seems little doubt that the intersecting Financial System Inquiry and Competition Policy Review in 2014 raised expectations among both policy makers and the public, not least through what were highly engaged public consultation processes. Whatever policy recommendations may come forward from this significant investment in inquiry, those expectations may well be disappointed without a coherent basis on which to evaluate options, including against policy objectives that are expatiated and agreed as such.

Accordingly, returning to the overarching issues identified earlier as essential bases for policy formulation, in this section the following considerations are explored in relation to current scholarship:

- The call for a nuanced understanding of the role played by banks in the ongoing economic prosperity of Australia. This occurs directly in ongoing growth of the financial services industry (which may be prejudiced by ‘financialisation’ of the industry), and indirectly as the enabler of productive activity in the wider economy (which may be unwittingly restrained by the business models of banks). In either case, it is with the concomitant capacity to unilaterally destroy significant economic value through private enterprise decisions and actions.
- The fundamental need for an independent, fact-based appreciation of the causal role of competition. Given the direct impact on outcomes for consumers and the indirect impact for the economy in terms of productivity outcomes, this brings into consideration possible or actual implications of concentration arising from entrenched incumbency by the ‘four pillars’.
- The crucial policy input required from an evidence-based assessment of potential risk from policies that continue to preference stability over competition. Given contemporary scholarship and empirical analyses, this particular policy horse may have already bolted in terms of options other than continuing with the ‘four pillars’ since other competitors have already been so marginalised.

7.1 Enabling Economic Prosperity

The provision of financial services plays a crucial role in the economic strength of Australia today. This is both directly by way of a contribution to national economic activity and indirectly by enabling productive business enterprise. The critical qualification is that markets be competitive in keeping with overseas research findings, for example from Cetorelli (2014: 320):

Empirical studies have documented that more competition in credit markets enhances entry in non financial sectors. This evidence has been recognized for its importance in supporting theories claiming that finance matters for real economic activity.

In an economy where SMEs play a central role in production of goods and services, and provide significant related employment, the potential impact of retail banking’s enabling role is hard to overestimate. In this, Cetorelli (2004b: 556) earlier identified the generic policy concern in relation to financial services, where her research showed ‘regulation that directly affects the market structure of the banking industry will also have effects, perhaps undesirable, down the line in non financial product markets’.

It is also worth noting that ‘credit availability to enterprises, but especially to SMEs, depends on the infrastructure that supports financial transactions, including the legal system and the information environment’ (Beck, Demirgüç-Kunt and Maksimovic 2006: 2939). In this, Australia is generally very well served, as noted in international comparisons by Brown (2010).

Elsewhere in the world, ‘numerous studies have provided empirical evidence that supports a positive relation between financial development and growth’ (Koetter and Widow 2010: 1529). As an example from another advanced economy, in their study of ‘Germany’s fragmented three-pillar system of private and government-owned banks’, Koetter and Widow (2010: 1530) considered whether the quality, rather than the volume, of financial intermediation would be of significance in promoting growth. They found that, ‘in Germany’s fairly mature economy, the availability of credit alone is not the main bottleneck to economic growth’ (Koetter and Widow 2010: 1540), rather that

their measure of quality showed a quality effect, i.e. that there is 'a significantly positive effect on growth' (Koetter and Widow 2010: 1540).

In contributing to economic prosperity, it is obviously important that banks themselves be efficient. In a study of 17 bank mergers in Australia (1983 to 2001), Wu (2008: 154) provided an important insight into the wider economic significance of bank mergers:

[T]he acquiring banks are larger, more aggressive and less efficient than the target banks [and] the major source of inefficiency is scale inefficiency, [with regression analysis confirming] a potential negative efficiency impact of a merger between any two of the major banks [meaning that whether] the abolition of the four pillars policy is socially beneficial depends on the evolution of competitiveness and contestability in the market.

In fact, beyond the lack of contestability that seems to prevail, and the scale diseconomies at play in such results, other findings show that using mergers to 'resolve' bank failure has a further hidden cost (Wu 2008: 153):

It appears that the larger and more profitable the target bank relative to the acquiring bank, the more efficiently the consolidated bank will operate. This contradicts the relative size effect hypothesis, which predicts that mergers between a large acquiring bank and a small target bank tend to achieve higher efficiency improvement.

This sits at odds with the unitary test, under the *Competition and Consumer Act 2010* (Cth), being whether the merger will substantially lessen competition. This research suggests that creeping market concentration through a series of takeovers, none of which would fail the substantial lessening of competition test, nevertheless has a hidden negative impact on system productivity. While essentially a commercial problem for the merger partners, this consideration may still weigh in the policy balance against any further concentration of the industry and consequent dampening of competition such as it is.

7.2 The role of competition

The intensity of competition has a direct impact on outcomes for consumers and an indirect impact for the economy in terms of productivity outcomes from that industry.

For financial services, this brings into consideration possible or actual implications of concentration arising from entrenched incumbency by the 'four pillars', which may substantially dampen the vigour of rivalry in this market. This is especially so when policy continues to follow conventional wisdom in preferring stability over competition.

At an OECD roundtable in 2010 (at which Australia was represented), the operative question was put in stark relief (OECD 2010):

A controversial question has arisen in the context of the ongoing global financial crisis: Is financial stability enhanced or weakened by competition? [A] clear causal link between either competition or concentration and stability in the financial sector can be found neither in theory nor in the data.

The 2015 policy debate generated by the Financial System Inquiry and Competition Policy Review will be incomplete without finding what factual circumstances prevail in this regard in Australia, as a basis for key governance decisions around whether competition may need to be engendered, and, if so, how best to do this.

7.3 Managing inherent risk

All commercial endeavour involves risk, but the operating risk of a bank is typically cast as distinctive due to the ramifications for the wider economy in which that bank operates. Moreover, there are specific risks of 'financialisation' of the financial services industry, which creates a growing distance between financial transactions in the wholesale sector and the productive activity that underpins those trades. As put by ASIC Chairman Greg Medcraft (2014):

At their core, markets assist in funding the real economy and in doing so help fuel economic growth. Markets do not simply exist to feed on themselves. The financialisation of markets – for example, through high-frequency trading, dark liquidity and speculative trading – creates new risks for market resilience. Financialisation has the potential for parasitic outcomes that can destroy confidence and potentially stall economic growth.

An understanding of how financial services enable economic prosperity would not be complete without considering the overall risk management of financial services sellers, including beyond retail banking. Given this role in the economy, it is also crucial to consider that the decisions and actions of private enterprise entities or their agents (such as individual employees) may destroy economic value. This is a lesson from the LIBOR scandal, a seemingly 'parochial affair involving Barclays, a 300-year-old British bank, rigging an obscure number' (The Economist 2012) that in fact proved to be globally significant (The Economist 2013). The lesson similarly applies closer to home, in probes by ASIC into the bank bill swap rate (McConnell 2015), and by the New Zealand Commerce Commission into misleading conduct in marketing of interest rate swaps in New Zealand (Fletcher 2014).

It is clear that financial services have considerable inherent risk, and certainly no less than other commercial enterprises on a similar scale. However, rather than making them a special case for crisis support from the public purse, or for ever more detailed regulation in an attempt to prevent such crises, the post-financial crisis assessment of Blundell-Wignall, Atkinson and Roulet (2012: R41) puts into perspective the particular character of risks. Specifically, this perspective shows that the interests of sellers and buyers of financial products are potentially in conflict, and:

The main way to deal with conflicts of interest is to reduce the opportunity set of conflicts and to improve corporate governance [including by stopping 'too big to fail'] cross-subsidisation, which is a massive temptation for bonus-hungry businesses to make easy profits in 'normal' periods prior to crises - using other people's (cheap) money while claiming there is somehow some skill in this. The OECD [recommended reforms include] implementation of the NOHC structure with ring-fencing for bank business models in the world of counterpart risk.

In this, the 'NOHC' referred to is a non-operating holding company, while 'ring-fencing' is a policy solution that has a variety of specific forms which may or may not include implementation of NOHCs.

In general, 'ring-fencing' is designed to regulate by forcing risk matching between the part of the portfolio providing funds and the part using those funds. For example, this may mean segregating household deposits, to be used for household lending, from wholesale sources of funds, to be used for wholesale lending.

By which ever means it is implemented, fundamentally ring-fencing works only as well as the actual risk profiles involved will let it. That is, the effectiveness of ring-fencing is determined by the quality of the loans funded. Clearly, if mortgages are not of the quality assumed in the arrangement, as in large swathes of the mortgage belt in the USA during the subprime crisis, a generic ring fence won't help.

Importantly for policy makers, even if the policy segregates 'retail banking' from 'commercial lending', the effectiveness of that policy is limited by the validity and completeness of reporting and supervision. In that context, it is worth recalling Brown's (2010) analysis of significant and consequential lapses in both the underpinning logic and the application of that approach, where policy makers effectively aided and abetted financial institutions (whether knowingly or not).

Interestingly, as pointed out by Blundell-Wignall, Atkinson and Roulet (2012), Macquarie Bank is the sole implementer of the NOHC approach in Australia, a voluntary step in self-regulation that seems particularly well advised amid the variety of wholesale finance scandals currently in the media (including those noted above). The RBA's supplementary submission to the Financial System Inquiry provided the view that 'such structures are more relevant to business models that combine commercial banking with substantial non-banking business or activities in capital markets; these are not applicable to the vast majority of ADIs in Australia'.

8 Conclusions

This working paper notes three distinguishing features of retail banking in Australia. First and critically important, the stability of the sector is sound and retail banking had a relatively soft landing in the aftermath of the financial crisis. Second, there is limited competitive rivalry and this is reflected in the static state of market share between the four major banks, along with the very slow and marginal improvements gained even by strong second tier competitors. Third, product and service innovation is limited.

There are two important implications that flow from these issues. First, the absence of vigorous rivalry, whilst providing stability, is likely to mean that the welfare of retail banking consumers is not optimised. Second, the level of innovation may not be as high as is feasible, and barriers, including prudential regulatory barriers to entry or expansion, mean that the extent of rivalry is unlikely to change without some form of promotion of competition. Further, the question of the long term vitality of the sector and its ability to 'resolve' any crisis by absorbing the business of a troubled lender remains open, noting the structural importance of financial services that is now observable.

This ought give pause in terms of the conventional wisdom of preferencing stability over competition, since the hidden costs of insufficient competition may well undermine the apparent benefits of stability. Proactive analysis on that point would be time well spent for researchers, policy makers and regulators alike.

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