



**DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS  
COMMITTEE ON COMPETITION LAW AND POLICY**

**ROUNDTABLE ON MERGERS IN FINANCIAL SERVICES**

**-- Note by Australia --**

*This note is submitted by the Australian Delegation to the Committee on Competition Law and Policy FOR DISCUSSION at its forthcoming meeting on 5-6 June 2000.*

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## **Introduction**

1. The national competition statute, the *Trade Practices Act 1974* (the Act), prohibits acquisitions which result in a substantial lessening of competition<sup>1</sup>. There are no special provisions in the Act which deal with financial services sector mergers and the general prohibition is enforced by the national competition regulator, the Australian Competition and Consumer Commission (ACCC), which has powers under the Act to seek interim injunctions and other remedies. Where an acquirer considers that a prohibited acquisition would result in a net public benefit, it may seek an administrative authorisation from the ACCC under the Act and, if authorisation is granted, the acquisition is then immune from court action under the Act.

2. Acquisitions are also subject to the provisions of the *Financial Sector (Shareholdings) Act 1998* where a 'national interest' test applies. This test normally only comes into operation once the ACCC has decided to take no action. In forming an opinion, the Treasurer considers a broad range of factors taking into account, but not limited by, the ACCC's assessment under the Trade Practices Act.

3. In recent years the ACCC has examined a number of mergers in the financial services market. Mergers that have occurred in the sector have been influenced by the restrictions imposed by the Government, independently of the Act, on mergers between the four major banks.

4. In enforcing the Act the ACCC has developed and refined its approach to market definition and the impact of such mergers on competition. Its approach has been influenced by the *Report of the Financial System Inquiry*<sup>2</sup> (the Wallis Inquiry) published in 1997. One of the major themes of the Wallis Inquiry Report was that Australia was irreversibly connected to global financial markets and that competition in many financial services markets may occur at a global rather than national or sub-national level.

5. The Wallis Inquiry Report recommended the removal of the so-called 'six pillars' policy which prohibited mergers between Australia's four largest banks and its two largest life insurance companies. The Government responded by ending the 'six pillars' policy but decided that mergers among the four major banks would not be permitted at this time. This is locally known as the 'four pillars' policy. The Government will review this policy when it is satisfied that competition from new and established participants in the financial industry, particularly in respect of small business lending, has increased sufficiently to allow such mergers to be considered.

### **1. Product market definition**

6. The Australian banking market is characterised by four large banks operating in all Australian States and Territories (and overseas) and a number of small regional banks typically operating in one or two States. Over the past few years, the ACCC has examined a number of mergers (and proposed mergers) between a 'big four' bank and a regional bank. Between 1995 and 2000 the market definitions used have changed significantly.

#### ***The Westpac/Challenge merger and market definition***

7. In 1995 the ACCC's predecessor, the Trade Practices Commission (TPC), examined the proposed acquisition of Challenge Bank, a regional bank in Western Australia, by Westpac, one of Australia's four national banks. The approach to market definition undertaken by the TPC was influenced by an inquiry conducted by Australia's Prices Surveillance Authority into bank fees and charges<sup>3</sup>.

8. The Authority's report had stated:

It appears ... that by focusing on a customer's broad range of needs over time, rather than particular products at a point in time, institutions are able to reduce the impact of price competition from competitors who offer individual products.<sup>4</sup>

9. The Authority pointed to relationship banking as a means of product differentiation which:

... allows banks to retain business they may otherwise be losing faster to more specialised competitors and camouflage fees and charges through packaged product design and pricing. Relationship banking essentially makes a homogeneous product different in the eyes of the customer. This approach by banks is intended to undermine the price-attractiveness of competitors' offerings on a product specific basis, while also highlighting the advantages of purchasing a range of services from the one institution.<sup>5</sup>

10. In its merger analysis market definition, the TPC took account of the importance that financial institutions attach to developing a long term relationship with customers and capturing all of the demand for a wide range of financial services by its customers.

11. The TPC took the view there was a considerable competitive advantage in supplying a full range of banking services, notwithstanding partial but often vigorous competition for particular banking products from non bank suppliers. In developing its view that the appropriate market was one for 'retail banking services' or as it is sometimes described a 'cluster market definition' the TPC noted the importance of the following factors:

1. Branch networks were of considerable importance. While recognising the growing importance of electronic banking, the TPC in 1995 took the view that small business and personal customers establish a banking relationship with a branch and utilise the physical branch facilities for a range of retail banking services. Transaction banking was seen as the basis of a relationship which generated other retail banking business.
2. The transaction relationship enabled 'cross selling' of service products and 'price rises' (increases in loan interest rates and decreases in deposit rates and higher bank fees) without significant movement of customers.
3. Banking products were delivered through combined or linked accounts such as linked transaction accounts and credit cards and linked personal loans and home loans.
4. The integration of banking products via electronic banking is likely to lower transaction costs for integrated product supply, decreasing the likelihood that consumers would be willing to pay the significant search and transaction costs involved in sourcing different products from different suppliers.

12. The TPC identified a range of products which comprised retail banking services. They included:

- deposit accounts, including term deposits and savings accounts;
- loans, including housing finance and personal finance (credit cards, small business loans and personal loans); and

- payments, including retail transactions accounts, automatic teller machines (ATMs), electronic funds transfer at point of sale (EFTPOS), cheques and electronic payments and transfers (bill paying, drafts etc).

### *The Westpac/Bank of Melbourne merger and market definition*

13. In 1997, the ACCC revisited its market definition in its analysis of the proposed acquisition by Westpac of another regional bank, the Bank of Melbourne. This merger was considered shortly after the publication of the Wallis Inquiry Report and took account of the rapid changes that had occurred in Australia's banking industry since its analysis of markets in the Westpac/Challenge merger proposal.

14. In its examination of the relevant markets, the ACCC noted that while product bundling was still occurring to a considerable degree, an increasing number of bank customers were willing to unbundle their banking requirements to obtain the best priced products where unbundling costs were significantly less than the potential pricing benefit.

15. The Wallis Inquiry Report had found that a significant percentage of consumer banking products were not bundled. It found that, on average, consumers acquire a significantly greater number of banking products per person (3.19) than they do from a single institution (1.67)<sup>6</sup>. However, other information provided to the Inquiry found that 64 per cent of consumers prefer to deal with one institution (primarily due to convenience and loyalty deals) while the remaining 36 per cent prefer to deal with several institutions (to obtain better rates, risk management and to put money aside for special goals)<sup>7</sup>.

16. The ACCC found that in certain banking products considerable unbundling had occurred. For example, non bank mortgage originators had had a significant effect on variable home loan mortgage rates. Mortgage originators offered home loans at lower interest rates than banks. In January 1996 Australian banks were charging an average of 10.5 per cent on variable home loans while non banks were charging nine per cent. By March 1997 the gap had been eliminated as banks responded to competition by cutting rates.

17. The ACCC decided that while there were many hundreds of differentiated banking products and services it was neither feasible nor useful to examine each separately. Instead it was decided to assemble the products into a small number of groups, ensuring that close substitutes were located within the same group. Each of these product groupings represented a separate market and each had its own geographic market dimensions. Six distinct product markets were identified:

1. Deposits: This group consisted primarily of products such as term deposits and longer-term 'investment' type products. Three key criteria were identified with respect to retail deposits – liquidity, security and return. For retail customers, cash management trusts, building societies, friendly societies and credit unions were seen as partial substitutes for bank deposits. While superannuation investments are also a depository alternative, their illiquid nature made them a poor substitute for bank deposits.
2. Home loans: The ACCC found that the cost of unbundling a home loan is relatively low compared to the potential benefits. Margins on bank home loans fell by more than 50 per cent between 1993 and 1997 and re-financing increased by 60 per cent indicating that a high degree of mobility in home loans had developed.
3. Personal loans: Market evidence indicated that customers often acquire personal loans separately from the institution where they acquire most of their other banking services. More

Australian consumers had personal loans and transaction accounts with different institutions than those who bundle the two.

4. **Small business banking:** It was considered that there was a separate 'cluster' of products/services in relation to small and medium enterprises (SME's). The difficulty of assessing credit risk for small businesses gives banks (or any other providers of bundled transactions and credit services) an advantage. Transaction accounts provide valuable information to financial institutions in monitoring the viability of businesses. This, in turn, makes it costly for small businesses to unbundle their ongoing credit needs from their transaction accounts. A 1995 Report<sup>8</sup> found that 85 per cent of small businesses surveyed applied to their main bank for a loan, with 78 per cent nominating one of the four major banks as their main financial institution.
5. **Credit Cards:** The ACCC considered that while credit cards combine the features of transaction accounts and personal loans they are an imperfect substitute for either. While the absence of transaction fees makes them an attractive substitute for transactions accounts, a customer is unable to write a cheque on them and if a cash withdrawal is made when the credit card balance is negative, interest accrues immediately. While credit cards offer greater flexibility when compared to personal loans, they do so at significantly higher cost. Thus the ACCC considered the provision of credit card services as a separate product market.
6. **Transaction accounts:** The provision of basic everyday banking accounts, used to withdraw and deposit cash and cheques, receive salary and social security payments were considered by the ACCC to constitute a separate market. Such accounts whether accessible by bank branch, phone, ATM, EFTPOS, Internet and personal computers form a distinct market.

### ***The Commonwealth Bank/Colonial State Bank merger***

18. In April 2000 the ACCC began to examine a third merger between a 'big four' bank and a regional bank. The merger parties proposed new market definitions. In some instances the definitions did not differ substantially from the ACCC's 1997 market definitions. The parties indicated that they saw unique markets for housing finance and small and medium enterprise finance which were similar to those previously proposed by the ACCC. They also proposed a market for corporate funding which would include the provision of funds to large corporations including listed companies and other major institutions.

19. However, other market definitions differed from those adopted by the ACCC in 1997.

20. The parties proposed a market for deposits and investments. This market comprised products used by consumers to manage their surplus funds. It was argued that while products in this market may offer a means of payment, this was not a defining characteristic. Products within this market would include interest earning investments (capital secure) and performance based products such as managed funds, government securities and direct equity. Transaction services would also be part of this market because many of the products would incorporate transactions services.

21. A separate market was proposed for retirement saving. The merger parties argued that such a market was distinguishable from the deposit and investment market because the taxation and regulatory regime for superannuation and retirement products was significantly different to that for deposits and investments.

22. The merger parties also proposed a market for consumer finance. This market would be comprised of all types of personal borrowings. The products within the market would include overdraft and personal loan borrowings, credit cards, private network cards, charge cards and also home equity loans. The inclusion of home equity loans with attached supplementary loan facilities decreases the distinction between the housing and personal loan markets in Australia. Many consumers use the built up equity in their home to extend their housing mortgage to purchase consumer durables, cars, holidays and other items often purchased on credit.

23. Under such an approach to market definition, the market for housing finance is less clearly delineated. Typically, finance for the purchase of residential, owner occupied housing has been considered to be a separate market. However, as financial institutions modify this traditional market category to allow consumers to utilise equity in the home to finance other spending, it may be that consumer finance and residential housing finance distinctions may become arbitrary in terms of competition analysis.

24. This particular merger is still under consideration by the ACCC.

## **2. Geographic market definition**

25. The ACCC has concluded that some product markets are regional and essentially State based while others are more likely to be national markets and some are even global.

26. The Wallis Inquiry Report noted that banks were generally unable to raise deposits in Australian States where they had no branch representation. This tends to suggest that the market for deposits is State based.

27. With regard to home loans, there is considerable diversity in the strategies taken by various suppliers of home loans in Australia. A branch presence is no longer essential to initiating home loans. Some market participants operate national call centres for loans. Non bank home mortgage providers have established a significant national presence. Consequently the ACCC has reached the conclusion that it is appropriate to adopt a national geographic definition for its analysis of the home loan market.

28. At the present time, competition in the market for the supply of personal credit appears to be regional. Competition is provided by building societies and credit unions (who have traditionally been strong in personal loans for cars) and such providers tend to be State based.

29. Similarly the SME market has regional and/or State based geographic dimensions. The need for cash based SMEs in particular to have physically close transaction and/or deposit facilities suggests that convenient access to branches is very important. While some products demanded by SMEs may be retailed nationally, the bundling of SME banking products typically gives competition in the SME market a local or State based dimension.

30. For large corporate lending the geographic dimensions is at least national, and probably global.

31. Credit cards have both regional and national geographic dimensions. Credit card issuers have argued that the geographic dimension is national. However, around 50 per cent of Australian credit card holders used a branch to make payments according to surveys in the late 1990s. The linkage of credit cards to ATMs also added a regional aspect as to make ATM transfers, customers need a linked transaction account and such accounts are unlikely to be held with out of State/region banks. However, as alternative credit card payment methods gain greater usage, it may be more appropriate to delineate a national geographic market.

### 3. Assessing anti-competitive impact other than barriers to entry

32. The ACCC has not assessed any bank mergers under a failing firm doctrine. In rare instances it has been suggested to the ACCC that a particular acquisition may be desirable on the grounds that the entity being acquired has no longer term viability. However, this does not necessarily mean that at the time of the merger there were severe prudential concerns regarding the immediate viability of the bank, but merely that the bank had little growth opportunity and was insufficiently capitalised to be a long term significant competitor in the banking industry.

33. The Australian banking industry is subject to prudential regulation by the Australian Prudential Regulation Authority (APRA). The ACCC has close liaison with APRA when it examines bank mergers. APRA has responsibility from a prudential perspective in determining whether the acquisition should proceed. However, in Australia there has been few instances where an acquired firm has had prudential problem and so competition analysis has normally been the critical element. The provisions of the *Financial Sector (Transfers of Business) Act 1999* enable the Treasurer to direct a compulsory transfer of business of a failing regulated institution to a competitor after consultation with the ACCC..

34. Australia has no fully State owned banks. The publicly owned Australia Post does not operate a bank but provides agency services for banks. Thus the Government, through bank ownership, is unable to influence price (interest rates) in financial services markets. Official domestic interest rates are set independently by the Reserve Bank of Australia, Australia's central bank, through its operations in the short-term money market.

### 4. Barriers to entry

35. The need for a widespread branch presence has often been considered to be the most significant barrier to entry in retail banking. However, new technologies and alternative distribution mechanisms may be reducing the importance of the branch network.

36. In Australia a banking licence is required to enable an institution to accept deposits. To obtain a banking licence firms must meet prudential regulations and minimum capital requirements. The need to obtain a licence has not been a barrier to entry and governments have issued numerous bank licences since deregulation of the industry in the early 1980s. However, the Australian market has not seen significant new entry, indicating that there may be barriers to entry more relevant than licensing requirements.

37. The importance of branch networks has been identified in a number of Australian studies. While the proportion of consumers who elect to do all or most of their banking at a branch is falling, there is still a significant minority who rely on branch networks. The emerging structure of the industry appears to be a mix encompassing full service branches, transaction only type branches and 'kiosk style' branches in supermarkets and shopping malls and electronic networks.

38. This emerging structure may be less costly to replicate than traditional branch networks especially as electronic networks of ATMs, EFTPOS, phone and Internet banking become commonplace. Insurance companies and home mortgage originators may be able to enter, as electronic banking becomes more popular and less costly.

39. Of course electronic banking exhibits numerous network characteristics which may be a barrier to entry. A new entrant without an ATM network or EFTPOS access would need to establish these facilities to enter the market, and the sunk costs are likely to be substantial. Alternatively, an entrant would need to establish arrangements with other electronic networks.

40. A new entrant may also be constrained by the existence of interchange fees. Interchange fees are levied on, or between, institutions whose customers use each other's ATM and EFTPOS networks. These fees tend to reflect the relative bargaining strengths of the institutions involved in bilateral negotiations. The more card carrying customers a card issuer has, the stronger is its bargaining position. Similarly, the larger the merchant network that a bank has developed (i.e. the merchants who have agreed to take a bank's EFTPOS processing facilities), the stronger its position. A new entrant with few customers and few merchants signed to its system will generally not be able to negotiate low interchange fees.

41. In Australia, customer inertia has been identified as a barrier to entry<sup>9</sup>. Information difficulties, transactions costs involved in 'shopping around', maintenance of credit standing and banking relationships have been identified as factors contributing to this inertia.

42. Economies of scale and scope appear to be significant in the provision of most banking services. Card and data processing and back office functions provide important scale opportunities. It has also been claimed that full service banks have considerable scope advantage over entrants via their national branch and electronic networks. However, in Australia the four major national banks have sometimes argued that the high costs associated with the maintenance of such networks and their significant sunk costs, disadvantage them relative to new entrants and smaller regional competitors.

43. Apart from the central bank, Australia has no government owned banks.

44. The authorisation procedure in the Act provides for the ACCC to consider a range of public interest issues. This would include the impact on the stability of the financial sector of a bank failing.

## **5. Efficiencies**

45. In many industries it is often claimed that mergers are necessary for the firm to achieve the efficiencies associated with large scale and to effectively compete in global markets. Australian merger policy recognises that such claims may be legitimate and via its processes of authorisation is able to allow a merger to proceed even when the merger results in a substantial lessening of competition. Merger parties may sometimes argue that even though their merger might lessen competition in the Australian market, their merger should be authorised on public benefit grounds. Public benefit analysis might recognise the need to merge to generate efficiencies and/or compete in global markets.

46. In Australian financial markets no merger proposal has yet made an application for authorisation. Therefore the ACCC has not been required to consider in detail arguments that globalisation of financial markets requires increased domestic concentration in financial services markets. However, in its analysis related to market definition in financial services mergers, the ACCC has not seen evidence that would indicate that most financial services markets are global. While the market for corporate finance is clearly beyond national borders, the market for many other financial services does not appear to be significantly influenced by globalisation. While most of Australia's largest financial institutions operate in overseas markets, their offshore activities do not necessarily indicate that markets are global. Foreign financial institutions operate in Australia yet many of the markets still remain national and even regional.

47. Australian financial institutions have generally not diversified geographically across Australia for the purpose of reducing risk. The risk profile of regions across Australia is unlikely to differ significantly so there is little incentive for Australian financial institutions to engage in geographic diversification to reduce risk. Australia's regional financial institutions are generally strong competitors to their national rivals.

## 6. Remedies

48. In one recent bank merger the ACCC required undertakings as a condition for merger approval. The Westpac acquisition of the Bank of Melbourne was allowed to proceed after Westpac provided the ACCC with a range of behavioural undertakings.

49. In the course of the ACCC's assessment of the merger, it became clear that the anti-competitive effects were regional and related mostly to markets for transactions accounts. In order to overcome the ACCC's concerns, the parties offered undertakings which committed them to implementing a strategy based on significant local autonomy. Westpac agreed to: maintain the Bank of Melbourne's opening hours; preserve the entitlements of certain transaction accounts to fee exemptions; and grant access to the combined electronic network for new and small local competitors for a reasonable period.

50. The ACCC took the view that the undertakings would preserve the competitive elements that existed via the Bank of Melbourne's presence in the market. The undertakings were both transparent and enforceable and enabled the ACCC to be satisfied that significant elements of competitive behaviour would be maintained.

## 7. Interaction with prudential regulators

51. The ACCC has extensive and regular communication with prudential regulators in Australia not only with regard to mergers but also with regard to consumer protection in financial services. There are clearly defined roles for each organisation and all agencies are responsible to the same Minister. Where appropriate, the sharing of information and intelligence is encouraged and regular meetings facilitates a high level of co-operation between agencies.

## 8. A special regime for bank mergers?

52. There are no special rules for bank mergers under Australia's principal competition legislation, the Act. Bank mergers neither receive more lenient treatment than mergers in other sectors nor are required to face a more stringent competition test than mergers in other sectors.

53. Generally speaking acquisitions by Australian banks have been of other financial institutions. In recent months a major Australian bank has acquired a major insurance company. The ACCC saw no significant competition concerns from the merger. As Australian banks are not major shareholders in companies in other market sectors, acquisitions by banks of their banking competitors have not raised competition issues in other markets.

## 9. Bank mergers and political sensitivities

54. Bank mergers are politically sensitive in Australia and the *Banking Act 1959* obliges banks to obtain the Treasurer's approval prior to selling their banking business, merging or reconstructing the bank in Australia. In addition, the Government has placed a ban on any mergers between the four largest Australian banks. This ban is separate from the standard merger provisions of Australia's competition law. The Government's ban is designed to ensure the maintenance of competition in particular sectors of the financial services market. The Government has indicated that it would consider lifting the ban when sufficient competition beyond the big four banks develops.

55. Australia has certain foreign ownership constraints but, as noted earlier, these constraints have not prevented and are not designed to prevent the entry of foreign financial institutions. Any proposed foreign take-over or acquisition of an Australian bank will be considered on a case-by-case basis and will be evaluated on its merits. Under the Financial Sector (Shareholdings) Act, the Treasurer's approval can only be given if it is considered in the national interest for the person to hold a stake in a financial institution. The Treasurer considers a broad range of factors in making a decision taking into account, but not limited to, the ACCC's competition assessment. While the national interest test could come into play before the competition test has been assessed, this has not happened in practice.

56. Foreign owned banks wishing to operate in Australia are permitted where APRA is satisfied that the bank is of sufficient standing and subject to adequate standards of prudential supervision in its home country, and where the bank agrees to comply with APRA's prudential requirements.

57. The competition test is clear, consistent and transparent and applies to mergers in all sectors. The ACCC publicises and explains the rationale for its decision in all mergers. If the Treasurer applies a national interest test then this would generally be accompanied by a public statement and the Treasurer would be accountable to Parliament for any decision made.

## 10. Co-operation with other countries

58. Recent bank merger cases have involved acquisitions of Australian financial institutions by other Australian financial institutions. The ACCC has used formal and informal arrangements with overseas agencies to consider issues relevant to the Australian circumstances, especially with regard to market definition and barriers to entry but co-operation in the evaluation of the mergers has not been necessary nor appropriate.

## NOTES

1. A substantial lessening of competition test operated from the commencement of the Act in 1974 until 1977. A dominance test was then used between 1977 and 1993.
2. Financial System Inquiry (The Wallis Inquiry) Wallis, Stanley 1939 - AGPS 1997.
3. *Inquiry into Fees and Charges imposed on Retail accounts by and other Financial Institutions and by Retailers on EFTPOS transactions.* Australia. Prices Surveillance Authority . 1995.
4. *Ibid.*, p 125.
5. *Ibid.*, p 167.
6. *Wallis, op. cit.*, p 433.
7. *Wallis op. cit.*, p 435.
8. *A Special Report on Finance & Banking Issues.* Yellow Pages Australia, Small Business Index. Sept 1995, p 11.
9. *Inquiry into Fees and Charges Imposed on retail accounts by Banks and Other Financial Institutions and by Retailers on EFTPOS Transactions.* Prices Surveillance Authority, 1995, p 128.