The Wallis Inquiry and Bank Merger Policy

Why the Wallis recommendations ought to be rejected

Penny Neal

The Australian financial system is in danger of becoming less rather than more competitive, and in greater danger of financial instability than hitherto, if the Government adopts the recommendations of the recent Wallis Inquiry (Financial System Inquiry 1997), into the financial system. Despite its mission to make recommendations, inter alia, 'on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness', the Inquiry has recommended the abolition of the 'six pillars' policy whereby the Government prohibited mergers between the four major Australian banks and the two major life insurance companies. This already means, given the Government's response to date, that a foreign bank can take over a major Australian bank, and may mean that mergers between the four major Australian banks can proceed in future. It is difficult to see how such mergers will increase competition in the market for financial services, and yet easy to see how they could increase financial instability.[1] Despite their recommendations, the authors of the Wallis Inquiry report were not unaware of these issues.

The Inquiry's report concluded that there were two important matters to be addressed with respect to the 'six pillars' policy (p. 426):

- First, do competition concerns justify the retention of the current policy, or a new version of it?
- Secondly, are there prudential issues – such as concerns about the creation of institutions which are 'too big to fail' – which justify the retention of a government policy in this area?

The answer to each of these two questions should be a resounding 'yes'. However, the Inquiry's response to each question was a muted 'no'.

The Inquiry concluded that concerns with respect to the prudential implications of proposed mergers should be referred to the prudential regulator. It was the Inquiry's view that this may change the conditions under which mergers will be allowed to proceed but should not prevent them. The Inquiry noted that concerns with respect to the concentration of economic power should be addressed through the exercise of competition legislation which is administered by the Australian Competition and Consumer Commission (ACCC). To date, the Treasurer has agreed that, subject to competition tests, any proposed mergers between a major bank and a major insurance company should be allowed to proceed. Mergers between any of the four major banks continue to be prohibited at least for present. However, the previous prohibition on foreign takeover of any one of Australia's four largest banks has been removed. The message from the Treasurer to the domestic banks is that the prohibition on domestic mergers may be removed if provision of finance to small business improves (which would be taken to be a sign of greater competition between banks).

It is my contention that competition policy is an insufficient basis on which to allow mergers between the major Australian banks to proceed. In any case, mergers between the major banks are unlikely to increase competition. Prudential concerns should take precedence over competition policy when assessing proposals for regulatory changes in financial markets. The origins of prudential regulation generally lie in attempts to increase stability in financial markets; whereas the origin of most competition regulation lies in attempts to limit rent-seeking behaviour of market participants. In both cases, regulations are imposed because there is some potential for market fail-

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1 Other recommendations of the Wallis Inquiry which have nothing to do with bank mergers also have the potential to increase financial instability. A mimeo, 'The Wallis Inquiry, Financial Regulation and Systemic Instability' which discusses this issue is available from the author on request.

ure. Market failure in financial markets differs in fundamental ways from the markets for most other goods and services. The Wallis Inquiry states (p. 189) that in markets for intense financial promises,[2] the two long-recognised sources of market failure are the risk of third-party losses due to systemic instability, and the problem of information asymmetry where most consumers cannot reliably assess risk. These are interrelated. Where consumers cannot adequately assess risks, their actions may precipitate systemic instability.

Systemic Instability

Systemic instability occurs when breaches of financial promises by one financial institution causes financial distress to others. This may be because, when one financial institution is unable to meet the demands of its customers for deposit withdrawals, other essentially sound institutions suffer a run on their deposits (because of information asymmetry where consumers are not in a position to judge the financial health of their own institution, or because they are cognisant of the fact that the health of their own institution may rapidly change as a result of negative developments elsewhere in the financial sector); or because the credit exposures of the sound institutions to the distressed institution may be such that in the event of the latter being unable to settle payments, the former may also have to withhold payments. In both cases, payments may be disrupted throughout the financial system because of contagion effects. Dale (1996: 216) notes it is primarily the susceptibility of financial institutions to contagion effects that distinguishes them from non-financial firms. As funds from financial markets underpin activity in all other markets, systemic instability can have severe and damaging consequences for the macroeconomy through its impact on output, employment and inflation (or deflation).

Prudential regulations are imposed on financial institutions in order to limit the development of systemic instability. These are regulations designed to prevent breaches of financial promises and to overcome some of the asymmetric information problems faced by consumers of financial services. They may include, inter alia, prohibitions on ownership, minimum capitalisation levels, capital adequacy requirements, minimum liquidity requirements, limits to large exposures and reviews of risk management systems.

Prudential Regulation and Bank Mergers

The fundamental question then with respect to prudential regulation and bank mergers is whether mergers between any of the four largest Australian banks or a foreign takeover of one of the four would increase the risk of systemic instability. The Wallis Inquiry (p. 427) notes from a Reserve Bank submission that if mergers between the major banks are allowed, Australia could end up with only two major banks and the most concentrated banking industry in the industrialised world 'which would take us into uncharted prudential waters'. The consequences for systemic stability are enormous. Should one of the banks become illiquid or insolvent, it is very unlikely that the other would not be affected through contagion. Even if only one bank was affected, the impact on real activity could be very damaging to the macroeconomy as a very large portion of loan and deposit activity would be affected.

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The Wallis Inquiry (p. 427) notes that, in effect, each of the four major Australian banks is already 'too big to fail' because ' ... the majors are already of a size which would limit the options for organised takeovers within Australia'. It notes a number of options for resolution of bank failures, but fails to account for the ways in which mergers between the four majors have the potential to increase systemic instability:

a) Joint ventures – If mergers were permitted between the majors so that Australia did end up with only two major banks, it is very unlikely that if one of the two failed, the other bank would have the resources to merge with the failing bank. In any case, a merger would then lead to a domestic monopoly in the banking sector, albeit one which may be subject to foreign competition.

2 The Inquiry (p. 189) denotes intensity of financial promises with respect to their risk characteristics which include the inherent difficulty of honouring promises, the difficulty in assessing the creditworthiness of promisors, and the adversity caused by breaching promises. Those promises with a higher degree of risk are said to be more intense.

b) Foreign acquisition – The Inquiry itself notes (p. 416): '[a] large scale transfer of ownership of the financial system to foreign hands should be considered contrary to the national interest' because it would restrict the options available for the future development of the financial system in Australia. Foreign ownership of major Australian banks will also both increase the risks of importing systemic instability and reduce the Reserve Bank's ability to conduct monetary policy. The failure of a bank to settle in some other country may lead to a foreign owned bank in Australia having to withhold or suspend payments in the domestic economy. If it is one of only two banks, then the payments system in Australia is likely to break down. The Reserve Bank conducts monetary policy by selling Treasury Notes in financial markets. Banks are amongst the major purchasers of these. The fewer the banks there are, the greater the difficulty the Reserve Bank is likely to experience in selling the required number of Treasury Notes to bring about a desired change in interest rates.

c) Partial acquisition by non-financial institutions – Current policy prevents substantial shareholdings of financial institutions by non-financial institutions so as not to compromise the safety of the financial system through association with the economic fortunes of industrial companies. The Wallis Inquiry (p. 340) notes that this restricts potential competition and potentially damages innovation in the market for financial services. The Inquiry does, however, recommend that the general principle of separation of financial and non-financial institutions be maintained in the interests of financial stability but that the rule be applied with greater flexibility than at present. If industrial companies are permitted to acquire financial institutions, then another potential source of instability derived from instability in the industrial sphere is added to the financial sector.

d) Management by the regulator – For a bank to be in a position where it is managed by a regulator means that it is either illiquid or insolvent. In either of these cases, the fewer the number of banks in the system, the greater the danger of financial collapse throughout the system. To prevent systemic instability, the Reserve Bank would have to provide a lender of last resort loan to the illiquid or insolvent bank so as to prevent financial collapse.

e) Recapitalisation – This option may be almost impossible to achieve if the bank is insolvent. The most likely scenario would be the exit of the bank from the industry, resulting in fewer banks, less competition and a greater probability of systemic instability.

f) Break-up prior to sale – This may in fact increase the degree of competition in the banking sector and enhance financial stability. Note, however, that mergers between major banks in the Australian context would have the opposite effect by greatly increasing the degree of concentration in the banking sector.

Competition and Bank Mergers

Many ordinary citizens are sceptical of the benefits to be derived from a more concentrated banking industry. (See, for example, the letters to the editor in *The Australian*, April 16, 1997, p. 12.) Given that the philosophy underlying the Wallis Inquiry's discussion with respect to mergers (p. 417) is '... that merger laws and their administration have an important role to play in ensuring a competitive structure for the Australian financial system', it is appropriate to ask how mergers between the major banks will increase competition.

Competitive markets in traditional (neoclassical) economic analysis are characterised by a large number of small firms, each providing identical goods or services, and no barriers to entry. Although market price is determined by the interaction between supply and demand for total output available on the market, any individual firm acting on its own is unable to influence market price and thus has no market power. Long-run profits are just sufficient to keep firms from exiting the industry. As the number of firms in a market declines, traditional economic analysis suggests that firms gain market power and exercise that power so as to increase profits by restricting output and increasing price compared with the outcomes in the competitive case. The ACCC's definition of market power is somewhat wider: '[m]arket power is the ability of a firm or firms to profitably divert prices, quality, variety, service or innovation from their competitive levels for a significant period of time' (ACCC 1996:21). Presumably, on the ACCC's definition, the power to divert quantities from their competitive levels is subsumed in the ability to divert prices. In recent years, the annual profits of the major banks, each of which has made more than $1 billion, suggests that they have been extremely successful in exercising market power. Thus, if mergers are to promote competition in the banking sector, they must reduce the market power of individual banks.

Section 50 of the Trade Practices Act 'prohibits acquisitions which would have the effect, or be likely to have the effect, of substantially lessening competition in a substan-

tial market in Australia, in a State or in a Territory'. The ACCC's Merger Guidelines (1996: 26) lists the 'merger factors' for which the ACCC must have regard in assessing whether a merger is likely to have the effect of substantially lessening competition in a substantial market. Even a cursory examination of the competitive benefits of mergers between major banks against the following merger factors suggests that they should not be allowed to proceed. The merger factors include:

a) The actual and potential level of import competition in the market – This is currently very low in Australia despite the entry of foreign banks in the 1980s. On the whole, foreign entry was unsuccessful and had almost no impact on retail transaction accounts and services to small and medium sized enterprises which the Wallis Inquiry notes (p. 415) are 'likely to be central to the competitive assessment of future retail bank mergers'.

b) The height of barriers to entry to the market – Barriers to entry are falling largely because of technological developments. One of the driving forces of bank mergers appears to be the substantial cost savings to be derived in the area of operations and systems and other support as indicated in the National Australia Bank's submission to the Wallis Inquiry (5-9) and as is being argued by Westpac and the Bank of Melbourne before the ACCC at the time of writing. Technological developments also allow a far greater number of transactions to be undertaken by electronic means. There is thus less need for a branch structure to meet the needs of consumers for financial services and so the requirements for physical capital are falling. However, the National Australia Bank submission (pp. 5-9) suggests that the scope for cost savings through the rationalisation of branch structures are minor compared with the impact of developments in information technology on costs. Whilst developments in information technology may lower costs, there is no guarantee that the cost savings of the merging banks will be passed on in price cuts or improved services to consumers rather than retained as increased profits by banks which may be in a position to exercise a greater degree of market power after merging. Other indicators of reductions in the height of barriers to entry brought about by improvements in information technology have been the development of conglomerates which provide a range of financial services (banking, loans, insurance, superannuation, securities, risk management etc.,), and the entry of specialised service operators such as the mortgage originators which have opened up the banking sector to new sources of competition. Nevertheless, it will be some time before an assessment of the success or otherwise of these potential competitors can be made. There is a danger that the major banks already have sufficient market power to be able to act in ways which ultimately eliminate at least some of these competitors from the market.

c) The level of concentration in the market – The banking sector is already highly concentrated and a merger between two major banks will only make it more so. Even if the market was to be broadened to include all financial services, if any of the major banks merge, there will also be a significant increase in the level of market concentration in the financial services sector.

d) The degree of countervailing power in the market – There is little countervailing power in the market for financial services whereby the consumers of financial services can counter the market power of the sellers of consumer services. The provision of financial services is dominated by the four major banks and the two major life insurance companies. Even with the entry of new competitors, the very large number of small consumers of financial services relative to the small number of large providers suggest that mergers between any of the four major banks is likely to reduce rather than increase the degree of countervailing power and thus lead to less competitive outcomes for the financial services sector.

e) The likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices or profit margins – It is hard to envisage why a firm providing financial services would consider taking over another in the same industry and thus expanding its operations without the incentive of an increase in prices and/or profit margins, because if the target firm is in the same industry as the acquiring firm, then diversification is not the objective of the takeover. The increase in prices and/or profit margins may come about through reduced costs, the reduction of existing or potential competition, or a lower gearing ratio for the takeover target enhancing the acquiring firm's ability to be able to service debt.

f) The extent to which substitutes are available in the market, or are likely to be available in the market – As indicated under point (b), substitutes have become available in the market for financial services but their potential to provide competition to the major banks in the long-term has yet to be demonstrated.

g) The dynamic characteristics of the market, including growth, innovation and product differentiation – Financial services provision has all of these characteristics. It is a growth industry where a large amount of innovation and product differentiation is already taking place, for example, in the area of derivative products. The Wallis Inquiry (p. 311) states that as a result of declining information costs, institutions appear likely to dichotomise into large scale finance generalists and boutique finance specialists. The latter will need to differentiate their products from the former, and can probably best do this by innovation, in order to compete with the scale economies that the generalists will reap.

h) The likelihood that the acquisition would result in the removal from the market of a vigorous and effective competitor – The ACCC's Merger Guidelines (p. 50) states: '[t]his factor focuses on the actual conduct of the target firm pre-merger and likely future conduct with and without the merger'. It seems from further comment by the ACCC that a vigorous and effective competitor is one which '... serves to undermine attempts [by other firms] to coordinate the exercise of market power'. Although all four of Australia's major banks actively compete with each other for the provision of financial services in attempts to increase market share, it is doubtful perhaps whether they do so by seeking to undermine market power. Nevertheless, a reduction in the number of major banks from four to three, or even two, increases each of the remaining banks' ability to exercise market power, and thus reduces the potential for vigorous and effective competition in the market for financial services. It also increases the opportunity for co-operative conduct between the remaining institutions.

i) The nature and extent of vertical integration in the market – This factor is of little relevance in the market for financial services.

The economic costs of allowing mergers between the four largest Australian banks or between one of the four and a foreign bank include a higher degree of concentration in the financial services sector, greater potential for systemic instability, less competition and therefore higher interest rates, greater opportunities for cooperative conduct, and where a foreign bank is allowed to merge with a domestic bank, the future development of the domestic financial services sector may be impeded. The principal potential economic benefit is greater economic efficiency achieved through increased economies of scale and reduced costs. However, the Wallis Inquiry (p. 464) is equivocal with respect to this potential benefit as '[t]he evidence from studies on bank mergers and efficiencies to date has been, at best, equivocal on whether or not there are efficiency gains to be derived from mergers and, on the whole, points toward there being no correlation between bank mergers and improved efficiency'. On costs, the Wallis Inquiry (p. 467) had this to say: '... while some mergers may achieve significant cost savings they are not guaranteed and many mergers may not achieve them'. The case for allowing mergers to proceed between the major Australian banks has yet to be made. *Policy*

ON ITS OWN LIST, THE ACCC SHOULD CONCLUDE THAT A MERGER OR FOREIGN TAKEOVER OF ANY OF AUSTRALIA'S FOUR LARGEST BANKS WILL SUBSTANTIALLY LESSEN COMPETITION.

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