Preliminary Report for the Australian Bank Employees' Submission to the House of Representatives Standing Committee on Finance and Public Administration Inquiry into the Australian Banking Industry

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Abstract
The Australian Bank Employees' Union commissioned the Centre for Technology and Social Change at the University of Wollongong to prepare a preliminary report for submission to the 'Martin Inquiry into the Australian Banking Industry'. This submission examined the results of deregulation of the Australian Banking Industry in terms of increased competition, the entry of foreign banks, innovation, new technologies and financial services, takeovers and mergers and human resources. The submission's recommendations to the Martin Committee were based on these findings.

Keywords
Martin Banking Australian Banking Industry Inquiry (1990-1991), Deregulation, Innovation, Technology

Disciplines
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PRELIMINARY REPORT FOR THE AUSTRALIAN BANK EMPLOYEES' SUBMISSION TO THE HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON FINANCE AND PUBLIC ADMINISTRATION INQUIRY INTO THE AUSTRALIAN BANKING INDUSTRY

Prepared by

The Centre for Technology & Social Change

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December 1990
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SECTION 1

REVIEW OF THE SUBMISSION MADE AT THE TIME OF THE CAMPBELL AND MARTIN INQUIRIES REGARDING THE BANKING AND FINANCE INDUSTRY.

1.1 What was promised as a result of deregulation?

A key consideration motivating the deregulation of the Australian financial sector and the entry of foreign banks was the assumption that it would result in a more competitive, innovative and therefore more efficient, financial system.¹

In their 1983 submission to the Martin inquiry, the ABEU expressed concern over a number of issues concerning the pending deregulation of the Australian financial sector.² These concerns proved to be well founded. In particular, they expressed concern that:

- full competitive benefits were unlikely to be realised due to a banking system possessing informational deficiencies, barriers to entry and the potential for collusive oligopoly;
- banks would redirect resources from less profitable but socially useful areas to more lucrative and speculative activities associated with wholesale finance;
- banks, as critically important social and economic institutions, should discharge all of their responsibilities and not be left, unconstrained, to merely satisfy the needs of their shareholders and large scale business interests;
- foreign Banks would not develop branch networks and would only involve themselves in wholesale banking. Therefore, the only competitive gain would be associated with the wholesale banking sector;
- local banks would have to be more aggressive in their involvement in the wholesale sector and minimise the retail banking sector subsidy;
- a segmented banking labour market consisting of a primary segment of a small number of educated and technically sophisticated staff and a larger secondary segment containing deskill, non-permanent and lower paid positions would be a likely outcome;
- it was not clear that services to all consumers would be of a higher quality, be more available and cheaper. It was likely that the weakest sections of the Australian community would be squeezed for funds by these developments.

1.2 What has been achieved by deregulation?

Examining the achievements of deregulation in terms of increased competition, innovation and efficiency, reveals mixed findings. There has been a definite increase in innovation in terms of the introduction of new technologies, and financial products, services and instruments. However, the goals of increased efficiency and competition have only partially been achieved.

² ABEU Submission to the group established by the Federal Government to re-examine the recommendations of the Campbell Inquiry into the Australian Financial System, July, 1983.
To examine the performance of the banking sector in terms of its efficiency, it is necessary to
distinguish between the two meanings of efficiency in economics, that is, 'technical efficiency'
and 'economic efficiency'.

'Technical efficiency' refers to 'obtaining any given output with the least cost combination of
inputs'. 3 'Economic efficiency' refers to 'the price of a good in the market [being] equal to the
marginal cost of producing it'. 4

Following deregulation, technical efficiency in the financial sector has markedly increased. One
source indicates that: 'real deposits per employee have risen 30 per cent and unit labour costs
have fallen by 22 per cent'. 5 However, economic efficiency in the form of marginal cost pricing
of transactions services has not eventuated. 6 The issue of the banks failing to fully achieve
marginal cost pricing of services is addressed in detail in Section 4.10.

An examination of the level of competition achieved in the banking sector since the entry of the
foreign banks reveals that there has been an increase in competition in the corporate sector at the
expense of competition in the retail sector. This outcome has been attributed to a number of
factors. The existing branch network infrastructure of the domestic banks provided an
insurmountable structural impediment to the new entrants, the foreign banks, whilst
simultaneously providing the existing banks with a large deposit base of low interest capital.

The subsequent focus of the foreign banks on corporate lending activities also increased the
domestic banks' activities in this area, effectively creating a highly competitive corporate sector.
In a bid to increase their competitiveness in this area, the domestic banks effectively cross-
subsidiised their corporate sector lending activities through an increase in their retail margins. 7

1.3 What has yet to be achieved?

The previous analysis reveals that a number of goals have yet to be achieved by deregulation.
These are the establishment of economic efficiency, and the introduction of actual
competitiveness in the retail banking sector.

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3 Wood, G., Competition, Innovation, Consumer Protection and the Role of the Market, in Fisher, M.
4 Wood, G. op. cit.
5 Milbourne, R. and Cumberworth, M., Australian Banking Performance in an Era of Deregulation: An
6 Milbourne, R. and Cumberworth, M., op. cit.
7 Milbourne, R. and Cumberworth, M., op. cit.
1.4 What unforeseen benefits and costs have emerged?

A number of unforeseen benefits and costs have emerged following financial deregulation and foreign bank entry. The benefits include:

- increased access for consumers to their deposits outside of bank trading hours through the introduction of ATMs etc;
- a lowering of wholesale interest rate margins.

Unforeseen costs which have emerged include:

- increased bad and doubtful debts through the application of imprudent lending policies by a highly competitive wholesale banking sector;
- the increased role of financial institutions in executing monetary policy;
- a greater reliance by monetary authorities on official interest rates to influence monetary policy;
- a rise in retail interest margins by 2 per cent over a ten year period.

1.5 How can the problems be overcome?

Overcoming the problems encountered by the financial sector following deregulation provides a number of challenges.

A politically controversial measure addressing the issue of increased bad and doubtful debts would involve increased prudential supervision and capital requirements. Such a move may be interpreted as partially eroding deregulation. However, a precedent for such a move is being set in the US where the Federal Reserve Bank is in the process of drawing up new and more stringent guidelines for US commercial banks which exceed the 8 per cent BIS capital-to-adequacy ratio.\(^8\)

The issue of the failure of deregulation to increase competition in the retail sector is also a difficult issue. It has been demonstrated that the entry of foreign banks failed to increase competition in the retail sector (see Section 4.9). In this case, it may be that it is necessary to apply a degree of 'moral suasion' (appeal to social responsibility) to the financial institutions concerned.\(^9\) The present inquiry into the Australian banking system can, in some respects, be interpreted as a partial application of this strategy.

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\(^8\) Lloyd, S., 'Greenspan's bombshell' timely for RBA', Financial Review, 18/7/90, p.15.

1.6 The relevance of the term "banking industry" as opposed to "finance industry"

Since deregulation, there has been a blurring of roles and an overlapping of services between the functions of formerly discrete financial service providers. In the words of one industry participant:

There has been a transformation of financial intermediation from closed institutionally defined systems to a single open system characterised by functional specialities.\textsuperscript{10}

The collapsing of the distinction between formerly separate financial marketplace activities can be attributed to the impact of information technology, increased competition, and the greater diversification of products to meet consumer needs. Effectively, this means that the traditional institutional labels are become increasingly inadequate to describe institutions performing diverse roles in the marketplace.

This trend is demonstrated by the increasing convergence of service provision by:

- merchant banking and the traditional activities of the large trading and saving banks;
- banks and finance companies;
- banks, superannuation, funds management and life insurance;
- investment banking and stockbroking.

An excellent example of the extent of the banks' forays into non-traditional areas of service provision is to be found in the size of their superannuation and life insurance operations. Bank by bank these are:

- Westpac: $10 billion
- Commonwealth Bank: $7.8 billion
- ANZ: $5 billion
- National Australia Bank: $2 billion.\textsuperscript{11}

Many of these additional, non-traditional services are offered by the banks concerned through their branch banking network. Consequently, bank staff are increasingly providing services which fall outside the scope of their traditional banking duties. The combination of these factors leads one to seriously question the validity of the application of the term 'banking industry' to an industry which has transcended the traditional boundaries associated with banking.

More details of this analysis are provided in the following Sections.


\textsuperscript{11} Thomas, T., 'How banks plan to beat the mutuels', \textit{Business Review Weekly}, 5/10/90, pp. 44-47.
SECTION 2

THE IMPORTANCE OF THE BANKING SYSTEM TO THE AUSTRALIAN ECONOMY

As a result of deregulation the banking system has increased its importance in the Australian economy. Banks, including the Reserve Bank, now play a critical role in national monetary policy through the price rationing of credit. Competitive forces in the financial market have directed funds and services to the wholesale banking sector, and have increased the level of bad and doubtful debts.

Caught between more competition in the wholesale sector and the pressure from small businesses who have been substantially affected by high interest rates policies, banks are widely regarded as having failed to provide an adequate service to this sector. Complaints include high service charges, a refusal to extend credit lines, and the collapse of a culture of trust and understanding between bank managers and small business. The high public profile of debt financed financial empires, followed by corporate collapses have linked banks to a "culture of greed" and profligacy that has had serious negative consequences for the national economy, culminating in the current recession of 1990-91.

The ABEU's submission to the Martin evaluation of the recommendations of the Campbell Inquiry argued that,

...... reform of the financial system can be discussed adequately in terms of efficiency and neutrality criteria and that any adverse social consequences of these changes can be handled via the tax system is to fundamentally underestimate the role of the financial system in our society and the impact which that system has in determining the character of our society.

The events of the 1980s leading up to the current recession have demonstrated the accuracy of this observation.

As a result of deregulation, which removed government control over the quantity and cost of money available for lending, government fiscal policy must now rely on tax policy, including wage-tax bargains, and lower government outlays to reduce the current account deficit. The principal monetary measure for affecting inflation is higher interest rates to reduce demand. This has increased the importance of the banking system in the Australian economy. It is now the banks, including the Reserve Bank, which have the major effect on the levers of monetary policy through variations in exchange rates and fluctuations in interest rates, although the government has maintained some role in affecting interest rates.

A primary role of deregulation, identified by the Campbell Report, was to regain a measure of control over financial activity through monetary policy, as well as to improve the efficiency and
productivity of financial institutions. This is because previous measures of monetary policy, through government regulation, had ceased to be effective.

While there has been benefit in the removal of restrictions from Banks which previously hindered their ability to respond to new consumer needs in the provision of financial services, and to provide a financial infrastructure for the increasing internationalisation of the economy, it has presented a number of problems for national fiscal and monetary policy. This in turn has increased the politicisation of the banking sector, and exposed the banks to a much greater degree of scrutiny of their public role in securing a sound financial system, as opposed to their private role of an adequate return to their shareholders.

Because credit availability is now determined by price, and the willingness or ability of the consumer to engage in intertemporal transfers (mortgaging the present for the possibility of future gains to offset the cost of the credit), there is a reduced speed with which monetary policy affects aggregate demand, compared to previous measures of quantity control. As we have seen recently, this in turn has led to the need for a much greater rise in interest rates to achieve the desired effect in reducing demand. Since deregulation, changes in monetary aggregates have tended to move in step with changes in economic activity and have ceased to be leading indicators of the economy.

Tom Fitzgerald, in his recent Boyer Lectures, has suggested that this reliance on increasing the cost of credit has created a "reciprocating-engine mechanism of disaster". This flows from the fact that higher interest rates lead to an increased exchange rate which in turn leads to cheaper, and hence increased, imports and more expensive and hence decreased exports. This negatively affects the current account balance and leads to a further spiral in the need to increase interest rates to attract foreign funds to make up the shortfall in loss of income from exports.

Government fiscal policy can attempt to apply a brake to this cycle by tightening government expenditure and holding down wage increases so as to reduce interest rates, thus reducing capital inflows, leading to a weaker exchange rate. This will reduce the cost of exports and increase the cost of imports, thereby improving the balance of payments.

The deregulation of the financial sector has meant that fiscal policy must rely on wage-tax bargaining, and that much greater attention must be given to the effect of taxation policy on savings and credit. For example it could be argued that the credit explosion in the 1980s was not so much due to the failure of price rationing versus government control, as the continuing tax advantages to debt as opposed to savings.

A fundamental difficulty with the floating of the exchange rate has been the rapid escalation of international activity on the short term money market (the casino society) which has swamped trade flows. As a result deregulatory changes have increased the disadvantages of using
monetary policy for a country, such as Australia, that wishes to improve its current account deficit. The high interest rates in Australia have led to us having one of the highest rates of monetary growth in the world, with our net deficit on income payments overseas increasing from $4 billion in 1983 to $16 billion in 1990.

Fitzgerald has suggested that a "national policy of offering and paying pawnbroker interest rates to anybody and everybody overseas who would deposit money on a very short term for no specified application and no interest in the employment of the money to help service the debt" makes little long term sense. For instance he notes that in 1987-88 as much as 70 per cent of incoming funds were repayable in less than three months, and another 16 per cent in three to six months. Fitzgerald traces this government reliance on attracting foreign capital through high interest rates to the previous Fraser government. It was their attempt to bridge the rapidly widening payments gap while also attempting to sustain the exchange rate, that set the scene for continuing difficulties with inflation and balance of payments. He pointed out that under the dynamics of this pattern even periods of recession continue to promote the fundamental imbalance by sustaining a high exchange rate and weakening investment in the trading sector, leading to a continuing weakening of our long term prospects.

However Fitzgerald's criticisms of deregulation have to be placed within the context of the rapid globalisation of the economy, and with this, the development of new fundamentals in the banking and finance system.

The basic nature of international economic activity has been changed fundamentally by the advent of information technology and the globalisation of the economy. For instance in 1988 while the total volume of tradeable goods among OECD countries was valued at $600 billion annually, the daily volume in foreign exchange trading amounted to $600 billion.\(^{12}\) Because the foreign exchange market has become such an important arena for investment in its own right, attempts by governments to use exchange rates to fix markets have only succeeded in making it more attractive to speculative foreign exchange traders. However, it was also this problem of speculative activity on the Australian dollar which was one of the reasons for floating the exchange rate. Economic globalism has meant that international funds arbitrage, aided by electronic funds transfer technology was bound to overwhelm any attempt to hold exchange rates against market forces. In this environment previous regulatory practices had a negative effect on monetary policy.

Thus even in the previous regulatory environment Australia was caught in a vicious spiral. A high exchange rate led to increased interest rates which led to capital inflows fuelling further

speculation about revaluation. This in turn led to devaluation to stop the inflow and inflation, leading to reverse speculation, leading to the need for revaluation.

In a deregulated environment, because of the ease of entry into the foreign exchange market, and the relative absence of legal restraints on practices such as insider trading, money supply has moved well beyond the control of any single government. As banks are major players in the foreign exchange markets, the importance of the banking sector in national economies, and the global economy as a whole has increased. There is also evidence that the traditional distinction between tradeable goods and non tradeable goods is being challenged by the emergence of a global economy serviced by global companies. Exchange rates are now affected by investment opportunities tradeable across borders, ranging from goods to assets, from 'real' money to futures, options and rights. Because global companies also seek to become insiders in key foreign markets, they are able, indeed find it essential, to insulate themselves against foreign exchange fluctuations. For these companies currency fluctuations only widen strategic options.

Thus although the banking system has increased in importance to the Australian economy, through its central involvement in monetary policy and market activity, monetary policy itself is becoming less important as an agent of industrial and economic policy. This trend is reinforced by the interlinked processes of economic globalisation and electronic interchange.

To the extent that the demand for currency erodes as a result of the development of electronic substitutes, the capacity of the Reserve Bank to manipulate economic activity and prices by changing the supply of its own liabilities will be diminished.\(^\text{13}\)

The volatility of the foreign exchange rate and its impact on commodity exports may be seen as a product of market failure which has required Reserve Bank intervention. In addition the credit explosion and its impact on the economy have provided a very painful learning curve for banks as they assume their greater role in monetary policy. As Senator Button has noted, cultural change is just as important for capital markets as it is on the waterfront and factory floor, in enabling banks to respond to the new business parameters. One such cultural issue that must now be faced has been the short term focus of the finance sector built into their own performance indicators, which has favoured debt driven speculation over production.

It would appear that the deregulators who predicted major benefits for the economy have been proved wrong. The imbalance of payments has worsened and speculation in foreign exchange have increased the volatility of the Australian dollar. It also seems that Australia's integration with the world financial system, through deregulation, has not yet benefitted the economy by

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giving productive Australian enterprises access to much greater and more diverse capital resources, which would underpin employment growth.\textsuperscript{14}

The corporate collapses and bank loan losses have provided the market discipline that is part of a deregulated environment. However given the increased importance of the banks in national monetary policy, and the weakening of fiscal measures available to Government, the banking industry is now faced with a considerable challenge in regaining public confidence in its ability to fulfil its public role in national monetary policy and a sound financial system, as well as its private role to its shareholders.

SECTION 3
THE PROFITABILITY OF THE BANKING AND FINANCE SECTOR
THROUGH TIME AND IN COMPARISON WITH OTHER INDUSTRIES.

3.1 In a comparison of banking with other industries, which have performed better?

A common method of measuring the performance of industries consists of calculating their ranking within inter-industry comparisons of profitability. These profitability comparisons measure performance indicators such as earnings on shareholder funds, profit after tax, profit per employee, and dividend yields.

The preferred performance measure within the banking industry literature appears to be the inter-industry comparison of earnings on shareholders' funds. By this measure, over the period 1986 to 1989, the banking and finance sector have consistently ranked twelfth, apart from 1987 when the sector ranked tenth (see Table 3.1). The banking and finance sector consistently performed above average when measured against the All Company Average.

<table>
<thead>
<tr>
<th>TABLE 3.1 Earnings on Shareholders Funds</th>
<th>1989 (%)</th>
<th>1988 (%)</th>
<th>1987 (%)</th>
<th>1986 (%)</th>
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<td>3.87</td>
<td>7.42</td>
<td>12.35</td>
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<td>OIL &amp; GAS</td>
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<td>5.23</td>
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<td>13.58</td>
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<td>DEVELOPERS &amp; CONTRACTORS</td>
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<td>10.30</td>
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</tr>
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<td>12.14</td>
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<td>16.43</td>
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<td>5.76</td>
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<td>7.89</td>
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<td>PROPERTY TRUSTS</td>
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<td>7.68</td>
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<td>MISCELLANEOUS INDUSTRIALS</td>
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<td>TOP 25</td>
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<td>ALL COMPANY MEDIAN</td>
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<td>7.99</td>
<td>8.41</td>
<td>8.35</td>
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</tbody>
</table>

Source: Australian Stock Exchange (1989)

Turning to the inter-industry comparison of profit after tax, over the period 1986 to 1989, the banking and finance sector consistently ranked third, apart from 1986 when the sector ranked second. The banking and finance sector achieved a performance level in 1988 and 1989 which exceeded the All Company Average by more than 700 per cent (see Table 3.2).
### TABLE 3.2 Profit after Tax

<table>
<thead>
<tr>
<th></th>
<th>1989 ($000)</th>
<th>1988 ($000)</th>
<th>1987 ($000)</th>
<th>1986 ($000)</th>
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<td>GOLD</td>
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<td>14,008</td>
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<td>4,849</td>
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<tr>
<td>RETAIL</td>
<td>46,444</td>
<td>33,287</td>
<td>34,101</td>
<td>20,774</td>
</tr>
<tr>
<td>TRANSPORT</td>
<td>64,705</td>
<td>51,960</td>
<td>36,062</td>
<td>27,777</td>
</tr>
<tr>
<td>MEDIA</td>
<td>51,216</td>
<td>51,283</td>
<td>37,931</td>
<td>28,928</td>
</tr>
<tr>
<td>BANKS &amp; FINANCE</td>
<td>263,961</td>
<td>217,717</td>
<td>145,480</td>
<td>128,284</td>
</tr>
<tr>
<td>INSURANCE</td>
<td>21,958</td>
<td>33,637</td>
<td>36,659</td>
<td>24,147</td>
</tr>
<tr>
<td>ENTREPRENEURIAL INVESTORS</td>
<td>(76,179)</td>
<td>16,103</td>
<td>54,592</td>
<td>75,198</td>
</tr>
<tr>
<td>INVESTMENT &amp; FINANCIAL SERVICES</td>
<td>5,231</td>
<td>4,249</td>
<td>3,787</td>
<td>2,947</td>
</tr>
<tr>
<td>PROPERTY TRUSTS</td>
<td>19,663</td>
<td>15,319</td>
<td>10,201</td>
<td>7,992</td>
</tr>
<tr>
<td>MISCELLANEOUS SERVICES</td>
<td>2,542</td>
<td>1,982</td>
<td>3,488</td>
<td>4,125</td>
</tr>
<tr>
<td>MISCELLANEOUS INDUSTRIALS</td>
<td>6,621</td>
<td>2,363</td>
<td>1,971</td>
<td>2,540</td>
</tr>
<tr>
<td>DIVERSIFIED INDUSTRIALS</td>
<td>104,312</td>
<td>79,148</td>
<td>43,831</td>
<td>35,453</td>
</tr>
<tr>
<td>TOP 25</td>
<td>306,972</td>
<td>231,627</td>
<td>163,261</td>
<td>126,136</td>
</tr>
<tr>
<td><strong>ALL COMPANY AVERAGE</strong></td>
<td>33,875</td>
<td>29,342</td>
<td>22,373</td>
<td>29,350</td>
</tr>
<tr>
<td><strong>ALL COMPANY MEDIAN</strong></td>
<td>4,079</td>
<td>3,615</td>
<td>3,408</td>
<td>2,573</td>
</tr>
</tbody>
</table>

Source: Australian Stock Exchange (1989)

### TABLE 3.3 Profit per Employee

<table>
<thead>
<tr>
<th></th>
<th>1989 ($000)</th>
<th>1988 ($000)</th>
<th>1987 ($000)</th>
<th>1986 ($000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GOLD</td>
<td>7,713</td>
<td>105,723</td>
<td>99,108</td>
<td>92,796</td>
</tr>
<tr>
<td>OTHER METALS</td>
<td>29,988</td>
<td>14,928</td>
<td>8,397</td>
<td>3,380</td>
</tr>
<tr>
<td>SOLID FUELS</td>
<td>12,515</td>
<td>5,689</td>
<td>7,604</td>
<td>12,477</td>
</tr>
<tr>
<td>OIL &amp; GAS</td>
<td>40,500</td>
<td>19,076</td>
<td>15,788</td>
<td>29,489</td>
</tr>
<tr>
<td>DIVERSIFIED RESOURCES</td>
<td>20,347</td>
<td>16,605</td>
<td>13,127</td>
<td>14,802</td>
</tr>
<tr>
<td>DEVELOPERS &amp; CONTRACTORS</td>
<td>11,392</td>
<td>9,721</td>
<td>7,648</td>
<td>3,494</td>
</tr>
<tr>
<td>BUILDING MATERIALS</td>
<td>13,181</td>
<td>10,840</td>
<td>9,529</td>
<td>7,975</td>
</tr>
<tr>
<td>ALCOHOL &amp; TOBACCO</td>
<td>18,146</td>
<td>12,970</td>
<td>12,964</td>
<td>11,146</td>
</tr>
<tr>
<td>FOOD &amp; HOUSEHOLD</td>
<td>5,349</td>
<td>5,331</td>
<td>5,373</td>
<td>3,604</td>
</tr>
<tr>
<td>CHEMICALS</td>
<td>14,376</td>
<td>12,472</td>
<td>9,337</td>
<td>6,707</td>
</tr>
<tr>
<td>ENGINEERING</td>
<td>3,632</td>
<td>4,815</td>
<td>3,877</td>
<td>3,068</td>
</tr>
<tr>
<td>PAPER &amp; PACKAGING</td>
<td>13,338</td>
<td>10,973</td>
<td>5,852</td>
<td>5,454</td>
</tr>
<tr>
<td>RETAIL</td>
<td>3,311</td>
<td>2,449</td>
<td>2,801</td>
<td>1,777</td>
</tr>
<tr>
<td>TRANSPORT</td>
<td>4,925</td>
<td>4,793</td>
<td>3,534</td>
<td>3,051</td>
</tr>
<tr>
<td>MEDIA</td>
<td>12,474</td>
<td>16,764</td>
<td>12,776</td>
<td>9,743</td>
</tr>
<tr>
<td>BANKS &amp; FINANCE</td>
<td>15,492</td>
<td>13,464</td>
<td>10,253</td>
<td>9,280</td>
</tr>
<tr>
<td>INSURANCE</td>
<td>19,526</td>
<td>27,211</td>
<td>18,959</td>
<td>12,585</td>
</tr>
<tr>
<td>ENTREPRENEURIAL INVESTORS</td>
<td>(4,779)</td>
<td>(2,502)</td>
<td>8,414</td>
<td>7,248</td>
</tr>
<tr>
<td>INVESTMENT &amp; FINANCIAL SERVICES</td>
<td>54,915</td>
<td>27,972</td>
<td>23,962</td>
<td>19,784</td>
</tr>
<tr>
<td>PROPERTY TRUSTS</td>
<td>n/c</td>
<td>n/c</td>
<td>n/c</td>
<td>n/c</td>
</tr>
<tr>
<td>MISCELLANEOUS SERVICES</td>
<td>1,806</td>
<td>1,614</td>
<td>3,201</td>
<td>4,254</td>
</tr>
<tr>
<td>MISCELLANEOUS INDUSTRIALS</td>
<td>4,826</td>
<td>1,697</td>
<td>1,524</td>
<td>1,938</td>
</tr>
<tr>
<td>DIVERSIFIED INDUSTRIALS</td>
<td>9,141</td>
<td>8,795</td>
<td>5,069</td>
<td>5,073</td>
</tr>
<tr>
<td>TOP 25</td>
<td>10,930</td>
<td>9,112</td>
<td>6,365</td>
<td>5,549</td>
</tr>
<tr>
<td><strong>ALL COMPANY AVERAGE</strong></td>
<td>9,719</td>
<td>9,900</td>
<td>8,212</td>
<td>7,633</td>
</tr>
<tr>
<td><strong>ALL COMPANY MEDIAN</strong></td>
<td>4,102</td>
<td>3,300</td>
<td>2,967</td>
<td>2,677</td>
</tr>
</tbody>
</table>

Source: Australian Stock Exchange (1989)
The profit per employee measure also over the period 1986 to 1989 revealed a steady improvement over time. In 1986, the banking and finance sector ranked ninth on this scale. By 1989, this sector ranked seventh. In comparison to the All Company Average, the banking and finance sector performed well above average (see Table 3.3).

The dividend yield performance measure over the period 1986 to 1989, ranked the banking and finance sector a steady second, apart from 1986 when it ranked fourth. In comparison to the All Company Average, the banking and finance sector once again performed well above average (see Table 3.4).

**TABLE 3.4 Dividend Yield**

<table>
<thead>
<tr>
<th>Sector</th>
<th>1989 (%)</th>
<th>1988 (%)</th>
<th>1987 (%)</th>
<th>1986 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GOLD</td>
<td>3.41</td>
<td>4.41</td>
<td>3.92</td>
<td>4.24</td>
</tr>
<tr>
<td>OTHER METALS</td>
<td>5.13</td>
<td>5.40</td>
<td>5.07</td>
<td>2.84</td>
</tr>
<tr>
<td>SOLID FUELS</td>
<td>4.25</td>
<td>3.93</td>
<td>5.43</td>
<td>7.99</td>
</tr>
<tr>
<td>OIL &amp; GAS</td>
<td>2.14</td>
<td>2.04</td>
<td>1.99</td>
<td>1.85</td>
</tr>
<tr>
<td>DIVERSIFIED RESOURCES</td>
<td>3.89</td>
<td>4.82</td>
<td>3.98</td>
<td>4.22</td>
</tr>
<tr>
<td>DEVELOPERS &amp; CONTRACTORS</td>
<td>6.18</td>
<td>5.85</td>
<td>6.09</td>
<td>3.32</td>
</tr>
<tr>
<td>BUILDING MATERIALS</td>
<td>6.14</td>
<td>6.24</td>
<td>5.47</td>
<td>5.07</td>
</tr>
<tr>
<td>ALCOHOL &amp; TOBACCO</td>
<td>9.33</td>
<td>8.40</td>
<td>4.33</td>
<td>3.38</td>
</tr>
<tr>
<td>FOOD &amp; HOUSEHOLD</td>
<td>5.12</td>
<td>4.73</td>
<td>4.10</td>
<td>3.55</td>
</tr>
<tr>
<td>CHEMICALS</td>
<td>6.93</td>
<td>5.76</td>
<td>6.60</td>
<td>5.74</td>
</tr>
<tr>
<td>ENGINEERING</td>
<td>5.58</td>
<td>5.50</td>
<td>5.62</td>
<td>5.32</td>
</tr>
<tr>
<td>PAPER &amp; PACKAGING</td>
<td>5.24</td>
<td>4.83</td>
<td>4.98</td>
<td>4.52</td>
</tr>
<tr>
<td>RETAIL</td>
<td>6.59</td>
<td>5.89</td>
<td>5.07</td>
<td>3.97</td>
</tr>
<tr>
<td>TRANSPORT</td>
<td>4.23</td>
<td>3.86</td>
<td>4.65</td>
<td>4.23</td>
</tr>
<tr>
<td>MEDIA</td>
<td>2.13</td>
<td>1.82</td>
<td>1.37</td>
<td>0.62</td>
</tr>
<tr>
<td>BANKS &amp; FINANCE</td>
<td>10.34</td>
<td>8.84</td>
<td>9.17</td>
<td>5.62</td>
</tr>
<tr>
<td>INSURANCE</td>
<td>4.15</td>
<td>3.54</td>
<td>2.35</td>
<td>1.80</td>
</tr>
<tr>
<td>ENTREPRENEURIAL INVESTORS</td>
<td>6.36</td>
<td>6.72</td>
<td>5.32</td>
<td>2.25</td>
</tr>
<tr>
<td>INVESTMENT &amp; FINANCIAL SERVICES</td>
<td>5.54</td>
<td>5.03</td>
<td>4.16</td>
<td>3.21</td>
</tr>
<tr>
<td>PROPERTY TRUSTS</td>
<td>10.38</td>
<td>9.82</td>
<td>9.35</td>
<td>8.59</td>
</tr>
<tr>
<td>MISCELLANEOUS SERVICES</td>
<td>4.43</td>
<td>4.10</td>
<td>3.85</td>
<td>3.59</td>
</tr>
<tr>
<td>MISCELLANEOUS INDUSTRIALS</td>
<td>4.83</td>
<td>5.17</td>
<td>4.02</td>
<td>5.29</td>
</tr>
<tr>
<td>DIVERSIFIED INDUSTRIALS</td>
<td>4.73</td>
<td>5.09</td>
<td>5.97</td>
<td>4.50</td>
</tr>
<tr>
<td>TOP 25</td>
<td>4.88</td>
<td>5.11</td>
<td>4.84</td>
<td>3.55</td>
</tr>
<tr>
<td><strong>ALL COMPANY AVERAGE</strong></td>
<td>5.81</td>
<td>5.68</td>
<td>5.01</td>
<td>3.91</td>
</tr>
<tr>
<td><strong>ALL COMPANY MEDIAN</strong></td>
<td>5.00</td>
<td>4.92</td>
<td>4.07</td>
<td>3.67</td>
</tr>
</tbody>
</table>

Source: Australian Stock Exchange (1989)

According to the above performance indicators, the banking and finance sector consistently performed above average when measured against the All Company Average. The best performance was recorded on the profit after tax indicator where in 1988 and 1989 the banking and finance sector ranked third and exceeded the All Company Average by more than 700 per cent. The worst performance was recorded in the performance indicator most quoted in the banking industry literature, earnings on shareholders funds. However, even on this indicator the sector still recorded an above average performance.
3.2 The growth in bad and doubtful debts

The phenomenon of bad and doubtful debts has accompanied most international financial sectors which have embraced financial deregulation. Lower prudential standards adopted in this competitive corporate climate have resulted in higher provisions for bad and doubtful debts. The major Australian banks have been particularly hard-hit in this environment as evidenced by Table 3.5.

Table 3.5 Bad and doubtful debts of major Australian banks

<table>
<thead>
<tr>
<th></th>
<th>Non-accrual loans</th>
<th>Annual Profit</th>
<th>Bad debt provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>WESTPAC</td>
<td>$2.46 billion</td>
<td>$683.9 million</td>
<td>$1.2 billion</td>
</tr>
<tr>
<td>NATIONAL AUSTRALIA</td>
<td>$1.52 billion</td>
<td>$767 million</td>
<td>$651 million</td>
</tr>
<tr>
<td>ANZ</td>
<td>$2.86 billion</td>
<td>$221 million</td>
<td>$793 million</td>
</tr>
<tr>
<td>COMMONWEALTH</td>
<td>$1.00 billion</td>
<td>$494 million</td>
<td>$461.7 million</td>
</tr>
</tbody>
</table>

Source: *The Australian*, 29/11/90

One report estimates that there are $15 billion of non-performing loans in the Australian banking system and that they are costing the banking system about $2.1 billion to service. This has had a number of ramifications for retail interest margins (see Section 4.10).

3.3 The problem of different reporting standards applicable for banks as opposed to other industries

One of the key tenets of a free market system is the availability of meaningful, comparable information so that consumers may make informed choices in their consumption decisions. Meaningful information enables consumers to compare alternative products and services and determine their preference accordingly.

In recognition of these principles, the Final Report of the Campbell Committee recommended that:

...banks should be required to maintain a standard of disclosure comparable to that applying to companies under the Companies Act, in addition to providing information that is particularly relevant to their financing activities.

...all financial intermediaries should be subject to consistent reporting requirements, which should be prescribed in regulations to the relevant legislation.

---

18 ibid., Chapter 21, p.370.
The current lack of comparability of the financial reports of financial institutions and the differences in financial reporting between various types of financial institutions, and between similar types of financial institutions, indicates that these recommendations have failed to be implemented.

Depositors of funds represent an important group of users of financial reports prepared by financial institutions. In many cases, the financial institution holds a large portion of the depositor’s life savings. Therefore, information conveying the viability of a financial institution is of major concern to facilitate economic decision-making. However, the diversity of accounting practices makes it difficult for users to compare the financial reports of different financial institutions. This lack of comparability can be attributed to differences in regulatory requirements.

All banks, other than state government-owned banks, must comply with the provisions of the Banking Act 1959, while other non-bank financial institutions must comply with the provisions of the Financial Corporations Act, 1974. The state government-owned banks are controlled by state legislation, as are building societies and credit unions.

Financial institutions which trade as registered companies are subject to the provisions of the Companies Code and therefore, in preparing general purpose financial reports must comply with the requirements of Schedule 7 and the Accounting Standards Review Board (ASRB) standards. Listed companies are also required to comply with the Stock Exchange listing requirements.

Banks, because of their special status as "prescribed corporations", are exempt from the requirements of Schedule 7 and ASRB.

Co-operative societies such as building societies, credit unions, and friendly societies are also not subject to ASRB. These financial institutions are required to prepare financial statements which comply with the appropriate legislation (Banking Act 1959, for banks and various state legislation for state-owned banks and co-operative societies) and with Australian Accounting Standards issued by the accounting profession.

It is increasingly difficult to rationalise why:

- banks should be permitted a privileged reporting position from that applicable to other companies; and
- the annual accounting policies of banks and building societies should differ when they are competing in the same marketplace.

In the interests of uniformity, consistency, and consumer accessibility, the limited accounting and disclosure provision of the Banking Act should be repealed, thus ensuring that comparable accounting disclosure standards are implemented and maintained.
3.4 Outcomes of the recent Premiers' Conference on banking and finance industries.

The recent collapse of the Pyramid Building Society has raised a number of questions about the adequacy of the prudential supervision of non-bank financial institutions.

The recent Special Premiers' Conference established a working group to prepare a report by March 31, 1991 on "specific proposals for a system of State-based prudential supervision, with national co-ordination of high uniform standards and practices and suitable industry-funded liquidity support mechanisms".19

A confidential paper considered by the Special Premiers' Conference, set out the model for non-bank supervision which would allow the states to establish their own supervision arrangements by legislation. The preferred model requires uniformity across all States. It would remove all prescriptive regulatory controls over non-banks and replace them with a deregulated system based on capital adequacy ratios, a prime asset requirement and supervision of liquidity and loan exposures.20

The system would also involve a National Advisory Board on Supervision which would seek state government agreement on minimum prudential standards and supervisory procedures. However the national body would not involve the Commonwealth and would have no power to directly regulate non-banks or issue directives to State supervisory bodies. The proposal also strongly rejects any system of government guarantees for depositors or shareholders in non-banks.21

21 Ibid.
SECTION 4

EFFECTIVENESS OF COMPETITION IN THE BANKING AND FINANCE SECTOR, INCLUDING THE IMPACT OF BARRIERS TO COMPETITION

4.1 Competitive performance and human resource development in the banking and finance sector

Financial deregulation has increased the importance of banks and market forces in monetary policy. This in turn leads to a concern with the mechanism of these market forces, in terms of the existence of the required real competition, and the need to recognise and address any market failures. Although financial deregulation has led to considerable innovation and rationalisation in the banking sector, so as to increase competitive performance, Australia has continued to have a persistent deficit trading in the area of banking and financial export services.

In May 1989, in a submission to the IAC Inquiry into International Trade in Services, the ABEU argued for the need to direct attention away from broad dramatic and potentially disruptive changes in the regulatory environment of the finance industry towards qualitative reforms within it, particularly in the areas of skills formation, the organisation of work and industrial democracy.

One of the most significant developments in microeconomic reform has been the realisation that the quality of human resources is critical to industry performance. This quality must be developed through industry training, appropriate work design and industrial relations reform, and career path planning. New technologies are collapsing old work distinctions, forcing greater integration and creating new areas of skill, while at the same time the globalised economy and international competitiveness are setting new standards in productivity performance around constant innovation, in response to new markets and new technologies. Research on the innovation process suggests that critical obstacles to effective innovation are more often non-technical. They are to do with strategic planning, organisational change, design, marketing and management, particularly within the context of new demands for knowledge and capability arising from closer integration with North Asia.22 The ability to learn faster than competitors is now central to competitive performance, and the new division of learning requires a vocabulary of colleagues and co-learners, of exploration, experimentation and innovation.23

The present national investment in award restructuring, industrial relations reform and training through the training guarantee levy is a recognition of these factors. New strategies of work organisation and skills development are part of a firm's competitive advantage.

While banks have always invested in internal training in low level clerical functions, the dramatic changes to the banking sector have radically changed the dimensions of this training challenge. An OECD study of twelve financial institutions in five countries found a significant decline in the volume of routine clerical work; a significant increase in the need for staff at all levels to be adaptable and able to operate in an ill-defined and changing environment, rather than a stable one; and a tendency for banks to hire people with higher credentials, to move away from a single entry-point to a multiple entry-point career system and to have more part-time staff.24

The ABEU therefore stresses the importance of the establishment of an Industry Training Council to oversee the development of policies for human resource development in the finance sector, including skill formation in its widest application, career path planning and work design. A prime goal of the Industry Training Council would be to overcome human-resource based non-regulatory domestic barriers to improving Australian banks' performance in trading in the area of banking and financial export services.

Shifting to the new functional emphasis on customer servicing rather than production of services demands a fundamental reorganisation in the division of labour in the financial sector, and a new emphasis on decentralisation of functions and decision making responsibilities. Although many financial institutions are attempting to respond to this requirement through their own internal programs, an Industry Training Council would provide an industry-wide approach which is capable of supporting Australia's competitive performance in the international financial services sector. Given the importance of the Banks in national monetary policy, the resistance by banks to develop industry based training strategies, as opposed to enterprise based training strategies linked to achieving a competitive edge over other banks, is not in the national interest.

A significant shortfall in present enterprise based training has been caused by the failure of banks to link this training with the awarding of formal qualifications linked to career path planning across the sector. Without this approach training tends to be task specific and does not contribute to industry flexibility or the kind of skills enhancement needed to underpin competitive performance. While flexible working hours, through the greater use of part-time employment, does create a measure of flexibility, it is an insufficient response to the productivity potential of the new technologies within the highly competitive and globalised context of the business environment in which banks must operate.

To ensure that people do not become trapped in certain grades or jobs, it is essential that linkages be identified and established both within and between the grades as part of career path planning. This is predominantly the responsibility of an Industry Training Advisory Body. However no such structure is currently in place in the Banking Industry.

Because of the importance of skill formation and training to employees, the ABEU has as vital an interest in this question as it has traditionally had in wage rates and working conditions. The recognition of this interest, in enabling the union to meet the needs of its customers, the employees in the banking industry, requires the establishment of a tripartite structure, similar to that already in operation in the manufacturing sector. Such a structure, along the lines of the Australian Manufacturing Council could provide for comprehensive discussions on the future shape of directions of the finance industry, particularly in the arena of human resource development and work design.

4.2 Take-overs and mergers in the banking and finance sector

The aim of deregulation was to increase efficiencies in the banking and finance sector along three dimensions. Operational efficiencies were expected to result in banks operating closer to minimum points of long run average cost curves. Allocative efficiencies were expected to result in the price of services being closer relative to the marginal costs of production. Dynamic efficiencies were expected to assist in the achievement of a much greater ability to adapt to changing needs and generate higher levels of innovation.

While dynamic efficiencies have certainly been achieved, with the banking sector playing a leading role in the adopting of new technologies, and developing a wide range of new financial products and services, other efficiencies have been less evident. Because of the large system of branch services, Australian banks have very high operating costs compared to other OECD Countries. While deregulation has led to some lowering of these costs since 1985, despite bearing the costs of investment in information technology, Australia's rate of 3.59 per cent of average assets in 1989 are still higher than the early 1980s and well above the OECD average of 2.2 per cent. The slowness of reducing operating costs in the retail sector, despite the increase in user pay fees for services, may be due to the preference of consumers for non taxed services in kind versus taxed earning on savings That is, the long term effects of such efficiencies producing a more efficient economy paying higher wages, even if they could be demonstrated, shifts the gain from non taxed services to taxed earnings.

The response of the Australian banks to this problem has been a consolidation of power through takeovers and mergers involving smaller banks and building societies and finance companies to enable the banks to meet competition from the 16 new entrants into the banking system. The
Australian banks have used their retail branch structures to achieve almost complete market dominance in this area of banking, while also rapidly expanding into corporate banking services. As a result the Australian banks have maintained their dominance in the banking and finance sector at the expense of both non-bank financial institutions and the foreign entrants. As a result the new banks by September 1989 had only 10 per cent of total assets of the banking sector.

One reason advanced to explain why financial deregulation has failed to deliver smaller net interest margins in retail banking is that the effective competition supplied by new banks has been confined for the most part to wholesale business, building on their background in merchant banking. The exceptions to this pattern were Citibank, National Mutual Royal Bank and Chase AMP.25

Because competition was therefore confined to the wholesale sector, bank lending policies have led to a rapid increase in doubtful debt provision, with the effect that retail customers have cross subsidised commercial business.26

As a result of deregulation Australian banks have emerged as financial supermarkets, seeking to combine banking, insurance, stockbroking and funds management. This poses two issues. Firstly the concentration of power which has unacceptable political and economic consequences in a democracy, and secondly, the contrary advantage that the existence of large strong national institutions both enables a high level of innovation and provides the basis for Australian banks to operate as international institutions.

This raises questions about the pattern of multiple cross directorships between banks and leading companies, and the movement of senior staff between Treasury and the Reserve Bank and the major Australian Banks. Thus the economic policy orthodoxy which sets national fiscal and monetary policy may be unduly influenced by these interlocking relationships. Max Walsh has reminded us that one of the lessons of the 1930s was the danger of excessive concentration of financial power.

4.3 Further take-overs and mergers

Speculation about further take-overs and mergers have included the reduction of the four major banks to only two banks, the merging of the big banks with the secondary banking sector, including building societies, the merger of state banks and life insurance companies, and the development of life insurance companies into banks. For example a mooted merger between the ANZ Bank and the NAB would create a bank which was the 17th largest in Asia and the Pacific

and the 32nd largest in the world. In Australia it would have one third of all depositors and more than one third of all loans. Similarly any merger between the ANZ Bank and the Commonwealth, seeking to combine their respective strengths in a Melbourne base and the corporate sector, with a presence in Asia, with the Commonwealth's Sydney base and strong retail presence, would give them 40 per cent of the market.

A significant factor fuelling speculation about these further take-overs and mergers among the Australian banks is the challenge of mounting global operations to service the global economy, and the collapse of public confidence in the non banking and secondary banking sector - the flight to quality syndrome. However while a study by the Bureau of Industrial Economics has claimed that this argument is specious, large strong institutions are obviously necessary to sustain high levels of innovation and investment in new technology. Merging and concentration makes sense in terms of efficient use of technological infrastructure, the organisation and management of markets, the management of large projects and the development of common products, and the effective producer and distributer coordination. However these trends require a global integrated approach to regulation and supervision, including the need to integrate the securities industry with the banking industry, as both affect the stability of the economy.27

The expansion of banking into the provision of a wide range of financial services, taking advantage of the retail infrastructure of the banks and networking capability of information technology, makes the fusion of insurance and banking services logical. This is further reinforced by the national policy on superannuation, and the encouragement of household superannuation funds. If savings are going to be thus directed, because of tax or union productivity deals, that is where banks will have to go to obtain their lending funds.

These trends raise important questions about competition within the banking and finance sector, in terms of the size and power of any merged group in control over corporate equity. It also requires a consideration of the prudential issues of insurance and banking systems, given the importance of superannuation funds. The recent decision of the Federal Government to disallow the proposed merger of the ANZ Bank and the National Mutual Life Association reflects this concern.

Given that the declared aim of financial deregulation was to increase competition, these trends towards oligopic concentration represent a serious market failure which may require government intervention. The difficulty is that the degree of concentration needed to compete internationally could bring a situation of near monopoly among major banks that could be against the public interest.28

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of government intervention, through trade practices powers, is required to remove market failure.

4.4 The concentration of new entrants in the corporate banking sector, ignoring the retail banking sector

It was largely the prospect of the entry of foreign banks that led to the round of mergers amongst the six major trading banks that created the four major Australian banks in existence today. The new foreign banks, without any branch infrastructure have concentrated on wholesale banking, with successful market penetration in commercial loans rather than commercial bill acceptance. On the other hand the new domestic banks which have evolved from building societies have been more active in retail banking, especially as lenders of housing finance. This pattern is demonstrated in Table 4.1.

<table>
<thead>
<tr>
<th></th>
<th>Housing</th>
<th>Housing Plus Other</th>
<th>Commercial</th>
<th>Commercial Plus Acceptances</th>
</tr>
</thead>
<tbody>
<tr>
<td>MAJOR</td>
<td>63.3</td>
<td>66.9</td>
<td>61.9</td>
<td>69.7</td>
</tr>
<tr>
<td>STATE</td>
<td>18.4</td>
<td>18.8</td>
<td>13.6</td>
<td>12.2</td>
</tr>
<tr>
<td>OTHER EST</td>
<td>1.1</td>
<td>1.1</td>
<td>3.1</td>
<td>2.8</td>
</tr>
<tr>
<td>TOTAL ESTABLISHED</td>
<td>82.8</td>
<td>86.8</td>
<td>78.6</td>
<td>84.7</td>
</tr>
<tr>
<td>NEW AUSTRALIAN</td>
<td>10.8</td>
<td>8.0</td>
<td>7.0</td>
<td>4.4</td>
</tr>
<tr>
<td>NEW FOREIGN</td>
<td>6.4</td>
<td>5.2</td>
<td>14.4</td>
<td>10.9</td>
</tr>
<tr>
<td>TOTAL NEW</td>
<td>17.2</td>
<td>13.2</td>
<td>21.4</td>
<td>15.3</td>
</tr>
</tbody>
</table>


The lack of real competition in the retail sector has two major effects. It has directly led to greater competition in the wholesale sector, resulting in unsafe lending practices, and bad debts. Further the failure of the Banks to significantly reduce charges and fees in the retail sector has been directly linked to both lack of any real competition and their need to cross subsidise to cover losses in the wholesale sector. For instance in February 1990 the Australian banks had 98 per cent of total housing lending, with only Citibank and National Mutual Royal active in this area. National Mutual Royal has since been acquired by ANZ.

4.5 The development of niche banking

As a result of the overwhelming strength of the Australian banks in the retail sector, the foreign bank entrants have found that the key to success for them has been to specialise in niche banking. Key service areas have included international banking, including foreign exchange,
and services to major corporations and high net worth individuals. A good example of this strategy has been the performance of Bankers Trust which has defied pressures to diversify and concentrated on those areas in which it already had strength from its previous role as a merchant bank.

A similar strategy of confining activity to areas of strength has been pursued by the Japanese bank entrants. Bank of Tokyo, along with the other two Japanese Banks have concentrated on wholesale banking and facilitation of Japanese-Australian transactions, and appear to be taking a slow and gradual approach to expansion into retail banking. Other Asian banks have also concentrated on providing corporate advice to Australian companies in Asian markets and Asian companies in the Australian market, with Hong Kong Bank scaling down its initial ambitions in retail banking to concentrate on service to medium to higher net worth corporates and individuals.

The experience of the last years indicates that future success for the foreign banks will continue to depend on a clear identification of a market niche supported by competitive pricing and superior service, building on international strengths.30

4.6 Competition between building societies, insurance companies, credit unions and banks in the retail sector

Deregulation has altered the balance of privilege and burden substantially in favour of banks. This is reflected in the rapid "re-intermediation" of financial activity from non-bank financial institutions to the banks following deregulation.31 A number of factors are collapsing the distinction between insurance, other financial services and banking services. These include the impact of information technology, the greater diversification of products to meet customer needs, and increased competition between major banks and the secondary banks in retail banking.

The impact of deregulation was to free the banks to compete more effectively with non banking institutions. Given the advantages of the banks in terms of size and retail branch infrastructure, it is not surprising that the future of non-bank financial institutions does not look robust. The most important issue here is the viability of true competition in the banking and finance sector, if deregulation is to achieve efficiencies and better customer service through genuine market forces.

Bill Jocelyn of the State Government Insurance Office of NSW has suggested that if the big insurance companies don't change their operations to better serve customers, they will cease to

30 McDonald, A. and Young, A., 'Newcomers find niche banking the key to success', The Interdata
31 Ibid, p.32.
exist within 20 years.\textsuperscript{32} To meet this challenge the GIO have decided to corporatise, and evolve into bank. He also suggests that insurance companies should convert their long-standing collective ownership by policy holders (mutual societies) to a structure more like a public company, with managers responsible to defined shareholders. Recent difficulties with life policy brokers will contribute to this shake-up in the structure of the insurance industry. However the problem for life offices is that banks such as WESTPAC are already making significant inroads into their life business and it is predicted that banks will have 30 per cent of this business within a few years.\textsuperscript{33} While the NSW GIO can take advantage of its branch structure to support its evolution into a bank, this possibility does not exist for most insurance companies.

**FIGURE 4.1** Banks & Selected Non-Banks  
(Per cent of Assets of all Financial Institutions)

![Graph showing the percentage of assets of different financial institutions from 1978 to 1990.]


Although it has been concluded by some that the reduction of the non-bank sector to a small group of specialist institutions servicing niche markets of one form or another should not be a matter of national concern, so long as the genuinely deserving are free to obtain banking authorities and compete on an equal basis with established banks\textsuperscript{34}, it is hard to see that this will not be at the expense of competition in the banking and finance services sector. The recent prudential problems in the non-bank sector have increased pressure for these institutions to achieve the same status as banks, as regards security of investment. The claim that "there is no reason why non-bank financial institutions should not continue to serve a market less concerned

\textsuperscript{32} Jacques, B., "We have to become banksR&D", *Australian Business*, 24/1/90.

\textsuperscript{33} Firth, B., *The Australian*, 5/9/90.

\textsuperscript{34} Ackland, R., and Harper, I. *op.cit.*, p.32.
about, or unwilling to pay the cost of, prudential supervision"\textsuperscript{35} rings rather hollow in the light of the large number of small marginal investors who have been adversely affected.

While again the experience of losses incurred by the general public, seeking to take advantage of higher interest rates paid to depositors in a more competitive market (the aim of deregulation), has painfully reinforced the fact that in general, high returns equal high risks, it has severely undermined public confidence in the national finance sector.

4.7 Allowing foreign bank entrants to become branch offices of their overseas parent companies

The relatively poor performance of the Foreign Bank entrants to the Australian market, in comparison with the Australian Banks, has undermined the effectiveness of the competition which was expected to come from deregulation. This concern to sustain some level of competition has led to recent moves to allow Foreign Banks to become branch offices of their overseas parents. This would enable the Foreign Banks to achieve substantial savings from the maintenance of local capital, separate boards of directors, segregated accounting, the duplication of management controls and the expense of subsidiary guarantees.\textsuperscript{36}

One positive aspect claimed for allowing branch status is that this would enable Sydney to emerge as a major financial centre for the Pacific time zone, matching Tokyo, London and New York. The Reserve Bank of Australia has reacted cautiously to this claim, given competition from the two major South-East Asian centres, Singapore and Hong Kong.

However concern exists that such moves might cause Australia to become a money laundering centre, attracting criminal elements and impacting on the security of the financial and taxation systems, if adequate regulatory controls are not in place. By obliging the Foreign Bank entrants to become subsidiaries, rather than branches, they were brought under the control of the Banking Act and Reserve Bank regulation.

The Australian Merchant Bankers Association has argued in a submission to Treasury that branch status would enhance not just the ability of individual merchant banks in Australia to participate in foreign exchange dealing, but would also inject much-needed liquidity and hence greater competition into the local market. Parent banks would no longer find cost disadvantages in dealing through their Australian branch, and hence business which now goes to South-East Asian centres could be directed into Australia.\textsuperscript{37}

\begin{footnotes}
\item[35] Ibid.
\item[36] Lloyd, S., 'Branching out in banking', Australian Financial Review., 19/7/90.
\item[37] Ibid.
\end{footnotes}
However such a move would raise significant prudential issues for the Reserve Bank in supervising the safety of depositor funds which might flow to what are now merchant banks, by dint of their becoming branches of fully fledged overseas trading banks. This would require the Reserve Bank to be satisfied that the prudential supervision in the branch's home country was compatible with Australian standards.

Thus although any move to allow branch status would encourage more genuine competition in the Australian and finance sector, and might assist the development of Sydney into a more significant world financial market, the prudential risks are considerable.

4.8 Competition and the problem of over banking

The success of Australian banks, through mergers and take-overs, in achieving market dominance and undermining the desired goal of increased competition from deregulation, has created a concern to ensure continued competition. However, at the same time, there is ample evidence that Australia now has over-capacity in banking for the size of its population.

Shepherd suggests that this has arisen because firstly consumer expectations from deregulation and foreign entry into banking encouraged the prospective entrants to introduce a wide range of products and services, and secondly because prospective producers moved by the fact that they needed to justify capital injections from their parents, projected Return on Earnings based on over optimistic expectations.38

Another aspect of over-capacity in Australia is the depth of banking networks per capita compared with other OECD countries.

Table 4.2 Banking networks for large banks in selected OECD countries, 1986

<table>
<thead>
<tr>
<th>Country</th>
<th>No of institutions</th>
<th>No of offices</th>
<th>Population</th>
<th>Offices per 100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>4</td>
<td>5,376</td>
<td>16.0</td>
<td>34</td>
</tr>
<tr>
<td>France</td>
<td>8</td>
<td>12,412</td>
<td>55.4</td>
<td>22</td>
</tr>
<tr>
<td>Germany</td>
<td>6</td>
<td>3,118</td>
<td>60.9</td>
<td>5</td>
</tr>
<tr>
<td>Japan</td>
<td>13</td>
<td>3,032</td>
<td>121.5</td>
<td>3</td>
</tr>
</tbody>
</table>


However, as Singh points out, although the number of branches in Australia is a factor in our high operating costs, the major Australian banks are able to attract large sums of free and cheap money, because of this network. Furthermore Australia also has a much more geographically

dispersed population, requiring a greater communications infrastructure per head of population than most countries.\textsuperscript{39}

It would be expected that the question of over-banking would be solved through market discipline in a competitive environment. However, it is important, for social reasons, to maintain a high level of physical as well as financial access to services among the population. The advent of information technology and its ability to create a distributed network across institutions through franchised services, and more automated services might enable banking and finance institutions to continue to provide a range of financial products and services, and an extensive network of branch-like services, while also reducing operating costs, and thus passing on these economies to the consumer.

4.9 The benefit of competition to different sections of the community

Corporations have gained most from deregulation, facing constant or smaller interest margins at greater risk factors. Retail customers have correspondingly lost from deregulation.\textsuperscript{40}

Recent studies of the effects of deregulation and the entry of foreign banks on competition within the Australian banking sector, have established that the corporate sector benefitted at the expense of the retail sector.

This outcome has been attributed to a number of factors. Firstly, the foreign banks failed to provide competition in the retail sector due to their inability to establish extensive retail branch networks.

Competition was therefore effectively restricted to the corporate arena. This enabled the established banks to increase their retail margins over the last decade due to a lack of competition, while lowering their corporate margins in a bid to compete with the new banks. Lower prudential standards adopted in this competitive corporate climate led to higher provisions for bad and doubtful debts.

Two recent studies concur in their findings that increased interest margins in the retail sector effectively cross-subsidised the corporate sector by providing for losses incurred through bad and doubtful debts.

Professor Ross Milbourne of the School of Economics at the University of NSW argues that:


\textsuperscript{40} Milbourne, R. and Cumberworth, M., \textit{op.cit}, p. 23.
the continued increases in margins on retail banking in the second part of the decade were
due to increased provisions for doubtful debts incurred mainly from corporate business
and tax.\textsuperscript{41}

Ackland and Harper (1990) agree with Milbourne's findings that the higher provisions for bad
and doubtful debts were subsidised by retail customers. They have argued that:

the less intense competitive environment in retail banking has enabled these provisions to
be recovered primarily through retail banking margins. To this extent, retail customers
have cross-subsidised commercial customers.\textsuperscript{42}

In light of this evidence, the retail sector appears to have been disadvantaged in two respects.
Firstly, through the lack of effective competition in retail banking and secondly, due to this lack
of competition, the retail sector effectively cross-subsidised the corporate sector's losses.

4.10 Bank pricing strategies and the impact on disadvantaged community
groups

The conclusion that the retail sector effectively cross-subsidised the losses experienced by banks
in the corporate sector provides an interesting starting point for an examination of the impact of
bank pricing strategies on disadvantaged community groups.

In light of this finding, it is questionable whether deregulation has produced a more competitive
and better banking system for the ordinary consumer.

The number of financial services and products available to customers have multiplied since
deregulation, however the assumed benefits to consumers at large may be somewhat illusory.
Although some of the services offer higher rates of interest on customers' deposits, only a
certain segment of the consumer base is in a position to take advantage of this.

Customers who are economically unable to deposit larger sums of money for longer periods of
time not only miss out on the benefits of high rates of interest and waived charges, in some cases
they are also charged account servicing fees. Effectively, they are penalised twice.

Banks argue that prior to deregulation, when competition on interest rates was ruled out, service
charges and transaction fees were not necessary on small deposit accounts due to the cross-
subsidisation of these services by other areas of the banks' operations. However, post
deregulation, a number of banks insist that small deposit accounts can no longer be subsidised
by other areas of their business and have therefore adopted a 'user pays' principle.

\begin{footnotes}
\footnotetext{41}{Ibid. p. 22.}
\end{footnotes}
If this 'user pays' principle is accepted as sufficient justification, a number of issues are raised. Amongst these, firstly is the principle applied broadly, or selectively and secondly, do these charges reflect the true cost of the provision of service or are the charges calculated arbitrarily? Even if an examination of the 'user-pays' principle is confined to the retail sector, one finds that 'the incidence of user-pays has impacted differently on different customers, not only across the different banks, but also within each bank'.

Taking these factors into consideration, one must conclude that the 'user-pays' principle has not been broadly adopted by the banks at all. Instead it appears to have been selectively applied at the expense of the retail banking customers who can least afford it.

Turning to the second point, a number of studies indicate that the fees charged by banks do not accurately reflect the cost of the services provided. A recent study by Singh argues that banks cannot accurately isolate the cost of a particular product. This argument is supported by Valentine who states that 'banks still have a long way to go before they have a full knowledge of their cost structure'. Therefore, one must conclude that the charges are arbitrarily applied and bear no relation to the actual cost of service provision.

Another insidious aspect of the effect of deregulation is that in many cases, the holding of a bank account is no longer a voluntary option. It has practically become almost compulsory so that welfare payments or salaries may be directly deposited. This 'captive customer' group is most often the victim of the selective application of the 'user-pays' principle. They are also the group who are least able to afford it.

4.11 The need for consumer education by banks re: bank charges, fees and products and services

The number and availability of financial products and services has proliferated since the deregulation of the financial sector. However, this has not been accompanied by an increase in accessibility to meaningful, easily comparable information which is readily understood by relatively unsophisticated retail consumers. Therefore, choosing between competing products and services is often a bewildering proposition.

In contrast to this, commercial customers have much better access to information through channels such as the financial media, brokers and the Australian Merchant Bankers

43 Taylor, J., Bank Regulation: Is the consumer really winning?, School of Economics, La Trobe University, 1989.
Association. They are also more sophisticated users and therefore better able to comprehend it.

In an environment of deregulation, readily available, easy to understand information is of the utmost importance in promoting competition. Without this resource, consumers are unable to make decisions based on a fully-informed understanding of competing products and services and therefore the financial marketplace can be less than efficient.

One of the recommendations of a consumer survey report prepared by Bernadette Healy for the Southport Financial Counselling and Advocacy Program recommended that:

Banks should give their customers regular information (possibly by computer mailouts) about banking options. This information should be targeted towards elderly people, and holders of high cost/low interest accounts (where there are better options).

While this suggestion is commendable, it is perhaps unrealistic to expect banks to add to their overheads by implementing a scheme of this nature. Also this does not take into consideration that it is not in the best commercial interest of the banks to inform low-interest account holders that accounts with a higher rate of interest are available to them. After all, low-interest accounts provide a significant source of inexpensive funds to the major banks. Research conducted by the Australian Bankers' Association indicated that in 1989 alone, non-interest income of the large Australian banks totalled $A5125.7 million.

The Australian Bankers' Association provides a valuable service through its provision of educational material for secondary schools to facilitate the education of secondary commerce students in the rudiments of consumer banking. This material assists in teaching students such skills as reconciliation of cheque accounts, interpreting account statements, etc. Perhaps they could also provide a similar service to the general consumer addressing subjects such as the various types of interest calculation etc. Information provided in this way could be distributed at bank branches, where the consumer needs it most.

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48 Singh, S., Op cit, p.32.