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The Dollars and Sense of Bank Consolidation

BANK MERGERS AND THE TRADE PRACTICES ACT IN THE LIGHT OF THE WESPAC/BANK OF MELBOURNE AND COMMONWEALTH/COLONIAL STATE BANK MERGERS

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Over the past twenty years financial markets have experienced significant changes. There has been substantial consolidation in markets here and abroad as financial institutions face up to pressures from regulatory reform, globalisation and technological change.

An industry seems to have developed in financial journalism where one of the more popular topics is examining the nature of past consolidation and the likelihood of future consolidation in financial services markets. We here today add our contribution to that industry.

I have been asked to talk about mergers and the way in which they are treated under the *Trade Practices Act* from two perspectives. The first is the historic context provided by the analysis undertaken by the Australian Competition and Consumer Commission (the Commission) of three significant banking mergers in the past decade. The second, I assume, is with regard to the approach the Commission might take to future consolidation given the restrictions imposed by s50 of the Act and the government's 'four pillar' policy.

Bank mergers have generated considerable controversy in Australia in recent years. Consumer organisations and financial sector unions have voiced considerable concerns over rising bank fees, branch closures and job losses. The major banks and their lobbyists have argued that the regulatory barriers to bank mergers prevent efficiencies from being generated and prevent the establishment of Australian owned global financial institutions. The government has also intervened in the issue, preventing mergers between the big four banks until they can show that competition in financial services markets has increased.

As the agency which enforces merger law, the Commission plays a major role in determining the structure of Australian financial markets. Its application of the s50 mergers provisions attract considerable scrutiny. In particular, its approach to market definition in the three major banking mergers of the past decade, Westpac/Challenge, Westpac/Bank of Melbourne and the Commonwealth/Colonial has generated much discussion. The fact that the Commission has altered its approach over time is worthy of further discussion.

Market definition

It is important to note at the start that market definition is not an end in itself, but an instrument to identify circumstances where there might be competition concerns. Competitive analysis focuses on market power. Market definition and market share serves as an easily available proxy for the measurement of market power enjoyed by firms. The single most important objective of defining a market is to identify those competitors who in some way can constrain the exercise of market power of the firms concerned.

The concept of constraints on market power is simply based on the idea that the exercise of market power can be constrained by demand substitutability, by supply substitutability and by potential competition.

With regard to demand substitution, competition agencies worldwide use the hypothetical monopolist test, the SSNIP test (small but significant non-transitory increase in price). This test asks whether the parties' customers would switch to substitutes in response to a 5%-10% permanent increase in price. If substitution would be sufficient to make the price increase unprofitable those substitutes are part of the relevant market.

Supply substitutability is also considered. This requires that an alternative supplier is able to switch production to the relevant product in response to the price increase. This supply substitutability should only be taken into account where its effects are equivalent to demand substitutability and requires both inputs which could quickly be used to produce the good or service and distribution networks to get the production quickly to consumers.

Potential competition is generally not relevant in the immediate market definition but is clearly significant when analysing market power.

The cluster market approach

In its analysis of banking mergers the Commission has moved over time from what might be described as a cluster market approach to a multi-product approach. In its analysis of the Westpac acquisition of Challenge Bank, the Commission's predecessor,

the Trade Practices Commission, (TPC) adopted a market definition based on the idea of a cluster of financial services function.

This approach has some substantial logic under certain circumstances. Where there are significant economies of scope in production and all firms supply all products in the cluster and in around the same proportions, supply side characteristics would suggest that a cluster approach might be appropriate. Further, if customers purchased all products and in the same proportions, demand factors would also support a cluster market approach.

Of course the cluster market approach can be criticised as can any market definition. It has the problem that it can both underestimate and overestimate the extent of competition. In many financial services markets, specialised providers of financial services may be a significant competitive factor. In Australia, specialised home mortgage providers are examples of a significant competitive presence in a particular product market which might be ignored in a cluster market.

Cluster market approaches may also overestimate the extent of the competition in a particular market by making incorrect inferences from another element of the cluster. For example, extensive competition for the provision of credit cards may not necessarily indicate that there is the same level of competition in say small business finance.

The cluster market concept is not the same thing as the economist's ideas of complementarity. The fact that two goods are complements does not necessarily mean that they are both part of a cluster market. There would be many complementary products produced by different firms. They may be unbundled without any significant additional costs of supply or purchase. Breakfast cereal and milk are obvious examples.

In its analysis of Westpac/Challenge the TPC was influenced by the report of the Prices Surveillance Authority (PSA) into bank fees and charges. This report found that most major financial institutions focussed on a broad range of customer needs and had strategies designed to reduce the impact of price competition from suppliers of single products.

This approach is not particularly dissimilar to so called ‘relationship banking’ practised by many financial institutions today. The bundling of financial services and linking that bundling to a variety of fee and charges exemptions will undermine the competitiveness of product specific options.

The TPC took the view that there was a competitive advantage in supplying a full range of banking services. Transaction relationships generated by branch networks provided opportunities for cross selling products and facilitated ‘price increase’ (effectively increases in loan rates and decreases in deposit rates) without significant customer movement.

The TPC concluded that there was a market for retail banking services. Within this market there were a series of banking products. Products identified included: deposit accounts including term deposits and current accounts; loans including housing and personal finance; and payments including retail transactions accounts and electronic payment and transfers.

Westpac/Bank of Melbourne

In early 1997 Westpac announced it was planning to buy the regionally based Bank of Melbourne. By this time, the Wallis report into financial services had been published and it had expressed the view that the cluster market approach had generated too narrow a definition of the market in Westpac/Challenge. It argued that by taking the market as being the cluster of products provided by retail banks, the TPC had not taken sufficient account of the competitive constraints imposed by the provision of certain financial services by non bank financial institutions.

However, the Wallis Report also made a prediction which was to prove to be remarkably accurate about where the competition issues would lie in future bank mergers commenting that:

> “The products likely to be the focus of future bank merger assessments are transactions accounts and small business products, especially small business finance”.

In Westpac/Bank of Melbourne the Commission identified six product categories for ‘retail banking’ and their associated geographic element. They were:

- home loans (moving to a national market)
- personal loans (state based)
- deposits/term savings products (state based)
- small business banking products (probably more local that state based, but state figures were used as no reliable regional statistics were available)
- credit cards (state based)
- transactions accounts (state based)

A market for corporate banking was also identified as a national market but this was not relevant in the analysis as the Bank of Melbourne had no significant presence in that market.

So what had changed in the two years from Challenge to Bank of Melbourne? Probably the most significant factor was market evidence that a significant proportion of bank customers were prepared to unbundle key components of the cluster and shop around for the best price on those components, especially home loans.

The decision to group the hundreds of different banking products into a series of categories generates market definition issues. It is not useful to examine each separately so the logical approach is to assemble the products into a small number of groups ensuring that, as far as possible, close substitutes are located within the same market. Of course, this grouping is also likely to generate controversy and market participants will not necessarily agree with the groupings.

The Commission's analysis of the deposits market, for example, term deposits and longer term 'investment' type products were included. Three key criteria existed: liquidity, security and return. At the time of the acquisition, security was an important issue for consumers, following the collapse of the Pyramid Building Society and a significant proportion of Victorian consumers did not consider the products offered by building societies and credit unions to be credible substitutes for the products supplies by banks. In terms of geographic dimension, Wallis had reported that virtually no bank has been able to raise deposits in states where they had no branch representation so that

factor was significant in the Commission's decision on the geographic dimension of the market.

With regard to home loans, most market evidence indicated that the cost of unbundling was relatively low compared to the potential benefits. Significant evidence was provided that refinancing was a popular option with more than 20% of new home loans taken out being for refinancing purposes. There was also substantial evidence of financial institutions offering loans in geographic markets where they had no branch network.

The Commission considered personal loans to be a separate product group. There was evidence (again from the Wallis Inquiry) indicating that many consumers unbundled their personal loans from the institution where they acquired most of their other banking services. Many consumers had personal loans and transactions accounts with different institutions.

Small business banking was identified as a specialised cluster of products sold to a particular group. While requiring similar products to household customers, small businesses also require facilities for frequent cash deposits/withdrawals, lines of credit/overdrafts, after hours cash deposit facilities and business loans. These services were typically acquired as a cluster, at the lowest overall cost, from a single financial institution.

The difficulty of assessing credit risk for small businesses gives banks (and any other providers of bundled services) an advantage, since transactions accounts provide valuable information to financial institutions, making it easier to monitor the ongoing viability of businesses. The consequence of this is that it is costly for small businesses to unbundle their ongoing credit needs from their transactions accounts, except to the extent that they can be secured against property etc. Empirical studies in Australia and overseas show that the average number of banks used by businesses is a direct function of turnover.

The service needs of small business are such that physical presence is important. Thus, those banks with a significant branch network have an advantage thus limiting the geographic dimension of the market.

Credit cards were also considered to be a separate market. While to some extent credit cards are also substitutes for personal loans and have certain features similar to transactions accounts, they were found to be imperfect substitutes for either. While the absence of transaction fees makes them an attractive substitute for transactions accounts, a customer is unable to write a cheque on them and cash withdrawals on credit cards immediately accrue interest. Compared to personal loans they offer flexible and convenient credit but at a higher cost.

Once the market definitions had been determined, the standard merger analysis could be applied. The acquisition in the first instance crossed the merger thresholds in terms of deposits and transactions while in home loans, personal loans, small business banking and credit cards, the thresholds were not crossed.

While substantially more analysis was undertaken with regard to entry barriers, countervailing power and the extent to which Bank of Melbourne had been a vigorous and effective competitor, most of the Commission's concerns were in relation to the deposits and transactions markets.

Consequently, any remedies to address the competition issues had to focus on these markets. Westpac acknowledged the Commission's concerns about the anti-competitive impact of the merger and offered to provide legally enforceable undertakings based on significant local decision making autonomy.

Westpac agreed to maintain Bank of Melbourne's extended trading hours and to preserve the entitlement of existing transaction account customers to fee exemptions. It also agreed to grant access to its electronic network for new and small Victorian competitors and their Victorian customers for a reasonable period.

At the time the Commission took the view that the undertakings addressed certain key criteria in the relevant markets where competition issues were substantial. However, over the years the Commission has received a large number of complaints from consumers particularly after the time period of the undertakings lapsed. In particular, the expectation that Bank of Melbourne would have an identity and autonomy independent of Westpac has not been realised, according to complainants.

The detailed analysis of Westpac/Bank of Melbourne is relevant to any discussion of the most recent bank merger of Commonwealth/Colonial. The Westpac/Bank of Melbourne market definitions were crucial in the Commonwealth decision.

Commonwealth/Colonial

The merger parties argued that Westpac/Bank of Melbourne market definitions were no longer relevant. They proposed five major product market definitions and associated geographic element:

- deposit and investment products, including transaction accounts (national market)
- housing finance (national market)
- consumer finance, including personal loans and credit cards (national)
- small to medium enterprise finance (state based tending to national)
- corporate funding for large enterprises (national)

A significant factor in the parties' proposing broader product markets than in Westpac/Bank of Melbourne was the emergence of 'hybrid products' which contain one or more of the aspects of the original markets identified in the earlier merger.

Specifically the parties argued that investment products with transactions facilities such as cash management accounts and cash management trusts were blurring the distinction between transactions products, traditional deposit products and retail investment products. They also claimed that home equity loans and personal line of credit products blurred the distinction between home lending, personal loans, credit cards and transaction accounts. Such products allow consumers to access equity in their homes for personal lending or investment purposes, while some have a credit card facility, or transaction functionality in terms of cheque and debit card access and options for salary and other income to be deposited.

They also argued that the growth in small and medium enterprise products which use residential property as security have enabled small business to unbundle their cluster of banking requirements and take advantage of lower borrowing rates.

With regard to the geographic dimension of markets, the merging parties claimed that non bank distribution channels such as phone banking, ATMs, EFTPOS, B-Pay and on-line banking has made markets national. Further, most major banks operate with national pricing policies, making state boundaries irrelevant.

The Commission did not accept the definitions advocated by Commonwealth/Colonial. The new products such as home equity loans and cash management trusts are generally available only to certain classes of customers, generally those customers who are higher net worth individuals and while these customers do appear to be substituting traditional personal loan and transaction products for newer hybrid products, there remains a substantial proportion of bank customers who still demand traditional personal loan products.

As for cash managements products, regulations attached to their use limit their substitutability with transactions accounts. They typically require high opening balances, relatively large minimum balance requirements and high minimum limits for cheque withdrawals. Their usage patterns are more consistent with the use of longer term deposit products than with day-to-day transactions products.

While credit cards have some payment functionality capacity similar to transactions accounts, there are some factors that would limit their substitutability. Most credit card payments are made using the features of the transaction account. Further, financial institutions do not allow people to have their salaries or pensions and other welfare payments paid directly into their credit card accounts.

Agency arrangements such as those provided by Giro Post do not appear to be seen by consumers as an effective substitute for over-the-counter banking services. Giro Post does not appear to be attracting customers except in those locations where bank branches have closed. It offers a basic banking service, providing deposits and withdrawals but cannot provide customers with advice on products nor can it provide more complex financial transactions.

For other products such as small and medium enterprise banking it appears that clustering of products is still preferred by the majority of customers and that a local presence is extremely important. Information provided by the Commonwealth Bank with regard to the proportion of its small and medium enterprise customers with credit facilities who also have a transaction/deposit facility with the Commonwealth indicated that there was little unbundling.

While the merger parties pointed to some unbundling by small and medium enterprises, market inquiries indicated that apart from leasing finance there was not a large amount of evidence that clustering was not still commonplace. The bundling of transactions and credit products and merchant acquiring services especially for small firms with low security was substantial.

The Commission did not agree with the merger parties that the market for the cluster of small business services was national. The Hawker Committee had commented on the negative effect of bank closures in regional areas on small and medium enterprises. The Commission took the view that there was evidence that many small businesses lever off a personal banking relationship which is already local in nature. Many of the aspects of the small business cluster require access to cash handling and deposit facilities which typically require a local presence.

It seems logical that for larger, small and medium enterprises the geographic dimension for their banking services would be wider than local and may be consistent with a regional or state market. However, despite the size of the geographic market increasing with firm size, the Commission was unconvinced by claims that the small and medium enterprise market was national.

There was little disagreement between Commonwealth/Colonial and the Commission with regard to market definitions for corporate finance and non-banking products such as retirement savings, wholesale funds management and insurance products.

The product markets which generated the most significant competition concerns for the Commission were those for transaction accounts, deposit products and small and

medium enterprise banking. Further, the Commission disagreed with the merger parties on the geographic elements of some of the markets, taking state based markets in some instances. The Commission remained unconvinced that the role of electronic delivery mechanisms would enable geographic definitions as wide as the merger parties proposed. While the Commonwealth had indicated in its submission that it had up to 500,000 customers for its on-line products, this still represented significantly less than 10 percent of its customer base. Other market evidence indicated that while on-line banking was growing rapidly, it still represented a very small proportion of total banking transactions.

The Commission was also concerned with credit card merchant services in the small and medium enterprise market. There appeared to be very little competition for merchant services at the small and medium enterprise end of the market. Because merchant servicing is usually purchased as part of the cluster of services for the small and medium enterprises, there was little evidence that the merchant services market for the smaller end of the market was very contestable.

The merger parties had indicated a range of services providers existed to provide unbundled services but there was little market evidence that small and medium enterprises saw opportunities for such unbundling.

Merger factors in Commonwealth/Colonial

Once it had been determined that the major competition issues were with regard to transaction accounts, deposit products and small and medium enterprise banking, market analysis was focused on the extent of barrier to entry in these markets and the nature of the competition provided by Colonial State Bank in these markets.

With regard to transactions accounts the Commission concluded that barriers to entry were high and that customer inertia and bundling compounded these entry barriers.

There was little evidence that suppliers of transactions accounts who had little or no physical presence in terms of branch, agency or ATM network could provide a competitive constraint. Pure on-line banks had tended to target technologically sophisticated consumers but for the vast majority of consumers, on-line banking offered little substitution possibilities.

In the area of SME banking, the Commission acknowledged that certain credit products such as leasing finance were becoming unbundled but clustering was still of major significance. The information provided by the merger parties indicated that the bundling of transactions and credit products remained high among their small business customer base, especially for those with low security or unsecured credit.

The need to provide face to face banking services suggested that barriers to entry would be high for any entrant without an established network. Further, overseas data indicated that where only four large players provided most of the small business banking, there was a high likelihood of supernormal profits being earned. The recent UK Competition Commission report supports this view making a number of adverse findings about the supply of banking services to small and medium enterprises by the four largest banks. This report also noted the high level of bundling and recommended that limits be placed on the bundling.

In the deposits market the Commission took the view that the apparent lack of demand side substitutability between at call transactions accounts and longer term savings type products led to the conclusion that there was a separate market for deposits while the merger parties grouped deposits, term savings and transactions into the one market.

In the Commission's view, barriers to entry in this market were substantial. New entrants would need to develop a branch network and establish a trusted and identifiable brand name. Independent reports indicated that Internet only banks had made little headway and that access to 'bricks' rather that just 'clicks' was important.

Remedies

The Commission concluded that there was likely to be substantial lessening of competition in five markets as a result of the Commonwealth acquisition of Colonial. They were transactions accounts, deposit products and small business banking in Tasmania and transaction accounts and small business banking in regional NSW. Considerable market disquiet was identified with regard to deposit products in regional NSW but on balance the Commission did not conclude that there was a substantial lessening of competition.

In assessing remedies the Commission recognised that its preferred option of structural reform may not be appropriate especially given Tasmanian circumstances. Colonial State bank had relatively recently acquired Trust Bank in Tasmania and the sale of Tasmanian assets presented both scale and prudential issues. Further, the NSW markets where a substantial lessening of competition had been identified were not ones where divestiture would be an effective outcome. While it is possible that divestitures in specific locations especially rural and regional locations might have overcome the problem of decreased full service branch representation, it is unlikely that there would have been acceptable buyers of the assets. It is also difficult to arbitrarily move customers from being customers of one bank to customers of another.

The Commission had a problem identifying a separate package of assets to sell. Trust Bank had gone through a significant period of disruption as it was sold to Colonial and further disruptions and uncertainty which would follow from another sale less than 12 months after the first was a factor to be taken into account. It was not in the interests of competition in the Tasmanian market to have ongoing uncertainty with regard to the ownership of Trust.

Behavioural undertakings to ensure that pricing, service levels and product range were benchmarked to equivalent services in more competitive metropolitan markets were offered by Commonwealth to solve competition concerns. The merging parties also provided undertakings to provide access to their EFTPOS and ATM networks and provide access to their credit and debit card processing on reasonable commercial terms for new and small financial institutions (ie other than the major banks).

The future

It might be tempting to conclude from Westpac/Bank of Melbourne and Commonwealth/Colonial that the Commission is moving away from its stated preference for structural undertakings (generally divestiture) where a proposed merger leads to a substantial lessening of competition. That would be an inappropriate conclusion. In two recent mergers, Mayne/Australian Health Care and Manildra/George Weston, the Commission required divestiture.

Each merger is analysed in the framework of its own particular facts. In the case of the two bank mergers discussed, it was possible to satisfy the competition concerns in the specific markets by undertakings of a behavioural nature. However, each merger leaves a market structure in most financial markets which has become more concentrated. Consequently, unless there is evidence of new competitive dynamics in the industry, future merger proposals are likely to generate greater competition concerns. It should not be assumed that behavioural undertakings would be sufficient to overcome the competition issues that might be raised by attempts by major banks to acquire the remaining regional competitors.

When the Commission examined the Commonwealth/Colonial transaction, a particularly relevant structural factor was the existence of a strong regional bank in NSW competing against the four major national banks that would remain after the merger. Obviously, concentration in the various NSW financial services markets has increased and as a consequence the effectiveness of behavioural undertakings could be expected to diminish, other things being equal.

It has been suggested by some commentators, that the approach to Commonwealth/Colonial is evidence that horizontal mergers that are socially desirable may get through, especially those which impose minimum regulatory pressures on the Commission. I think it is important to note that the Commission did not find a substantial lessening of competition in a number of markets. Its major concerns were limited in a geographic sense to certain product markets in Tasmania and non-metropolitan NSW. Had the geographic dimension and the consequent competition issues been greater I am not convinced that the type of remedy adopted might be appropriate.

The Commission spent some time looking at divestiture options in Commonwealth/Colonial before deciding that they were not appropriate in that case.

The option of divestiture of regional branches did not appear feasible. However, I note with some interest a proposal floated by ANZ that they would be willing to purchase regional branches of NAB. It may be that structural remedies are not as difficult as parties have indicated.