Market Wrap:

Four pillars debate needs refining

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Owen Young and Bob Marks examine the seven fallacies of the "four pillars" policy.

NOW THAT the government has gained control of the Senate, there is renewed debate about the "four pillars" policy that prevents mergers among Australia's major banks.

Common arguments for removing the policy concern the ability of local banks to compete against foreign banks, while those supporting the policy are based on competition, prudential risk and labour market impact. But several of the arguments used by both sides are not supported by hard evidence.

Fallacy 1: Australian banks need to be larger to prevent foreign takeovers.

Some argue that unless the Big Four are allowed to grow through mergers, foreign banks will inevitably acquire them. But the likelihood of a foreign takeover is low, as the major Australian banks are already large and fully priced.

Even Westpac, the smallest of the four, has a market capitalisation of about $36 billion. Usually, acquirers pay a premium of about 20 per cent; hence Westpac's price tag would be $43 billion ($US32 billion). But the largest attempted announced cross-border bank acquisition in the world in the past eight years was about $US19 billion (Figure 1). Finally, any foreign acquisition of a major Australian bank requires the approval of the treasurer, who has the ability to block foreign takeovers independent of the four pillars policy.

Fallacy 2: Australian banks need to be larger to compete against foreign banks in Australia.

Some argue that, given their size, Australian banks are disadvantaged compared with the foreign banks in Australia. Citigroup's market capitalisation is $US240 billion, compared with Commonwealth Bank's $US38 billion. Australian banks, however, have in-market scale advantages over foreign banks. Citibank is present in more than 100 countries and must allocate capital to each market. In Australia, Citibank has assets of $26 billion, while CBA has assets of $234 billion.

In most countries, foreign banks are at a disadvantage to domestic banks, particularly in retail banking. Besides in-market scale advantages, domestic banks often have well-established brands, extensive branch networks and established customer bases. Customers are sometimes initially wary about dealing with foreign banks due to concerns

about their long-term commitment. It can take up to 15 years for a foreign bank to compete on the same basis as a domestic bank. With an 11 per cent share of Australian deposits, foreign banks hardly dominate the local scene.

Fallacy 3: Australian banks need to be larger to compete offshore.

Since banks are at a disadvantage when entering foreign markets, do Australian banks need to be larger to successfully compete offshore? Not necessarily.

A transferable competitive advantage is required to successfully compete offshore — this is not necessarily a function of size. Macquarie Bank, with a market capitalisation of $US10 billion, is significantly smaller than global investment banks such as Goldman Sachs ($US52 billion) and Morgan Stanley ($US58 billion), but it has been successful internationally due to its expertise in market niches such as infrastructure funding.

Australian banks could acquire inefficient overseas banks and add value by improving processes. Size is not a prerequisite for this. Moreover, Australian banks are already significantly larger than the domestic banks in many overseas markets. In Asia, only Japan and China have banks larger than Australia's biggest banks. All the banks in the countries of the Association of South-East Asian Nations are smaller than Westpac, including DBS, the acquirer in the largest cross-border bank acquisition in Asia (Figure 1).

To compete successfully overseas, Australian banks need to possess competitive advantages and be able to transfer them offshore — developing these skills is more important than increasing the bank's size.

Fallacy 4: Removing the policy will result in a reduction of domestic competition.

A common argument is that the policy ensures banking sector competition. There are two issues: first, will competitiveness fall if mergers are allowed among the Big Four? And, second, is the four pillars policy the best way to ensure competition?

A study in 50 countries has found that levels of bank competition were primarily influenced by foreign bank entry, and by entry and activity restrictions. It found no evidence that higher concentration reduced competition. Similarly, research has found that competition in banking was not driven by foreign banks' market share but by the number of foreign banks in the market.

We conclude that contestability, rather than concentration, is driving the level of competition. So the presence of foreign banks is sufficient to encourage competitive behaviour among banks. This is happening in the Australian market: with foreign banks targeting profitable niches and domestic banks responding with matching offers. For example, CBA recently introduced an online deposit account to counter ING Direct and HBOS subsidiary BankWest.

Some argue the policy lowers the threat of changes in management control, thereby inhibiting competition. With a low potential for foreign takeover and no possibility of an Australian company acquiring one of the majors, bank management is in a comfortable position and does not need to be overly aggressive. Westpac chief executive David Morgan, referring to the policy, admitted "artificial impediments make

people a little bit lazy".

So the justification for a rigid four pillars policy on the grounds of competitiveness is debatable. If a merger were announced in any other industry, it would be subject to approval by the Australian Competition and Consumer Commission, assessing the competitive impact of the merger. The Wallis report into the financial system recommended that ACCC scrutiny was sufficient on competition grounds and a specific four pillars policy was not required.

Fallacy 5: Removal of the four pillars policy will result in higher prudential risks.

Some argue that if mergers among the Big Four result in a Big Three or Big Two, then this will result in unacceptable prudential risks — if one bank encountered financial difficulties, then the government would not be able to let it fail. But if one of the Big Four were in trouble tomorrow, would the government let it fail?

Analysis of banking systems in 69 countries from 1980 to 1997 found that financial crises are less likely in economies with more concentrated banking systems. Larger banks have larger profits and are therefore better able to withstand market shocks. Fewer banks are more easily monitored and regulated. The argument against mergers on prudential grounds is debatable. An inflexible policy is no substitute for nuanced prudential regulation.

Fallacy 6: The four pillars policy protects low-income jobs.

The impact of mergers on low-income jobs may not be as severe as feared and could be better than some alternatives.

Low-income bank employees work mainly in two areas: customer services and back-office processing. Staff numbers in both areas are a function of transaction volumes. In a merger of two in-market banks, the transaction volumes would not significantly shrink. The total number of credit card purchases would not fall with a reduction in the number of banks. As a consequence, the merged entities could still need most of their customer service and processing staff.

There would be some reductions due to more efficient use of labour — nine people might be able to do the work previously done by two groups of five. But these efficiency improvements are not precluded by the existing four pillars policy — banks can already pool transactions, as CBA, NAB and Westpac have done with cheque processing.

The four pillars policy does not protect against jobs going offshore. A report by CSFB found that about $8 billion of the banks' combined annual costs of about $20 billion could be relocated overseas. Enabling consolidation of back-office processing among the Big Four banks reduces the cost advantages of offshoring and keeps jobs in Australia.

Branch closures will occur, but primarily in locations where there is a duplication of services. A merger is unlikely to result in a closure of the last remaining branch in a rural town and might even allow a single branch to survive where two were unprofitable.

The four pillars policy is protecting high-income jobs in the head office and support functions. These jobs are typically not a function of transaction volumes and

would be heavily cut, but such highly skilled employees would readily find new jobs.

Fallacy 7: Legislation prevents mergers between the Big Four banks.

There is no law preventing mergers among the four major banks. A merger proposal would need to be approved by the ACCC on competition grounds, the Australian Prudential Regulation Authority on regulatory grounds and by the federal treasurer under his reserve power. Treasurer Peter Costello has steadfastly reiterated he would not approve any merger among the four majors. This is despite the Wallis committee's recommendation in 1997 that the policy was outdated, and that any merger should be considered on a case-by-case basis by the ACCC and APRA.

If removal of the policy could result in a more efficient financial sector without reducing competitiveness, why does the government maintain it? The Treasurer has referred to a lack of competition in business lending as a major barrier to any review of the policy. If this is a major concern, the debate should be focused on this, rather than arguments based on international competitiveness. Potential issues include: Is there a lack of competitiveness in business lending? What is the cause of this? Is the four pillars policy the best solution? The four pillars policy is a costly way of imperfectly protecting lending to small businesses.

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ON THE PROWL

Largest cross-border bank acquisition attempts 1997-2005*

	Year	*Target*	*Acquirer*	*Value $USbn*
1	2005	HVB Group (Germany)	Unicredito (Italy)	18.9
2	2004	Abbey National (UK)	Banco Santander (Spain)	15.2
3	2001	Banamex (Mexico)	Citigroup (USA)	12.6
4	2004	Charter One (USA)	Royal Bank of Scotland (UK)	10.3
5	1998	Bankers Trust (USA)	Deutsche Bank (Germany)	9
6	2005	Banca Antonveneta (Italy)	ABN Amro (Netherland)	8.6
7	2005	BNL (Italy)	BBV (Spain)	8.5
8	1999	Republic New York (USA)	HSBC (UK)	7.7
9	2000	Bank Austria Creditanstadt (Austria)	HVB Group (Germany)	7.3
10	2001	Dao Heng Bank (Hong Kong)	DBS (Singapore)	5.7

* 2005 transactions are in progress
Source: Bloomberg, AGSM

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