Pillars of sand
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On April 23, Dutch bank ABN Amro capitulated to a $US91 billion takeover offer by the UK's Barclays Bank, potentially paving the way for an entity with banking assets of over $US3 trillion - almost three times the asset base of the four major Australian banks combined.

The Barclays takeover is only one further step in a process of global banking consolidation. PricewaterhouseCoopers says the value of European bank mergers (excluding the Barclays transaction) more than doubled last year to almost $US136 billion. And in the US, which historically had a myriad of banking and thrift institutions, exits, mergers and takeovers have halved the number of banks over the last decade.

Set against these global trends, the basic structure of Australia's banking sector seems frozen in time. This is largely the result of the so called four pillars policy, which rules out mergers between the major trading banks.

The origins of that policy go back to May 1990. Earlier that year, Australia and New Zealand Banking Group and National Mutual insurance company (which was struggling with the consequences of poor commercial decisions and with capital adequacy issues) announced plans to merge. The commonwealth government, acting also on the view that the two institutions were likely to be weakened by the merger, opposed the transaction, saying it would have reduced the "diversity of institutions and effective competition in banking, in life insurance, and more generally in the provision of financial services". Relying on its powers under section 63 of the Banking Act, which provides that the consent of the treasurer must be obtained before any merger or restructure of an authorised deposit-taking institution, the government announced that it would not permit mergers between any of the four major banks or the two largest life insurance companies - these forming the "six pillars" of the Australian financial system. As a result, banking mergers which otherwise would probably have been approved by the Australian Competition and Consumer Commission under the Trade Practices Act's competition test, were prohibited.

On coming into office in March 1996, the present Treasurer stated that the prohibition would remain in force at least until the government had received and considered the final report of the Wallis inquiry. The Wallis inquiry, reporting almost a year later, recommended the abolition of the six pillars policy, but the Government rejected that recommendation. Instead, in April 1997, it announced a modified four pillars policy in which mergers among the four major banks would not be permitted. This new policy was be reviewed once "the Government is satisfied that competition particularly in respect of small business lending, has increased sufficiently".

That policy has remained in place ever since. There is no sign from the government that change is forthcoming, while the Australian Labor Party, at its recent national conference, reaffirmed its support for the four pillars. But despite its acceptance by both sides of politics, there is little evidence today that four pillars reflects sound economic policy. To the contrary, Australian banking markets are far more competitive now than they have ever been, and banking customers have gained from an unprecedented array of choices for all the major banking products and services.

That greater competition is partly the consequence of banking deregulation - that is, of the removal of the Pillars of sand 1 many regulations that until the 1980s restricted the ability of banks to compete. But it also reflects more fundamental trends that are altering the economic role of banks and the extent and nature of the competition they face. Given those trends, it seems difficult to believe that a case remains for retaining the four pillars policy.

To understand these trends and their implications for competition in financial services, it is important to start with a definition of what it is banks do.

Banks provide intermediation services between suppliers of liquidity (depositors and other lenders) and users of liquidity (borrowers): put simply, they attract funds from those with funds to spare and then rent - as it were - funds to those who can put them to valuable use. This temporary transfer of resources is economically efficient - it redirects liquidity from lenders, to whom it is less valuable, to borrowers to whom it is more valuable. Some part of that gain in value accrues to the banks through the spread in interest rates between lending and borrowing, and through the fees charged for transactions, providing the income with which banks cover their costs.

Historically, three factors made banks well placed to provide financial intermediation services.

First, extensive branch networks gave banks unique access to the physical infrastructure that was required to collect and disburse funds. These branch networks, run by managers with close links to the community, also ensured that banks were well placed to monitor local developments, which helped them assess credit risk.

Second, by virtue of being long established and having a large book of clients (many of whom had relatively long tenures and bought several banking products), banks had unique access to information about customers. This gave banks a special advantage in dealing with the problem of information asymmetry that characterises markets for loans: the risk, for example, that the person willing to pay the highest interest rate on a loan is the one who knows (but clearly has no incentive to reveal) that he or she is likely to default; or the risk that having taken a loan, the borrower will have reduced incentives to keep a business afloat (since some part of the cost of failure will be borne by the lender).

Third, regulation protected banks from competition by other financial services providers domestically and from foreign banks, as well as providing them with an implied guarantee against failure.

In combination, these factors made banks the unchallenged suppliers of financial intermediation services. Because banks had the ubiquitous physical distribution required to collect and disburse funds, they were the natural repositories for individuals' and businesses' liquidity: no other institution could provide as ready access to deposited funds. As a result, banks could obtain funds from holders of excess liquidity at a lower cost than could other financial institutions.

Nor could other institutions match the banks' advantage in providing loans. More specifically, because banks knew more about customers than other potential lenders, they could reduce the risk of default to themselves and the cost of loans to borrowers. This made loans more profitable - which in turn made it easier for banks to pay the interest needed to attract deposits, consolidating the banks' position in the market for funds.

Finally, having a wide range of depositors and borrowers made banks especially well placed to "spread their bets". Given very large customer numbers, the risk of all (or even many) depositors wanting to withdraw their funds simultaneously was extremely low. As a result, banks could promise to provide liquidity on demand while still holding assets, in the form of loans, that were themselves highly illiquid (such as claims on houses). Banks alone could therefore combine the function of assuring short-term liquidity to lenders with that of providing long-term funding to borrowers.

But things have changed. Traditional sources of advantage, that historically made banks pre-eminent in financial intermediation, have been eliminated by technological developments and by shifts in government policy, creating competitive forces that are reshaping banking markets.

The first and most obvious change is that branch networks are no longer essential for collecting, processing or disbursing funds. Ubiquitous internet access allows consumers to place and manage funds in online money market accounts and other deposit products without ever going into a bank branch. Equally, access to a bank branch is not required for consumers to withdraw cash or to obtain the cards that allow them to.

Last year, for example, the average user of banking services used the various distribution channels on which banks rely - the internet, telephone banking, automatic teller machines and branches - some 17 times a Pillars of sand 2 month. Fewer than three of those times involved going into a branch. The single most frequently used channel was the internet, which has overtaken telephone banking and ATMs as Australian consumers' primary means of effecting banking transactions. So while banks would like to use their branches as a source of competitive differentiation, those branches are hardly likely to be the bottleneck to competition they once were.

The declining role of the bank branch is also evident in the writing of loans. Here traditional bank branches face widespread competition from agents and brokers - many of them former bank staff who were made redundant in the branch closures of the 1990s. These agents and brokers, who are especially active in housing finance, consumer credit and small and medium enterprise (SME) lending, provide a ready distribution channel for new suppliers of banking products, such as credit unions, capital market institutions (such as insurers and superannuation funds) and foreign banks.

Just as branch networks are becoming less important, technological change has also eroded the extent and significance of the information asymmetry between suppliers and users of finance.

In the past, a longstanding relationship with a bank, and the customer information that the bank derived from that relationship, were often a precondition for obtaining a loan. Today, credit scoring technologies (which evaluate the likelihood of default through statistical profiling) are widely used, by banks and their competitors alike, to manage credit risk without the detailed information on potential borrowers that was needed historically.

In the area of lending to SMEs - where relationships were traditionally crucial - the progressive upgrading of accounting standards has greatly increased the availability of high quality data on SME performance, making established relationships much less important. And the fact that so many transactions occur electronically, and are in any event captured in electronic records, makes it easier for potential borrowers to attest to their financial status and experience. As a result, banks' inherited access to customer information no longer confers the competitive advantage it once did.

Finally, regulations that restricted entry into banking activities, be it by domestic or foreign players, or that limited the ability of banks to compete through pricing and product development, have been largely removed internationally - and almost completely in Australia.

These changes have significantly reduced entry barriers into banking. With access to physical distribution and to customer information no longer bottlenecks, new competitive models have emerged which greatly increase the pressure on incumbent banks. Though these models differ, their common elements are reliance on low cost wholesale funds and on low cost product distribution.

An entrant (a foreign bank or a capital markets firm expanding into banking services) can use the internet to attract online deposits which it uses to back a loan portfolio (for example, of mortgages) that it distributes through agents or brokers. It then securitises some part of those loans, say as residential mortgage-backed securities: that is, by putting together the cash flow from a bundle of individually illiquid assets (in this case, the individual mortgages), it creates a tradeable asset that it can sell to investors. This further reduces its cost of funds, allowing it to compete even more aggressively in the supply of loan products.

The impacts of these new business models on markets for banking services have been nothing short of dramatic.

Nowhere is this more clearly the case than in the market for mortgages. Entry has been widespread, by specialist mortgage originators, foreign financial institutions (such as GE Capital, ING and Citibank) and regional banks and credit unions. These entrants have financed their expansion through increased reliance on the market for mortgage-backed securities, where the spreads over the bank bill swap rate that investors require to hold AA rated and AAA rated securities have declined from around 70 and 35 basis points a few years ago to between 22 and 16 basis points today. At the same time, independent dealers and brokers - who now account for 30 per cent of all sales - have provided these entrants with a highly motivated and flexible sales force, and at a relatively low cost.

The competition has forced a steep and sustained decline in interest rate spreads on mortgages. In the mid-1990s, the average interest rate paid by new borrowers was around 20 basis points below the standard variable rate. By early 2000, the average discount had increased to around 30 basis points. Now it is off 60 Pillars of sand 3 basis points or more, with further pressure coming from growth in the provision of so called low doc loans (that is, loans that involve a large element of self-verification and are designed mainly for those who do not have the documentation required to obtain a conventional mortgage). And it is not only spreads that have declined: consumers have also benefited from an increase in permissible debt-servicing and loan-to-valuation ratios, and from the use of property valuation techniques that are more favourable to the borrower.

Similarly dramatic, albeit less widely recognised, changes have occurred in the supply of banking services to SMEs.

In recent years there has been a proliferation of increasingly sophisticated products aimed at SME customers, from short-term factoring to long-term investment finance. The terms on which these products are sold are complex, and frequently involve the provision of collateral or other forms of asset backing. It is difficult to summarise the changes that have occurred in the form of simple price indices (all the more so at a time when spreads overall are coming down). That said, it's clear the terms on which SMEs obtain finance have improved substantially. In its most recent Financial Stability review, the Reserve Bank cites a survey of business borrowers by JPMorgan and East & Partners which finds the number of businesses that have experienced a reduction in their borrowing spread over the past year significantly exceeds the number that have experienced an increase. Moreover, lenders appear more willing to compete on the non-interest features of business loans, with the same survey showing that the number of businesses whose lending fees have been reduced has exceeded the number that have experienced an increase over recent years.

All of this is consistent with what information there is on spreads, with risk-adjusted spreads on SME loans decreasing from over 300 basis points early this decade to around half that level today.

Finally, the credit card market, where competition has been historically muted, has also been transformed. According to the RBA, most issuers, including the five largest banks, now offer low-rate cards with interest rates in the range of 9 to 14 per cent, compared with 17 per cent on traditional cards. Like other segments of the loan market, competition has been spurred by smaller players and newer entrants - with foreign-owned banks, for example, increasing their share of total bank credit card balances outstanding from 8 per cent in early 2002 to around 12 per cent today.

The overall effects of these trends on the major banks have been far-reaching. Banks' interest margins (the ratio of net interest income to average interest-earning assets) declined by some 40 per cent over the last decade.

With competition also constraining fees and charges, it is mainly tight cost controls that have allowed the major banks to reduce their aggregate cost-to-income ratio from 60 per cent in the mid-1990s to 48 per cent in 2006.

But there are limits to how far cost controls can go - and it is here that the constraints associated with the four pillars policy become most relevant.

There is mounting evidence from the economics literature that very large banks can achieve economies of scale, both from spreading the essentially fixed costs of IT systems over high volumes of transactions and from better managing the risks associated with large and complex financial transactions. Smaller banks can and do compete, especially through superior service, but the Australian trading banks risk being stuck in the middle: too big to be customer-friendly boutiques, but too small to achieve really low unit costs.

This risk on the cost side is compounded by the difficulty the Australian trading banks will face in being competitive on the largest corporate transactions - the "mega deals" that require very large scale capital backing. Those transactions are increasingly important, not solely in absolute dollar terms but also in defining major clients' strategic banking relationships. Were Australian trading banks durably excluded from participating in those transactions, their key corporate accounts would be severely compromised, while they would have great difficulty in establishing relationships with emerging global purchasers of banking services.

The difficulties the trading banks have in competing for "mega deals" are already evident - and have been for some time. BHP Billiton's acquisition of WMC Resources in 2005 marked a turning point in this regard. The ANZ had been BHP's house bank since the turn of the twentieth century; but no Australian trading bank acted as a lead bank in the 2005 transaction. Since then, the Australian trading banks have not had a lead bank role Pillars of sand 4 in the headline-grabbing restructurings of Channel Seven and Publishing and Broadcasting and the recent private equity bid for Qantas.

It's difficult to see how the Australian trading banks could survive as independent entities if they remain unable to achieve scale economies and compete for major transactions. While current share market valuations make bids for Australian banks expensive by any standard, it would be only a matter of time before the global "megabanks" moved in on their Australian counterparts.

This is not to suggest that foreign investment and by extension, foreign ownership are undesirable - far from it. What would be undesirable, however, is if longstanding Australian banks, that had every prospect of being viable and successful internationally, were driven into foreign ownership by a policy that is essentially misconceived.

It is misconceived because Australia's banking system does not rest on four pillars: rather, at every layer of the markets in which Australian banks compete, and in each of the services those markets provide, there are far more than four effective and competitive suppliers.

At the corporate end of the market, there are now well over a dozen major players, most of them far larger than the Australian trading banks (eg Dresdner, Rabobank). As for SMEs, the trading banks jostle for their business with myriad specialist operators and with regional banks and credit unions, all of whom have proved able to expand geographically and in terms of the product range they offer. And households too place their deposits, secure their loans and manage their assets in a market place in which the trading banks compete with specialists (such as mortgage originators), the regional banks, foreign banking entrants and ever more importantly, capital market institutions. It's all of these, rather than the four trading banks alone, that are the pillars of the Australian banking system.

Set against the backdrop of this multiplicity of effective and competitive suppliers, the four pillars prescription now smacks more of numerology than of sound analysis. There is nothing magical about the number four - nothing that says that four is the right number of major trading banks now and for the future. Rather, the number and ownership of the financial institutions - including the trading banks - should be determined by market forces, operating within the constraints of competition policy and of prudential supervision.

This is not to deny that in the early days of deregulation, when the banking system was still finding its feet after the changes and errors of the 1980s, there may have been a case for being especially careful about banking mergers. But with competition now well established and the banks on a sound footing, banking mergers should be regulated on the same basis as mergers elsewhere in the economy: they should, in other words, be subjected to the tests set out in the Trade Practices Act. Those tests will ensure that bank mergers do not harm consumers and competition. Of course, banking specific issues, to do with the stability and security of the financial system, may arise. But if they do, they can and should be dealt with transparently through the system of prudential regulation.

After all, a major objective of the reform process that began with the Campbell Inquiry of 1981 was to separate prudential regulation from controls over banking industry structure; with effective prudential regulation now firmly in place, concerns about bank supervision cannot justify artificially constraining the banking industry's structure.

Historically, the structure of Australian banking has evolved in line with shifts in financial markets and in the domestic and global economy. The four pillars policy marked a pause in that evolution. With the international financial system undergoing far-reaching change, rethinking that policy is as pressing as it is overdue. Henry Ergas is the regional head for Asia-Pacific of economic consultancy CRA International. He has been a consultant on the competition aspects of bank mergers to major Australian trading banks and to European banks.