

General Discussion

There was a wide-ranging discussion on the underlying economics of banking. One important aspect of this was the role of joint production costs for the banks' core services of credit, savings and payments. To what extent should these be thought of as inherently joint-cost products, with production costs unable to be broken up? The response to this question was that historically they had been joint-cost products, but that new players were now able to produce them on a stand-alone basis. This meant that the joint providers now needed to provide these services as efficiently as the specialists.

Closely related to this was the question of cross-subsidisation. Participants argued that retail payment services in Australia were, on average, cross-subsidised from interest margins. This had been a response to public demand: the public had seemed to prefer to pay more on the interest margin in order to support the low-fee regime for transactions. The cross-subsidies were uneven – the most heavily subsidised customers were those with low average balances but high transaction volumes. It was noted that Canadian and New Zealand banks had quite a different pricing structure. They had narrower interest margins but higher transaction fees more closely related to costs. As a consequence there had been no opportunity for specialist mortgage originators to expand in those markets. It was argued that, given the increasing pressure on margins in Australia, there would inevitably be a move toward higher transaction charges here as well.

This raised the question of whether transaction service markets might become more open and banks might lose their special position as transaction providers. On this point it was suggested that banks were likely to maintain their central position in this market. Wholesale payments were already being priced competitively on a marginal cost basis and this business had not left the banks. The same would be true in the retail area. It was anticipated that banks' role in transaction services would continue to be a core advantage for their overall business. Notwithstanding the move towards stand-alone products there were still some important synergies. For example, banks' role as transaction providers gave them opportunities to cross-sell other products.

Another major issue concerned economies of scale and scope in banking. This had an important bearing on the industry's efficiency and on the possibilities for improving efficiency through mergers and acquisitions. Comments generally took the line that there were important economies of scale to be realised in certain bank *processes*, but not in geographical expansion or in expansion across lines of business. With regard to processes it was argued that bank branches were often well below the optimal size and that there could be considerable gains from branch rationalisation. One way of achieving this could be through 'in-market' mergers (mergers among banks in the same geographical area) which could potentially raise efficiency by reducing branch numbers and increasing the average branch size. 'Cross-market' expansion on the other hand was regarded as much more risky. Successful geographical expansions in retail banking were quite rare, NAB and Citibank being exceptions. And it was regarded as risky to attempt to expand into completely new areas of expertise by takeover.

Although branch networks needed to be rationalised, they were regarded as having an important continuing role for the banks. It was noted in particular that, while machines and telephone networks could service many customer needs, branches were still highly effective in meeting some basic needs and in attracting new customers. What was needed was to reduce the number of branches to bring them up to an efficient average size.

In contrast to retail banking, which had a strong local character, investment banking was argued to be developing increasingly on a global scale. Participants involved in the industry thought that we were seeing the demise of a distinctively Australian investment banking sector, and its increasing international integration. The same was true in funds management, at least at the wholesale level, although at the retail level the business had to retain a local character.

A further issue for funds management was the problem of 'short-termism'. It was remarked that competition among funds managers led to a focus on comparative rates of return over quite short periods. The question was raised as to what could be done to encourage a longer-term, forward-looking focus. The problem seemed hard to solve as it was hard to stop people using the 'rear-view mirror' to assess funds managers. But it was important for people to understand that past performance in funds management was a poor predictor of future performance. It was more appropriate to assess funds managers on the basis of their strategies than on historical returns.

A final issue concerned the impact on banks of securitisation. The trend seemed to be that the best assets of the banks were the ones most likely to be securitised and taken off the balance sheet. This meant that banks would be left with a portfolio of loans of lower average quality than was typical in the past. One response to this point was that it would not be a problem, provided loans were correctly priced to reflect the risk. But it was suggested that this could be an issue for bank supervisors to give attention to in the future.