

Discussion

1. Andrew Mohl

Professor Llewellyn's paper outlines quite definitively why banking is an industry under pressure, focusing on the related pressures of competition, declining entry barriers, deregulation, financial innovation and technology. I have no reason to challenge the particular arguments as they have been thoroughly researched and are broadly self-evident to anyone who watches TV or reads a newspaper. My comments on the paper are from the perspective of a former central banker cum-private banker cum-bancassurance executive. They are also heavily based on Australian observation although I believe they have wider international context.

Banks' Evolution into Financial Services

My first main point is that major banks in Australia have for some time now recognised and reacted to the proposition that they are in fact no longer in the business of banking, defined to be the provision of loans and advances, deposits and transaction payment services. They are instead in the business of financial services, defined to be the provision of all types of products and services that are important to the customer's financial well-being. This is why ANZ, for example, owns a life company, a trustee company, a unit trust company, a lenders' mortgage insurance company, a general insurance company, a stockbroker, and so on, in addition to its banking licence. For my sins, I have the responsibility of managing most of those non-bank legal entities and determining how best to deliver those products and services to the market while creating ever-increasing shareholder value.

The impact of the banks in these areas has been significant. In retail managed funds, for example, the four major bank subsidiaries feature in the top ten with CBA second in size, ANZ fifth, Westpac seventh, and NAB ninth, accounting in total for over 20 per cent of the market. A related point to this is that major life companies in Australia are also no longer in the business of life insurance, which itself is changing quite radically in terms of product, pricing and distribution but, like the major banks, are really in the business of financial services.

To be sure, banks and life offices are at present very different in their cultures, skill sets, service delivery processes, and so on, but the pressures in the marketplace are bringing about a substantial convergence in strategies and business objectives. The illustrations of this are everywhere: for example, AMP launching Priority One, Colonial buying State Bank of New South Wales and National Mutual's alliance with Advance. Less clear is the role of the general insurers who have had limited success in expanding outside their traditional product set.

This convergence is, of course, also one of the important forces that have led to the Wallis Inquiry, as some have begun to question, *inter alia*, the wisdom of institutional supervision when institutions more and more behave and look like each other. That is a subject, however, best left for another time. Instead, let me move to my next important point.

Banking Groups' True Competitive Advantages

The paper identifies the fundamentals of banking and concludes that banks are essentially in the 'information business'. I would argue this differently. When I look at the increasingly competitive marketplace, I conclude that in essence ANZ, along with every other major bank or life office, in effect only has two basic competitive advantages:

- it has a brand name; and
- it has customer relationships.

The value of the brand and the themes that customers identify with a particular brand vary from organisation to organisation. Marketing areas track this in detail. Our research indicates we have a very strong brand, and this is worth a fortune as we seek to deliver shareholder value in the modern day delivery of financial services.

The customer relationships, over three million in total, are similarly invaluable. Notwithstanding the Australian media and politicians' pastime of 'bank bashing', most Australians are very satisfied with their bank and even more so with their branch manager and staff, and likely to exit only in extreme circumstances. This access to, regularity of and often longstanding nature of our relationship with, customers gives us both the potential to cross-sell other products and services but also constitutes a major barrier to new entrants seeking to win over these customers.

Beyond that, I doubt we have much to compete with that has any sustainable value. Risk assessment can be accessed via mortgage insurers and/or credit scoring systems in the case of personal lending. Risk assessment in the case of mid-market lending will probably go much the same way in time. Payments services can be accessed via cards (issued by banks or non-banks), or phone, EFTPOS services and the like. Products can be bought from all and sundry with even the most innovative product copied within a matter of months, if not sooner.

Branch banking was, of course, the foundation for both the creation of brand equity and customer relationships above, but it has obviously had its best days. Contrary to many others, I believe branch distribution will continue to be prominent in future distribution although I don't expect to see non-banks rushing in to create similar new bricks and mortar distribution.

Banking Groups' Ability to Compete in Highly Competitive Markets

My third point is that the paper leads one to believe that banks are likely to have faced a very tough time meeting financial hurdle rates. If banks operated previously in a protected and comfortable competitive environment, they will surely have suffered in financial terms in this new world of collapsing barriers to entry, deregulation, rapid innovation and powerful new technologies. The reality, to date at least, suggests this is not happening, and indeed the opposite appears to be the case. The Edey and Gray paper contains a chart on major banks' profitability that shows that returns on equity are presently as high as at any time in the past 35 years and in inflation-adjusted terms are at record highs. Returns on equity in top-performing US banks are even higher. Another measure is the premium of market to book value. The four major banks presently are in

the range of 150 to 180 per cent, indicating that the market takes a strongly positive view of the value of the franchises and infrastructures held by the major banks.

How can this be so?

As in most other markets, the stifling of competition in banking only succeeded in creating a highly inefficient industry that gave customers poor value for money. As a result, the 'returns' from protection were largely dissipated in a range of ways, including the usual culprits of major overstaffing, credit excesses, head office grandeur, expensive and mostly ill-conceived acquisitions, and the like. Customers battled on with branches open 34 hours a week, housing loans a prized scalp, no interest paid on cheque accounts, no telephone enquiry centres, no ATMs, no EFTPOS terminals, no financial advisers, or any of the rest of what we now regard as standard services from a bank.

The response of banks to competition has been subject to fits and starts but at the end of a decade has truly been very substantial. Australian banks are now much leaner, return-driven, customer-focused, sales-oriented and internationally-minded in their business approach. They have shed thousands of staff, hired many more thousands at all levels – from part-time tellers to CEOs (in the case of Westpac) – and are rapidly seeking to build skills in the areas of customer segmentation, database marketing, distribution channel economics and risk grade pricing, to name just a few.

Of course, the real force of competition is only just beginning, and we are all to be properly tested. In that regard, I must say I wonder whether returns on equity of 18 per cent or more can be sustained by even the best major player in an environment of 2-3 per cent inflation, a view which I presume is shared by Ian Macfarlane, judging by reports of his recent speech.

At least until now, however, I think the observed experience has been that the traditional players have added back more shareholder value in their response to the increased competitive pressures than they have lost in shareholder value from the reality of those pressures. That is, I would suggest that competition and bank profitability have both gone up. So much for economic theory!

Contract Banking in Practice

My final point relates to the emergence of contract banking. This is no more or less than the process of unbundling at work as management seeks out more cost-effective ways of delivering value to customers.

The best example of this in my view is the celebrated Charles Schwab in the US which has evolved from a discount broker to become one of the leading distributors of other managers' mutual funds through a range of distribution channels. The reorganisation of major banks is similarly forcing them to consider outsourcing an increasing array of activities and/or contracting out activities where they have substantial competitive advantage. This is already part of the way we do business at ANZ Funds Management as we have a broad array of strategic partnerships with general and life insurance underwriters, superannuation administrators, external advisory groups, and the like, as we focus on our preferred area of distribution versus product origination.

Concluding Remarks

Banking groups have been facing the full challenge of competition for over a decade now. They have survived far better than many first thought. Think of a really successful foreign bank in Australia if you can, aside from Citibank, of the original 16 new entrants. They are now confronting an intensification of those pressures.

My contention is that they can fully meet this challenge, by leveraging off their brands and customer relationships. That said, we have a saying inside ANZ that success in financial services is 10 per cent strategy and 90 per cent execution. The hard work is therefore largely in front of us.

2. General Discussion

The discussion focussed on three main issues:

- the unbundling of banks' traditional products (what the author referred to as 'deconstruction');
- dividing lines in the financial system between different types of institutions; and
- the nature of banks' core competencies and the long-term role of banks.

On the first issue the paper had argued that unbundling was likely to be an important driving force for further change: competition would take place more and more at the level of individual products and processes. A consequence would be greater diversity in the finance industry because institutions would tend to specialise rather than necessarily aiming to be full-service providers. The question was raised as to why this unbundling process was occurring. Presumably the traditional structure had evolved because bundling had been efficient. Why had this changed?

It was suggested that there were two possible answers to this. One was that technological change was lowering the relative cost of individual services, making them easier to split up – for example, it was easier than in the past to set up a mortgage business outside a major financial institution. The other answer was that the competitive environment had changed. Bundling might have been inefficient in the past but could not be challenged because of entry barriers which have now come down.

Some participants thought that the importance of unbundling had been overemphasised: we should not accept as inevitable that further unbundling would happen, or would happen quickly. The home mortgage market was cited as an example. It had taken some years for the current competitive pressures to develop and, despite intense competition and advertising of low interest rates, many customers still displayed considerable inertia. This experience suggested that banks would continue to have some important advantages in defending their traditional business base. Many customers had an inherent tendency to stick with banks, possibly related to banks' role in payment services.

The second main issue of discussion concerned the dividing lines among financial institutions. Participants emphasised that the traditional dividing lines were becoming

less meaningful as financial businesses were increasing their activities outside their traditional areas. This was happening at several levels: banks were developing their financial service subsidiaries, non-bank financial institutions were offering some traditional bank-style products, and companies from outside the financial sector altogether were moving into some areas of financial services. The whole process illustrated the dramatic decline in entry barriers in markets for financial services.

It was argued that there were important asymmetries in this process. Banking could be invaded from the outside more easily than banks could invade other markets. Equally important was the question of exit barriers. Outsiders entering markets for financial products faced very low exit barriers and therefore faced very little risk in entering such a market on a trial basis. Examples cited were the UK retailer Marks & Spencer, which was offering some consumer financial services, and the development of 'in-house' banks by a number of large industrial corporations. These companies could easily exit from financial service activities if they proved unprofitable. Banks on the other hand were not diversified and could not get out of key markets without shutting down. It was argued that this situation would lead to increasing competitive pressure on banks, and possibly even to pressure from banks to be able to diversify into non-financial activities. If that were to happen it would further undermine the distinction between financial and non-financial enterprises.

A number of policy implications of these trends were discussed. It was argued that some dividing lines between institutions needed to be drawn because, if not, the central bank would end up regulating and underwriting the whole financial system. This would clearly be unacceptable.

Other participants thought that the special status of banks in the financial system would be hard to maintain. Banks were expanding into non-bank financial services through subsidiaries, but customers did not always recognise the distinction between banks and their subsidiaries. This gave the subsidiaries a marketing advantage as they were perceived to have bank support. To level the competitive playing field, it was argued that the special status of banks had to be removed, or the firewalls between banks and their subsidiaries had to be more strongly enforced.

The third main issue concerned the 'core competencies' of banks – their underlying sources of comparative advantage. It was argued that the process of unbundling was making the core competencies harder to identify, since the old notion of banks as full-service suppliers was breaking down. Instead each bank would have to identify its particular area of strength. The notion of a bank's brand name and customer base as sources of comparative advantage was challenged. If the fundamental economics of the finance industry were changing, the banks would have to respond. The example of IBM was cited as illustrating that the advantages of a prestigious name could have a short shelf life in times of change.