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FOREIGN BANK ENTRY INTO AUSTRALIA

Kevin Davis
Department of Economics
University of Adelaide

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I. INTRODUCTION

Any attempt to discuss trade in banking services is hindered by definitional problems. One such problem is that of defining and measuring the output, or more precisely outputs, of a banking firm. A second is that intermediation, the business of banks, involves (virtually by definition) the production of an output which has the property of jointness in consumption. A third problem is that many 'banking' services can be produced by financial institutions not defined under national laws as banks. This last problem is of particular significance to the issue of foreign bank entry (i.e., the granting of Australian banking licences to [at least partially] foreign-owned institutions).[1] Foreign-owned entities, as an alternative to obtaining a licence, should be able to provide many banking services to the Australian market by local presence as a non-bank institution[2] or from an overseas location.

Whether these alternatives to domestic licensing are in fact viable depends crucially upon the nature of banking services and upon the determinants of the economic value of a banking licence. Thus, to assess the costs and benefits to the Australian community of alternative policies towards providing bank licences to foreigners we need answers to the following questions. Are banking services tradeable? Does physical location of the producer vis a vis the (joint) customers impinge upon the cost of

production? Do foreign-owned producers have any comparative advantage over at least some potential domestic producers in supplying services to residents? Is a banking licence necessary for effective provision of such services? What are the costs to the Australian government and community of producing banking licences which have a positive demand price? What factors should influence the supply of such licences, what characteristics should those licences possess, and what mechanism should be used to determine their allocation, particularly between foreigners and residents?

These questions are addressed in subsequent sections of this paper. The first three are essentially theoretical and, although relevant to the more applied material in section four, could be disregarded by those readers whose interest lies primarily in the latter area. Section one examines the nature of banking services, with particular emphasis upon the tradeability of various components of bank output. Section two deals with the questions of protection and foreign ownership in national banking markets. Explanations of past growth and form of multinational banking are examined to consider the importance of location, and sources of comparative advantage, in the provision of banking services. In section three, the focus of discussion is shifted from banking services to banking licences. The rationale for licensing and the source of licence value are considered, as are the arguments surrounding allocation of licences to foreigners. Finally, section four will take up an issue of special significance in Australia at the current time: if a limited

number of banking licences are to be allocated to foreigners, what criteria should be used for selection of successful applicants? To focus that discussion specific attention will be paid to entry by Japanese banks.

II. THE DEFINITION OF BANKING SERVICES

Although modern banks typically undertake a widely diversified range of activities, their fundamental purpose is intermediation. In this respect, defining the outputs of the banking sector is largely equivalent to explaining why bank intermediaries exist. By reducing the various costs and inefficiencies involved in the financing process which inhibit direct financing, banks provide a set of services - the demand for which justifies their existence. These services can be listed briefly as:

- the reduction of search and transactions costs associated with the borrowing and lending process
- risk reduction services: to depositors via the pooling of asset portfolio risks and via more informed appraisal of the risk characteristics of borrowers; to borrowers via the establishment of implicit contracts or banker-customer relationships which, for example, reduce the risks a borrower might face by otherwise attempting to undertake a sequence of independent borrowings.

- asset transformation services such as maturity transformation and liquidity production.

By appropriate use of real resources, superior information and acquired skills, economies of scale, and taking of risks, owners of successful banking firms are able to provide these services at a profit. They do not, however, charge explicitly for providing each of these services.

In addition to these services associated with intermediation, banks have been distinguished by their provision of payments services. At both a domestic and international level, they have facilitated the transfer of ownership of financial assets as the counterpart to exchange of title to goods and services (and other financial assets). Such services involve banks not only in the production of transferable claims, but also in the development of a cooperative mechanism (the clearing house, correspondent arrangements) whereby transferability of ownership is facilitated. These payments services can be charged for explicitly, although in practice (partly due to regulation) explicit charges have often been eschewed.

Emphasising the economic functions of banks immediately makes clear the appropriate way to measure bank output. The level of deposits or loans is not appropriate. Bank output is created by entering loan and deposit contracts with various customers, **with the differences between the characteristics of those contracts representing the services produced.** Bank production thus requires simultaneous provision of services to both a loan

customer and a deposit customer. In general, the output produced by banks is a case of, and indeed can only arise by, joint consumption by the bank's loan and deposit customers. Maturity transformation, for example, enables borrowers to borrow for longer periods and depositors to lend for shorter periods than would occur in the absence of such intermediation. Payments services, by definition, involve the bank providing a joint service to two of its (or some other bank's) customers (and, in addition, will generally require inter-bank cooperation).

Three consequences, of relevance to studying trade in bank services, follow from recognising the 'jointness in consumption' characteristics of bank output. First, it may be impossible to allocate bank 'output' between various customers, except in an arbitrary way. Thus, where one or both loan and deposit customers reside in a different location or are of different nationality to the bank servicing them, **a meaningful definition of trade in bank services may be difficult.** Estimates can no doubt be made, but it needs to be remembered that it is inappropriate to treat services provided to depositors independently of services provided to loan customers.

A second consequence is that the geographical location of a bank may be irrelevant to the provision of some bank services to particular customers. Communication between a bank and its customers is necessary, but physical presence of customers at the bank's offices is not essential. In this respect, bank services can be provided by foreign-owned producers to local residents on

an **establishment** basis (foreign bank entry) or on a **trade** basis from an overseas location. It is thus inappropriate to consider the issue of foreign bank entry independently of exchange and capital controls which impinge upon financial dealings of local residents with overseas-based entities. The particular bank services to which this interrelationship relates are discussed below.

The third consequence of the 'jointness in consumption' characteristic of bank services can be seen in the nature of bank-service pricing and problems associated with valuing bank output. The charge for bank intermediation services is an implicit one levied jointly upon customers through an interest differential between borrowing and lending rates. (In addition to jointness in consumption, this pricing strategy reflects the fact that each contract entered into with a borrower or lender involves a 'package' of characteristics. Very rarely will it be possible to identify a particular set of loan and deposit contracts involving production of only one service, say maturity transformation, and not another such as risk reduction). As national income accountants are well aware, it is necessary to impute a bank service fee reflecting this implicit form of charging and valuation of bank services.[3] How to allocate this fee between customers, necessary if trade flows are to be measured, is obviously a complex question.

Another characteristic of bank services which deserves mention relates to the role of contracts. Loans and deposits clearly

involve explicit contractual relationships, but of equal significance are the implicit contracts between banks and their customers. Banker-customer relationships built up over time make 'old' and 'new' customers distinguishable groups to a bank, influence customer perceptions of the bank's reliability as a service supplier, and can thus be expected to influence the nature of changes in customer affiliation over time. Underlying the development of these producer-customer relationships is the 'knowledge capital'[4] built up by each party about the other as a result of the repetitive nature of service provision. As in the case of jointness, the importance of this market characteristic varies between different types of services and customers. Consequently, the ability of foreign producers to penetrate the local market on either an establishment or a trade basis is dependent upon different market factors.

In this context an important distinction needs to be made between wholesale and retail banking activities, a distinction based, at first sight, solely on the scale of loan and deposit transactions involved. More fundamentally, though, the wholesale-retail distinction involves marked differences in the nature of services provided, costs incurred and banker-customer relationships. Retail intermediation, for example, is a relatively high-cost activity (which is reflected in interest rate margins) but is also relatively conducive to liquidity production. Wholesale intermediation, in contrast, involves lower margins and provides less scope for liquidity production by individual banks.

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It is in the provision of services by wholesale activities that foreign producers seem best able to penetrate local markets either on a trade or establishment basis. Reasons for this are discussed in the following section. In contrast, provision of services by retail activities appears to require establishment. Experience overseas, however, of foreign bank involvement in retail markets[5] suggests that remaining entry barriers would be sufficiently high to inhibit entry.

Two comments are warranted. First, market shares provide little information on the effect of foreign bank entry and competition on the provision of banking services. Any competitive spur may arise from the presence of competitors rather than from the scale of their activities. Whether this applies to retail markets depends in part on whether greater competition in wholesale markets spills over into the retail arena. Secondly, past experience about the 'natural' barriers to entry into retail markets may be of limited relevance given modern technological advances and associated financial innovations. As the growth of cash management trusts in Australia in the early 1980s suggests, an extensive branch network may no longer be necessary to tap parts of the retail market. For foreign bank entrants, the other major entry barrier, that of sunk costs involved in establishing a reputation as a reliable supplier of services, is probably less significant than it is for entrants **de novo.**

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III. TRADE IN BANKING SERVICES AND ITS GROWTH

One of the critical distinctions made in the previous section was between the provision of banking services to residents of another country by means of **establishment** or by means of **trade.** The latter activity corresponds to what is often defined as international banking - home-based transactions with foreigners, although the term also includes transactions in foreign currencies with domestic residents. Provision by establishment corresponds to multinational banking - whereby banking services are provided to foreigners by operating establishments in their own country.

Given this twofold means of providing banking services to domestic residents by foreigners, two legal safeguards are required for domestic producers against foreign competition. Prevention of foreign bank entry precludes competition by establishment, while exchange controls are necessary to prevent competition by trade.

The rationale for this is that it provides a further explanation for the nature of the growth in multinational banking to those usually advanced. Typically the emphasis is on patterns of trade, multinational servicing, tax differences, etc. as discussed below. The arguments above suggest that a further explanation may lie in differences in exchange-control arrangements between countries which inhibit foreign competition by trade and which provide inducement to competition by establishment.[6]

However, where removal of the protection afforded by exchange-control arrangements does not diminish the desire for entry by foreign entities (as appears to be the case for Australia) two factors would appear to be relevant. First, production of some banking services would appear to involve costs which increase with the distance between consumers and producer or which, generally, are location-specific. Second, potential entrants must perceive a chance for making high profits from entry. Differences in cost of service production vis a vis domestic competitors would seem to provide the key (unless an expectation of generalised above-normal profits in banking prevails).

Where such differences in cost arise is of course crucial to an understanding of the benefits from foreign bank entry. It is my contention that they reflect the specific nature of bank services as discussed above, rather than some set of technological, physical or human-capital skills. Since the design of successful financial instruments is easily copied, as are organisational and accounting systems, and since the relevant human capital involves a relatively low firm-specific element, it is difficult to perceive sustainable, generalised cost advantages within a standard production function framework. Any such advantages stem either from the implicit value of the banker-customer relationship which, effectively, reduces the cost of providing some services to particular customers, or from advantages involved in 'multi-plant' operations in providing jointly consumed services to customers in different locations.

Recognition that some costs of service provision may be location-specific and that costs of servicing particular customers may vary between producers underlie most explanations of the past growth of multinational banking. The early growth of multinational banking has been seen by most observers as a response by banks to the internationalisation of the business of their corporate customers. With a physical presence needed in the foreign market to provide the required services (and to encourage customer loyalty), foreign banks were able to offset the local banks' home-ground advantage because of the specific asset of knowledge capital possessed by the foreign bank.

Multinational banking expansion based around the financing and facilitating of trade and capital flows reflects similar factors. While the principals involved in the transactions can each deal with a local bank, and the joint service be provided by correspondent arrangements between those banks, multinational expansion enables the whole transaction to be internalised by one bank. Because **intra**-bank arrangements may be less costly than **inter**-bank ones in respect of such things as size of 'float' necessary, offsetting hedging requirements, documentation etc., multinationals may achieve cost advantages which enable them to prosper on foreign ground. The principals engaged in trade and capital transactions may also find it less onerous to deal with a common intermediary.

Other explanations of multinational bank expansion relate to the role of tax concessions, desire to avoid home regulatory

constraints, etc. However, these have more relevance to the growth of offshore or eurocurrency-type activities, with which this paper is not concerned. We turn instead to the arguments relating to the prevention of entry by both foreigners and domestic residents into banking by licensing requirements.

IV. THE MARKET FOR BANKING LICENCES

As in most other nations, bank licences in Australia have been a government-supplied good which has been far from freely available. Those in existence have, however, had an explicit price of zero attached to them, although an implicit cost to licence holders via reserve ratio requirements has undoubtedly existed.[7]

That these goods (licences) have a demand price (even after allowing for implicit costs) in excess of zero is unquestionable. It is important, however, to be aware of why this is the case. There are only two possible reasons. First, licence holders are able to undertake profitable activities denied to others. Provision of domestic payments services falls into this category. Even if not a direct source of significant profits, provision of payments services enables 'full line servicing' of customer needs and thus provides competitive advantages. This apart, all other banking services can be provided by unlicensed suppliers, who have also developed substitute forms of payments services in an effort to offset bank advantages.

The second reason is probably more significant. Licences, in themselves, are of value because their holders are thereby able to distinguish themselves in some competitively beneficial way from alternative non-licensed providers of otherwise equivalent services. Either government selection criteria must mark licence holders to be superior providers of services, or indicate the existence of some special relationship between bank licence holders and government, such as would arise from government guarantee of the safety of bank deposits. Both features reflect the special characteristics of banking services and governmental responses to these characteristics. Government 'stamp of approval' may enable potential customers to avoid the costs associated with ascertaining the reliability of the service provider. It is, however, difficult to see how an ongoing approval can be given without resort to some governmental supervision of approved institutions, and thus this source of licence value merges inextricably into the other of government regulation and (although not necessarily, some would argue) government 'guarantee'.

Exactly why governments might wish to verify the standard and guarantee the reliability of providers of banking services is beyond the scope of this paper.[8] Suffice it to say that the production of (at least some) banking services involves risks which customers are unable to completely assess. Since the sustainability of the contracts between banks and each of their customers, whereby bank services are produced, is conditional upon the activities of other customers (because of the jointness

in consumption characteristics), bank runs and banking crises cannot be ruled out as a feature of an unregulated banking sector. For example, if some customers respond to a shock in financial markets by starting a bank run, it is rational for other depositors to join the run and, given the problems facing bank customers in distinguishing specific from general shocks, not necessarily irrational for the run to spread to other banks. Government involvement is one way in which the social costs of a disruption to bank service provision from such events can be prevented.

Preventing the real social costs of banking crises, or alternatively facilitating the production of banking services (by, for example, the provision of liquidity-support facilities), cannot be regarded as a socially costless government activity. Not only are resources used in the process, but the nature of the competitive process can be easily disturbed by the distinction between 'guaranteed' (i.e., licensed) and other providers of banking services. Either the supply of licences needs to be highly elastic, or if the number of licences is limited the implicit and explicit government charges for licences need to be appropriately set (and varied), to prevent unwarranted dominance of the financial system by a few licensed banks.

In the absence of these last two conditions there are obvious concerns which can be expressed about the appropriate principles underlying the allocation of bank licences. At one level, if the competitive advantage of licence holders drives out unlicensed

suppliers of substitute services, bank owners (or managers) as a group attain a position of significant economic power because of the important role of these services in economic life. Where the number of licences is limited, grounds for enforced spreading of ownership thus appear to have merit, although less so as the number of licences is increased. In this respect, the recent decision to loosen the Bank (Shareholdings) Act provisions is consistent with the contemporaneous announcement of a proposed increase in licences.

The other concern relates to the allocation of these scarce goods (licences), and the net benefits flowing to foreigners. There would appear to be only two possible arguments which could be used to support such an allocation. The first is that there are no domestic applicants able to meet the government's standards for guarantee or seal of approval. The second is that foreign entrants would yield social benefits to the Australian community, for which they do not receive full recompense, and which would not be realised without a banking licence.

If the latter argument is thought to apply because of competitive advantages held by domestic licence holders over foreign-owned non-licence holders, an alternative to the grant of licences warrants attention. For example, it would be relatively easy to impose a licence fee on domestic holders which wipes out the cost advantage arising from licensing and thus enables non-licensed foreigners to compete effectively. Regardless of whether such an approach is practicable (although the 1970s growth of the

foreign-owned merchant banks, when the Australian banks faced heavier implicit licence fees than currently, suggests it is) some form of licence fee on holders (domestic or foreign) is warranted. The Martin Report's interim proposal of application of a low-yielding fixed reserve ratio requirement is one possible approach - although the unwillingness to extend the requirement to banks' subsidiaries leaves considerable scope for evasion of appropriate levels of licence payments.

If we accept the need for licence availability to attain effective foreign participation, it remains to be asked, what is the nature of the social benefits gained from such participation? The effect of increased competition is an obvious one, and in some banking markets at least, foreign entrants may face lower natural entry barriers. The magnitude of sunk costs associated with establishing a 'brand name' as a reliable supplier of banking services is relevant here. In this respect, foreign entrants may be more readily available than domestic entrants, although the granting of a banking licence (and associated government 'guarantee') would clearly reduce the magnitude of sunk costs needed for a domestic entrant. Given the penetration of most retail banking service markets by domestic non-bank thrift institutions, this argument would appear most pertinent to the wholesale arena.

Considering the nature of banking services other social benefits must be sought. Foreign entrants may be able to play an important role in further reducing transactions and search costs

involved in the financing and payment of foreign trade. Similar benefits may flow from reduced transactions and search costs associated with their intermediation between Australian residents and foreigners. Generally, their presence and activities may serve as a conduit for information flows. Many of these services can undoubtedly be provided to some residents on a trade basis. The benefits brought by establishment lie in increasing the set of residents to whom these services can be provided. The servicing of smaller business may be a case in point. These activities involve relatively little risk-taking on the part of the bank.

Once we turn to consider other types of banking services, however, any social benefits brought by foreign banks also entail additional complications. In particular, these activities (such as liquidity production) involve banks in adopting a structure in which the probability of insolvency is non-zero. Indeed, one of the reasons for government involvement is that such involvement may, by reducing the capriciousness of depositor confidence, reduce this probability.

When bank operations involve both a domestic and foreign market there are obvious difficulties associated with national government involvement unless the activities in each market are independent. Since the arguments for government involvement relate solely to domestic activities and not at all to those in foreign markets, national governments could then focus upon domestic activities, irrespective of the nationality of the

supplier, and ignore those in foreign markets. But in that case it is difficult to see why the transfer of technology, capital and human skills involved in foreign bank entry needs to arrive as a package - rather than by local entrepreneurs hiring or buying these factors independently from overseas sources and assembling the package domestically. More importantly, many of the perceived benefits flowing from the presence of multinational banks hinge upon their supply of services jointly consumed in different national markets, thereby necessitating some degree of interdependence between their activities in domestic and foreign markets.

The dilemmas arising for national prudential supervision and customer protection from the operations of multinational banks are well recognised (see Pecchioli, 1983). Requiring local incorporation rather than allowing operation as a branch (as, for example, is to be the case in Australia) reduces some of the complexities. Some of the interdependencies between foreign and local operations, which have the potential to affect the 'standing' of the local entity, are reduced and the responsibility for prudential supervision placed firmly upon the local authorities. But exactly what role is to be played by the local authorities in supervising and supporting unlicensed foreign suppliers of substitute banking services is another matter. Given the decision to effectively allow foreign banks to provide most banking services by establishment through an unlicensed wholely owned subsidiary, it is a matter of some significance.

Because bank licences, in their current form, involve the establishment of a special (guarantee/guarantor) relationship between the national government issuing the licence and the licence holder, arguments can be advanced for governmental discretion in the issue of licences. That licence fees should be charged goes without saying. But, taken in isolation, willingness to pay gives no indication of the net social benefits to be gained from the grant of a licence. Particularly with foreign-owned applicants, governments will need a set of criteria upon which to judge the merits of applicants. The following section will consider some such criteria.

V. SELECTION CRITERIA

It is possible to identify a large number of criteria relevant for selecting among foreign applicants for banking licences. Obvious ones are:

- size of applicant
- reciprocity in home country
- trade volume between Australia and home country
- current international diversification
- volume of capital transactions between Australia and home country
- provision for local equity participation
- spread of ownership
- prudential arrangements in home country
- special characteristics of the applicant's activities
- links with business enterprises in Australia

In what follows, the merits of these criteria are examined, paying particular attention to their relevance for entry by Japanese banks.

Size of applicant

If the size of the 'parent' of the proposed new bank is used in selecting among applicants (largeness being seen as a virtue), Japanese banks would dominate. As Table 1 indicates, there are currently eight Japanese banks among the twenty largest in the world. More generally, there are some twenty Japanese banks of a size at least equal to the largest of the Australian banks.

Size may be a relevant criterion as: an indicator of successful past growth, indicative of safety (although the recent experience of Continental Illinois - forty-eighth largest in the world in 1983 - and the international debt crisis call such a presumption into question), or broadly, as an indicator of ability to provide effective competition in the domestic markets. In two respects this last factor may have merit. First, the ability of an entrant to sustain or countenance operating losses while establishing a domestic foothold may be positively related to the size of the existing operating base over which those losses are spread.[9] Second, the entry barriers associated with establishing a 'brand name' may be less for larger well-known foreign entrants. However, it is not necessarily the case that such perceived advantages will accrue as a function of size. In the

Table 1

THE TWENTY LARGEST BANKS IN THE WORLD, 1983

Rank	Bank	Home country	Assets ($b)
1	Citicorp	USA	126
2	Bank America	USA	115
3	Dai-Ichi Kangyo	Japan	110
4	Fuji	Japan	104
5	Sumitomo	Japan	101
6	Banque Nationale de Paris	France	101
7	Mitsubishi	Japan	98
8	Barclays	UK	94
9	Sanwa	Japan	91
10	Credit Agricole	France	90
11	Credit Lyonnais	France	88
12	National Westminster	UK	87
13	Societe Generale	France	86
14	Deutsche	West Germany	77
15	Midland	UK	76
16	Chase Manhattan	USA	75
17	Norinchukin	Japan	75
18	Industrial Bank of Japan	Japan	71
19	Mitsui	Japan	67
20	Royal Bank of Canada	Canada	66

Source: **The Banker** June 1984.

absence of any hard evidence on these matters, it would seem inappropriate to use size **per se** as a criterion for selection.

Reciprocity

The issue of whether reciprocal right of entry by local banks to the home market of foreign applicants should be required as a criterion for entry ought to be determined by economic factors. In practice, however, political considerations may be expected to supervene. To the extent that international diversification increases the competitive status of a bank in any of its geographical markets, an economic case can be made for demanding reciprocity. Foreign bank entrants whose home markets have restricted entry would have a competitive advantage (although perhaps very slight) by virtue of their potentially larger international network.

In recent years the significance of reciprocity has been reduced as an issue because of the worldwide liberalisation of financial markets. Among OECD members,[10] for example, only Iceland, New Zealand and Sweden now impose an absolute ban on foreign bank entry in some form, although Australian banks are already well represented in New Zealand under grandfather clauses. Nevertheless many nations demand reciprocal entry rights and an argument can be made for allocating scarce licences to the banks from these nations. Where no reciprocal rights are required, Australian banks are already able to enter. Thus, maximum widening of the gates to international diversification by

Australian banks would be achieved by allocating licences to banks from countries demanding reciprocity. Japan, Canada, France, Italy, Switzerland and some others come into this category but not, notably, the UK, the USA (excepting some states) and West Germany.

Whether demanding reciprocity or taking account of reciprocity conditions of entry criteria elsewhere in granting licences provides much in the way of benefits to Australians - other than those accruing to Australian banks from subsequent international diversification - is an open question. One possible benefit is considered in the next section, but the low political cost of this measure as a partial compensation to Australian banks for their loss of eminent domain suggests that reciprocity will play an important role.

Trade links and geographical dispersion

Because banks play an important role in facilitating and financing international trade, it is often argued that the allocation of licences should reflect trade patterns and involve geographical dispersion. Underlying this argument is the assumption that the financing of trade etc. is performed more efficiently by one bank operating in both countries rather than by different banks in each linked by correspondent relationships.

If this argument is correct, it raises an important dilemma associated with the allocation of a small number of licences between banks from different countries. Allocating one licence

to a bank from country X gives that bank advantages over other banks from country X in financing trade between the two nations. Only if Australian banks are also active in country X, or if licence holders from other countries have diversified internationally into country X, will a monopolistic advantage be avoided. In this respect, ensuring reciprocity may have merit.

If trade patterns are to be used as a criterion for licence allocation, the breakdown of Australian trade as given below is of interest. On current trade patterns, Japan and the USA have the dominant claim, with little to separate the cases of the ASEAN countries, the remainder of Asia, the UK and the remainder of the EEC. Whether current trade patterns are an appropriate indicator of benefits from entry of foreign banks from these regions is another matter. Certainly the existing base upon which improvements in trade financing etc. are calculated is larger, but it may be argued that efficient financing links are already likely to be in place. Greater gains may come at the margin, such as where foreign bank entry facilitates growth of previously impeded trade between Australia and the entrant's own nation of origin. The reinstatement of the licence of the Bank of China would appear to reflect these considerations.

Capital flow considerations

One of the dramatic features of the past decade has been the massive international redeployment of current surpluses of particular nations through the world's private banking system.

Table 2

PERCENTAGE OF TOTAL EXPORTS FROM AND IMPORTS TO AUSTRALIA, 1982/83

Country	Australian exports	Australian imports
Japan	27.1	20.6
ASEAN	8.7	7.1
Other Asia	12.1	8.8
USA	10.1	21.8
EEC	14.0	20.1
Pacific	8.5	3.9
Other	19.5	17.7

Source: INDECS (1984), Table 6.5.

The very problem of the international debt crisis which that activity has led to indicates the imperfection of the information flows associated with international capital markets. Undoubtedly this, and the extent of current account imbalances, will change. Nevertheless, by tapping efficiently the financial resources of current account surplus, nations may be aided by the domestic presence of banks from that nation.

At least one commentator (Curtin, 1984) has suggested that the international importance of Japanese banks in the foreseeable future will continue to increase because of a prospective sustained large Japanese current account surplus. In his words:

> Japanese financial institutions stand to gain as the intermediaries of the Japan surplus and as the suppliers of the new world currency.

If such a forecast has credence, the case for a relatively large share of licences to Japanese banks would appear to have some merit.

Multinational servicing

As noted earlier, one of the contributors to growth of multinational banking has been the expansion of multinational business corporations. Not only will banks perceive benefits in their home market from providing worldwide service to these customers but they can be expected to offer some advantages over indigenous banks in servicing the needs of the multinationals in foreign markets.

Multinational servicing appears to be a major activity of foreign banks which have entered other overseas markets. Whether it yields benefits to the residents of those countries, as opposed to the multinationals and banks involved, is another matter.

In the case of Japanese banks, a particularly relevant issue warrants note. Japanese multinational business companies are significant in the Australian economy, and most importantly these companies have close links with Japanese banks. Indeed, one need only peruse the list of names in Table 1 to recognise that the bank-business link is of a different dimension to that familiar

(in fact, legally enforced) here. As the Bank of Japan (1978) explains:

> Following World War 11, the **zaibatsu**, or holding companies, were liquidated but subsequently each leading city bank has acted as the pivot to which the affiliated big business group is attached.

Less discreetly, the **Economist** (1983) noted:

> Japanese bankers and industrialists lie in the same bed.

Exactly how applications for licences from Japanese (or German) banks closely associated with multinationals operating in this country should be handled is a question which cannot be answered here. Given the 'arms-length' relationship expected in Australian banking by law and convention, it is obviously an important one.

Ownership and local equity participation

As noted earlier, the arguments for diversified ownership of individual banks weaken as the number of bank licences increases. A willingness by the government to support a large degree of ownership in a new entrant by a single foreign shareholder, however, must reflect different considerations (since only minor relaxation of ownership limitations on indigenous banks is contemplated). It reflects, presumably, the view outlined previously that capital, technology, and human skills involved in banking are transferred better as a package than independently and that social benefits accrue from economies reaped by

organisations operating as a worldwide entity, rather than as individual independent national organisations.

The requirement that successful applicants be constituted as a separate legal entity from their overseas owners (as entry via subsidiary rather than branch involves) might effectively reduce the number of these social benefits. On the other hand, greater impact is likely to arise from the requirement that foreign owners have less than complete control as implied by local equity participation. Whether these effects are significant is open to question, since ownership links would tend to enhance the nature and closeness of correspondent relationships between new banks and overseas parent.

Offsetting these effects is that of reduced parental ownership increasing the independence of a new entrant from the policy and decision making of its parent. Where complete parental control exists, decisions made (appropriately) on a global basis may be to the detriment of part of the organisation and the market that it serves. (The problems of transfer pricing of multinational business corporations are a case in point.) In this respect, requiring a substantial local equity participation may be an appropriate means of achieving some degree of independence.

Prudential liaison

One reason for requiring new entrants to the banking market to be a locally incorporated entity is to avoid problems arising from an intermingling of risks of the overseas parent and the local

offshoot. Where, for example, entity is allowed via the establishment of branches the question of national responsibility for prudential regulation and supervision is raised. Does the branch come under the regulatory responsibility of the authorities in the host country, the home country, neither, or both?

The problem of requiring establishment as a separate entity arises from the greater difficulties created for smooth exit from the local market should the venture prove unprofitable. Whereas branches can be wound up (or down) with relatively minor complications, for both the parent or the local authorities, this seems less true for a locally incorporated entity. A substantial difference to the insolvency of an ordinary firm is clearly involved here. Since the affiliation with an overseas parent will be well known, the supply of additional equity from that source can be expected to be somewhat elastic in order to prevent unwanted tarnishing of the parent's image by difficulties faced by the local entity. Should it become apparent that future profitability is an unlikely prospect, the difficulty of how exit can be achieved must be addressed. Unfortunately, the Australian government has refused to face up to this possibility (which has increased with deregulation, freer entry and overseas activities of the Australian banks), even in the case of our indigenous banks.

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Special characteristics

Although much of the discussion has focused upon the home country of possible applicant banks, it should be noted that many are already widely diversified internationally. In this respect, the current international diversification of applicants is a separate issue. Although the applicant's main activities may be in its home market, its entry can bring benefits via the extra links with other national markets. On this criterion, two countries, the USA and UK, appear to dominate, as Table 3 shows, with Japan easily the third largest nation represented abroad by its banks. Unfortunately, aggregate information of this sort tells us little about the international diversification of individual banks.

Given the government's explicit reference to employment opportunities in its announcement of application requirements,[11] Table 4 is also of interest. It shows the ratio of deposits per employee of the largest banks in various nations in 1983.

Underlying these dramatic differences is presumably the diversity in the nature or range of business conducted rather than differences in banking technology. The large Japanese banks, for example, have a strong emphasis upon wholesale business. Such an emphasis may also explain the remaining differences in Table 4. For example, international earnings (mainly from wholesale business) account for almost 50 per cent

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Table 3

PRESENCE OF BANKS OF SELECTED COUNTRIES ABROAD, 1981

Country	Branches plus subsidiaries	Representative offices
USA	1,801	n.a.
UK[a]	1,348	135
Japan	232	196
Germany	143	n.a.
France[b]	80	24
Netherlands[c]	172	13
Italy	65	140
Switzerland	70	n.a.

a 1982

b 1979, first column includes affiliates

c First column includes affiliates

Source: Pecchioli (1983), Table XXVII.

Table 4

BANK DEPOSITS/EMPLOYEE ($m)

Country	Largest	1983
Japan	Ten	5.77
USA	Five	1.34
UK	Four	0.78
Australia	Four	0.58

Source: **The Banker** (June 1984)

of total earnings of the ten largest US banks. (See Peccioli, 1983, Table 26.)

Local knowledge

Given the importance of information and knowledge in the provision of financial services, pre-existing local knowledge or the ability to rapidly acquire it would appear to be a pre-requisite for new banks to provide effective competition in a number of banking markets. Here a number of alternatives are apparent. New banks could draw upon local knowledge and skills acquired by previous operations in Australia as non-bank intermediaries. Alternatively, they could obtain this experience by links with an Australian operation which has an equity share.

To the extent that the first two of these alternatives are seen as substitutes for licensing purposes, Japanese banks would seem more dependent upon finding local partners than some of their competitors. Although many of the likely Japanese contenders are already involved in the Australian financial market (see Table 5 for a somewhat dated listing) their presence appears more limited than that of banks of some other nations.

As Table 6 indicates, a number of non-Japanese foreign banks have already a large fully-owned Australian non-bank subsidiary.

Table 5

JAPANESE BANK PRESENCE IN AUSTRALIAN FINANCIAL MARKETS, 1979

Japanese shareholder	%Share	Australian company	Assets ($m)
Bank of Tokyo	19.2	Beneficial Finance	394
Bank of Tokyo	33.3	Partnership Pacific	444
Mitsubishi Bank	25	A.I.F.C.	213
Dai Ichi Kangyo	10	B.A. Australia	239
Sanwa	33.3	Commercial Continental	103
Fuji	15	Euro-Pacific Finance	271
Tokai	21	Intermarine	75
Mitsui	13	Tricontinental	209

Source: AFSI, Interim Report (1980), Chapter 5.

Table 6

FOREIGN BANK FULLY OWNED SUBSIDIARIES IN AUSTRALIA, 1979

Foreign parent	Local financier	Assets ($m)
AVCO (USA)	AVCO	272
Beneficial Corporation (USA)	BFC	158
Barclays (UK)	Barclays Aust Finance	125
Citicorp (USA)	Citicorp	1,144
First National Chicago (USA)	First Chicago	414
National Westminster (UK)	Lombard Australia	403
Barclays (UK)	Barclays Aust Limited	283
Bankers Trust Co (USA)	BT	186
Hill Samuel (UK)	Hill Samuel	144
Lloyds (UK)	Lloyds International	138
Swiss Bank Corp (Sw)	SBC Australia	106

Source: AFSI Interim Report (1980), Chapter 5.

VI. CONCLUSION

Any outline of criteria relevant to selection among applicants for banking licences leaves unanswered the important issues of the appropriate weighting of each of the criteria and the number of applicants to be selected. These are issues which this paper has not sought to address.

Instead, the focus of the paper has been upon the following policy dilemma posed by foreign bank entry. The removal of barriers to competition across national boundaries in banking services has undoubted merit (one such barrier is the competitive benefits conferred upon domestically owned licence holders vis a vis unlicensed foreign-owned suppliers). On the other hand, the supply of licences by government is not a socially costless activity, so that in the absence of appropriate licence charges there is no guarantee that net benefits will flow to Australia from the licensing of foreign banks. Criteria for selection among applicants thus become necessary to ensure that positive net benefits flow to the community.

This dilemma (as well as that of ensuring a competitive financial system) arises from the special characteristics of bank licences and suggests several solutions. One is to change the characteristics of bank licences in order to avoid the dilemma. Those who advocate free entry into banking and explicit removal of any government 'guarantees' of banks are, essentially, advocating this solution.

The alternative solution, favoured by this author, rests upon the view that the special characteristics of banking services outlined in earlier sections justify some form of government-bank interrelationships and associated licensing requirements. Exactly what form the interrelationships should take (or what economic characteristics a banking licence should have and how the supply of licences should be determined) cannot be considered here.[12] If licensing is to prevail, however, one conclusion can be drawn - and forms the recommendation of this paper.

Large fees (certainly larger than currently apply) should be charged by the government for the supply of banking licences to both domestic and foreign holders. Such charges would offset the competitive advantage given by a licence for the supply of banking services and thus strengthen the position of unlicensed suppliers. If this path is followed, the temporary suspension (as of September 1984) of foreign investment guidelines limiting foreign ownership in merchant banking might well turn out to be a more effective way of increasing competition and trade in banking services than increasing the number of licensed suppliers.

NOTES

1. On September 1984 the Australian Government called for applications for banking licences which would be available to groups with a significant foreign ownership.

2. The announcement, also on 10 September 1984, of the temporary suspension of foreign investment requirements in respect of merchant banking has enhanced this option.

3. The flow of interest from borrower to lender, it should be noted, is treated as a transfer payment rather than as a component of national product. Some of the problems associated with measuring and allocating the imputed bank service charge figures are addressed in Covick (1982).

4. See Davis and Lewis (1982, section 5.3) for further discussion.

5. See, for example, the discussion in Pecchioli (1984, paras 3.39, 3.40).

6. There is, of course, an opposing effect whereby absence of exchange controls may encourage establishment not to service the local market but to provide a base from which to conduct international banking business. In this paper, however, the concern is not with offshore or eurocurrency activities and thus this effect is ignored.

7. Grubel (1983) discusses the appropriate measurement of these costs.

8. See, however, Davis (1984) for a discussion of the issues.

9. Where, however, equity sharing with smaller domestic partners is involved, constraints on the latter's ability to provide funding weaken the argument.

10. See OECD (1984, Table 1) for a listing of conditions regarding entry.

11. Notably, the **Australian Financial Review** carried on the same page as its report of the announcement of application conditions, a separate report about merchant banks obtaining special immigration approval for entry of 122 executives.

12. See Davis (1984) for a critique of the current characteristics of bank licences.

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