An Evaluation of Privatisations in Australian Banking and Insurance

Monica Keneley and Margaret Mckenzie

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Abstract

In the 1990s Australian governments, both federal and state, committed themselves to a policy of microeconomic reform of which privatisation of key government assets was a major component. Government owned banks and insurance offices were amongst the first institutions to be sold off. The results of this policy have been both complex and in cases unforeseen. Few of these privatised financial firms are in existence today. An information cost framework is used to evaluate the experience of privatised banks and insurers. This approach points to a dynamic process of organisational change within the financial sector that has influenced the outcome of the privatisation process in the financial sector.

JEL: G18, G21, G22, G34, O16

Keywords: privatisation, financial markets, banking and insurance, deregulation, information costs, organisational change

1 Introduction

Privatisation has been an important platform of government policy both in Australia and overseas. A driving force in the implementation of this policy has been the efficiency gains predicted to accrue with the change in ownership structures. It has been more than a decade since the wave of major privatisations occurred in Australia so it seems timely that a reappraisal of the policy is considered. It is the intention of this paper to initiate this process and investigate the outcomes in respect of the privatisation of bank and insurance institutions.

International studies of the impacts of privatisation in regard to banking suggest that it has been associated with improved performance (Megginson, Nash and Van Randenborgh, 1994; Megginson, 2005, p. 346). Such studies do not usually place the

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evaluation of outcomes within the environmental context of the privatising institutions. The approach taken in this paper is to identify the factors impacting on the financial sector and their implication for ownership structures.

Ten years after the major push to privatise government financial agencies very few are still in existence. In tracing the destiny of privatised financial firms it is intended to analyse the reasons for this trend. It is argued that whilst the impact of privatisation on individual enterprises may have been in many cases negative, taking the financial sector as a whole it has allowed the process of structural adjustment to proceed. That is privatisation has been an intrinsic part of the restructuring process within the financial sector.

In developing the central argument this paper will proceed by assessing the case for privatisation in terms of its relevance to the financial sector. It will locate financial institution privatisations in the context of policy regarding privatisation in Australia. It will then outline a theoretical framework for evaluating the environment in which the change in ownership structure occurred. It will analyse the position of government owned institutions within Australian financial markets. The institutional outcomes of the sell off of government owned banks and insurance institutions will then be appraised.

2 Privatisation policy and the financial sector.

The consequences of privatisation for Australian bank and insurance institutions cannot be understood without considering the environment in which the policy was implemented. Privatisation is usually taken to mean the sale or transfer of assets of state owned entities into private ownership (Domberger and Piggott, 1986, p. 56). It has come to be viewed as an intrinsic element of policies seeking to liberalise economies. It has been promoted as a source of efficiency gain for the enterprise, sector and economy. An underlying assumption in the case for the sale of government owned financial institutions was that they are by nature inefficient. Three key reasons have been put forward as to why this was the case. First, managers of government institutions are thought to have weaker incentives than those of privately owned firms and are less committed to maximising revenues and minimising costs. Second, government enterprises are not as strictly monitored as private enterprises and there are fewer effective methods for
disciplining managers. Third, government enterprises are inefficient because they are accountable to political interests rather than markets (Megginson, 2005, p. 315). On this basis, supporters of privatisation argue that the sale of government agencies will lead to more efficient outcomes.

In Australia, the rate of privatisation was accelerated with the implementation of microeconomic reform policy measures through the 1990s. Privatisation was incorporated as part of this program. The express purpose of microeconomic reform was to expose to competition those parts of the economy that had been shielded from it. It was argued that this would allow hitherto unexploited efficiencies to be realized at the microeconomic level leading to an improvement in the overall productivity in the economy.

In the case of Australia, privatisation has occurred in the context of the intention of microeconomic reform to widen markets beyond state and national borders. Many state owned enterprises, including the government banks, were limited to operation within statutory borders. One intention of privatisation was to address federal issues and open up these markets. National markets were also opened up to the extent that public asset sales were made to multinational companies, so that privatisation played a major and direct role in the integration of Australia’s capital into the international economy. This market widening in turn shaped the outcomes for those privatised institutions.

The pattern of privatisation has varied widely across sectors as have the regulatory arrangements for the privatised entities. Nowhere better illustrates the variety of circumstances, processes and outcomes for privatisation than the financial sector in Australia. The banking and insurance institutions were privatised in circumstances which were unique to the sector in which they were operating. Exponents of microeconomic reform in Australia have referred to these privatisations as examples of regulatory reform (Gerritson, 1992, pp. 32-33). This paper argues that with the process of structural change occurring in the financial sector, privatisation became inevitable. Governments found themselves in the position of being unable to sustain the capital investment required for state institutions to grow and compete in the emerging financial markets of the time. The sale of these enterprises provided a solution to this problem.
Measures to deregulate the financial sector commenced with the Committee of Inquiry into the Financial System (The Campbell Report, 1981). The recommendations of the inquiry presented a justification for the sale of state owned financial institutions. It was argued that these agencies should be assessed according to the principle of competitive neutrality. That is, their operation should not be competitively advantaged relative to private institutions. Under competitive neutrality, markets work most efficiently if participants have an equal opportunity to compete for business and equal access to information, and the incidence of regulation and taxation is neutral, impacting in a consistent way (The Campbell Report, 1981, p. 522). The Campbell Inquiry argued that the state owned institution should be evaluated to ensure that it was ‘filling a market gap in the most cost-effective way’ in a changing financial environment. Government institutions should be economically viable, operationally efficient and not cause market inefficiencies or distortions. If these conditions were not met consideration should be given to the sale of the enterprise (The Campbell Report, 1981, p. 802). Once the Campbell Report’s other recommendations had been implemented, especially those on the competitive structure of banking, there would cease to be justification on efficiency grounds for continued government ownership of banks. It was accepted however, that governments may wish, for various reasons, to continue to own and operate these institutions (The Campbell Report, 1981, p. 803).

The privatisation of the financial institutions commenced largely before the articulation of microeconomic reform as a coherent program occurred with the release of the National Competition Policy Review (The Hilmer Report, 1993) and Working Nation (1994). The Hilmer Report argued that the most systematic distortions to competitive neutrality arose when government businesses participated in competitive markets. Government businesses were often seen as enjoying a unique set of competitive advantages by virtue of their ownership, including exemption from tax (The Hilmer Report, 1993, p. 293). The report reinforced the argument that state owned financial institutions such as banks and insurers should operate in a competitively neutral environment. Where they did not, they should be subject to competitive neutrality reforms (The Hilmer Report, 1993, p. 298). Concerns over competitive neutrality could
be addressed in four main ways; privatisation, corporatisation, reform of sources of advantage and disadvantage, and pricing directions (The Hilmer Report, 1993, p. 300).

Analysis of the debate over the sale of government banks and insurers indicates that the proponents of privatisation paid lip service to these arguments (Victoria, Hansard, 1991, p. 1494). However examination of the circumstances and timing of sales indicates motives other than efficiency gains driving the process (State Bank NSW, 1990, p. 4). A second Inquiry into the Financial System (The Wallis Report, 1997) suggested as much when it pointed to the series of financial crises associated with government financial institutions which had occurred in the 1990s. It referred to the exit of government from ownership of financial institutions as ‘motivated by the desire of governments to exit commercial businesses’ and ‘prompted by losses in certain state government owned organisations and the resultant burden on taxpayers’ (The Wallis Report, 1997, p. 131). The sequencing of policy events indicates that financial privatisations were not undertaken as part of a concerted program of policy implementation. Rather, they were an opportunistic and ad hoc consequence of events arising in the financial markets and the economy.

3 Theoretical Framework
Various interpretative frameworks may be adopted to explain how the processes of industry change and restructuring influence institutional ownership structures. Kane (1984) offers one explanation for the adaptation of financial institutions to the changing environment in which they operate. Kane (1984, p. 760-63) argues that the fusion of financial institutions confirms the contestable market hypothesis which suggests that market structures adapt to promote the growth of economically efficient service providers. Technological developments create the potential for firms to reap economies of scope and this provides the incentive for financial institutions to move into other related markets. In this view regulatory intervention may act to impede the process of adaptation by imposing avoidance costs on firms. The concept of the regulatory dialectic is used to explain how firms respond to their regulatory environment (Kane, 1981). The implication of this type of analysis is that a reduction in the influence of government in
the market, say through the process of privatisation, will initiate further market restructuring.

An alternative line of inquiry is to consider market responses to changes in environmental factors with reference to an information cost approach. Such an approach suggests that the organisational structure adopted by the firm can be analysed as a rational response to information costs (Casson, 1997, p. 152). As information costs change, pressure is brought to bear on financial intermediaries to adapt. Organisational renewal is seen as a regular process within this model. Firms which do not evolve and adapt do not have a long term future (Casson, 1997, p. 168). The outcome of this model suggests that factors which impact on information costs will lead to organisational change. Technological and regulatory influences are two obvious factors affecting information costs. Accordingly this paper considers the impact of the rapid technological change in information processing on information costs in the financial sector. It also considers the extent to which regulatory controls influenced the market response to this trend. The progressive lifting of controls, particularly in the banking sector, throughout the 1980s and 1990s allowed the market to readjust. What evolved in the long term was a multi staged process of adaptation which has impacted on the broader financial sector, and had implications for the organisational structures of financial service providers.

The model of information costs is influenced by the new institutional theory of transaction costs. Transaction cost economics points to the reasons why firms adopt certain growth strategies such as vertical integration or diversification. The organization which develops is argued to be that which deals with transactions costs most efficiently. The problems of information asymmetry and bounded rationality contribute to the cost of transacting. Thus firms and market structures that can create effective transacting frameworks will be more efficient than those that cannot (Boyce and Ville, 2002, p. 19). Information costs are a more generalised form of transaction costs. They not only include costs associated with ensuring transactions are efficient and opportunistic behaviour is minimised, they also include the costs of collecting and processing information necessary for the firm to conduct its business (Casson, 1997, p. 151).

Much of the focus of studies which have applied a transaction cost analysis has been on the behaviour of firms providing physical goods. The centre of attention in this
respect has been on production and distribution. In considering the behaviour of firms providing services it is necessary to consider what types of qualifications are necessary to the prevailing orthodoxy. Financial services are a particular case in point as they represent the ultimate information intensive industry. The strategic behaviour of providers of financial services is to likely have a different emphasis than firms providing physical goods. In this respect the use of an information costs framework may be particularly applicable to the analysis of the strategies adopted by firms in the financial sector. Such a framework suggests that changes in organisational structures are driven by changes in the processes of intermediation. These in turn are a response to changes in information costs Casson (1997, pp. 151-53). The process is indicated in Figure 1.

![Figure 1: The Information Cost Model](image)

Two important influences on information costs are technological change and regulation. Whilst technological developments ultimately reduce information costs, regulation tends to impede the flow of information and raise costs in this model. The lifting of controls, in freeing up the market mechanism alters the nature of information costs. The new and different competitive influences that arise put pressure on the organisational structure of firms and markets. The lifting of regulatory controls at a time of rapid technological innovation will create an environment in which organisational change becomes inevitable. The demutualisation of major life insurers in the 1990s is an illustration of this. The privatisation of government owned banks and insurers could be argued to be another.

4 **Features of government owned financial institutions**

An appreciation of the place of government owned enterprises within the banking and insurance markets is necessary in developing an understanding of the outcomes of privatisation. Governments initially established state owned banks and insurance offices to provide particular services to the public. In respect to banks the emphasis was on the
provision of savings bank facilities. Insurance offices were initially established to provide workers compensation insurance and later compulsory third party insurance.

4.1 Government owned banks

Historically there was a division between the retail and wholesale services that banks now provide. This division was enshrined in the Banking Act that reinforced the distinction between savings banks and trading banks.¹ Government owned savings banks were established in the various colonies in the nineteenth century. The underlying motivation was to encourage savings amongst the ‘industrious classes’. The provision of services to business and the wealthier classes was left to the private sector. This distinction is significant. State owned banks came from a heritage of savings associations rather than commercial institutions. Moreover this system also imposed geographic boundaries on these banks as their spheres of influence were largely constrained to the states in which they were established.

The bank crashes of the 1890s increased support for a government owned national bank which would provide the security to depositors which was lacking in the private sector. The Commonwealth Bank was established in 1912. The distinguishing feature of the Commonwealth Bank was that it had both trading bank and savings bank departments and it was not restricted in its operation by state boundaries.² The Commonwealth Bank savings functions operated in direct competition with those of the state banks. A number of mergers occurred between these entities which contributed to the growing market share of the Commonwealth Bank. Table 1 details the mergers of government owned banks.

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¹ This division was not altered until 1989 when amendments to the Banking Act eliminated the distinction.
² The savings bank function of the Commonwealth Bank was given a more formal status when the Commonwealth Savings Bank was created in 1928.
TABLE 1
MERGERS OF GOVERNMENT OWNED BANKS

<table>
<thead>
<tr>
<th>State Owned Bank</th>
<th>Year of Merger With Commonwealth Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Savings Bank of Tasmania</td>
<td>1913</td>
</tr>
<tr>
<td>Queensland Government Savings Bank</td>
<td>1920</td>
</tr>
<tr>
<td>State Savings Bank W.A.</td>
<td>1931</td>
</tr>
<tr>
<td>Government Savings Bank of NSW</td>
<td>1931</td>
</tr>
<tr>
<td>State Bank of Victoria</td>
<td>1991</td>
</tr>
</tbody>
</table>

Compiled from Wallace (1964, pp. 238-43)

Merger activity gave the Commonwealth Bank a virtual monopoly on savings bank deposits in three states. It allowed it to expand its activities into each state on the back of already established facilities. In addition as banker to the federal government it benefited from the spin offs associated with government activities and the spread of the benefits payment system that led to an increase in new savings accounts and deposits. The Commonwealth bank rapidly grew to be the major savings bank in the country. Until the 1950s its major source of competition in the household savings market was from the remaining state banks and a limited number of non bank financial institutions which were also largely state based. In 1956 the first of the private trading banks opened savings banks subsidiaries. However it was not until the 1960s that the spread of private savings banks occurred.

Competition between banks occurred within the confines of a regulated banking sector. In this context information costs were heavily influenced by the nature of regulation. This in turn impacted on the process of intermediation and organisational structure. Regulation of Australian banks placed very rigid controls on the way they conducted their business. Regulation defined the boundaries within which the financial sector firms could operate. The ability of banks to operate in other financial markets such as insurance or credit finance was restricted. This led them to set up subsidiary arrangements in markets where direct activity was constrained. The competitive processes within the finance sector were redirected. Regulation fixed the market share of existing banks and reduced incentives for them to compete with each other (Lim and Valentine, 1985, pp. 57-58). In addition, restrictions to entry protected existing firms.
from competitive market forces. The regulatory environment provided little inducement for banks to react to changing global markets and technological forces.

4.2 Government Owned Insurance Offices

As with banks, government owned insurance offices were established on a state by state basis in the early decades of the twentieth century. The rationale for creating these offices was, by and large, to provide for compulsory insurances created by state legislation. Workers compensation legislation introduced by the various states was the initial driver, followed later by compulsory third party insurance. Between 1914 and 1927 the six states all established insurance offices. Unlike the banking sector there was no national insurance office and the provision of government insurance products remained firmly embedded in the state system until these offices were privatised in the 1990s.

A characteristic of insurance markets in Australia is that there are several distinct and differentiated sub markets determined by the classes of insurance provided. Understanding the place of government insurers in these markets gives an indication of how and why these firms evolved after privatisation. It is necessary in the first instance to differentiate between life and non life insurance. Life insurance has been, and continues to be separated from the provision of non life insurance.3 Within the non life insurance sector there are a number of classes of insurance including fire, general and marine insurance, motor vehicle, public liability, employee liability, and compulsory third party insurance. Whilst concentration in the insurance market as a whole has been typically low, in the various sub markets it has been much higher. Government insurance providers obtained a degree of market power in compulsory insurance markets in their respective states. By 1970 state insurers accounted for 59 per cent of the compulsory third party premiums and 24 per cent of workers compensation premiums. The proportion of total insurance premiums was around 20 per cent (Pursell, 1974, p. 218). With the exception of the Queensland government insurance office, state participation in other forms of insurance was limited in scope. It was not until the 1980s that state governments began to actively seek to expand these enterprises (Benjamin, 1993, p. 239).

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3 This distinction has a legal basis in the Life Insurance Act 1945 which requires that life insurance assets be held in separate statutory funds to other insurance business and that life insurers be registered.
Government insurance offices were constrained in their ability to grow by the nature of the insurance market and competitive forces within that market. Their major focus remained in the provision of compulsory insurances. Their ability to expand was also restricted by the geographic boundaries imposed by state legislation. They were unable to develop national markets for their products and so were limited in their ability to grow beyond a certain point. Despite this however, some insurance offices were more aggressively competitive than others. The Queensland government insurance office specifically, developed a culture of market expansion from an early stage in its history. Soon after its foundation it branched into fire and life insurance, followed later by marine and motor vehicle insurance (Thomis and Wales, 1986). Queensland was the only state in which the government office succeeded in accounting for more than 25 per cent of premium incomes in all types of non life insurance (Pursell, 1974, p. 218). The Queensland office was also one of the first to adopt a strategy of broadening its corporate base. In the 1970s it formed the SGIO Building Society as a result of a series of amalgamations of several Queensland Building societies. In the 1980s it acquired the Permanent Finance Corporation and along with it a major shareholding in the Bank of Queensland (Thomis and Wales, 1986, pp. 228-31). In adopting such a strategy the Queensland SGIO was emulating the approach taken by other financial institutions in expanding its sphere of influence. In doing so it had begun to build a diversified base upon which a privatised company could grow.

5 Deregulation of financial markets and its impact

The environment within which government owned banking and insurance offices operated was altered irrevocably with the progressive lifting of regulatory controls in the financial sector. With the opening up of the financial sector, barriers to entry and the segmentation of markets were reduced. The industry reorganisation that resulted from the lifting of restrictions led to the emergence of new institutions which no longer focused on the provision of one bundle of products, transforming the information costs and risk in widened markets.

Deregulation initiated a period of restructure within the financial sector. It did so because the change in the institutional environment in which financial firms operated
altered the nature of information costs. In removing restrictions, firms were better able to take advantage of the potential for economies of scope. Casson (1997, p. 155) argues that competition between intermediators tends to select in favour of those most successful in minimising information costs. The process of adjustment which occurred in the finance sector in the 1980s and 1990s supports this conclusion. However there was also an additional factor which altered the manner in which information costs impacted on intermediation and placed pressure on the existing organisational structure of the industry.

Concurrent with market adjustment inspired by deregulation, rapid technological development in the production and distribution of financial services impacted on the traditional providers of banking and insurance products. Through the decades of the 1980s and 1990s the provision of services was being revolutionised by advances in information processing. The outcome of this development was to change the nature of information costs which in turn placed pressure on the manner in which business was traditionally done. Changes in information costs led to changes in intermediation processes and resulting in pressure for organisational restructure. Table 2 explains how the process outlined in Figure 1 applied.

<table>
<thead>
<tr>
<th>Information Costs ⇒</th>
<th>Intermediation ⇒</th>
<th>Organisational Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>↓</td>
<td>Evolved as regulatory and technological changes impacted on the finance market</td>
<td>↓ Sale and demutualisation of traditional service providers in particular markets</td>
</tr>
<tr>
<td>Altered as deregulation and technological innovation reduced barriers to entry – increased potential for economies of scope</td>
<td>Promoted the spread of conglomerates and ‘allfinanz’ institutions</td>
<td>↓ Further adjustments within these markets as newly privatised firms react to competitive pressures - mergers and acquisitions</td>
</tr>
<tr>
<td>↓ Led to increased competition as other large financial institutions gained direct access to banking and insurance markets</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Harper (2000, p. 68) argued that financial intermediaries owe their existence to information asymmetry in that its presence impedes the ability of markets to operate efficiently. The reduction in information asymmetries resulting from the adoption of technological innovation has meant that financial intermediaries are in more direct
competition with financial markets. Financial institutions are forced to adapt to this shift. Those that do not adjust run the risk of failure and insolvency. This line of argument not only explains the pressure on organisational structures but the progressive rationalisation of the industry which occurred through the 1990s.

In the lead up to government exit from banking and insurance markets there were several identifiable trends which have some bearing on the context and effect of the sale of these assets. These trends were influenced both by the emerging financial environment after deregulation and the spread of information technology changes. Four main trends were identified by the Reserve Bank in its submission to the Financial System Inquiry of 1996. These were changing market share, product mobility and diversity and changes in the structure of financial firms (RBA, 1996, pp. 1-4).

Deregulation was associated with a change in the institutional structure of the financial system. The extent of this shift is evident in Table 3.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve Bank</td>
<td>8.0</td>
<td>6.7</td>
<td>3.3</td>
<td>3.7</td>
</tr>
<tr>
<td>Banks</td>
<td>38.7</td>
<td>37.8</td>
<td>42.7</td>
<td>44.2</td>
</tr>
<tr>
<td>Non Bank Financial Institutions</td>
<td>27.7</td>
<td>25.8</td>
<td>19.0</td>
<td>13.2</td>
</tr>
<tr>
<td>Life and Super Funds</td>
<td>17.2</td>
<td>18.0</td>
<td>20.7</td>
<td>25.5</td>
</tr>
<tr>
<td>Other Managed Funds</td>
<td>1.0</td>
<td>3.9</td>
<td>6.2</td>
<td>6.1</td>
</tr>
<tr>
<td>General Insurers</td>
<td>5.9</td>
<td>5.9</td>
<td>4.3</td>
<td>5.4</td>
</tr>
<tr>
<td>Other financial Institutions</td>
<td>1.6</td>
<td>1.9</td>
<td>3.7</td>
<td>1.9</td>
</tr>
</tbody>
</table>

Source: Collated from Davis, 1997, p. 11

From Table 3 the shift in market share of various financial intermediaries is evident. Banks have gained a greater share of industry assets but this has been at the expense of other types of deposit taking institutions. Managed funds, particularly life insurance and superannuation funds have increased their share of total assets. General insurance on the other hand has maintained a relatively static share of assets. Aggregates such as these can only give an indication of the trends in industry adjustment. Underlying this data is a
fundamental realignment of the financial sector. Part of the decline in non bank deposit institutions for example, is explained by the conversion of a number of these firms to banks. Likewise the relaxation of regulation was associated with an increase in the number of foreign banks in the market (Davis, 1997, p. 10; Edey and Gray, 1996, pp. 5-8). What is clear from the information in Table 3 is that there was a change in the composition of the financial sector throughout the 1980s and early 1990s as deregulation was progressively introduced.

Associated with the shifting structure of the financial sector was an increase in product mobility and diversity. Deregulation allowed financial institutions the scope to provide a greater and more diversified range of products. For example housing loans could be obtained from life insurance companies or mortgage brokers. Life insurance companies were also supplying savings products with very similar characteristics to term deposits (RBA, 1996, p. 2). Technological and market innovation provided the facilities for financial institutions to offer an increasing array of services to the customer. The result of this trend was to not only to increase the range of financial products. It also broke down the distinctions between financial firms and increased competition for the consumer’s dollar. These trends were not confined to changes taking place in the Australian financial system. They mirrored international trends in the growth and expansion of the financial services sector (Llewellyn, 1996, pp. 153-55).

Realignment in the financial sector in the 1990s was also associated with the rise of conglomerates. A popular strategy adopted by both banks and non bank financial institutions wishing to expand into other markets was to acquire an interest or a subsidiary in that market. Such trends were not new and had occurred in the 1950s and 1960s. At that time however the regulatory environment limited the approach to and extent of organisational change (Keneley, 2004, pp. 96-100). The dismantling of regulatory controls allowed the growth of financial conglomerates to proceed. The evolution of the “allfinanz” institution offering a full range of financial services gathered pace in the 1990s. The Reserve Bank (1996, p. 3) reported that by 1996 conglomerates accounted for around 80 per cent of financial system assets. The largest 25 held close to 70 per cent of assets.
The market trend both in Australia and overseas was for financial firms to become larger, spreading into other financial markets in a bid to take advantage of economies of scope and improve their competitive advantage. Establishing the place of government owned banks and insurers within this scenario explains why privatisation became an imperative and why so few of these institutions have survived in their original form. In this sense the sale of these assets may be seen as a necessary step in the process of structural adjustment within the financial sector. Table 4 summarises the position of government institutions in the Australian financial sector in 1990, just prior to the major period of privatisation which occurred between 1991 and 1997.

TABLE 4
THE RELATIVE POSITION OF GOVERNMENT OWNED INSTITUTIONS IN THE BANKING AND INSURANCE SECTOR 1990

<table>
<thead>
<tr>
<th>Sector</th>
<th>Total Assets $m 1990</th>
<th>% of Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>All Banks</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commonwealth</td>
<td>54088</td>
<td>16.6</td>
</tr>
<tr>
<td>State Bank NSW</td>
<td>15326</td>
<td>4.7</td>
</tr>
<tr>
<td>State Bank SA</td>
<td>14038</td>
<td>4.3</td>
</tr>
<tr>
<td>R&amp;I Bank WA</td>
<td>5955</td>
<td>1.8</td>
</tr>
<tr>
<td>State Bank of Victoria</td>
<td>19830</td>
<td>6.1</td>
</tr>
<tr>
<td><strong>General Insurers</strong></td>
<td>31623</td>
<td></td>
</tr>
<tr>
<td>Public sector insurers</td>
<td>14958</td>
<td>4.5*</td>
</tr>
</tbody>
</table>

* Average for six insurers. Data for individual insurers is not available.

As mentioned previously, with the exception of the Commonwealth Bank all the government institutions were state based. Whilst some operated in other states through agencies the focus of state based banks and insurers was within their state of origin. The extent to which this limited the ability of these institution to compete and expand in the emerging financial markets of the 1990s can be gauged by considering the number and location of branches government owned banks had as shown in Table 5. By comparison their major competitors, the privately owned domestic banks, had branches in every state.
Government owned insurers faced similar state based geographic constraints. In 1980 government owned insurers accounted for around one third of total premium income in Australia. However this was not distributed evenly between the different types of insurance cover. Although these insurers had extended their services into most types of insurance they were only limited players in these markets at a national level. The bulk of business done was still in workers compensation insurance where they accounted for 30 per cent of premium income in 1980. In all other markets they earned less than 20 per cent nationwide.\(^4\)

The system of government ownership of financial institutions which had emerged to fulfil particular market needs early in the twentieth century ill equipped these institutions to compete in the deregulated environment of the last decades of that century. Without the ability to move into new markets or expand capacity beyond traditional boundaries these organisations became less relevant in the emerging financial structure.

Pressure to compete and expand market share in a context of the growth of increasingly costly credit led some government owned institutions along a path of destruction. In the early 1990s several government owned banks got into trouble as a result of aggressive and risky lending policies. Large losses mounted as the economy slowed and the speculative asset bubble burst. The two most publicised cases were the losses that accrued from the lending activities of the State Bank of Victoria and the State

\(^4\) Camilleri (1986) provides the data upon which these proportions are derived.
Bank of South Australia. Factors contributing to the problems of these banks included the limited customer base and the rapid shift in the nature of the business of these banks (Gizycki and Lowe, 2000, p. 183). The Rural and Industries Bank also ran into trouble in 1991 but unlike the state banks of Victoria and South Australia it survived the experience (Newby, 1994, p. 17).

These examples serve to illustrate the problematic nature of state banking at a time when the pressures on traditional organisational structures were mounting and the financial sector was evolving rapidly. Without large injections of capital and the ability to expand and become conglomerates as their competitors were in the process of doing, these institutions faced extinction. The same was true of government insurers. The pressures felt in the banking sector were reflected in the insurance sector. The latter was entering a phase of organisational restructure as its market became incorporated into the ‘allfinanz’ trend sweeping national and international markets.

5 The privatisation and post privatisation experience

The experience of privatisation in the Australian financial sector indicates a dynamic process of adaptation and change. In most cases the sale of the government institution was followed fairly rapidly by further change in ownership or the organisational structure of the new enterprise. The information cost model provides an explanation of why this occurred. Changes in traditional methods of conducting business brought about by technological advance created an environment in which organisational structures were evolving. This was taking place over the same period that government offices were being sold off.

The sale of government owned banks and insurance offices began in September 1991 when the first tranche of shares in the Commonwealth Bank were offered to the public. Table 6 summarises the details of the privatisation of government banks and insurers.\(^5\)

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\(^5\) The State Bank of Victoria was not included in this table as it was acquired by the Commonwealth Bank prior to the sale of the latter.
### TABLE 6
THE PRIVATISATION OF GOVERNMENT OWNED BANKS AND INSURERS

<table>
<thead>
<tr>
<th>Institution</th>
<th>Year Established</th>
<th>Year Sold</th>
<th>Type of Sale</th>
<th>Price $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commonwealth Bank</td>
<td>1912</td>
<td>1991-97</td>
<td>Float</td>
<td>8138</td>
</tr>
<tr>
<td>State Bank NSW</td>
<td>1933</td>
<td>1994</td>
<td>Trade Sale</td>
<td>574</td>
</tr>
<tr>
<td>State Bank SA</td>
<td>1984</td>
<td>1992</td>
<td>Trade Sale</td>
<td>730</td>
</tr>
<tr>
<td>R&amp;I Bank WA</td>
<td>1895</td>
<td>1995</td>
<td>Trade Sale</td>
<td>900</td>
</tr>
<tr>
<td>NSW GIO</td>
<td>1927</td>
<td>1992</td>
<td>Float</td>
<td>1260</td>
</tr>
<tr>
<td>SIO Victoria</td>
<td>1914</td>
<td>1992</td>
<td>Trade Sale</td>
<td>125</td>
</tr>
<tr>
<td>Suncorp Qld</td>
<td>1916</td>
<td>1997</td>
<td>Float</td>
<td>1950</td>
</tr>
<tr>
<td>SGIC SA</td>
<td>1924</td>
<td>1996</td>
<td>Trade Sale</td>
<td>75</td>
</tr>
<tr>
<td>SGIO WA</td>
<td>1926</td>
<td>1993</td>
<td>Float</td>
<td>165</td>
</tr>
<tr>
<td>TGIO</td>
<td>1919</td>
<td>1995</td>
<td>Trade Sale</td>
<td>53.5</td>
</tr>
</tbody>
</table>

The majority of institutions were sold to other companies, with only three being publicly floated. In the case of the Commonwealth Bank four tranches of shares were offered to the public over a six year period. The fate of these newly privatised enterprises is outlined in Table 7. It is significant that only two have survived in their original form. The others have disappeared through the process of merger and acquisition that has been a characteristic of the Australian financial sector in the last decade.
TABLE 7
THE FATE OF PRIVATISED BANKS AND INSURERS

<table>
<thead>
<tr>
<th>Institution</th>
<th>Initial Outcome</th>
<th>Further Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commonwealth Bank Australia</td>
<td>Listed as Commonwealth Bank</td>
<td>Continues to trade as such</td>
</tr>
<tr>
<td></td>
<td>became Colonial State Bank</td>
<td></td>
</tr>
<tr>
<td>State Bank SA</td>
<td>Acquired by the Advance Bank</td>
<td>Advance Bank acquired by the St George Bank 1996 Delisted 13/5/1997</td>
</tr>
<tr>
<td>Bank of Western Australia</td>
<td>Acquired by the Bank of Scotland</td>
<td>Halifax acquired Bank of Scotland and all public shares in BankWest in 2001</td>
</tr>
<tr>
<td>(BankWest)</td>
<td>which offered 49% as public shares</td>
<td></td>
</tr>
<tr>
<td>NSW GIO</td>
<td>Listed as GIO Ltd and registered as a general insurer</td>
<td>Acquired by AMP in 1998 in a hostile takeover. Sold to Suncorp in 2001</td>
</tr>
<tr>
<td>SIO Victoria</td>
<td>Acquired by the GIO</td>
<td>Acquired by Suncorp Delisted 19/1/2000</td>
</tr>
<tr>
<td>Suncorp Qld</td>
<td>Listed as Suncorp-Metway Ltd</td>
<td>Continues to trade as such</td>
</tr>
<tr>
<td>SGIC SA</td>
<td>Sold to Legal and General and SGIO insurance. L&amp;G acquired the life and superannuation business, SGIO the general and health insurance business</td>
<td>Legal and General acquired by Colonial; SGIO acquired by NRMA (later IAG) in 1998. Delisted 25/1/2000</td>
</tr>
<tr>
<td>SGIO WA</td>
<td>Became SGIO Insurance and registered as a general insurer</td>
<td>Acquired by NRMA in 1998</td>
</tr>
<tr>
<td>TGIO</td>
<td>Acquired by Fortis Australia</td>
<td>Tasmanian business sold to the GIO in 1998</td>
</tr>
</tbody>
</table>

Table 7 reveals something of the nature of the problems which state based institutions faced in the competitive environment. To compete at a national level it was necessary to expand market share in each state. This required either the establishment of new offices in states where the company had not previously operated, or the acquisition of such infrastructure, or the development of strategic alliances with related companies. At the same time other financial institutions were looking to expand in a similar manner. The newly privatised enterprises were both predators and prey in this competitive environment.

Analysis of the operational history of privatised entities and the firms that acquired them gives an insight into why some enterprises survived in the competitive market and others did not. Given the limited extent of the Australian experience it is not possible to draw conclusions as to whether the method of sale (float/trade sale) had any substantial impact on the outcomes. Whilst the most successful appear to be those in which public share offerings were made, this cannot be said to be a necessary condition. A deeper analysis suggests that it was the corporate approach, strategies and performance...
of firms in the lead up to privatisation that had a significant bearing on the ability to
compete in the competitive market. In the case of both Suncorp and the CBA there had
been a culture of competition within the organisation. As mentioned previously, Suncorp
was one of the few government insurers that pursued a strategy of competing with private
insurers from an early date. During the 1970s and 1980s it had diversified into related
markets acquiring interests in building societies and finance companies. In the lead up to
privatisation the strategy was continued. The acquisition of the Metway Bank, gave it
greater access to banking facilities both in Queensland and interstate. Likewise the
merger of Suncorp with the Queensland Industry Development Corporation expanded its
influence in the commercial lending market. At the time of privatisation Suncorp had a
presence in a variety of financial markets. It built on this structure post privatisation,
extending into newly emerging markets such as mortgage securitisation as well as
consolidating its assets in retail and business banking and insurance.

The Commonwealth Bank also went through a restructuring process in the 1980s
which allowed it to implement a strategy of expansion and development in both products
and markets. In 1980 the range of products available to customers was fairly limited, and
related investment services were offered through the bank’s subsidiary companies
specialising in finance and merchant banking. At the same time it was able to benefit
from its large share of retail business nationally. By 1990 the range of services available
to households had more than doubled. Dealings in related markets had expanded and the
bank had established subsidiaries in life insurance and superannuation as well as fund
management (CBA, 1991, p. 47). In the case of the CBA its size and presence in all states
was also a significant factor in its success.

Both companies that successfully negotiated the privatisation process had
established a diversified business network prior to sale and were well positioned to
compete in major financial markets. Apart from the restrictions imposed by the
geographic limitations of government owned banks and insurers there are no common
characteristics associated with those companies that did not survive the adjustment
process. Several identifiable factors however, may have influenced the outcome. Both
Colonial which acquired the State Bank of NSW and Advance Bank which acquired the
State Bank of South Australia had recent history as mutual associations. Mutual associations were limited in their ability to raise the necessary capital for expansion. This was one of the major triggers for the wave of demutualisations that occurred in the 1990s. Upon demutualisation, firms went through a period of transition and experienced erratic performance outcomes (Keneley, 2002, p. 78). This occurred at the time the NSW state bank was acquired by Colonial. The former mutual structure may have made these companies vulnerable but it was the wave of merger activity in the banking sector in the mid 1990s that accounted for their demise. Merger activity increased as competition intensified in response to changing forms of intermediation.

The GIO in NSW and the SGIO in Western Australia were privatised through the issue of shares to the public. After an initial period of success these companies fell victim to takeover bids. Within six years of listing on the Australian stock exchange they had been absorbed by other insurers. The common characteristic of these companies was that their core business market had been restricted historically by state boundaries. Like Suncorp, these firms pursued a strategy of diversification prior to privatisation. However they were not in as strong a position when privatisation occurred. The GIO for example had developed a group structure which incorporated financial and asset management services (GIO, 1990). However exposure in other states apart from NSW was being built up from a very limited base. Whilst the process of building customer bases in other states began before privatisation, it was in the years immediately after that the push to expand gained momentum. This occurred at a time when the underwriting performance of the general insurance sector was volatile. Underwriting losses had been experienced over a number of years during the 1990s (APRA, 1996-2000). Competitive pressures were identified as a factor contributing to losses and were a major issue for firms such as the GIO in this market (GIO, 1995). Losses experienced in the general insurance market made these firms susceptible at a time of significant outlay in an effort to build market share in that area.

The TGIO and BankWest were the only two privatised entities that were acquired by a majority overseas interest. In both these cases it was international considerations that

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6 Colonial was formed with the demutualisation of the Colonial Mutual Life Assurance Society in 1996. The Advance Bank was the product of the demutualisation of the NSW Permanent Building Society in 1985.
led to the further sale or merger of these companies. TGIO was sold to Fortis Australia, a subsidiary of Fortis, a Dutch banking and insurance company. The Tasmanian insurance business was sold in 1998 to GIO as a result of a company restructuring leading to a greater emphasis on the company’s European business. BankWest became part of HBOS after the merger of Halifax with the Bank of Scotland in 2001. The new company acquired all publicly listed shares in BankWest after that date. In the case of the TGIO and BankWest it was merger activity in the European and Scottish financial markets rather than local restructuring pressures that initiated further changes in ownership.

The post privatisation history of government owned banks and insurance companies illustrates the dynamic nature of the process of organisational change within the financial sector. This process, driven by the need to adapt to the changing nature of information costs in a deregulated market undergoing rapid technological change, was the overriding influence on the outcome of the sale of government owned assets in this sector.

6 Conclusion

The deregulation of the Australian financial sector in the last two decades initiated a process of structural and organisational change. The privatisation of government owned financial institutions in the 1990s was an important and inevitable part of this development. Using an information cost framework it is possible to evaluate the outcome of this change. This theoretical framework suggests that factors that impact on information costs will lead to organisational change. The two most significant factors impacting on information costs in the banking and insurance sector were technological innovation, and changes to regulation. Whilst technological change reduced information costs, regulatory controls impeded the response by the government owned institutions to this trend. The process of deregulation in reducing barriers to entry into this industry altered the manner in which information costs impacted on financial markets. The concurrent advances in information processing and marketing of financial products changed the nature of information costs. The result was the transformation of financial markets and the emergence of new financial institutions offering a diverse range of products to consumers. A characteristic of this process was the pressure on merger and
acquisition as financial firms sought to expand market share and reap the economies of scope made possible by technological innovation. It was within this context that state and federal governments embarked on a process of privatisation.

The position of government owned banks and insurers prior to privatisation had an important bearing on the outcome of the process. With one exception these institutions had been limited in their ability to develop and grow market share in their core business by the geographic limits of the respective regulatory jurisdiction. With a few exceptions they were slow to move into new product markets and develop a competitive culture. A characteristic of the most successful privatised firms was that they had effectively pursued a strategy of diversification prior to privatisation. Those firms that were not able to establish market share in related financial markets prior to privatisation battled to do so in the financial climate of the mid 1990s. Privatised banks and insurers were by and large ill equipped to compete with the changing nature of financial intermediation and its implications for the organisational structure of financial markets. Acquisition and takeover was an inevitable result as these markets continued the restructuring process.

The experience of privatised banks and insurers illustrates the complex and in some cases unforeseen impacts that regulatory and deregulatory policies have on the nature of financial markets. When these policies are implemented in times of rapid technological innovation the outcomes are even more involved and difficult to predict. The information cost approach provides a useful format for understanding and interpreting this complicated process of change.
REFERENCES


