

# **Community Banking in Australia**

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**T**he general public has expressed a great deal of dissatisfaction with Australia's major banks. A particular manifestation of this dissatisfaction has been customers' anger about the closure of bank branches in both rural and suburban centres (1706 bank branches in Australia were closed between June 1993 and June 1999). The banks for their part have pointed out that customers are increasingly making use of electronic banking, which has reduced the need to maintain branch networks. The banks have also argued that they must reduce their operating costs in order to ward off the threat of further low cost entrants, such as the mortgage originators, who presumably will be unencumbered by expensive, labour intensive branch networks.

One bank, the Bendigo Bank, is experimenting with franchising its branch operations as a means of keeping branches open but without sacrificing its own profitability. These so called 'community banks' have sprung up in various parts of the country. The purpose of this paper is to analyse the legal, regulatory and economic implications of the Bendigo Bank's franchised community bank branches in order to understand the role that they may possibly play in the Australian financial system and determine if franchise banking has a future in Australia.

In the first section the present and past structure of Australia's deposit-taking institutions is examined in order to understand the context in which the franchised community bank branches operate. In the second section the basic structure of the franchised banks, as associated with the Bendigo Bank, is discussed. The following section analyses the economic implications of different ownership structures with reference to the Bendigo Bank and its franchisees. Finally the future prospects of franchise banking are discussed.

## **The Structure of Australia's Financial System.**

The community bank branches are operating in a banking climate that has reached an advanced stage of development. In Australia, commercial banks are the major type of deposit taking institution — both in terms of their individual size and their market share. The share of the financial assets and deposits held by the banks has risen since the deregulation of the banking sector in the early 1980s. In 1983 the banks accounted for 43 per cent of assets and 88 per cent of deposits. By 1997/98

these figures had risen to 49 per cent of Australian financial assets and 93 per cent of deposits.<sup>1</sup>

The other types of Australian deposit taking institutions besides the banks are the credit unions and the building societies, both of which have traditionally had a mutual form of ownership. The building societies accounted for 10 per cent of financial assets on the eve of bank deregulation, but since then their share of assets has fallen to only 1.6 per cent in 1997/98 (*Reserve Bank Bulletin*). Much of the decline in the importance of the building societies can be explained by the conversion of the largest building societies to banks. During the late 1980s and 1990s there were regulatory incentives for the building societies to obtain a bank licence as it provided them with access to the payments system and the prudential regulation of the Reserve Bank. Between 1980 and 1998 the number of building societies in Australia fell from 113 to 21, only three of which have retained their mutual status (Weerasooria, 1993; AFIC 1998). In the process of converting to banks the building societies lost their mutual status and were required to become stockholder-owned companies. Demutualisation — the shedding of mutuality for shareholder ownership — has been a global phenomenon and is not limited to deposit taking institutions like the building societies. In the United States more than 1,000 mutual thrifts (savings and loans) have converted in the last 20 years (Hemmings and Siler, 1995) while the demutualisation of insurance companies has also become widespread in the United States and elsewhere.

In contrast to the banks and building societies, the credit unions have a relatively short history, having developed since the end of the Second World War. Today credit unions, or credit cooperatives as they are sometimes known, have maintained their mutual status, unlike the building societies (Lewis and Wallace, 1993). Credit unions arose in order to encourage thrift among a group of people with a common bond of association, such as religious, occupational or geographic locality. With the conversion to stock ownership by the majority of building societies, credit unions are the only remaining significant deposit-taking institutions with mutual status in Australia. Immediately after bank deregulation, credit unions lost market share in the face of intensified competition and their share of deposits fell from 5.6 per cent in 1986 to 3.9 per cent in 1989. During the 1990s they regained some of this ground with an average growth in their assets of 7-12 per cent per annum compared to an average 5.7 per cent per annum for the banks (*Reserve Bank Bulletin*, 1991-1998). Today credit unions may only account for 4.4 per cent of deposits but their large membership shows that they are an important alternative to the banks for many ordinary depositors — 3.5 million members in 1997 (AFIC, 1996/97). Besides their continued existence and consolidation in the market the other striking characteristic of the credit unions has been their fall in number. The number of credit unions reached a peak level in the 1970s at 700, but by 1998 that number has fallen to 245. Many smaller credit

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<sup>1</sup> In this case financial institutions refers to banks, credit unions, building societies, money market corporations, general financiers, life insurance offices, superannuation funds, approved deposit funds, cash management trusts, public unit trusts, common funds, public unit trusts, pastoral financiers and finance companies.

unions have found independent existence in the modern financial world too difficult and have merged with other credit unions (AFIC, 1998).

Since the deregulation of the banking system in the early 1980s there has been a large increase in the number of banks at the wholesale level but at the retail level depositors have seen a steady concentration of financial institutions. At present 61 per cent of deposits in Australia is held by the four main commercial banks (Westpac, ANZ, National Australia and the Commonwealth Bank). Through the 1980s and 1990s there has been a succession of mergers. The first round occurred in the early 1980s when the National Australia and Westpac banks were created from bank mergers. The state banks disappeared in the late 1980s and early 1990s and finally the major building societies converted to bank status before being swallowed up in takeover bids. With the rationalisation in the number of banks and building societies, and the move toward electronic banking, the need to maintain the labour intensive bank branch networks has become less necessary. Since 1993 when the number of bank branches in Australia peaked at 7,064, branch numbers have fallen to 5,358 (June 1999). The number of credit union branches has also declined as a result of credit union amalgamations. The closure of the bank branches has helped to create a gap in the market. Many discontented bank customers, especially small business owners, who would in the past have turned to a state bank, building society or credit union, are looking for alternatives.

The first franchised bank branch opened in Rupanyup/Minyip in Victoria in June 1998, with others following in Upwey in Melbourne, Lang Lang, Avoca, Maldon, and Toora in Victoria, as well as Henty, Wentworth and Coleambally in New South Wales. By April 2000 twenty-one community franchise bank branches had opened, the bulk of them in Victoria (thirteen), with three in New South Wales, four in Western Australia and one in South Australia. It has been reported that groups in more than 120 country towns have discussed the possibility of opening franchised community bank branches (*Sunday Herald Sun*, 1998). One of the surprising elements of the move has been the interest shown by bank customers in suburban areas as well as those in more isolated country areas. Small traders in particular seem to be the driving force behind the efforts of suburban and country communities to establish community bank branches.

## Community Banks

In Australia the Bendigo Bank (formerly the Bendigo Building Society) has pioneered the 'community banking' concept. Community bank branches differ from credit unions and from orthodox bank branches in that they do not directly retail financial services, but are franchisees of the services of another financial institution. A brief history of the Bendigo Bank helps to explain why this small regional bank has successfully launched the first franchised banking business. Bendigo Bank had its origins on the Bendigo goldfields in 1858 as one of Australia's first building societies. Since then it has continued to grow steadily, declaring profits in each year of its operation, even through the financial crises of

the 1890s and 1930s. Over the past twenty years it participated in a number of mergers with other financial firms culminating in the conversion of the building society to a bank on 1 July 1995.<sup>2</sup> Bendigo Bank now operates 75 branches throughout Victoria, southern New South Wales (Albury and Deniliquin,). It has assets in excess of \$52.6 billion, is listed on the Australian Stock Exchange and is Australia's only bank headquartered outside a capital city. A key feature of this institution has been its strong links to its local community. This strong community spirit has persisted despite the demutualisation process and subsequent listing on the stock exchange, fostered by the fact that there are no institutional shareholders and one-third of the share register are local Bendigo residents.<sup>3</sup>

Bendigo Bank sees 'community banking' as a way of expanding its operations in rural and suburban Victoria as well as into other states where it has little presence. The Western Australia Government provides dollar for dollar support for the undertaking of feasibility studies by banks interested in establishing community banks (*Australian Financial Review*, 1998) — three community bank branches had opened in Western Australia at Kulin, Goomalling and Tambellup/Cranbrook by the end of 1999 and a fourth, Toodyay, opened in March 2000. An independent adviser appointed by the community banking steering committee undertakes these feasibility studies and a favourable result is mandatory before the community raises the required funds necessary to proceed. The Queensland Government has expressed an interest in providing assistance to the Bendigo Bank to extend its franchising operations into rural Queensland and the ANZ Banking Group and Bank of Melbourne-Westpac have also expressed interest in supporting similar schemes. Government assistance seems unnecessary given that a large number of communities have already had the motivation and means, especially in Victoria where no government assistance has been forthcoming, to investigate the possibility of establishing a bank branch franchise in their locality.

A community bank, as sponsored by Bendigo Bank, is a franchise branch of the Bendigo Bank. It is a legal entity 100 per cent owned by a community group of citizens or businesses in its operating locality. The franchise agreement with Bendigo Bank provides for income, before deduction of branch operating costs, to be split 50-50. The first wave of companies formed as community bank branches were legally limited by guarantee, with shareholder liability limited to the amount of capital invested. One community bank branch (Avoca) chose a co-operative structure. The last dozen community bank branches formed are public companies limited by shares. This is the only option now given by Bendigo Bank. The franchisee contracts with Bendigo Bank to provide the latter's usual range of financial services.

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<sup>2</sup> Bendigo Building Society mergers include the Bendigo and Eaglehawk Star (1978), Sandhurst (1983), Sunraysia (1985), Capital (1992) and Compass (1992). Trustee company Sandhurst Trustees (1991), mortgage securitisation firm National Mortgage Market Corporation (1995) and Monte De Paschi Australia Limited (1997).

<sup>3</sup> Information provided by O. Davies, (Communications Manager, Bendigo Bank).

The community bank branches possess some of the characteristics of traditional credit unions. Just like credit unions, shareholders of the branches are entitled to only one vote. Also although they are not mutuals in the sense that depositors are necessarily shareholders, in the case of those established so far there is a heavy overlap of the owners and customers. The franchise arrangement provides a key advantage, as with all bank deposits, that depositors are protected by Bendigo Bank. This means that any loans made by the community bank branch sits on the Bendigo Bank's balance sheet. The community bank receives an income stream from these assets and has no role in setting deposit/loan rates and other fees. The Bendigo Bank, therefore, carries the credit risk, although the pledge money (shareholdings) is at risk as in any business. Bendigo Bank also makes all credit decisions and protects individual client privacy. Although the Bendigo Bank must approve all loans made, loan decisions for community bank branches are approved the same day. The Bank places considerable weight on the recommendations of the community branch managers.

A franchised community bank branch originates when a steering committee, usually formed by local businesses, approaches Bendigo Bank with a business plan to set up a branch. Once that has been approved the steering committee ratifies selection of a Board which then forms the banking entity and determines its organisational structure. The members pay a once-off franchise fee (\$250,000 – \$350,000) which entitles them to the right to run a banking branch. In return the Bendigo Bank provides the banking framework and infrastructure, the name, bank licence, capital adequacy, and support in the form of start up assistance, staff training, administration, legal checks, credit assessments and marketing of the new entity. The community bank branch also gets an exclusivity clause that no other Bendigo Bank franchise can set up within a five-kilometre radius. After the franchised branch is operating shareholders may elect to have their pledge money repaid from profits or alternatively earn a 'dividend' or return on the monies. A board of management, of between eight and ten members, manages the branch with day-to-day running coordinated by a director and usually two customer service representatives.

At the present stage of their operations, the original twenty-one community bank branches have achieved their primary goal of covering their operating expenses, while eight are at break-even point.<sup>4</sup> In the local communities in which they operate, market penetration has been very high. The Rupanyup and Minyip branch (the first opened) which serves a combined local population of 1,100 opened 843 accounts in its first six months with almost 200 investors contributing funds to raise the \$250,000. If immediate family members were counted as part of the pledge, 700 of the 1,100 population have a direct stake in their bank.<sup>5</sup> After twelve months of operation the Rupanyup/Minyip branch has managed to cover its operating expenses and is distributing surpluses to shareholders. In Melbourne the Upwey branch opened in October 1998 and has more than 2,000 customers and

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<sup>4</sup> Information supplied by Simon Cornwall, Bendigo Bank, April, 2000.

<sup>5</sup> Information provided by O. Davies, (Communications Manager, Bendigo Bank).

deposits worth \$16 million.<sup>6</sup> After a year of operations it was operating with a monthly average surplus of \$10,000. Despite their size, these small community bank branches are able to offer a full range of financial services as Bendigo Bank provides the 'back-office functions' on a cost-effective basis. These 'parent bank' functions allow them to provide services on a competitive basis with other banks. A successful strategy to assist in obtaining a critical mass of business has been for the branches to waive loan establishment fees for customers switching loan business from other banks. This is for a limited period of time, usually three months (extended to six months in Upwey's case).

### **Franchising and Mutuality — Economic Implications of Different Ownership Structures**

In recent years franchising arrangements have become an increasingly important method of retail distribution. The success of franchising in a number of fields suggests that it is a form of retail distribution that offers some commercial advantages over a vertically integrated firm. An economic analysis of franchising suggests it is a hybrid organisational form lying between the extremes of markets and hierarchies that can follow either a business format or a simple dealership model (Cline, 1989). Bendigo Bank's franchising complies with a business format, whereby the franchisor supplies a brand name (Bendigo Bank 'name association' and Bendigo Bank products), a model business plan for the franchisee to copy, continuous transfer of 'know-how' and regular technical assistance. Bendigo Bank utilises 'plural forms' of organisational control mechanisms to undertake similar functions — both company-owned branch networks and franchisee-owned outlets (corporately-managed but independently-owned community banks).

Franchising theory has developed from agency theory and transaction cost economics which can be traced back to Coase's (1937) theory of the firm and Williamson's (1971 and 1988) extension. Traditional arguments about the capital-structure function of franchising have been the most common explanation of the success, namely that franchising can help to overcome capital constraints (Ozanne and Hunt, 1971; Caves and Murphy, 1976; Mendelsohn, 1985). Rubin (1990) emphatically argues that this makes no sense unless we assume that the franchisor is more risk averse than the franchisee. This he argues is implausible given that franchisees normally sink their personal wealth into a business. A more efficient way to raise capital is to sell shares in an entity that owns part of both the old and new enterprises. According to Rubin franchising is only justified if there are other non-capital benefits such as retail and local effort. In the case of the Bendigo Bank's franchised community bank branches, the capital arguments might provide part of the explanation for franchising as it is able to make use of financial resources of a local community for the financing of expansion into regions that would be regarded as risky ventures. Local community action is important not

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<sup>6</sup> Information provided by Peter Marks (Director, Upwey Community Bank).

just in raising capital for the formation of the bank, but is also important in conferring the benefits of franchising. They include low search costs, superior local knowledge about markets, the availability of a more highly motivated, non-unionised workforce, and marketing of services relative to the franchisor (Mathewson and Winter, 1985; Minkler, 1992).

Brickley and Dark (1987), Norton (1988), Brickley, Dark and Weisbach (1991) and Lafontaine (1992) argue that organisational costs are the main driving force behind franchising. Empirical work in the first two studies supports the importance of geographical dispersion in the franchising decision. Geographical dispersion of Bendigo Bank franchisees extends across four states (Victoria, New South Wales, Western Australia and South Australia). Agency-based theories of franchising emphasise monitoring problems connected with hidden information or hidden actions. Distance from the head office might make monitoring more difficult. A key benefit from franchising is the creation of additional incentives. Profit sharing provides such incentives in the form of dual benefits for both franchisor and franchisee, ensuring sufficient monitoring by the former and efficient management by the latter. Franchising provides the advantage of 'built-in' quality control because the franchisee only sells Bendigo Bank products. This provides the additional benefit of allowing the franchisor to structure profits in relation to costs.

A distinguishing feature of bank branch franchising, setting it apart from normal franchising, is that community ownership replaces the usual independent ownership. Community banking, although strictly speaking not conducted on a mutual basis, possesses some of the advantages traditionally associated with mutual financial organisations. They also possess many of the advantages and disadvantages that are associated with franchising more generally, as discussed above. The basic advantage associated with mutuality is that it provides a contractual solution to information costs (Akerlof, 1970; Hansmann, 1985). Various types of groups bound by a common interest (such as occupation, religious, recreational or location) have been accepted as appropriate for mutual credit unions and building societies. The common bond restriction on credit union membership can reduce the cost of gathering credit information and therefore reduce the likelihood of bad debt losses. The greater knowledge of the parties involved in the financial transaction — in particular, knowledge of the borrower by the lending party — provides an effective response to the problems of adverse selection and moral hazard. This contention is supported by credit union records in the United States where 'nationally, credit union delinquency rates on loans are at least one-third less than the delinquency rates at banks' (Garlock, 1991). Similarly, the mutual building societies in the United Kingdom have had less repossession of houses from troubled borrowers than banks (The Economist, 1994). Also, there is strong evidence that when life insurance first began to be marketed in the United States in the nineteenth century, the mutual form arose precisely to deal with contracting uncertainty (Hansmann, 1985).

Presumably the community bank branches will enjoy most of the advantages that accrue from the tight common bond of the shareholders and depositors living

in a close knit community that are traditionally associated with small, mutual building societies and credit unions. This would be especially true for those in rural centres. Davis (1997:323) points out that as well as the advantages accruing from information benefits, credit unions with a strong common bond also 'provide a form of bonding mechanism among borrowers, who will therefore be less willing to default on obligations to the co-operative and thus their fellow members'. This view is supported by Kane and Hendershott (1994) who note characteristics of the structure of credit unions that have some relevance for franchise banking as practised by the Bendigo Bank. First, they note the likelihood for increased monitoring because common bonds may enhance information flows and volunteers and sponsors, who contribute time and resources, have incentives to monitor management. Second, the use of outside sureties that have strong incentives to monitor has enhanced bonding of credit union management and boards. Presumably community bank branches, especially those in rural centres, will be assisted by this phenomenon.

### **Future Prospects**

The characteristic features of a good franchise operation are: extensive training and support; site approval and design; set hours of operation; set accounting procedures; an established marketing/promotional plan; and protection against encroachment within its own system by the inclusion of exclusivity clauses. The essential element is a comprehensive plan to succeed. Bendigo Bank's franchising plan meets all these features. A comprehensive campaign strategy is provided that details every step that must be taken and backs it up with physical support from 'remote banking' personnel.

Despite these positive features community bank branches will have to overcome a number of problems if they are going to survive. The problems associated with risk concentration and liquidity concentration could be potential threats to their survival, especially in rural centres. Many of the small rural centres where community bank branches have been, or are planned to be, established depend on a limited range of rural activities. A sharp collapse in specific rural commodity prices and subsequently farmer's income in these regions, or alternatively drought conditions, could put many of these institutions under a great deal of strain. The banks that operated branches in these places in the past were able to pool the risk of heavy involvement in rural activity in a particular region with its lending activities elsewhere. It appears inevitable that some, or possibly all, of the rural community bank branches will be subject in the future to the stresses of fluctuations in rural incomes. It will be interesting to see the degree of commitment of the sponsor institution to those franchises that suffer from the consequences of falls in commodity prices.

Another problem is that of adverse selection. Many observers have expressed concern that credit unions have in recent times been subject to a form of adverse selection, in that they attract customers shunned by the banks. This is another potentially dangerous problem for community banking — possibly even a fatal

one. Community bank branches arise to take the place of bank branches that the banks have decided to close. In many cases banks have withdrawn from centres because custom has fallen to a level where it is simply not commercially viable to provide direct banking facilities. Some centres have experienced a decline in population in recent years, or alternatively customers have conducted more of their banking business either at larger regional centres (larger country towns or suburban shopping centres) or through electronic transfers. Where branches have been closed because of a decline in bank business, community banking will find it difficult to survive. Obviously, a community bank branch will have to encourage greater amounts of quality custom, as well as restrain costs relative to normal commercial bank branches. In these circumstances they will have to take full advantage of all of the benefits that a close-knit organisation possesses if they are to survive and prosper.

## **Conclusion**

Bendigo Bank may choose to have either a branch network or independent franchises for expansion. The choice does not rest on capital considerations. Whether to use franchising or ownership rests on complex issues relating to incentives for efficient operation and control of quality. The benefits of franchising in geographically dispersed locations cannot be understated for franchise banking. The key disadvantages are loss of control for Bendigo Bank and the manager-owner problems that have plagued other mutual deposit-taking institutions in the past.

Community franchise banking is currently enjoying public favour and has added approximately \$100 million of new banking business to Bendigo Bank in 1999.<sup>7</sup> Community franchise banking has provided the means for small rural and urban communities to have a return of banking services and control over the banking destiny within their community. They will have their own bank branch from which their communities can actually profit as their share of profits are retained for reinvestment back into their own district.

In the long run it is probably technical change that will determine if community franchise banking, with its emphasis on face to face customer service, will survive. With the continued expansion of electronic, phone and Internet banking, as well as electronic transactions, it is possible that branch banking as Australians have known it for the last one hundred years may disappear, taking the community bank branches with it.

In the short term it appears that many people, especially small traders, still have a strong demand for branch banking services that can not easily be replaced by electronic alternatives. This is particularly true in small country towns where the loss of branches is a much greater inconvenience than in other places and where the common bond of living in a close knit community is of relevance. The

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<sup>7</sup> Information provided by P Marks, Director, Upwey Community Bank.

survival of community franchise banks, therefore, will depend on their ability to take full advantages of the benefits that flow from community involvement.

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*The views expressed in this paper are not necessarily those of the employers of the authors. The authors wish to thank Bendigo Bank for their help in providing information regarding the franchised community bank branches. The authors are grateful for useful comments from anonymous referees.*

