BANKING COMPETITION INQUIRY

SUBMISSION TO SENATE ECONOMICS COMMITTEE: PETER MAIR

LET'S TALK TURKEY AGAIN

By way of an overview, the Committee's brief envisages stimulating competition in the retail banking industry. A complementary focus includes the broader market environment, especially the state of play with competition for related financial services – not least superannuation investment facilities. There are issues about deposit taking; retail payments operations; fees and charges and especially the growing importance of superannuation funds for investment in public infrastructure and securitized long–term loans, including for housing.

It will be helpful if this Committee deals frankly and forthrightly with some fundamental regulatory flaws distorting the retail financial system. These flaws have their foundations in long-standing failures of regulatory will – and that judgment explains the*, let's talk turkey again,* sub-title. Those wanting to restore some semblance of competition to the retail financial services arena will need to address some difficult issues that other, like inquiries, have not.

Prologue

A decade and more since the Wallis Inquiry – and three since Campbell – an inquiry into the retail financial services arena is well overdue. Restoring some semblance of competition and fair play to markets for retail financial services is the challenge.

A backlog of outstanding matters needs attention, not least by the industry and its regulators, to assist the committee reporting to the parliament and to the wider community. The risk, as usual, is a 'bandaid' outcome with critical issues again left languishing in the too-hard basket.

The chances of either the industry or the relevant regulators cooperating generously are slim. The participation of key players – even regulators -- at parliamentary inquiries is negotiable, often on terms that see some issues plea-bargained off the agenda. That hubris compounds the flaws inherent in regulators compromising their responsibilities and relationships with their charges contrary to the broader public interest.

Most regulatory agencies, supposedly subordinate to parliamentary committees, are nothing of the sort: casual perusal of transcripts of evidence given by bureaucrats to parliamentary committees reveals a degree of disdain (and acceptance) illustrative of important issues casually downplayed.

This inquiry embraces a political minefield where the overbearing and overwhelming commercial grunt of the four pillars stands in sharp contrast to the apparent powerlessness of the appointed regulators to keep them in check. These power plays colour contentious issues including bank fees, bank margins, payments cartels, financial advisers, superannuation sales commissions and finance for housing and small-businesses.

One could, frankly, be forgiven for thinking the appointed regulators have been on long-service leave as an accumulating raft of issues compromising the competitive environment have not been properly addressed. It is unlikely that these principal regulators will now volunteer reforms that they should have initiated earlier. Regulators dislike inquiries that might find, however politely, they have been asleep at the wheel, or not candid, when some burgeoning problems likely to be unearthed took root.

The misgivings of some standing were only reinforced by the consequences of the global financial crisis and the special steps taken to protect and manage the restoration of stability.

Mostly it is just not easy to find the responsible regulator among a field concurrently adept at bureaucratic imperialism while either ducking or playing pass-the-parcel when problems emerge. On most issues before this committee, regulatory responsibility and authority is confused, not least as between the ACCC, ASIC, RBA APRA and the tax office, ATO. It is lamentable but hardly surprising that none has taken real responsibility for dealing with some tough issues compromising competition and fair play for decades.

Quite apart from what legislation might say, regulators blend operational agendas to reconcile conflicts between their objectives and powers with their own ideas on ‘priorities’. Published ‘memoranda of understanding’ between overlapping regulators is typically a blancmange with little practical content. Also typically, the parliament has no arrangements in place to audit these blended agendas: some regulatory agencies are specifically exempt from expert audits measuring performance against assigned objectives (including the RBA).

It is, frankly, no wonder that the general situation with retail financial services has drifted into such disarray that the beneficiaries of ineffective regulation – the pillars -- take advantage of the situation, arrogant to the point where they are telling regulators what they will do while spinning stories about appearing to cooperate with national policy agendas.

Fairly described, the general situation with the four pillars and competition for retail business is ‘out of control’. The pillars are more acutely aware than anyone else of their special status – unable to be allowed to fail, beneficiaries of regulatory concessions underwriting their monopolistic power, solvency and profitability, and generally able to do as they please with contempt for a wider community hoping to be served with an approximation to otherwise competitive outcomes.

FUNDAMENTAL PROBLEMS: SOME ELEMNTS

After some scene setting, the following illustrates problems frustrating initiatives to protect the public interest and promote a sustainable institutional framework with some semblance of effective competition for providing retail financial services.

THE STATE OF PLAY

The Committee will not need to be reminded that the four-pillars run the game, that after another decade of commercial imperialism accentuated by a financial crisis, the concentration of market power in their hands is now unconscionable: not satisfied, they call from the sidelines ‘two pillars good’.

In meeting the challenge to understand the mechanics of the pillars dominance, the analogy I would park in the mind of the committee is of a group of ‘allies’ at war with almost unlimited ammunition at their disposal (individually and collectively) and the flexibility to concentrate that unlimited firepower on the skirmish of the moment with an ‘ambitious enemy’. Incredibly, the very regulators supposed to protect the public interest and encourage competition effectively supply the unlimited ammunition available to the pillars for beating up potential competitors.

Realpolitik for the pillars implies no rush about becoming two, it is an exercise in serendipity to wait until one crisis or another has the regulators begging likely survivors to absorb a troubled competitor. As things stand all the pillars are ‘in play’ with their present (money-and-run) management teams apparently indifferent about whether their bank endures as a separate entity or not.

Meantime the pseudo pillars-debate distracts attention from the takeover, in recent years, by the pillars, of some limited remaining prospects for competition – mortgage brokers and the next biggest banking group are now within the pillars’ fold and other fringe competitors have fallen by the wayside. It is always just a matter of time before unsettled markets see emerging targets shaken and become fodder for the pillars.

Other apparently independent players in the retail financial services arena are similarly beholden to the pillars for their erstwhile existence. [One cannot even rule out the takeover of credit unions and industry super funds in a familiar sequence of cooperatives privatizing, and finding the going tough, before being absorbed into the pillars, as has happened to most financial sector mutual players in recent years.]

Without reforms akin to a revolution in the policy settings effectively driving everything into the arms of the pillars, the game is effectively over. Even now, it is simply pointless for the government to be entertaining the community with rhetoric about shopping around for the best deal among banks – and the outlook is for worse – a decade or two on, two may become one.

SO WHAT WENT WRONG AND REMAINS WRONG?

The provision of retail financial services now embraces both conventional banking -- deposits and loans and payments facilities, conducted in a framework with capital backing to ensure 'no-risk', and no-capital, investment banking, especially retail superannuation where the customers take the risk. There is some common ground across conglomerated retail operations: marketing strategies and placements of funds can converge at the margin, but the different operations are best considered separately, and payments operations separate again.

TOTAL CAPITAL INADEQUACY

Banks are typically very highly geared (under-capitalized) with little incentive for incumbent management to act prudently and no serious prospect of bank supervisors identifying looming insolvencies. Ask 'who was responsible for the sub-prime debacle' and, notwithstanding a gross inflation of housing prices globally, 'which prudential regulators anticipated and responded sensibly to the emerging situation?'

The conduct of conventional retail banking is fraught with the risk of mismanagement. The 'sub-prime' crisis may have been imported, but Australia has a rich history of similar instability, especially among fringe banking institutions. The survival of key Australian institutions has often been a close run thing, at one crucial time dependent on foreign 'lifesavers' paying a 'rescue' entry-fee to get into the local market under the guise of takeover buyouts, some of which were contrived.

Not to put too fine a point on it bankers gamble with other peoples' money. There is, frankly, no salvation in the much-touted prudential supervision of banks. Every failure and near failure in the past 50 years has followed hard on the release of audited accounts showing sustainable solvency while the reality of a collapse, then about to be revealed, was repeatedly a consequence of simple, never-learn mismanagement.

To cut to the chase, the so-called capital-adequacy and prudential risk-management requirements in place for banks are more likely to be a source of false comfort than any genuine protection against failure and unrecovered loss. That is the global experience.

[A critical element of a sensible solution is probably a requirement that some 50% of 'deposit style liabilities' rank ahead of shareholders funds (capital) but be subordinated to ordinary bank deposits in terms of their entitlement to be repaid in the event of a banks insolvency.]

The never-ending pussyfooting around in Australia with some unfunded 'deposit insurance' scheme is just so much pap: no big bank will ever be allowed to fail to meet any liability to its depositors or anyone else, and any small 'bank' will be taken over before it is allowed to fail. Think *Northern Rock* in the UK as the first in a domino-like sequence of bank failures globally, and then recall a litany of local failures similarly bailed-out over the years as the pillars picked up the pieces.

Requiring substantial subordinated deposits – debentures listed on the stock exchange – would give new impetus to ratings agencies' assessments of banks. Bank management would be determined to be so 'demonstrably prudent' that the bank's solvency would never be questioned. The Parliament needs to address a very real problem with prudential standards in banking. The claimed reforms of the past two decades were always a sham and the sham stands revealed – by the global financial crisis.

It is a moot point just how banking regulators globally will eventually react to the 'sub-prime crisis' which, in the sub text, is an indictment of the predictable failure of current 'prudential' supervision arrangements: they did not work, and react they did – but so far there is no confident expectation that the, necessarily limited, reaction is anything like a fully satisfactory response.

Nonetheless the local pillars are protesting being included in any tightening of prudential standards.

The menu of a fully satisfactory reaction is on hold while the mandarins are in some temple praying for deliverance – splitting big banks into smaller units may take on new appeal as a way of insulating the system from irresponsible (and mercenary-monopolist) financial conglomerates posing unmanageable systemic risks: four pillars could be required to become forty.

THE MYTH OF BANKING DEREGULATION

The Reserve Bank (RBA) reputedly does some things well, in particular the management of monetary policy since the late 1980's. Unfortunately this good reputation spills over into other areas of its policy responsibilities where it does some things badly: in particular the Payment System Board's (mis)management of the retail payments system over the past decade (but extending back some 25 years in total including the PSB's forerunner the Australian Payments System Council).

Other lamentable shortcomings include the failure to speak up about tax policy settings fuelling the addiction of Australians to owning and investing in residential real estate. More recently, the central banking brotherhood collectively failed to identify and deal with a global housing price bubble: there are very real obligations attending the privilege of 'tenured independence'.

The most generous thing one could say is that the RBA never understood much beyond its monetary policy role about what is driving the system – against that, when told, it apparently does not listen.

One of the more misleading hoaxes perpetrated on the Australian community was that the retail financial system was deregulated, commencing about 1985. The truer assessment is that while the then soon to be marauding 'pillars' were given free rein, some critical structural policy settings tilting the playing field in favour of the pillars were left in place, allowing the pillars to wreak havoc with the competitive environment.

A tragedy of compounding regulatory errors saw the initial – mid 1980s - surge of foreign bank competitors driven out after sustaining heavy losses: the counterpart, the pillars attack on the invaders, left two pillars badly wounded along with the humiliating demise of all state banks (quite apart from an anticipatory halving of the field of eight pillars around 1980).

What happened next was equally tragic as the hoped for competitive impetus from the building-society banks and credit unions was equally easily repelled by the pillars taking advantage of their unassailable advantage courtesy of a range of policy settings which will eventually come to be seen as 'ignorant' and 'destructive': the following elaborates.

Giving particular examples and illustrations of how misguided regulation underwrites the might of the pillars risks distracting attention from a situation that, as a whole, is a complete shambles from a public interest perspective. The general point is that the pillars <u>at any time</u> have and have had readily available to them the discretion to take out any player competing with them – and they did and still do.

The consequential illustrations are endless. Historically – the '50s, '60s and '70s -- the pillars set up fringe banking subsidiaries to take-out the non-bank financiers. As deregulation emerged in the 1980s, they allowed 'cash management trusts' to run for a year or so before overwhelming them. In the mid '80s the foreign bank invaders were repelled with a sequence of 'failures' that had Australian businesses effectively receiving substantial 'foreign aid' as measured by the losses of the foreign bank parents with burnt fingers. In the 1990s, excessive interest rates charged on housing loans allowed the pillars to rebuild their capital but opened a door for 'mortgage broker' competition which was first ignored, then matched and is now floundering as the financial crisis pulled the funding base supporting the brokers.

The consistent theme in this overwhelming market power is the competitive firepower, the sheer commercial grunt the pillars get from their regulation-protected low-cost deposit funds and a raft of cartel-like, regulator-condoned, follow-the-leader arrangements that see the pillars rorting the community with impunity.

In almost every case the character of the rorts misusing 'uniform' prices and excessive commissions is disguised in overpriced 'sucker come in' arrangements presented to the customers as 'free services'. The deceptions include all you-can eat monthly bank account fees (but otherwise free transactions); free credit card transactions; free credit for credit card purchases and free rewards; free BPay transactions; free financial planning advice et al. All up – a deceptive hoax, a set of arrangements that ensures the customers have no idea of the price they are actually paying (usually secretly) for anything. These arrangements concurrently preclude the entry of competitors unable to offer 'free anything' because they have no practical access to the regulatory subsidies flowing only to the pillars.

The converse of this ingrained deception of the community sees the RBA invariably prefacing its pious posturing about payments system regulation with homilies about the importance of a properly functioning price system for the retail payments system and retail financial services more generally. There is of course no practical prospect at all of a properly functioning price system for any services provided by the four pillars.

Fairly described in one word, the situation generally is a disgrace.

A FEW PARTICULARS

Over the past decade, I have outlined the systemic flaws in published articles and papers including submissions put to various inquiries conducted by parliamentary committees and regulatory agencies: submissions put to the RBA at various stages of the decade long review of card payment arrangements offer a convenient summary. [This material remains relevant and is accessible to the committee secretariat in the ‘payments system’ area at ‘rba.gov.au’. as is material previously put to other parliamentary imquiries.]

One principal regulatory shortcoming bearing on competition policy is the failure to deal with the institutionalized cartel arrangements and related price fixing for credit card, debit card and BPay transactions. ‘Joint venture’ provisions in the trade practices law shield these cartels. The amendments were not made, but, some six years ago the Dawson review proposed amendments to the trade practices law to preclude this misbehaviour.

Even more insidious is the way other uniform trading policies complement the objectionable cartel arrangements and drive business to the more profitable operations of banks. The use of BPay is ‘encouraged’ by harsh penalties imposed on mistakes associated with the use of ‘direct entry payments’ the cheapest payment option.

The use of credit cards (and so-called ‘scheme debit’ cards) is similarly encouraged by limiting the ‘over the phone and net’ functionality of ordinary debit cards. In short even where there appear to be substitutes in the range of payment options banks offer, the pricing is set to favour the choice most profitable to banks.

There needs to be some confrontation of the banks to hammer out deals that will approximate outcomes likely to prevail if the retail payments system was a competitive business.

-- the heart of the problem (interest-free deposits)

Putting aside objectionable cartel pricing and product ‘forcing’ arrangements, a most important regulatory concession available to banks flows from the tacit approval given to the tax-avoiding barter of ‘free transactions’ for ‘interest free deposits’.

The value of deposits in personal transaction accounts with banks, on which no interest of any consequence is paid, could be some $200 billion or more. Taking a ‘cash rate’ of 5% p.a. as a benchmark earning rate, the interest not paid could run to some $10 billion annually, and the income-tax not paid on the interest not received perhaps some $3 billion.

One might pause to wonder why the banks are, de-facto, paid an annual subsidy of some $3 billion from the public purse. One might especially wonder why the regulators do not collect statistics on the value of deposits held in retail transaction accounts on which no interest of any consequence is paid – as things stand there is no official indicator of the non-interest bearing deposit base and the interest income not paid.

One might further ponder why the 'deemed' earning provisions applicable to social security means tests, do not have a counterpart in requiring bank customers to pay tax on interest deemed to have been paid on their transaction account deposits. The analogy readily extends also to the sense of deeming to be 'taxable income' the interest not paid on credit card debt when customers are allowed 'interest free credit' for up to 55 days on purchases and similarly to the value of 'flyer' reward points – both being deceptive features of credit-card (and like) products that distort the competitive environment.

Those wondering about the absence of competition in retail banking might consider the impossibility of any new player building a substantial transaction deposit base on which no interest is paid: it is just not on – there will be no new retail banks until these issues are addressed.

-- seductive deception (credit cards and debit cards)

Over the past decade a story of regulatory failure, beggaring belief has unfolded as the RBA adopted the stance of a 'reluctant regulator' in relation to the retail payments system – especially of interchange fees for credit card transactions. The lamentable story goes back over the decade for which the RBA has had specific legislation and a specific board – the Payments System Board – to pursue the issues, a pursuit which has come to nought and a halt.

The matter generally was the subject of a special two-day hearing of the EFPA Committee in mid-2006. I gave evidence at the public hearings elaborating a related submission: and there have similarly been a raft of other articles and submissions over the past decade on card payment systems.

To summarise in a few words: the credit card has long been a technically redundant product but, with the benefit of various contrivances underwriting its excessive profitability, it remains the dominant card product globally.

[A moment's reflection reveals the 'credit card' to be simply a 'debit card' to which a line of credit is attached. The deception is about linking the illusion of free-credit (for 55 days on purchases) and 'flyer rewards' to the imposition of excessive charges on retailers, part of which – called an interchange fee – is paid to the bank issuing the credit card, supposedly to fund the 'free credit' and 'rewards'. There is no accounting for the actual cost to banks of either net 'free credit' given to bank customers or the 'rewards' actually redeemed. Deeming to be taxable income the gross value of these concessions would quickly expose the deception.]

In the event the international card scheme operators – Visa and MasterCard – have now privatized and floated these once-cooperatives while restructuring the operation to eventually migrate ‘credit cards’ to ‘(scheme) debit cards’ and potentially shifting the (mis)use of their cartel-style pricing powers to include participation (scheme) fees payable direct by retailers.

The regulatory emphasis for card transactions – and other network payment schemes -- now shifts to applications of trade-practices policy to curtail the excesses: that application may need to be coordinated internationally to address an issue global in its scope.

It is not at all clear that the Reserve Bank is, or was ever, the most appropriate regulatory authority for the retail payments system: a very different approach is required to ensure the retail banking and payments system works for the community rather than exploiting it.

-- institutionalized corruption (superannuation sales commissions)

The establishment of compulsory superannuation in Australia was a masterstroke and it was similarly fortunate that a complementary initiative concurrently taken jointly by labour unions and employers, established the so-called industry funds that provide retail superannuation facilities quite cheaply and very effectively to most Australians.

What was unfortunately unique about the superannuation innovation was the absence, from the outset, of a government-owned player operating in the retail superannuation field. Australia has paid a heavy price for abandoning a historical tradition of government banks, government insurance companies and various specialist providers of ‘new’ financial services owned by government monitoring the establishment phase of new financial services.

In the event the retail superannuation industry stands on the unsatisfactory foundation of a discredited life-insurance sector: discredited because it misused a commission-driven sales force promising a nest egg but eroding long-term earnings on the investment with excessive fees. Life-office products delivered little unless policyholders died early and triggered an insurance payout. It was a disgraceful industry allowing disgracefully unprofessional people to sell a product that sounded good but was no good.

The ‘sounds good’/‘no good’ culture has most unfortunately carried over into the retail superannuation industry. The problem gets worse as retirement throws more people onto the open market. Even major employers are closing ‘in house’ super schemes, resettling their employees with sub-contracted retail operators offering a good deal only to current employees – those changing jobs or retiring pay more ahead of becoming food for wolves dressed as financial advisors.

This situation is a major flaw in the retail financial services arena. Delivering redemption is not hard. Most promoters of retail super facilities are more or less equally likely to deliver a competitively competent gross return on the investment of member funds. The difference is that members of retail (for profit) funds are paying over 1% p.a. more in management fees than low-cost, industry-fund members do. The comparative difference for members over a working lifetime can be a payout some 20% more or less. The difference from the outset is that members of retail funds pay excessive sales commissions – especially trail commissions – that erode their investment earnings: as the industry-fund ads say, compare the pair (and the pare).

The problem at heart is the sales commission culture of retail funds, funds mainly operated by the pillars – outlawing sales commissions, and especially trail commissions, is an appealing option (and it appealed to the Jeremy Cooper review group) .

The problem, at the next level, is that those wanting to switch to a lower-cost operator – so called choice-of-fund – are impeded: a major impediment when markets are volatile is the potential for losses to crystallize as growth assets, liquidated on a falling market, are reinvested some weeks later, at higher prices, on recovered markets.

Those who would stimulate competition for retail super would do well to ensure that ‘choice of fund’ is a truly viable option. Fund members should be able to switch to a lower cost operator almost seamlessly and certainly smoothly with little if any uncovered risk of loss from inadvertent exposure to market risk.

One cannot overstate the importance of super fund members switching to low cost funds in the more general pursuit of the best outcomes for building their retirement savings. As things stand, far too many Australian’s are still holding super fund investments that perform relatively poorly because the contracts allow the deduction of excessive sales commissions: disadvantaged investors switching funds will be the most effective way of correcting the problem.

The work of the review group chaired by Jeremy Cooper earlier this year promised a very useful response to these issues -- one can only hope that it is not put aside as some tradeable inducement to defuse political instability.

END PIECE

All roads leading to the salvation of competition for retail financial services – including housing loans – have their origins in the identification and removal of existing barriers -- barriers mainly erected and maintained by the very regulators supposedly assigned to prevent them being put in place.

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