COMING CLEAN

Three decades ago, a mistake in regulating retail financial markets in Australia and like countries put many retail financial systems on a path leading to the market environment now prevailing -- one operating more as a cartel than ensuring an institutional framework that operates fairly and efficiently, and is competitively diverse.

Correcting that mistake now might restore better market conditions but, damage done, new approaches will be required as well to have outcomes consistent with fair trading, safe conduct and operational efficiency.

Competition can help, so can sound regulation.

...............but first, what went wrong?

relevant background

The global depression of the 1930's brought bank regulation prohibiting the payment of interest on bank deposits in cheque accounts (and capping interest rates paid on term and savings account deposits.)

The reasoning was sound: bank deposits in cheque accounts, not earning interest, would be kept to needed minimums (and caps would restrain reckless competition for other loanable funds). As well, a bank's easy-earnings on the investment of 'free deposits' could be reserved to cover cyclical, bad-loan losses (but, less sensibly, subsidize the cost of 'free banking' – banks providing account keeping and transaction services 'free of charge'.)

40 years on this arrangement broke down under global pressure. Deregulation, to restore order to national banking systems brought higher interest rates, floating exchange rates and integrated financial markets globally.

Necessary as deregulation was, the competitive environment for retail financial services was disrupted – unintentionally or not -- when major banks, newly permitted to pay interest on cheque account deposits, chose not to. Concurrently, banks broadened their interest-free deposit base to include savings-account deposits ever more readily accessible for day-to-day transactions using ATMs and EFTPOS cards.

a critical mistake

Banks were awake – regulators, apparently, were not.

On reflection, any thought of banks, then deregulated, paying interest at market rates on transaction account deposits was not rational. The sensible strategy for major banks was hardly to start paying a high rate of interest on at-call transaction account deposits. Rather, the major banks' collective commercial interest was to continue reaping the burgeoning endowment of easy-earnings from lending and investing the 'free deposits' at the high market interest rates prevailing (circa 15%+ p.a. in the 1980s)

The four major banks, already dominant and best placed to exploit this flaw, became a destructive competitive force.

The converse is, of course, the consequences of the critical policy mistake. Not neutralizing this destructive combination of free money and high interest rates, removed any prospect of a fairly competitive environment for retail financial services. All this, except, perversely, that the major banks were 'competitively' positioned to out-compete, as they liked, any other retail financial institution.

.... and, did they ever so like................ erstwhile competitors of any substance were soon either failed, run out of town or, becoming unviable, their business was merged into a major bank. Obituaries included the newly licensed foreign banks, the state banks, the 'new' building society banks and anyone and anything else in the way. Plundering, not competing.

That rampage through the banking system was not the end of it – major bank conglomerates were soon dominating the retail businesses of insurance, superannuation, funds management, stockbroking et al.

What we got, what we have, are 4Pillars dominating retail financial services while still holding, and abusing, an unassailable competitive advantage gifted from the regulators.

Concurrently worrying, the 4Pillars, apparently teamed up with party-political allies, are running interference on the not-for-profit, industry super funds -- the union-employer cooperatives that so consistently deliver better performance for their members than the Pillars' retail funds do. The Pillars do not enjoy others encroaching on their territory.

A genie is out of the bottle ....is broke ... needs fixing ....are thoughts that come to mind.

How did this happen?

The importance of the 'big mistake' is that it created a systemic flaw, a barrier to competition, in the retail financial system.

The way that this systemic flaw compromises the system can be explained from different perspectives. So done – persuasively -- the defect will be recognizable and no longer ignorable by the key players -- banks, bank customers, bank regulators and politicians.

Apparently, as is, no one who should can simply say what happened and explain it.

(i) the narrow perspective: the business of banking

A focal point is, of course, the consequences of banks holding transaction account deposits on which 'no' interest is paid while providing related account keeping facilities and transaction services either free of charge or underpriced, relative to costs.

The free-services banks provide on transaction accounts are best seen as tax-free, income-in-kind, available to customers as an alternative to making explicit interest payments which would be taxable income. The converse is that banks cover the costs of giving 'free services' from part of their easy-earnings on the investment of 'free deposits' in loans and investments at market rates.

Beyond that the Treasury is denied the tax payable on income paid in kind and the community generally, seduced into a tax-avoidance barter-scheme, is denied a fair, competitive and efficient financial system (because, practically, no other player can build a substantial 'free deposit' base needed to match a major bank deal.)

The importance of this tax-free bartering scheme is underscored by recognizing that banks 'interest free' deposits currently run to some one trillion dollars -- $1,000 billion – and the annual taxable interest income not paid, is still a substantial $25 billion even if less than normal. [In more normal times, it would be at least some $35 billion (at the 3.5% p.a. natural rate) and the likely additional income tax actually payable some $10 billion or so.]

The situation in the 1980s was very much worse—with interest rates running at 15%+ p.a. the major bank coffers were flooded with the easy-money they used to fund 'plundering competition'. Two of the Pillars tripped over their pile of easy-money money, nearly fatally.

This arrangement can be seen, truly, and fairly, as the banks being given an enormous subsidy from the public purse to run their business as they liked – including in many ways which only disadvantage the community.

Other 'losses' inherent in these inappropriate arrangements include official endorsement of the cultural attachment the community has to 'free banking'. Allowing the customers to pay, directly, little or nothing for bank services is quite contrary to the regulators obligations to ensure a properly functioning payments system – one where bank costs are recovered from customers with explicit, full-cost, fees for services provided.

In the middle of this muddle is an astonishing failure of the political and regulatory commitment to sound policy. This bartering of ‘free deposits’ for ‘free services’ entails an objectionable political and regulatory agreement to turn a blind-eye to the income tax evasion inherent in this banking practice – and the anti-competitive consequences.

Implicit in such blind-eye, regulatory forbearance is the gifting of unassailable market power to the four major banks that hold ‘all’ the free money. The consequences of that for the community are overwhelmingly evident on the historical record of repeated misbehavior in sharp contrast to routine official parroting of mantras promising competition that never comes.

This is not a good look.

In particular, the naturally profitable business of borrowing money ‘for nothing’ and investing it at market rates, is exactly what national note issuing authorities do and the Reserve Bank does in Australia. The profit naturally accruing from the RBA’s note-issue operations is available first to fund market operations associated with monetary policy responsibilities of the RBA – and any ‘surplus’ is paid into the consolidated revenue of the government.

In short, the banking authorities know what a ‘free money’ business is all about – those holding bank notes, in effect, have a deposit with the RBA on which interest is not paid.

What is not comprehensible is those same authorities being apparently unconcerned with commercial banks taking, and misusing, the natural profits from essentially the same style of business – ‘free deposits’ invested in loans and bonds at market rates.

These days, of course, banknotes on issue – some $70 billion – pale in comparison to ‘transaction account deposits’ running to some one-trillion dollars and held mainly by the Pillars who are not accountable for their use, and misuse, of the natural profit.

(ii) broader perspectives – the nature of tax-free bartering

The mechanics of the bartering that compromises sound banking policy can also be illustrated with analogies drawn from the media – newspapers and, most easily, free-to-air television business.

In that TV arena, viewers are entertained, at no explicit cost. The free entertainment is, like free banking services, personal income-in-kind which is untaxed. The free-delivery of such valued entertainment is made possible by advertisers -- advertisers incurring tax-deductible costs to fund broadcasting operations – taken together, that equates to a public subsidy of operating free-to-air TV businesses.

Akin to the bank bundle, ‘free deposits for free services’, the bundling process in the TV arena -- ads for programs -- becomes one of converting tax-deductible business expenses into tax-free income-in-kind for the viewers.

If that point is appreciated, implications of other barter style 'conversions' may also be more readily recognized and accepted: low-priced newspapers have for centuries been very important bundles of ads and stories, made possible only by the de facto subsidy from the public purse.

Those not grasping that may like to reflect on the consequences of businesses now shifting to the internet the advertising information from the newspapers and TV broadcasts – both these media businesses are struggling without the generous de facto subsidy from the public purse being maintained.

One key difference with major banking businesses is that their unfair advantage can be approximately measured as the interest not paid as taxable income to individual depositors. In short, as with age pension means tests, applying a deeming interest rate to customer's daily deposit balances would bring to account, as taxable income, the interest income not paid.

One likely outcome is that banks would pay interest (at the deeming rate) to depositors and their unique competitive advantage would be moderated. The further adjustment to such a different regime would be generally beneficial but, initially, very noisy all-round. Among other things, banks would newly be charging full-cost prices explicitly for transaction account services. Welfare recipients would be shielded by government calling tenders for providing them with basic 'free of charge' banking facilities – a cost to the budget easily covered by the income tax then payable on the deemed (or paid) interest income.

Why did the regulators let it happen unstopped?

The banking regulators have some questions to ponder -- including an explanation of why, when it became clear what was happening, in terms of unfair encroachments by the 4Pillars, nothing was done to arrest it.

This policy decision – or mistake -- was not some momentary lapse of regulatory attention: what happened was apparently intended and the consequences for the community have been dramatic.

At even higher levels of reasonable concern are the implications for the use, and misuse, of political power in the hands of particular players. At the risk of being impolite, restraining the overwhelming dominance of a cartel-like club, as the 4pillars comprise, has obvious attractions. There would be less contrived 'noise' and postured insincerity in the media and the parliament about 'dealing with the banks' but much more intelligent expositions of what has been happening and its purposeful exposure.

Commentary, like what is said above, will not be found in the mainstream anything or anywhere locally. In Australia, Canada and the UK it is as if it such things are simply not to be spoken of. Conversely, in Scandinavia, the banking authorities of those four nations would consider it entirely sensible to expose these facts and their implications for market failure.

END PIECE

After a sequence of compromised reports flowing from 'official' studies of the retail financial system, and the current, do-anything, floundering to avoid a 'banking' royal commission -- the prospect of the Productivity Commission bringing trusted competence and independence to the fray is a very welcome development.

There will, no doubt, be industry submissions of the usual self-serving tripe as well as more befuddling snow-jobs from appointed regulators hoping to avoid critical assessments of their forbearance.

Evident enough as they will be, competent assessors dealing with such nonsense is a prospect to be savoured.

.... for starters, let us not forget that a bank-tax bone recently thrown into the policy ring produced a wonderfully unseemly and unedifying display of ignorance and selfish incompetence, all confirmed with a raft of intemperate objections from business and banking leaders, bordering on bullying of the political process.

None of the major players had any apparent recall, or understanding, that a more substantial bank-tax was in place for some 50 years from the 1940s -- or that, while companies may write the cheques, only people ultimately pay taxes – wider margins for customers, lower wages for employees and lower dividends for shareholders.

We will soon see if those that so savaged the bone are, on reflection, now more thoughtful.

The temptation to end on a thoughtful note is irresistible.

The 'bank tax' proposal so recently thrown into the ring, to sustained public applause and bankers' sustained consternation, is likely to be of little consequence to banks or bank customers (who will anyway pay most of it). What really needs to be done, to rein in the banks and restore retail financial markets, is along the lines sketched out above.

Ideally any new pulling on the banker-reins would not be called a 'tax' – it could be called 'just deserts' or 'comeuppance', for bankers. Presented, in the way suggested, as tax levied on customers actual or deemed taxable income – it would not be a tax on banks at all. Such a new income tax impost could be refunded by a lowering of income tax rates. Banks would have nothing to complain about.

Importantly, now is an ideal time to act – taking advantage of the low interest rate climate and heading off any resurgence of a bigger problem as interest rates return to normal levels.

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