# Financial System Competition: Interim Report

This interim report does not cut it. It does not meet the reasonable entitlement and expectation of the community to have a proper explanation of the failure of governments and appointed regulators to ensure the operation of the financial system is competitive – or is regulated to operate 'as if' it was competitive.

Rather, allowing a decades-long degradation of competition (and fairness) was deliberate, well known, well understood and, not only, not addressed, progressively made worse. I was just not polite to say so.

This long-standing situation cannot be now portrayed as some regulatory miscue -- not properly striking a balance between 'stability' and 'competition'. The PC now proposes to correct this situation with a reoriented ACCC bringing a competition brief to the table of the Council of Financial Regulators (CFC).

It is quaintly Dickensian to envision the ACCC, at the big-table, 'asking for more' when it never, effectively, asks for any. The ACCC would soon re-discover that expecting rapt attention at the table-of-stable is fanciful -- those that run this game could hardly have made their preference, attitude and authority, more clear.

This standing reality stands in sharp contrast to the PC contention that:

*The Council of Financial Regulators is a valuable forum for a rigorous and informed competition debate*. (15.1)

For decades, Treasurers have noisily promised a competitive retail financial system – for decades the community has seen only the converse, an ever more closely-owned, more cartel-like, industry behaving ever more badly. Regulators heard the promises and saw the misconduct but, if anything, only doubled down and endorsed the license-to-kill given to the Pillars. What happened was deliberate.

Ahead of the government's compromised royal commission (into systemic misconduct) there was a range of diversionary initiatives – one was the brief given to the PC to investigate 'competition'. That brief, from the Treasurer, is self-serving and deceptive – it asks the Commission to respect some 'existing wide-ranging financial system reform agenda' before going on to

suggest this agenda already embraces hallmarks of competition -- resilience, efficiency, innovation, fairness and regulator's capabilities and accountability.

The PC may not respect this tripe but it did not reject it.

The PC remains a cop on the local beat, spiritually and practically independent, still holding the respect of the wider community. There were, and remain, expectations of the PC delivering a properly investigated explanation for the uncompetitive environment that undermines efficiency and fairness in the Australian financial system. These expectations are fueled by the lengths to which the government went to avoid any full and proper investigation of systemic failings.

Whether the brief given to the PC necessarily compromises its scope and objectivity is an open question – this report gives rise to concerns.

## INDEPENDENCE WITHOUT ACCOUNTABILITY

A sense of despair about the outcomes for competition is inherent in granting independence to single-minded regulators – 'independence' nominally portending hope but without the necessary complement of accountability. Regulators acting as they like, with impunity, is not on.

'Independence' allows doing nothing as well as right things and wrong things. That goes to the heart of the issues for which financial system players and regulators should be accountable but are not.

If the royal commission is covering the misconduct of the players, the PC is the counterpart to assess the regulators' use, and misuse, of their independence. The delivery of an uncompetitive, and unfair, system to the community was no accident.

Overall, however, this interim report does not evidence an insightful investigation and explanation of misused regulatory independence leading to the current imbroglio. Neither does it meet the challenge of restoring a workably competitive sense of order.

It is naive.

That said, it seems the PC has elected to take a different approach – to let bygones be bygones, to just look at what we have, recognize shortcomings, and propose reforms to the policy framework to restore competitive order.

Against this naivety, understanding the past, and obvious regulatory abuses, is reasonably prerequisite to now framing a well-founded competition agenda.

As is, the offending regulators will simply 'file' this report (after a faux display of praise cooperative concern).

What follows briefly outlines some important misuses of regulatory independence compromising competition, efficiency, fairness -- and now stability.

[Player misconduct will be exposed by the royal commission.]

## NOT GOOD ENOUGH

As in *Hamlet without the Prince* the PC story on competition is incomplete without giving the leading role to the **one-trillion in transaction accounts** on which 'no' interest is paid.

The 'one-trillion', historically parading as 'current accounts not bearing interest' and now as 'transaction account deposits' (on which low or no interest is paid), comprises deposits in cheque and savings accounts repayable 'on demand'.

The great bulk of the 'free' deposits is held by the 4Pillars and has long underwritten destructive competition -- the misuse of the windfall earnings flowing from the investment of these 'free' funds at market rates.

These earnings, rightly belonging to the people, are used against the people.

Traditionally this soft-profit endowment cross-subsidized 'free banking' payments facilities to customers – something competitors could not match. Far worse, however, was the explosion of the 'soft profits' in the 1980s that funded the Pillars running rampant, pillaging the financial system.

Accountability is called for.

[ -- an invitation not accepted

The terms of reference invited the PC to ***.. examine the degree and nature of competition in the provision of personal deposit accounts...*** It has not.

Is this an interim oversight?]

On a closely related matter – **the bank levy** – the PC report is naively unfamiliar with banking history.

Fact is, for some 50 years, from 1941, the Pillars and their forebears were subject to a raft of de facto regulatory taxes (e.g. Statutory Reserve Deposits) that, very intentionally, moderated their unfair competitive advantages and constrained their competitive power. The effectiveness of this 'tax' regime was illustrated by non-bank institutions competing with banks (some became banks – and Pillar prey).

All this came unstuck in the late 1980s when deregulation (of the Pillars) removed these regulatory constraints in the high interest rate circumstances of the time.

Game over for competition.

[That said, a 'levy' is not the ony or best option to rein back Pillar power – taxing deemed interest income on transaction deposits is the first preference.]

## THREE SHORTCOMINGS

### (i) Circle work with the credit card cartel

There is a saga of regulatory intervention (and not) in credit card schemes.

In the early 1990's the mirror-image global schemes – Visa and MasterCard -- were recognized as an affront to competitive efficiency and fair dealing. What happened after, and ongoing, is a case study in regulatory substitution of never-ending circle work for any genuine commitment to deal with the market failure. With the protection of studied regulatory inaction, promoters of credit card schemes prospered at great cost to the wider community.

Nothing was done, or intended to be done, until the 1997 report of the Wallis Committee forced the regulatory hand. Regulatory reluctance has remained the key note. Over two decades, a succession of time-buying reviews has seen only slow and confusing progress after an initial bold step halved the overall maximum interchange fee payable. The way further progress has been snail-paced begs for accountability.

This disturbing background could be contrasted with the intention of the PC to 'ban card interchange fees' (draft recommendation 10.3).

This sensible proposal has some history. In December 2001, the RBA announced an intention to effectively reduce credit card interchange fees to almost zero. Why the RBA reneged on that intention, in August 2002, was never explained.

The idea that the RBA may now embrace a ban anew is not sound – apart from a couple of idle threats to reduce the limit, the RBA is yet to even endorse the lower global standard in place for credit card interchange fees.

Back around 2000, the ACCC, then jointly writing with the RBA the post-Wallis review of credit card schemes, also took an interest in credit card fees being set uniformly, contrary to trade-practices law. There was some brief penalty-posturing and regulatory skirmishing before the ACCC was abruptly shouldered aside by an RBA taking sole responsibility.

This history bears on the PC proposal for the ACCC to be now accepted as a respected advocate of consumer and competition protection at the Council of Financial Regulators (CFR). That idea is fanciful -- the way the RBA dismissed the ACCC, took over and protected the banks' credit card racket is illustrative.

Issues with credit card schemes remain red-hot – one ever clearer prospect is for the VMC schemes to displace cash as the tap'n'go, pay-wave technology underpinning e-cash becomes ubiquitous.

Meantime the RBA is issuing newly designed $50 and $100 currency notes – a payments medium ever more redundant.

[Note: chapter and verse on the sad history of credit card regulation is set out in submissions to a raft of credit card reviews conducted by the RBA and Parliamentary Committees since 1999.]

### (ii) Intransigence: featherbedded stability - outlawed competition

The PC, among many others, is apparently unable to contemplate that financial system regulators have, in their own interests, pursued financial stability to the exclusion of competition, efficiency and fairness.

Among the implications is the inability to also see that the single-minded pursuit of stability may have left the system less stable in the now prevailing low interest rate circumstances.

Put bluntly, in the deregulated and high-interest rate circumstances of the 1980s, the 4Pillars were gifted the unassailable competitive advantage underwriting their subsequent rampant-run through the system – not only driving out foreign-bank subsidiaries, only licensed in the mid 1980s, but plundering and absorbing most substantial banks and other financial service businesses across the board.

This was buccaneering – it was unchecked.

The mechanics of the regulators pursuit and delivery of an inefficient and unfair financial system, devoid of meaningful competition, are set out in a first-round submission titled 'Coming Clean'.

[**A related aside**: unforgivably, while the banks were buccaneering using the windfall of taxable-interest income not paid to depositors, 'overpaid' age-pensioners were being deemed to earn means-tested interest income on their no-interest account balances.

One correct, sensibly complementary step, towards fairness and competition, would have seen all bank customers being deemed to earn taxable interest income on their transaction account balances.

The banking buccaneers would have smelt, and felt, grapeshot.

This option is preferred to moderate the competitive advantage banks get dirty-dealing 'free transactions' for 'free deposits'. Moreover, that done, the system may get closer to proper, cost-related pricing of payments system services – a needed feature sadly lacking.

The 'free-banking' culture now entrenched is inimical to competition -- this should be said clearly.]

### (iii) **a system perversely less stable**

The wheel of fortune has turned – for buccaneers and compliant regulators.

Misguided regulation is now having perverse consequences, for stability, in a low interest rate environment. These perverse consequences flow from the attendant devaluation of the goodwill/franchise-value of the 'rents' regulators gifted to banks.

The devaluation of banks' franchises reflects the sharp reduction in the 'soft earnings' banks get investing 'free deposits'. The capital equivalent, de facto, the present-value of these 'rents', has been a very important part of a bank's total resources (capital) available for sale to meet liabilities in a crisis.

Now, considering that expected, base, interest rates have fallen from some 7.5% p.a. to 2.5% p.a., a 5% p.a. reduction in the margin on some $1 trillion nominally reduces bank revenue by some $50 billion p.a. (other things unchanged). The present capitalized value of such a reduction, being a multiple, is a big number in relation to the share market value of the 4Pillars.

Put illustratively, in the early 1980s when 4 major banks merged to form two Pillars, the 'pre and post' market value of the four banks increased some 25% -- this windfall reflecting merged banks taking both sets of 'rents' but, consolidating to the bigger scale, saving overhead and operating costs.

The purchase price, on the market, of the banks 'entitled' to these eroded rents is now substantially lower. The PC may like to weigh the 'de-facto capital'

so eroded against the 'cash capital' added after the Murray Report demanded cash-capital injections.

It is this line of thinking that puts on the horizon the prospect of further consolidating the banking system to 2 Pillars and separately incorporating their basic banking functions – providing payments services and holding transaction deposits matched by safe assets.

The script for what else sensibly follows is in a box belonging to Pandora.

There is no clean slate to write about competition initiatives -- smart regulation can promote outcomes 'as if' the system were competitive.

For this reason alone, but also more generally, the PC might give some attention to direct regulatory interventions that will substitute efficiency and fairness for featherbedded complacency and profiteering characterizing the operations of major financial institutions.

Looking ahead, deeming taxable interest income on customers' transaction account deposits would be a useful start – a wise preparatory step before rates rise and the value of the rents, taken so unfairly, also rises.

If competition is to come – best be ready for it.

## END PIECE

One lost option for the PC was to 'return-to-sender' a political brief compromising its objectivity and funded capability -- a job that looks too hard may never be done by anyone else either.

Problems with a culture corrupting the regulatory framework should not remain official secrets -- they should be corrected. If not, the retail financial system may be on a collision course with eventual regulatory overkill akin to nationalization. We are getting closer to a retail banking system more tightly regulated on behalf of a community being the last-resort, bail-out owner but mocked for the privilege.

Doubters may like to ponder how an intensely 'national' debate would unfold if a global banking conglomerate were to make a takeover bid for one of the Pillars – a prospect not beyond belief.

To be denied in the national interest for sure – but why?

Peter Mair 16 February 2018