RETAIL BANKING: APPROXIMATING 'COMPETITIVE OUTCOMES'

My submission to this 'Harper' competition-policy review is mainly about issues bearing on retail banking and payment systems -- my proposals for competition-policy reforms link to my primary submission -- regulatory failure & regulatory reform **--** to the 'Murray' financial-system inquiry -- published at http://fsi.gov.au/consultation/submissions-20140417/.

Thinking about 'competition', it is more than a little interesting that policy reviews about both 'competition policy' and 'the financial system', are underway concurrently, with, presumably, some scope for the reform proposals emerging to overlap: potentially -- that's competition!

Cutting to the chase, the format of what follows presents italicised extracts from the FSI submission before sometimes elaborating an implicit counterpoint for competition policy reform.

The financial system – especially retail banking and payments facilities – has elements of a natural monopoly both nationally and, increasingly, internationally. Competition is a means to an end, especially efficiency, and that end is best kept in sharp focus – and otherwise compensating as best can be done for entrenched impediments to competition.

Whatever the proximate objectives of regulating the major retail banking and superannuation conglomerates, one corollary of their inclination to act as a natural monopoly is the sense of establishing a coordinating regulatory authority to oversee the overall quest for good outcomes. As is, it is nigh impossible to know which regulator is responsible for what and how any overlap or needed cooperation will be achieved. The regulatory framework has failed to deliver what the community is entitled to have.

However separately the key regulatory agencies might continue to operate an independent coordinating authority should embrace the RBA, APRA, ASIC, ACCC, ATO and its influence extend to various other industry bodies including the FOS, APCA SCT et al.

More generally, whatever Australia may want to do locally in the way of negotiating outcomes akin to 'competitive outcomes', begs the question of also encouraging the negotiation of some sensibly compatible global outcomes as a next step.

FOCAL POINTS FOR REFORM

-- the (un)competitive environment

One especially troublesome element of trade-practices policy concerns 'joint-venture' exemptions allowing collusive price fixing. This issue was addressed in 2003 in a review of the trade practices legislation (the Dawson Report). Substantial reform of the 'joint venture' exemption there proposed would limit 'price fixing' and related collusive agreements to 'reasonably necessary' practices only.

This recommendation was ignored – a decade on, one can only wonder why joint ventures are still being used as unlimited cover for collusive anti-competitive arrangements at the discretion of their major national player-partners.

The efficient conduct of 'competitive' retail banking and payment operations requires extensive cooperation on compatible systems and standards and the policy challenge is more about separating necessary cooperation from discretionary collusion. Such separation may be easier asked for than delivered. If so, the challenge is different – more about supervised codes of practice intended to ensure that pricing and service standards approximates competitive outcomes.

Monopolistic collusion 'exemptions' allowed to 'joint ventures' in particular need to be limited to an establishment phase – and then curtailed. The practice of charging ad-valorem transaction fees for credit-card payment transactions should be proscribed – as the RBA once promised (in 2001).

-- finding the right balance between competition, stability and efficiency.

.... proposing changes to reform a financial system that is uncompetitive and inefficient in important respects, risks instability if well-intentioned adjustments then set in train are destabilising – this happened in the wake of both Campbell and Wallis.

Trusted regulators were exposed as grossly incompetent – not understanding what they were doing.

One alternative approach, to regulatory force, would see key institutional players, including regulators, agreeing to voluntarily work towards performance benchmarks coupled with rigorous accountability for meeting indicative outcomes.

This approach would be more credible, more likely to work, if there were an independent overseer of regulatory performance – an independent 'merits-review' professional body, akin to the Productivity Commission, able to assess regulatory performance and report frankly.

Hopefully -- a self explanatory elaboration of fixing an uncompetitive environment.

The current exemption of the RBA from any prospect of 'independent merits review', however rational in respect of its monetary policy responsibilities, has become perversely irrational as it applies to anything the RBA does. It is inconceivable that any independent review agency would endorse the RBA's current management of the currency note issue and retail payments system.

-- fear for the future: will technology challenge the old banking franchise?

..................if there is a visible prospect of destabilising innovations in retail payments systems, preparations to safely accommodate those innovations had best start soon.

-- competition and efficiency in retail payment systems

Prospects for the efficient allocation of the considerable resources of the payments system depend on the service prices paid fairly reflecting costs. .... as things stand, the pricing of payments services is perverse – some expensive services are provided 'free' of charge, while *some cheaper and better services are withheld, and others are monopolistically grossly overcharged in exempt 'joint ventures'.*

.... this submission concludes, not surprisingly, with a proposal that the RBA be relieved of its present responsibility for regulating the commercial operation of the retail payments system – it is not a function that the RBA wanted and it has, so demonstrably clearly, not taken the responsibility to heart. This is an important regulatory function inexcusably being done very badly for far too long – at enormous cost to the community.

Shortcomings of the RBA in regulating the payments system – next illustrated -- underscore the sense of having an independent 'merits review' coordinator to recover lost ground.

(i) destructive bartering of 'free services' for 'free deposits'

Anyone wondering why four bank-conglomerates now dominate the Australian financial system need go no further than a simple explanation which the RBA is apparently unable to acknowledge and unwilling to address.

Allowing major-banks to engage in tax-avoiding bartering of 'free' services for 'interest free' deposits is fundamentally disruptive – it was dramatically destructive of the competitive environment in the late 1980s when 'all' the new foreign banks failed along with 'all' the long-established state banks. Subsequently the major-banks took over of 'all' the new building-society banks.

One corollary is that, while this fundamental 'barter' flaw remains, there is no credible prospect of viable new retail banks being established. No credible prospect – none!

Another is that the efficiency of the retail payments system is and remains compromised by cross-subsidization precluding prices reflecting costs, especially when the associated cross-subsidies are allocated perversely – e.g. to support costly cheque payment facilities provided 'free'. Such barter-revenue distortions have, for decades, sadly denied cheap, person-to-person direct-transfers made electronically.

The RBA could and should have dealt with this disruption of competition and efficiency – it did not – it does not, apparently, even acknowledge its relevance. When pressed, however, the RBA says it was not, and is not, its job to seek the coordination of tax-policy settings that are unfairly disruptive.

Memorably in 2011, asked at a Senate inquiry into banking competition, to explain the wholesale 'failure' of the foreign-owned retail banks newly licensed in the mid-1980s, the RBA governor's 'no idea' response was noted as 'nonchalant'.

-- a correcting step

One simple and sensibly realistic reform would see the ATO require banks to advise transaction-account customers of taxable interest income 'deemed' to have been paid on daily deposit balances on which less than a market interest rate is paid. Such 'deeming' policy principles are well established in means-tested entitlements to pensions and social security payments.

One attraction of this approach now is that the current low-interest rate environment is uniquely favourable to making the change – reform now would preclude a repeat of the destructive disruption of tax-free barter when 'cash rates' are higher (e.g. the 15% p.a.+ in the 1980s). There would be a useful stimulus to competition and efficiency in retail payment systems.

(ii) redundant exploitative credit-card schemes

The RBA very deliberately made no material submission on payments policy issues to the Wallis committee. Eventually the Wallis secretariat asked informally for help and that was provided, mainly published material from the central banks of Finland and Norway –a framework that became the basis of a well-regarded Wallis report on payments policy issues.

.... in 1999 the RBA was put under pressure to deal with Visa and MasterCard and, after a convoluted go-slow process, it made minimal reforms in August 2002 – essentially regulating a 50% reduction in the offending ad-valorem interchange fees paid by merchants, then-after capped at 0.5%. Superficially a meaningful step, it was practically not – especially when the RBA previously considered the 'correct' cap on ad-valorem transaction fees was zero – as it initially proposed in December 2001.

-- the current state of play

Australia is not alone in its reasonable concern about a monolithic credit-card, payments-card duopoly still affronting national and global communities – joint-venture 'price fixing' is writ large.

More fundamental points for the panel to consider here are, first, about the essential redundancy of the credit card product and then about a product, using exploitative uniform ad-valorem pricing, continuing to be the vehicle for a raft of efficiency sapping trade practices.

On the matter of redundancy: there is no longer any need for a separate credit-card product when, usually, the very same bit of plastic is also an EFTPOS debit card linked to transaction accounts (to which a separately priced line-of-credit could be attached and used by those wanting to borrow).

The critical marketing hook, '55 days free credit', is an illusion – there is no 'free credit' unless the account is paid-off in full by the due date -- and the funds transfers typically come from deposit accounts on which no material interest has been paid. The associated efficiency-sapping trade practices, not yet outlawed, mainly involve making superficially 'free' credit-card transactions more attractive to customers otherwise paying fees for debit-card and other transactions.

Additionally, only credit cards, and internationally branded scheme-debit cards, have the convenience of allowing pay-by-phone, card-not-present payments .... tap-and-go functionality is also denied for transactions using debit cards not issued by Visa and MasterCard.

Put simply, for many years now the marketing of credit-card products has been exclusively about monopolistic price-fixing and denying customers the convenience and efficiency of a single account and card for deposits and payments (and unsecured overdraft loans).

It would be salutary, and hardly unfair, if the 'free-credit' nominally allowed on credit card payments were 'deemed' to be taxable income in the hands of card holders, calculated at the interest rate payable on credit card loans. The deceptive nonsense would stop.

(iii) 'free banking' is a costly illusion

An apparently immovable foundation stone of 'political' banking-policy is that Australians are more or less entitled to unlimited banking services essentially 'free of charge' – the problem is that, in the misled mind of most Australians, this entitlement is apparently delivered.

Practically, of course, this is not true[1] *-- 'free-banking' is a very costly, efficiency sapping illusion.*

The vocal political objection to 'bank fees' doubles the deception: only bank fees that can be clearly seen by customers are 'objectionable' -- best avoided or otherwise kept very low. Conversely, the sky is the limit if customers are unable to 'see' high transaction and account keeping fees deceptively hidden in obscure, complex pricing arrangements operating out-of-sight.

The real cost of the deceptive political attachment to free banking is untold – and deliberately untold by the RBA. Consider the 'cost' of key elements in the overall deceptive illusion.

Customers are not paid a market rate of interest on their daily balances on deposit in transaction accounts but banks earn a market rate when lending those funds. Hundreds of billions in bank deposit accounts are denied billions in interest 'not paid' – current ball-park figures are $900 billion and $20 billion p.a. respectively.

Banks use part of those soft net earnings to subsidise the cost of providing services free-of-charge. The other part – often the major part – was used to run competitors out of town.

One inequity here is that banks do not account for how that 'endowment' of soft income is spent -- another is that no tax is paid on the personal interest income not paid, so the national treasury is left short of about one-third of the interest not-paid to individuals.

Why are the major banks effectively being given lavish subsidies then mainly wasted on pricing strategies denying competition in retail banking and retail financial services more generally – including superannuation?

What's worse, these perverse outcomes take away the very competitive incentives that customers and their banks should have to choose, and provide, the lowest cost services. Cheques, for example, are still only too slowly being made redundant and person-to-person electronic transfers have been too long denied

The overcharging racket banks run with credit cards beggars belief – and it has only partly been brought to book. Customers, told that credit card transactions are 'free of charge', do not see that behind the facade the retailers pay high ad-valorem fees as a % of purchase values.

One can only wonder if politicians would not demand action if they were clearly told of these deceptions – perhaps the panel could propose that a full and frank exposition be made of the workings of the retail banking and payments system.

[1] Lest we get lost in semantics, fees charged explicitly but below full cost have a substantial 'free' component

The community and the parliament could at least be given the full facts on which to base preferences for continuing, or not, the illusion of 'free banking' – and the attendant destructive nonsense. A community being given scant sympathy for ever higher energy and utility bills, could surely cope with the (low) explicit fees that would cover the cost of efficient electronic transaction services

[Some people, known to be needy – like pensioners -- are reasonably entitled to have access to basic banking services free of charge. The sensible way to cover the cost of providing basic banking to the needy is by specific payments to banks from the commonwealth budget – the cost would be contained by putting the business to competitive tender from banks.][2]

....

(iv) RBA currency notes are impeding the development of electronic payments

The note-issue is, of course, of declining relevance to a broader retail payments system with the potential to develop dramatically once the RBA is relieved of its dead-hand authority to handicap it as it does (see above).

The future of the retail payments system has long been about substituting electronic payments technology for tangible payments instruments like cash and cheques.

Currency notes are an ongoing impediment to the development of electronic payments systems and there is a sound <u>conceptual</u> case for reviewing the composition of the note issue to foster the commercial development of electronic systems (as well as to reduce tax-evading hoarding).

Conceptually, the simplest proposition is about withdrawing $100 notes from circulation – they do not circulate............and it is a short further step to similarly withdraw $50 notes: it is evident enough that notes of the $5, $10 and $20 denominations are, with coins, more than enough to cater for the sensible cash transaction needs of the community.

Practically, of course, there are problems with considering these changes without regard for a raft of potential disruptions that quickly come to mind – not least the stimulus of some $50 billion flowing back into the banking system. There would also be a predictable public outcry -- from those inexplicably 'needing' high-denomination notes (but never hoarding them).

Reason to 'hasten slowly' does not, of course, mean doing nothing and a management and reform program should be put in train. The problem with the present arrangements will only become ever more embarrassing and difficult to deal with.

That assessment endorses a more general indictment of an RBA so apparently oblivious to the range of payments policy issues and responsibilities it has ducked and allowed to fester. It may not have happened this way if the RBA were not allowed such broad and unquestionable 'independence' -- any process of proper 'merits review' accountability for the RBA would have exposed these problems many years ago.

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[2] The courts are currently reviewing the legitimacy of a myriad of so-called 'exception fees' that banks impose as punishment for inadvertent customer mistakes usually of no consequence in long-term relationships -- e.g. overdrawing of accounts or late payments.

The touted independence of the RBA – often displayed as the independence to not do things it has been asked to do – should be cleaned up and its decisions made reviewable.

What was once the dominant medium for day-to-day payments across all purchase values is not now: cheques, historically, and transaction-card accounts more recently have displaced cash for most substantial payments – and, most recently, the tap-and-go functionality of cards is making inroads into the role of currency for even small payments.

The problem perceived is that, as the need for cash transactions is diminishing, the value of notes on issue continues to increase. The disparity is ever more evident.

These days, it seems the primary role of high-denomination bank notes is about their 'hoarded' withdrawal from circulation -- mainly with a fraudulent intention of, either, avoiding income-tax liabilities or 'hiding' means-tested assets to increase age-pension entitlements.

I have trouble with the idea that the Bank is unable to acknowledge that there is a management issue here or to do something about discouraging such hoarding.

A radical response would see the two highest denomination notes simply withdrawn from circulation and the sense of that, in my mind, is only reinforced by the prospective redundancy of currency, especially for high-value purchases.

OTHER ISSUES

There is a raft of other policy issues which bear more or less directly on the prospects for approximating competitive outcomes in the financial system.

Mostly these issues are more squarely in the box to be dealt with by the Murray inquiry.

Two that might be endorsed nonetheless are:

- The scope for a government enterprise participating in the faltering market for 'reverse mortgages' and other home-equity release schemes – as was envisaged by the Productivity Commission to facilitate the payment of accommodation bonds and care costs associated with residential aged care. A sunset provision could see this business privatized after, say, 15 years: and
- more forceful coordination of the work of FOS and ASIC to ensure that particular service providers engaging in systemic abuses can be 'named and shamed' so the community is alerted to be wary. [My second submission to the Murray inquiry details a failure of FOS and ASIC to deal effectively with an ongoing practice of a major national motor vehicle insurer agreed to be deceptive.]

Peter Mair / 18 April 2014