

REGULATORY REDEMPTION

The challenge of redressing shortcomings in the structure, culture, operation and regulation of the Australian retail financial system will be more easily met if those taking responsibility for doing so:

- first ‘come clean’ about past policy mistakes; and
- second, embrace reform options of immediate practical relevance.

- sunk on the Murray -- a text for today

Contemplating reform, pause to reflect on an opportunity lost three years ago.

In August 2014 a second-round submission said to the Murray Committee:

The interim report of the Murray Committee, reviewing the Australian financial system, admits some preconceptions likely to blur its vision and compromise its credibility.

Consider these ‘Observations’ in the executive summary:

The banking sector is competitive.....

Australia’s regulatory structure has served us well.....

Australia generally has strong well-regarded regulators.....

.....Australia’s regulatory coordination mechanisms have been strong.....

Regulators’ mandates and powers are generally well defined and clear.....

Now, not only do these preconceptions not reflect attitudes in the wider community, past and recent evidence is clearly to the contrary. Put more sharply, such preconceived assessments, not being correct, have no right to linger for much longer in the collective mind of this committee.

Needless to say this cautionary note – right on the money -- went through to the keeper untouched and blind-eyed.

In its rush to prejudgment the Murray Committee became just another in a line of inquiries compromised with a brief to deliver marketing material promoting predetermined outcomes – all cloaked in a charade of open scope and independence. Worse illustrations are readily found in a raft of preset, closed-not-open parliamentary inquiries and regulator initiated reviews.

It is no wonder the coagulating mess has further degenerated.

ONCE MORE UNTO THE BREACH

Living in hope, what follows outlines issues needing attention – attention now, well ahead of any royal commission detailing cultural degradation among financial institutions and regulators.

For decades, Treasurers promising more competitive retail financial markets have stood powerless and mute as just the opposite unfolded. Almost unbelievably, cartel-like behaviour was protected, not threatened, when regulators ignored, and made worse, obvious market failure in the financial services arena.

Renewed demands to bring these markets into line may be no match for the resistance of major banks and inexplicably compliant regulators. What happened was no accident.

A quest for competition is concurrently a quest for a retail financial system that works efficiently and fairly in the public interest -- as if it were competitive. Disturbingly, the prevailing ‘as if’, is as if competition, efficiency and fair play are the last thing on the mind of regulators.

The realization that there is regulatory work to be done differently may be tuned with a brief digression prompting quiet reflection on a topical concern well within reach of most.

CASE STUDY: BURYING FUNERAL INSURANCE

There are problems with funeral insurance and the failure to properly regulate it.

Funeral insurance is understood by regulators to be a rip-off but the consumer protection regulators are not empowered to proscribe the sale of offending policies, nor demand the refund of premiums already unfairly paid.

The only watchword is disclosure – and then let the buyer beware.

This is not good enough. Politely worded ‘customer advice’ information-sheets on a regulator’s web site do not cut it when those most in need of a warning are the least likely to read it and understand it.

Consumer protection regulators need a supply of ‘STOP’ signs.

Usually it is the elderly that are the target of morning-TV ads and call-centre sales tactics exploiting emotional vulnerabilities before ‘selling’ a policy which will be a serious financial mistake for the buyer.

It is entirely fair and reasonable to declare the sale of these products to be ‘**elder abuse**’ of a kind that should be both proscribed, in terms of not allowing future sales and order redress by requiring existing policies to be voidable at the discretion of the policyholder and premiums already paid refunded.

Gentle readers may be unwilling to believe that major national financial institutions would engage in any combination of products and sales tactics that could be called '**elder abuse**'.

They do it: the cultural maxim seems to be 'if it is not yet illegal to do it, do it'.

Google-up 'funeral insurance' and talk to call-centre sales staff to audit the offers: ask questions and make judgments about tactics and value -- take notes for reflection on the offers and what may be on the carefully worded sales 'script' used to respond to questions.

The important issues are about:

- **target market** – elderly people glimpsing death and open to heart-plucking suggestions to 'not be a problem' for family and friends about funeral expenses.
- an implicit preference for **privacy** – you-phoned-us, we tell you the deal, we tell you it is a good deal, we say your prudent foresight will be a pleasant surprise for family and friends, we say nothing about your need for independent advice.
- **asymmetric information** – old people, as individuals, worry they may die sooner than later, insurance underwriters covering many elderly people 'know' how many will die in any future year and work the gap to build a business.
- **rough deals** – in broad terms a mid-70s person would pay some \$2000 each year (\$40 per week) for \$10,000 cover but, most likely to live to their mid 80s, will have paid \$20,000 before they die – and there will be no earnings on the 'investment'. Sales staff are clearly under pressure to close a deal but do not disclose the commission entitlement.
- **don't default** – premiums are payable until death (or age 85/90) and failure to pay cancels the policy and the seller can cop-the-lot. Apparently most policies eventually lapse when premiums are not paid – and the insurer keeps the premiums paid.
- **some saving grace** -- some policies now provide for the payout, on death, to be no less than the total premiums paid so that, for example, if \$20,000 or \$30,000 was paid in by age 85 or 90 the lot would be refunded (but no earnings). A relevant comparison is about investing the premiums in a managed fund earning a compounding 5% p.a.
- **drawing a long bow** -- funeral insurance deals may be considered akin to hoarding cash / no earnings / money back on death. Many age-pensioners hoard cash to reduce means-tested assets declared, increasing pension entitlements -- they could probably do so with a funeral insurance policy albeit with a loss of liquidity. It is unlikely that data matching by the ATO and Centerlink extends to 'assets' held as entitlements to funeral insurance payouts.
- almost above all, as a relevant concern, is the plain certainty that what is happening here is in direct conflict with the '**golden-rule**' -- none of the management team responsible for the design and sale of these products would ever condone the comparable targeting of their ageing parents and ageing friends. That is a damning indictment!

The consumer protection regulators are well aware of the consumer-protection issues entrenched in this combination of bad products and pressure sales tactics. The community

would be inclined to think that their interests are protected by the consumer regulators – they are not. Vulnerable aged people are being financially abused.

Looking forward – if funeral insurance is to be sold, the minimum terms and conditions required to be built into policies should be agreed by a panel of industry promoters, consumer regulators and consumer representatives.

.....so endeth the digression

PARTICULAR ISSUES

Reforming a financial system that is uncompetitive, inefficient and poorly regulated, risks instability – it happened in the wake of both Campbell and Wallis. Trusted regulators were then exposed as not understanding what they were doing.

This prospect is not an argument for doing nothing -- the quest, rather, is about finding safely sensible paths to preferred outcomes.

What we once enjoyed is unrecoverable and what we hope for may be wishful thinking. A financial institutional framework irreparably damaged decades ago has continued to implode.

Cultural competition – play by the golden-rule?

The record of deliberate institutional abuse of customers is recurrently disturbing. Financial institutions not meeting a golden-rule test could be required to both desist and redress damage done.

Consumers want - ‘golden rule’ reassurance and low-cost avenues for prompt redress.

New review and arbitration arrangements could review complaints against one telling test:

.....would executives, responsible for an offending business, like done to them, and theirs, what is being done to others by their company?

Elder-abuse promotions of ‘funeral insurance’ are illustrative of products and practices that could be summarily proscribed and damage done redressed with refunds.

It is envisaged that participants providing retail financial services would subscribe to a code of ethical behaviour – a benchmark ‘golden rule’ obligation if you like, allowing adjudication of complaints in low-cost dispute resolution schemes. Practically, market participants, found by their peers to have misbehaved, would be required to compensate the customers they disadvantaged.

Given that there is already an embryonic push for key players to make personal commitments to an ethical code, a more general expectation is no longer an idea from the left-field.

In the US one response to issues like these was the establishment of a Consumer Financial Protection Bureau [<https://www.consumerfinance.gov/>]

Two basic regulatory reforms

.....would do much to correct the present situation.

One overwhelming need is for regulatory accountability -- as is, the regulatory framework sees nominal responsibilities being compromised by cover-up diversions and conflicting private agendas.

An independent regulatory supervisor and coordinator for the retail financial system could continually mark performance against agreed objectives for both institutions and their regulators.

Independent regulatory oversight would substitute for parliamentary committees nominally having responsibilities for performance reviews but lacking competence and objectivity.

An independent regulatory coordinator could summarily address key issues, proscribing regulatory forbearance that condones behaviour exploitative and offensive to community standards.

An independent oversight board advised by an expert secretariat would allow issues of 'accountability', 'cooperation' and 'coordination' to be addressed in a collegial framework. Appropriate co-ordination, would displace very evident problems attending regulatory fiefdoms pursuing conflicting private agendas under varying degrees of influence from powerful industry lobbyists.

.....**Another** overwhelming need is to correct regulation conducive to inefficiency and unfairness

It is an ongoing national shame that no 'inquiry' or 'independent reviewer' has put squarely before the Australian community the basic operational mechanics of the failed market environment for the conduct of retail banking and payments services. For the past 50+ years and ongoing, Australia has seen only the growing dominance of corporate conglomerates known as the 4-Pillars.

It is never frankly acknowledged that this outcome – among others -- is a consequence of inappropriate and incompetent regulation across the regulatory board, including the competition and consumer protection regulators.

Three key points

.....**underpin the market dominance gifted to the 4pillars**

- **(i) tax-free barter concessions**

There have been predictably disruptive consequences of allowing the 4-Pillars unaccountable access to the soft income earned on the ‘interest free’ deposits held in transaction accounts, mainly with them.

That is the reason why the 4Pillars had an unassailably dominant position precluding effective competition when interest rates were high -- but ‘no one’ explained that.

Now, as interest rates are low, restoring competition is not an attractive option because the Pillars are in a fragile state and letting loose the dogs of competitive war could see some carnage – and the question is whether ‘no one’ will now explain that.

Putting aside the embarrassing silence, the time is now right to make sure that the basic rules in place are made sound. At a minimum all customers should be deemed to have earned, and be required to declare, taxable interest income on transaction account deposits either paid or calculated daily at the ‘deeming rate’ for age-pensioners.

- **(ii) cartel-like domination of card transactions**

The other major racket let run to featherbed the easy profitability, and solvency, of the Pillars has been the de facto card scheme cartel.

Excessively profitable and deceptively marketed credit card products are ever more a redundant contrivance -- a product that should have been displaced by debit cards linked, as appropriate, to an overdraft line of credit. The unrestrained domination of Visa/MasterCard branded credit-card products exploits ‘joint venture’ price-fixing privileges and the reluctance of the RBA to demand reforms to restrain a de facto cartel.

The “Dawson” review of trade practices law in 2003 sensibly proposed to outlaw price fixing designed as a cover for anti-competitive arrangements and likely to substantially lessen competition.

The 4Pillars would not want any change to ‘RBA only’ regulation of retail banking and payments – one very good reason for superimposing an independent regulatory coordinator.

The relevance of the cartel-like structure around ‘cards’ is a burgeoning issue as ‘tap-‘n-go’ functionality quickens the demise of cash for making in-person transactions.

- **(iii) the RBA as a reluctant regulator**

20 years back, when its Payments System Board was established, the RBA promise to be a ‘reluctant regulator’ has been met to a fault, except as it left in place one critical regulation that suited its purpose --- a Nelsonian eye was turned to the tax-free barter of free-services for free deposits.

Such poor performance, bordering on dereliction, and extending back some 30 years and more would not stand even cursory scrutiny of its merits by any independent assessor of the community’s best interests.

Most of the explanation for this nonsense is about the RBA’s preoccupation with stability, and cossetting 4 dominant Pillars, rather than fostering a competitive market risking occasional problems and institutional buy-outs.

In the end this tactic has only ensured instability -- a financial system now rocked to its foundations by low interest rates and ever more dependent on the public purse to underwrite its solvency.

Proper supervision and coordination of regulatory action could preclude and correct such deception.

Regulatory confusion – mixed messages

As things stand there is confusion of regulatory responsibility. It is never clear which regulator is responsible for dealing with particular issues – an endless pea-and-thimble confusion that would make a Times Square huckster blush. A supervising and coordinating regulatory overseer would help to define differences and promote coordination and cooperation.

This approach would see key institutional players, including regulators, agreeing to voluntarily work towards performance benchmarks – as if markets were competitive and regulators cooperated -- coupled with 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.

Whatever ‘regulatory review’ body may be put in place, one aim would be ‘continuous interaction’ as distinct from delivering periodical ‘fail’ report cards too late to be of any use.

Now, consider some points where conflicting and uncoordinated regulatory settings are sending mixed messages to the market institutions and the community about important policy objectives.

-- (i) less bank capital not more?

Some consequences of a low interest rate environment suggest now may not be the right time to engineer an outbreak of real competition in retail financial markets.

Regulators proclaiming additional bank capital seem to have not noticed that the ‘goodwill’ value of the 4Pillars has fallen away -- ‘top up’ capital going into banks needs to be weighed against losses of de facto capital ‘falling out the bottom’ as interest rates moved lower and the value of banks rent entitlements fell sharply.

Pending some semblance of normality returning to financial markets, there is an issue about the solvency of too-big-to-fail institutions now ever more reliant on bail-out access to the national purse. Put differently, the low interest rate regime pulled from the Pillars some regulatory props, valuable rent entitlements, previously underwriting their solvency – in their place is a blank cheque drawn on the public purse.

- (ii) discordant notes about cash

The use of tangible paper notes to make payments, being ever more redundant, puts in sharp focus the role being played by some \$70 billion of banknotes, almost all being \$50 and \$100.

Both these notes are now better recognized as bearer bonds mainly in demand for unnecessary and unlawful purposes, especially tax evasion.

As for RBA reliance for funding on bank-note profits, there are more sensible ways of funding the operation of the RBA - from the budget – as are other public policy agencies.

- (iii) the lure and illusion of ‘free banking’

There is no semblance of a proper price system governing the conduct of the retail payments system. On the contrary the whole thrust of the regulatory stance has been to promote and foster an illusion of ‘free banking’.

Only penalty fees – at exorbitant rates – are registered in the public mind: the fees charged for making an account keeping mistake, like a late payment.

Otherwise very costly transaction and card payment services are either underpriced or provided free of charge (except when a ‘go-away-price’ steers customers to use a credit card instead of a debit card, because the banks secretly make more money from the ‘free’ service.)

Perversely, the lure and illusion of ‘free banking’ has the community hooked on the very nonsense of it – to the disadvantage of all. So deeply embedded is the fiction of ‘free banking’ that trying to correct the culture and restore a proper market, may be beyond the credible inclination of any regulatory reformer – but it needs to be done.

REGULATOR PERFORMANCE -- FRANK ASSESSMENTS

Any idea that the appointed regulators of the retail financial system have served Australia well simply does not meet the pub-test – nor would it meet with the approval of any independent review body (bar the *Murray Committee*).

Reserve Bank of Australia

The RBA is competent in meeting its monetary policy responsibilities – beyond that, the assessment is not favourable.

The RBA now has a financial system it probably considers ‘ideal’ – a system dominated by four very profitable conglomerates – the Pillars -- each so too-big-to-fail that they are effectively underwritten by taxpayers first funding regulated rent-entitlements boosting their profitability and now, with these rents eroded, responsible for bailing them out.

For a central bank enjoying the ‘quiet life’ of a single policy preoccupation – stability -- it is ‘nirvana’. The RBA’s preoccupation with ‘stability’ has denied ‘competition’ and ‘efficiency’ in retail banking and a fair-go in retail superannuation.

Challenging work remains to be done, presumably by regulatory agencies newly given jobs the RBA chooses to not do well.

The transition to any new regulatory regime had best be made carefully – and that bolsters the sense of having an independent regulatory reviewer to oversee and coordinate any reorientation of the regulatory focus: again, it needs to be done – again, it needs to be done carefully.

Ideally, the RBA would 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 badly for far too long – at enormous cost to the community.

The RBA could and should have dealt with this mockery 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 the tax-policy settings that have been, and remain, so unfairly disruptive. It has not asked for the job to be done.

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’.

The apparent failure of the RBA to understand these market realities in the 1980s is never mentioned in polite company.

The RBA has been more generally derelict in its failure to regulate the retail payments system – a responsibility first allocated to it 33 years ago and then given formal legislative status in 1998. It has not asked for credit-card schemes operators to be precluded from gouging excessive revenues from retailers and cardholders.

The RBA has never mustered the ‘independence’ to explain frankly how the retail banking and payments system works – why it is inefficient and why there is only ever less competition. The ‘independence’ of RBA the community is entitled to expect is made bogus.

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.

Recasting the role of the RBA would also sensibly see responsibility for the issue of banknotes transferred to an independent currency board as a subsidiary of the Treasury.

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.

While ever the RBA writes the cheques to bail out troubled financial institutions, it will always have a keen sense of being the top-dog irrespective of other nominal allocations of regulatory responsibility.

The separation of bank supervision from the RBA in 1998 was, in essence, a pre-agreed, Treasury-driven initiative of the Wallis committee -- with a 'payback' undertone to punish the RBA for its incompetence in allowing the circa-1990 banking crisis.

Payback for this incompetence started in February 1989 with a casual 'announcement' in the AFR that the incumbent deputy-governor would not be appointed governor in August.

Whatever, it was becoming fashionable internationally for the prudential supervision function to be done separately from the central bank – APRA was established in 1998.

On reflection, this was all a bit group-think and ill-advised – particularly relocating, in Sydney, the insurance supervisors then based in Canberra. The wash up is now legendary – supervisory disarray allowed a major insurance failure to bypass the supervisory radar.

The more fundamental problem with prudential supervision eventually surfaced as the global financial crisis. The origins lay with an incredibly flawed framework developed in the 1980s by the central banks' own central bank, the Bank for International Settlements (BIS).

One frightful irony is that this flawed framework was sold as ensuring 'capital adequacy' when it was a truly Trojan horse making 'capital inadequacy' the only certain outcome.

The 1988 BIS rules were practically a direction to banks to minimise capital by securitizing and selling loan portfolios – and they did, in the inflated volumes of never-repayable loans that financed a global asset price bubble that eventually burst with spectacular consequences.

In Australia, in December 2006, the just-retired RBA governor was inexplicably moved to reveal – in his Boyer Lectures -- that he feared an asset price bubble bursting but – wait for it – 'it was not the RBA's job to deal with it'.

Australian Securities and Investment Commission (ASIC)

I have little inclination to say much about ASIC in this submission.

ASIC has never enjoyed the illusion that it is well respected in the Australian community – whatever culture took root in ASIC and its predecessors, it seems to have been a fatally flawed institution from the outset.

Too many lawyers, perhaps, too inclined to protracted legal debate, perhaps.

Whatever the reason, ASIC has floundered so badly for so long that it cannot credibly endure in its current form with its current range of responsibilities – in particular, responsibility for 'consumer protection' should be relocated, possibly in a specialist consumer-protection agency dedicated to retail financial markets and institutions.

It is unnecessary to labour criticism of ASIC that is so well known and so widely and clearly accepted – an indictment so persuasively made by ASIC itself, an institution seemingly unable to do anything right.

[.....'unnecessary' criticism does not extend to ASIC still tolerating funeral insurance.]

Australian Consumer And Competition Commission (ACCC)

Whatever happened to the ACCC?

The ACCC has, unnoticed, apparently ‘died’ or otherwise ceased to have any practical day-to-day relevance for the wider community.

The ACCC may well have done whatever it can in a small open economy best suited to having a couple of dominant players competitively (or collusively) presenting a mirror-image front.

The basic set of trade-practice rules in place presumably precludes blatant abuses but, generally, there is not usually much effective difference in the choices consumers face. The most effective addition to the competitive environment in retail trade arrived with the internet reinforced by a ‘higher’ Australian dollar exchange rate.

The retail financial system fits this ‘no real choice’ mould – with the notable exception perhaps of the retail superannuation industry where ‘industry funds’ consistently rate better than ‘retail funds’.

The misgivings with the ACCC are mainly about consumers not being protected from obvious abuses – of which funeral insurance is one illustration and ‘elder abuse’ an angle that may allow the ACCC a proscribing role.

Circa-2000, the ACCC made an effort to review bank credit card schemes – this was short lived as the RBA shouldered aside an ACCC encroaching on ‘its patch’. Similarly, there was, presumably, a territorial stoush between ACCC and ASIC about ‘protecting’ consumers of superannuation products. With the ACCC sidelined, ASIC struggled, for a decade or more, to appreciate the sense of financial advisers being required to give the ‘best advice’ to clients rather advice ensuring a higher commission income for the adviser.

What can one say?

Perhaps repeat the proposal for a regulatory review requiring ‘competing’ regulators to cooperate in the quest for ensuring the customers get a fair go – not least promoting ‘golden rule’ product design and pricing in industries, like the retail financial system, where competition is elusive.

Perhaps repeat the proposal for a coordinating regulatory agency with the independence to continually review the individual and collective performance of the appointed regulators ‘on their merits’. There needs to be accountability – proper professional independent accountability in addition to, or instead of, the usually ineffective arrangements, such as parliamentary committee reviews.

Australian Taxation Office (ATO)

Practically, and politically, the Treasurer is the ‘governor’ of the ‘ins’ and ‘outs’ from the public purse of the Commonwealth.

Accordingly, it is up to the Treasury to advise the Treasurer on tax-policy issues and, as appropriate, to advise the ATO of changes in policy. The ATO should not be mute – and

it has, on occasion, reacted quickly to head-off proposed schemes of tax-avoiding barter among tradesman and other professionals.

Considering tax-policy settings distorting the financial system, one stands out.

Putting aside what the RBA does not think, it is clearly critical to the prospect of competition in retail banking to ask that banks be required to 'deem' the taxable interest-income payable on daily deposit balances in customer accounts.

Any credible review agency, co-ordinating regulatory co-operation, would demand this.

End note

Calls for the Australian retail financial system to be made 'more competitive' are hardly sensible for the time being.

The system is not presently stable enough to substitute 'vigorous competition' for what is largely none, now, and has only been ever less competitive over the past three decades.

A better approach would see some redemption of regulatory competence and commitment to reforms that would reorient the present structure so that it worked 'as if' it was competitive. Only from that reformed practical base could the emphasis shift to promoting competition in a, then, more conventional market framework.

The more pressing challenge is about restoring regulatory competence – establishing a regulatory framework able to address an initial objective of having the system operating 'as if' it were competitive.

To meet that challenge the suggestion is for the creation of a new policy agency empowered to act as a regulatory reviewer and coordinator – not so much having a prominent public role but rather working, with overall authority, behind the scenes to set performance objectives for the system and coordinating regulatory action and cooperation to meet them.

Peter Mair

3 September 2017.