REGULATORY FAILURE & REGULATORY REFORM

Much has happened since the Campbell and Wallis committees reported on their inquiries into the Australian financial system – the community will be similarly enlightened when the Murray report is tabled in the Parliament later this year. Ahead of that, a cautionary note recalls the destabilising aftermath of both earlier inquiries.

No fault of Campbell or Wallis, but the scent of change in the air saw key players, regulators included, scrambling for private advantage and exploiting regulatory confusion. The consequences, however unintended, included a local banking crisis around 1990 and a major institutional failure in 2001. Proposals for change need a strategy for careful implementation.

More fundamentally, whatever contribution Campbell and Wallis made to 'efficiency' and 'regulation', both issues remain front and centre in any broader pursuit of 'economic development'.

Regulation – good and bad – is a major driver shaping the financial system. Australia's regulatory framework is not working well -- a weakness that demands a review of 'regulatory philosophy' with focal points of 'clarity', 'accountability' and 'coordination'.

SOME PRELIMINARIES

The primary focus of this submission reflects my comparative advantage, assessing regulatory failure and proposing regulatory reform for the financial system. That said, the performance of the financial system is not immune from flaws in a broader national policy context.

-- rules of the game: 'business is business' v. 'the golden rule'

Many lament the alacrity with which financial institutions, and their professional associates, are party to commercial practices that confront a 'fair go' and the national interest.

An ever-ready defence couples obligations to 'act in the interests of shareholders' with professional advice legitimising 'unfair' practices not yet illegal or otherwise proscribed.

..... one may well ask, 'what happened to the golden rule'?

Competition approximates golden-rule outcomes. However, when competitive environments are elusive, as in Australia, the challenging quest is for a business culture that approximates competitive outcomes.

The panel will be familiar enough with practices confronting community expectations and standards. The community will be interested to see what the panel deems to be an appropriate ethical code which financial institutions and associated businesses might be encouraged to adopt.

Whatever, the practical responsibility to maintain order and ensure fair play ultimately falls to the parliament and the regulators it empowers to promote the public interest.

So, while it may be a reasonable objective to seek golden-rule business practices, it is otherwise imperative that a sound regulatory framework is in place and that the appointed regulators do their job – and collectively co-operate to do jobs needing their collective authority.

..... sadly and too often, however, regulators clearly fall short of the inclination and coordinated commitment to meet their responsibilities..... illustrating such apparent regulatory failure, being one focus of this submission, flows through to practical proposals to reform the regulatory framework and to make regulatory agencies accountable, individually and collectively.

That said, and as my story unfolds, the panel will hopefully also see need for a substantial reformation of the regulatory framework for the protection of consumers. When taking opportunities to 'look abroad' for guidance, focal points could include the Consumer Financial Protection Bureau, recently established in the US, and travellers might seek an opportunity to meet with its sponsor, Elizabeth Warren, now a senator in the US Congress.

-- funding growth: correcting misallocations of resources

The financial system plays a critical role in the allocation of resources but it is handicapped if related policy settings are not coordinated, especially tax policy.

Looking for distortions, 'housing' is a glaring illustration of a failure to coordinate policy settings leading to a misallocation of resources. Key elements of this complex mess include 'negative gearing', capital-gains tax concessions, family-home exemptions from age-pension means tests – to say nothing of the community's apparent cultural preoccupation with owning and investing in over-priced housing financed by borrowing from banks.

A major challenge for the panel - what to do about 'housing'? - is a political minefield – not easy to deal with perhaps but an issue for national 'resource allocation' and financial 'stability' that deserves close attention.

One sensibly short-term regulatory response could be the inclusion, in the age-pension means test, of the value of owner-occupied housing in excess of the median national home value. A deferred next step would include total housing assets – possibly coupled with innovations to allow a supplementary 'home-equity' income-stream to be drawn down against housing assets.

The 'best' mix of policy initiatives and likely consequences would need to be cleverly assessed: hopefully there can be inducements for scarce housing assets, presently under-occupied, being sold to release housing equity. Retirees downsizing, to access housing equity, could work to restrain housing price inflation. Re-housing retirees in higher-density dwellings could stimulate residential construction.

There are risks for 'stability' in tampering with 'housing' but those in not doing so, soon, probably greater. One practical focal point is about the institutional innovation needed to facilitate the release of housing equity via 'reverse mortgage' loans and like schemes. There is a strong case – and an Australian cultural tradition -- for a government-owned intermediary to operate on commercial terms in new arenas like this one. The Productivity Commission envisaged such a scheme to facilitate user-pays for residential aged care.

-- the (un)competitive environment

Appropriate, or not, for a relatively small domestic economy, local 'retail' industries are typically highly concentrated and more conducive to 'de facto cooperation' akin to collusion, than competition.

Markers for collusive behaviour include most players acting similarly but contrary to golden-rule expectations – e.g. uniform fees and charges widely considered 'excessive'. The retail banking and financial system is sadly illustrative in recent years.

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.

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

Not to labour the earlier cautionary note but, 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.

This prospect is not an argument for doing nothing when changes so clearly need to be made -- the quest, rather, is about finding safely sensible paths to preferred outcomes.

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. Again, whatever 'Regulatory Review' body may be put in place, the intention would be 'continuous interaction' as distinct from delivering periodical 'fail' report cards too late to be of any use.

THE REGULATORY INDICTMENT

What follows next is the substantial contribution of this submission.

The content, kept mercifully brief, aims to be informed and argued through to practical reforms. Different regulatory agencies are assessed separately but that should not distract from a major underlying theme of ensuring willing co-operation to co-ordinate regulatory agendas in the way that an independent 'Regulatory Reviewer' could oversee.

As things stand, it is never clear which regulator is responsible for dealing with particular issues – and the search for relief entails an endless game of pea-and-thimble confusion that would make a Times Square huckster blush. A co-ordinating regulatory overseer would help.

1: RESERVE BANK OF AUSTRALIA (RBA)

The RBA is a predictably a primary reference point in this submission[1].

The RBA's conduct of monetary policy in recent years is exemplary – and applauded. A freely floating $A coupled with an array of expert analysts in Australia and abroad, underwrites the 'independence' and competence of the RBA in setting interest rates consistent with price stability. Well-informed open markets would punish any mistakes immediately.

A not-so-glowing historical record on that score is behind us.

Historically and currently, however, there is good reason to be sceptical about the performance of the RBA in meeting other responsibilities – including prudential management of the financial system, promoting efficiency in the retail payments system and the management of the currency note issue. There is no 'automatic auditing' here -- no credible process is in place to assess and review the merits of the RBA's performance beyond monetary policy matters.

Seven years ago, the RBA commissioned an academic to write a 'History of the RBA: 1975-2000' – many doubt that any objective commentary on that critical period will ever be published by the RBA.

Sad and disturbing elements colour RBA history after 1982 --- not least, unstable and incompetent management had unfortunate consequences for a local banking system left damaged and in crisis by the late 1980s.

Comparable incompetence at other central-banks, and at the global confraternity of this brotherhood in Basle, eventually delivered a global financial crisis. That Australia was relatively unscathed in the wake of the global crisis owed much to the dramatic consolidation of the local banking system after 1990 and lingering fears of a repeat.

A conundrum for a panel balancing 'competition', 'concentration' and 'stability' is underscored: what we once believed we enjoyed is unrecoverable and what we claim to aspire to may be wishful thinking. A financial institutional framework irreparably damaged a couple of decades ago has continued to implode.

---

[1] Peter Mair has a keen interest in financial system reform extending back to the 1960s – primarily at the RBA itself and as a senior adviser to the Campbell Committee and 'helper' to the Wallis Committee -- and subsequently as a long-time regulation-writer for a Fairfax business magazine – *CFO* – and contributor of submissions to financial reform processes.

The starting point is from where we are now – but because it is relevant to know how we got to this point, the following includes some brief historical commentaries.

-- the RBA is not accountable

Objective assessments of the RBA's performance are impeded and denied.

Importantly, and needing to be addressed, a not credible concept of the 'independence' of the RBA extends, unnecessarily, beyond its monetary policy responsibilities.

A 2006 taskforce -- *Rethinking Regulation* -- reviewing regulatory burdens on business, recommended that the merits of the RBA's administrative decisions be subject to administrative review**.**

The government rejected that proposal: in particular it said, about RBA decisions relating to the operation of the payments system: *these decisions..... should not be subject to merits review*. The 'House' economics committee stopped asking the RBA about payments system policy.

Ahead of that, the RBA declared that it is a 'reluctant regulator' of retail payment systems, and proceeded to act accordingly, unchecked: the community has been denied the more efficient, cost-effective payments system it is entitled to.

Arrangements, superficially promising 'RBA accountability', are simply ineffective. It is, for example, fanciful to expect various committees of parliamentary backbenchers to have the freedom to take-on the RBA in public in any meaningful way. Among other things, too much bi-partisan common ground has been marked 'do not go here' – major-party backbenchers daring to trespass have a limited future (other critics are confidently ignored).

The RBA exemplifies a well resourced and clever bureaucracy: never caught off-guard and never under pressure, deftly massaging problems before they become contentious. One polished tactical ploy is scheduling unnecessarily long inquiry and review processes, even when the answers are obvious, and then delivering a minimal regulatory response. Along the way pressing questions are deflected with 'under review' explanations.

More generally, the RBA itself simply does not mention a raft of inconvenient facts that would, fairly in the public interest, draw attention to politically contentious issues – like the major-banks tax-avoiding barter deals underwriting 'free banking' nonsense -- or risk its unreasonably inflated flow of 'private' profits from the note issue, contrary to the national interest.

More generally, the RBA knows what it is not doing to avoid meeting its allocated responsibilities. Pressed, it may say that needed action is the primary responsibility of another regulator. Pressed again, and reverting to 'not-my-job' defences, it declines to ask other regulators for co-operative action or to ask the Treasurer to encourage co-operative approaches. Memorably, circa 2000, the RBA roughly shouldered aside an ACCC about to review anti-competitive elements of credit card schemes – 'get off our patch' denied needed reform.

Considering RBA responsibilities, beyond monetary policy, the record -- for what-is-never-said and never-done -- belies a trumpeted 'independence' better seen as some 'private' mutual-agreement quite contrary to the national interest. The rules of this game ensure there is no scrutiny -- the RBA enjoys the 'quiet life' of an unquestioned monopolist regulator.

At a minimum, those rules, precluding scrutiny, need to be rewritten to ensure the RBA is accountable. Beyond that, some present functions and responsibilities of the RBA would best be re-located with another agency.

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

The Panel's inclination to address some aspects of regulatory forbearance in retail banking may be stronger if a disturbing parallel, with print and broadcast media businesses, is appreciated.

Media businesses share with banks a soft, tax-free barter concession. For the media, the advertising revenue which pays most production costs is, practically -- in the eyes and ears of readers and viewers -- an untaxed 'income' for consumer beneficiaries undercharged for the total product delivered. With banking, the river-of-gold funding 'free banking' and under-priced transaction services, flows from the interest not paid on, apparently, some $900 billion of essentially 'interest free' funds on deposit with banks[2].

Incentives to undermine this free-deposit, pot-of-gold franchise will, probably, eventually, see challenging combinations of innovative payments technologies and customer account relationships. If and when that comes to pass, 'old' banks may be scrambling to substitute a different business model – and the RBA may be unable to arrest a challenge, possibly organised beyond its reach and protected by free-trade agreements.

The most likely challengers to the de-facto banking monopoly are the mirror-image global giants – Visa and MasterCard. These global businesses, long dominating card-payments globally, are already first-mover invaders extending credit-card functionality as a loss-leading, cutting edge of a tap-and-go substitute for cash – available 'free' to card-holders is a capacity to pay for 'anything' no matter how small the purchase. This is the new cash.

One wildcard is the burgeoning popularity of so-called 'mobile' (phone) payments. This technology, incorporating sophisticated anti-fraud monitoring, facilitates on-credit payments to be settled with automated withdrawals from interest-bearing deposit accounts with licensed deposit takers in Australia or abroad. Telcos will be gearing up.

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

Unfortunately, as the following illustrations suggest, the RBA is, apparently, not alert to this risk, nor is it taking preparatory steps to ensure the retail banking system is put on a shock-proof operational footing.

It will be interesting to see what the RBA puts to the Panel on payments system issues.

-- inappropriate 'regulatory forbearance' briefly illustrated

Brief outlines of longstanding examples of regulatory failure at the RBA illustrate the need to ensure the RBA is made more accountable for its performance in (not) meeting appropriate 'national interest' objectives in key elements of the financial system.

[2] March 2014 RBA Bulletin article "Developments in Banks' funding Costs and Lending Rates' (page 71).

Deliberate and determined regulatory forbearance prospectively points towards relieving the RBA of some responsibilities it chooses to subordinate and relocating those functions to other agencies.

In defence of the RBA, it can be said to have acted sensibly selfishly in making 'stability' its over-riding policy priority and simply subordinating the otherwise conflicting responsibilities. However relevant that 'private' selfish defence may be, it reinforces the inclination to relieve the RBA of some conflicting responsibilities that it does not respect, does not do properly and, probably, should not have been given.

Put differently, the RBA now has a financial system it probably considers 'ideal' – a system dominated by four very profitable conglomerates each so too-big-to-fail that they are effectively underwritten by the taxpayers responsible for bailing them out of any trouble: for a central bank enjoying the 'quiet life' of a single policy preoccupation, it is 'nirvana'.

For the rest of us, however, 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 other regulatory agencies newly given jobs the RBA will not do.

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 broadening of the regulatory focus -- again, it needs to be done – again, it needs to be done carefully.

-- competition and efficiency in retail payment systems

A particular focal point for the panel is the responsibility the RBA has for the retail payments system. Prospects for the efficient allocation of the considerable resources of the payments system depend on the service prices paid fairly reflecting costs. Practically, 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'.

Hopefully the standing exemption of RBA payments system policy from 'merits review' does not preclude the panel making objective assessments.

As will unfold, 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.

(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.

The abject failure of the RBA to understand these market realities in the 1980s is never mentioned in polite company. One can only wonder what an edited 'history' will say.

The RBA has been more generally derelict in its failure to regulate the retail payments system – a responsibility first allocated to it 30 years ago and then given formal legislative status in 1998. 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 RBA 'independence' the community is entitled to expect is made bogus.

(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.

My reward was a recommendation that the Visa and MasterCard credit-card schemes be investigated, with a view to regulating excessive transaction interchange fees. The 'reward' for the RBA was to have confirmed, by legislation, its disdained responsibility to promote 'efficiency' and 'stability' in the retail payments system – a responsibility that it did not want so formalised and one which it has not met, except in the perverse sense that doing little ensured 'stability' to a fault.

Whatever, 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. Other national regulators have now gone further than Australia has, capping credit card fees at lower levels.

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[3] -- '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.

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.][4]

---

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

[4] 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.

(iv) a currency note issue perversely milking the national coffers

It is ironic, to say the least, that the demand for currency notes is ever higher at the very time that the use of cash, for making transactions, is ever less. Something's a bit silly here.

The naturally profitable business of issuing bank notes once belonged to commercial banks which eventually (circa 1860) paid taxes to the states based on notes on issue. Federation saw the note issue become the exclusive preserve of the Commonwealth, and the business of the Treasury, until the Commonwealth Bank (later Reserve Bank) was established in 1912.

The RBA has first call on the profit of the note issue – but its retention can be contentious as illustrated by the recent 'taking' and 'restoring' decisions affecting the government budget position. (Why, one well may ask, are the numbers not consolidated?) The coin issue is still the business of Treasury.

The note issue is not a natural preserve of the RBA. Other countries have currency boards separate to their central monetary authority.

The following 'argument' supports a thoughtful proposal to separate the note issue function from the RBA. A brief outline of the nonsense now parading as the management of the Australian currency issue, demands reform.

The basic issue confronting Australia is most easily comprehended by comparison with New Zealand – in essence the great bulk of notes on issue in Australia (by value) are being hoarded as a bearer-security medium for tax-evasion and are never in circulation as a medium of exchange.

In short:

- The per-capita value of notes on issue in Australia some $2000+ is about 3 times that of New Zealand -- the principal explanatory difference is that a means test limits eligibility for the age pension in Australia but not in New Zealand. Many aged Australians very sensibly hoard, and do not disclose, these bearer securities, masquerading as bank-notes, to manage their declared means-tested eligibility for the pension.
- Some 90% of the $60 billion+ currency notes on issue in Australia are $50 and $100 -- and the share of 'green' ones, never seen in circulation, would be more prominent if they were easily practically available. In NZ the comparable figure is less than 50%.
- Banknotes are also hoarded as a medium of tax evasion by others – mainly participants in businesses with a cash payment component in their sales revenue and black-economy players needing anonymity. NZeders are probably more law abiding than Australians – and that would account for some of the wide difference.
- Similar comparisons between other 'means-test' and 'no-means-test' countries point to similar conclusions.

Notwithstanding these readily available facts, the RBA writes its annual and other reports as if the situation with currency hoarding is not relevant and not worth mentioning, ever.

The RBA inflates its profit by allowing the note issue to expand 'on demand' – whatever is asked for -- all without any regard for the net damage being done to the national coffers.

Make no mistake, while 'hoarders' do lose the after-tax interest they would receive if the cash were invested in fixed term deposits, they more than cover those 'losses' with ill-gotten gains -- tax not paid and additional pension received.

Hasten slowly with any anti-hoarding reform arrangements for sure -- but it is well past time to start stopping this rot.

Options are open to manage the note-issue in ways that would discourage such tax-evasion. It would be practical enough and cost effective to limit the face-value life of banknotes to say five years – ensuring that hoarded notes are recycled to avoid a substantial redemption-discount to the face value of out-of-date notes. The mechanics of swapping large values of notes and exposing hoarders to view (and cash-transaction reports) would facilitate enforcement of obligations to disclose assets and taxable income.

That line of argument deals with the sense of the note-issue as an RBA function – and it begs the question of the nonsense continuing, unrestrained, for much longer if responsibility for the note issue was returned to the Treasury (or a separate currency board under Treasury supervision).

The RBA is moving to issue a new series of redesigned banknotes and that may be an opportunity to consider issuing notes with 'face value' use-by dates.

It is, incidentally, hardly a natural fit for a central bank to be managing note-printing businesses – as sadly illustrated by the well-publicised mismanagement of international marketing abuses.

[Similarly, it is, these days, hardly a natural fit for the RBA to be the ringmaster for a substantial retail banking operation on behalf of government – this function could also be gradually displaced to the commercial banking industry.]

(v) 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.

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.

2: AUSTRALIAN PRUDENTIAL REGULATORY AUTHORITY (APRA)

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

There are costs with the single-minded pursuit of 'security' and 'stability' – and not learning new tricks.

------ some imprudent history

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.

The payback for this incompetence started in February 1989 with an apparently-casual speculation, but actual de-facto announcement, in the AFR that Bernie Fraser would be appointed governor in August 1989 – and, implicitly, that a self-serving, incumbent would not be. All hell broke loose in the RBA – in February 1989.

Whatever, by the mid 90's, it was fashionable internationally for the prudential supervision function to be done separately from the central bank – APRA was established.

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 fester under 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.

Needless to say the members of the BIS brotherhood – including the RBA – blindly, blandly endorsed the BIS rules and never wavered in their faith, notwithstanding the pleas from others for commonsense to be restored. The nonsense extended through to the global crisis.

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'.

The BIS – itself a failed bank -- should have been closed down. It was not.

Undeterred, however, it was back to the ramparts in Basle – and the writing of revised prudential guidelines now parading as Basle III.

---- a more durable prudential framework?

I have no truck with 'rules' based approaches to prudential management substituting the 'discretion' and 'subjective judgment' of banks and their supervisors for market-based disciplines.

That said, I see no realistic alternative being embraced locally or globally anytime soon.

Whatever, for my money to be safe, I would like to see banks required to issue half their non-capital liabilities, deposits and marketable bonds, on a basis that subordinates their repayment to other liabilities, bar capital.

A self-interested market would soon get wind of any looming problems – and self-interested bank boards and bank managements would have systems in place to make sure an ill-wind never blew.

This is not so radical a proposal these days when most have substantial investments in superannuation-fund and like investment arrangements which can be fairly described as 'no-capital banks' managing asset portfolios, and obligations to members, that fluctuate in value with market vagaries.

Importantly, self-managing, bank-capital structures subject to market disciplines would deal with most deposit insurance issues: those wanting a safe haven can have the protections of 'priority' deposits – at a lower interest rate – while those able to accept risk, may trade-off some safety for a higher yield.

Not a realistic proposal just now perhaps, but it probably should be.

3: AUSTRALIAN SECURITIES AND INVESTMENT COMMISSION (ASIC)

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

ASIC, unlike some other regulators, 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 action, 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.

In this same general area there are issues about the management framework governing the Financial Ombudsman Scheme (FOS). The origin of FOS, as a banking industry initiative some 30 years ago, was an exemplary 'golden rule' initiative of the banks (by a former Treasury/Campbell/Westpac staffer) at a time when ADR arrangements generally were embryonic. Now, however, it is less clear that it is appropriate for FOS membership to be 'voluntary' – including the obligation to fund the facility.

Preferably, FOS would be recast as a formal regulatory agency of government with authority to resolve disputes, preferably informally, and also to 'name and shame' financial institutions shown to have systemically flawed systems and policies.

[There is an unresolved matter on foot – about NRMA Insurance – with both ASIC/FOS and the Senate economics committee reviewing ASIC and both are due to report shortly: depending, I may provide this material to the FSI as a separate submission.]

4: 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 has, of course, arrived with the internet reinforced by a 'high' Australian dollar exchange rate. In short, lengthy ACCC investigations of local restrictions on the availability of cheaper books and electronic entertainment have, for example, been overwhelmed by fingers doing the travelling on keyboards.

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'.

One moot point is the aforementioned risk of an internet led revolution in retail banking.

The community is more generally left wondering what 'competition' practically colours the array of retail markets with which most consumers must deal day-to-day.

It was noted above that, circa-2000, the ACCC made an effort to review the terms and conditions on which bank credit card schemes were operating – this was short lived as the RBA unceremoniously shouldered aside an ACCC encroaching on 'its patch'. In similar vein it may be informative to ask 'Aussie John' about the help, or resistance, he got from the RBA, circa 1990, when Aussie Home Loans was in its infancy – and, now, of course it has passed through the predictable cycle of 'success' before being embraced by a major bank.

Similarly, there was, presumably, a comparable territorial stoush between ACCC and ASIC about 'protecting' consumers of superannuation products: it is a pity the ACCC did not win that one either as ASIC struggled, for a decade or more, to appreciate the sense of financial advisers giving clients the 'best advice' for them rather than advice which would cost the client more but return the adviser a higher commission income.

Even in recent days, ASIC has said it would not be pursuing advisers for not complying with fair-trading obligations that the incoming government intends to remove.

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 – a Regulatory Reviewer -- 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.

5: PANDORA'S BOX: TREASURY / 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.

Distortions originating in an apparent political capriciousness of tax-policy rulings are central to many entrenched problems standing in the way of the retail financial system operating safely and efficiently in the first instance – and then best allocating scarce loan resources.

One hesitates to interfere with this 'Pandoras box'.

Pressing ahead, however, one must so interfere.

I have limited appreciation of the mechanics of all the tax-policy settings possibly distorting the financial system – listen to others better informed.

In my mind, two proposals stand out nonetheless.

First, whatever 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, but not paid, on daily deposit balances in customer accounts.

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

Second, and similarly, when pensioners housing assets can be converted, using a home equity loan, into a 'not counted' income stream (identical to a 'super fund' pension) – there is an overwhelming case for including housing assets, above a modest base initially, in the means-test on assets for age pension eligibility. Houses are de-facto personal superannuation funds – not least when home equity is shifted to inheritors making mortgage-secured, non-repayable loans to, usually, benefactor parents.

I believe that any credible, review agency co-ordinating policy would also demand this.

Others will have different but equally credible demands for tax-policy reforms likely to enhance the contribution from the financial system.

PRACTICAL PROPOSALS FOR CHANGE: A SUMMARY

The following pulls together three groups of practical reforms argued above.

The threads are:

- Regulatory Review: clarity, coordination and continual accountability.
- Consumer Protection: 'golden-rule' accountability for product design and pricing.
- Resource Allocation: correcting over-exposure to over-priced housing.

Regulatory Review: clarity, coordination and continual accountability

A pressing need in the financial services arena is for the establishment of an expert independent regulatory review agency – a Regulatory Reviewer -- akin to the Productivity commission, able to review a regulator's performance 'on its merits' and hold appointed regulators accountable for shortcomings.

The bland 'good-intentions' framework in place for the regulation of the Australian financial system, however superficially comprehensive, simply does not deliver the outcomes that the community is entitled to.

Key regulatory agencies apparently substitute their own agenda with, apparently, wilful disregard for obligations imposed by parliament in legislation.

An appropriate reform initiative would first ensure that regulatory responsibilities are clearly stated and accepted. Next, where regulatory responsibility is shared or overlapping, a formal obligation to cooperate and coordinate an overall regulatory response would be agreed – something, incidentally, very different to the existing 'memoranda of understanding' that read like exercises in confusing semantics.

Finally, in relation to specific regulatory objectives, separate and joint statements of outcomes achieved would be filed by regulators and be subject to merits review by an independent expert 'review agency'.

An appropriate prelude to the establishment of such a 'regulatory reviewer' would include a fundamental reassessment of regulatory responsibilities given to particular agencies. Without labouring the points, the RBA has been 'outed' for an apparent inability to act responsibly on a number of fronts while widespread disdain for ASIC in the consumer protection field, is legendary. That some responsibilities are not being met, demands their reassessment and a relocation of authority for some functions.

Any adverse expectations about the role of a 'regulate the regulator' agency will likely be self serving and unlikely to be well founded. Any expectation that regulatory performance is 'reviewable' will be a strong incentive to ensure obligations are met or, where not, shortfalls are properly explained in combination with proposals to ensure the objectives are met in future.

As is, with no effective process for 'merits review' accountability in place, and the RBA specifically exempted, it is not surprising that regulatory failure is a norm not an exception.

Consumer Protection: 'golden-rule' accountability for product design and pricing

One element of a 'Regulatory Reviewer' function would be ensuring consumer protection by requiring providers of financial services to behave ethically – 'golden rule' ethically.

Among many people and in so many ways, it is considered simply scandalous that vulnerable consumers with limited understanding of complex financial products are at the mercy of major institutions and are routinely exploited by them.

The sense of scandal is only ever compounded by fanciful proposals to 'improve financial literacy' and otherwise overwhelm customers and clients with an avalanche of 'required disclosure' documentation. That superficially well-intentioned nonsense is itself practically 'intended' to ensure that those so incomprehensibly flustered, are induced to enter 'trust me' relationships with professionals so often and so easily proven 'untrustworthy'.

Whatever the good intentions, much 'black letter' law and related regulation is a game of semantics played in complete contradiction of the spirit of the good intentions.

Australia can, and should, do better than that.

A smarter than usual approach to 'consumer protection' would see providers of professional service voluntarily subscribing to a 'Golden Rules' code of conduct. Financial institutions and associated professionals could promise to not do to others things that they would not like done to themselves or their family and friends.

A golden-rule obligation, faithfully accepted, is almost self-enforcing in its simplicity.

There would, of course, need to be a framework for supplementary review and administration of a code of practice. Much of that supplementary input would flow smoothly from industry associations accrediting particular product designs and related terms and conditions. Ultimately, there would be a backstop role for an ombudsman scheme – possibly based on the FOS scheme suitably restructured and re-oriented to protect its authority and independence. Among other things the FOS needs the authority to 'name and shame' service providers found to have 'systemic' shortcomings.

Even as we speak, the community is being flustered by fast-talking spokespersons seeking to 'clarify' the recently legislated obligation for financial advisers to act in the best interests of their clients and facilitate renegotiation of running fees and charges considered excessive.

Australia can do better than this and an enforceable commitment to observe golden rule precepts would be a sensible step in a direction that the community would endorse and applaud.

Just how 'golden rule' arrangements might be best institutionalised is the challenge.

The existing, nominal, consumer protection responsibilities of, among others, the RBA, ASIC and ACCC, would first need to be clearly spelt out. From there the issues would be about either re-allocating these responsibilities, with equally clear intentions to pursue accountability, or commissioning a new agency, akin to the US Consumer Financial Protection Bureau, to bring some overall sense of co-ordinated purpose and direction to the total task.

Not to labour the point, but one might fairly ask why financial institutions, and their professional associates, would be reluctant to subscribe to a golden-rule ethos – and what any reluctance might portend.

Resource misallocation: correcting over-exposure to over-priced housing

Financing infrastructure development and major projects is a primary focus of the current inquiry and that embraces 'national savings' – non-consumption – and the investment of saved resources in the most productive way. In this context, it is surely perverse to maintain arrangements diverting current savings of workers into overpriced housing assets, only to then see them 'wasted' in inflated current spending of retirees. Home-owning retirees can supplement their 'inflated' age pensions by 'cashing' their equity in housing, including taking duly formalised 'cash supplements' from expectant inheritors.

Expectations of inflating house prices are driving a gross misallocation of resources underwritten by both cultural traditions and tax concessions favouring home owners. Complex and wide ranging as 'housing' issues surely are, there is one element of the puzzle that may be best dealt with summarily.

As things stand it is common for an age pension to be paid to owners of homes exempted from a means test otherwise limiting eligibility. Conversely, there is nothing precluding pensioner home owners converting the equity in a home to current income – much as those with super fund assets take a pension-style income. In this situation, smart retirees would be sensibly advised to switch 'counted' super fund assets into exempt housing assets and then reverse-mortgage them to deliver an also exempt income stream as well as the full age pension.

One consequence of misguided policy is that exempt and under-occupied housing assets are 'locked up' for decades, as earmarked inheritances, when a preferable national interest outcome would see retirees more flexibly open to downsizing and freeing up scarce residential resources.

The political nonsense that buttresses this dam wall will not easily be busted – nonetheless it makes sense to take available opportunities to expose it and the panel may like to add its weight to the quest for reform.

END NOTE: THE HEADLINE PROPOSALS

Given the regulatory havoc that flowed in the wake of both 'Campbell' and 'Wallis' – a touchstone for any response to the David Murray inquiry must surely be a sense of proceeding only thoughtfully and carefully with any reform proposals however 'obvious' they may be.

That said, I have put the case for some reasonably pressing reforms – however carefully they may need to be pursued. We need to get started.

A first cab off the rank should be a long-overdue display of RBA 'competence' and 'independence' reflected in a full and frank expose of the economics of the retail banking and payments system. If the RBA continues to refuse, ask someone else.

The sense of establishing a new national consumer protection agency is overwhelming – the present allocation of responsibilities among the RBA, ASIC and ACCC et al has simply not delivered the protections the community fairly deserves and is reasonably entitled to.

These regulators have failed. The law of the jungle is not the correct one.

Australia needs a financial system committed to a ‘golden rule’ ethical standard – full stop.

An Australian cultural preoccupation with owning ‘housing’ assets needs to be dealt with.

A more general concern is for a framework of ‘regulatory review’ which, in a process of ‘merits review’, makes regulatory agencies accountable for meeting their legislative responsibilities.

One present reality, the exemption of the RBA from such scrutiny, is simply untenable. Monetary policy specifics aside, the RBA has so not met its other responsibilities, across such a broad range, that it must now be called to account.

Almost inevitably, the so evident sense of the RBA’s disinterest will dictate a re-allocation of its ‘other’ responsibilities to different regulatory agencies – the responsibilities needing to be met afresh are ones that the RBA has declined to accept and failed to meet.

In sharp focus, The RBA has simply not met its reasonable responsibilities as the primary regulator for:

- competition and efficiency in the retail banking and payments system;
- the appropriate management of the national currency-note issue; and
- prudential management of the national financial system, broadly conceived.

Put differently, the RBA’s preoccupation with ‘stability’, to the exclusion of all else, has delivered a retail banking and retail payments system that makes a mockery of the ‘competition’ and ‘efficiency’ we should have.

We now have a financial system so ‘stable’ that it is wholly dominated by four too-big financial conglomerates, collusively exploiting the community without restraint, yet concurrently so vulnerable to needed regulatory reform, and unpredictable technological revolution, that it is at risk of being ‘unstable’.

In sharp focus, appropriate policy responses include;

- relocating responsibility for competition and efficiency in the retail banking and payments systems to a new consumer protection agency;
- relocating responsibility for the national currency issue (including note printing) to a national currency board under the direction of Treasury;
- a wholly revised framework for ‘prudential supervision’ putting primary emphasis on market disciplines for managing the sound and solvent management of ‘banks’ and other deposit takers.
- a separate division of any ‘golden rule’ consumer protection agency, devoted to providers of superannuation advice, management and investment services.

Finally, and above all, Australia needs a ‘Regulatory Reviewer’ agency charged to work with appointed regulators to negotiate and manage a process of setting benchmarks for performance outcomes and ensuring co-ordinated commitment of appointed regulators to meeting those outcomes.

Peter Mair / 24 March 2014