SUBMISSION TO THE FINANCIAL SERVICES ROYAL COMMISSION

WHY IT HAPPENED & WHAT CAN BE DONE

The emergence of misconduct in providing retail banking and other financial services was essentially a consequence of mismanaged banking regulation at the highest levels for decades.

Regulatory interest in associated ‘consumer protection’ was not really on the official agenda until the 1990s when emerging misconduct could no longer be ignored.

It is, nonetheless, inexplicable that the authorities did not recognize and correct the mistakes as our retail financial services industry imploded in the 1980s and has languished since.

There is a straight path from the 1937 banking royal commission through to the present. A little historical context helps to understand the steps on this path to perdition, albeit paved with good intentions.

WHY IT HAPPENED

Until the 1980s there was a ‘bank tax’ regime in place that contained the market power of the banks.

Not called a ‘tax’ or a ‘levy’, it was a raft of regulatory imposts including ‘reserve deposit’ requirements, quantitative lending directives and caps on interest rates paid and charged.

This regime, dating from the 1941 wartime banking regulations, was not ideal but it worked well enough for some 40 years.

The conduct of banks was then exemplary – bordering on paternal.

The 1980s ‘decade of de-regulation’ ended in a banking crisis. It precipitated the demise of all state banks, the new foreign banks, and the building-society banks -- two of the 4-pillars teetered. The ‘de-regulation’ was botched.

The ‘bank tax’ was steadily eroded after 1949 and finally removed in the 1980s -- at the very time it should have been increased.

The profitability of the 4-pillars surged with the cash-rate settled around 15% p.a.

The unassailable competitive advantages the 4-pillars then had unleashed a destructive competitive rampage.

The whole retail financial system was soon consolidated into the hands of the 4-pillars. The wash up is a de-facto cartel extending to insurance, superannuation and stock broking.

Over at the 4-pillars, inflated profitability, surging share prices and grossly overpaid executives became a potent mix. Misconduct followed when good-fortune flagged before being dashed as the global crisis a decade ago melted banks’ wax-wings.

The conduct of bank conglomerates became differently exemplary – bordering on rapacious.

- a critical flaw

A short full story starts in the 1930s.

Central banks then coupled a determination to avoid another ‘great depression’ with a well-intentioned, initially benign mistake.

Prohibiting the payment of interest on deposits in transaction accounts with banks was a mistake. It was intended to endow banks with ‘free profits’ to underpin their solvency. It did, and does, but with perversely deceptive twists.

The ‘free profits’ banks earn from lending and investing the ‘free deposits’, are partly dispersed as ‘free services’ to customers. However, this ‘income in kind’ is not declared and taxed as interest income would be. The community loves ‘free banking’ and the government turns a blind-eye to the tax avoidance inherent in the bartering.

Not reckoned in this deceptively benign deal was the consequences of volatility in the values of the ‘free-deposits’, ‘free-banking’, ‘free-profits’ and of the income-tax not paid on the undeclared ‘income-in-kind’.

Unwittingly the scene was set for trouble – central banks did not foresee the now so evident consequences of interest rates later being substantially higher and lower.

One problem, of course, is that the 4-pillars hold all of the free-deposits. Material interest is not currently paid on about one-trillion dollars of deposits in transaction accounts with the 4-pillars.

Now tighten the seat belt.

If the cash-rate returned to 15%, the free-profit flowing to the 4-pillars would blow out to some $150 billion annually.

30 years ago the numbers were smaller but the impact was the same. Surging free-profits of the 4-pillars funded their unrestrained competitive attack on the retail financial system. The competitive environment in retail financial services was destroyed.

This destruction, not officially resisted, or still even acknowledged, remains unrepaired.

- **dramatic and continuing fallout**

Deregulated banks, taking more risk, needed more capital.

Regulation of bank capital is coordinated by a brotherhood of central bankers under the auspices of the Bank for International Settlements.

The BIS capital-adequacy framework promoted in 1988 was defective. Intended to ensure banks had adequate capital, the wash-up was the opposite.

One defect encouraged banks to minimize required capital by securitizing and selling loans.

US banks sold packages of risky housing loans. Investors, globally, believed these packaged loans were safe-as-houses. Too many loans were not repaid. The system fell into the global crisis.

Interest rates fell dramatically. So did the free-profits from bank transaction accounts. Falling interest rates, less free-profits, had a disturbing dimension. Banks were more exposed. Their ride on the magic carpet was over.

The value of a bank includes the capitalized value of its entitlements to free-profits. The value of this de-facto capital is high when interest rates are high – and the converse.

Dramatically lower interest rates devalued the total capital base of the Pillars, prompting calls for additional capital and a scramble to replace lost revenue.

Predictably perhaps, none of this was ever anywhere part of the official story told about what was going on. The international brotherhood of central bankers has a code of silence about kicking own-goals.

WHAT CAN BE DONE?

The retail financial system will never be stable while it is resting on unstable foundations.

Most of this nonsense – regulatory failure and gross misconduct -- has its recent origins in the miscalled 1980s deregulation.

Removing the direct controls on banks was one thing. Not then containing the free-profits flowing to the 4-pillars was another thing altogether.

It is clear enough what should happen next.

Common sense says, correct the policy mistakes that corrupted the retail institutional structure and then inclined the 4-pillars to misconduct.

Common sense then demands revised bank-tax arrangements to return the ‘free profits’ to the public purse or otherwise contain the flow of free-profits to the 4-pillars.

Commonsense has not been commonly displayed. On the contrary, a central banking preoccupation with contriving stability was coupled with regulatory incompetence.

It makes sense to now remove the competitive advantage unfairly endowed on the 4-pillars.

This continuing anomaly is a consequence of their practically exclusive entitlement to ‘free profits’. The4-pillars hold the nation’s primary retail payments medium – deposits in transaction accounts, now running to some $ one-trillion.

The bank-levy on the 4-pillars, introduced in 2017, could be increased to corral their free-profits but direct levies on these banks may not be the most acceptable approach.

Historically, none of this ‘free profits’ stuff mattered so much until the 1980s. For the forty prior years interest rates were stable at normal levels. Bank profits were contained, by regulatory imposts and their costs of providing ‘free services.

It mattered a lot when interest rates went to 15%+ p.a. and, later, as rates fell to less than 2% p.a.

The formal prohibition against paying interest on transaction deposits was removed in the 1980s but it made no difference.

Not paying the interest is commercially sensible: the 4-pillars get competitive power from the free-profits and their customers get free-banking, avoiding tax.

Problem is, the deal is unfair and disruptive. Policy unchanged the system will remain corrupted. It is past time for the depositors' income-in-kind to be declared as taxable income.

One appropriate public policy approach to address this tax-avoiding barter scheme is well understood.

Means-tests limiting access to age-pensions apply a 'deeming rate' of return (now 3.25% p.a.) to assets not already earning a full market rate of return. One can only wonder why the 'deeming rate' is not similarly applied to the taxable income that should be being earned on all deposits in bank transaction accounts.

Considering what 'could be' and 'should be', a policy proposal along these lines is eminently practical. It is demonstrably fair and any tax due will be payable by bank customers, not banks. It would not be a bank-tax directly.

Indirectly, of course, deeming the payment of taxable interest may well see banks paying the interest. If so, some political issues would be back in play. Less free-profit would probably mean higher interest rates on bank loans and less free-banking.

On the plus side -- the competitive playing field would be more level and substituting proper user-pays pricing of banking services would promote efficiency and innovation in the retail payments system.

Whatever, most age pensioners and some others would still need free-banking – access to basic bank account and transaction facilities free-of-charge. There could be a competitive tender to provide these free-banking services. Contracted suppliers would be paid to do so from the budget.

END PIECE

'Profits before people' is at the heart of what this Commission has found so far.

Those same three words neatly capture the concerns that Ben Chifley brought to and took from the banking royal commission that, in 1937, delivered the report that became the foundation for the regulation of banking from 1941 to 1980.

Ben Chifley became Treasurer in 1940, and Prime Minister in 1945, continuing as both until 1949. The banking regulations Ben Chifley put in place included a de-facto bank-tax regime that worked to better balance bank profitability and the public interest for the next 40 years.

80 years on, it is timely to reconsider this prescient historical record.

This submission makes one thing clear. The 4-pillars, on which our retail financial system stands, have long been wrongly endowed with revenue that properly belonged in either the public purse or the pockets of their customers.

The disruption and gross misconduct of the retail financial system over the past 40 years is, accordingly, booked to monetary authorities failing to appreciate that and fix it. A failure so painfully exposed as interest rates first went so high and now so low.

Too-late is the realization that what was passed off over those 40 years as 'regulatory reform', is now more correctly assessed as 'regulatory failure'.

Ben Chifley and Keith Campbell, among others, only envisaged the opposite.

Both Ben Chifley and Keith Campbell died prematurely – in no small part as a consequence of the stressful contributions each made to fix the financial system.

The most meaningful apology would do that – fix the system.

Peter Mair

18 October 2018

[**Notes about 'free'**:

Using 'free' is a fair convenience: material interest is still not usually paid on transaction account deposits with the 4-pillars and most bank transactions are still 'free of charge' to customers.

The 'free profits' endowed on banks always belong in the public purse. They are the commercial-banking counterpart of the profits on the issue of banknotes by the Reserve Bank (on which interest is not paid). These days the 'currency of the realm' embraces not only deposits in transaction accounts but elements of payment cards and so on to 'bitcoin' and beyond]