REGULATORY REFORM -- AN INSIDER'S VIEW

'only talk about it, don't do it'

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Regulators are monopolists craving the quiet life, in my experience, often misusing their authority to 'quietly' cover up problems. Not being accountable, regulators do what they like but usually do not like to offend those they regulate.

George Stigler, a Nobel Prize winning economist, exposed the 'only talk about it, don't do it' mantra so characteristic of regulators. Appalling regulatory performance is tolerated -- 'they must have been doing their best' -- when the resulting shambles was entirely predictable, and, objectively assessed, exactly what was aimed for.

Take the banking industry. Take credit cards. Take a deep breath.

In October 1992, over a sandwich with Alan Fels, I outlined banks' agreements on interchange fees for credit card transactions. Given that the law prohibits competitors setting uniform prices, the audacity of the credit card agreements is breathtaking[*]. A decade later, credit card schemes are finally recognised to be offensive, and we still wait for effective regulatory action.

This is about the lost decade, about the regulatory failure allowing this nonsense to go unchecked. The interchange fees banks unfairly took run to billions of dollars. The excessive profitability of credit cards has meant better but less profitable services are withheld. The community is overcharged, twice.

The spotlight is on the Reserve Bank, since 1984, nominally responsible for ensuring efficient (and fair) retail payments. Every Chairman of a 'banking inquiry' over the past 25 years lamented that the Reserve Bank consistently failed to do this job with a proper sense of purpose. Some years ago, I was rebuffed when asking the Reserve Bank to deal with credit cards -- "this has nothing to do with the Reserve Bank -- you should go and work at the ACCC".

More telling, when the ACCC did charge banks with price fixing in 1999, it was 'crowded out' by the Reserve Bank. First, the Bank took over the 'joint report' on transaction cards and then it took

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[*] Retailers pay some 1% of credit card sales to card issuers that do nothing to justify a fee of this magnitude. Customers are not told this or that it entails higher retail prices -- on the contrary, customers are told credit card transactions are 'free' with 'interest free credit' and 'rewards' as well.

over the prosecution "because the ACCC was likely to get bogged down in the courts".

This run of events had hallmarks of the Reserve Bank 'looking after our little mates'. Those that once said 'this has nothing to do with the Reserve Bank' were now saying it was a matter only for the Reserve Bank. At no point did the Reserve Bank say, as it should have, that the Trade Practices Act should be strengthened. This was 'hugging the ball' by a team more inclined to passing time running in circles than straight and true. Always promising, not delivering. Five years since 'Wallis' reported, the Reserve Bank is yet to lay a glove on the credit card schemes it should have 'decked' a decade earlier.

A rule of thumb was -- 'if the Reserve Bank does not want to do something, do not gather information that might suggest it should'. Although banks agreed, in 1993, to supply statistics on 'merchant service fee' income from card transactions, the question was deleted by the Reserve Bank -- "we have never collected details of banks' incomes, and we are not going to start now". A 'smoke alarm' was disarmed.

In 1996, a submission to the 'Wallis' Inquiry highlighting issues with credit cards, was aborted. Instead a description of 'card transactions' was put in a minor report in a way that obscured known problems. 'Wallis' nonetheless became aware of the issues, enough to recommend that interchange fees be investigated. A diary note of responses to informal inquiries from the Wallis Secretariat was marked: "this Committee is playing fast and very loose on payment system issues" -- 'all future inquiries are to be referred to the Departmental Head to ensure a consistent RBA line'. Hypocritically, the Reserve Bank now says it 'welcomed' these Wallis recommendations on credit cards that initiated its interest in credit card schemes.

This 1996 report was one of three reports where the Reserve Bank posed the question -- 'should the cost of free credit be recovered in interchange fees? On the Bank's own marking scale, the answer it gave in 1996 was completely wrong; the answer it gave in 2000 half right and only the clear 'no' finally given under pressure in 2001, was correct. The correct answer was, of course, always the same and known to be so.

Along the way the Reserve Bank did not deal properly with the obnoxious 'Visa debit' product that takes credit card fees for 'no credit' transactions: asked to discourage it, the mid90s decision was, 'no -- nothing wrong with that'. Nor did the Bank reconcile banks taking credit card fees for transactions using 'no free credit' cards. The Reserve Bank is still to address the reasonable inference from its work, that the credit card is now simply a contrivance against the public interest, and inferior to a debit card with a line of credit.

In the mid-1990s banks worked secretly to establish a new payments network, BPay. The BPay scheme copied the credit card model, including an interchange fee, and it works using the same infrastructure as is used for processing bulk direct-transfer payments. The cost of BPay transactions to billers and customers is, however, much higher than for direct transfers. When launched in 1997, the banks publicly claimed that BPay 'had been cleared with the Reserve Bank and ACCC'. It was not then, has not been since and is now under investigation. When this claim of 'cleared' surfaced, the Reserve Bank was 'affronted' and 'complained', asking banks for 'full information' about the Bpay scheme. Nothing happened. No useful information was provided. The quiet undisturbed silence gave the promoters of BPay their 'approval'. The Reserve Bank was mocked. Not wanting to do anything, it did nothing.

The reprehensible credit card and BPay schemes are two illustrations of pattern-misconduct involving banks that is more widespread and condoned by the Reserve Bank.

Behind the popular facade of a 'deregulated' and 'competitive' banking industry is a never-spoken-of sham. Banks run a pernicious tax avoidance scheme, swapping 'free transactions' for 'interest free deposits'. Tax avoided aside, this practice frustrates competition in banking, precluding innovations that would transform a banking industry needing to operate cost effectively. The Reserve Bank will not openly address the consequences of this tax-avoiding barter for competition and efficiency in banking. This is the 'no secret' why our banking industry has become ever more concentrated. The die is now cast for two pillars not four -- and a quieter life for the regulators.

It is, of course, well known in the Reserve Bank that the spoken 'commitment' to promoting efficient retail payments is not matched by intelligently purposeful action: 'only promise it, don't do it' -- so to speak. One senior manager in the Reserve Bank stood up to be counted about this failure to deliver, and one went down for the count -- sidelined, 'redundant', effectively fired.

The Governor recently reflected on the way all this unfolded over the past decade. He found no problem. He said it was fair -- reporting that those involved in the sidelining of issues and people, were of the same view.

Among other obvious implications for the ongoing allocation of responsibilities to the Reserve Bank, these failings could usefully be formally investigated.

Peter Mair 3 July 2002.

INTERNET ECONOMY NEEDS INTERNET MONEY

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A decade or so back, many were excited by the prospect of stored value cards. It seemed then that conventional currency -- notes and coin -- was threatened by smart money technology. Policy frameworks were put in place to accommodate stored value cards, and electronic money more generally. And then nothing happened. The new economy came and floundered: customers unable to pay for goods and services over the internet meant disappointment for many marketing initiatives focused on the internet. Some big bets were lost.

The 'new economy' will come again. It would seem sensible to put in place a payments infrastructure to let the 'new economy' achieve its potential. The internet economy needs internet money.

What are we talking about here? Imagine a phonecard accepted universally for quick, no-change, 'cash' purchases of newspapers and fast food among many other things, as well as phone calls. Imagine slotting the phonecard into a personal computer and downloading 'premium content' stories from newspapers and magazines for a couple of cents. What may be more difficult to imagine is how we will practically get from 'cant' to 'can' about using electronic money, especially to buy products delivered electronically.

Private entrepreneurs are researching and developing electronic money schemes. Some schemes are being tried in pilot applications. These pioneers deserve high praise. Nonetheless, one might reasonably wonder why a group of like-minded national monetary authorities does not get together to coordinate promising initiatives. It is an international matter -- one or two electronic money systems will probably be dominant worldwide.

There are different explanations for why electronic money schemes have not found a viable niche. The visionaries may now say that electronic money needs government support. Otherwise it will be difficult to build community confidence and offset impediments that hinder electronic money schemes getting off the ground (e.g. 'always free' conventional cash transactions). Such interventionist ideas do not sit easily with fashionable 'leave it to the market' attitudes and more general anathema to government owned commercial businesses.

The challenge is formidable. The internet economy will not work without internet money. The retail economy more generally will continue to be handicapped by inefficiencies inherent in a currency of round pieces of metal and coloured pieces of paper. Even if suitable electronic money schemes were already available, their practical implementation would require much more -- a national network for issuing, spending and redeeming electronic money and a costly marketing campaign to build community acceptance. For Australia alone, the capital investment required (including establishment 'losses') might run to some $2 billion or more.

There are also conflicting interests among the major players. The Reserve Bank issues Australia's currency now and gets the profit from conducting a naturally very profitable business (banknotes are government securities on which interest is not paid). The most likely private issuer of electronic money would be commercial banks attracted by the profits from issuing a superior 'currency'.

There is a checkmate here. Central banks like the easy independence that flows from easy profits on the note issue and may resist, rather than foster, competition from electronic money. On the other hand, commercial banks realise that governments would not lightly give up control of their national currency. Banks also know that if a scheme they developed were successful, governments would eventually sequester the natural profits. Moreover, commercial banks already run profitable non-cash payment systems and they may not develop an alternative that is likely to be less profitable and likely to be 'taxed' by government if it were a success.

There are two main options for breaking the deadlock. First, should commercial banks be the issuer, it is feasible to pay interest on electronic money and neutralise concerns about 'natural profits'. A problem here is that scheme promoters would be counting on interest-free funding to subsidise losses in the establishment phase and then resist giving them up. Alternatively, central banks could make the running and sponsor the development of an electronic money scheme operated in conjunction with commercial banks -- essentially the same model as now where conventional currency is manufactured by the Reserve Bank and commercial banks provide the distribution network. Central banks will ultimately be held responsible for any currency in wide circulation, so they might as well get involved at the outset. Central banks are, however, loath to be involved in a venture that may be unsuccessful.

This matter is important and it needs leadership. Regulatory authorities, usually seen as restraining the excesses of private business activity, can coordinate innovations otherwise beyond reach of private businesses. Electronic money may be a suitable case for this treatment.

Peter Mair
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