RECENT DEVELOPMENTS - DEREGULATION OR REREGULATION

RETAIL BANKING - REGULATION OR DEREGULATION

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INTRODUCTION

The title of this section of the conference is Recent Developments - Deregulation or Reregulation, and my stated role is to comment on the excellent paper prepared by Lee Aitken. You Probably will not be surprised to hear that I intend to comment only marginally on Lee's paper nut will address myself to some broader questions which arise when taking a consumer perspective to the question of deregulation or reregulation in retail banking. In particular, I wish to provide some food for thought in the contemplation of the future of regulatory aspects of retail banking and banking law in the 1990s.

But first a comment on terminology. The phenomena that the term "deregulation" is usually used to describe in the broader banking industry are those changes largely brought about by"

- the floating of the Australian dollar in 1983;
- the entry of foreign banks in 1983;
- the removal of exchange rate controls in 1983;
- the removal of quantitative and qualitative lending contracts between 1979 and 1985.

The dramatic changes we have seen in retail banking largely flow from the removal of quantitative and qualitative lending controls; from an unprecedented period of technological innovation and change; an equally dramatic and unprecedented change in the culture of the retail banking sector and, finally, from the movement of the retail banks into non-traditional areas of financial services.

DO THE GODS OF THE COPYBOOK HEADING REALLY EXIST?

Back to Lee's paper which is so aptly titled. Lee's paper is predicated upon a growing orthodoxy that, to use Kipling's words: "Then the Gods of the Markets tumbled" and one does not have to look far to see such a phrase applies equally to the Australian banking industry as it does to our failed entrepreneurs.

In the last two years the public's attention has been focused on what is described as the excesses of the banking industry in the 1980s. Some have even described it as a "crisis" in banking. The phenomena the terms "crisis" and "excess" are used to describe culminated in the spectacular collapses of the late 1980s. Many of these collapses have been attributed to the profligate lending practices of the 1980s. The cadavers include Fairfax, Qintex and Bond Corp.

In 1991 the Governor of the Reserve Bank, Mr Bernie Fraser, was moved to say:

> "There were mistakes made by bankers. The bankers ceased to be bankers I suppose. In that environment commonsense, conservative banking practices went out the window in the mad scramble that was going on at that time, for market share and preserving market share, financing borrowers who were pursuing properties, property developments, property takeovers, company takeovers, mergers and acquisitions ... the banks themselves, in the early stages did not have good information systems. They did not have good risk assessment and credit monitoring arrangements."[1]

Even the recently appointed Commonwealth Director of Public Prosecutions has attributed the corporate collapses to the "excesses" of the banks' lending practices.[2]

While Mr Fraser's statement supports Lee's view that the crises were not due to low liquidity ratios or loose licensing provisions, it is more difficult to accept that the "moral hazard" Lee refers to cannot be restrained by regulation. The question is how do you regulate to ensure sound credit assessment and balanced lending portfolios.

In 1984 Mr Andrew Graham, a member of the UK 1977-80 Wilson Committee of Investigation into British Financial Practices, visited Australia and told the Caucus Economic Committee:

> "I have argued that in the more competitive environment that follows deregulation the tendencies towards instability that I have identified will be significantly increased and that deregulation therefore needs to be accompanied by more supervision. Moreover the kind of supervision that is needed will require more staff and more highly qualified staff, and the Reserve Bank undertaking detailed analysis of the books of individual institutions. There is no evidence that either Campbell or martin fully recognised the importance of this point."[3]

This point is perhaps belatedly taken up in the 1991 Martin Report in its recommendation that the Reserve Bank develop the capacity to inspect bank systems and assess their evaluation of assets, particularly the adequacy of provisions for doubtful debts (Recommendation 26).

The adequacy of prudential supervision becomes an issue for consumers when they are expected to pay for the losses incurred as a consequence of poor management. They may pay in their capacity as depositors, as shareholders, as customers or as taxpayers. It seems that no bank depositors will ultimately lose their savings as a consequence of the excesses of the 1980s. Even the depositors of the Farrow Building Societies have been rescued by the Victorian Government. However, the Australian community as a whole is certainly paying to preserve those deposits and the figures are staggering. In February 1991 the State Bank of South Australia required an injection of $500 million from the State Government; in August it required a further $1,700 million. The total represents $1,500 per person in South Australia. In Western Australia the R & I Bank announced a loss of $100 million in 1991 and required $70 million in capital from the State Bank.[4]

However, Australian consumers are not just paying for the 1980's lending binge through their taxes. They are also paying as retail customers of all Australian banks.

The Martin Report informs us that bad debts rose continuously from 1984 and that rise has been greater than the fall in profits.[5] Westpac's admission in 1990 that the suggestion that the burden of bad debts fell on profitability was "misleading" is a tacit acknowledgement that it is bank customers who have paid for the losses.[6] But more importantly there is considerable evidence that it has been retail customers, not corporate, who have paid.

Following an extensive study of interest margins in 1990, Milbourne and Cumberworth of the Department of Economics at the University of NSW concluded that:

> "Whilst average interest margins might have fallen for the first half of the 1980s, and risen slightly thereafter, interest margins rose throughout the decade for retail business and were offset by a fall in margins in wholesale and off balance sheet items. Thus deregulation has brought with it falls in some interest margins, but large increases in others."[7]

Another report which has received inadequate attention in Australia is the 1991 report of the Bank of International Settlements which concludes that Australian banks had the second highest margins, second highest levels of profitability, and second highest bad debt provisions of selected OECD countries.[8]

I think the point I would like to make here is that while Australia has not experienced the financial institution collapses that America has, particularly with its Savings and Loans corporations, it cannot sit back complacently and ignore what has and is happening in retail banking. Because of the oligopoly power the banks have in the retail sector, particularly the big four, they are more able to pass on the losses of the 1980s to retail customers than they are in wholesale and corporate banking. There is a question of equity here which should not be ignored.

However, this is a digression from the main points I wanted to make about Lee's paper. While I would agree that the question of "moral hazard" in the prudential regulation of the banking industry is a pertinent one for consumers, it is eclipsed by far more fundamental issues in retail banking.

The 1980s were not simply a decade of excesses induced by removing the shackles inherited from an era of tight regulation. The 1980s also witnessed:

1. the substitution of paternalistic marketing practices with aggressive free market selling of credit and other financial products;

2. the triumph of technology over direct staff-customer relationships; and

3. the diversification of bank interests from traditional deposits and credit products into broad financial advice, travel insurance and investment services.

My question, and I think a key question for this conference, is whether the existing regulatory and legal framework is adequate to the task of moderating the excesses of retail banking into the next century.

1. The Demise of the Paternalistic Bank

Let us turn to the demise of the paternalistic bank. There is abundant evidence of Australian consumers being caught unawares by the emergence of the voracious free market bank. Tales of aggrieved consumers have been making headlines for years now. The examination of the concerns expressed about credit overcommitment, foreign currency loans and third party security reveal a consistent theme. That is the scream of betrayal by consumers who believed and trusted the banks to look after their interests.

(a) Credit Overcommitment

While the average Australian entrepreneur was enjoying a credit binge in the 1980s, so was the average consumer courtesy of the banks.

Between 1980 and 1990 total retail finance grew from $29 billion to $118 billion and the banks' share of the market from 52% to 78%.[9]

Personal debt, excluding home loans, peaked at $45 billion in June 1990.[10] There were many casualties of this binge, often they were people who believed the banks would not lend to people unless the bank believed the borrower could repay. What they did not know was that the banks had moved away from credit assessment on the basis of a demonstrated capacity, to credit assessment on the basis of statistical stability profiles. Stability profiles are more concerned with the predictable ease of debt recovery. A pensioner with long term stability of residence may score more highly than highly paid but mobile employed people.

The consumer movement has been highly critical of the inadequacy of the law in dealing with the conflict of consumer expectations and the credit assessment practices of financial institutions. It has successfully argued that the redrafted credit legislation must impose a duty on lenders to assess capacity to repay.[11]

(b) The Foreign Currency Loan Débacle

One might also argue that the level of agitation by the foreign currency borrowers directly relates to a sense of betrayal. In November 1991 there had been 22 reported and unreported judgments in foreign currency loan cases and a further 90 pending. A review of those cases illustrates the conflict between community expectations, banking practice and the law.

The Martin Committee sought the advice of the Attorney-General's Department in relation to the decided cases. The advice provided was that: "There is generally no duty to provide advice in relation to risks associated with foreign currency borrowings."[12]

The treatment of the foreign currency loans by the Martin Committee is almost a parable of the wider conflict between expectations, and law and practice. Notwithstanding the fairly unequivocal advice of the Attorney-General's Department, the Committee concluded that not only did the banks have a moral obligation to advise customers of the risks, but an obligation to provide assistance and management in relation to exchange rate movements.[13] The reality of what really occurred is best described in the banks' own words:

> "Presently we are facilitators into the market [of foreign currency borrowings] and virtually abandon our customers on entry ... Exposure management has not been offered because it takes resources, both manpower and technical, that we do not have."[14]

(c) Third Party Security

Third party securities are another area in which the clash of consumer expectations of being looked after by the bank and the reality of banking law and practice has attracted scrutiny from regulatory agencies.

A review of the banker customer disputes brought to court under the various fair trading legislative provisions and in equity under the doctrine of unconscionability will reveal that the vast majority of them relate to guarantees and third party security. In one of its submissions to the Martin Inquiry, the consumer movement argued that there is a risk of unfairness inherent in the very nature of the guarantee relationship because:

- guarantees are sought when there is doubt about the principal's capacity to pay;
- guarantors take on a financial liability without in most instances obtaining any benefit;
- guarantors rarely know the full details of the transaction and cannot assess the risk that they are taking on;
- there is generally a poor understanding in the community about the status of a guarantee; and
- It is likely that the emotional relationship between the guarantor and the principal borrower will be the determining factor in the decision to enter into the arrangement.[15]

In early March of this year the Trade Practices Commission released a discussion paper, *Guarantors: Problems and Perspectives*, in which it comments:

> "Many guarantors mistakenly believe that a bank owes them a duty of care in respect of the transaction. While this is incorrect in law, it is not unreasonable for a layperson to make such an assumption given that in many cases the bank is well placed to offer such advice and may have a long standing relationship with the guarantor as well as the principal debtor."[16]

Again, these expectations are dashed in the face of banking law and practice. At common law a banker has no duty of care in relation to guarantors. While the banker must truthfully respond to specific questions, there is no obligation to disclose material facts about the principal borrower or the loan transaction.[17] While there is authority for the proposition that banks must disclose unusual facts, the distinction between material and unusual facts is a fine one and likely to be beyond the average consumer. In **Amadio v Commercial Bank of Australia**, the High Court did not regard the fact that the principal borrower repeatedly exceeded his overdraft facility as "unusual".[18]

The proposition that the law is not in accordance with reasonable community expectations has certainly found favour with the Martin Inquiry which recommended that unlimited guarantees should be prohibited.

2. The Triumph of Technology

I will only make a passing reference to questions of technology and banking as the issues involved are complex and beyond the scope of this brief discussion.

In retail banking, technology has to date impinged primarily upon the legal framework of transactional services. The common law provides the banker with the right to deal with a customer's account when authorised and directed to do so by the customer. Traditionally, this authority is evidenced by the customer's signature on a direction to pay. In an era where value is transferred by electronic impulses initiated in automatic teller machines, home banking modems, EFTPOS and even the corner public telephone, these laws have become irrelevant.

In the early days of banking technology the banks gallantly stepped into the breach with standard form contracts which transferred any risk to the cardholder. Typically, the Commonwealth Bank's Keycard/Autobank conditions of use (1/84) provided that:

> "Until the bank has received notice of loss or theft of a keycard from the holder, the holder will have no claim against and will be liable to the bank in respect of any Autobank transactions made by any unauthorised person using the keycard."

Thus liability:

- was unaffected by an absence of negligence;
- was not limited to the balance of the account; and
- was not limited to the daily transaction amount.

In 1989 a code of conduct was negotiated between the banks, consumer groups and government and on the initiative of the consumer groups the terms of that code were required to be incorporated into the terms and conditions of use for EFTS.

On the more general question of technology and banking law, in the long suffering negotiations for credit law reform the banks have argued that the notion of offer and acceptance in the formation of contracts must be jettisoned because it will inhibit the development of contract formulation via exchanges between the computers of the bank and the customer.

3. The diversification of Bank Business and Cross-Selling of Products

Banks are no longer the simple repository of the average Australian's savings. They have become financial supermarkets offering funds management; unlisted (soon to be listed) property trusts; insurance; travel; superannuation and investment advice.

In many respects this diversification will be highly beneficial to consumers. The expertise, geographic spread and scales of economy in distribution through existing bank branch structures mean there is a potential for better and cheaper products. For example, the distribution arrangement reached by AMP and Westpac may have a dramatic effect on the price of insurance products. AMP, which had the highest management costs of the life companies, now has access to Westpac's branch structure via the jointly owned AMPAC.

However, the risk is that the banks will embark headlong into a marketing strategy which, while attempting to capitalise upon public perceptions of bank stability and soundness will create expectations which cannot be met because, as with the banks' lack of capacity to properly manage foreign currency loans in the early 1980s, the banks will not have the systems, personnel and experience to deliver.

(a) Superannuation

Superannuation is the area in which the banks are most likely to come to grief. The banks have a problem, government policy is artificially distorting household savings into superannuation. In 1983, $34 billion was invested in superannuation funds, in 1990 it was $125 billion.[19] A desire to get their hands on this money inspired ANZ Bank to propose a merger with National Mutual in 1989.

The banks have pursued market share in superannuation through their subsidiary life companies and divisions. The big four are amongst the ten largest funds managers and have between then 20% of total managed funds.[20] The problem is the extent to which the banks are obtaining this market share by capitalising upon misconceptions that the banks stand behind these funds. As one banker said to the Martin Inquiry:

> "We do not resile from acknowledging that [linkage] ... We believe that gives some comfort to the people who may be applying for units."[21]

Allowing the banks to capitalise and promote these misconceptions simply delays the almost inevitable conflict that will arise should the management and progress of these funds betray consumer expectations. The banks pursued a similar course with the unlisted property trusts necessitating a political rescue when the viability of those funds was brought into question. As the Australian Securities Commission advised the Martin Inquiry:

> "The chances would be remote that unit holders in a major bank sponsored property trust would voluntarily vote to suspend redemptions, when they have the image of a bank parent standing behind."[22]

It will be a gross hypocrisy if, at some future date, political deals are done to save the banks from dealing with the full consequences of misleading consumers about the security of bank managed superannuation funds.

(b) Consumer Credit Insurance

The consumer credit insurance (CCI) market is a big one: in 1989-1990 it was worth nearly 1.3 billion dollars. It is also an extremely profitable market. Its average loss ration is 32.5%, that is only $32.50 in every hundred is paid out in claims. This is half the average ratio for comparable types of insurance. It does however have the highest expense ratio: 55.9%. This is largely because the average commission is 30.7%.[23]

It is not surprising that the banks are keen to sell consumer credit insurance either on a commission basis or directly. Selling CCI is good business for the banks, it is a premium on their core business of lending. In a survey by the Trade Practices Commission (TPC), one of the four major banks stated that it had a "penetration rate" of 6-70% of all personal loans. Litigation in Sydney involving a major bank is likely to reveal that it has targets for branches selling loans with CCI. Another survey by the TPC found that 25% of all customers with CCI were unaware that they had it.

On one view of it the banks should be congratulated for doing just what is expected of them in a free market - aggressively selling their products. The difficulty with this is that CCI is a dubious product sold or forced in circumstances where consumers are unlikely to be able to make an informed choice because of their preoccupation with the principal product, the loan.

Moreover, despite the acknowledgement within the industry that loan contracts are written with CCI without the knowledge of the consumer, no action under s47 of the Trade Practices Act 1974 has been brought against a bank.

Again there is a conflict between consumer expectations and banking law and practice. In matters such as the negotiation of loans when a bank employee extols the virtues of CCI they are inclined to trust the ingenuousness of such advice. Such a consumer may come to regret such advice. The case of **Warnock v ANZ Banking Group**[24] is telling. Warnock negotiated a loan for $60,000 from the ANZ Bank. The manager encouraged him to take CCI. In completing the policy the manager advised him not to disclose a pre-existing condition. Subsequently, the insurance company, ANZ Insurance Ltd, refused to pay while the manager went on a trip to the Americas Cup having won a bank competition for the most number of loans with CCI. The Federal Court found that the bank had engaged in misleading and deceptive conduct.

CONCLUSION

While I share Lee's cynicism in relation to the "Gods of the Copybook Headings", my conclusions in relation to the "excesses" of the deregulation decade differ. It is not a question of "deregulation or reregulation" as the debate is so often simplistically portrayed, but a question of how can the excesses of a free market banking industry be restrained.

In retail banking it is not so much a question of containing "moral hazard", as addressing the consequences of market failure. An examination of the major issues in retail banking reveals that a regulatory ideology which is predicated on the sacrosanct nature of the market is foolish. Retail banking in Australia is characterised by classic instances of market failure:

- Information availability is imperfect in the extreme. The average consumer has difficulty comprehending their bank statements, let alone increasingly complex transactions.

- In many cases there are high implicit transaction costs. The real cost of a consumer making informed choices is prohibitive. For example, the cost of engaging a lawyer and an accountant to advise on the implications of a third party security or a foreign currency loan is likely to be prohibitive. In these circumstances the consumer is likely to rely upon the advice and assistance of bank staff.

- In all cases there is an imbalance of bargaining power. Four banks have 78% of the market, they deal in non-negotiated standard form contracts or they rely on implied terms that only their lawyers know about, and "they have more sophisticated record-keeping and data management systems and greater capacity to enlist outside legal, technical and accounting advice."[25]

This is the context in which the retail banking industry continues to undergo major structural change. This change has found banking and regulation wanting. The divergence of the law and community expectations in relation to banking technology, aggressive promotion of bank products and diversification is brutally apparent in many areas. The historical reliance upon the common law to move, if belatedly, with the times will be misplaced in an era in which the vast bulk of the population are precluded from participation in the evolution of the law.

New vehicles of change must be found. One such vehicle is the Banking Ombudsman scheme, of which I am a Council member. The rate of complaints to the scheme are continuing to escalate with 4,513 complaints being received in the six months to December 31 1991. As the Ombudsman's 1990-1991 Annual Report states:

> "Without a doubt there is considerable evidence of the need for new standards to be developed in a number of areas of current banking practice. It is clear that consumer attitudes have changed in relation to their expectations of banks. This will require banks to make adjustments to policies and procedures in areas where the prevailing consumer notion of fairness is in conflict."[26]

Another necessary vehicle for change is the dedication of a single regulatory agency to consumer banking and financial services issues. Presently no single Commonwealth agency has this responsibility. However, I support wholeheartedly the recommendation of the Martin Inquiry to give such responsibility to the Trade Practices Commission. Moreover, I believe that it is possible for the Trade Practices Commission, working with consumer groups and industry, to support a variety of regulatory and non-regulatory measures which will address the deleterious effects of market failure in retail banking.

FOOTNOTES

1. Martin Report, *A Pocket Full of Change*, Report of the House of Representatives Standing Committee on Finance and Public Administration, AGPS, Canberra 1991, 86 (hereafter referred to as "Martin Report").

2. Rozenes, QC, M, Director of Public Prosecutions, *Prosecuting Regulatory Offenders*, Conference on the Future of Regulatory Enforcement in Australia, Institute of Criminology, March 1992, 30.

3. Graham, Andrew, *Deregulation, Competition and Supervision*, paper to the Caucus Economics Committee, Parliament House, 1984.

4. Martin Report, 189.

5. Martin Report, 86.

6. Martin Report, 86.

7. Milbourne, R & Cumberworth, M, *Australian Banking Performance in an Era of Deregulation. An Untold Story?*, Working Papers, Centre for Applied Economic Research, University of NSW, 1990, 14.

8. Bank of International Settlements, Annual Report 1990, 104.

9. Reserve Bank of Australia, Monthly Bulletin, August 1983, July 1987, September 1990.

10. Reserve Bank of Australia, Monthly Bulletin, 1990.

11. Consumer Groups, ACA, AFCO & AFCCRA, *Protecting Your Pocket: The Consumer View on the Draft Credit Bill*, 1989.

12. Martin Report, 554.

13. Martin Report, 323.

14. Martin Report, 323.

15. Kirk, Greg, *Banking Law and Practice*, A Submission to the Inquiry into the Australian Banking Industry, 1991, 37.

16. Trade Practices Commission, *Guarantors: Problems and Perspectives*, Discussion Paper, March 1992, 10.

17. **Kennard v AGC (Advances) Ltd** [1986] ATPR 48,127.

18. **Amadio v Commercial Bank of Australia** (1983) 151 CLR 447.

19. Martin Report, 161.

20. Martin Report, 161.

21. Martin Report, 166.

22. Martin Report, 169.

23. Trade Practices Commission, *The Market for Consumer Credit Insurance*, June 1991, 13.

24. **Warnock v ANZ Banking Group** (1989) ASC 55-702.

25. Kirk, Greg, *Banking Law and Practice*, A Submission to the Inquiry into the Australian Banking Industry, 1991, 1.

26. Banking Ombudsman, 1990-1991, Annual Report of the Australian Banking Industry Ombudsman Ltd, 61.