Did Martin get it right?

Ruby Hutchison Memorial Address, Friday 13 March 1992

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FEDERAL BUREAU OF Consumer Affairs

A CONSUMER PERSPECTIVE ON FINANCIAL DEREGULATION

Ruby Hutchison Memorial Address on World Consumer Rights Day
Presented by Jonathan Brown, Essential Information
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I deeply appreciate the invitation extended to me by the Federal Bureau of Consumer Affairs to deliver the Ruby Hutchison Memorial Address on the topic of financial deregulation. Consumers have a large stake in the proper functioning of financial institutions. Thus, World Consumer Rights Day provides a fitting occasion to examine the far-reaching issue of financial deregulation from a consumer and broad public interest perspective.

The consumer stake in the performance of financial institutions is multidimensional. First, as customers of financial institutions, consumers have a direct interest in the safety of their funds, the level of competition within financial service markets, and adequate information on financial service products.

Second, from both a community development and a social equity perspective, providing disadvantaged consumers with access to basic banking and insurance services is recognized as a key policy goal.

Third, as workers on the production side of the economy, consumers have a strong interest in seeing that financial institutions adequately serve the productive sectors of the economy, especially small businesses, which are highly dependent on banking institutions for access to credit.

Fourth, consumers also have an indirect, but nonetheless powerful, interest in preventing large loan losses and failures at banking institutions. In many countries, large banking institutions exercise considerable market power over consumers and small businesses and thus are in a position to cover large losses in their commercial operations by raising fees and charges (or lowering rates paid on deposit accounts) for consumers and small businesses. Alternatively, where banking institutions collapse and are bailed out by government, consumers as taxpayers must pick up the tab.

In Australia, as well as in most other developed countries, the last 10 to 15 years have witnessed efforts by national governments to deregulate or at least liberalize large components of their domestic financial service sectors, especially banking and securities markets. These deregulation initiatives have typically involved (1) lifting of loan rate and deposit rate controls, (2) relaxation of restrictions on the types of products that may be offered by various types of financial institutions, (3) reduction of the barriers to entry that have traditionally segmented financial service markets, and (4) gradually tearing down the walls that have sought to insulate domestic financial service markets from foreign penetration.

In Australia, the process of financial deregulation was begun in earnest with the publication of the Campbell Committee Report in 1981. Last November, the report of the House of Representatives Standing Committee on Finance and Public Administration, *A Pocket Full of Change, Banking and Deregulation* (Martin Committee Report), provided a timely assessment of the progress made – or damage wrought, from a negative perspective – by financial deregulation in Australia.

Financial deregulation has generally been viewed as a deliberate policy course chosen by political leaders. One should keep in mind, however, that much of the recent innovation in financial service markets is essentially the result of new technology rather than deregulation itself. Electronic banking and derivative securities products are prime examples of financial service products made possible by new telecommunications and computer technologies. Indeed, to an important degree, technological change has driven much of financial deregulation, and when viewed realistically, the policy options on whether to deregulate or not were often narrower than generally realized.

Financial deregulation has invariably been undertaken in the name of making the financial system more efficient, more innovative, and more competitive. In today's economic environment, few would quarrel with such goals. However, from a more ideological perspective, financial deregulation has been seen as a key step in the broader campaign to dramatically reduce government intervention in the economy. Unfortunately, the paradigm of ending government intrusion into the private sector does not work well when applied to financial institutions. It has been the source of much confused thinking and many misguided policies toward the financial service sector. Policies premised on the desirability of an across-the-board rollback of government regulation of financial institutions are seriously flawed. They threaten serious instability and insolvency within the banking sector, pose disadvantages for many consumers, and raise serious concerns about future access to credit for small businesses and rural areas.

I. Financial Deregulation and Increased Risk-Taking.

What advocates of a sweeping rollback of government intervention in the financial sector have failed to recognize is that financial deregulation unleashes powerful pressures that often induce financial institutions, especially depository institutions, to take greater risks. Unless financial deregulation is accompanied by more rigorous prudential control, it can become a prescription for financial instability and even mounting insolvency of financial institutions. Hence, there is a basic paradox inherent in the process of financial deregulation: deregulation undertaken to reduce government control over financial institutions actually increases the need for government to supervise their risk-taking activities.

a. Link Between Greater Competition and Increased Risk-Taking.

Policies that increase the level of competition in banking or insurance markets are likely to increase the level of risk-taking and the failure rate within those industries. For example, a banking institution that is losing market share may be tempted to push into higher-risk lending markets that have traditionally not been served by banks. Or, a bank may choose to respond to stiff competition in commercial real estate lending markets by relaxing its lending standards – i.e., applying lower equity requirements for real estate developers and more lenient appraisal rules. Similarly, a bank that sees its profit margins being squeezed may decide to reach for higher yields by lending to highly leveraged corporate borrowers.

The U.S. commercial banking industry provides a good illustration of the interaction between competitive pressure and proclivity toward risk- taking. In the 1970s, U.S. securities firms began to aggressively market new financial products (commercial paper and money market deposit accounts) that took away from large commercial banks many of their best corporate borrowers and high balance depositors. Commercial banks responded by booking a massive volume of high-risk LDC loans in the early 1980s and then going on a commercial real estate lending spree in the late 1980s. The loan losses associated with this high-risk lending have severely weakened many of the larger U.S. commercial banks and caused the failure or distressed merger of a number of very large regional banks.

Financial deregulation is intended to give financial institutions much greater latitude in designing new products. This flexibility, in conjunction with new technology, permits the introduction of complex new financial products which could not, as a practical matter, have been created under the old paper-based regime. Yet this mounting complexity makes the management of financial institutions a far more difficult task.

The core business of financial institutions has always been managing risk. As this management task becomes more difficult, the likelihood that misjudgments will be made undoubtedly increases. For example, how is the management of a large multinational bank to judge the level of risk presented by its burgeoning off-balance sheet liabilities? Further, financial deregulation itself has increased both the speed with which financial markets react and their volatility, both of which can amplify the adverse consequences of mistakes made by financial institution managements.

Finally, financial institutions must deal with a non-financial sector that is more unstable than in years past. Much of this new instability stems from increasing international competition in manufacturing and increasing cross-border flows of capital. As a consequence, domestic manufacturers are today more prone to failure, and housing markets in many countries, including Australia, now exhibit unprecedented price instability. Needless to say, instability in the manufacturing and real estate sectors can quickly lead to defaults on bank loans and an erosion of the value of loan collateral, especially the real estate collateral that secures a growing share of bank loans.

This trend toward increased risk-taking is clearly manifest in the rising level of loan losses experienced by banking institutions in a number of industrial nations. In the U.S., the average annual loan charge-off rate for large commercial banks has risen inexorably from approximately 0.14% in the second half of the 1970s to 2.22% in the 3rd quarter of 1991 – a dramatic sixteen-fold increase. In the U.K., the four large clearing banks suffered aggregate loan losses of £5.6 billion in 1991 – their largest domestic loan loss since the Depression years of the 1930s. Even in countries once considered paragons of financial stability, such as Switzerland and Germany, regional and cooperative banking institutions have failed or required rescue measures because they have not been able to deal adequately with the changes and rising level of competition in banking.

This pattern is not just an aberration resulting from the current bout with recession in many industrial nations. Rather, it is a trend stemming in large measure from financial deregulation itself. Just two weeks ago in London, Alexandre Lamfalussy, general manager of the Bank for International Settlements, warned that rapid financial deregulation, unstable asset prices, and a lack of transparency in financial institutions have created "fertile ground for a full-blown crisis."

Financial distress and insolvency have also begun to rise on a worldwide basis in the insurance industry. For example, in the U.S. an average of 35 property/casualty insurers failed per year during the 1988-90 period, compared to an annual average of only 10 such failures during the 1969-1983 period. Similarly, an estimated average of 35 life insurance companies failed per year during the 1989-1991 period, compared to an annual average of only 6 failures during the 1981-1983 period. In the U.K., the venerable Lloyds has asked the Bank of England to provide financial assistance to its investors.

b. Lack of Effective Market Discipline for Depository Institutions.

While increased competition, mounting complexity, and a more unstable economic environment are key factors inducing greater risk-taking by financial institutions, they do not entirely explain the rising incidence of problem institutions and insolvencies. To fully understand the position of banking and insurance institutions in a deregulated financial system, one must grasp the central fact that bank depositors and insurance policy holders do not exercise effective discipline against risk-taking by the banks and insurance firms to which they entrust their funds. This inability of depositors and policy holders to curb risk-taking means that the pressures for increased risk-taking unleashed by financial deregulation will not be checked by the market-place. Unless the tendency toward greater risk-taking is curbed by more rigorous prudential supervision and regulation, it will remain unchecked, and financial deregulation will quite logically lead to greater instability at financial institutions. It is this inability of depositors and insurance policy holders to exert market discipline – in other words, to protect themselves through conventional market-based responses – that renders the goal of full-fledged deregulation of financial institutions an unrealistic objective.

The underlying nature of banking makes it extremely difficult for even sophisticated participants in financial markets to judge the level of risk borne by particular banking institutions. Bank assets consist primarily of hundreds of loan contracts – even thousands in the case of large banks – that are non-public information. Equally important, the underwriting standards employed by a bank in extending credit are often not visible – so even when loan contract terms are reasonably standardized, it may be difficult for market participants to judge the quality of loans. This lack of transparency is further compounded by the fact that individual loan officers may deviate substantially from their bank's official underwriting standards. Such deviation was an important factor in the collapse of Continental Illinois National Bank, a large U.S. money centre bank that failed in 1984. Moreover, the growth of off-balance sheet liabilities further complicates the task of judging a bank's true financial condition.

Research conducted by the Federal Reserve Bank of Boston shows that financial market professionals – stock analysts and debt rating agencies – do a poor job of anticipating which banks will encounter loan difficulties and assessing the severity of the situation once loan problems have become public. In view of the lack of public information on the level of risks embedded in bank loans and their other assets and contingent liabilities, this research finding is not surprising.

If the financial market professionals who track debt and equity securities issued by banks have a difficult time judging and disciplining bank risk-taking through their buy and sell recommendations, is it not implausible to expect depositors to perform this function? The vast majority of depositors certainly do not have the expertise required to assess their bank's financial condition.

Moreover, the lack of market discipline exerted by depositors is particularly significant because banks are so highly leveraged – with deposits often 20 times greater than equity and debt securities. Even when some modest scrutiny over bank risk-taking is exercised by financial market professionals, this is not likely to influence the behaviour of depositors, who constitute banks' primary source of funds.

Free market enthusiasts like to argue that depositors would provide effective market discipline if only they were not shielded from risk of loss by government deposit insurance or ad hoc bailouts. Unfortunately, there are two serious flaws in this line of reasoning. First, depositor discipline invariably arrives only after a bank has reported large losses. Yet effective discipline against undue risk-taking must occur much earlier in the process – when a bank first begins to book poor quality loans and the resulting credit risk becomes embedded in its portfolio. Depositor discipline exercised on an ex post facto basis doesn't curb risk-taking so much as it means that a bank with problems will encounter additional difficulties due to sudden deposit withdrawals. Second, exposing depositors to bank failure risk presents the classical problem of bank runs: depositors panicked by rumour seeking to withdraw their deposit funds ahead of other depositors.

c. Deposit Insurance and Too-Large-To-Fail.

Governments of most developed countries have rejected depositor discipline as a tool for curbing risk-taking by banking institutions, at least in regard to larger commercial banks. Even the minority of countries, such as Australia, that have eschewed *de jure* deposit insurance schemes will act to shield depositors in the case of a large bank failure. In some countries, depositors of relatively small banks, building societies, or credit unions that fail may have their funds encumbered for months and lose all interest on their deposits and even some principal. For example, depositors at the London branches of BCCI – an institution assigned Third World status by Western banking regulators – may receive only 60 cents on the dollar. But national governments and their banking regulators will invariably act to guarantee all *deposits* at larger or more prestigious banks that encounter difficulty, as witnessed by the bailouts of Continental Illinois National Bank (U.S.), Johnson Matthey Bank (U.K.), and Den norske Bank (Norway).

This "too-large-to-fail" or "too-large-to-default" syndrome is not about to disappear, notwithstanding all the political rhetoric about free markets. National governments will continue in the foreseeable future to protect all the depositors of their larger banks for a number of compelling reasons– fears about financial instability, concern about maintaining the international competitiveness of their banking institutions, and worry about political backlash if a large number of depositors were to suffer losses. The only real policy issue is whether full depositor protection is to be afforded to smaller banks and non-bank depository institutions or reserved for the club of larger banks.

One can only conclude that depositors are not in a good position to judge the risk of bank failure and that governments are not likely to force them to do so – at least in regard to larger banks. If the incentives for risk-taking unleashed by financial deregulation are to be restrained, the task must be performed by government itself through prudential supervision and regulation of depository institutions.

d. Limited Market Discipline: Insurance Companies.

Moreover, with respect to financial deregulation, the situation of insurance companies is roughly analogous to that of banking institutions. In a deregulated environment, insurance companies will face the same pressures to take on greater risk as banks. As with depositors, insurance policy holders are not in a good position to judge the financial condition of their insurance company. This lack of transparency is particularly true in regard to the growing real-estate-related assets of many life insurance companies. Requiring insurance policy holders to assess the financial condition of life insurance companies is particularly inappropriate since these companies are obligated to make payments to policy holders many years into the future and their financial condition may change dramatically in the intervening years. It is true that policy holders may be able to cancel their insurance contracts and switch to another insurer, but they usually pay a high price when they exercise this option.

When insurance companies default on their policy claims, policy holders often encounter severe hardship, and the political backlash is likely to be significant. For this reason, policy holders are often protected against insurance company failure by insurance guarantee schemes, and where they are not, the insurance regulator and the insurance industry will often orchestrate an ad hoc bailout. Accordingly, one should not expect insurance policy holders to discipline excessive risk-taking by insurance companies. Once again, prudential supervision and regulation is the key.

e. Primacy of Prudential Control.

Rigorous prudential control is the only realistic strategy for curbing excessive risk-taking by financial institutions and containing the cost of operating deposit insurance and insurance policy guarantee schemes within tolerable bounds. In regard to depository institutions, the essential elements of prudential control can be summarized as follows: high capital standards; rigorous accounting standards; comprehensive financial reporting to the regulators; frequent on-site examination by the regulators; publication by such institutions of comprehensive financial statements; prohibition or strict limitation of high-risk investments; prohibition or strict limits on insider lending; and, perhaps most important of all, prompt action by the regulators to halt unsound practices and prompt disposition of failing institutions.

Rigorous prudential control must also be the focal point of insurance regulation. Many of the basic prudential concepts needed in the insurance area are analogous to those employed in the banking area –

e.g., capital adequacy, prompt supervisory action, and limits on high-risk investments. Moreover, a policy of maximizing disclosure – both by insurance companies and their regulators – is again necessary.

f. Public Accountability of Banking Regulators.

Adequate prudential control requires not only strong legislation and regulations, but the rules must be rigorously enforced by regulators. To ensure that the banking and insurance regulators do, in fact, engage in adequate supervision on a timely basis, it is important to facilitate public monitoring of the performance of the regulators. It is also useful to foster public interest advocacy for strong prudential control.

Public monitoring of the prudential performance of banking regulators requires a fundamental transformation of the culture of banking supervision – a relinquishment of the tradition of supervision in secrecy and an acceptance of the need to maximize public disclosure. Yet bank regulators have traditionally viewed their enforcement actions and supervisory agreements as strictly confidential and have generally been unsympathetic to efforts to enhance the public transparency of banking institutions themselves. A major and not accidental consequence of this traditional regulatory preference for confidentiality has been the fact that the performance of bank regulators has been in large measure inscrutable to both the legislative bodies that empower the regulators and to the public at large – except when prudential supervision breaks down and there are major bank failures. Such after-the-fact accountability has limited value, since the damage has already been done. Further, when legislators or public advocates are poorly informed about the true condition of the banking system and the current state of prudential supervision, they are not in a good position to offer judicious advice or support necessary policy changes in periods of financial stress.

A critical element in establishing greater public accountability of bank regulators is to require them to disclose their supervisory actions, such as orders or agreements requiring banks to cease unsound banking practices or to raise additional capital or critical assessments of the adequacy of bank loan loss reserves. These actions – or the failure to take them – lie at the heart of prudential supervision and regulation.

Equally important, maximizing the financial information made public by banks themselves is a crucial step in enhancing the public accountability of bank regulators, as well as a policy that serves the interests of bank shareholders. The more limited the scope of bank financial disclosures, the more difficult it is to judge or even raise informed questions about the performance of bank regulators. Thus, it should not be surprising that bank regulators have tended to oppose broader financial disclosure requirements for the institutions they regulate. For example, in the U.S. a running battle took place for many years between the Securities and Exchange Commission, which wanted to increase bank disclosure requirements, and the federal banking agencies, which preferred a minimalist approach to bank disclosure.

g. Need for Independent Prudential Advocacy.

In conjunction with broad disclosure, there is also need for an independent advocate or watchdog to support strong prudential control of banking and insurance institutions and to monitor the performance of the banking and insurance regulators. Banking and insurance regulators are inevitably subject to intense pressure from the institutions they regulate for exemption, forbearance, and permission to venture into high-yield, but also high-risk, activities. Under such circumstances, an independent advocacy capacity, focused on the need for strong prudential control of banking and insurance firms, is needed as a means to counter the pressure for laxity. It is a dangerous mistake to assume that the banking and insurance regulators will automatically take care of prudential matters and that independent advocacy is not needed. In the U.S., the folly of this assumption was one of the central lessons of the savings and loan debacle.

The independent advocacy capacity needed in the banking and insurance areas should be lodged within the consumer movement. Although it may appear novel to look to consumer organizations for expertise on matters of prudential control, there are a number of compelling reasons for adopting this approach. First, consumer organizations are accustomed to advocacy and are relatively independent of political parties. Second, consumers – as depositors, insurance policy holders, and taxpayers – have a vital stake in the adequate prudential control of banking and insurance institutions. Third, consumers have a direct interest in other key aspects of banking and insurance regulation, especially competition policy, access to financial services, and consumer protection matters. Because prudential control is generally intertwined with these other aspects of financial regulation, consumer advocacy will be better informed and more effective if it is active on all the major fronts.

II. Banking Structure: Competition Policy and Access to Banking Services.

The issue of banking structure should be examined from two perspectives. First, is the structure of the banking industry conducive to competition and, if not, what structural policies will foster competition? Second, does the structure and operation of the banking system afford reasonable access to banking services to all segments of society and, if not, what affirmative policies are needed to achieve this goal?

The Martin Committee Report quite rightly placed considerable emphasis on the issue of whether there is an adequate level of competition within the Australian banking system. By comparison with the banking systems of most developed countries of any size, the Australian banking system is extremely concentrated – with the big four commercial banks accounting for 72% of deposits and 82% of branch offices.

a. Vital Link Between Depositor Protection and Competition Policy.

In evaluating the competitive structure of any banking system, it is essential to consider the interaction among prudential control, implicit or explicit depositor protection policies, and the level of competition. Since the security of deposits is of paramount importance to consumers and other depositors, deposit protection policies that discriminate against certain classes of depository institutions place such institutions at a distinct competitive disadvantage and thereby reduce the level of competition. At issue here is the competitive impact of the "too-large-to-fail" syndrome.

The financial playing field is especially biased against smaller depository institutions in a system such as Australia's in which there is no formal deposit insurance scheme, but it is implicitly understood that the largest commercial banks will be bailed out – or at least that their depositors will be protected. The fact that deposits placed in building societies and credit cooperatives – and possibly even in smaller commercial banks – are not protected by the implicit government guarantee constitutes an important barrier to entry or expansion by such smaller institutions.

Australia should adopt a deposit insurance scheme that provides explicit protection to small and medium-balance depositors at all depository institutions. The lack of such a scheme is not only unfair to individual depositors who are not shielded by the "too-large-to-fail" syndrome, but also undercuts the possibility of developing a more competitive Australian banking structure. The failure to examine the relationship between deposit insurance and competition policy – and also the potentially pro-competitive role of a more robust credit cooperative sector – was a major weakness of the Martin Committee Report.

b. Tension Between Prudential Control and Competition Policy.

Another key banking structure issue emerges from the fact that there is to some extent an underlying conflict or trade-off between prudential control and competition policy. A banking market with a high level of competition is likely over time to experience more bank failures than one with an oligopolistic structure. Since banking regulators are subject to harsh criticism when banks fail, it is not surprising that they have been somewhat less than vigorous champions of competition policy.

Given this tension or conflict, the appropriate course is to assign primary responsibility for reviewing bank mergers – and other mergers involving financial conglomerates – to the antitrust agency, rather than the bank regulator. Indeed, the Martin Committee Report wisely adopted this approach and recommended that the Trade Practices Commission be given authority to make competition policy determinations in bank merger and financial conglomeration cases.

c. Absence of Economies of Scale in Banking.

Extensive research in the U.S. has consistently shown that there are few, if any, economies of scale in banking once banks achieve a minimum size of $100 million to $500 million in assets. The absence of substantial economies of scale in banking has profound ramifications for banking structure and competition policy. Most pointedly, it means that it is not necessary to consolidate or merge banks into institutions of increasing size in order to achieve greater efficiency or improved profitability. Indeed, a comprehensive study of 134 bank mergers recently prepared by the U.S. Federal Reserve Board found that no more than one merged bank out of ten managed to increase its profitability relative to banks that did not merge.

The lack of economies of scale in banking has direct bearing on the competition policy standards that should be employed to evaluate proposed mergers between large banks. Anticompetitive effects of such mergers –i.e., the elimination of competition between the proposed merger partners – should not be excused on the theory that the mergers will provide substantial public benefits in the form of increased efficiency due to economies of scale. In short, a bank merger that would have significant anticompetitive effects should be denied, or at least the applicants should be required to divest their overlapping banking operations.

Moreover, there is an additional reason for subjecting mergers between large banks to close scrutiny from a competition policy perspective. Giant banks may gain preferred access to markets for equity and debt securities if their "too-large-to-fail" status is perceived as protecting their securities holders as well as their depositors. Thus, size itself may become a goal of bank management. But, this represents a spurious "economy of scale" that derives from discriminatory government policies in handling problem banks, rather than from genuine economic efficiency.

In a national banking system as concentrated as Australia's, competition policy should affirmatively foster the growth of small-sized depository institutions. Retail banking markets – which serve consumers, small businesses, and smaller farms – are essentially local in nature and well-served by smaller, locally-oriented depository institutions. U.S. banking experience over the last 15 years demonstrates clearly that smaller-sized banks, if given a level playing field, can compete successfully in today's banking world of new technology and financial deregulation.

In fact, recent data suggests that the profitability problems and loan loss problems of the U.S. commercial banking sector have been concentrated in larger banks, not smaller banks. Over the 1987-1990 period, the average return on assets for different bank-size categories was as follows: 0.68% for banks with assets less than $100 million (about 10,000 banks); 0.80% for banks with assets between $100 million and $1 billion (about 2,500 banks); 0.59% for banks with assets between $1 billion and $10 billion (about

300 banks); and 0.20% for banks with assets greater than $10 billion (about 45 banks). Moreover, during 1990, banks with assets less than $100 million experienced a loan charge-off rate of only 0.68%, while banks with assets greater than $10 billion had a loan charge-off rate of 1.86%.

d. Reducing the Conflict Between Competition Policy and Prudential Control.

With respect to the underlying tension between competition policy and prudential control, it is important to recognize that supervisory procedures can be adopted that will minimize this conflict. For example, if bank regulators act quickly to take control of problem banking institutions, this will on average significantly reduce the size of the losses that occur when banks fail.

Moreover, it is important to have in place problem bank and bank failure resolution policies that are consistent with competition policy. For example, if one of Australia's four giant banks were to encounter serious difficulties, there is no reason why the bank should be acquired in *toto* by one of the other three giant banks. In such cases, the Trade Practices Commission should require the problem giant bank to divide its retail branch network into a number of different retail segments and then oversee the sale or assisted transfer of these segments to different banking institutions. A modest example of this divestiture process can be seen in the U.S., where antitrust authorities are insisting that Bank America and Security Pacific divest approximately 200 of their combined total of 2,512 branch offices before they consummate their proposed merger.

e. Consumers and Bank Profits.

Questions involving banking structure, market power, and the price of bank services are paramount in regard to consumer financial services. Data from a growing number of countries shows that the profit margins of large banks tend to be very high on consumer banking activities (or, more broadly, retail banking services, including both consumer and small business activities), but quite narrow and even negative on wholesale banking activities (services for large corporations, institutional investors, inter-bank markets, and governments). Moreover, for several countries, including the U.S., the U.K., and Australia, the evidence suggests that this pattern of high profits on the consumer side and narrow profits on the wholesale side has been exacerbated by banking deregulation.

At a number of large U.S. banking institutions that straddle both consumer and wholesale banking markets, high profits from consumer banking have been used to cushion the large losses associated with high-risk wholesale lending activities, including Third World lending and the financing of commercial real estate deals and corporate take-overs. For example, Citicorp reported that in 1990 its consumer banking operations provided net income of $979 million, while its wholesale banking operations resulted in a loss of $423 million. Similarly, Chase Manhattan reported for 1990 a net income of about $400 million on its retail banking operations (consumer and small business), but a loss of $734 million on its wholesale banking activities. Also, Security Pacific showed for 1990 a net income of about $420 million on the consumer side, compared to a loss of about $260 million on the wholesale side.

Last month, the *Financial Times* of London reported that in 1991 National Westminster Bank, which experienced the largest loan losses ever incurred by a U.K. bank on domestic lending, was able to use its "oligopoly power" to raise the retail fees and charges at its domestic branches by 24%. In May and June of 1991, *The Sunday Times* of London published a series of case studies showing that larger U.K. banks were raising both interest margins and fees on many small business loans. In some instances, small businesses were being charged an effective rate (interest rate and fee) as much as 9% above the bank base lending rate.

Some insight into the market power which larger banks exercise in consumer banking markets can be gleaned from the credit card operations of major U.S.

banking organizations. Research recently published in the *American Economic Review* by Professor Lawrence Ausubel of Northwestern University indicates that during the 1983-1988 period, larger U.S. commercial banks achieved annual pre-tax rates of return on equity (ROE) on their credit card business of 60%-100% or more – a rate of return 3 to 5 times greater than the ordinary pre-tax ROE for the U.S. banking industry.

Further, the U.S. Federal Reserve Board reports that during 1990, large bank credit card issuers in the U.S. achieved an average pre-tax rate of return on their credit card portfolios (ROA) of 3.67%. This stands in sharp contrast to an average pre-tax rate of return on total banking assets (ROA) of only 0.56% achieved in the same period by larger U.S. banks.

Australian banks have shown a pattern of rising net interest margins in consumer banking and falling margins in wholesale banking as financial deregulation has unfolded during the 1980s. According to a recent study by Professor Ross Milbourne and Matthew Cumberworth of the University of New South Wales:

> Despite the fall in wholesale margins, retail margins continued to rise over the decade by an average of 0.2% per year. Thus, retail customers found the differential 2% more in 1990 than in 1980.

Moreover, such analysis of net interest margins – the spread between interest earned on loans and interest paid on deposits – tends to understate the divergence in profitability between consumer banking and wholesale banking. Net interest margin data does not take into consideration loan losses, which can have a major impact on bank profitability. Thus, net interest margin data does not reflect the current difference in loan charge-off rates between consumer loans and wholesale-type loans.

In the present economic climate in Australia, loan losses have been much greater on the wholesale side than the consumer side of banking operations. For example, National Australia Bank has reported for 1991 net charge-off rates of 9.05% on its domestic real estate construction loan portfolio, 2.39% on its domestic commercial and industrial loan portfolio (exclusive of agriculture, forestry, and fishing loans), and 1.83% on its domestic financial sector loan portfolio, compared to only 0.48% on its domestic consumer loan portfolio (instalment loans, credit cards, home mortgage loans).

Many large banks, including those in Australia, have vigorously contested the assertion that they use profits from consumer banking activities to cross-subsidize their wholesale banking operations. One might argue that large banks with market power over consumers will use it to extract oligopoly profit, regardless of whether or not they are engaged in wholesale banking operations. In this theoretical vein and from a long-term perspective, one might be tempted to claim that cross-subsidization should not take place. But, in the real world and in the short-run – where most business decisions are made – large banks will be inclined to use their market power over consumers to help cover large and unexpected losses on the wholesale side. Equally important, since this market power over consumers provides a cushion that large banks can fall back on if they encounter heavy losses on the wholesale side, the presence of this cushion may actually lead large banks to take on greater risk in their wholesale banking operations.

The Martin Committee Report recommended that banks disclose profitability data for their different lines of business activity. This call for disaggregate profitability data is one of the most important recommendations of the Martin Committee Report. The recommendation should be implemented promptly.

Needless to say, a central goal of line of business profit reporting is to require banks to report separate profitability data for their consumer banking operations. Such profit reporting for the consumer sector is vital for three reasons.

First, it will provide direct evidence on the level of profitability and degree of competition in consumer banking markets. If the data show high profit levels, this will provide strong impetus for new strategies to enhance price competition in consumer banking markets.

Second, to some extent, such disclosure should work to discourage banks from engaging in cross-subsidization or viewing their consumer operations as a cushion that allows for greater risk-taking on the wholesale side.

Third, high profits in consumer banking operations strengthen the case for requiring banks to offer low-cost checking and savings accounts to low and moderate income persons (basic banking services). Banks have argued that they cannot afford to provide basic banking services because their overall profitability is weak. However, if their profitability is high on the consumer side, this would weigh heavily in favour of establishing a basic banking requirement. As a matter of social equity, it would be appropriate to require banks to recycle a share of the high profits earned from the consumer side back to consumers in the form of basic banking services.

The Martin Committee Report also recommended that the Prices Surveillance Authority investigate and monitor the level of profitability in credit card operations. A far more efficient and less bureaucratic approach would be to recognize bank credit card operations as a key line of business and require banks to report separate profitability data for their credit card operations.

f. Small Business Credit Access.

Providing access to credit for small business on reasonable terms is one of the central functions of any banking system. Small businesses are heavily dependent on banking institutions for credit, and this dependence, coupled with the significant costs to small businesses of switching banks, can give banks substantial market power over their small business borrowers. Evidence from various countries indicates a number of public policy concerns about the small business lending practices of banking institutions. These concerns appear to be more pronounced with respect to very large banks with extensive branch networks than small, locally-oriented banks. At least in the U.S. and Canadian context, the evidence suggests a lack of affinity between very large banks and small business borrowers.

A 1988 survey by the Canadian Federation of Independent Business found excessive collateral requirements to be a persistent problem and also found a diminishing "favourability of loan terms as banker turnover increases, and as lending authority moves from the local branch to a more centralized regional or divisional office." A recent survey by the Australian Chamber of Manufacturers shows that on average, banks demand that small business borrowers provide collateral covering 99% of their borrowing and that less than one-third of small business borrowers are able to use business assets, as opposed to personal assets, for collateral.

Further, in both Australia and the U.S., much criticism has been levelled at banks during the current economic downturn in regard to arbitrary reductions of outstanding lines of credit to small businesses.

In the U.S., concern has also been voiced that financial deregulation may ultimately lead to structural changes that will threaten small business access to credit. In this view, which is supported by some early indicators, financial deregulation will lead to consolidation of the banking industry into very large banks with nationwide branch networks and implementation by such banks of cost-cutting and standardization procedures – both of which are likely to reduce the small business lending capacity of the banking system.

Perhaps the most universal complaint of small businesses against banks is that they are overcharged for bank loans. In deregulated banking systems, including the Australian system, small business invariably pays higher interest rates for credit than large corporate borrowers. Whether small business lending actually entails risk or administrative cost differentials that justify the higher price of credit is questionable. Concern about excessive small business loan rates is particularly warranted in a banking system with a high level of concentration, as in Australia.

The banking reform legislation enacted by the U.S. Congress in late 1991 contains a provision that will require banks to publicly disclose information on their small business loan portfolios. In establishing this disclosure requirement, the Congress recommended that the implementing regulations to be adopted by the bank regulators require banks to disclose the total number and aggregate dollar amount of their outstanding small business loans, as well as profitability data for this loan portfolio. The Congress further recommended that this loan data be itemized and listed separately for several different size categories of small business borrowers. This important new disclosure requirement should for the first time enable policy makers, the small business community, and public interest organizations to monitor the volume and profitability of small business lending.

In implementing the Martin Committee Report's recommendation for line of business profit reporting, small business lending should be recognized as key banking activity for which separate profitability data is warranted. In particular, banks should be required to report the total number of loans, aggregate dollar volume, average yield, and net charge-off rate for their small business loan portfolios. It would be useful if this data were reported for several different size categories of small business. For example, a small size category might include small businesses with annual sales of $250,000 or less, while a larger size category might include small businesses with annual sales between $250,000 and $1 million.

At least in the U.S., small businesses with annual sales of $250,000 or less represent more than 50% of all business firms. Because firms in the small-size segment of the small business sector tend to have the least bargaining power and are often the first to be affected by retrenchment in bank lending, it is extremely important for banks to disclose loan volume and profit data for this sub-sector. Also, requiring banks to disclose the number and dollar amount of loans made to start-up small businesses would provide information of great value for economic development purposes.

g. Access to Banking Services by Disadvantaged Social Sectors.

The issue of access to banking services by various disadvantaged segments of society has been raised in many different contexts and has many different dimensions. For example, as just discussed, concern has been expressed in Canada and the U.S. that the existing banking structure (Canada) or ongoing structural changes within the banking sector (U.S.) may disadvantage small business access to credit.

A second manifestation of the credit access issue has been the 25-year struggle within the U.S. to deal with the reluctance of many banking institutions to extend mortgage credit to residents of minority neighbourhoods – a practice known as redlining. A third example is provided by the efforts of U.S. banking institutions in recent years to support low and moderate income housing initiatives – particularly through cooperation with local community organizations, non-profit housing developers, and local governments.

A fourth example of concern over banking access involves the efforts of developing countries to create a modern banking infrastructure in their rural areas. This goal has led a number of developing countries to require commercial banks seeking regulatory approval to open branch offices in high-growth urban areas to concurrently open a few branch offices in rural areas.

A fifth and more universal example is provided by various proposals in a number of industrial countries to require banking institutions to offer no-frills savings and checking accounts with no fees or only very modest fees (basic banking) to low and moderate income persons.

Access concerns generally focus on the banking needs of individuals, small businesses, or communities that are underserved by or excluded from the banking system – typically, low and moderate income persons, minorities, small businesses, and rural communities. Quite often, inadequate access stems from a complex web of factors – social bias on the part of bankers, limited income on the part of consumers, lack of business experience on the part of business loan applicants, and geographic isolation. Frequently, public policy calls for affirmative lending efforts toward minorities in order to offset the negative impacts of social discrimination or systematic economic disadvantages.

Although banking access concerns predate financial deregulation, such concerns have often been heightened by its advent. In many countries the recent trend toward privatization of government-owned banking institutions (including postal savings banks) has dramatically reduced government's ability to control the pricing and availability of banking services for the purpose of ensuring broad-based access. Even in a country such as Australia where the national government has owned only one of the larger commercial banks, this government ownership position has traditionally given government considerable leverage with which to address banking access concerns.

A second ground for concern is the judgment that financial deregulation and technological change within the banking sector will lead to widespread changes in banking practices that will in turn exacerbate the access problems of disadvantaged sectors. For example, mounting bank losses in increasingly competitive wholesale banking markets have exerted strong pressure on many banks to cut their operating costs – often by reducing personnel involved in retail banking operations – and to increase their fee income – invariably by raising fees on retail banking services. In a similar vein, new technology and new marketing strategies provide strong incentives to reduce the number of skilled bank personnel in local branch offices. Yet such personnel are often vital to serving the banking needs of disadvantaged sectors.

h. The U.S. Community Reinvestment Act.

In the U.S., federal legislation enacted in 1977, known as the Community Reinvestment Act, stands as the centrepiece of a number of laws, rules, and policies designed to encourage banking institutions to address various concerns about access to banking services by disadvantaged sectors of society. The Community Reinvestment Act (CRA) establishes that commercial banks and savings and loans have an affirmative obligation to help serve the credit needs of individuals and small businesses who tend to be underserved by or excluded from the banking system – a very general standard that can be applied to widely diverse local circumstances. The Act's primary focus is on credit access concerns, although it has been interpreted to extend to deposit and payment services.

The Community Reinvestment Act requires the federal banking regulators to periodically assess the performance of each banking institution (commercial bank or savings association) in serving the credit needs of its community, with particular emphasis on its performance with respect to disadvantaged sectors. After completing a periodic assessment, the institution's regulator prepares a written evaluation and assigns a performance rating to the institution. All CRA written evaluations and performance ratings are made public by the regulators.

Whenever a federal banking regulator acts on an application by a banking institution to expand its operations (branch, merger, or acquisition application), the regulator must take into consideration the applicant institution's record of performance under the Community Reinvestment Act. During this review process, local community organizations and the public at large are encouraged to submit comments on the institution's CRA performance record. Quite often when an applicant is judged to have an unsatisfactory performance record, the regulator will indicate to the institution that it should make specific commitments to improve its performance. In a few situations, where applicant institutions have blatantly disregarded their CRA obligations, the regulators have formally denied expansion applications on CRA grounds.

The Community Reinvestment Act has proven to be a useful mechanism for addressing concerns about access to credit by disadvantaged sectors. Several key aspects of its implementation deserve mention.

Flexible performance standard. The underlying CRA performance standard – affirmative obligation to serve local community credit needs – is very general and flexible and quite different from the conventional credit allocation requirements under which banking institutions have been required to invest fixed percentages of their loan portfolios in specified types of loans. Under CRA, the types of credit or other banking services that are emphasized or given priority will vary depending on the specific needs of the disadvantaged sectors within a bank's local community.

This flexibility has been useful not only in coping with significant geographic variation in credit needs at the local level, but also in allowing the primary focus of CRA activity to shift over time as economic circumstances change and new credit needs arise. During the late 1970s, most CRA activity centred on the reluctance of banking institutions to extend home loans in older urban areas, especially minority neighbourhoods. In more recent years, housing affordability, rather than redlining per se, has become the central concern of many community organizations, and much CRA activity now centres on efforts to encourage banks to cooperate with non-profit organizations and local government officials in implementing affordable housing projects and programs.

Public participation. It is essential to recognize that the driving force behind effective CRA implementation has been public participation. The core of such participation involves intervention (the filing of protest comments) by local community organizations in application proceedings and, more broadly, negotiations between local community organizations and banking institutions which have led to myriad community lending commitments by banking institutions.

Such public participation is vital from a number of perspectives. First, some degree of local community participation is needed to adequately identify the particular banking needs of the disadvantaged sectors within each local community.

More broadly, without public participation, it very likely that regulatory implementation of CRA would be insipid. Given CRA's very general performance standard, there is inherently a large element of discretion and subjectivity in evaluating a bank's CRA performance record. Absent the scrutiny and countervailing pressure that flows from public participation, the bank regulators would tend to view CRA performance from the perspective of the institutions they regulate, especially that of the larger banks. In such a setting, general patterns and practices within the banking industry would come to define satisfactory CRA performance, virtually all large banks would receive satisfactory CRA ratings, and CRA would lose most of its force as an affirmative action mechanism.

Third, public participation in the CRA process has often evolved into permanent working relationships between banking institutions and local community organizations. Building such relationships is a vital component of any effective strategy to address credit access concerns in a community development context. Moreover, the fact that local NGOs can participate in the CRA implementation process has made banking institutions less inclined to dismiss their concerns and more ready to work with them in developing community reinvestment initiatives.

Public disclosure of performance data. A key reason why community organizations and other NGOs have been able to participate effectively in the CRA implementation process is that in the U.S., banking organizations are required to make public a considerable amount of data that is useful in evaluating their CRA performance records. Most importantly, the Home Mortgage Disclosure Act, enacted in 1975, requires commercial banks, savings and loans, and credit unions to disclose the geographic pattern of their housing loans. The availability of this data has enabled community organizations, other NGOs, and local government officials to conduct their own evaluations of bank CRA performance records and greatly facilitated their ability to make effective presentations in application proceedings.

Moreover, without such public data on banks' CRA performance, community organizations, other NGOs, and local government officials would be in a very weak position to judge the validity of the CRA evaluations and ratings assigned by the bank regulators. A public information gap of this nature would seriously undercut both public participation and regulator accountability in the CRA implementation process.

Overall impact. Over the course of the 14 years since its enactment, the Community Reinvestment Act has had a major positive impact on the response of U.S. banking institutions toward credit access concerns. From a narrow perspective, CRA-related negotiations between community organizations and banking institutions have resulted in specific bank lending commitments that have been conservatively estimated to total more than $20 billion in aggregate.

However, the Act's overall impact on the banking industry extends far beyond the dollar volume of the negotiated agreements. As a consequence of the Act, many banking institutions have modified their behaviour in ways that have significantly enhanced their responsiveness to community reinvestment concerns. Among such changes are the following: (1) establishment by banking institutions of many different types of CRA programs, (2) employment on bank staffs of CRA specialists, (3) greater willingness on the part of banking institutions to participate in government programs designed to advance community reinvestment goals, (4) greater inclination on the part of banking institutions to work directly with community organizations and other non-profit entities, and (5) establishment by banking institutions in a number of states and metro areas of loan pool programs to undertake CRA-related lending, especially mortgage financing for low and moderate income housing.

Affirmative obligation standard. As a general rule, the affirmative obligation standard contained in the Community Reinvestment Act has been interpreted to mean that in the effort to provide banking services to disadvantaged sectors, banking institutions have some obligation to (a) offer the type of credit services required by the disadvantaged sectors of their local communities, (b) engage in affirmative marketing of these services, and (c) absorb some administrative costs or price some services at cost. With respect to CRA-related lending – e.g., low and moderate income housing loans and commercial lending in distressed areas – the willingness of banking institutions to initially incur and absorb above-average administrative costs has proven to be crucial. Strong administrative support from lenders (technical assistance, loan packaging, credit counselling) is often a critical factor in determining whether community reinvestment loans are successful or not.

Overall, the costs resulting from implementation of the Community Reinvestment Act have not had a significant negative impact on bank operating costs or bank profits. From a public policy perspective, the affirmative obligation standard is viewed as a reasonable quid *pro quo* for the extensive government support that is provided to banking institutions. Such government support includes explicit and implicit protection of bank deposits, the Federal Reserve System's lender of last resort facility, and exclusive access to the payments system.

Moreover, it is important to keep in mind that this government support exists and is vital to the functioning of banking institutions in privatized and deregulated banking systems, such as that within the United States. Privately capitalized banking institutions that must compete in open financial markets are still beneficiaries of such government support and thus are properly subject to community reinvestment requirements. Hence, the worldwide trend toward banking deregulation and banking privatization should not be seen as undercutting the validity of imposing on banking institutions some duty to respond to the banking access needs of disadvantaged sectors.

III. Consumer Protection Issues.

While financial deregulation may benefit consumers through the introduction of new financial service products, it unquestionably complicates the decisions consumers face and the financial risks they encounter. In deregulated financial markets, consumers must select from a growing array of financial service products, cope with mounting complexity, and deal with greater credit risk and interest rate risk.

Further, financial deregulation should place banks under greater competitive pressure – indeed, a decline in profit margins is the expected outcome of a shift to a more competitive regime. Yet, banking institutions are inclined to respond to profit decline by adopting marketing strategies that pose additional difficulties for consumers. These strategies generally seek to blunt price competition by means of tactics that obscure the underlying cost of financial service products.

Financial services are often bundled into complex packages whose real value and cost are not easily measured by consumers. Consider, for example, credit cards which are linked to a variety of other services, such as discounts on various retail purchases or added frequent flyer mileage –or, consider the example of mortgage loans tied to complex life insurance or annuity policies.

Ancillary and hidden fees are often raised to new heights, especially contingent fees, such as bounced-check fees or penalties for early termination of life insurance policies. Such fees are often overlooked by consumers in pricing financial services.

Unfair contract terms, which reflect the underlying imbalance in bargaining power between individual consumers and financial institutions, often multiply in deregulated financial markets. Examples of unfair contract terms would include the imposition of substantial prepayment penalties on adjustable rate mortgages – mortgages on which the lender bears no interest-rate risk – or the use of deposit balance calculation methods that deprive consumers of a fair return on interest-bearing deposit accounts – e.g., the lowest monthly balance method.

Needless to say, a deregulated financial service environment calls for adoption of new and stronger consumer protection measures. Major reforms are needed on a number of fronts, including, but not limited to, the following areas: (1) full disclosure to the consumer of contract terms, (2) adoption of standardized cost disclosure formats to facilitate comparison shopping, (3) curtailment of unfair contract terms and practices, (4) restrictions on fees and practices that inhibit consumers from switching financial service providers, and (5) stronger enforcement procedures.

Several consumer protection issues that have particular relevance in deregulated financial service markets, including Australia's, provide useful examples of the broader range of consumer concerns. The issues mentioned below are merely illustrative, rather than exhaustive of the many consumer protection concerns raised by financial deregulation.

a. Standardized Cost Disclosure.

Credit products. Among the top priorities of financial deregulation policy should be the promulgation of comprehensive consumer disclosure requirements for retail financial service providers that are designed to facilitate comparison shopping by consumers. With respect to credit, this requires standardization of the manner in which the cost of credit is disclosed to consumers, small businesses, and small farmers. Such standardized disclosure of the cost of credit is often referred to as Truth-in-Lending.

Undoubtedly, some variation in the cost disclosure format may be appropriate for the different types of credit – i.e., fixed-term consumer loans, revolving credit, mortgage loans, hire-purchase contracts, and retail sales instalment credit. But there are basic principles of comparative disclosure that should be applied across-the-board. The cost of credit should be expressed in terms of an annual percentage rate (APR) calculated on an actuarial basis. To the maximum extent feasible, all interest payments and loan origination fees should be incorporated into this annual percentage rate. Moreover, the disclosure requirements should apply uniformly to the different classes of creditors, such as banks, credit unions, finance companies, and retailers.

A comprehensive Truth-in-Lending regulation should be central to any financial deregulation policy that is undertaken with the goal of increasing price competition in retail credit markets. When credit costs are not quoted and advertized on a uniform basis, the ability of consumers to comparison shop is undermined and the efficiency of credit markets is impaired. Given the vital link between effective comparison shopping and market efficiency, Truth-in-Lending should be seen not only as a consumer protection measure, but also as an instrument of competition policy.

Savings products. Another key reform is standardization of the balance calculation method used by depository institutions to compute the amount of interest paid to consumers on deposit accounts. Such standardization, often referred to as Truth-in-Savings, serves a two-fold purpose: first, it provides comparability in quoted interest rates; and second, it precludes the use of unfair balance calculation methods.

In November 1991, the U.S. Congress enacted Truth-in-Savings legislation that provides a useful model. Under this new requirement, all depository institutions must calculate interest payments on the basis of the average daily minimum balance method. In a sense, the U.S. Truth-in-Savings law mandates standardization of a particular product term (the balance calculation method), not simply standardization of the cost or yield disclosure.

From a broader perspective, there is clearly a direct link between public policies designed to facilitate comparison shopping and regulations that force standardization of product terms. On one hand, a major goal of financial deregulation is to encourage, or at least permit, product innovation and product differentiation, which in turn implies a substantial increase in the number of non-standardized product terms. On the other hand, unfettered differentiation among financial service products may seriously erode the ability of consumers to engage in comparison shopping – a consumer behaviour trait not lost on financial service providers seeking to avoid price competition. Hence, there may be situations in which it is appropriate to force standardization of product terms in the interest of facilitating comparison shopping. A useful first principle would be to force standardization in cases where product differentiation greatly complicates comparison shopping, while adding little in the way of product value for consumers.

Life insurance products. In many countries, life insurance policies with an investment component – universal life, whole life, and various annuity products – are the financial service area where the need for cost disclosure reform is most pressing. In Australia, "privatization" of retirement savings has led to aggressive marketing of instalment savings plans (annuity-type products) by life insurance companies. The high commissions, low surrender values, and increasing frequency of early termination associated with these savings plans indicate that they have been poor investments for many consumers, especially moderate-income consumers with low marginal income tax rates. The absence of disclosure requirements that would show consumers the true rate of return on these savings plans and facilitate comparison shopping must be judged as a major factor contributing to this unsatisfactory development.

Life insurance products with an investment component should be subject to a legislative disclosure scheme that would require standardized disclosure of the projected rate of return for different policy-holding periods – e.g., 1 yr., 3 yr., 5 yr., 10 yr., 15 yr., 20 yr., and 25 yr. periods. The quoted or advertized rate of return under this standardized disclosure requirement should reflect both the projected rate of return on the investment component of the policy and the implicit rate of return associated with the policy's death protection provisions. Such a disclosure regime would drive home to consumers the high costs (negative rates of return) associated with early termination of most life insurance policies and more generally facilitate comparison shopping.

b. Unfair Contract Terms and Practices.

In all types of financial service markets, both regulated and deregulated, statutes and regulations establishing specific consumer protection provisions provide an important means to curb unfair contract terms and practices. In the U.S., examples of specific consumer protection measures would include the Truth-in-Lending Act, the Fair Credit Billing Act, the Electronic Funds Transfer Act, and the Truth-in-Savings Act.

However, in deregulated financial service markets – where products and practices are in constant flux – it is often difficult for specific statutes and regulations to keep pace with innovation in regard to unfair contract terms and practices. In such circumstances, it is important for the overall scheme of consumer protection legislation and regulations to also contain general consumer protection provisions that can be applied to a variety of situations not covered by the specific provisions.

For example, U.S. securities law requires securities issuers and their underwriters to disclose inter *alia* all information that is likely to be material to a reasonable investor. A recent proposal to modernize the State credit codes in Australia would curb improvident extensions of credit. Another example would be a statutory provision requiring that all fees bear a direct and reasonable relationship to costs, unless the imposition of a penalty has been expressly authorized by law. Broad language of this nature places financial institutions on notice that they have a general duty of care – perhaps even a quasi-fiduciary duty – to their financial service customers.

Quite obviously, general consumer protection provisions must be interpreted and enforced by administrative agencies, special tribunals, or the general courts. While enforcement initiatives by administrative agencies have many advantages, it is always vital to give consumers the right to seek redress before a judicial body, i.e., a general court or judicial-type tribunal. The availability of such private legal actions provides a vitally needed check and balance against the administrative inaction that so often results from insufficient agency resources or an unsympathetic agency view toward consumer interests.

Where an administrative agency is assigned the leading enforcement role, it should have an institutional culture that is responsive to consumer concerns. Banking and insurance regulatory agencies, which invariably perceive their primary mission to be the prevention of bank and insurance company failures, are very likely to develop a protectionist attitude toward the industries they regulate which precludes a due regard for consumer interests. When it comes to interpretation of very general consumer protection provisions – where agency discretion is the broadest – such institutional bias can exert a very strong negative influence on the outcome from the consumer perspective.

The U.S. experience with implementation of general consumer protection measures applicable to banking institutions provides insight into this dynamic. In 1975, the U.S. Congress authorized and directed the Federal Reserve Board to issue regulations that would from time to time define "unfair or deceptive" banking practices. During the subsequent seventeen years, the Federal Reserve Board has not once used this discretionary rule making authority to specify a banking practice as unfair or deceptive. Admittedly, the Board has adopted regulations under this general provision that prohibit specific credit practices, but these rules were not truly discretionary. Rather, they tracked a credit practices rule previously adopted by the Federal Trade Commission – an outcome mandated by the 1975 legislation. From a consumer perspective, it would have been far wiser for Congress to assign the rule making authority to proscribe unfair or deceptive banking practices to the Federal Trade Commission, the federal agency with the broadest responsibilities in the consumer protection area.

The Martin Committee Report recommended that primary authority for developing consumer protection standards in the banking area be assigned to the

Trade Practices Commission, rather than the Reserve Bank or the Treasury Department. The U.S. experience points to the underlying wisdom of this recommendation.

c. Interest Rate Risk on Home Mortgage Loans.

Worldwide economic changes, as well as financial deregulation itself, have unleashed forces that tend to increase the risks associated with mortgage loans – from both the borrower's and the lender's perspective. A key risk factor is the increased potential for interest rate instability. In Australia, as in many other countries, most mortgage loans used to purchase homes have variable interest rates and are not subject to any limitation on how fast the interest rate may increase. Where such unconstrained mortgage contracts are common, any rapid escalation of interest rates in general can quickly translate into large monthly payment increases on home mortgage loans which are beyond the budget capacities of many households.

Such monthly payment shock can lead to personal hardship, mortgage defaults, and in some economic circumstances, forced sales of homes at deeply discounted prices that wipe out home owner's equity – or, alternatively, strong political demands for government intervention to curb interest rate increases on outstanding mortgage loans. For example, when mortgage rates escalated sharply in Canada in the late 1970s and early 1980s, such payment shock rippled through the Canadian household sector, and many families were forced to sell their homes at depressed prices.

The risk of payment shock inherent in variable rate mortgage loans is compounded by the growing volatility of home prices that is in evidence in many countries, including Australia. For example, it has been estimated that housing prices in the Melbourne area have fallen by as much as 15% during the current recession. When payment shock is accompanied by a major decline in housing prices, this maximizes the erosion of home owner's equity, which in turn means large losses for financially strapped home owners who are forced to sell their homes.

In large measure, the Australian housing finance system managed to avoid payment shock during the rapid run-up of mortgage rates in the 1988/89 period. This occurred because mortgage lenders implemented rate increases on many outstanding mortgage loans by extending the maturity of the loan, rather than by raising the monthly payment. However, this maturity extension strategy was only feasible because a large number of outstanding mortgages had terms as short as 15 years. When mortgages are originated with maturities of 25 to 30 years – as is the current practice in Australia – maturity extension is no longer an effective means to avoid monthly payment shock. In any future escalation of mortgage rates, it seems unlikely that Australia will be able to one again dodge the bullet of mortgage payment shock.

Moreover, if home equity lines of credit become common in Australia, this will further exacerbate the risk of mortgage payment shock. Home equity lines of credit – i.e., variable rate, revolving consumer loans secured by a junior mortgage lien on a home – have become widespread in the U.S. However, in the U.S. housing finance system, the great majority of home purchase mortgage loans are long-term (25 to 30 year) fixed-rate loans, which carry no risk of payment shock for the home owner. Combining long-term, fixed-rate home mortgage loans with variable-rate home equity loans produces only moderate payment shock risk. By contrast, combining unconstrained variable-rate home mortgage loans with variable-rate home equity loans – the emerging trend in Australia – maximizes the risk of sharp monthly payment increases.

In a financial system such as Australia's, where variable-rate mortgage loans are the predominant home financing instrument, consumer protection legislation should set a ceiling on how much the interest rate on outstanding variable-rate home loans may be increased during any short-term period. For example, rate increases might be limited to 1% per year or, alternatively, to 2.5% in any three-year period. Such a ceiling would result in a sharing of interest rate risk between mortgage lenders and home buyers, rather than having it placed entirely on the backs of home buyers.

In the U.S., the Federal Housing Administration (FHA) – a federal government agency that insures many home mortgage loans originated by depository institutions and mortgage companies – has recently established a guarantee program for variable rate mortgage loans. Mortgage loan contracts guaranteed under this program must limit interest rate increases to 1% per year and 5% over the life of the mortgage loan.

Establishing a ceiling for annual or periodic interest rate increases on outstanding variable rate mortgage loans would provide a number of important benefits in Australia. First, and most important, it would greatly reduce the considerable risk of future payment shock – an obvious benefit for home owners with only a limited capacity to absorb increases in their monthly mortgage payments. Second, a ceiling would indicate to lenders exactly how fast they can realistically expect to raise interest rates on their outstanding mortgage loans during periods of sharp interest rate escalation. Under the variable-rate mortgage loan contract commonly in use in Australia today, lenders have total discretion in raising interest rates on outstanding loans – a position which gives lenders great leverage, but also entails considerable ambiguity. Third, by indicating to banking institutions how much interest rate risk they would have to bear in a period of rate escalation, interest rate ceilings would encourage such institutions to develop more comprehensive strategies for hedging interest rate risk. At present, Australian banking institutions must factor into their strategic planning the rather imprecise assumption that in a period of sharply rising interest rates they will be able to raise the rates on their outstanding mortgage loans as much as most home buyers can tolerate, and should payment shock become too extreme, a political solution (i.e. government assistance) may be arranged. As demonstrated by the erosion of profit and capital at many U.S. savings and loans during the early 1980s, it is not prudent for depository institutions to hold large portfolios of long-term, fixed-rate mortgage loans. For depository institutions, which are funded in large part by shorter-term deposits, the holding of large volumes of such assets entails far too much interest-rate risk.

Long-term, fixed-rate mortgage loans remain the predominant mortgage instrument in the U.S. because government-sponsored housing agencies have established a powerful secondary market into which fixed-rate mortgage loans can be sold by mortgage originators and converted into securities for resale into broad capital markets. As a result of this policy, there is a broad supply of competitively priced fixed-rate mortgage loans and consumers may choose freely between variable rate home financing and fixed-rate home financing.

Not surprisingly, the majority of home buyers prefer fixed-rate loans. For example, 72% of all home loans originated in the U.S. in 1990 were fixed-rate loans, while the comparable percentage for 1991 was 77%. The fixed-rate home loans originated during this two-year period had on average a term to maturity of 26 years.

The underlying advantage of the U.S. housing finance system is that it assigns the interest-rate risk associated with fixed-rate mortgage loans to the capital markets where such risk can be readily borne by securities investors – rather than placing it on depository institutions or, alternatively, shifting it to home buyers in the form of variable rate mortgages. For this reason, consumer organizations in other countries may find it useful to support the development of secondary mortgage markets and the mortgage securitization process. It is worth noting that the establishment of secondary mortgage markets and securitization pipelines tends to undercut the market power exercised by depository institutions in mortgage markets, especially their ability to dictate the terms of the home mortgage loan contract.

d. Compliance.

Ensuring compliance with consumer protection provisions is a major problem in the financial service area. Without an effective system to ensure compliance, even the strongest consumer protection measures are likely to have only a limited impact. In Australia, for example, recent litigation indicates a substantial level of non-compliance by finance companies and banks with state consumer credit codes.

The experience of a number of countries suggests that there are two general approaches to achieving compliance with specific consumer protection provisions in the financial service area. One approach is to require regulatory agencies to conduct detailed, on-sight examinations of financial institutions at regular intervals. This approach, however, is quite labour intensive and may be difficult for agencies with limited enforcement resources. A second approach is to rely on consumer complaints to trigger review by an ombudsman, formal administrative proceedings, or civil litigation. Under either approach – but, especially when primary reliance is placed on consumer complaints – it is important to establish civil penalties for violations of law.

Without a system of civil penalties, financial institutions in many situations have only a limited incentive to comply with consumer protection provisions. Indeed, limiting recovery to compensatory or actual damages may well encourage some financial institutions to disregard consumer protection laws on the calculation that they often will not get caught, and if they do, they will only be out of pocket for what they would have owed the consumer if they had been in compliance in the first place. Equally important, in the absence of civil penalties and authorization of class actions, private enforcement is likely to remain fallow. Without civil penalties and class actions, in many situations the very limited recovery available to individual consumers will be outweighed by the costs involved in litigation or pursuit of administrative remedies.

IV. Consumer Information Needs: The Case for a Collective Information System.

Consumer protection strategy in the financial service area has traditionally sought to address the problem of consumer information needs by requiring financial service firms to provide individual consumers with product information at the point of sale. However, mounting evidence from a number of countries suggests that in many situations this conventional approach to information dissemination has not resulted in informed decision-making by financial service consumers. There is an underlying consumer information deficit which becomes particularly serious in deregulated financial service markets, where product innovation and aggressive marketing work to expand consumer information needs and complicate the decisions that consumers must make.

In the current era of financial deregulation, conventional point-of-sale disclosures by financial service firms remain critically important. But, they must be supplemented with a new collective approach to consumer information that emphasizes the collection and analysis of comparative price and term information on financial service products and the dissemination of such information to individual consumers.

A new, collective consumer information system should be established that will provide financial service consumers with the information necessary for informed and efficient decision-making: (1) comparative price information (shoppers guides) for various financial service products; (2) computerized shopping programs that will scan the market for a specified financial service and select the best buy for a given consumer, taking into consideration the consumer's financial profile; and (3) brochures and other publications providing analysis and advice about various financial service products offered in the market, including pointers on such key concerns as financial risk, product suitability, and hidden fees and charges. Such a collective consumer information system is vitally needed to address the failure of many consumers to comparison shop and make informed decisions in regard to financial services.

a. Inadequate Consumer Information: Pervasive Market Failure.

The many existing consumer information gaps with respect to financial services translate into market failures that in turn result in market power for financial firms, especially those that are skilled at implementing aggressive marketing strategies that eschew price competition. Unless a collective information system is built that will go a long way toward eliminating this consumer information deficit, the promise of financial deregulation to provide direct benefit to consumers in the form of increased competition *and* lower product prices will remain largely unfulfilled. It is surprising and unfortunate that to date financial deregulation policies have focused almost exclusively on the goal of increasing competition from a supply-side or financial industry perspective. Public policy that is genuinely interested in increasing price competition in consumer financial service markets – as opposed to simply giving large financial service firms opportunities to build their market shares through sophisticated advertising techniques – should support the establishment of a collective information system that will enhance the capacity of consumers acting on the demand side of the market.

Market failure: credit cards. A striking example of the limitations of the traditional approach to consumer information needs is provided by the credit card market in the U.S.. With more than 4,000 credit card issuers, the U.S. credit card market must be viewed as highly competitive from a structural or supply-side perspective. Moreover, the U.S. Truth-in-Lending Act requires credit card issuers to provide consumers with comprehensive and standardized price and term information. This information must be provided to the consumer not only just prior to the consummation of a credit card agreement, but also in conjunction with any application or solicitation to open a credit card account, including solicitations by mail or telephone. Further, the required price and term information must be presented in a tabular format prescribed by the U.S. Federal Reserve Board.

Notwithstanding this highly competitive supply-side structure and comprehensive scheme of consumer disclosures, the credit card market in the U.S., as mentioned earlier, shows the classic symptom of market failure – an abnormally high rate of return. This abnormal rate of return on credit card assets reflects a widespread failure on the part of credit card holders to respond to price signals. Card holders do not switch to credit cards offering comparatively lower interest rates and fees, and consequently the market share held by high-priced credit card issuers remains large. In selecting a credit card, many consumers apparently assume that they will routinely pay their entire monthly balance within the grace period and thus never use the card's revolving credit facility – an assumption that makes the interest rate irrelevant to a consumer's shopping decision. Yet the recent credit card study by Professor Lawrence Ausubel of Northwestern University found that approximately 75% of bank credit card holders do, in fact, generate revolving credit balances on which interest must be paid, and in 1987 the average outstanding balance of active accounts was $1,038.

Market failure: deposit accounts. Many U.S. consumers are also very sluggish in responding to price signals in the deposit account market. As with credit cards, such inertia on the part of consumers translates into substantial market power for banking institutions. The inertia of many consumer depositors in responding to price signals – in contrast to the close attention given by corporate treasurers and institutional investors to the yields on their deposit balances – is a major reason why retail deposits, often called "core deposits", are valued so highly by banking institutions.

Market failure: life insurance. Within the financial service sector as a whole, life insurance products provide the most dramatic example of market failure and excessive profit resulting from inadequate information and uninformed decision-making by consumers. According to a 1985 report issued by the U.S. Federal Trade Commission, 80% of the consumers who have life insurance policies did not shop for life insurance, while another 18% of these consumers shopped ineffectively (without the use of cost indexes). In other words, only 2% of consumers with life insurance policies had shopped effectively for life insurance. Similarly, a 1986 report by the U.K. Office of Fair Trading found that only 10% of consumers who purchased life insurance policies had engaged in comparison shopping.

Enactment of effective life insurance cost disclosure legislation would undoubtedly facilitate comparison shopping and more informed decision-making by life insurance consumers. Nonetheless, the complexity of many life insurance products and the personal salesmanship with which they are often sold suggests that even with greatly improved point-of-sale disclosures, many consumers would still not engage in effective comparison shopping.

b. Inherent Limitations of Conventional Disclosure Requirements.

Conventional point-of-sale disclosure requirements encounter a number of obstacles in deregulated financial service markets. As products become more complex, the likelihood that such disclosures will omit key information or, alternatively, overload the consumer with information at the point of sale increases. Moreover, the ability of many financial service firms to redesign or bundle their products provides them with a ready means to circumvent or blunt the efficacy of specific disclosure provisions.

c. Ineffective Information Intermediaries.

Another key factor that argues for establishment of a collective consumer information system is the general failure of the private sector to provide information intermediaries who engage in cost-effective comparison shopping on behalf of individual financial service consumers. Existing information intermediaries, such as insurance agents or securities brokers, are geared primarily to selling financial service products, rather than selling information about the different financial service products available in the market. Generally speaking, they operate with only limited incentives to search diligently for the best deal for their consumer customers. Indeed, in many situations where commissions are based on the price of the financial service product sold to the consumer, agents or brokers have a perverse incentive to recommend and sell high-cost products to their customers. In other cases, intermediaries are tied to particular financial service firms or are formally part of financial service conglomerates and – although ostensibly providing "independent advice" – they operate with strong incentives or even orders to sell the products of their affiliates.

d. Advantages of a Collective Information System.

A collective information system would provide a cost-effective means to address the consumer information gaps that have proven to be intractable to more conventional consumer protection strategies. By publishing shoppers guides and making computerized shopping programs widely available to consumers, a collective information system would dramatically reduce the search costs faced by individual consumers. Clearly, there are tremendous economies of scale in collectivizing search costs. Moreover, economic theory suggests that information needed by consumers has certain "public good" characteristics, which means that it tends to be underproduced by the conventional private sector – an additional reason for producing it on a collective basis.

A collective information system would have the capacity to respond quickly to product innovation and to evaluate the consumer value of complex or artfully bundled financial service products. For example, shoppers guides and computer shopping programs can be easily modified. Informational brochures are a useful medium for evaluating inherently complex financial service products. By way of contrast, considerable time lags are usually involved in modifying statutory or administrative disclosure requirements, and it is generally considered to be inappropriate to incorporate judgmental evaluations in such disclosure requirements.

Another major advantage of a collective information system is that it would operate free of the many conflicts of interest that entangle the traditional financial service intermediaries who are engaged in selling financial service products as well as providing financial service information to consumers. A collective information system would not sell financial service products. Hence, its judgments would not be influenced by the prospect of earning large commissions or maintaining relationships with tied firms or affiliates. Simply put, its raison *d'etre* would be to provide the best financial service information to consumers. Moreover, establishing a collective information system as a consumer-controlled organization would reinforce this commitment to serve the underlying information needs of financial service consumers.

A collective information system would be in a strong position to put new computer and telecommunications technology directly to work on behalf of financial service consumers. This new technology makes it possible to rapidly collect, tabulate, and disseminate comparative price and term information on a wide range of financial service products. Given access to computerized shopping programs, individual consumers could quickly identify the best buy available for various financial service products—a process that can be extremely tedious and time-consuming for consumers when traditional search and calculation tools are used.

To be fully efficient, a collective information system needs to be supported by a legislative or administrative framework that will give it ready access to current price and term information on the various banking, credit, and insurance products offered by financial service providers. For example, where regulatory agencies, such as insurance commissions, receive the necessary price and term information from insurance companies on a current basis, they could be required to transmit the information to the collective information system. Alternatively, financial service firms could be required to report their price and term information directly to the collective information system, with incentives to encourage reporting in a computerized format.

An efficient collective information system will also need to develop mechanisms to disseminate financial service information to a broad range of consumers. For example, shoppers guides could be published in local newspapers, while computer shopping programs might be made available to individual consumers through computer terminals located in credit unions or other cooperative credit institutions.

In building political support for a collective information system, it is important to recognize that such a system could provide important benefits to small businesses and small farmers, as well as consumers. As the Martin Committee Report astutely observed, small businesses and small farmers by and large face the same comparison shopping problems as consumers in the financial services area.

A collective information system could be operated by a government agency, but it would be far more effective to lodge it within a consumer membership organization. As an independent, consumer-controlled entity, it would escape from the bureaucratic delays and narrow vision that so often plague administrative agencies. Equally important, it would not be subject to the financial industry pressures that so frequently weaken the will of government agencies to represent consumer interests in the financial service sector.

Ultimately, a full-blown collective information system should be able to generate enough revenues from membership dues and other fees to achieve self-sufficiency or close to it. However, during its start-up phase and early years of operation, it is likely to need a modest level of government support. Such support is particularly important if the collective information system is to provide adequate information services to low and moderate income persons. While such persons often have the most pressing information needs, they also have the least capacity to pay membership dues or user fees in any collective information system.

Providing a collective information system with ready access to current price and term information for specific financial service products – either directly from financial service firms themselves or indirectly via regulators – would substantially lower the system's operating costs and thereby reduce the need for government assistance. Also, negotiating information dissemination agreements with credit unions or other cooperative credit institutions should further reduce operating costs and the need for government assistance.

Government support for a collective information system could be provided in a number of forms. For example, the government could distribute notices to consumers informing them about the nature and purpose of the collective information system. Or, financial service providers could be required to enclose such notices in their periodic account statement mailings to consumers. A surtax could be imposed on financial service products that exhibit abnormally high rates of return – e.g., credit card outstanding balances with very high interest rates. Alternatively, a special annual assessment could be levied on all depository institutions and insurance companies that benefit from government operation or sponsorship of deposit protection schemes, lender of last resort facilities, or insurance policy guarantee programs.

A country such as Australia is ideally suited for establishing a collective information system for consumer financial services. The number of financial institutions is not great (at least relative to U.S. financial service markets) and this reduces the burden involved in collecting, analyzing, and disseminating comparative information. Also, the vast majority of the country's population is located in urban areas, which facilitates dissemination of information to individual consumers. Moreover, a demand-side, collective information strategy has particular relevance in a country such as Australia, which on the supply-side of the financial services market has a structural tendency toward oligopoly.

V. The Financial Consumers Association: An Institutional and Democratic Approach to Developing Public Safeguards for Financial Deregulation.

A broad review of financial deregulation shows that it has a number of important public interest dimensions: prudential control, competition policy, access to financial services, consumer safeguards, and collective information. If these public interest dimensions are not adequately developed, it is highly unlikely that financial deregulation will benefit the great majority of consumers, small businesses, and small farmers. Moreover, given the potent influence wielded by the financial industry over both the legislative and the administrative process, the public interest dimensions of financial deregulation are likely to be given short shrift unless an independent advocacy and watchdog capacity is developed with respect to these dimensions.

Specifically, an independent advocacy and watchdog capacity is needed:

(1) to monitor the prudential performance of the banking and insurance regulators and to advocate rigorous prudential control of banking and insurance institutions;

(2) to monitor the level of competition within financial service markets and to advocate policies that will encourage greater competition in retail banking markets (strict bank merger standards, disclosure of profitability data, access to deposit insurance);

(3) to monitor the availability of financial services to less affluent consumers and small businesses and to advocate policies that will ensure reasonable access to basic financial services for such persons and entities (community reinvestment provisions, small business loan disclosure, and basic banking rules);

(4) to advocate consumer protection measures (standardized cost disclosure requirements, restrictions on unfair contract terms) and, under appropriate circumstances, to

negotiate codes of fair financial services practices; and

(5) to operate a collective information system.

Needless to say, an independent advocate and watchdog for the financial service sector that must come to grips with all of these complex issues and also operate a collective information system will require substantial resources. The best strategy for ensuring that sufficient resources are available to perform these monitoring, advocacy, and information dissemination functions is for the national government to (1) charter a public-purpose, financial consumers association, (2) subject the association to specific charter duties with respect to each of its key functions, and (3) provide the association with an adequate level of support. Specifically, chartering legislation could direct the financial consumers association to (1) operate a collective information system and in doing so to take affirmative steps to disseminate financial service information to persons of modest means, (2) monitor and report annually on the prudential performance of the banking and insurance regulators, (3) report periodically on the level of competition in retail financial service markets and the availability of financial services to disadvantaged sectors, and (4) serve as an advocate for policies that advance prudential control, competition policy, access to basic services, and consumer protection in the financial service area.

Although operating within the framework of the public-purpose duties specified in its chartering legislation, a financial consumers association should be constituted as a consumer membership organization democratically controlled by its consumer members. This democratic structure would provide the association with the independence so vital to performing its advocacy and watchdog roles. To this end, the chartering legislation should specify rigorous rules of democratic governance that must be followed by the association.

In view of its broad mission, a financial consumers association will require a measure of government support, at least in its formative years. As discussed earlier in regard to the collective information system, such government support might include the distribution to consumers of notices about the association, a surtax on high-profit financial services, or a special assessment on depository institutions and insurance companies with the resulting revenues dedicated to the association.

Consolidating the various monitoring, advocacy, and information dissemination activities that need to be performed within a financial consumers association should provide important public benefits. In developing and operating a collective information system, the association should acquire extensive knowledge about various retail financial service markets, and this knowledge should greatly enhance the association's capacity in its advocacy and monitoring roles. Assigning the association an advocacy and watchdog role with respect to each of the major public interest dimensions of financial deregulation – prudential control, competition policy, access to basic services, and consumer protection – should enable the association to come to grips with the vital interactions between these different policy dimensions and to develop a balanced perspective in its advocacy and monitoring activities.

National governments, including Australia's, that pursue financial deregulation should assign high priority to the establishment of a financial consumers association. Such a mechanism is needed to ensure that financial deregulation is accompanied by safeguards that are adequate to the tasks of maintaining prudential control, preventing undue concentration and anti-competitive practices, ensuring reasonable access to basic services for disadvantaged sectors, and protecting consumer interests. A financial consumers association is also the most appropriate locus for the collective information system that is essential if financial deregulation is to spur price competition in retail financial service markets and provide genuine benefit to the majority of consumers.