



Banking on Competition (by John Dahlsen).

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*Overregulation and red tape in banking has destroyed competition to the detriment of consumers, argues former ANZ Director, John Dahlsen.*

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Banks are very powerful. Banks have a huge influence on our economy and our lives. Banking, like energy and communications is an essential service, fundamental to our wellbeing. Banks are essential to intermediate between those with money and those who need it and money is what makes the world go around. Without banks our modern economy would fail.

Because of the crucial role they play, Commonwealth legislation requires they must be licensed to take deposits by the Australian Prudential Regulation Authority (APRA). This license with its exclusivity is not a fair exchange to the consumer for benefits the banks gain. In Australia we have one of the most concentrated banking markets in the world, with four banks controlling 80 per cent



of our market. So, the four banks control our destiny. The imbalance between banks and consumers has been revealed by numerous inquiries and it requires redress. The risk-based models used by banks and regulators should also be reviewed as a matter of urgency.

**THE RISK-BASED MODELS USED BY BANKS AND REGULATORS SHOULD BE REVIEWED AS A MATTER OF URGENCY.**

Our banks are heavily influenced by APRA, which regulates the banks intensely and has a huge influence on bank behaviour through guidelines for risk weighting and consequent capital allocation rules, amongst other things. This substantially influences when, where and how banks lend and provide services, but APRA is among the least accountable Federal agencies. APRA is a protected species just like its parent, the Commonwealth Government's Treasury. Successive governments have ceded power to APRA so much that the regulator now represents an obstacle to improving the system. If APRA was funded directly by Government, appropriations for its expenses would have to be included in the budget and be subject to Parliamentary review, but instead it is funded by levies on the banks, which removes accountability and reinforces the cosy relationship between the regulator and the banks.

There is an incestuous relationship between APRA and the banks. There is no separation of influence. Nearly all senior staff are ex bankers. You are unlikely to get any independent and innovative thought. More entrenched sameness.

Meanwhile, APRA has substantially ceded power to the Basel Committee on Banking Supervision, established by a club of the world's central banks (the Bank for International Settlements), further limiting the scope for reform and reducing democratic accountability.

For the free market to work, individuals need to be well informed and competition must be allowed to flourish, but APRA not only defines and limits competition, it stops competition. It does not want competition because its prime role is protecting systemic safety. It does not want the winners and losers that result from competition. APRA has a simplistic view that systemic safety cannot co-exist with competition. APRA hides a lot of relevant information from the public using the secrecy provisions in its governing legislation, preventing an informed market.

Because of the lack of information about APRA's operations, there is a certain mystery or vacuum around it, so it increasingly behaves like an imperious god, disregarding others' opinions and views. APRA uses this massive information imbalance to maintain the fictions that risk is a science, everything is quantifiable, and that all material required by APRA is intelligently reviewed.

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APRA does not justify its position by scientific evidence. We need to know the theories and

assumptions on which it relies so we can check. Similarly, we need to understand its economic rationale and get answers on some key questions. What is the consumer benefit of regulations and decisions? What are the objectives? Why is there secrecy between the regulator and regulated institutions?

Cosmetic changes from time to time give an impression of great precision and clarity of position at APRA, but we simply do not know what the position is. Some claim that APRA was substantially responsible for getting Australia through the global financial crisis of 2009, but it can be proven that that the opposite is the case and that APRA has increased systemic risk.

We cannot criticise our banks merely for being an oligopoly, as a market dominated by a small number of large sellers is not all bad news. But in Australia, the big four are heavily fortified and the moat surrounding the castles are deep and wide. The licensing, risk and compliance controls are such that the moat is too difficult for new entrants to cross.

Further, the four interlinked castles have further fortified themselves by buying out prospective, emerging and existing competitors. There is nothing innately wrong with that, as competition is all about destroying new and existing competitors, a reality accepted in Competition Law. The difficulty in Australia is that we have regulatory and compliance regimes which have gone too far. The regulator has run riot and has, in effect, further buttressed the banks and made it extremely difficult for new entrants. The issue is also tackled by Dr Darcy Allen and Dr Chis Berg in their book [\*Australia's Red Tape Crisis: The causes and costs of over-regulation\*](#), which suggests APRA uses regulation to prevent new entrants and competition in financial services.

Former Federal Treasurer Peter Costello has also criticised APRA's self-contained, protected and cosy ecosystem, letting banks make massive profits while consumers lose out. Our bank profits represent the highest percentage of GDP in the world.

APRA's regulation and compliance processes should be open to much more scrutiny by analysts, banks and consumers. The regulation and compliance costs are extraordinary. The banks simply accept this (any attempt to protest would be seen as self-serving) and the cost is justifiably built into their pricing. The regulatory cost is enormous and the value is questionable.

APRA issues regulation after regulation without any cost benefit analysis. No risk analysis is undertaken, nor its potential cost. The Productivity Commission produced an excellent report on regulation reform some years ago, pointing out how it should be done, but this was ignored by APRA. At APRA regulations are not reviewed over time or modified; they are simply piled on top of each other. It is like a dirty clothes basket when the laundry is not done: it piles up and the smell simply increases.

It is simply not possible for APRA to intelligently review the vast amount of data it demands from the banks. The more the data, the more the obfuscation and pretence as all concerned agree with the interpretations. Vastly different interpretations and conclusions can be reached on the same data.



APRA also contributes to the huge sameness of our banks because one size fits all and APRA ensures that best practice flows from the best to the worst performers. APRA is following the Basel requirements based on international averages, which are different from the Australian averages, and this has serious implications. APRA is a lap-dog of the Bank for International Settlements which protects big foreign banks (Globally Systemically Important Banks, socially deemed 'too big to fail') which hold the world to ransom because they're too big to fail. This is not in Australia's best interests. This control and sameness makes the fortress impregnable. Many foreign players and others have been discouraged from entering the market because of the size, power and concentration of the fortresses.

APRA's activities flow through to the credit streams in the banks. These streams are very powerful and protected silos, which are difficult to penetrate in a bank as the silo reaches right up to the CEO. This criticism of the silos in the banks extends to the similar silos which exist in APRA, and indeed right through the system all the way up to the Basel Committee. The bank credit silos need opening up and their policies exposed to real critique, even though the banks will not like this.

There are potential solutions to the problems discussed here.

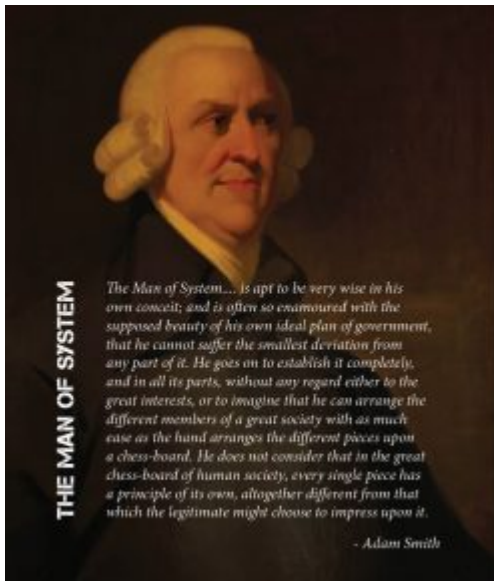
Firstly, APRA should have a Commissioner with competition experience and the mandate should be changed to enable the Commissioner to review all regulation and consider its competitive effect.

Secondly, the Government should establish an independent APRA board with the power and capability to intelligently assess and review its operations (and this should also be done for the other key regulator, the Australian Securities and Investments Commission). Questions the board could ask include: What is the economic foundation for a decision? Does it have appropriate evidence? How can we get rid of the huge imbalance of information on regulation and competition? A board could ensure more information is made public, particularly in relation to gambling with financial derivatives, which is a time bomb involving a lot of activity adding no value to the bank but lining the pockets of the bankers. Even an independent Advisory Board would be a step forward.

Thirdly, according to free market principles, APRA should not be regulating what the banks do (as in their products) but should be regulating how the banks conduct themselves to ensure a fair and well-informed market. These alternative methods of regulation should be considered. It is well accepted that the better you define a problem, the better the outcome or decision. If a problem of systemic or individual risk or poor compliance is well defined, including the cost of failure, then why not establish clear objectives to solve that problem and ask each of the banks how they are going to respond? APRA could review the proposed response with the bank and if it was not satisfied, debate the issues to get resolution with the ultimate form of veto.

This would avoid the sameness that comes out of APRA's supervision. The individual bank solutions and policies might be quite different but still achieve APRA's objectives. As further encouragement, the quote from Adam Smith regarding 'The Man of System', below, should be

framed and put on the walls of every APRA office.



Portrait of Adam Smith | Wikimedia Commons

Few are prepared to challenge APRA. The banks and other market participants fear retribution. But an open and respectful discussion with the interest of the community and consumer at heart would be very positive. Treasury and APRA should allow this debate and not be so secretive and protective of their actions. This will not reduce their power but gain respect. I am sure the politicians and the public would welcome it.

The current Royal Commission into banking was precluded in its mandate from considering APRA and its role, but the Government has asked the Productivity Commission to undertake an inquiry into competition in Australia's financial system, with a final report expected in July 2018.

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The Productivity Commission in its draft report of early 2018 did a good job of identifying competition issues, acknowledging that the oligopoly achieves stability but at the cost of competition and the consumer. The difficulty is that the commission is not critical enough about the role of regulations and their effectiveness, and there are real limitations in the measures it proposes. The draft report did confirm that:

- The consumer has lost power to shareholders
- The banks' power has enabled them to game the regulations to maximise returns at the expense of consumers.
- There is little product competition because of the general obfuscation, with very minor product differences in price and features
- Banks provide unclear and insufficient information for customers

- The regulatory environment distorts the market.

The commission acknowledged that we need a competition champion, but unfortunately looked only at reallocating activities between ASIC, the Reserve Bank of Australia, APRA and the Council of Financial Regulators (the regulators' club).

Problems in banking won't be solved until the structure is changed. While governments should not interfere in the market, there are a number of levers that could encourage reform. These could include bank license conditions, government guaranteed deposits, capital gains tax exemptions and persuading the states to remove stamp duty on genuine reorganisations.

With such barriers to demerging removed, it is possible that banks and the investment market will see the potential to unlock shareholder value in structural separation, following the principle of the US *Glass-Steagall Act* of 1932, which kept commercial and retail banking separate. Many say the repeal of this Act in 1999 contributed to the Global Financial Crisis 10 years later.

Voluntary demergers are unlikely because vertical integration enables a gravy train of 'coupon clipping' for fee extraction, but the application of a Glass-Steagall separation in Australia seems inevitable (there is already a private member's bill in the Parliament to achieve this), and probably the mere threat of it would prompt demergers.

The alternative of further complex regulation is frightening. Complex regulation never works (the US *Dodd-Frank Act* measures of 2010 have been disastrous) because of the extreme difficulty of interpretation and enforcement under current legal systems. Simple regulation is simply better.

Demergers would enable the Treasurer to drive real reform in the banking system, requiring a statement of objectives and business plans from the demerged entities to ensure community and consumer benefit. The conditions of approval would keep the demerged entities separate, and restrict government guarantees to customer deposits in retail banks.

It is hoped that one or more of the political parties will embrace systemic reform and a push for demergers in their election platforms. Such a move could have popular appeal.

Huge costs and risks can be removed from the system without destroying it, but it is likely reformers will be frustrated by Treasury which typically wants to protect the status quo and will not want its or APRA's power diluted. Strong political leadership is required.

*John Dahlsen is a former Company Director and solicitor. As well his roles on the Boards of major listed companies he was co-founder of Growth Factor Pty Ltd, a fintech company, and remains Co-Chairman of the family company, JC Dahlsen Pty Ltd, which was founded in 1877. He gratefully acknowledges the assistance of a former APRA employee in the preparation of this article.*