

DEREGULATION, RETAIL FINANCING AND CREDIT UNIONS*

Kevin Davis,

Department of Economics,
University of Adelaide.

Over the past decade a number of factors have changed markedly the structure of our financial system, and hold promise of an unsettled outlook for some years to come. Listing those factors is relatively straightforward, predicting their eventual outcomes is not - partly because they interact in an often complex fashion. In what follows no attempt is made to predict that future. Rather, the approach taken is to identify a number of key issues to which government and financial institutions must respond and, in so doing, influence the future course of events. The focus of the paper is upon retail financing and, in particular, upon the role of Credit Unions.

THE FORCES FOR CHANGE

Any attempt to categorise the major factors influencing the recent and prospective changes in the financial system is unlikely to prove completely satisfactory. That caveat having been entered, the following four-fold category seems to me to aptly describe and summarise the important issues.¹

First, there has been financial innovation, one form of which has been the development of new financial assets; Cash Management Trusts, Australian Savings Bonds, interest rate futures, new deposit instruments - to name but a few. There have been innovations in the payments system technology, with new payments instruments such as Bankcard introduced

and the development of Automatic Teller Machines and other features of Electronic Funds Transfer systems. Financial intermediaries have offered new services such as bill paying facilities, and have developed new lending techniques. At the retail level, credit card lending has grown in importance while at the wholesale level roll-over floating rate loans have become more important.

That development in wholesale lending techniques partly reflects the second in our four-fold listing of factors - that of inflation. Increased and variable inflation in the 1970s illustrated the deficiencies in standard financial assets such as those involving fixed nominal interest rates and/or fixed nominal value repayment streams. By creating cash flow problems in financial markets and creating new uncertainties for participants, inflation appears to have raised the consciousness of savers and investors and borrowers and lenders, thereby altering the pattern of financial market behaviour.

Integration is the third heading in our list. Integration has occurred internationally, in the form of tighter links between national capital markets. It has a sectoral aspect, as retail and wholesale markets have become more closely linked. Integration in service provision has also happened, as institutions have tended (by merger or by diversification) to provide a full line of financial services under one corporate banner. Reflecting this latter trend, integration between sectors of the financial sector has occurred as inter-industry barriers have broken down.

The final factor to be identified is that of deregulation - some major components of which are listed in Table 1. In part that deregulation has been a response to the effects of innovation, inflation and integration which have weakened and often distorted the effects of

TABLE 1Deregulation Calendar: The High Spots

December 1980	Interest rate ceilings on most bank deposits removed.
March 1982	Maturity controls on bank deposits relaxed.
May 1982	Interest Rate on Trading Bank SRD deposits increased from 2.5 per cent to 5 per cent. ^a
June 1982	(1) Treasury Bond Tender introduced. (2) Lending Restrictions on Trading Banks abolished.
August 1982	Savings Bank LGS type requirement reduced from 40 per cent to 15 per cent, they are permitted to accept corporate deposits, and are given greater asset flexibility.
December 1983	Australian dollar floated and exchange control regulations largely abolished.
August 1984	Interest rate prohibition on cheque accounts removed.
September 1984	(1) Applications for bank licences from foreign banking interests invited. (2) Temporary suspension of foreign investment guidelines regarding merchant banking. (3) Abolition of 30/20 rule for life offices and pension funds.

X / a

existing regulations. But it would be foolish not to recognise that deregulation has reflected a (largely independent) change in the intellectual climate towards the appropriate role of government - and in so doing has fed back to prompt innovation and integration in financial markets.

Most of the deregulatory moves summarised in Table 1 have involved a freeing up of the banks. Controls on interest rates, asset portfolio restrictions, deposit facility restrictions, affiliation restrictions have all been removed or substantially weakened. The effects are not unexpected, and Table 2 gives an indication of the impact on the retail market. Since mid 1980 when the lifting of restrictions began, the discrepancy between the growth rate of the banks and other competitors for household savings has been largely removed.

Unfortunately, any more detailed interpretation of the effects of deregulation on financial sector shares is beyond the scope of this paper. Because of deregulation and innovation the financial statistics have lost much of their meaning. To give but two examples: many bank (and other) deposits have changed in characteristics over recent years making comparisons of deposit growth over the years inappropriate; trading banks, additionally, have developed other forms of financing such as commercial bill acceptances, which have seen their deposits grow by 30 per cent between June 1981 and 1984 but their total liabilities grow by 60 per cent over the same period, and it is far from clear which of these two figures is the more significant. For reasons such as these we eschew such statistical comparisons and turn to a consideration of specific issues crucial to the future development of the retail financial market.

TABLE 2Household Asset Holdings

	Share of Total June 1970	Annual Rate June 1970- June 1980	of Growth June 1980- Sept 1984	Share of Total Sept 1984
Trading Banks	19.5	15.8	14.7	20.2(a)
Savings Banks	64.3	11.5	12.0	41.7
Australian Savings Bonds	6.6	16.5	17.4	8.0
Permanent Building Societies	8.6	26.7	15.6	22.5
Credit Unions	1.0	33.2	22.0	5.7
Cash Management Trusts	-	-	...	1.9
	<u>100.0</u>			<u>100.0</u>

Source: Reserve Bank of Australia, Statistical Bulletin.

(a) Author's estimate based on June 1983 division of Trading Bank deposits into personal and other holders.

SIZE SURVIVAL AND BRANCHING

In 1979 there were 13 Savings Banks, now there are 10.

In 1979 there were 146 Building Societies, now there are around 75.

In 1979 there were 669 Credit Unions, now there are 550.

Mergers have become an everyday occurrence.

The obvious question is: can small institutions survive in the deregulated environment?

There is no doubt that regulation (of banks) aided the springing up of small retail financiers in the 1950s, 60s and 70s. Those controls which inhibited competition amongst the banks also inhibited them from competing effectively against outsiders. Exactly how deregulation affects the prospects for small financiers depends upon what deregulation means - in particular, the status of banks vis-à-vis others. But some general issues can be identified and the retail grocery market provides a good parallel.

Just as in groceries, supermarkets look to be fashionable. Those offering a full range of diversified services have the best chance of survival, for when customers consolidate accounts at one institution (as they are likely to for reasons I will outline later) the obvious choice is one satisfying all needs.

But diversity does not necessarily imply enormity. Small supermarkets seem to be able to survive along with large, and the same (I suspect) is inherently true in retail financing. Here it is important to bear in mind the distinction between differences in size of institutions resulting from differences in the number of outlets in the supermarket chain and differences in the size of the outlets.

Economies of scale appear to exist at the outlet level. In terms of financial institutions, average costs decrease as the size of the branch increases at least up to some point. That is what the historical record says, but modern technology may be changing the nature of these cost relationships. (A study of Credit Unions in British Columbia,² for example, found quite different cost/output relationships between credit unions relying on manual, trionics, and computer technology. And since that study the developments in electronics, computer technology and financial service provision such as via Automatic Teller Machines have been marked.)

The critical issue though, is whether a two (or more) outlet firm has any cost or marketing advantages over two otherwise equivalent one outlet firms. Could, for example, an Australian Teachers Credit Union operate better than the seven separate state-based Teachers Credit Unions? Or, would mergers between credit unions operating in the same geographical region yield a lower cost operation than those two credit unions operating separately?

Again the retailing industry provides some clues. The gains from multi-branch operations seem to come from three sources. One is the ability of the combined branches to extract better deals from suppliers by bulk ordering, etc. A second is the reduction in such shareable costs as advertising and establishing a brand name - one advert serves for all branches. The third gain is enhanced customer appeal arising from the customer's ability to deal with one institution at different locations. But, as retailing shows, there is no reason as to why these gains cannot be achieved by cooperation among single branch institutions rather than by merger. And, of course, this is already done to some degree by credit unions - centralised liquidity facilities such as the pooling and investing of cash reserves are a form of bulk ordering,

shared advertising occurs, and agency arrangements are well established.

These cooperative arrangements can help single (or few) branch institutions to compete affectively against the multi-branch giants, and the rapid expansions in shared automatic teller machines and other EFTS phenomena are reducing further the significance of a physical branch network as a competitive weapon. In these circumstances it is pertinent to look more carefully at the relationship between costs and branch size and in particular at the determinants of the cost minimizing size of branch. Are the very small credit unions able to capture enough of the economies of scale existing at the branch level to enable them to compete effectively even with the aid of cooperative arrangements?

Here there are two factors operating which suggest that the optimum branch size is likely to be increasing. One is the developments in EFTS which, by reducing the significance of geographical location, reduce the ability of small institutions to offset operating cost disadvantages by locational advantages. The other is deregulation, reversing the previous incentives given by regulation to overbranching.

< delete r The general winding down of bank branch networks over recent years is consistent with these views, but cannot be~~y~~ solely attributed to technology and deregulation. As the banks have debranched, the building societies have expanded their networks (from 775 to 1450 branches between June 1978 and June 1981 for example) and credit unions have developed more extensive agency arrangements. And until very recently, the low growth of banks relative to non banks makes these facts consistent with an interpretation of a substitution of branch facilities of building societies and credit unions for those of banks.

But what about the optimal size of a branch (or single branch institution) and the outlook for small credit unions? Table 3 presents

TABLE 3

Branching Statistics, June 1982

	N.S.W.	VIC.
Largest Building Society		
- Assets (\$000)	1,555,336	852,350
- Branches	161	70
- Assets/Branch	9,679	12,176
Commonwealth Savings Bank		
- Deposits (\$000)	3,698,452	1,879,276
- Branches	424	216
- Deposits/Branch	8,723	8,700
State Savings Bank		
- Deposits (\$000)	-	4,780,843
- Branches	-	541
- Deposits/Branch	-	8,837
Private Savings Banks		
- Deposits (\$000)	3,188,692	2,814,775
- Branches	1,260	1,085
- Deposits/Branch	2,530	2,594
Total Banks (trading + saving)		
- Deposits (\$000)	21,318,000	17,249,000
- Branches (a)	1,887	1,842
- Deposits/Branch	11,297	9,364
Credit Unions		
- Deposits (\$000)	971,635	738,960
- Number (b)	267	178
- Deposits/Credit Union	3,639	4,151

Note

- (a) Taken as larger of savings bank or trading bank branches.
- (b) Number of separate credit unions - data on branches not available.

Sources:

Housing Loans Insurance Corporation, Permanent Building Society Directory 1983.

A.B.S., Banking Australia, Cat. No. 5605.0.

Commonwealth of Australia Gazette, No. G35, 31 August 1982.

A.B.S., Credit Unions, Cat. No. 5618.0.

some information, although it is a very preliminary gathering together of relevant statistics. Those figures indicate a marked divergence between the branch sizes of private and government owned banks, but with less divergence between the latter and the building societies. Whether the government-private bank discrepancy reflects simply the greater use of agencies by the former, or is a product of the fact that private savings banks are a phenomenon of the past thirty years, or can be traced to differential responses to regulation is a topic deserving of further study. Alternatively, the shared trading-savings bank use of branch facilities may make comparison with building societies distorted. Incorporating trading bank deposits raises the deposits per branch figure, but since wholesale activities rely less on branch networks the comparison with retail financiers is still distorted.

Despite these caveats the figures in Table 3 suggest an average size of credit unions significantly below that of the branches of their competitors. And while tax advantages may, in the past, have enabled small credit unions to offset resulting cost disadvantages, the pressures for increased branch size outlined above make the survival of very small institutions more and more doubtful. Consequently, some of the paths to growth and survival are considered in the next section.

SIZE AND COMMON BONDS

For the cooperative reasons outlined above, it seems appropriate to regard Credit Unions as not so much a group of separate financial institutions but as akin to individual branches of one national retail financier. Certainly the branches are independent (often jealously so) and the integration and cooperation between branches not as complete as with say a nationwide bank, but one important similarity exists - or at least used to exist. Just as branches of a bank have a market sharing

arrangement based on geography, so credit unions have a market sharing arrangement based on their common bond arrangements. To the extent that those bonds do not overlap, competition between credit unions for members does not exist.

Of course, bonds have been gradually widened so that now the possibility of inter-credit union competition is possible. And that path to increased size has a lot of appeal to the disinterested observer, implying as it does, an increase in competition and a better deal for the customer - mainly by the pressures of the market place keeping management lean and hungry. The alternative way of widening bonds - by mergers of credit unions serving different groups - brings with it a reduction in competition: good perhaps for credit union managers but not necessarily for members. I suspect that the credit union movement (if that phrase really applies nowadays) would gain greater members by widening bonds so that they overlap and competition for members occurs. The danger in that path is whether cooperative arrangements necessary for survival can be maintained between competing credit unions.

(Purely as a digression it seems worth pointing out that Credit Unions are the odd group out in so far as mergers and industry concentration go. As Table 4 (taken from the Martin Report) shows, Credit Unions are the only group for which the concentration ratios - the share of assets held by the largest institutions - have declined.)

One other aspect of size and common bonds warrants comment, because I fear that credit unions may be entering very treacherous waters. I refer here to the practice of taking deposits and offering services to non-members. The objective of these activities is to make a profit on transactions with these non-shareholders which can then be paid to

TABLE 4
Concentration Ratios

	<u>Largest Five</u>		<u>Largest Ten</u>	
	<u>1979</u>	<u>1983</u>	<u>1979</u>	<u>1983</u>
Banks	75	88	95	98
Building Societies	39	43	56	64
Credit Unions	16	13	26	22
Finance Companies	46	54	64	66
Money Market Corporations	27	29	48	50

shareholders in the form of lower loan interest rates and subsidised services. Apart from the different way by which the profit is distributed to shareholders, how are these activities different from those of corporate profit-oriented bodies? How then can one morally and politically defend the special tax treatment of credit unions which is based on their supposed mutual, self-help, nature?

EXPLICIT INTEREST OR SUBSIDISED SERVICES?

Credit Unions are past masters at providing customers/members with an implicit rather than explicit interest yield, by providing a package of costly services at subsidised rates to members. Either that or they are a very inefficient group of financial institutions! These are the alternative interpretations of the data in Table 5 which gives a perspective both nationally and internationally on the issue.

Credit Unions have a ratio of (non-interest) expense to assets of around 4.5 per cent. Building Societies have an expense/assets ratio of only slightly over 2 per cent and that for Savings Banks is only 3.5 per cent. Internationally - a study of US credit unions³ classified high efficiency Credit Unions as having a ratio of only 1.9 per cent with the others in their sample at a ratio of around 4 per cent. The authors wouldn't have been impressed about the efficiency of Australian credit unions - with ratios greater than 4 per cent.

Unfortunately it is not appropriate to equate expense/asset ratios to inefficient operations or, more generally, to managerial "expense preference" - an hypothesis examined for Australian Building Societies by Turner.⁴ High expense/assets ratios may reflect the provision of costly services to customers either without charge or at subsidised rates instead of charging for those services and paying higher explicit

TABLE 5
The Costs of Retail Intermediation

	CU 1 1983/4	CU 2 1983/4	CU 3 1983/4	CU 4 1983/4	SBSA 1983/4	US CUs Efficient/Other	Savings Banks 1981/2	Building Societies 1981/2	CUs 1981/2
Income/Total Assets	15.79	14.82	14.87	16.26	11.90	11.18	n.a.	13.22	14.81
Interest Paid/ Total Assets	9.00	9.72	9.10	10.00	7.26	9.2	n.a.	10.13	9.42
Other Expenses/ Total Assets	6.21	4.27	4.12	5.38	3.97	1.9	3.56	2.27	4.56
Surplus/ Total Assets	0.58	0.83	1.67	0.88	0.66		1.38	0.82	0.83

Sources: Columns 1-5 - Annual Reports.

Column 6 - Cox and Whigman, "Larger and Efficient Credit Unions", Federal Reserve Bank of Atlanta Review, October 1984.

Columns 7-9 - Commonwealth of Australia Gazette, ABS, Cat. No. 5618.0, 5632.0.

interest rates. In the past this strategy does not seem to have inhibited the growth rate of credit unions.

But can Credit Unions go on cross-subsidising between services and between customers (who use these services differently) in a deregulated environment?

Many advocates of deregulation predicted they could not. In their view, cross-subsidisation reflected the effect of interest rate controls: implicit interest was the competitive market's response to constraints on explicit interest. Abolish interest rate controls and implicit interest would disappear.

So far that hasn't happened, and one reason is obvious. Implicit interest is tax free, explicit interest is taxable. Even if customers prefer \$1 cash interest to free services which cost \$1 to provide, at a marginal tax rate of (say) 40 per cent they need around \$1.60 in interest to get \$1 after tax. Little wonder that free services often have an appeal over explicit interest.

Another reason for the persistence of cross-subsidisation is that it often makes sense to bundle together a number of services in a package for which an all inclusive price is charged. Why, for example, don't thrift institutions levy an explicit charge every time someone deposits or withdraws funds over the counter to reflect the cost of providing teller facilities and pay a higher yield on the account balance? The answers are, presumably, that customers prefer the all-inclusive package because of convenience reasons, and that it is cheaper not to unbundle the services provided and so avoid the costs associated with pricing each service individually. (Such an account with a transactions charge and higher interest rate is, in effect, a variant on minimum balance/fixed term type accounts - you induce the customer by

the structure of charges to use the account infrequently for only a few, large, transactions.)

For these reasons cross subsidisation can be expected to continue - but the form it takes will no doubt change. Otherwise institutions which cross subsidise (i.e. Credit Unions) are at risk from those which unbundle services. It makes good sense to be a member of a credit union and use to the full the free or cheap services while simultaneously depositing most of one's savings elsewhere at higher explicit yields. Other credit union members are subsidising any such customers, and they and ultimately the credit union lose. If cross subsidisation is to be viable, it is necessary to ensure that ~~there~~ ^{there} is not scope for some members to benefit at the expense of others. The sum of implicit and explicit interest a member can gain needs to be closely linked to the size of that member's deposit. That does not currently happen.

But it will happen. And the unbundling of services (or end of cross customer subsidisation) together with the tendency towards full-line servicing (financial supermarkets) will have an important effect. Unlike now (or the recent past) when customers had an incentive to diversify their funds among institutions, the new environment will encourage them to consolidate their accounts at one institution.

The questions raised for Credit Unions are:

- (1) where will customers consolidate accounts?
- (2) to what extent will growth now depend solely upon getting more members rather than also depending upon getting a larger share of the savings of existing members?

Many factors will determine the answer to these questions, but one thing is crucial. Customers are only going to put all their eggs in one

basket if they are absolutely sure it is safe. Can credit unions without the de facto government backing which the banks have, ensure that such an image prevails?

One other aspect of implicit interest needs to be mentioned - because it impinges heavily upon the future role of Credit Unions. I refer to the question of access to housing finance. Preferential access or reduced interest rates on housing loans to those with a good deposit history is another form of implicit interest on deposits. Even with deregulation of housing loan interest rates I do not believe that this form of cross subsidisation will disappear.

Now, if Savings Banks and Building Societies are permitted to extend into the personal credit area - as has already happened - where does that leave Credit Unions? When customers consolidate accounts at one institution, mortgage loan availability and terms will be a plus factor in their eyes. Can Credit Unions avoid becoming explicitly first mortgage financiers? Should Credit Unions and Building Societies continue to be identifiably separate institutions?

FOREIGN BANK ENTRY AND RETAIL FINANCING

penetration
/

The historical record of foreign bank entry overseas suggests two "laws": (a) foreign banks typically achieve limited overall penetration of the domestic market; and (b) the penetration they do achieve is concentrated in mainly wholesale activities. If repeated in Australia, this means that the impact on retail markets would be limited to indirect effects as existing banks adjust retail activities in response to increased wholesale competition.

Is history a good predictor? Certainly not in this case, and mainly because of the effects of modern technology on the retail

financial sector, which have altered the nature of barriers to entry. Previously one of the main barriers to entry into retail finance was costs of establishing a branch structure. Another was the costs of establishing a "name" as a reliable supplier. ATMS, POS etc. reduce the significance of establishing a branch network as an entry barrier as does "home banking" - by definition. And while possession of a bank licence helps in establishing a name - it is far from sufficient. New entrants must still: (1) attract customers; (2) attract a larger share of each customer's savings, if they are to grow. How can foreign bank entrants without the inherent advantage of access to potential clients, which Credit Unions have, get customers? An increase in advertising can be predicted - both as an offensive and defensive strategy. Provision by new entrants of particular services at a loss in order to gain customer affiliation can also be predicted. Finally, it is worth noting that all of this should be mainly on deposit side since there are more "bodies" involved. (In retail finance the tendency for average loan size to exceed average deposit size means that there are more depositors than borrowers at any time.)

These predictions assume that successful foreign applicants will want to enter retail financing. It appears likely that there will be enough new licences to ensure a few retail interests at least, while, more importantly, the recent change in foreign investment guidelines for merchant banks reduces dramatically the incentive to get a bank licence for solely wholesale activities. Availability of foreign exchange dealer's licences similarly reduce the value of a bank licence for wholesale activities.

This does not mean that a bank licence is not worth anything to a wholesale specialist - far from it. The argument is simply that a licence is worth more in retail activities - mainly because of the

implied government guarantee which allays depositors' fears and the access it gives to the payments system which helps full line servicing. Foreign banks interested in both retailing and wholesaling will be able to present to the government a more attractive proposition (in terms of the implicit licence fee they offer) in their licence application than pure wholesale specialists.

THE GROWING INTERDEPENDENCE OF RETAIL AND WHOLESALE MARKETS

Until the mid 1970s, household sector financing was largely insulated from happenings in the wholesale financial market. The direct link to the wholesale market was weak as households held little in the way of government debt and ever-declining amounts of shares. Indirect links were also weak - the only institutions spanning retail and wholesale markets were Trading Banks and Finance Companies. Happenings in the wholesale markets would flow through into retail markets - although trickle rather than flow might be the best description.

What has changed?

1. In 1976 Australian Savings Bonds were launched, giving the authorities a security which was directly competitive with retail deposits and making those deposits more sensitive to the general level of yields. (Of course, ASBs were not very well designed for policy purposes and moral concerns can be voiced about the government ripping off unsophisticated savers who do not up-grade to higher yielding, new, series when interest rates are going up.)
2. In 1980 the first Cash Management Trust was formed. Households were able to invest in a retail deposit type instrument whose yield reflected short term wholesale market trends.

3. The deregulation of the stockbroking industry and the likely incorporation of stockbroking services into financial supermarkets might see the renaissance of the individual investor.
4. Generally, the telecommunications and electronics revolution is (a) improving information flows, (b) reducing transactions costs. Both factors can be expected to increase the sensitivity of household saver/investors to market opportunities.
5. Liability management has come to rival asset management as a means of coping with temporary disturbances to financial flows. Once, when interest rates and thus asset yields were (relatively) pegged, it made good sense to ~~(response)~~ to an outflow of deposits by running down cash assets and selling (say) government securities out of the asset portfolio. Now, given that deposit outflows are likely to coincide with high interest rates and thus depressed asset prices, it makes sense to also respond by buying in funds in wholesale amounts. These funds will, of course, go wherever the yield is best. In that way even if normal depositors are not particularly responsive to wholesale yields, the marginal funds important to overall portfolio management will link wholesale and retail markets.

X respond

What do these developments together with deregulation mean for retail financiers?

- (a) The portfolio diversification role of intermediaries will tend to diminish as technology reduces (but does not eliminate) the comparative advantage of intermediaries. Previously for example individuals used to have one deposit account reflecting the average of the institution's assets. Now, individuals may be offered, and

hold, various deposit accounts each reflecting a particular set of the institution's asset holdings, so that individuals do their own most preferred form of averaging. To keep all of a customer's funds institutions will therefore need to offer a full range of deposit account types. It has already happened in some areas such as the CMTs which have been cloned by the thrifts. Will we soon see deposit accounts (more precisely a fund) linked to, say, a share market portfolio?

- (b) Greater interest rate volatility will be the norm. First, the improved links between retail and wholesale markets must make retail yields follow the more volatile wholesale yields more closely. Second, the decline of implicit interest and increased importance of explicit interest increases the ability of retail financiers to vary yields in the short term. Third, the removal of interest rate controls on banks means that now only currency has a fixed interest rate relative to which other yields are determined. In this latter respect the floating of the exchange rate also reduces the link of domestic interest rates to the (variable) peg of overseas rates, and affects the impact of seasonal liquidity fluctuations.
- (c) Seasonal liquidity fluctuations will impinge differently on retail financiers. Previously big companies could avoid the seasonal squeeze by borrowing offshore at fixed rates determined overseas. The squeeze was forced onto other borrowers because the government, in trying to achieve monetary targets, was forced to mop up the liquidity so created by bond sales. Other, smaller, borrowers unable to borrow offshore bore the brunt of the squeeze. Now, attempts to borrow overseas cause the spot exchange rate to appreciate and create a premium in the forward market for foreign

currency thereby raising the effective cost of hedged overseas borrowing. Big companies share the burden of the liquidity squeeze and there is less impact upon smaller borrowers.

RE-REGULATION

The ongoing technological revolution has dramatically altered the nature of money. In particular the range of financial assets which can serve as the means of payment has (or can be) expanded markedly. And for economists who have emphasised the importance of monetary control for macroeconomic stability this creates problems. No longer, if ever, will control of the banking sector suffice. Unfortunately we do not know with any certainty which financial institutions matter most for monetary control, what is money, or how governments should exert control.

Proponents of deregulation have avoided these issues by placing their faith in the use of open market operations. Personally, I do not believe they will suffice. Open market operations work by altering the quantity of cash held by the private sector and thereby, through various portfolio reshuffles, influencing quantities of other assets and their yields. Is this mechanism strong enough in the new high technology, deregulated, environment? A major effect of EFTS for example is to make cash obsolete for a number of purposes. Changing the quantity of cash will undoubtedly affect things - but the link I suspect will be fairly elastic, and less predictable.

If OMOs do not suffice for monetary control what will happen? The obvious possibility is some form of re-regulation for monetary policy purposes. And in the new environment where banks and non banks look much more alike, institutions such as Credit Unions can hardly expect to avoid a share of the burden.

THE PAYMENTS SYSTEM

Until about ten years ago the payments system hardly attracted any interest or attention. Payments were made by cash or by cheque drawn on an account at a bank. Since then, Bankcard and other credit cards have come onto the scene, direct crediting of accounts (with pay, etc.) has become popular, non-bank institutions provide indirect chequing facilities and bill paying services, and electronic signals are replacing paper based signals (cheques) as the means by which transfers between accounts take place. At the moment, deregulation and technological change have meant that the whole system is in a state of flux. Worse still, the mystique of money has tended to confuse the issues surrounding the payments mechanism. And unfortunately the practical complexities have tended to obscure the simplicity of the principle of the payments system.

Essentially the payments system is nothing more than a mechanism whereby wealth is transferred from individual A's account at institution X to individual B's account at institution Y. And viewed in this light there are really only two questions of principle which need to be addressed. What institutions should be allowed to offer accounts which have the property of transferability of ownership? How should the transfer mechanism and mechanism for settlement between institutions X and Y be arranged? It is not generally recognised that electronic signalling is changing the appropriate answers to these questions - and it is far from clear that the conventional wisdom was correct anyway.

The conventional wisdom found in the Campbell and Martin Reports, is that only institutions of the highest repute should be allowed to be involved in the payments system - so as to ensure the integrity of that system.

Why should that be so? The only reason is that in the process of wealth being transferred between individuals and between institutions there are time lags involved. The recipient of a cheque, for example, may have given up possession of a good - only to find several days later that the cheque is valueless - either because of the financial state of the cheque writer or because of the solvency of the institution upon which the cheque is written. In such a situation, doubts about the integrity of a cheque-issuing institution might disrupt the payments system - as sellers of goods refuse to accept that institution's cheques.

But take the world of electronic signalling. There need be no lags in the payments system. When I encounter a POS terminal at a retail store and try to pay for goods by using funds from my account with the "Very Dubious" Credit Union, the transaction will not go through unless: (a) my account is in the black, (b) the Very Dubious Credit Union is able to transfer ownership of assets of the required value to the retailer's account with (say) the ANZ. The obvious transfer would be one between exchange settlement type accounts held at the Reserve Bank by both Very Dubious and the ANZ. (Lags in the settlement between institutions may create default risk, but insurance type arrangements should be able to obviate these risks).

The problem of risk in the payments system is that of doubts about whether debts, accepted to facilitate exchange, will be honoured. Electronic Funds Transfer by making virtually instantaneous the information flows and settlement arrangements can remove those doubts. In such a world there is no reason as to why Very Dubious should not offer accounts which have ownership transferable through the payments system.

X S
 /
 \

Even in a world of paper signalling (cheques) involving time lags, the risk^s have been grossly overstated and the potential for finding ways of averting those risks not realised - or ever examined.

Of course, one other argument thrown up against letting institutions such as Very Dubious participate is the effect on costs of operating the system. The system, it is argued, is much cheaper with only a small number of participants. That may have been so once but the validity of the argument nowadays is far from apparent. Suppose for example, the ANZ with its 960 branches was split into 960 separate unit banks, i.e. each branch was made into a separate bank. What happens to the number of clearing transactions required as a result of customers writing cheques on their accounts at those institutions? The answer - absolutely nothing. Each branch/bank has to engage in exchange and settlements with each other branch/bank and with the other banks, Westpac, etc. The number of exchanges is exactly the same. The only difference is that previously the exchanges between the 960 branches were internalised within the ANZ institution and then exchanges occurred between ANZ and the others at the clearing house. It was simply a two step process. It may very well be that a two step process is cheaper than a one step process where all 960 are represented individually at the clearing house. But, if so, that simply says something about how the clearing house should price its services and how small institutions should interact with it - as a group, for example - rather than whether they should be allowed to.

As this suggests, I am all for institutions like credit unions being allowed to participate in the payments system in their own right - not as is currently the case piggybanking on the bank-based payments system. And while Credit Unions might survive without participating - because of the offsetting benefits from their privileged tax status -

growth probably depends on participation. Customers will want a full range of services available at the one institution.

But how best to get involved given the current state of flux in the payments technology industry is a difficult question.

Is it, for example, best to shun the opportunity to participate in the paper based cheque system - on the grounds that it will soon be superseded by the newly emerging alternatives? The answer to that question clearly depends on the costs of entry to that system, the costs of the alternatives, and the extent to which cheques continue to be the best instrument for effecting certain transfers. What transfers might those, for which the cheque is superior, be? Face to face transactions are unlikely to be best done by cheque. Merchants will presumably either have POS terminals or accept credit cards. How about face to face transactions between individuals - say, at a garage sale? Cash seems to be the preferred option there - cheques involve risk. Perhaps there is a role here for institutions who provide cheque guarantee cards to have their cheque accounts used in place of cash. But the risks and costs involved hardly make it seem an attractive proposition for institutions, and if ATM's proliferate the transactions costs of obtaining cash to complete a purchase are obviously reduced. That leaves transactions at a distance - essentially payment of bills. Here the cheque has had an obvious role in the past. What about its future?

An obvious point is that Credit Unions already provide bill paying services which obviate the need for their customers to have a cheque account. (And it is often forgotten that only 50 per cent of households possess a cheque account anyway.) But to the extent that these bill paying services involve the Credit Unions in writing cheques, they can hardly be seen as replacing the cheque system. In the absence of cross

subsidisation, tax induced cost distortions and monopoly control of the cheque issuing and clearing system (which of course all exist) it is difficult to see how Credit Union members would not be better off with their own cheque books as a substitute, or at least alternative, to the Credit Union bill paying service. The same number of cheques has to be written and members have an extra degree of flexibility. But, as I suggested above, tax considerations and other distortions alter the story. Also, for bills which are frequent - such as those associated with public utilities - direct transfer from customer account to the utility's account is a way of avoiding the cheque.

That Credit Unions have grown so rapidly over the past two decades indicates that they can survive without having to provide chequing facilities. Whether they would grow faster if they did is another matter - but I am not convinced that, given the distortions introduced by the tax system and other market characteristics, they necessarily would. And in expressing doubts about the merits of entry into chequing, I have not even mentioned home banking as an alternative means of bill paying. The reason for that neglect is the likely time involved before home banking becomes a major growth industry. A recent survey by Payments Systems Inc.⁵ in the USA suggested that 30 per cent of bank/thrift customers definitely or probably would use home banking services if offered. But only 45 per cent of those (i.e. 14 per cent of the total) would be willing to be involved if the costs exceeded \$10 per month. No doubt the market will grow - but if 50 per cent of the population has to this day avoided having cheque accounts, the day when 50 per cent of the population engages in home banking is likely to be a long way off.

Chequing facilities may not be so vital for survival in the modern financial world, but participation in other payments services will be.

Take, for example, the recent government decision to pay social security benefits by direct crediting of accounts rather than by cheque. In itself that may not be a major issue in the battle among institutions - but link it to the development of POS terminals and provision of EFTS facilities with retailers and it becomes significant. Those institutions who can offer their customers the chance to get at their income when they shop - and thus do banking and shopping in one hit - are obviously advantaged.

More generally EFTS, particularly Point of Sale terminals, should not be seen as purely a substitute for the cheque system. One of the effects of P.O.S. is to extend the cashless payments system into areas previously served by the cash payments system. In this respect retail financiers whose savings accounts have played an important role in the cash payments system by providing cash storage and cash dispensing facilities are faced with a new threat as this role loses its importance.

CONCLUSION

Of the issues considered above two stand out as particularly vital in determining the future of the retail finance sector. One is entry to the payments system and the argument in favour of relatively free entry to the system for retail financiers have been outlined above. The other, treated less explicitly, concerns the issue of depositor protection and government backing of retail financiers.⁶ Given the forces inducing the consolidation of individuals' accounts at single, full service, institutions and the obvious competitive advantage which protected or guaranteed institutions will have in this process, the issue of depositor protection is clearly important for shaping the future structure of the retail financial sector. Determining which, and

in what way, institutions are to be "guaranteed" and, importantly, the appropriate set of constraints on the activities of these privileged institutions are, together with entry to the payments system, the important unresolved issues for the future of the Australian retail financial system.

FOOTNOTES

- * Revised version of a talk given at the annual conference of Australian Teacher Credit Unions, Adelaide, January 1985.
- 1 The headings used in what follows are not original. They are taken from my notes on a seminar given at Adelaide University in 1983 by Andrew Graham.
- 2 J. Murray and R. White, "Economies of Scale and Deposit-Taking Financial Institution in Canada", Journal of Money Credit and Banking, February 1980.
- 3 W. Cox and P. Whigham, "What Distinguishes Larger and More Efficient Credit Unions?" Economic Review, Federal Reserve Bank of Atlanta, October 1984.
- 4 R.W. Turner, "Expense Preference in Building Societies", Bulletin of Money, Banking and Finance, 1982-83, No. 4.
- 5 A. DeCotiis, "The Business Plan for Home Banking", Economic Review, Federal Reserve Bank of Atlanta, July/August 1984.
- 6 See K. Davis, "What is or Should be a Bank?" Building Society Review, December 1984 and K. Davis, "Moving Towards a More Responsive Financial System", Australian Financial Review, Banking and Finance Supplement, November 12, 1984 for further discussion of entry to the payments system and depositor protection.