

ACCC inquiry into foreign currency conversion services

Introduction

This inquiry is welcome and very necessary. Australian retail FX costs are high by international standards (as the World Bank report found), but it will not suffice merely to bring our FX cost levels into line with the better countries in that survey. Very high FX transaction costs are able to persist worldwide because of low levels of public financial literacy. Regulators and consumer bodies in Australia are well aware of this problem, more broadly. Good work has been done to mitigate this, but the extent of bad behaviour and poor service uncovered in the finance, banking and advice sector over the last 10 years shows that, in general, the public just does not understand many financial concepts. Even when they do, they often do not have access to enough unbiased information to be able to select the best offer or product available. Moreover, because of the somewhat derivative and abstract nature of FX, which is one step removed from the customer's primary purchase of goods and services, the public is likely more prone to being overcharged for FX services than for other financial products.

A clear example is in the purchase or sale of foreign currency notes or stored value cards. Customers are likely to be attracted by offers that are "commission free" but don't realise how important the exchange rate used is: or that that is likely to be much more disadvantageous to them than the "removed" commission or fee. It's hard to know whether this is entirely because of a lack of numeracy, or to what extent behavioural economics play a part. It is probably both. This lack of consumer understanding is aggravated by sophisticated and often misleading selling techniques, even by well-known institutions, both here and abroad. This is most evident in FX booths to exchange currency notes at airports etc, but applies even when physical currency is not involved.

I shall comment only on aspects of two of the issues raised by the ACCC paper:

Issue 1 – The pricing of foreign currency conversion services

Issue 4 – How prices are communicated and factors limiting the ability of consumers to effectively compare prices.

Example 1. I used █████ to remit A\$210,000 to UK in sterling in November 2016. The conversion rates below were taken from █████ website, as were the comparison rates for 3 large banks. I do not intend to imply any criticism of █████ per se: I give this example because I conducted the actual transaction with them. The purpose is only to highlight what are likely to be systemic inefficiencies in the FX provider market in Australia.

The rates offered by █████ were almost static for transfers between A\$ 100K and A\$ 1 million. The one-way spread of 76bp (for A\$/GBP exchange) equated to 1.27% against the interbank rate of 0.5989 at that time. For a transfer of \$20,000 the 102bp spread equated to a one way margin of 1.7% against the interbank rate. This is consistent with the 1.8% one-way margin on a \$10,000 transfer that is quoted from █████ in the ACCC paper.

You're Transferring	AUD/GBP Rate:	Diff from IB rate
AUD 1,000,000.00	0.5913	-76 bp

AUD 500,000.00	0.5913	-76 bp
AUD 250,000.00	0.5913	-76 bp
AUD 150,000.00	0.5913	-76 bp
AUD 120,000.00	0.5912	-77 bp
AUD 100,000.00	0.5909	-80 bp
AUD 20,000.00	0.5887	-102 bp
Interbank rate	0.5989	

AUD/GBP Rate	GBP Amount received	Provider	Time Checked
0.5776*	121,296.00	██████	Wed16 Nov 2016 10:02:58 AM
0.5734*	120,414.00	██████████████████	Wed16 Nov 2016 10:02:59 AM
0.5712*	119,952.00	██████████	Wed16 Nov 2016 10:03:15 AM

*Indicative rates for transfers of A\$210, 000 stated by ██████ as comparisons to its own quote for my AUD 210K transfer.

My transaction was for A\$/GBP. This is a highly liquid currency pair; probably only Euros and USD would have deeper liquidity v the A\$. I expect that the discussion below would be replicated with perhaps slightly tighter pricing for same value examples in USD and Euros, and could be worse in other currency pairs. Also, my remittance of A\$210K is likely to be much larger than the average retail transaction. The cost inefficiencies that I discuss are probably far greater for smaller transactions.

Two points are specially noteworthy: ██████ pricing didn't tighten for sums between \$120,000 and \$1m—one would have expected tighter spreads as the transfer sum increased. It is understandable that ██████ would charge wider spreads for sums below say \$50K, but the above figures suggest that there is a lack of strong competition in the range \$100K to \$1m. Perhaps only as amounts approach A\$3m-\$5m would the competitive pressure that exists in the wholesale interbank FX market start to force ██████ (and its peers) to sharpen their margins. My understanding is that the interbank market operates mainly at A\$5m and above, and where one-way spreads against the midrate would be +/- 10bps at most.

Secondly, ██████ provided the rates from three trading bank competitors- as in the table above -as real time comparisons with the rates offered by ██████. It is possible that they shifted slightly during that day, but the interbank rate was not volatile that day so I doubt that the 3 figures attributed to the banks above would have been "wrong" by more than say 20bp. The best rate above was ██████ at 0.5776, which was 213bp away from the interbank rate. That equated to a one-way spread of 3.56%! The other banks' spreads were wider. Since the stated rates were for a relatively high value (by retail standards) remittance of \$210K, these one-way spreads are astonishing.

I did not check those figures to the three banks' websites: no doubt those banks would have demanded a correction quickly by ██████ if they wrong. (Several years ago I made high value transfers with ██████: my experience was that their FX rate sheet was set at the beginning of the day (Australian time)—perhaps even the night before- and not changed during the day. It would be useful for ACCC to inquire whether banks have now moved closer to real time pricing-perhaps they still don't do it for amounts under say A\$250,000).

A crucial point is that the FX market is obviously a two way market, just like buying and selling shares or bonds. For highly liquid currency pairs (e.g. A\$ with USD, GBP, Euro and 1 or 2 others) [REDACTED] and the banks would either match the customer's trade with opposite orders from other clients, within a short space of time, or act as principal counterparty. These service providers are highly knowledgeable: they would be expert in gauging typical total each way currency flows every day-and perhaps even by the hour- based on historic and recent patterns. They would have the skill to decide whether to be prepared to act as counterparty (as principal) for the NET position of their customers in each currency, up to a given threshold, and/or hedge part of their net position in the wholesale market. Thus except in highly unusual circumstances, it is reasonable to expect that at most times the banks and their smaller FX competitors could make accurate estimates of their NET daily positions in all the main currency pairs. They could then choose either to reduce that NET wholesale risk to nearly zero by hedging, or to take a deliberate NET principal position as counterparty, dependent on their risk appetite and view of the FX market dynamics. I understand that all those parties conduct 24hr FX trading around the world, so there would be no *need* to take any unprotected "overnight" risk.

My first major argument concerns the size of FX spreads. This is to rebut the assertion that banks and other FX service providers need to charge wide spreads because of the capital that they must allocate against currency risks. That is obviously true up to a point, but it cannot justify the very wide spreads that are prevalent. To simplify the argument, one should look at the whole system, not single transactions. The service providers can in effect maintain a NET position in major currency pairs of close to zero except for very short time periods, either through matching client transactions or using interbank hedging. If they do not, that is their choice (in effect, to speculate). On a net position of zero, they would in effect enjoy a two-way spread of $2 \times 1.8\% = 3.6\%$ using the [REDACTED] example mentioned in the ACCC paper, for matching client transactions of A\$10K, or $2 \times 1.27\% = 2.54\%$ between \$120K and \$1m, in my own [REDACTED] example above.

The quotes from [REDACTED], applied to two offsetting buy and sell customer transfers of my example of \$210K, would earn a two-way spread of at least $2 \times 3.56\% = 7.1\%$. Doubtless, the two-way spreads would have been even higher –perhaps 8%- for smaller amounts like \$10K, which is still a relatively large sum for a retail customer.

My analysis solely discusses spreads for transfers that are made electronically, using website applications or phone calls, and involving no branch presence. I expect that most banks charge additional fees for conducting such transactions in branches. Such fees are (probably) fixed—so they could be large as a percentage for amounts below say \$1,000. The effective cost to the customer for small transactions would be very high, especially for changing physical currency in bank branches, where their quoted FX rates would usually be worse than for electronic transfers, as well as charging the flat fee.

My conclusions from the above are:

1. [REDACTED] is providing a service which offers spreads to retail customers that are well below those of the major banks, but still lucrative. I cannot comment on other non-bank FX providers.
2. There may be insufficient competition (in the entire FX market) in the range of \$100K up to \$1m-or perhaps even more- since [REDACTED] spreads do not tighten over

that range. I have not checked, but it's unlikely that [REDACTED] would choose to be much out of line in this respect with other non-bank providers.

3. The two-way spreads earned by [REDACTED] are at least 2.5% for large "retail" sums, and 3.5% at \$10K. The major banks are enjoying two-way spreads of at least 7%, even for amounts as large as \$200K, doubtless higher effective percentages for amounts of \$50K or less.
4. It is interesting to compare such costs with electronic stockbroking, where equities brokerage rates are now typically below 25bps on both buy and sell trades, with lower rates for higher value trades, and many free trades etc for more active customers. The brokerage must be added to the buy/sell spread in the equities market itself, to get the full cost, but in most liquid stocks that should be below 0.5%. Even full service brokers charge under 1%. Brokers also offer "free" information, research and other services to the clients. The cost of supplying these "free" inducements is absorbed in the brokerage. Although I accept that FX providers have to cover the cost of using their working capital, the same is true of brokers in bonds and equities. It would be instructive for ACCC to make comparisons also with the pricing in the futures markets and CFDs for example.
5. My analysis is looking only at FX spreads, and ignores the extra commissions and fees that some FX providers charge. Except for the time involved in making transfers or notes exchanges over the counter in bank branches, it is hard to understand why any such fee is justified- except for passing on the fees levied by overseas correspondents-which should also be very small, or preferably nil.

I can only conclude that these very high spreads remain unchallenged because of the public's low level of financial literacy and experience. Most customers probably make very few FX transactions, which would not help their level of inexperience and information asymmetry. This is well known to ASIC and consumer bodies. Sadly, given the extraordinary breadth of mis-selling and overcharging revealed at the Royal Commission, with services that are more "concrete" and familiar than FX, it is hardly surprising that these high FX spreads persist—indeed in other developed countries as well as Australia. These concepts do require a good level of numeracy to understand.

The ACCC says its inquiry was prompted by numerous complaints, and the finding that Australian FX charges were the third highest in the World Bank's article. That does rightly merit investigation, but it is disturbing that even the best figures in the World Bank survey are at levels that suggest super-profits. That again must reflect public ignorance in other countries, which diminishes the pressure for competition.

I note the disclosures below by [REDACTED] about remuneration for their representatives, including commissions and bonuses related to profits earned. It is good that the fact of this is disclosed, but the exact disclosure is limited (as is so often the case in FSGs), so customers cannot really understand what amount such payments may be as a percentage of the representative's total salary.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

My second subject concerns FX charges levied on so-called “foreign” transactions on credit cards. My specific experience is with [REDACTED], but I expect that similar issues occur with most, perhaps all, card providers, and other payment systems. I show below the relevant section from [REDACTED] website. This disclosure may have been improved and made more explicit over the last 2 or 3 years. Certainly, I was not aware of it until it affected me personally.

[REDACTED]

[REDACTED]

- [REDACTED]
- [REDACTED]

[REDACTED]

There are least three important issues here: 1 the amounts, 2 what is a “foreign” transaction, and 3 disclosure.

On the first point, for reasons very similar to my arguments above, I feel that a 3% charge/spread is highly excessive. The aggregate FX risk taken by card providers etc should be looked at NET over all their customers, at a wholesale level. Given their enormous data sets, the providers would be able to estimate their likely net total positions on all major

currencies in almost real time; certainly at worst daily. If there are patterns of being net long or short particular currencies, these positions could be hedged at very tight pricing in the interbank market. It is not unreasonable for the banks to charge some spreads on these transactions, given the huge investment in banking infrastructure, but my guess is that the purely FX aspects of the card services would be profitable even at a 0.5% charge, perhaps lower.

Although [REDACTED] now discloses the 3% fee (separately), it doesn't explain or disclose what the "base" exchange rate used is. I hope that it would be the interbank rate. It would be instructive to look at what rate was used at the same time to convert transactions for customers resident in other countries for purchases made in Australia. One hopes that the two "base rates" would be the same. It's worth the ACCC checking some examples of this, since it would be almost impossible for a customer to do so.

My second theme is the most troubling. Whatever the level of fee charged, it should apply only for a transaction conducted in a foreign currency. The location of the vendor is irrelevant.

I first encountered this when paying a hotel bill in Vienna. I was asked if I would like to pay in Euros, or in A\$ using dynamic currency conversion. I was well aware of the latter scam—the spread offered was about 6% !-so I said I would pay in Euros. Unfortunately the 50% deposit that I had already paid had been converted into AUD without my knowledge, at a rate determined by the hotel's Viennese bank. (That proved to be a surcharge of about 3% on the interbank rate). To add insult to injury, when that transaction was debited to my [REDACTED] card- despite the fact it was then already denominated in AUD, [REDACTED] "deemed" it an overseas transaction and charged me a 3% fee on it (i.e. on top of the 3% conversion charge that the Austrian bank had levied). This is outrageous and completely unjustifiable. There was no FX risk for [REDACTED]. I protested to [REDACTED]: their telephone operator was eventually able to point me to a wording like the above on its website, even though she herself had not encountered that issue before.

Unfortunately, that has now become a wider trend. When I buy books from UK ([REDACTED] [REDACTED]) despite all the invoices being stated in AUD, [REDACTED] now adds a 3% change on every such purchase. Nothing has changed in the vendor's process, and this impost has only started recently. Again this is completely unjustifiable as [REDACTED] has no FX risk with these purchases. It levies them solely because it can detect a "foreign" aspect.

The card providers are already changing both their customers and vendors annual and merchant fees, not to mention the extremely high level of interest and late payment fees on credit cards- so the cards are already highly profitable without adding in FX charges.

I can only conclude that these fake FX fees have been levied because it is easy to exploit Australian customers' ignorance, confusion and/or apathy. The 3% rates are- as I said earlier- far too high, even in the cases where they are genuinely foreign transactions billed in foreign currencies. The move to charge 3% fees on AUD purchases when the merchant is bearing all the FX risks is outrageous. Surely this is deceptive conduct, to characterise it as "foreign".

The same comments apply more obviously with regard to so-called "dynamic currency conversion". Fortunately more people are becoming aware that the DCC rates are highly unfavourable to the customer, but the manner in which the DCC is offered by the overseas

retailers is often highly misleading. In some cases it may be genuine ignorance on the part of the merchant, but in many I suspect it is done knowingly, with the active encouragement of the card providers. I don't say that the practice of DCC should be banned: I accept that some risk-averse customers may find it useful. However, the rates and consequences should be spelt out more clearly before the customer has to decide to use DCC. Given the prevalence of smart phones now, regulators should insist that all card providers who "offer" or promote DCC through their merchants should provide an APP that enables the customer to compare the DCC cost with what it would cost if charged to their card or bank account in real time, using the bank's standard rate on the day including their 3% or similar standard foreign" currency conversion fee. I suspect that in most cases the DCC charge is about double the standard FX levy.

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