



Abacus
Australian Mutuals

Association of Building Societies and Credit Unions

3 July 2012

Mr Tim Bryant
Secretary
Senate Economics References Committee
Parliament House
Canberra ACT 2600

economics.sen@aph.gov.au

Dear Mr Bryant

Inquiry into the Post-GFC banking sector

On behalf of the customer-owned banking sector, *Abacus – Australian Mutuals* welcomes the opportunity to contribute to the Committee's examination of recent developments in the banking sector arising out of the impact of the global financial crisis.

Customer-owned banking institutions – credit unions, building societies and mutual banks – provide important competition and choice in the retail banking market, with a customer base of 4.5 million Australians and total assets of \$86 billion. Customer-owned banking institutions have 11.4 per cent of the household deposits market, 8.2 per cent of new home loans and are market leaders in responsible lending and customer satisfaction. For more information about our sector, see the Fact Sheet attached to this submission.

Executive Summary

The customer-owned banking sector's share of new home loans has fluctuated around the 9 per cent mark since 2007 and our share of the household deposits market has fallen slightly from 13 per cent to 11.4 per cent.

Australia's banking system, including the customer-owned banking sector, is very sound. From a prudential perspective, it has survived the GFC in a better position than most banking systems around the world.

However, this stability does not mean that the banking sector does not face any challenges, nor does it mean that the regulatory status quo should continue without being questioned as to its capacity to deliver good outcomes for consumers and the Australian economy into the future.

The stability of the Australian banking system and the economy generally gives us a valuable opportunity to reflect on our regulatory structures and frameworks and ask some searching questions about whether that framework will see our economy through the next twenty years. In our view, there is a need for a far-reaching review that considers both the stability and competition elements of the banking system.

Abacus recommends a wide-ranging, independent inquiry into the Australian financial system. This inquiry should examine regulatory settings, the position of the major banks,

consumer perceptions about competition and choice, funding markets, performance of regulators, and recognition of the customer-owned business model.

Abacus also recommends that government and regulators more closely consider the impact of current regulatory reforms, including:

- Basel III capital reforms which do not currently provide equivalent treatment for customer-owned banking institutions compared to listed banks; and
- Basel III liquidity reforms on demand for retail deposits.

We urge the Committee to also consider endorsing calls for legislative change to address:

- the unfair taxation of retail deposits to underpin long-term demand for those deposits, and
- flaws in the Corporations Act definition of 'basic deposit product' exposed by the Basel III liquidity changes.

More detailed comments on the Committee terms of reference are provided in the attached Appendix.

Thank you for the opportunity to make a submission to the inquiry – we would be pleased to appear before the Committee in due course if that would assist the Committee's deliberations.

In the meantime, if you have any questions, please contact my colleague Luke Lawler on
or

Yours sincerely

MARK DEGOTARDI
Head of Public Affairs

Regulatory and Market Changes

This section addresses the following terms of reference:

- (a) **the impact of international regulatory changes on the Australian banking sector, particularly including changes to liquidity and capital holding requirements;**
- (b) **the impact on relative shares of specific banking markets;**
- (c) **the current cost of funds for lending purposes;**

Abacus and our member ADIs are currently engaged in consultations with APRA about the implementation of the Basel III capital and liquidity reforms.

Basel III capital reforms

Mutual ADIs already have regulatory capital ratios well in excess of the new minimum requirements of the Basel III capital reforms.

The key challenges for mutuals in the Basel III capital reforms are:

- criteria to qualify as Common Equity Tier 1 'ordinary shares'; and
- alternatives to 'conversion' and 'write-off' for mutual Additional Tier 1 (AT1) and Tier 2 (T2) capital instruments.

APRA's *Response to Submissions: Implementing Basel III capital reforms in Australia* issued in March 2012 said:

"[A] theme in submissions was that the Basel III reforms presented particular difficulties for ADIs with a mutual corporate structure, which are unable to issue ordinary shares. APRA acknowledges this concern and will consult separately with mutual ADIs on the issues raised. However, it does not see these issues as a reason for departing from its longstanding policy of applying a common set of prudential requirements across the ADI industry."

"Unlike other jurisdictions, banks, credit unions and building societies in Australia are supervised under the same legislative regime and APRA's longstanding policy is to apply a common set of prudential requirements across the ADI sector. When appropriate, these requirements can take account of an individual ADI's size, complexity and risk profile. In APRA's view, the Basel III reforms will improve the regulatory capital framework for ADIs and, in so doing, strengthen the protection available for depositors and the resilience of the Australian banking system as a whole. There are, nonetheless, certain aspects of the Basel III reforms that are problematic for mutually owned ADIs (mutual ADIs). APRA intends to consult separately with mutual ADIs on these aspects."

"A number of submissions argued that the [AT1 & T2] non-viability requirements were unworkable for mutual ADIs, given their ownership structure and the fact that they do not issue ordinary shares... APRA will continue to engage with mutual ADIs on the practical application of the non-viability principle. In particular, it is willing to consider proposals for capital instruments issued by mutual ADIs that would meet the Basel Committee's goals of improving the quality and loss absorbency of regulatory capital."

Abacus and our member ADIs appreciate APRA's commitment and willingness to consult on these issues.

We believe recognition of the mutual model is critical to delivering APRA's statutory objectives of competitiveness, contestability and competitive neutrality, along with safety and stability, in the prudential framework.

Our sector is strongly capitalised and the vast majority of this capital is in the form that is of the absolute highest quality – retained earnings. However, mutual ADIs must have access to capital in addition to retained earnings to increase market share and to take opportunities in future. We want to increase, rather than reduce, access by ADIs to different forms of high quality capital. It is unacceptable to the mutual ADI sector to be required to demutualise to gain access to external capital.

We seek application of the Basel III framework taking into account the mutual model, as is expressly permitted by the Basel Committee. The Basel Committee says the Basel III principles "can be tailored to the context of non-joint stock companies to ensure they hold comparable levels of high quality Tier 1 capital." Non-joint stock companies in the Australian market are mutual ADIs – credit unions, building societies and mutual banks.

We are pursuing *equivalent* treatment for mutual ADIs and listed ADIs because *identical* treatment of the two models in a framework that blatantly prefers the listed model will harm competition, choice and diversity for no prudential benefit.

APRA's revised prudential standards implementing the Basel III capital reforms are expected to be finalised by the end of 2012.

Basel III liquidity reforms

The proposed new liquidity regime is already significantly affecting the key funding market for mutual ADIs, i.e. retail deposits, as the major banks' appetite for deposits, and particularly term deposits, has increased. The liquidity reforms have also had the unintended impact of creating significant regulatory uncertainty about the status of 'basic deposit products' under the *Corporations Act 2001*.

The Basel III liquidity framework introduces a 30-day Liquidity Coverage Ratio (LCR) to address an acute stress scenario and a Net Stable Funding Ratio (NSFR) to encourage longer-term resilience.

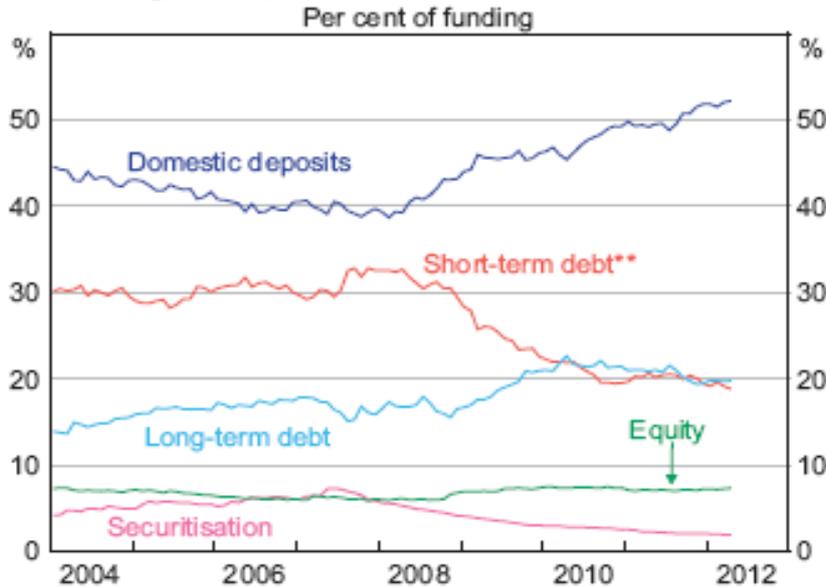
APRA is proposing to apply the LCR and NSFR to large, complex ADIs and to allow smaller, less complex ADIs such as mutuals to use a simpler framework, the Minimum Liquidity Holdings (MLH) regime.

The LCR and NSFR require "stable" sources of funding and APRA is proposing that all ADIs, whether or not they are subject to the LCR and NSFR, must ensure that their activities are funded with stable sources of funding on an ongoing basis.

Deposits, particularly term deposits, are stable funding.

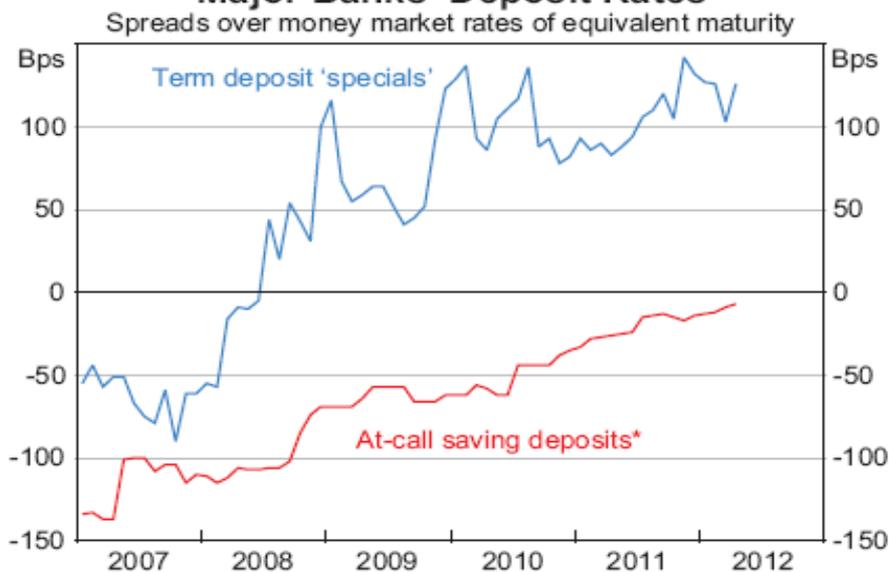
The LCR is not due for implementation until 2015 and the NSFR until 2018 but APRA is proposing that ADIs subject to the new requirements report on their compliance on a 'best endeavours' basis from January 2012. Combined with wholesale funding market developments, the new regulatory requirements are already a significant factor in the changing composition of bank funding and associated hike in pricing of deposits.

Funding Composition of Banks in Australia*



* Adjusted for movements in foreign exchange rates
 ** Includes deposits and intragroup funding from non-residents
 Sources: APRA; RBA; Standard & Poor's

Major Banks' Deposit Rates



* Spread to cash rate; existing customers only; excludes temporary bonus rates
 Sources: Bloomberg; RBA

According to the RBA,¹ the major banks have increased their use of deposits and reduced their use of short-term debt while the regional banks have significantly decreased their use of securitisation and increased their use of deposits. There has also been a marked reduction in foreign banks' use of short-term wholesale debt. Credit unions and building societies continue to raise the vast majority of their funds via deposits.

Higher funding costs for lenders means higher costs for borrowers, such as home buyers. Smaller ADIs rely more heavily on deposit funding than the major banks – 82 per cent for credit unions and building societies compared to 52 per cent for banks - so aggressive

¹ Banks' funding costs and lending rates RBA Bulletin March 2012

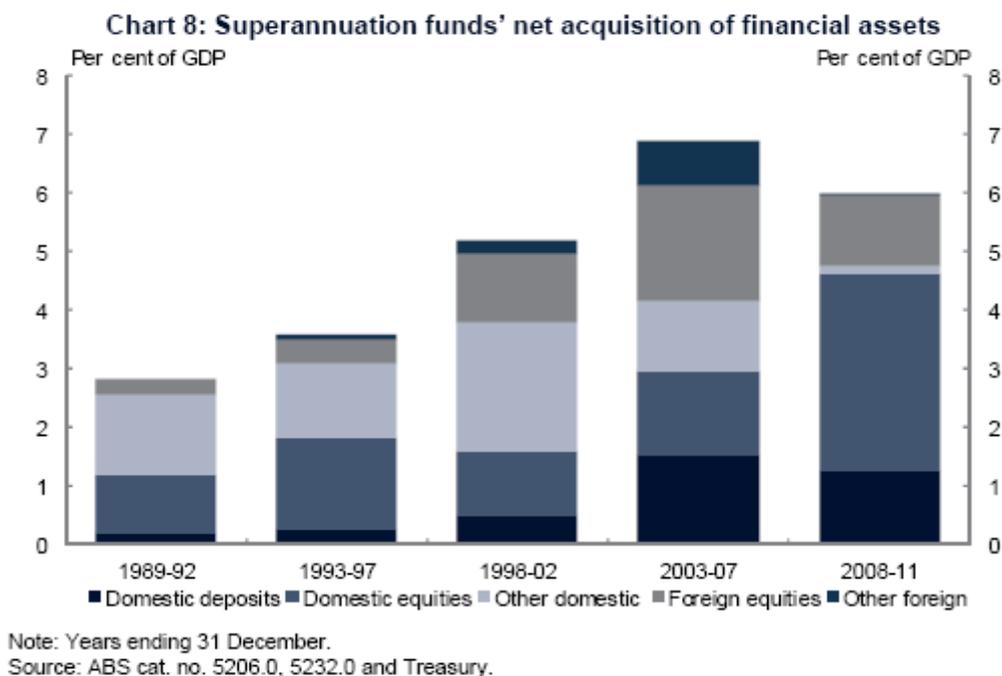
competition for deposits has a more acute impact on smaller ADIs and their capacity to provide competitively priced lending products.

It is critical for both stability and competition reasons that action is taken by Government to address the supply and demand issues in relation to household deposits. One area that Abacus believes should receive attention is the imbalance between the taxation of deposits and the taxation of other investment classes (eg superannuation and equities).

Taxation of deposits

Competition for deposits will intensify further when the current period of global instability and uncertainty comes to an end. Households and other savers will look to alternatives to deposits that are more favourably taxed, such as equities and superannuation.

The phased-in increase in compulsory superannuation contributions from 9 to 12 per cent will put further pressure on the deposits pool. The graph below from the 2012-13 Budget papers² shows that the proportion of domestic deposits acquired by superannuation funds actually fell during the GFC while the proportion of domestic equities increased.

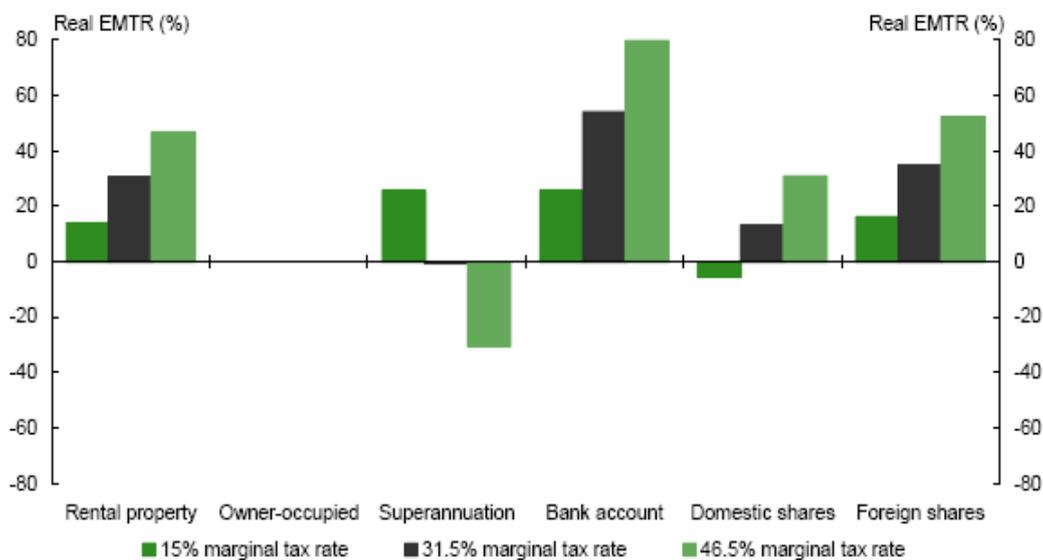


Deposits are the most heavily taxed savings vehicle. The *Australia's Future Tax System* report³ (Henry Report) showed that real effective marginal tax rates on deposits were as high as 80 per cent, compared to a "negative" tax rate for superannuation.

² Statement 4, Budget Paper No.1 2012-13

³ *Australia's future tax system* Report to the Treasurer, December 2009

Chart A1-19: Real effective marginal tax rates on savings depend on asset class



The Henry Report noted that there is considerable evidence that tax differences have large effects on which assets a household's savings are invested in. The Henry Report recommended a 40 per cent savings income discount to individuals for non-business related net interest income. The Government announced in the 2010-11 Budget that it would introduce a 50 per cent tax cut on interest income, but capped the eligible amount of interest at \$1000. This welcome, but very modest, measure was later twice deferred and the Government announced in the 2012-13 Budget that it would not proceed with the measure.

Abacus recommends the reversal of this disappointing decision as a first step, accompanied by a commitment to implement the Henry Report recommendation as soon as possible.

The unfair taxation of deposits must be addressed to reduce pressure on ADI funding costs, to reduce distortions and biases in the taxation of savings, and to ease the burden on Australian households who choose the simplest and safest savings vehicle.

'Basic deposit product'

An unexpected consequence of the Basel III liquidity regime is that it has led to significant uncertainty about the regulatory status of 'basic deposit products' under the *Corporations Act 2001*.

Prompted by the Basel III changes, ASIC revisited the definition of 'basic deposit product' and issued a consultation document questioning whether commonly available term deposits of up to two years qualify as 'basic deposit products'. Term deposits that do not qualify as 'basic deposit products' are subject to significantly more burdensome disclosure, conduct and licensing requirements.

ASIC's November 2011 consultation paper said: "The definition of basic deposit product in section 761A of the Corporations Act does not specify the period of notice that an ADI may require a depositor to give in order to make an early withdrawal from a term deposit of up to two years. Given that a minimum notice period of 31 days would be required for term deposits to gain recognition under the Basel III liquidity standards, there is potential regulatory uncertainty about whether such term deposits would satisfy the basic deposit product definition without some form of relief provided by ASIC."

ASIC's view that for a term deposit to qualify as a 'basic deposit product' it must be 'at call' or subject to a short notice period is controversial and at odds with current market practice.

Many ADIs currently issue 'basic deposit product' term deposits of to two years that are only breakable at the discretion of the ADI.

The fact that ASIC has published a controversial interpretation of the 'basic deposit product' definition after 10 years of uncontroversial operation of the definition in a competitive and diverse term deposits market illustrates that the definition is unsatisfactory and lacking in clarity.

Abacus recommends amending the 'basic deposit product' definition to remove doubt that term deposits of up to two years, where early withdrawal is at the discretion of the ADI, are covered. We further recommend that the amended definition should cover term deposits of up to five years where early withdrawal is at the discretion of the depositor but is subject to a notice of withdrawal period of up to 31 days.

This would ensure that:

- the Corporations Act framework for regulating financial services complements prudential reforms promoting stable funding and a more resilient banking system; and
- there is no disruption to a competitive and dynamic term deposits market.

Market share changes

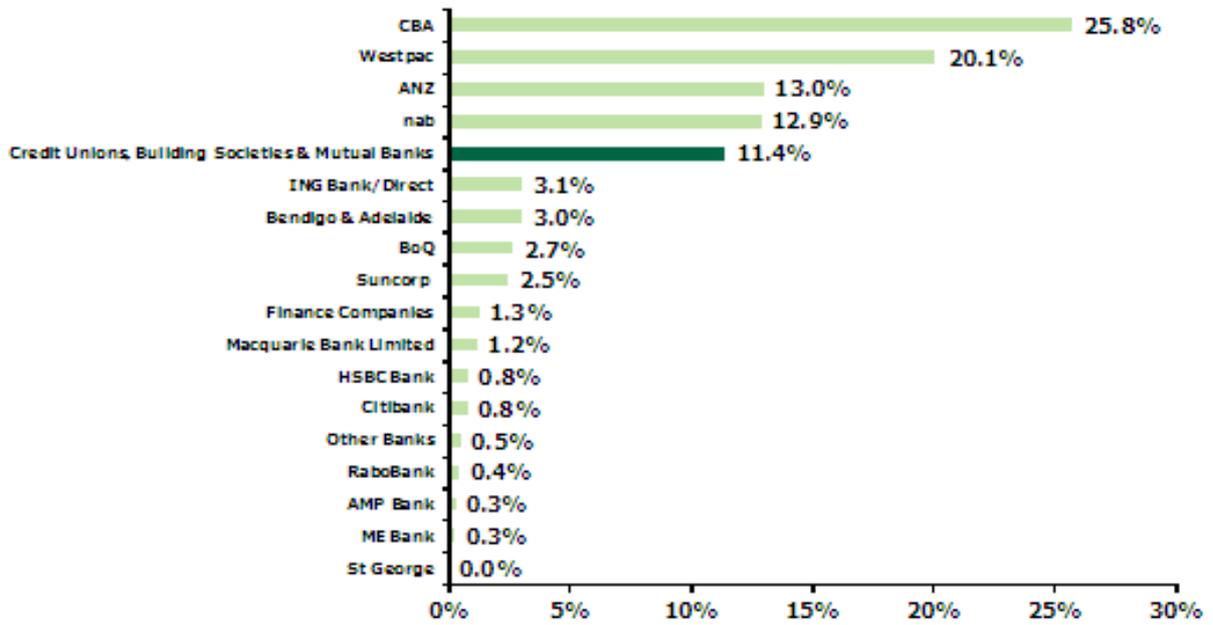
The customer-owned banking sector's share of new home loans (by number) has fluctuated around the 9 per cent mark since mid 2007, peaking at around 12 per cent early in 2011.



The customer-owned banking sector's share of the household deposits market has fallen only moderately since September 2007, from around 13 per cent to 11.4 per cent.

The more significant change is the ranking of our sector compared to the big four banks, with our ranking dropping from second behind CBA to fifth behind all four majors. The dominant positions of CBA and Westpac reflect their acquisitions of BankWest and St George.

Market Share - Household Deposits March 2012



Need for independent inquiry

This section addresses the following terms of reference:

- (d) the need for further consideration of the state of the broader finance and banking sector; and**
- (e) any other relevant matters.**

The Committee's May 2011 report *Competition within the Australian banking sector* commented that a more concentrated banking market, with the big four banks increasing their dominance, has the potential for undesirable impacts on competition.

The ACCC chairman Rod Sims observed this year that the big four banks feel protected from others entering the market and that makes for arrangements that are too cosy for consumers. Mr Sims said: "Normally four players in a market leads to a lot of competitive activity. In the banking sector it seems to need more because even though there are four of them there is a lack of full and effective competition."⁴

The chief executive of the Australian Bankers' Association concedes that "for most in the community, banks are seen as powerful and greedy."⁵

During the GFC, the major banks reaped the benefits of a wholesale funding guarantee that, while critically important to the Australian economy, was heavily skewed in their favour by its unfair fee structure. The fee for major banks was 70 basis points compared to 150 basis points for most ADIs. The RBA subsequently confirmed that the differential in the fee structure was "relatively large by international standards" and that the fee paid by the major banks was "at the low end of the international range."

The position of the four major banks is now so dominant that the majors frame competition in banking as something that occurs only between themselves and within their multiple brands.

NAB's "serious" commitment to customers is to have the lowest standard variable "of the major banks for 2012."⁶ NAB's brand portfolio includes Ubank.

CBA brand Bankwest claimed to have "Australia's cheapest credit card" until ASIC raised concerns that the claim was misleading. ASIC said: "In fact, there were some other credit card issuers (such as credit unions) that offered cheaper credit cards."⁷

Westpac's multi-brand strategy includes regional bank brands and "non-bank" brands. Westpac says "there is a very significant set of customers that would prefer a regional bank over a major bank"⁸ and that "RAMS is actually to cater for that component of the community that wants to deal with a non-bank lender."⁹ ASIC noted in a media statement¹⁰ that the RAMS Saver account "is issued by Westpac Banking Corporation and distributed by RAMS" but did not clarify that the RAMS brand and distribution business is owned by Westpac.

⁴ ACCC says more banks should open in Australia Sunday Herald Sun 22 January

⁵ *The challenges of funding banks in 2012* Steven Munchenberg 14 March 2012

⁶ <http://www.nab.com.au/wps/wcm/connect/nab/campaigns/personal/95/1>

⁷ *Bankwest amends credit card advertising following ASIC action* ASIC 4 June 2012

⁸ *Multi-brands 'make for happy customers'* Australian Financial Review 3 November 2011

⁹ *RAMS to start online deposits* Australian Financial Review 8 November 2011

¹⁰ *RAMS changes advertising in response to ASIC concerns*, ASIC 3 July 2012

In our view, whatever these customers targeted by Westpac might think they're dealing with, what they are actually getting is a major bank. If these customers wish to deal with a regional bank or a "non-bank" why are they dealing with a major bank? There does appear to be at least some degree of consumer misconception in play.

The screenshot shows a 'Compare and Save' section on a website. At the top, there are several promotional links: 'EYEON Inspection Reports', 'Domain's Property Newsletter', 'Win a \$10,000 Europe Holiday', 'Sell your car easily', 'Geelong Child Care', 'Shepparton Child Care', 'N...', and 'S...'. Below these is a navigation bar with categories: 'Best Deals', 'Mobile', 'Broadband', 'Credit Cards', 'Rewards Cards', 'Low Rate Cards', and 'Home'. The main content area is titled 'Check out today's best deals' and features four promotional cards:

- Bankwest:** 'New Rate' of 5.82%. Offer: 'New low rate + FREE online redraw + no ongoing fees'. Button: 'Find out more >>>'.
- UBank:** 'UHomeLoan' at 5.62%. Offer: '0.21% rate cut to Australia's cheapest home loan'. Button: 'Compare Home Loans'.
- RAMS:** 'RAMS Saver' at NEW 5.75%. Offer: 'RAMS charges into the savings account market'. Button: 'Savings Accounts'.
- Same:** Partially visible card with a mobile phone image. Offer: 'All new for the...'. Button: 'Find out more >>>'.

The sheer size of the major banks and their massive spending on marketing reinforces consumer misconceptions that there is no real competition.

Big four banks are able to lend at higher prices than their smaller competitors while raising funds at lower prices than their smaller competitors.

Their status as being 'too big to fail', or more precisely 'too big to be allowed to fail', is acknowledged and factored in by credit ratings agencies in assigning ratings that influence the cost of funding.

Ratings agency Standard & Poor's said of CBA in December 2011: "Our counterparty credit rating on CBA is two notches higher than the [stand alone credit profile], reflecting our view of a high likelihood of extraordinary government support in a crisis. This reflects our view of CBA's high systemic importance in Australia, and our assessment of the Australian government as highly supportive of institutions core to the national economy."¹¹

Higher capital requirements are being introduced for global systemically important banks and regulators are considering how to extend such measures to domestic systemically important banks, like our big four banks.

The RBA and APRA have been contributing to this work and the RBA says there is a strong case for a high degree of national discretion and flexibility in how domestic systemically important banks are identified and the risks addressed.¹²

¹¹ <http://www.commbank.com.au/about-us/group-funding/articles/group-funding-standard-and-pooors.pdf>

¹² *Developments in the Financial System Architecture* Financial Stability Review RBA March 2012

Abacus welcomes APRA using “a high degree of national discretion and flexibility” in setting the prudential regulatory framework.

Broad-ranging, independent inquiry

Abacus endorses the Committee’s May 2011 recommendation for an independent, broad-ranging inquiry into the Australian financial system.

Abacus recommends that such an inquiry should examine:

- whether regulatory and policy settings have shifted too far to stability and away from competition, choice and innovation;
- consumer perceptions about the banking system and choice;
- market power and funding advantages of the major banks, including the ‘too big to fail’ factor;
- major banks’ dominance over the wider financial services and wealth management market;
- performance of regulators (APRA, ASIC, ACCC, RBA, Treasury) in supporting competition and consumer choice;
- need for equal treatment and appropriate recognition for the ‘customer-owned’ banking business model in the corporate, prudential and taxation regimes;
- funding markets, including deposits, securitisation, retail bonds, and the role and performance of superannuation funds in these markets; and
- impact on competition of the increasingly complex regulatory compliance burden, including measures intended to be pro-competitive (such as laws against “price signalling”).

Abacus has commissioned a report from Deloitte Access Economics on the state of competition in banking and the case for a major review of the financial system. We look forward to providing this report to the Committee in due course.

Australian Mutuals

Credit Unions, Building Societies & Mutual Banks

Key Fact Sheet

Size & Strength

- > \$83.2 billion in assets
- > Serving approximately 4.5 million members
- > Fifth largest retail deposit holders collectively
- > High customer satisfaction
- > No conflict of interest between customers and shareholders
- > Strong community focus
- > Same prudential regulation as banks

Strong Regulation

- > All credit unions, mutual banks and building societies are Authorised Deposit-Taking Institutions (ADIs), regulated under the Banking Act. We meet the same high standards of prudential regulation as banks with full regulatory oversight.
- > The Government has guaranteed deposits at Australian mutuals and banks.

Competitive Advantage

- > The mutual structure means no tension between servicing members and external shareholders—members are the owners of their ADI.
- > Mutuals are better placed than most to satisfy key needs of consumers, that is:
 - Member focus
 - Sense of community / belonging
 - Honesty and integrity
 - Guidance
 - Simplicity
 - Competitive pricing
- > Strong regional & rural focus

Size

- > **90 credit unions**
- > **6 mutual banks**
- > **7 mutual building societies**

Assets and Growth

- > Collectively, our sector has \$83 billion in assets.
- > As at March 2012, credit unions, building societies and mutual banks have combined on-balance sheet assets of \$83.2bn, growing by 4.9% annually.

Market Share

- > Hold 8.4% of the new home loan market and 11.3% of household deposits as at April 2012.
- > Collectively, credit unions, mutual banks and building societies are the fifth largest holder of household deposits in Australia.

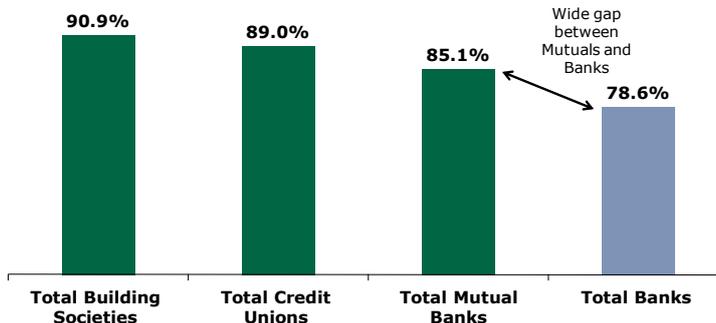
Population Penetration

- > Australian mutuals serve approximately 4.5 million members - or 1 in 5 of the total population.
- > Population penetration (members as a proportion of the total population) is highest in NSW (27%) and SA (26%).

Strength

"Mutuals consistently outperform banks in customer satisfaction."

Customer Satisfaction - April 2012



Source: Roy Morgan Research Customer Satisfaction Survey, 6 months to April 2012, aged 14 and over
 Note: 'Total Building Societies' excludes Heritage Bank
 'Total Mutual Banks' includes bankmecu, QT Mutual Bank, Teachers Mutual Bank, Victoria Teachers Mutual Bank, Heritage Bank and Defence Bank
 'Total Credit Unions' excludes bankmecu, QT Mutual Bank, Teachers Mutual Bank, Victoria Teachers Mutual Bank and Defence Bank
 'Total Banks' excludes 'Mutual Banks'
 Satisfaction is the proportion who answered 'very satisfied' and 'fairly satisfied'

Mutual ADIs

Credit unions, mutual banks and building societies are customer-owned – entities, operating under the mutual principles of one member one vote, an equal share in the say of the organisation, and with the purpose of member and community benefit at the forefront of their operations.

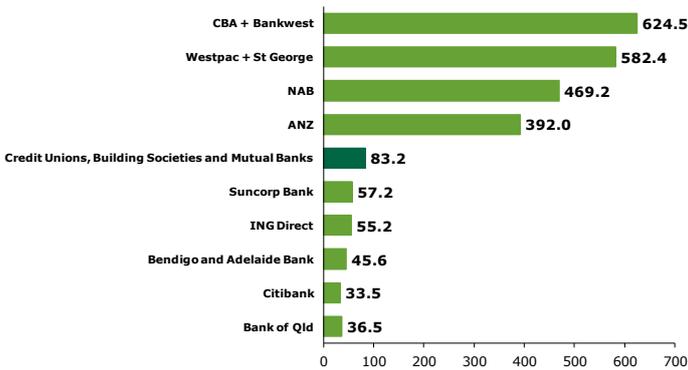


Mutuals have strong community and customer focus.

Market Share

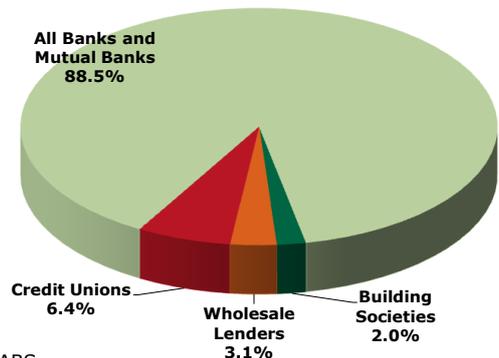
Collectively, credit unions, mutual banks and building societies sit behind the four major banks in terms of total on-balance sheet assets. Mutual ADIs hold 8.4% of the new home loan market.

Total Resident Assets (\$'bn)
as at March 2012



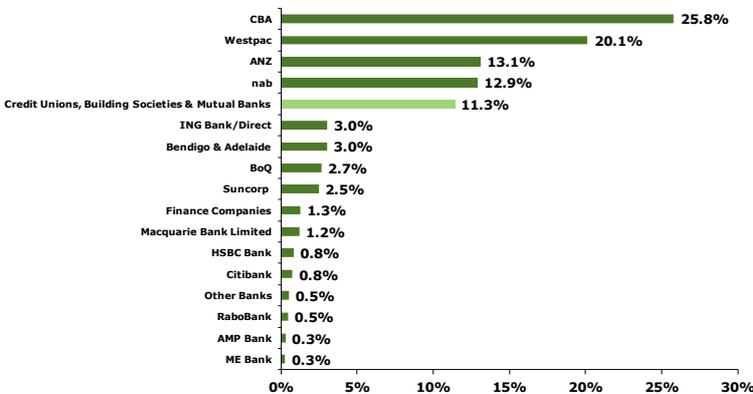
Source: APRA

Market Share of New Owner Occupied Loans
- number, April 2012



Source: ABS

Market Share - Household Deposits
April 2012



Source: APRA, RBA and Abacus

As a group, credit unions, mutual banks and building societies are the fifth largest deposit gathering force after CBA, Westpac ANZ and NAB reaching 11.3% market share.

Products & Services

The majority of credit unions, mutual banks and building societies offer a full range of personal banking services. Mutuals typically charge less than the major banks in loan interest, while also offering attractive deposit rates on saving investment accounts and 90-day term deposits.

The latest Canstar Cannex comparative rates are shown in the tables at right.

15-June-2012

Standard Variable	Avg (%)	Min (%)
4 Major Banks	6.92	6.78
Credit Unions	6.54	5.85
Building Societies	6.51	6.29
Mutual Banks	6.50	5.74

15-June-2012

TD 10K 3-Month	Avg (%)	Max (%)
4 Major Banks	4.63	4.80
4 Foreign Banks	3.85	4.90
Credit Unions	4.60	5.50
Building Societies	4.94	5.20
Mutual Banks	4.94	5.35

Source: Canstar Cannex

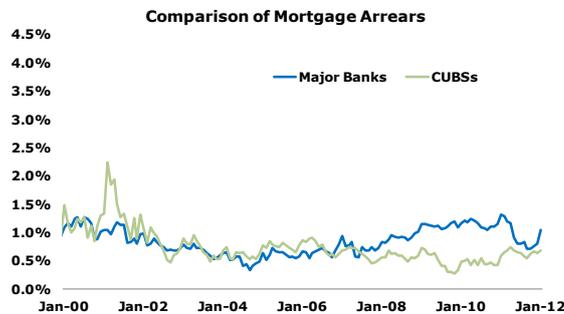
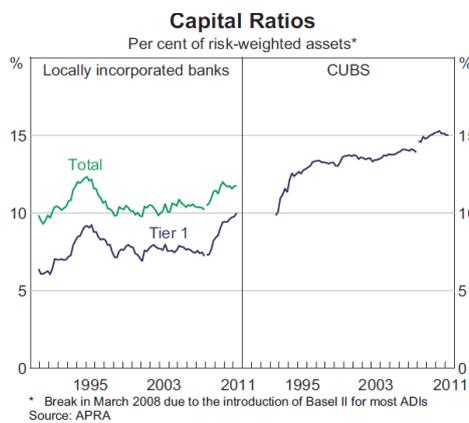
ATM Accessibility @ June 2011	Number of ATMs
CBA/BankWest	3,757
rediATM	3,400
Westpac/St George Bank	2,875
ANZ	2,714

Source: APRA & Cuscal

The mutual sector has the second highest ATM accessibility across the country

The spread of ATM coverage is important to customers who want convenient service without incurring fees. The rediATM network used by many mutual organisations has the highest accessibility ahead of ANZ, Westpac and St George, widening the accessibility levels for our members.

Solid Fundamentals

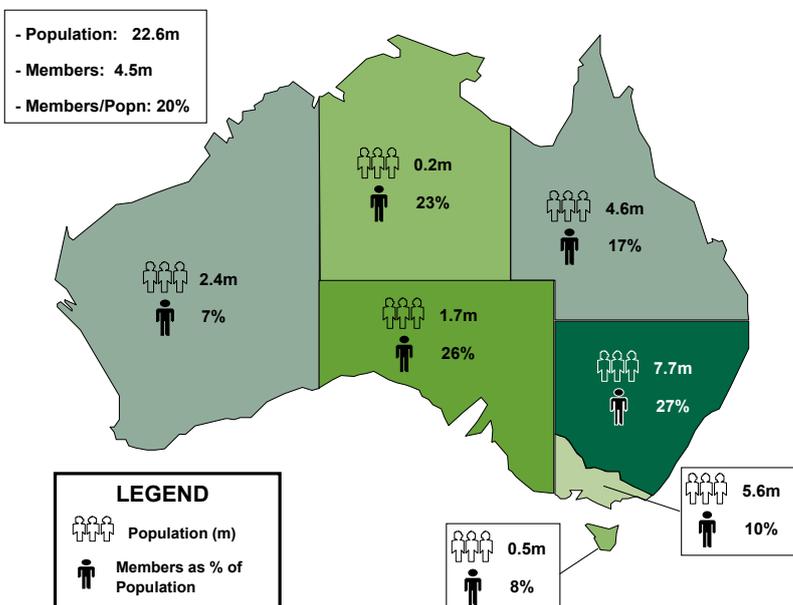


The mutual sector is sound and secure

The credit union, mutual bank and building society sector is well capitalised, with aggregate Tier 1 capital ratio of about 15%, as compared with around 10% for Australian banks, according to the RBA's Sept Financial Stability Review.

The sector continues to demonstrate prudent lending practices with respect to mortgage arrears—currently lower than peers as shown in the Standard & Poor's Prime RMBS SPIN Index above.

Strong Coverage Across Australia



There are approximately 4.5 million credit union, mutual bank and building society members in Australia as at December 2011.

This represents an overall population penetration of approximately 20%.

Population penetration (members as a proportion of the total population) highest in NSW (27%) and SA (26%).