14 January, 2011

Department of the Senate
PO BOX 6100
Parliament House
Canberra ACT 2600

Dear Sir/Madam

SUBMISSION TO THE SENATE INQUIRY INTO COMPETITION IN THE AUSTRALIAN BANKING SECTOR

Citi welcomes the opportunity to submit comments to the Senate Economics Committee's inquiry into competition within the Australian banking sector. Citi commends the Federal Government for reviewing competition with a view to determining how the level of competition within this sector can be increased.

Citi Australia is part of Citigroup Inc., a global diversified financial services holding company with operations in more than 160 countries. In Australia, Citi operates through its local bank branch, Citibank NA Sydney, and local bank subsidiary entity, Citigroup Pty Ltd, each of which possesses an Australian banking license. It has been an Australian Authorised Deposit-taking Institution since 1985. To provide a broad range of financial services, it also operates as a broker/dealer through Citigroup Global Markets Australia Pty Ltd.

In Australia, Citi employs approximately 2,000 staff. They service the needs of 1.3 million retail customers and over one thousand local corporate clients. The retail bank provides deposit and investment products, mortgages, credit cards, and personal loans. The institutional business provides corporate and investment banking services. Citi is one of the few non-Australian banks to have continued to provide a comprehensive range of retail and institutional services in Australia since the local market was opened to foreign banks in 1985.

Over the past few years, Citi Australia has diversified its funding base by attracting more retail and corporate deposits, thus competing with the major domestic banks on pricing, volume attraction and retention. Based on APRA monthly banking statistics, Citi has outstripped other players in the Australian market place, growing its retail deposit base by 36% compared to an average of 8% across the industry in the 12 months to November 2010. Citi Australia's corporate deposits have grown by 20% over the same period.Citi Australia now has 1.4% share of the domestic retail deposit market and 1% of the domestic corporate deposit market, both of which continue to grow.

INTEREST WITHHOLDING TAX (IWT)

It is an acknowledged fact across the Australian banking industry that there is an insufficient pool of domestic deposits with savings often diverted through superannuation to the equity market. There is intense competition in the Australian market for this limited deposit pool resulting in a higher cost of deposit funds and the need to access more expensive offshore funding. This issue will only increase over time as compulsory superannuation contributions continue and tax concessions favour equities over retail deposits. Corporate deposits across Australia are also subject to intense competition amongst banks.

IWT is a particular disadvantage for foreign banks which typically do not have a sizable deposit base to match their desired domestic asset base. Citi would like to attract more retail and corporate deposits into Australia. It is in a good position to do so due to its significant presence in other countries, particularly in Asia. However, the major impediment to doing so is the 10% IWT. This limitation has contributed to Citi Australia's need to supplement its funding base with inter-branch funding from its offshore parent and Asian branches. This inter-branch funding is itself subject to a minimum 5% IWT. The impact of these IWT imposts is to increase the cost of operations within Australia and this translates to a higher cost of loans to customers. The growth of foreign banks in Australia have been impeded as a result of IWT.

<u>Arguments in favour of removing IWT include:</u>

1. Increases the competitive stance of foreign banks in the Australian market through a reduction in funding costs.

2. Translates into more competitive pricing and growth of foreign bank balance sheets in Australian assets such as mortgages and corporate loans.

3. Increases total deposit volume in the Australian economy, providing a balance against withdrawals from the system due to the compulsory superannuation guarantee contribution.

4. Citi anticipates a short time frame (within 12 months) in which a significant increase in non-resident deposit volume can be attracted into Australia, from the time IWT is removed. As at December 2010, Citi in Asia has a latent $5 billion pool of Australian dollar denominated retail and corporate deposits which can be redirected into Australia with greater ease if the IWT impediment were removed.

5. Boosts the attractiveness of Australia as a financial centre. Regional financial centre competitors such as Hong Kong do not impose IWT on non-resident borrowings.

6. Redirects the focus of competition amongst banks for a limited pool of Australian domestic deposits to a broader focus of competing with banks in other countries for their domestic deposits.

7. Diversifies the funding base of <u>all</u> banks operating in the Australian market by:

(i) creating an inflow of retail and corporate foreign funds, not just wholesale;

(ii) potentially creating a new source of funding for Australian banks in offshore sourced deposits .

8. Provides another tool to assist banks transitioning to the Basel 3 liquidity rules, which weight more favourably towards retail and corporate deposits than any other type of funding.

9. Both the Johnson Report and Henry Review recommended the removal of this tax.

The Government will recoup lost IWT revenue through higher bank profit margins, as a consequence of increased deposit volumes, increased mortgage and corporate lending, and cheaper funding costs. The benefits would flow to banks in Australia, Australian consumers and corporates, and to the Australian economy overall.

We urge the Government to consider supporting the case to remove interest withholding tax.

LIBOR CAP:

Under the foreign bank branch rules of the Income Tax Assessment Act 1936, the tax deductibility of interest paid by a branch on borrowings from its parent is limited to the London Interbank Offered Rates (LIBOR). When funds are provided at a rate in excess of the applicable LIBOR rate, the excess is denied a tax deduction. This is known as the 'LIBOR cap'.

Whilst historically it may have been possible for bank branches in Australia to absorb the costs involved, as foreign bank Australian loan portfolios increased and the impact of the global financial crisis (GFC) raised funding costs globally, the constraints presented by the LIBOR cap also increased.

The impacts of the LIBOR cap on competition in Australian banking are:

1. It increases the cost of funding for foreign bank branches. This cost was further exacerbated during the GFC and thereafter due to the higher cost of funds.

2. In response to the GFC, banks have had to seek longer term funding (3 years or longer) throughout the last few years. This will continue into the future as a consequence of current requirements by APRA as well as their intended future adoption of the recently published Basel liquidity pronouncements. LIBOR does not prescribe any rates for lending terms of greater than 12 months. Hence, the tax deductibility of borrowing costs of longer than 12 months is artificially capped at the LIBOR 12 month rate.

3. LIBOR is an inaccurate and outdated representation of the cost of funds of an Australian branch from its foreign bank parent. Foreign bank branches only are forced to comply with a technically inaccurate transfer pricing rule.

4. Foreign banks looking to grow their balance sheet with Australian customer assets are most impacted by the LIBOR cap as they typically do not have a sizable matching deposit base. Consequently they need to access parent bank funding, to which the LIBOR cap applies.

Both the Johnson Report and the Henry Review recommended the abolition of this tax.

Citi strongly recommends the removal of the LIBOR cap on deductibility of interest paid on branch parent funding. The removal will increase competitiveness of foreign banks in the Australian market and the benefits will flow onto customers and the economy.

Please feel free to contact either of us to discuss any items raised in this submission.

Yours faithfully,

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