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Association of Building Societies and Credit Unions

Abacus
Australian Mutuals

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Mr John Hawkins
Committee Secretary
Senate Standing Committees on Economics
Parliament House
Canberra ACT 2600
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Dear Mr Hawkins,

Abacus supplementary submission:

- **Responses to Treasury answers on franking credits and RITCs; and,**
- **Answers to additional questions from Committee about deposit insurance and other matters.**

Abacus hopes the Committee will be able to consider this supplementary material, in addition to our submission lodged with the Committee on 30 November 2010, and our appearance before the Committee on 13 December 2010.

I can be contacted on 02 6232 6666 to discuss this supplementary submission.

Yours sincerely

LUKE LAWLER
Senior Manager, Public Affairs

Franking credits
Treasury's response to the Committee received on 4 February 2011 concerning franking credits and mutuals contains incorrect information.

Treasury says: "Credit unions and building societies that are liable to pay company tax are taxed as co-operative companies." This is not correct.

All credit unions and building societies, except for a handful of very small credit unions, are liable to pay company tax but Abacus is unaware of any credit unions or building societies that are taxed as co-operative companies. It is the case that credit unions and building societies may be able to elect, from year to year, to be taxed as co-operative companies, but to do so they would have to satisfy certain criteria. The fact that most, if not all, credit unions and building societies do not elect to be taxed as cooperative companies indicates there are significant barriers to doing so.

Despite paying company tax like our listed bank competitors, credit unions and building societies are unable to provide franked returns to their owners. For example, should a mutual choose to pay a cash dividend, the level and type of dividend is tightly constrained by ASIC Regulatory Guide 147. The result is that credit unions and building societies continue to accumulate franking credits but cannot pass on the benefits.

Reduced input tax credits
Treasury's response to the Committee received on 4 February 2011 concerning mutuals and the GST reduced input tax credit (RITC) regime is highly contentious.

Treasury says the existing reduced credit acquisition item 16 (credit union services) "effectively allows credit unions to partially recover GST on all their acquisitions." This assertion creates a very misleading impression. To be in any way accurate, it would require credit unions to obtain <u>all</u> their acquisitions from an entity owned by credit unions. This does not happen and has not happened in more than a decade of the GST RITC regime operating.

Abacus is seeking an extension of item 16 to cover mutual building societies. Treasury says this "would be at odds with the policy rationale underlying the RITC regime."

There is no basis for this claim by Treasury. The Henry Review re-confirmed that GST input taxing "gives large, vertically integrated businesses an advantage over small competitors." Big banks have the capacity to self-supply services and lower their tax burden. Smaller, customer-owned banking institutions – credit unions and mutual building societies – do not have this capacity. That is why the RITC regime was introduced. Industry developments, including the formation of Abacus and mergers between credit unions and mutual building societies, require an update to RTIC item 16 to restore the intended policy outcome.

Written question to Abacus from Committee

Q: What form should a permanent deposit insurance scheme take if it is both to promote confidence in the financial system and competition?

Abacus believes the existing deposit guarantee under the Financial Claims Scheme (FCS) should remain unchanged and the limit should be retained at $1 million.

This would be the single most important decision that could be taken to promote competition in retail banking.

As stated in our November 2010 submission, there is a minimal financial risk to the taxpayer in the unlikely event that the guarantee is invoked because:

- the prudential regulatory framework ensures that it is highly likely that the remaining assets of a failed institution will be sufficient to recover funds paid out under the FCS to depositors; and

- in the unlikely event of there being a shortfall, regulated banking institutions would be levied to make up the difference.

The Basel Committee on Banking Supervision and the International Association of Deposit Insurers, of which APRA is a member, released a set of core principles for effective deposit insurance systems. Australia's FCS meets these principles, as outlined in the **attachment** to this supplementary submission.

The existing FCS cap of $1 million is pro-competitive and any reduction will only benefit the major banks and reduce competition. The big four banks would like to see the deposit guarantee scheme removed entirely.

Major banks dominate not just banking but the entire financial sector and are seen as so important to the system that they are too big to fail. The competitive advantage this gives to banks includes a significant cost of funding advantage. Any reduction in the deposit guarantee will just increase the advantage of major banks over their smaller competitors and it is an advantage they will not hesitate to exploit:

> "Australia's big four banks, which increased their dominance of the financial system during the global financial crisis, are determined to use their higher credit ratings to gain a market advantage over small, less highly rated financial institutions. One major bank has already made it clear to this columnist that when the guarantee comes off…it will be heavily advertising its financial strength in order to win a bigger share of bank deposits."[1]

The prudential regulatory framework protects all depositors. The FCS provides a large proportion of those depositors with an early access facility in case, however remote, of an ADI failing. Unfortunately, due to the low level of public understanding about the prudential regulatory framework, the level of deposit guarantee becomes a proxy for the regulatory regime. Given that smaller banking institutions rely more heavily on deposits for funding than major banks, the level of the deposit guarantee is a critical competitive factor.

Larger depositors who may place considerable importance on the level of the guarantee include local councils, universities, schools, hospitals, faith-based groups, unions, superannuation funds, sporting clubs and community groups. If access to these sources of deposit funding is reduced, smaller banking institutions will not be able to apply competitive pressure to the major banks.

A relatively high cap for the deposit guarantee in Australia compared to similar economies is justified by the structure of our banking market, with four dominant players, and by the previous long-standing implicit guarantee for the big banks.

In the USA where an explicit deposit guarantee scheme is a long-standing feature, the level of the guarantee is $250,000. The explicit guarantee is novel in the Australian context and to promote competition it should be maintained at the relatively high level of $1 million. The pro-competitive benefits of a higher guarantee have been recognised in Canada, where the provincially-regulated credit union system enjoys high or unlimited deposit guarantees.

Q: How important are economies of scale in retail banking? Does this constitute a barrier to entry and a force for concentration?

[1] *Chanticleer* column, *Australian Financial Review,* 23 August 2010

Economies of scale are important in any industry. Retail banking is a service-based industry that relies heavily on technological infrastructure.

The push for greater scale is one factor that influences merger activity in the mutual ADI sector. A smaller credit union may see a strong business case to merge with a larger credit union that operates under similar principles and in the same or a neighbouring region to achieve greater scale and operational efficiency.

However, we do not believe the need for greater economies of scale acts as a significant barrier to entry. A number of ADIs now operate without branch networks, choosing to operate exclusively as an online bank.

Due to their smaller size, credit unions and building societies outsource a range of functions that a major bank would otherwise usually in-source. Typically, this would increase the GST burden on these institutions. As noted above, the GST RITC regime is intended to mitigate this disadvantage.

Q: Your submission (page 24) refers to borrowers having to pay a new lender's mortgage insurance premium on the new loan without obtaining a rebate on the premium on the previous loan as an impediment to borrowers switching from a bank to another lender. What can be done about this?

We support the Government's announcement in the *Competitive and Sustainable Banking System* statement that it will accelerate development of potential frameworks to transfer LMI from lender to lender to avoid consumers losing the value of the insurance when switching.

LMI provider Genworth has advised the Committee (submission 136) that a degree of portability already exists but that it does not support 100% portability.

Q: Your submission (page 16) suggests the AOFM support programme be expanded to lower rated 'B' securities. What default risks would AOFM be taking if they purchased such securities?

Whilst these securities are lower rated than the senior tranches of the issuance, the risk of loss on the B notes is still extremely low. The purpose of a subordinated tranche is to enhance the security for investors in senior tranches – these subordinated tranches have become a feature of the requirements of ratings agencies of securitisation transactions.

The subordinated tranches still consist of Australian residential mortgages. These mortgages may be less seasoned or have higher LVRs on average than the mortgages in the senior tranches but the risk of default and the loss given default for these securities is still very low. It is worth remembering that credit unions and building societies are very conservative lenders, that we do not engage in sub-prime lending, and that our arrears on loans have decreased since before the GFC.

For these reasons, our view is that the risk on the subordinated notes would be extremely low.

Q: It appears that your members generally charge lower fees than the banks. Do you think potential customers fully realise this, or do they just focus on the headline interest rate when deciding where to borrow?

For a large number of Abacus members, both the fees they charge and the headline interest rate are lower than the major banks. Yet many customers still choose a major bank for their loan, even though the comparison rate could be anywhere up to 100bp higher than a smaller competitor.

This is partly a function of the entrenched position of major banks, with their massive marketing budgets and their multi-brand strategies, and the lack of visibility for our members.

Abacus members are currently running a national market campaign to lift our sector's profile with this theme:

> "4.5 million Australians choose to bank at a place that isn't a bank at all. A place with the products of a major bank but where profits go back into making better products. When you bank with a credit union or building society, it all comes back to you."

Q: Do your members have access to ATM networks on fair terms?

Yes. The rediATM network used by many Abacus members is the second largest financial institution network, with 3,500 ATMs, just behind the CBA network but well ahead of the Westpac and ANZ networks.

Q: The banks' average cost of funds has increased about 1 per cent more than the cash rate since June 2007. The interest rates they charged on housing have also increased by about 1 per cent more than the cash rate and small business interest rates have increased by over 2 per cent more. Do you know what the comparable numbers would be for the average building society and credit union?

Abacus does not collect detailed data on funding costs for credit unions and building societies and we do not hold any data on business lending rates, which make up only a small proportion of our sector's loan portfolios.

Credit unions and building societies are overwhelmingly funded by deposits, which make up around 85% of their funding base.

The major banks' source around half of their funding from deposits[2], much less than mutuals but a significant increase on June 2007 levels of 44%.

The structural shift upwards in pricing in the deposits market has been good news for savers but has increased the cost of funding for lenders whose primary source of funding is deposits.

The RBA's March 2011 Bulletin says that since 2008 there has been a significant increase in deposit rates relative to market benchmark rates.

"The average cost of the major banks' new deposits has risen noticeably relative to the cash rate; currently it is estimated to be only slightly below the cash rate, whereas prior to the onset of the financial crisis, it was about 150 basis points below the cash rate," the RBA says.[3]

"Within the deposit market, competition has been most pronounced for term deposits. The average spread above market rates of equivalent maturity on banks' term deposit 'specials' – the most relevant rate for term deposit pricing – has increased by around 150 basis points since the onset of the crisis. This average spread is currently a little below 100 basis points. For example, 6-month term deposit rates are currently around 6 per cent, compared to bank bill rates of about 5 per cent. Rates on at-call savings deposits – including bonus saver, cash management and online savings accounts – are currently estimated to be around 35 basis points below the cash rate compared with 100 basis points below in mid 2007.

"Overall, the average deposit cost for the regional banks is likely to have increased by slightly more than for the major banks, reflecting the regional banks' greater use of (relatively more expensive) term deposits," the RBA says.

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[2] http://www.rba.gov.au/publications/submissions/inq-comp-aus-bank-sect-1110/tables.html#table-2

[3] *The Effects of Funding Costs and Risk on Banks' Lending Rates*, RBA March 2011

Despite these funding cost pressures, credit unions and building societies remain highly competitive in their core markets, offering better rates than the major banks for 90 day term deposits and better rates than the major banks for standard variable home loans.

Q: Your members do not seem to pay their CEOs and senior management as high salaries as do the banks. Do they struggle to find good CEOs?

No. This question is based on the presumption that major banks *need* to pay salaries in excess of $10 million per year to attract a good CEO, which is highly debateable.

A large credit union or building society pays a competitive salary in real terms and therefore has no trouble attracting high quality CEOs.

According to a 2010 McGuirk/AMI Institute remuneration survey[4], a large credit union or building society with greater than $2.5bn assets pays its CEO an average salary package of approximately $538,000.

[4] McGuirk Management Consultants 2009/10 Remuneration Survey: this survey determines the remuneration for 126 positions within 100 credit unions and 8 building societies for the current financial year.

ATTACHMENT

Core Principles for Effective Deposit Insurance Systems

Bank for International Settlements; International Association of Deposit Insurers

http://www.bis.org/publ/bcbs182.pdf

Principle	Abacus comment
1**. Public policy objectives**: the first step in adopting a deposit insurance system or reforming an existing system is to specify appropriate public policy objectives that it is expected to achieve. These objectives should be formally specified and well integrated into the design of the deposit insurance system. The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and protect depositors.	FCS legislation second reading speech: ensure confidence in Australian financial institutions is maintained; in the event an institution fails, provide depositors in ADIs with timely access to their funds
2. Mitigating moral hazard: Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net.	Limited to ADI deposits of up to $1m. Large depositors, i.e. more than $1m, outside FCS have incentive to impose market discipline on ADIs, along with other creditors and shareholders who are also outside the FCS. Relatively high cap, i.e. $1m, is credible, so large depositors are convinced the FCS is limited. Setting the cap at a credibly high level is important to a successful permanent transition from the pre-existing implicit blanket guarantee. Strong prudential regulatory framework, regularly strengthened and enhanced (APRA, Treasury) Strong financial stability regulator and central banker (RBA) Strong corporate regulatory and disclosure framework (ASIC, ASX) Unlisted mutual banking institutions are not motivated to take excessive risks to generate excessive returns.
3. Mandate: It is critical that the mandate selected for a deposit insurer be clear and formally specified and that there be consistency between the stated public policy objectives and the powers and responsibilities given to the deposit insurer.	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS
4. **Powers**: A deposit insurer should have all the powers necessary to fulfil its mandate and these powers should be formally specified. All deposit insurers require the power to finance reimbursements, enter into contracts, set internal operating budgets and procedures, and access timely and accurate information to ensure that they can meet their obligations.	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS
5**. Governance**: The deposit insurer	APRA is an operational independent

should be operationally independent, transparent, accountable and insulated from undue political and industry influence.	statutory authority with 3-member executive group responsible for determining APRA's goals, priorities and strategies.
6. **Relationship with other safety-net participants**: A framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety net participants. Such information should be accurate and timely (subject to confidentiality when required). Information sharing and co-ordination arrangements should be formalised.	APRA has formalised frameworks in place with other safety net participants - RBA, ASIC and Treasury – including as members of the Council of Financial Regulators
7. **Cross-border issues**: Provided confidentiality is ensured, all relevant information should be exchanged between deposit insurers in different jurisdictions and possibly between deposit insurers and other foreign safety-net participants when appropriate. In circumstances where more than one deposit insurer will be responsible for coverage, it is important to determine which deposit insurer or insurers will be responsible for the reimbursement process. The deposit insurance already provided by the home country system should be recognised in the determination of levies and premiums.	APRA is a member of the International Association of Deposit Insurers. APRA is active internationally and has memoranda of understanding with many of its counterpart prudential regulators.
8. **Compulsory membership**: Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits from those deemed most in need of protection (eg. retail and small business depositors) to avoid adverse selection.	All ADIs are 'members' of FCS
9. **Coverage**: Policymakers should define clearly in law, prudential regulations or by-laws what an insurable deposit is. The level of coverage should be limited but credible and be capable of being quickly determined. It should cover adequately the large majority of depositors to meet the public policy objectives of the system and be internally consistent with other deposit insurance system design features.	The FCS applies to ADI deposits of up to $1 million on a per-account holder, per-ADI basis. Protected deposits are defined in the Banking Act and regulations
10. **Transitioning from blanket guarantee to a limited coverage deposit insurance system**: When a country decides to transition from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as a country's circumstances permit. Blanket guarantees	Transition was achieved in less than two weeks; 12 Oct 2008 announcement of guarantee of all deposits; 24 Oct 2008 announcement fee-free guarantee applies only to deposits up to $1 million from 28 Nov 2010; 7 Feb 2010 announcement of closure of large deposits and wholesale funding guarantee from 31 Mar 2010.

can have a number of adverse effects if retained too long, notably an increase in moral hazard. Policymakers should pay particular attention to public attitudes and expectations during the transition period.	
11**. Funding**: A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system. For deposit insurance systems (whether ex-ante, ex-post or hybrid) utilising risk adjusted differential premium systems, the criteria used in the risk-adjusted differential premium system should be transparent to all participants. As well, all necessary resources should be in place to administer the risk-adjusted differential premium system appropriately.	APRA is funded by industry levies on ADIs and other supervised entities. As part of the FCS arrangements, the Government has made a standing appropriation for funds to be available for FCS purposes. From October 2011, the appropriation is for a maximum amount of $20 billion for payouts to account-holders at any one time and $100 million for expenses relating to the administration of the FCS. The former amount would be used to pay account-holders in the first instance, with this amount to be repaid to the Government from the liquidation of the ADI. Payments made under the FCS are covered by the depositor preference provisions in the Banking Act, such that the assets in Australia of the ADI in winding up must first be applied to repay amounts paid under the FCS. If the assets of the ADI are insufficient to meet the amounts paid under the FCS (including expenses incurred in administering the FCS), an industry levy may be imposed to cover any shortfall.
12. **Public awareness**: In order for a deposit insurance system to be effective it is essential that the public be informed on an ongoing basis about the benefits and limitations of the depositor insurance system.	As argued elsewhere by Abacus, there is a strong case for action on this principle.
13. **Legal protection**: The deposit insurer and individuals working for the deposit insurer should be protected against lawsuits for their decisions and actions taken in "good faith" while discharging their mandates. However, individuals must be required to follow appropriate conflict-of-interest rules and codes of conduct to ensure they remain accountable**.** Legal protection should be defined in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified.	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS
14. **Dealing with parties at fault in a bank failure**: A deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure.	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS
15. **Early detection and timely intervention and resolution**: The deposit insurer should be part of a framework	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers

within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks**.** The determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and on the basis of well defined criteria by safety-net participants with the operational independence and power to act.	to administer the FCS
16. **Effective resolution processes**: Effective failure-resolution processes should: facilitate the ability of the deposit insurer to meet its obligations including reimbursement of depositors promptly and accurately and on an equitable basis; minimise resolution costs and disruption of markets; maximise recoveries on assets; and, reinforce discipline through legal actions in cases of negligence or other wrongdoings. In addition, the deposit insurer or other relevant financial system safety-net participant should have the authority to establish a flexible mechanism to help preserve critical banking functions by facilitating the acquisition by an appropriate body of the assets and the assumption of the liabilities of a failed bank (eg. providing depositors with continuous access to their funds and maintaining clearing and settlement activities).	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS. APRA works closely with the RBA. RBA has responsibility for stability of financial system.
17. **Reimbursing depositors**: The deposit insurance system should give depositors prompt access to their insured funds. Therefore, the deposit insurer should be notified or informed sufficiently in advance of the conditions under which a reimbursement may be required and be provided with access to depositor information in advance. Depositors should have a legal right to reimbursement up to the coverage limit and should know when and under what conditions the deposit insurer will start the payment process, the time frame over which payments will take place, whether any advance or interim payments will be made as well as the applicable coverage limits.	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS. APRA's intention is to provide accountholders with access to their deposits up to the FCS limit as soon as possible following the declaration of the FCS.
18. **Recoveries**: The deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits.	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS