CUSTOMER OWNED BANKING ASSOCIATION

www.customerownedbanking.asn.au

LEVEL 11, 35 CLARENCE STREET, SYDNEY NSW 2000 GPO BOX 4686, SYDNEY NSW 2001

8 March 2017

Senate Economic References Committee
Parliament House
Canberra ACT 2600

Via email: economics.sen@aph.gov.au

Dear Committee Secretary

COBA submission to the Senate inquiry into consumer protection in the banking, insurance and financial sector

On behalf of our member banking institutions and our sector's 4 million customers, COBA welcomes the opportunity to contribute to this inquiry into the regulatory framework for the protection of consumers in banking.

Our sector is a significant force in retail banking, with a 10 per cent share of the household deposits market and total assets of $104 billion.

Our key messages to the inquiry are:

- The customer owned model offers a genuine alternative to the listed bank model and has a proven record of delivering superior customer outcomes.
- The enduring solution to concerns about the banking market is action to promote sustainable competition so that poor conduct is swiftly punished by loss of market share. COBA proposes specific action to promote competition.
- A wide range of new legislative and regulatory measures to improve consumer protection are already being planned or implemented so exercise caution about adding to the regulatory compliance burden. Increasing the regulatory compliance burden harms competition and benefits the biggest players.

CUSTOMER OWNED MODEL

Customer owned banking institutions are different

Australia's mutual banks, credit unions and building societies provide a genuinely consumer focused way of banking. We bring a fundamentally different model to the market, a model where customer interests are not in conflict with shareholder interests.

Customer-owned banking is distinguished by:

- prioritising customer benefit over profit maximisation
- conservative business models and prudent risk management, and
- a deep community engagement and strong customer loyalty.

The customer owned model has an important role to play in the retail banking market because consumers are entitled to genuine choice. Trust is more critical in financial services than in most industries because consumers find themselves at a disadvantage compared to the firms they are dealing with. ASIC's benchmark consumer research reveals that almost a third of Australians find dealing with money stressful and overwhelming.

The Financial System Inquiry (FSI) found that: "To build confidence and trust in the financial system, firms need to take steps to create a culture that focuses on consumer interests." The FSI specifically recommended that the interests of financial firms should be aligned with those of consumers.

The customer owned model achieves this alignment and this is reflected in the sector's market-leading customer satisfaction ratings, highly competitive pricing and community focus.

Mutual banks, credit unions and building societies are subject to the same regulatory framework as listed banks and are competing in the same business of retail banking but their reason to exist is entirely different. Customers, rather than a separate group of shareholders, are our sector's one and only priority.

The customer-owned banking sector has market leading levels of customer satisfaction because we focus on putting customers first. According to Roy Morgan Research[1], mutual sector customer satisfaction was 90.2% in January 2017 compared to major four bank satisfaction of 80.1%.

This customer satisfaction increases to 93.2% when we are their main financial institution (MFI). This compares to 82.1% for the major four banks. This highlights our focus on customer relationships. Customer-owned institutions hold seven of the top eight highest individual MFI customer satisfaction ratings.

For the last five years, a customer owned banking institution has won Roy Morgan's Bank of the Year Customer Satisfaction award.[2]

Our sector is a market leader on competitively-priced credit cards, with our standard credit cards 5.7% lower than the four major banks (on average). Analysis from the Canstar Online Database shows 11 credit card products issued by customer owned institutions with rates below the lowest rate of the major banks', including some rates as low as 8.99%.[3]

Our average standard variable home loan rates are 0.64% lower than the big four banks.[4]

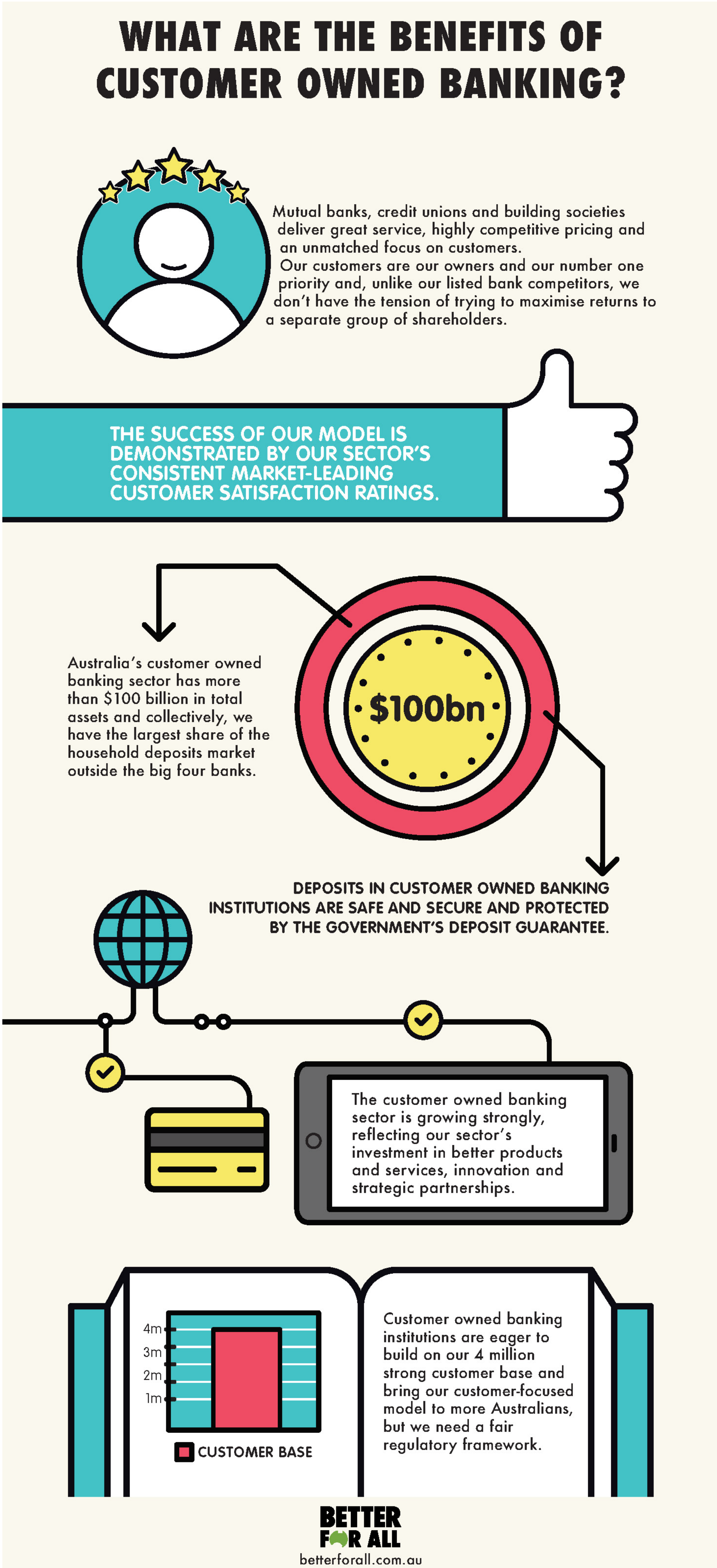
Focus on community

Customer owned institutions put their customers first and give back to the communities in which they operate. An independent report[5] has confirmed that mutual banks, credit unions and building societies are living up to their promise of community engagement. The report by the Customer Owned Banking Code Compliance Committee reviewed our sector's focus on community and the impact of that engagement on the wider communities we serve.

[1] Roy Morgan Research, Customer Satisfaction: Consumer Banking in Australia Report January 2017
[2] Victoria Teachers Mutual Bank in 2012 & 2013, P&N Bank in 2014, Teachers Mutual Bank in 2015 and Greater Bank in 2016
[3] Figures sourced from Canstar Online Database, for standard credit cards (unsecured), excluding premium cards and special offers, 20 February, 2017.
[4] 14 February, 2017: Comparison calculated using data sourced from the Canstar Online Database for standard variable rate products, which are available to owner occupiers borrowing $400,000 at an 80% LVR. Package, basic, and introductory rates are excluded.
[5] http://www.cobccc.org.au/uploads/2017/01/COB-OMI-Community-Engagement-18Jan2017.pdf

The report’s findings include:

- Overall, the inquiry has found that customer owned banks are community focused, reflecting their history and the culture and frameworks that underpin their dealings with customers. The extent of community engagement is impressive as many institutions work with over 100 different community groups on an annual or ongoing basis.
- Overall, sport & recreation, welfare/community, education & training and health are the community groups served by the majority of Code subscribers, while there is strong interest in supporting parenting, children & youth as well as the institution’s specific industry sector.
- Philanthropic or voluntary community engagement, which provides no direct financial benefit to the institution, is wide-spread irrespective of the size of the institution.


WHAT ARE THE BENEFITS OF CUSTOMER OWNED BANKING?
Mutual banks, credit unions and building societies deliver great service, highly competitive pricing and an unmatched focus on customers. Our customers are our owners and our number one priority and, unlike our listed bank competitors, we don't have the tension of trying to maximise returns to a separate group of shareholders.
THE SUCCESS OF OUR MODEL IS DEMONSTRATED BY OUR SECTOR'S CONSISTENT MARKET-LEADING CUSTOMER SATISFACTION RATINGS.
Australia's customer owned banking sector has more than $100 billion in total assets and collectively, we have the largest share of the household deposits market outside the big four banks.
$100bn
DEPOSITS IN CUSTOMER OWNED BANKING INSTITUTIONS ARE SAFE AND SECURE AND PROTECTED BY THE GOVERNMENT'S DEPOSIT GUARANTEE.
The customer owned banking sector is growing strongly, reflecting our sector's investment in better products and services, innovation and strategic partnerships.
4m
3m
2m
1m
CUSTOMER BASE
Customer owned banking institutions are eager to build on our 4 million strong customer base and bring our customer-focused model to more Australians, but we need a fair regulatory framework.
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Commitment to Code of Practice

The Customer Owned Banking Code of Practice (COBCOP) is the code of practice for Australia's mutual banks, credit unions and building societies.

The COBCOP is a market leading, plain English commitment to fair, ethical and responsible banking. It is the public expression of our commitment to these fundamental principles – a legal and moral commitment to delivering on our promises to our customers.

The independent review of the ABA's Code of Banking Practice has recommended that a new, revised ABA code should adopt elements of the existing COBCOP "to keep pace with the standards set by credit unions, mutual building societies and customer owned banks." These elements cover responsible lending, financial difficulty, default fees, guarantors, compliance with the Department of Human Services Code and reverse mortgages.

The COBCOP is due for review before early 2018 and we will consider the ABA code review and the ABA's response as part of the COBCOP review.

COBA member banking institutions educate their staff about the customer owned model to ensure that staff understand the core proposition: that each customer is an equal owner of the business and the business only exists to serve its customers.

The education process is delivered through induction programs, ongoing training and directly reinforced by senior management.

The COBCOP includes the following key promises:

- We will be fair and ethical in our dealings with you. We will always act honestly and with integrity, and will treat you fairly and reasonably in all our dealings with you.
- We will focus on our customers. We will place a high priority on service, competitiveness and customer focus.
- We will deliver high customer service and standards. We will issue and distribute products and provide services that are useful, reliable and of value to our customers. We will make sure our staff and agents or representatives are well trained.
- We will recognise our customers' rights as owners. As customer owned banking institutions our customers are our owners.

In some institutions, an employee's induction into our philosophy begins during recruitment. These employers introduce potential recruits to the model before the first interview to help them see whether this institution is the right fit for them. Once on board, induction programs educate new employees about why the customer owned model is different from other banking models. These programs include sessions about the history and philosophy of that particular institution as well as the credit union and building society movements and the COBCOP.

COBA members reinforce the customer focused culture during regular briefings, ongoing training, refresher courses, and events such as staff conferences. Managers ground discussions on strategy and targets in the customer owned context.

COBA members provided the following quotes about their approach:

> "Our training model is customer centric with an emphasis on customer relationships as the basis for 'sales through service' model."

> "New employees are initially introduced to the customer owned model and our points of difference to the broader finance industry. They gain insight into how the credit union was formed, our heritage and our vision and purpose."

"On commencement and annually we all complete Customer Owned Banking Code of Practice training which outlines the philosophy of the industry."

"Training and development from induction to leadership training all focus on customer rather than sales outcomes."

"Customer owned model education is reinforced for all employees through our regular team briefings, weekly communications and sales conferences."

"All new employees attend a face-to-face induction which includes facilitated discussion about mutual banking and the Code of Practice."

"Employees participate in corporate activities such as our lunch with a difference program, where our CEO talks about the organisation's mutual and customer focus."

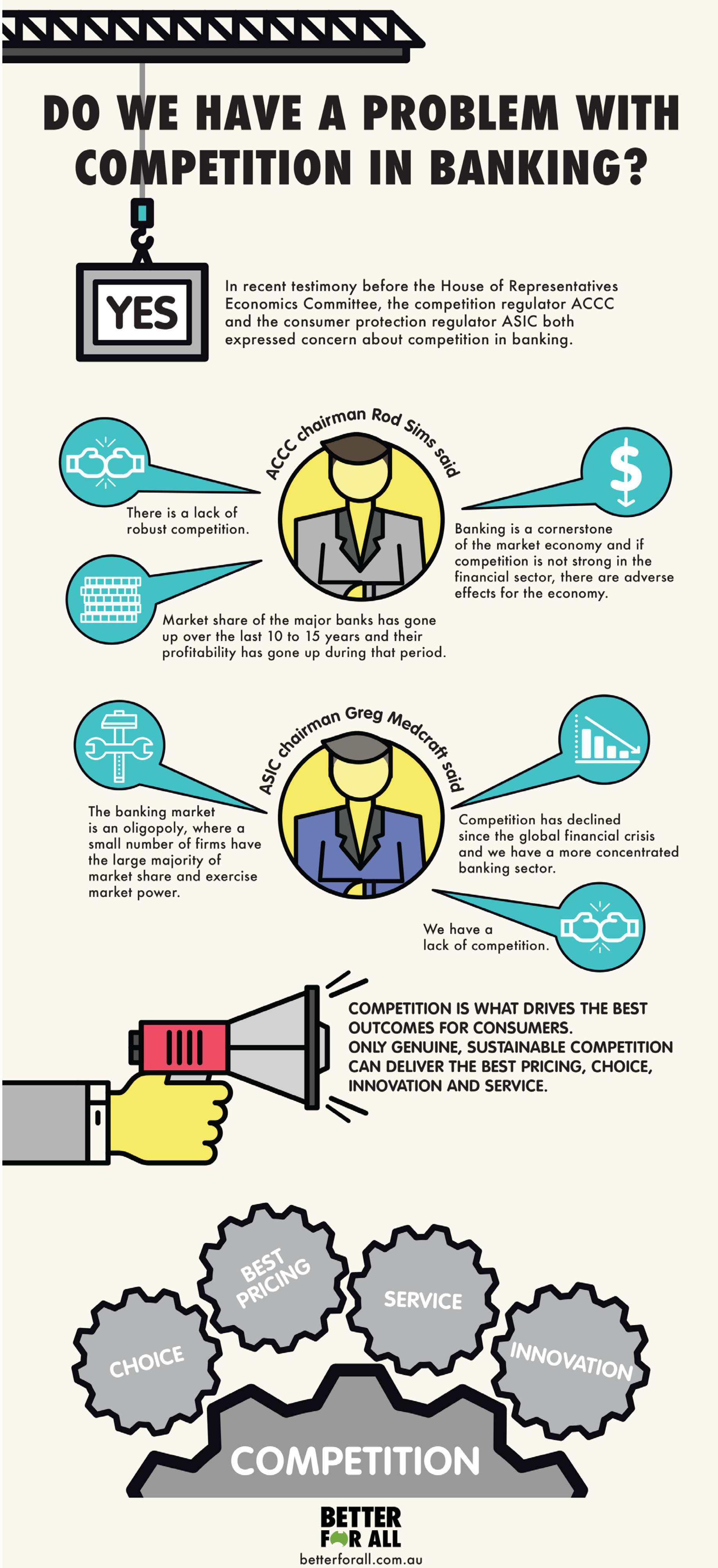
"The philosophy of the organisation is inculcated into all staff at their induction and includes a strategy overview from the CEO."

"We focus on customer service and needs at our annual staff conference. Each year we have three actual members and a non-member attend and tell us from their perspective what they expect from their financial institution."

"For all new staff we provide an orientation that includes 90 minutes with myself as CEO explaining the credit union model and the credit union culture and specifically our strategic plan and focus."

"The customer centric model is reinforced at every opportunity, and our people openly and frequently tell us that this is why they join and why they stay with the bank."

"The customer owned model is covered at induction for all new employees, where we talk about members owning the organisation and the mutual model more broadly."


DO WE HAVE A PROBLEM WITH COMPETITION IN BANKING?
YES
In recent testimony before the House of Representatives Economics Committee, the competition regulator ACCC and the consumer protection regulator ASIC both expressed concern about competition in banking.
ACCC chairman Rod Sims said
There is a lack of robust competition.
Banking is a cornerstone of the market economy and if competition is not strong in the financial sector, there are adverse effects for the economy.
Market share of the major banks has gone up over the last 10 to 15 years and their profitability has gone up during that period.
ASIC chairman Greg Medcraft said
The banking market is an oligopoly, where a small number of firms have the large majority of market share and exercise market power.
Competition has declined since the global financial crisis and we have a more concentrated banking sector.
We have a lack of competition.
COMPETITION IS WHAT DRIVES THE BEST OUTCOMES FOR CONSUMERS.
ONLY GENUINE, SUSTAINABLE COMPETITION CAN DELIVER THE BEST PRICING, CHOICE, INNOVATION AND SERVICE.
BEST PRICING
SERVICE
CHOICE
INNOVATION
COMPETITION
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PROMOTING COMPETITION

COBA proposes the following measures to promote competition.

- The Turnbull Government should allocate funds in the May Budget to bring forward a planned Productivity Commission review of banking competition.
- APRA should respond positively to the March 2016 Senate Economics Committee recommendation that it set a target date for the outcome of discussions with the co-operative and mutuals sector on issues of capital raising and bring those discussions to a timely conclusion.
- Amend the APRA Act to give the prudential regulator an explicit 'secondary competition objective' and require APRA to report annually against this objective.
- APRA should act without further delay to implement the 2014 Financial System Inquiry (FSI) recommendations on bank capital to:
  - ensure major banks are 'unquestionably strong'
  - further narrow the gap in mortgage risk weights between the major banks and smaller banking institutions, and
  - tackle the 'too big to fail' problem.
- Reduce the unfair burden on customer owned banking institutions stemming from the company tax and GST regimes.

Improved competition would lead to better customer outcomes

The enduring solution to concerns about the banking market and its impact on consumers is action to promote sustainable competition so that poor conduct is swiftly punished by loss of market share.

ACCC chairman Rod Sims has indicated the ACCC is limited in its capacity to promote competition in the banking market, despite his view that:

- there is a lack of robust competition
- banking is a cornerstone of the market economy and if competition is not strong in the financial sector, there are adverse effects for the economy, and
- the market share of the main four banks has gone up over the last 10 to 15 years and their profitability has gone up during that period.

ASIC chairman Greg Medcraft has told MPs that strong competition encourages firms to innovate and has positive effects on both price and quality of what is delivered to consumers. However, ASIC's view is that:

- the banking market is an oligopoly, i.e. where a small number of firms have the large majority of market share and exercise market power
- competition has declined since the global financial crisis and we have a more concentrated banking sector, and
- we have a lack of competition.

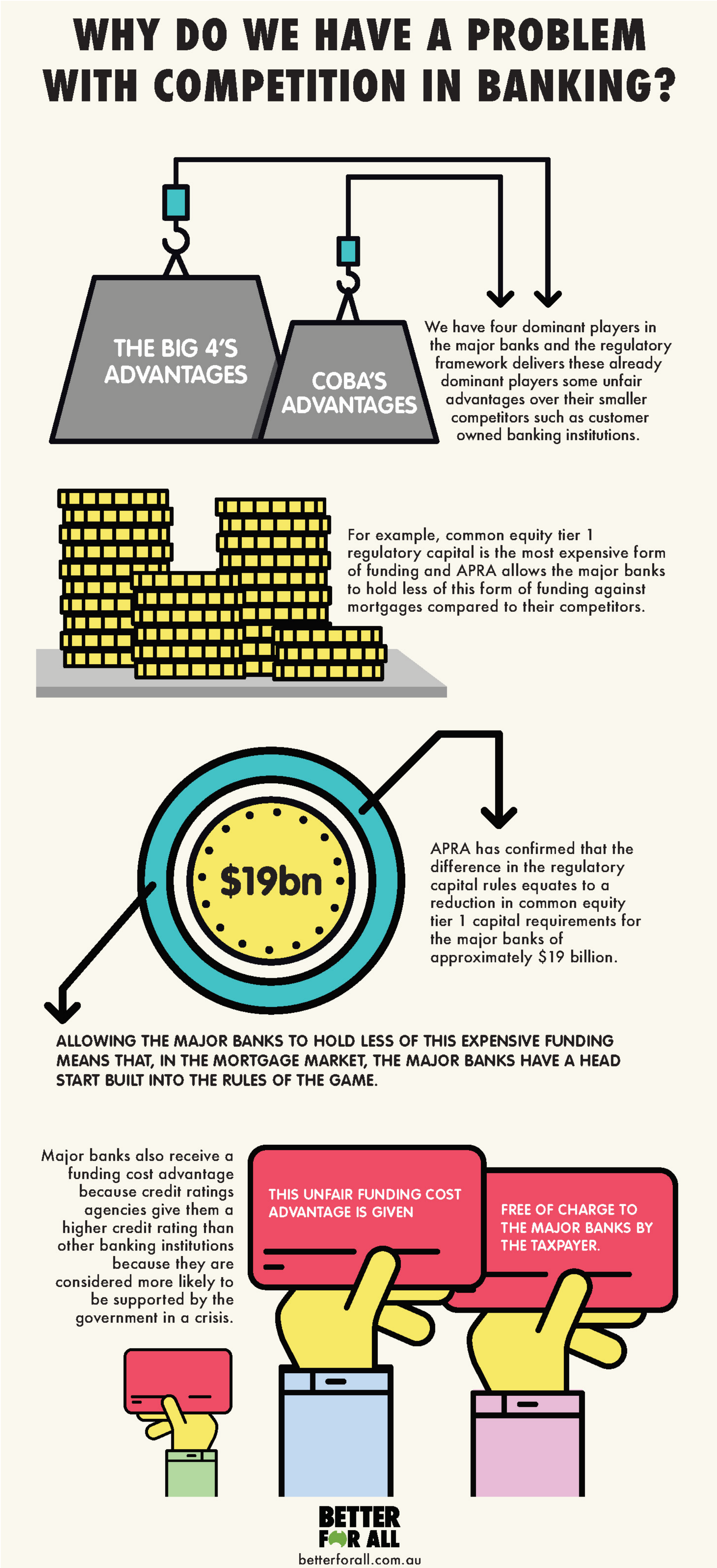
The House of Representatives Committee report[6] on its review of the four major banks, found that:

> "Australia's banking sector is an oligopoly. The major banks have significant market power that they use to protect shareholders from regulatory and market developments. Despite this market concentration, under our current regulatory structure no entity is tasked with regularly making recommendations to improve competition. This must change.

[6] Review of the Four Major Banks (First Report) November 2016

> "Oligopolies are problematic when they are able to use pricing power to the detriment of consumers. Australia's banking system is such an oligopoly. Australia's four major banks have significant pricing power, higher than average returns on equity and large market shares.
>
> "A lack of competition in Australia's banking sector has significant adverse consequences for the Australian economy and consumers. It:
>
> - creates issues around banks being perceived as too-big-to-fail (such as moral hazard);
> - reduces incentives for the major banks to innovate and invest in new infrastructure; and
> - can allow banks to use their pricing power to extract excess profits from consumers."

If there was a truly competitive banking market, consumers would be more likely to vote with their feet in response to poor conduct. Promoting sustainable competition is the only long-term solution to improving outcomes for consumers in banking.


WHY DO WE HAVE A PROBLEM WITH COMPETITION IN BANKING?
THE BIG 4'S ADVANTAGES
COBA'S ADVANTAGES
We have four dominant players in the major banks and the regulatory framework delivers these already dominant players some unfair advantages over their smaller competitors such as customer owned banking institutions.
For example, common equity tier 1 regulatory capital is the most expensive form of funding and APRA allows the major banks to hold less of this form of funding against mortgages compared to their competitors.
$19bn
APRA has confirmed that the difference in the regulatory capital rules equates to a reduction in common equity tier 1 capital requirements for the major banks of approximately $19 billion.
ALLOWING THE MAJOR BANKS TO HOLD LESS OF THIS EXPENSIVE FUNDING MEANS THAT, IN THE MORTGAGE MARKET, THE MAJOR BANKS HAVE A HEAD START BUILT INTO THE RULES OF THE GAME.
Major banks also receive a funding cost advantage because credit ratings agencies give them a higher credit rating than other banking institutions because they are considered more likely to be supported by the government in a crisis.
THIS UNFAIR FUNDING COST ADVANTAGE IS GIVEN
FREE OF CHARGE TO THE MAJOR BANKS BY THE TAXPAYER.
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Measures to promote competition

Bring forward PC review of competition

The Government should bring forward a planned Productivity Commission review of banking competition.

There is an urgent need for well-considered measures to promote competition in banking. In its response to the 2014 Financial System Inquiry (FSI), the Government agreed to implement periodic reviews of competition in the financial sector. The customer owned banking sector is calling for allocation of funding to enable the Productivity Commission to complete the first such review by the end of 2017. The Government's current commitment is to commence, but not complete, such a review in 2017. Given the state of competition in the banking market, we cannot afford to wait.

The Productivity Commission can deliver a prompt, expert review to identify the barriers to a more competitive market and measures to overcome those barriers and deliver a more competitive market.

COBA recently commissioned Deloitte Access Economics (DAE) to assess implementation of key recommendations of the FSI. These recommendations - 1, 2, 3 and 30 - cover regulatory capital and competition. DAE's report[7] highlights that significant work remains on implementing these key recommendations and proposes a draft terms of reference for a Productivity Commission review of competition.

COBA welcomes DAE's suggestion that the Productivity Commission review should consider whether regulators' rules and procedures are creating inappropriate barriers to competition and whether there is appropriate regard to other business models, including the customer owned model.

The DAE report mentions two examples of regulator decision-making affecting competition:

- APRA's approach to regulatory capital instruments for customer-owned banking institutions, and
- APRA's application of the cap on investor lending growth.

The case for an accelerated timetable for the Productivity Commission review of competition in the banking market is underlined by the House Economics Committee's finding that it is "very surprising that no Australian government has completed a wholesale review of competition in the banking sector in recent times."

> "More surprising, however, is that despite the ACCC's clear concerns about the level of banking competition, it has acknowledged not closely monitoring the sector because 'the RBA, APRA and ASIC are...observing the banks.' None of these regulators, however, have a clear mandate to promote competition in the financial sector."[8]

[7] http://www.customerownedbanking.asn.au/media-a-resources/media-release-alerts/1217-banking-reform-report-card-could-do-better
[8] Review of the major banks, First Report, House Economics Committee, Nov 2016 , p23

Why don't consumers switch?

Many Australian consumers are willing to switch home loans but believe the process is too painful, there is too much paperwork and it is not worth the effort.

A national poll of 1000 Australians by *BLACKMARKET Research*[9] commissioned by COBA on what drives competition in the banking market found Australians want competitive home loans, but they're being let down by the switching system. The BLACKMARKET Research found:

- 36% of people say are they are fairly/very likely to change home loans in the next 12 months
- More than one-third of people say they haven't switched because the process is painful
- One in five gave the reason of paperwork or it not being worth the effort for not switching.

We support all stakeholders looking at this issue to see if switching can become more efficient. If consumers want to switch from a major bank to a customer owned banking institution, we find it hard to understand in 2017 exactly how it can take up to three months in some cases.

COBA is also supportive of technological innovation and measures that promote competition. The Productivity Commission's draft report on data availability and use identifies a range of measures to unlock greater competition in the retail banking market to benefit consumers. We have called on the Productivity Commission (PC) to more strongly back the implementation of open APIs in the banking market and mandate comprehensive credit reporting to empower consumers and spark competition and innovation.

Increase capital raising capacity for customer owned banking institutions

APRA should respond positively to the March 2016 Senate Economics Committee recommendation that it set a target date for the outcome of discussions with the co-operative and mutuals sector on issues of capital raising and bring those discussions to a timely conclusion.

Customer owned banking institutions do not have capacity under APRA's prudential standards to directly issue, on a 'going concern' basis, the highest quality capital instruments, i.e. Common Equity Tier 1 (CET1) instruments.

Listed banks regularly issue CET1 capital instruments, and it is important that mutual banks, credit unions and building societies also have the capacity to do so while preserving their mutual model. Having the option to raise capital in addition to retained earnings allows for more ambitious growth targets, diversifies funding options and provides capacity to seize acquisition opportunities and invest in technology and innovation.

Prior to the Basel III changes to the prudential framework implemented in 2012, customer owned banking institutions did have capacity to issue the highest quality capital instruments and did issue such instruments.

APRA's prudential framework has fallen behind comparable jurisdictions, i.e. Europe and the UK, where mutual banking institutions have been given capacity to issue CET1 instruments. Canada is also taking steps to deliver this capacity.

Allowing customer owned banking institutions to directly issue CET1 instruments that are consistent with the mutual model can be achieved by:

[9] http://www.customerownedbanking.asn.au/images/stories/media-releases/2017/20170214%20Blackmarket%20Research%20Banking%20Competition%20and%20Switching.pdf

- removing the current prohibition in APRA's prudential rules on the direct issuance of mutual equity interests (MEIs), and
- modifying the definition of MEIs in APS 111 *Capital Adequacy: Measurement of Capital* to better align with ASIC's Regulatory Guide 147 *Mutuality - Financial institutions.*

APRA is currently engaging positively with our sector on possible amendments to the prudential framework but COBA would appreciate the support of the Committee in encouraging APRA to continue to give this issue due priority.

Change APRA's legislative mandate to increase the focus on competition.

<u>Amend the APRA Act to give the prudential regulator an explicit 'secondary competition objective' and require APRA to report annually against this objective.</u>

APRA's UK counterpart, the Prudential Regulation Authority (PRA) has since March 2014 been subject to a 'secondary competition objective' (SCO). In June 2016, the PRA delivered its first *Annual Competition Report* setting out how it is delivering against its SCO and the steps it is taking to drive more competition and innovation in financial services markets.

The SCO states that:

> "When discharging its general functions in a way that advances its objectives, the PRA must so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities."

The SCO does not make the PRA a front-line competition regulator and there is no reason why effective competition should undermine prudential standards that emphasise the safety and soundness of firms and the stability of the financial system.

APRA has considerable power and discretion as the prudential regulator of banking institutions but it does not give sufficient attention to the impact of its decisions on competition.

Under its current mandate as prudential regulator, APRA "is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia."

APRA interprets its mandate in the following way:

> "It is not our job to set standards for competition, efficiency et cetera, but if we are faced with a policy choice that delivers prudential outcomes, which one is more likely to have a better competition outcome? Or, how can we achieve prudential outcomes, first and foremost, without damaging any of those other considerations."[10]

The state of the banking market indicates that the competition objective ranks too far behind all other objectives.

The FSI found that there needs to be a stronger focus on competition in the financial system and "that there is complacency about competition, and that the current framework does not systematically identify and address competition trade-offs in regulatory settings."

Introducing an explicit SCO and related reporting obligation for APRA will increase this powerful regulator's focus on competition and improve accountability.

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[10] APRA chair Wayne Byres, House Economics Committee Inquiry into APRA annual report, public hearing 14 October 2016

Anti-competitive impact of investor lending cap

APRA introduced a 10 per cent growth cap as a macroprudential measure to reduce investor lending credit growth in December 2014. In applying the cap, APRA said "that investor loan growth materially above this rate will likely result in a supervisory response".

The design of this blunt instrument benefits banks who expanded their investor lending most aggressively before the cap was applied and banks who already had large investor lending portfolios in actual and proportionate terms. It had the effect of freezing market shares and rewarding banks whose behaviour led to the intervention.

Customer-owned banking institutions (COBIs) have a lower proportion of their book as investor loans compared to major banks. Major banks portfolios had 40 per cent of their mortgage books as investor lending compared to only 23 per cent for COBIs.[11] COBIs held investor lending portfolios of around $15 billion at December 2014 compared to over $400 billion for the major banks,[12] highlighting that growth of investor lending by our sector at even a very high rate is unlikely to have a systemically significant impact. In the 6 months after the cap was announced, major banks grew their investor lending books by around 13 per cent while our sector's growth rate was around 7 per cent.[13]

The fact the major banks were so easily able to reprice their investor lending back-books demonstrates that this measure has undermined competition. Smaller banking institutions were prevented from competing for existing borrowers wanting to refinance when hit with higher rates by the major banks. This is despite refinancing not actually increasing the level of investor lending in the system.

The cap has restricted COBIs' ability to run their business and consequently deliver value to their customers. COBIs seeking to grow investor lending books in line with their risk appetite cannot do so. Others have had to turn away valued members from their investor lending products.

The cap is designed as a macroprudential measure and the microprudential problem of poor lending standards has been solved by APRA's action to tighten rules around mortgage lending. Imposing the growth cap on smaller financial institutions with strong lending standards has no impact on macroprudential outcomes but does harm competition.

KPMG's Mutual Industry Review 2016[14] singled out the investor lending cap as a particular external factor in constraining the sector's "rise". KPMG said the cap restricted our sector to a maximum of 1 percent market share of investor lending growth. KPMG said a "graduated approach to the lending growth cap would be fairer and closer to the IMF's goals. This would preserve a level of competitiveness and opportunity for the mutuals, whilst reinforcing sound lending practices."

[11] COBA estimates based on APRA's Monthly Banking Statistics and Quarterly Property Exposures
[12] COBA estimates based on APRA's Monthly Banking Statistics and Quarterly Property Exposures
[13] COBA estimates based on APRA's Monthly Banking Statistics and Quarterly Property Exposures
[14] https://home.kpmg.com/content/dam/kpmg/au/pdf/2016/mutuals-industry-review-2016-report.pdf

Implement the FSI's recommendations on bank capital requirements to increase system resilience and promote competition

APRA should act without further delay to implement the 2014 Financial System Inquiry (FSI) recommendations on bank capital to:

- ensure major banks are 'unquestionably strong'
- further narrow the gap in mortgage risk weights between the major banks and smaller banking institutions, and
- tackle the 'too big to fail' problem.

The Government's 2015 response to the FSI said the bank capital recommendations aim to ensure our financial system remains robust in the face of severe external shocks:

> "The system must be able to maintain its core economic functions in crisis circumstances, including the provision of credit to households and firms. By requiring banks to take greater responsibility for their own resilience, the need for taxpayer-funded bailouts is reduced. The measures reduce the advantages the larger banks have over their smaller counterparts, increasing competition and leading to better outcomes for consumers."

APRA's response to the FSI recommendation on 'unquestionably strong' capital is now overdue, according to the 'end 2016' target date set in the Government's response. APRA did take a welcome 'interim' step on mortgage risk weights by increasing the average mortgage risk for major banks in 2016. However, major banks are still able to apply risk weights of 5% to the lowest risk loans whereas smaller banking institutions have a minimum risk weight of 35%. The difference between 5% and 35% is not merely a gap, it's a chasm.

Major banks also gain an unfair funding cost advantage on their smaller competitors because they are considered 'too big to fail' by investors and ratings agencies and hence obtain a free subsidy from taxpayers. APRA should respond to this unfair advantage by increasing the 'systemic importance' capital surcharge it imposes on major banks from one per cent to at least two per cent.

Competitively neutral tax treatment for customer owned banking institutions

Reduce the unfair burden on customer owned banking institutions stemming from the company tax and GST regimes.

An important principle of competitive neutrality is that competitors should be subject to the same effective tax burden.

Customer owned banking institutions bear a heavier company tax burden than their larger listed bank competitors because the company tax and dividend imputation regimes do not accommodate companies that retain, rather than distribute in the form of dividends, their after-tax profits. Customer owned banking institutions are such companies. Their earnings have an effective rate of 30 per cent while the effective tax rate on major bank earnings is between 22.15 per cent and 25.5 per cent.

A competitively neutral company tax rate for customer owned banking institutions would be around 23 per cent rather than 30 per cent.

A discounted company tax rate of 23.5% for customer-owned banking institutions in the year to September 2016 would have allowed the sector additional retained earnings of around $51 million. As a simple illustration of the impact, assuming a regulatory capital ratio of 10%, an additional $51 million in regulatory capital would have enabled the sector to increase home lending by $1.45 billion. Alternatively, the additional retained earnings could be applied to investment in technology, innovation, customer service or our sector's communities.

Under the GST regime, smaller banking institutions bear a heavier tax burden than major banks because they are more reliant on outsourcing key inputs. This 'self-supply bias' of GST input taxing has long been recognised as a problem by policymakers. The remedy for reducing the anti-competitive impact of GST input taxing on customer owned banking institutions urgently needs amending and updating.

For more information on this, see COBA's January 2017 Pre-Budget submission.[15]

CURRENT REGULATORY REFORM AGENDA

Trust in banking

Clearly, there is currently a problem of trust in banking.

In testimony in late 2016 to the House of Representatives Economics Committee, major bank CEOs conceded that they have:

- let down their customers
- lost touch with their customers
- not treated customers with the respect they deserve, and
- opened up a trust gap with customers.

The House Economics Committee noted that the catalyst for its inquiry "is the seemingly endless spate of scandals within the financial advice arms of the big four banks over recent years [that] have seen tens of thousands of Australians lose money, and have eroded trust in the financial services sector."[16]

The independent review of the Code of Banking Practice[17] says the context for its review "is one in which a series of scandals and failures have called into question the banking industry's bona fides, competence and fairness." The report by independent reviewer Phil Khoury discusses bank "blind spots" that lead to consumer mistrust and lists the following five "trust issues":

- not doing what was promised
- being tricky
- being secretive
- high handedness
- sweeping problems under the rug.

Given this environment, there is a risk of 'whack-a-mole' policy making that ends up increasing the regulatory compliance burden without necessarily improving customer outcomes.

There is already a broad suite of policy action in train to respond to failures of consumer protection.

The pipeline of regulatory reform measures includes:

- Higher standards for financial advisers
- Product intervention power for ASIC
- Design and distribution obligations for product issuers

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[15] http://www.customerownedbanking.asn.au/media-a-resources/submissions-download-submissions-and-sign-up-for-alerts
[16] House of Representatives Economics Committee Report on the review of the four major banks, p.115.
[17] http://cobpreview.crkhoury.com.au/

- Improved ASIC funding and capability
- Review of ASIC's penalties and powers
- Review of external dispute resolution (EDR)
- ABA code review and COBCOP review
- ABA retail banking remuneration review
- ASIC review of mortgage broking
- Improving consumer outcomes with credit cards
- Review of corporate whistleblower protections
- Inquiry into small business lending by Small Business and Family Enterprise Ombudsman

COBA urges the Committee to take into account progress with these initiatives before adding to the list of regulatory compliance measures that banking institutions, large and small, will have to absorb.

COBA is concerned that measures to solve problems created by major banks may reduce the flexibility of COBA members to operate their businesses in the interests of their number one stakeholder: the customer.

For example, we support sensible reforms to improve EDR but we are concerned about unwarranted changes that are not based on evidence.

Increasing the regulatory compliance burden can harm competition because the biggest players have much greater capacity to handle the costs. The fixed costs of regulatory compliance, particularly staff costs, can be spread over a much a larger asset base by the major banks. Higher costs for customer owned banking institutions means they have to shift resources away from customer service, product innovation and competitive pricing.

A much more effective way to improve the behavior of the major banks is to unleash competition and increase the risk that they will lose customers and market share in response to poor conduct.

COBA RECOMMENDATIONS TO COMMITTEE

1. Support the five proposals set out in this submission to promote sustainable competition in retail banking.
2. Exercise caution about adding to the regulatory compliance burden, given the significant pipeline of consumer protection measures already being implemented.

Please do not hesitate to contact Luke Lawler (or or Sally MacKenzie (or if you wish to discuss any aspect of this submission.

Yours sincerely

MARK DEGOTARDI
Chief Executive Officer