

Financial System Inquiry

Recommendations for Government policy and
regulation to recognise and reward
socio-economically responsible behaviour
in the financial system.

March 2014

31 March 2014

Mr David Murray AO
Financial System Inquiry
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Dear Mr Murray,

Bendigo and Adelaide Bank (BEN) is looking forward to working with the Financial System Inquiry (FSI) to help Australia identify the issues and opportunities that will guide the financial sector in facilitating the growth of Australia's national prosperity.

To this end, BEN is participating in three separate submissions to the inquiry:

- firstly, through the attached submission which represents BEN's own thoughts and recommendations on aspects of the financial system we deem to be important for the Australian community;
- secondly, together with other regional banks, we are submitting on the need for a level playing field in domestic banking; and,
- thirdly, at an industry level through the Australian Banker's Association, where more macro issues are discussed.

Whilst the inquiry will look at all facets of Australia's Financial System, BEN has focussed its comments predominantly on the traditional role of banks rather than the more broadly defined sector.

BEN believes a strong financial system is the foundation for a flourishing economy and society. Banks and similar institutions have always played a critical role in economies through facilitating capital distribution, enhancing the creditworthiness of projects that deserve funding by intermediating between those with excess funds and those with opportunities, and facilitating payments, commerce and trade.

The privileged position these institutions are licensed to have within the broader economy carries with it significant responsibility. To fulfil this role adequately, they must demonstrate both market-driven characteristics that support liquidity and growth and more qualitative commitments that ensure security and longer-term economic prosperity. Complementary roles, such as those of the regulators and government, are designed to modulate behaviours and ensure that outcomes serve both the market and the broader national interests. However, it is only when all participants share a common understanding of how the system should build national prosperity that we can hope to meet society's expectations.

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The attached submission encourages the FSI to design a principled framework that will guide all participants in such a way: a framework that provides a reference point for system participants against which they test their behaviour and decisions, whilst also establishing incentive for institutions to provide all individuals and communities with the products and services required to achieve their financial goals.

Under the overarching approach outlined above, the submission also identifies specific action the inquiry can take towards remediating issues currently preventing access to appropriate financial services for all segments of society.

BEN thanks the FSI for the opportunity to submit the ideas outlined and looks forward to discussing these with the FSI at a future time.

Yours sincerely,



Robert Johanson
Chairman, Bendigo and Adelaide Bank



Mike Hirst
Managing Director, Bendigo and Adelaide Bank

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Introduction

A strong financial system is the foundation for a flourishing economy and society. Banks and similar institutions (credit unions, building societies, and the like) have always played a critical role in economies through facilitating capital distribution and growth, and by intermediating the flow of capital between those with excess funds and those with opportunities.

These institutions, both large and small, have a privileged position within the financial system and broader economy that carries with it significant responsibilities. To fulfil this role adequately, they must demonstrate both market-driven characteristics that support liquidity and growth, and more qualitative commitments that ensure security and longer-term economic prosperity. Complementary roles, such as those of the regulators and government, are designed to modulate behaviours and ensure that outcomes serve both the market and the broader national interests.

Since the Global Financial Crisis, when many players and processes within the global financial system either failed or required government support, the spotlight has rightly been turned on the duty of banks to operate judiciously and sustainably. This focus has driven a substantial increase in regulatory requirements, including an emphasis on transparency and reporting, attempting to provide the market with a level of confidence that GFC-like crises are unlikely to recur. The policy settings of government and regulators have underpinned the drive to ensure that the system as a whole is stable and secure.

However, this attempt to redress the balance between short-term market demands and broader economic and social obligation has come at a cost to competition. The smaller industry players already bear proportionately greater regulatory cost and capital burden to support the same business compared to their larger counterparts. The mispricing of the Government's guarantee for wholesale funding, together with the pricing advantage available to "systemically important banks" through the Government's implied support only exacerbates this situation.

An indirect outcome is that the prudential framework effectively drives the allocation of capital to those specific parts of the economy that generate the best short-term returns on a risk-adjusted basis. In effect, this can lead to credit scarcity from time to time in discrete sections of the economy. Aspects of this regulatory onus and government focus thus create unintended consequences that are directly contrary to the best interests of not only the economy, but also the broader society.

The need for the Inquiry

The Financial System Inquiry is a timely opportunity for Australia to review the current state of its financial system, and determine the most appropriate framework for the future. The Inquiry allows the nation to reflect and identify any changes required for the financial system to deliver the benefits, security and growth needed by society.

The financial system is constructed so that banks and other players apply capital to critical sectors of the economy (including consumers, small business, larger business and corporations). It has the power to play a more committed and mutually beneficial role by adding value in the application of these funds, thereby improving commercial outcomes and the health of the economy, while also creating value for the banks' shareholders, their customers and the broader community.

Although the capital markets can service some sections of the population, banks are empowered by the Government to support the domestic agenda of service delivery and growth across all Australian businesses and communities. However, the current financial system does not optimise sustainable economic growth through mutually beneficial engagement with individuals, organisations and the community.

The focus of this submission

This submission focuses on how banking could better serve the community in which it operates. Many of these points are relevant also for other financial system participants, but the predominant focus is the bank-like institutions (for the purposes of this submission, categorised as banks) and their stakeholders.

This Inquiry should introduce incentives for banks to act as enablers of broad national prosperity, rather than simply distribute capital in a way that maximises shareholder returns and maintains regulatory standards. Banks have a privileged position in the economy (so privileged that the Government has both licensed them and guaranteed their depositors) and with this privilege comes obligation and responsibility.

Banks have the capacity and capability to initiate and drive socio-economically beneficial outcomes through innovation, partnership and long-term investment. Based on progress to date, however, this potential will not be realised within the current penalty-oriented structure of regulation and the short-term demands of shareholders and management.

The role of banks within the economy should include financial, economic and social responsibilities, and regulation and government policy should support that role. This approach would encourage banks to generate commercial benefits which accrue not only to the bank and the market, but also to the community in its broadest sense. Further, this approach would enable a range of capability and resource enhancements for communities which creates a more sustainable, productive and resilient national economy.

Overview of recommendations

We believe that the Inquiry should include in its scope the major issue of how Government policy and regulation can recognise and reward socio-economically responsible behaviour within the financial system. Recommendations advanced in this submission include:

- Adopting a more cohesive and principle-driven approach to the financial system, ensuring that all participants are focusing on common outcomes that support national prosperity;
- Better enabling communities, which play such a critical role in building and sustaining local economies, to develop the capability and resources that underpin their sustainability, growth and resilience;
- Creating and supporting innovative solutions to address underserved market demand, and drive improved productivity and inclusion.

In order to optimise the banks' broader role at the centre of the economy and as enablers of equitable wealth creation, the Inquiry should not only review current regulatory and market practice, but also encourage the development of an approach that incentivises institutions to take on this holistic scope. By incentivising banks to build community prosperity, there is the opportunity to encourage a more constructive and cohesive role for banks within the national economy, and move towards an integrated, responsible and sustainable financial system for all Australians.

Recommendations

1. Establish a principles-driven framework for the financial system

Adopting a more cohesive and principle-driven approach to the financial system, ensuring that all participants are focusing on common outcomes that support national prosperity.

The Financial System Inquiry is a broad and rigorous appraisal of the Australian financial community and its stakeholders, and provides an ideal opportunity to establish a common intent for the Australian financial system.

This Inquiry should recommend the development of a set of principles underpinning the conduct of the financial system, to be adopted by all financial system providers and regulators. These principles would be used to guide and test industry codes, regulation and legislation as it is established and updated, and provide a common aspiration and direction for the system as a whole.

Developing a common set of principles will also support the integration of policy and regulatory decision-making, and ensure that the financial system more effectively meets its internal need for regulatory and policy alignment. Constructed appropriately, it will help to ensure that the financial system both protects and enables the socio-economic well-being of all Australians.

The financial system is a fundamental piece of national infrastructure that should benefit all Australians, similar to other socio-economic systems such as health, transport and education. Through this lens, the financial system's performance is only as good as the benefits it delivers to its users, whether they be individuals, communities, businesses or any other organisation.

The Financial System Inquiry is an ideal opportunity to establish a strategic perspective on what the nation wants from its financial system.

Broadening the perspective

The Australian banking sector accounts for more than 30 per cent of the S&P/ASX200 Index (Joye 2013), and the four largest Australian banks hold \$2.2 trillion in assets – nearly half as much again as Australia's Gross Domestic Product (Yeates 2014).

Australian banks have been ranked amongst the most profitable in the developed world, particularly due to increased market share and lending, strong cost management and low impairment charges (KPMG 2013, p. 3). Domestic investors have strongly supported this role of banks as shareholder wealth creators, with recent research showing that local banks account for nearly 60 per cent of direct share portfolios of Australian households. This is unsurprising given the banks' outstanding shareholder performance: shares in the major Australian banks between 2012 and 2013 rose between 47 and 57 per cent, and paid a yield between nine and 11.5 per cent (Chunn 2014).

Banks are not just profit-making businesses, however. They are licensed by the government to play a core role in enabling the effective distribution of capital, nationally and internationally. Economies require finance to flow from those with excess capacity to those with growth opportunities, enabling a return on investment as well as investment-enabled economic growth. Banks are critical facilitators in this process, providing a level of accountability, stability and risk management to transactions that otherwise would be logistically difficult and systemically risky.

Given there are no overarching principles or direction to align sector participants' needs and obligations, the banks' role as a distributor of capital across the economy is shaped by three major external forces: customer demand, market return and regulation. These three drivers shape the range of services and offerings, the operations and the strategic direction of the bank.



Figure 1: Three External Forces

There is no issue with this equation *per se*, except that it assumes that the address of customer demand will always be shaped and supported by regulation and justified by market returns. This assumption does not hold for many segments of customer demand that are underserved by current structures because their profitability and / or risk profile does not generate what are deemed as 'acceptable' shareholder returns.

Economic growth, driven by the market and guided by the regulators, is a major component for the long-term address of economic challenges. But it is not inherently sufficient: economic and social sustainability are contingent on the equitable support and dissemination of growth. An inclusive approach to application of funding and a longer-term timeframe for returns are also critical factors in the success or otherwise of the outcome.

Regulation, as it is currently structured, cannot compel banks to address the full range of customer needs: its natural focus is on risk mitigation rather than building prosperity.

Neither the banks' pursuit of returns nor the regulators' pursuit of stability, either separately or in combination, adequately focuses on the broader aspirations – innovation, productivity, resilience – of the economy and society that they serve.

Market limitations

The market's inability to adequately address national resilience and growth is largely due to its short-termism.

The banking industry is predisposed to short-termism (Brochet *et al.* 2012, p. 2), and the market's quarterly performance requirements means that internally limited capability, priority and capacity are naturally directed by banks to those activities generating the best returns in the shortest time frames. At the same time, there is limited financial motivation for banks to invest in those areas that offer a lower but still sustainable return for risk incurred, but require more attention (cost) or new product development (time) to do so.

When a bank allocates its funds predominantly based on a short-term, profit-driven assessment, it effectively excludes those market opportunities that have longer-term horizons, even where the returns over the longer-term are attractive viewed in net present value terms. This leads to ineffective

investment of capital across the national economy, and substantially limits productivity and sustainability.

ANZ Bank Group Managing Director Mike Smith made the point recently, disgruntled that even superannuation funds, which would appear to enjoy longer-term horizons than most, are struggling with a short-term perspective:

You would expect them... to invest in long-term assets like agriculture. But they are not, because the way it has been set up is that you look at the performance on a quarterly basis.... What is the point of looking at a 30-year asset on a quarterly basis? It's ridiculous but they all do it.

(Quoted in Sprague 2014)

This short-term thinking also substantially limits investment in innovation and entrepreneurship, both of which are so critical to productivity and economic growth. Both innovation and entrepreneurship entail a limited return in the early stages (and often a loss) in order to achieve longer-term pay-offs, and have a higher risk profile than investing in known, stable opportunities that may not generate as much of a premium in the case of success, but can be depended on to fulfil the required short-term return.

National productivity loses in this market-driven approach, as financial system providers become inherently conservative and inward-looking, competing for increasing market share in their short payback sub-set of the true market, rather than exploring and innovating to find new opportunities and build a broader and more sustainable basis for growth.

Further, the disenfranchisement of those opportunities that do not fit the system leads to a growing underclass of financially excluded individuals and businesses. This means good opportunities to generate national wealth go unfunded at a time when Australia's ageing society and other economic pressures demand greater participation.

As long as banks and other private sector financial system providers are predominantly motivated by meeting short-term market expectations, they will naturally resist the call for supporting the longer-term, lower-return initiatives that are required to build sustainable national prosperity. The market's demands for short-term profitability, with its disregard for longer-term socio-economic costs, simply make the proposition financially unattractive.

Regulatory insufficiency

A level of regulation is a prerequisite for a healthy economy and society, but it rarely acts as a driver of productivity, innovation or growth.

In terms of ensuring stability, Australia's regulatory system is undoubtedly one of the better examples internationally (Cornell University *et. al.* 2013, p. 135). Australia's financial system's relative health throughout the GFC is testament to its regulatory competence.

In Australia, regulatory intervention is apparently focused on ensuring that banks manage capital and risk responsibly, in a way that maintains "a stable, efficient and competitive financial system" and protects "the financial well-being of the Australian community" (APRA 2014).

While the first obligation of this regulatory role – stability – is rigorously pursued by the regulator, its approach to efficiency, competition and the financial well-being of Australians is somewhat opaque.

The full issue of regulatory impost, its effects and mitigation are discussed extensively in the two submissions to which Bendigo and Adelaide Bank is already a signatory¹. This discussion will focus exclusively on those aspects of regulation that are particularly relevant to this submission's recommendations.

¹ These are the Australian Bankers' Association submission, and the Regional Banks' submission.

Growth constraint

Consumers bear a substantial cost burden due to the banks' compliance with the ever-changing requirements of the national and international legislation and regulation. This burden is constituted through banks passing on both the capital holding costs and the operating costs associated with that compliance. The implementation of the constant stream of new regulations is possibly the largest impost on banks, and on a unit cost basis, smaller banks incur larger costs.

These costs are significant contributors to the need for increasing efficiency and standardisation across the banks' operations and product sets. Both cost and risk are managed more effectively and efficiently by centralising decision-making, standardised product and services and lower risk profiles. Given that this mitigates the end cost to consumers, this is of itself no bad thing.

However, this centralisation compounds the disadvantage already suffered by customer groups perceived as higher-risk or more peripheral. Those that do not fit with this quantified, centralised decision-making approach and its criteria (e.g. rural and regional areas, small business, financially illiterate consumers) are excluded, because each of these segments require extra time and effort to understand their situation and identify solutions. This more discretionary assessment naturally increases the cost associated with the transaction, and lowers the return.

The combination of the short-term profitability imperative and the costs of compliance are therefore mutually reinforcing in limiting accessibility to financial services by some of the customer segments discussed above. The flow-on effects impact on national economic growth and resilience: a strong Small-Medium Enterprise (SME) sector, sustainable regional areas and widespread innovation are all drivers of national productivity and growth.

It is our belief that the market demand for short-term returns, combined with the regulatory focus on prioritising risk management as its *raison d'être* means the longer-term and broader horizon of sustainable national productivity is being substantially constrained.

Resultant economic gaps

Innovation

Innovation is the development and implementation of new ways of doing things: implicit in innovation is the assumption of risk. As seen, the approach of both banks and regulators inherently discourages innovative risk-taking in its distribution of capital. Innovation may generate profits in the long-term, but from a short-term perspective, entails upfront costs and an increased risk profile, and is therefore less attractive than a more predictable investment.

This inherent risk-aversion and its impact on innovation is particularly evident in the SME segment, where financing is a key enabler. SMEs already struggle with higher financing costs than other parties, and suffer from a lack of appropriate banking services (Australian Chamber of Commerce and Industry 2013, pp. 16-17). On top of this, the centralisation of bank decision-making is inversely correlated with innovation in its SME customers (Alessandrini *et al.* 2010, p. 874), and centralisation is a common feature of providers in the Australian banking system.

Yet SMEs are the most productive economic activity entities, due to their structure, flexibility, payback periods and lower capital intensity (World Intellectual Property Organization 2010, p. 6.). The lack of adequate servicing by providers is to both the SMEs' own detriment and also that of the broader national innovation agenda.

The aged customer segment is another underserved segment with clear needs but inadequate opportunities. Australia's ageing population is a massive demographic that will put unprecedented pressure on government services particularly in health and welfare (Australian Government 2010, p.39), so opportunities to leverage the existing but often illiquid asset base of this demographic will be critical.

Yet there are few financial products genuinely tailored to meet seniors' needs (Productivity Commission 2011b, pp. 95-128), and despite consistent policy recommendations and a clear market demand, innovation from the banking industry and investors is limited.

Innovation is a critical contributor to productivity and growth, and therefore fundamental to economic health and sustainability. However, the current reliance on market and regulatory forces is not sufficient to drive innovation in the financial system.

If you want the financial system to serve the growth of the Australian economy, then it has to facilitate the appropriate taking of risk. It has to facilitate innovation and entrepreneurship, because that is where growth comes from.

(Professor Ian Harper, Deloitte Access Economics, quoted in Liondis 2014)

Participation

Banking is critical to enabling economic participation. Through the delivery of banking and investment services, banks enable other businesses to grow and thrive, increasing their size and expanding the number and range of consumer-workers in the economy.

However, more could be done. The SME sector, for instance, is substantially underserved by the banks due to complexity, risk and resultant cost implications. Yet as of June 2011, SMEs represented almost half of total industry employment, with 4.8 million employees (Department of Industry 2012, p.23), making SMEs a core contributor to economic participation.

Similarly, rural and regional populations are often underserved as banks reduce the size of their branch networks. The departure of local banking undermines community economic infrastructure: businesses are disempowered through the lack of a local banker relationship, trade in the area decreases, and residents struggle to find employment. Yet - despite each of these communities' potential contribution to national participation rates - banks are not incentivised to support their sustainability and growth, because these areas are more costly to service.

Finally, there is a significant subset of the population that is fundamentally disenfranchised from the Australian banking system: nearly three million Australians do not have access to a basic set of enabling banking products (Connolly 2013, p. 10). This level of disenfranchisement has profound impacts from a socio-economic perspective. Without more innovative product development, and a genuine incentive to service less profitable customers, participation rates in the economy cannot be optimised.

From Banking Services to Medical Facilities

Cummins is a South Australian farming community with approximately 700 residents, and another 1,500 in the surrounding districts. When the last bank in the town closed 12 years ago, residents were forced to travel 70 kilometres to Port Lincoln to undertake their banking. It was then that the Cummins community rallied together to partner with Bendigo and Adelaide Bank to form their own **Community Bank®** branch.

This initiative not only delivered local banking services in Cummins, it also gave the community capital to fund new ventures. Cummins District **Community Bank®** branch has contributed more than \$1.2 million to local community projects.

The Cummins District **Community Bank®** branch has also played a pivotal role in restoring access to medical facilities for the community. Within the township, housing for Locum GPs and Registrars was desperately required in order to maintain a local medical service at the hospital and medical clinic.

The **Community Bank®** branch provided \$100,000 towards this project, and assisted the community in securing Federal Government funding of \$100,000. In partnership with the Federal Department of Health and Ageing, the **Community Bank®** branch upgraded the accommodation to ensure the community has continued access to a local GP, and improved opportunities for quality locums and registrars.

Productivity

Productivity is an ongoing issue for the Australian economy. The combined effects of the banks' commercial and the government's regulatory agendas have effectively constrained capital to those areas of the economy that deliver lower-risk, shorter-term returns. Although this approach delivers value to shareholders and some customers, as well as a stable financial system, it constrains innovation, limits participation, and does not address the issue of productivity at a national level.

Australia is facing a range of challenges, including the passing of the resources boom, an ageing population, a declining manufacturing sector, and increased international competition. The financial system should be a key enabler for the nation in meeting these challenges.

This requirement extends beyond improved product development and social inclusion into funding and allocation. Those areas that can support the nation's future in terms of long-term socio-economic sustainability, resilience and growth require focused investment and aligned policies. Banks should be incentivised to support the extension of funding beyond those areas that deliver stability and short-term, reliable returns, to invest in longer-term, more innovative solutions and approaches to help the nation navigate its changing environment.

World Economic Forum Multi-Stakeholder Compact

The World Economic Forum has recognised the gap between regulation and commercial incentives within the financial system, and has moved to address the disparity at the international level by capturing a collective view of the financial system's obligation to society. It has done this through specifying the social needs of the financial system, and then breaking these into required financial system activities, together with indicators of success, so that all participants can recognise both their rights and obligations within the system (World Economic Forum 2013).

The framework lists nine societal needs which the whole of the financial system should fulfil:

1. Promote financial and economic resilience
2. Safeguard savings and the integrity of financial contracts
3. Facilitate efficient allocation of capital to support economic growth
4. Provide broad access to financial services products and services
5. Enable smoothing of cash flows and consumption over time
6. Enable payments
7. Provide financial protection, risk transfer and diversification
8. Collect, analyse and distribute information for better economic decision-making
9. Provide effective markets

These principles are then used to inform the participating financial institutions (regulatory and corporate) in their decision-making and approach, and provide a level of international consistency, alignment and direction to that decision-making.

The need for a framework

Neither banks, nor the broader financial system, should be held solely accountable for the social and economic prosperity of the nation. However, given the critical position of banking and the financial system in enabling prosperity, there is opportunity for improvement in the roles they play.

The financial system is a complex network of providers and regulators with different needs and agendas to progress. However, beyond all of these participants and their specific needs is the requirement of the Australian economy for the financial system to operate in a way that serves the interests of the nation. At the macro-level, these interests incorporate financial stability, international credibility and effective capital distribution. They also encompass the broader socio-economic indicators that actively support and drive growth and prosperity, rather than simply managing risk and return.

This raises a fundamental question for the Inquiry: given the financial system's criticality to Australia, how does it best serve Australia's national social and economic interests?

A Stakeholder Compact?

Australia's financial system needs to be able to adapt and thrive in a future buffeted by unpredictable variables: an ever-diminishing resource boom, continued productivity issues, an ageing population, increasing socio-economic disenfranchisement, superannuation growth, and turbulent international markets.

Regardless of the difficult environment, however, it is imperative that the financial system underpins and enables Australia's broader societal and economic requirements. In doing so, there should be a common understanding from all financial system participants of how to best meet these needs. An overarching direction is required, to sit above regulatory restrictions and the market's commercial reward structure, and provide a unifying approach.

To this point, the Inquiry should consider providing a framework to guide all system participants, including end users, on how the national interest may best be served.

This common set of principles could be used to test and align business decisions, legislation and regulation across the financial system.

The value of shared principles

The lack of a shared perspective on Australia's ideal financial system creates difficulty in aligning and integrating regulatory activity. Other submissions to this Inquiry (e.g. ABA, Regional Banks) attest to the lack of cohesive and integrated decision-making borne by the various financial participants, and the resultant cost and efficiencies generated from this lack of unity.

Without the need for sustainable growth, constructive competition, genuine accessibility and productivity improvement at the forefront of their thinking, regulators are less likely to consider the full impact of their decision-making and activities. They are effectively working from the premise that stability is by definition the sole interest of the nation.

Banks in turn are driven predominantly by a market that has little concern for returns beyond a regular and growing dividend, and an attention span that is limited by short-term performance requirements. This affects their capacity and interest levels for supporting those customer segments that are higher-risk, geographically disadvantaged or financially disenfranchised, perpetuating a cycle that lowers innovation, reduces productivity and limits sustainable socio-economic growth.

Thus regulators and other financial system participants have limited impetus to consider national growth and sustainability in their own decision-making, or more broadly, in the direction, coordination and integration amongst themselves.

Sample principles

The Financial System Inquiry represents a unique opportunity for Australia to determine and explicitly capture the principles by which it expects the financial system to serve society. This challenge is critical to the more effective and positive implementation of regulatory requirements, and also to the establishment of common priorities and shared commitment across participating financial providers.

The introduction of a principles-driven framework, directing the financial system to best serve the interests of the community in which it operates, could deliver an alignment of regulation and a clarity of purpose across the entire system, while also encouraging financial system participants to consider their roles more holistically and in light of the broader national aspirations.

The Australian Bankers' Association submission to the Inquiry already speaks to the key characteristics of a healthy financial system, such as stability, resilience, safety, competition, innovation, diversity, efficiency, inclusion and profitability. In addition to those characteristics that meet the banks' own criteria for health, agreement should be reached on the *purpose* of the banks, and indeed the financial system as a whole, and their obligation to the broader society.

Such a framework might commit the financial system to, for instance:

- **Sustainability** – enabling the development and implementation of long-term thinking that generates positive economic and social outcomes;
- **Accessibility** - ensuring that all the economy's participants have the ability to constructively engage with solutions that empower them as participants in the financial system²;
- **Fairness** – requiring that all parties trade fairly, sharing information in a way that protects the rights and entitlements of the parties transacting, and supporting the economic marketplace;
- **Equity** – structuring financial transactions to allocate reward in proportion to contribution
- **Integration** – committing government and regulatory bodies to work together in adapting and co-developing their approach to drive the targeted outcomes for the system as a whole.

These principles, along with most of those identified in the ABA submission, would sit above the individual agendas of the banks, the regulators and other financial system participants. The framework intent is not to prescribe the means by which these various parties pursue their agendas, but to ensure a common rationale for decision-making and prioritisation that ensures the financial system serves its constituency rather than simply itself.

These principles could be integrated into the mandates and permissions required to act as part of Australia's financial system, so that all providers and regulators are committed by virtue of their participation in the system. The framework would inform, assess and prioritise changes to the system to create systemic integrity and ensure the system's alignment to longer-term national interests.

Summary

The regulatory bodies for the financial system have critical roles that must be played in order to protect the economic and financial stability of the nation. However, their agendas are pursued within the limited context of risk mitigation. Meanwhile, the providers' focus is predominantly centred on competing for market share and delivering short-term profits to their shareholders.

A healthy, functioning financial system is critical to Australia's economic well-being, and banks and other providers hold a unique position of trust and community dependency within this system. A framework uniting all stakeholders in a common commitment to deliver the most appropriate financial system for Australia could lead to more productive approaches to the market, and ensure improved consideration by financial system providers of the key issues that underpin national prosperity.

This Inquiry should endorse the development of an overarching direction and principle-driven commitment for the financial system that will underwrite the socio-economic prosperity of Australia.

² NB "Accessibility" here includes all characteristics that enable usage – from physical proximity to financial literacy to acceptable price points.

2. Empower communities to become self-sustaining, prosperous and resilient

Better enable local communities, which play such a critical role in generating prosperity, to develop the capability and resources that underpin their own sustainability, growth and resilience.

Robust and self-sustaining communities are critical in the development of a prosperous, productive and resilient national economy. However, current government and financial system structures could do more to provide the incentives and support to enable communities to develop the required strategy, capabilities and investments to ensure they are sustainable.

To create self-reliance, rather than a dependency on hand-outs, these structures need to move beyond a benefactor-recipient relationship, to a genuine partnership which benefits all stakeholders. This requires a shift in approach from both the traditional 'benefactors' (i.e. government, private sector providers) and the 'recipients' (communities).

Although the various financial system participants have the capacity and skills to support communities in becoming more socio-economically sustainable, the existing financial system does not promote this behaviour. With the market largely rewarding short-term, higher-return initiatives, and regulators focused on minimising risk, there is limited incentive for providers to invest in building local capability.

The Inquiry should recommend that the following actions are taken to provide appropriate incentives for the Government, banks and other financial system stakeholders to work together in supporting communities through:

- a) Establishing functional protocols between government and local communities, to support long-term community-Government partnerships and funding;
- b) Introducing a tax incentive to promote Community Investments that facilitate economic growth and sustainability within communities;
- c) Developing partnerships between Government and community for the establishment of multi-service community hubs.

A genuine review of the financial system should be pursued not only from the perspective of those service providers in the system, but also from the perspective of the community in which it operates, and whose interests it should serve. This is not a charitable pursuit: the focus on shared value creation is still well within the bounds of capitalism. Shared value creation has been described as "self-interested behaviour to create economic value by creating societal value", and "the next stage in our understanding of markets, competition and business management" (Porter & Kramer 2011, p.17).

In the financial system, it makes sense for banks and for the broader financial system to support the society in which they operate, and from which they prosper and grow. The economy requires a financial system that supports communities nationally as a core source of economic prosperity, sustainability and growth.

The criticality of communities

The economic and social health of a nation's communities are "the building blocks of a true national prosperity" (Business Council of Australia 2010, p. 26). Although the economy is more frequently discussed in terms of industries and sectors, it is through the localised communities of the nation, and their members' participation in the workforce and broader social network, that the economy as a whole operates.

To enable economic growth and sustainability, these communities themselves need to be sustainable and empowered to actively participate in the maintenance and growth of their local economies.

From a community perspective, economic growth and social prosperity are too closely intertwined to segregate and pursue one at the expense of the other. Economic resources are clearly critical for growth, including access to equity capital and credit, as well as human capital and expertise. When combined and directed with and for the community, these resources address both social and economic requirements.

Community-Led Disaster Recovery

In January 2014, bushfires in the Perth Hills devastated the area surrounding Mundaring, a West Australian shire with a population of 40,000. The ravaged community was in urgent need of a recovery effort.

The Mundaring **Community Bank**[®] branch donated over \$30,000, including contribution to an appeal made in conjunction with the Salvation Army, and established a Community Trust in conjunction with the Community Enterprise Foundation to provide immediate assistance in disaster events and also channel funding relief from government and other sources. Joint efforts to date have raised over \$400,000.

Funding has been used to assist small businesses to re-establish, structure de-briefing for the fire-fighters and cater events for residents to engage, de-brief, plan and mobilise.

The **Community Bank**[®] branch connected members of the community, helping to organise a number of community forums to solve immediate problems and also plan for future events. It also offered its corporate office to the Salvation Army as a counselling location.

Through establishing internal community networks and enabling residents to identify issues and generate their own solutions, the Mundaring community is able to sustain residents and businesses affected by the disaster and accelerate economic and social recovery.

A strong local economy is a foundation for a resilient community. Resources, diversity, leadership, networks, learning and innovation and infrastructure are all elements of a resilient economy as well as a resilient community.

(Australian Social Inclusion Board 2009)

Community resilience is at the heart of sustainable socio-economic prosperity, because it is the means by which communities are able to weather change and crisis. It is enabled by both economic development and social capital, and enables the community to "adapt to pressures and transform itself in a way which makes it more sustainable in the future" (*ibid.*).

Resilient communities serve the national economy in terms of increased productivity, increased innovation, minimised welfare dependency, and improved growth prospects. It is therefore in the interests of both the Government and the financial system to support the development of economically and socially healthy and resilient communities.

The importance of local banking

Banking – access to finance and capital – is a particularly core contributor to the economic health of a local community. A comparison of communities with different levels of local finance support shows that the difference between the highest performer and the lowest performers are substantial. The community best-served by local finance, compared to the worst-served in the group, demonstrated:

- Up to a 5.6 per cent increase in the odds of an individual starting a business
- A decrease of up to five years in the average age of a business founder on starting the business
- Up to a 25 per cent increase in the ratio of new firms to population
- Up to 17 per cent higher number of existing firms by population
- Per capita GDP growing at up to 1.2 per cent more per annum (Guiso *et al.* 2004, p. 930).

Local banking enables a compounding mix of local capital retention, SME growth and innovation, and value creation in rural and regional areas, all of which are important in delivering a resilient and sustainable national economy.

Capital retention

Locally-controlled sources of finance and capital effectively empower a community by building geographically proximate enterprise and employment opportunities. This local finance is particularly important given that the increasing centralisation of the financial system, accompanied and compounded by increasingly centralised business growth, has ensured that capital and its benefits tend to be both invested and realised in the major metropolitan areas.

This trend works to the detriment of rural and regional areas: savings flow overwhelmingly into the major banks, shares vest predominantly in metropolitan businesses, superannuation payments vest in funds situated in the larger cities. To exacerbate matters, banks are generally inclined to invest their money in opportunities physically proximate to their own situation, so the funds tend not to flow back (Guiso *et al.* 2004, pp. 966-968). Without local opportunities for investment, regions become increasingly capital-starved and unable to direct their funds into their own growth.

Local financial development helps to retain local capital. The neighbourhood bank is comprised of locals' deposits, and loans to individuals and businesses based in the community. Their accounts and transactions drive profit, and where the bank is owned by members of the community, this profit creates dividends for local shareholders as well as specific investment in local community needs.

As shown in the range of case studies provided, this community investment often also attracts third party investment into the local initiative, from government, not-for-profit and private sector partners, increasing the flow of capital into the community. The community assets then generate outcomes that build local prosperity, which drives an increase in savings and loans, and feeds into the virtuous cycle of local capital retention.

The Community Bank® Model

The Bendigo and Adelaide Bank's (BEN's) **Community Bank®** model was introduced in 1998, based on the bank's long-held conviction that "Successful customers and a successful community make a successful bank – in that order".

The Bank works with local communities that self-nominate for a **Community Bank®** branch, helping them to raise capital and secure local commitment.

These branches are community-owned and operated, and BEN provides the banking license, full range of banking products, depositor protection, staff training and ongoing support. Each Branch also has a Board independent of BEN, with local volunteer Directors responsible for running the Branch and distributing its profits.

Once profitable, the Branch reinvests in the community through shareholders' dividends (capped at 20 per cent) and local community investments.

The **Community Bank®** model supports participating communities by providing local financial services, local employment opportunities, local investment opportunities for local shareholders, local capital retention, and local funding for community improvement.

There are currently over 300 **Community Bank®** branches in metropolitan, regional, rural and remote areas across Australia, generating profits that have contributed over \$120m in funding for their local communities.

Small business

The local banking service is particularly important for SMEs, which contribute 57 per cent of private sector economic activity and 70 per cent of private sector employment (Department of Industry 2012, p.20-23). As such, they are critical to the broader economic health of the nation.

However, these businesses are paying more for debt, on average, than either larger businesses or households, and also carry more of the increase in costs across lending and product fees (Matic *et al.* 2012, pp. 17-18). Part of this premium is due to SMEs' risk profile – they are often considered risky to finance, given that the information required for a quantitative credit assessment is so difficult to source (*ibid.*, p. 18; Alessandrini *et al.* 2010, pp.848-849).

Credit to small businesses is traditionally based on sufficient collateral, a good credit history and dependable cash flow. However, small businesses often struggle with this approach to credit assessment, as particularly in the early stages of development they may have limited collateral, an inadequate credit history (due, for instance, to internal financing) and poorly-documented or irregular cash flow.

**Deloitte Access Economics:
Community Strengthening Index Findings for the
Community Bank® Model**

During 2011 and 2012, Deloitte Access Economics analysed the community level impacts associated with the community investments made through the Bendigo and Adelaide **Community Bank®** model.

30 diverse investments across six communities throughout Australia were analysed.

There were consistently recurring themes across the investments. **Specific needs** vary across communities, but investing in particular areas of need for each community ensures greatest value for the community. In other words, what is good for one community is not necessarily good for another.

Local economic flow-on contributions are maximised when the investment contributes to demand for goods and services that the local community supplies.

Social benefits included community pride and participation, enhanced volunteerism, human capital development, wellbeing and networking - both within and between organisations.

Environmental impacts associated with the investments are predominantly in enhanced urban amenity.

The value of some investments cannot be captured by standard economic assessment tools. Examples include investments in schools, hospitals and sporting clubs, where assets provide a core rationale for people to select a particular community as their home, and where the assets' absence would diminish the community.

Often it is the smaller and more isolated communities that benefit the most from the **Community Bank®** investments. These communities tend to have a less diversified economic base, and are more vulnerable to socioeconomic decline in the absence of targeted investments of the sort made by the **Community Bank®** model.

Based on the findings from the Community Strengthening Index work, it is likely that much more than the direct investment value (approximately \$120 million over 65,000 unique investments as of December 2013) has been injected in communities of Australia. The value of these benefits is even higher if social impacts are included alongside the economic ones.

Well over half of this value delivery has been in small towns and regional centres across Australia, where even the smaller investments by the bank can represent proportionally large beneficial shocks to the local economy.

While these proxy metrics of collateral, credit history and cash flow undoubtedly represent some key indicators of a business's credit-worthiness, their lack is not necessarily an indication of any individual business's inherent risk profile. However, the more qualitative attributes that would demonstrate this worthiness are only visible to those in immediate proximity to the business and its owner-operators. The strength of a local relationship-banking approach is such that SMEs are quantitatively benefited by not only the length of their personal banking relationship with their banker (Han *et al.* 2012, pp. 62-63), but also by proximity of the banking decision-maker to their location of business.

It is the loan officer who has personal contacts with the borrower, lives in the same community, knows people and firms who do business with the latter, shares a common set of cultural values, social norms and business language. It is their effort to combine hard with soft information on which the ability to select worthy projects depends.

(Alessandrini *et al.* 2010, p.846.)

SMEs' dependency on this more qualitative approach to credit assessment means that the formulaic response to small business lending is largely ineffective. A more quantitative, automated approach cannot do justice to their situation, yet this is increasingly faced by SMEs as the physical branch networks constrict.

Local banking services are thus particularly critical to the initiation, growth, innovation and sustainability of SMEs. The lack of local banking services has been demonstrated to limit provision of funds, restrict SME start-ups, and constrain local economic growth (Guiso *et al.* 2004, pp.929-30).

Rural and regional areas

The increasing standardisation of products and services, and the ongoing centralisation of bank decision-making, has a profound impact on rural and regional areas. Similarly to the SMEs, local borrowers and depositors suffer when local banking is physically withdrawn from their area, given the lack of personal exposure to branch decision-makers; and essentially the same effect is created when decision-making is automated away from the local branch and centralised to head office metrics and standards.

Further, rural and regional areas are more economically dependent on the health of small business, as it is these firms that comprise the bulk of the local economy, where larger firms tend to gravitate to metropolitan hubs. Thus when banks centralise decision-making and SMEs have their finance limited, the impact compounds throughout the local community as business growth is curtailed.

The actual departure of a local bank has a material impact not only on funding for individuals and businesses, but also the broader economic stability and sustainability of the community. The loss of a local bank has been calculated as representing an economic impact of between three to seven per cent of the local economy's output, calculated across the retail, health and employment sectors (Kryger 2002, p.23)

These flow-on benefits of local banking in regional and rural communities are central in generating national socio-economic stability, particularly through driving productivity and building resilience. Local financial development has been shown to be critical to supporting business start-ups and the promotion of growth, and the lack thereof can have a material effect on the economic viability of an entire region (Guiso *et al.* 2004, p.968).

Although it is tempting to see only productivity gains from the increasing centralisation and automation of banking services – both at the customer interface and in-house – the truth is substantially more complex. As banks pursue centralisation, they effectively constrain the potential for growth in regional areas, through implicit discrimination against local borrowers, a lack of support for innovation and small businesses, and the ongoing drain of regional capital to city centres.

Building Economic Development

The Nathalia **Community Bank**[®] branch in Victoria launched in May 2000 and became profitable within a year. By mid-2013 it had contributed over \$2m in community investments and the Board turned its attention to a longer term development strategy for Nathalia. Several shops had recently closed, the area was losing its previous appeal as a tourist attraction, and the government forestry services provider was moving out due to lack of office facilities.

Seeing the opportunity to retain local services and jobs, the Nathalia **Community Bank**[®] provided funding of \$650,000 for construction of the Parks Victoria Office Complex. Parks Victoria also participated by contributing fixtures and fittings to the value of \$120,000.

The complex was constructed using local tradespeople, providing employment opportunities for local residents and retaining capital in the community. In November 2006, the tenants moved in to their new offices on a 15 year lease, ensuring retention of the local forestry management service in Nathalia, together with sixteen jobs. The rental income from the project has flowed back into the community through the **Community Bank**[®] branch's local grants and sponsorships program.

In October 2013, the branch sold the building with a view to moving profits into funding for further community projects. The complex remains a valuable asset for the town, as it is used as the regional fire control centre in the event of an emergency.

The community is now working on ideas to generate development of commercial/light industrial land within the area.

Growing prosperity

Local banking relationships are critical because they enable SME credit at the micro-level, and because every new, community-owned business established in an area delivers direct benefit to the local community. Each new business offers the community access to its specific products or services, and also new employment opportunities to staff the business, local investment opportunities to capitalise the business and returns to the local shareholders of the business.

Recreation and Community Benefit

The Gin Gin **Community Bank**[®] Branch was established in 2007 to service one of the poorer communities in remote Queensland, which due to a council amalgamation often struggles for local government funding.

Tragically, the town was impacted by several child drowning deaths in recent years. The community needed a venue to be able to foster water confidence and safety for young children, but the Gin Gin Pool complex needed urgent repairs and was not a council priority.

After many negotiations, and funding issues, the **Community Bank**[®] Board succeeded in confirming council and Sports and Recreation investment of \$30,000, to which it added \$48,000 from the Gin Gin **Community Bank**[®] profits.

Since project completion, attendances to the pool increased from 10-20 per day to 150-190 per day, with many families travelling to the area from larger towns such as Bundaberg and Childers. The pool has two full-time employees, but the increase in attendances has meant that an additional part-time employee is needed for busy days. The Learn to Swim programs enable young children in the area to develop skills and familiarity with water to assist in preventing local drowning.

In a small town with limited services, the Gin Gin pool has been vital for community confidence and remains the only low-cost activity for families in the area.

Community investments generally have 'flow-on economic contribution' (also known as 'indirect economic value added') in terms of the impacts that result from their direct benefits (Deloitte Access Economics 2012, p.2, 86-88).

Local economic flow-on contribution is naturally maximised when the investment draws on goods and services supplied by the local community. There are also other less tangible but no less critical benefits that are realised.

For instance, a new recreational facility may draw new visitors to the town, who not only support the investment through their custom, but also generate other business as they eat, stay or shop locally. In aggregate and over the longer term and multiple investments, this new custom may be sufficient to warrant the establishment of other new small firms to meet an increased demand for services.

Thus the establishment of local banking services has multiple and iterative flow-on effects for a community: it makes banking services locally available, enables funding for community businesses, generates employment and community investments, and all these in turn create their own virtuous cycles of economic growth and increasing community participation.

Summary

A community-based, micro-economic model creates macro-economic resilience and sustainability. When value generation is dispersed across communities nationally, sustainable growth is much more likely than when value generation is centralised, whether it be in geographies, organisations or sectors. When each community has the capability and capacity to maintain its own economic health, the risk to national prosperity is dispersed across the multitude, rather than concentrated in the few.

The financial system generally, and banks particularly, have a key role to play in enabling communities to build the capability and resources to proactively manage and transform in response to challenges. This community empowerment creates genuine grass-roots resilience, where communities develop their own skills, relationships and competencies to enable them to work together with the bank and their other stakeholders to face the inevitable crises, mobilise themselves and develop their own solutions.

Without question, this approach to banking is still founded in shared commercial success: banks and their shareholder interests are naturally served by economic improvements in any and all communities, as these benefit the bank directly in the increased volume of transactions and more prosperous customers. Equally, communities benefit from new businesses driving economic activity locally.

The concern, however, is that as more decisions are made at the centre, creditworthy opportunities that can make an invaluable contribution to local prosperity will be left unfunded for lack of local knowledge.

In order to further empower communities, and support funding for local opportunities, the Inquiry should make the following recommendations.

Stabilise the Government interface

Establishing funding and functional protocols between government and local communities to support long-term community-government-private sector commercial partnerships for delivering banking to underserved communities.

Communities and their constituents are best placed to identify their specific financial and social needs. A long-term investment that empowers local communities, through the provision of local banking services and growing local capability, will significantly improve the efficiency and quality of economic outcomes and stimulate economic growth within each community.

Given the ambition and commitment entailed in these investments and the social needs that they are aiming to meet, they are ideal candidates for government funding, but often the communities' engagement with government is a complex and challenging process.

Major community projects are long-term commitments, often spanning several years from inception through capital raising and project planning to delivery. During this time, the political environment can change substantially, with each successive party marking its imperative by restructuring, reappraising and refunding the structure and functions of the regional interface.

The recurring disruption makes it difficult for communities to work together with government at any level in a consistent fashion, and particularly in pursuit of those longer-term strategic initiatives that are required to build local prosperity.

While acknowledging that the funding of local initiatives will always be subject to some extent to political preferences, creating inherent stability within the structure and interface of government and communities would substantially enhance communities' ability to drive productivity and growth through government and private sector partnerships.

The Inquiry should call on Government to establish a long-term, stable structure for the community-government interface, to facilitate the funding and support for local banking, and recognise communities' efforts in the development of economic prosperity.

The Community Bank® model: From Inception to Maturity

As Community Bank® branches and their Boards mature, they have been observed to evolve in terms of roles and approach:

1. **Sponsor:** the Community Bank® branch makes its first profit for re-investment, and tends to sponsor local clubs/events, with minimal Board proactivity.
2. **Supporter:** the Board establishes a systematic grants process, and may begin proactive engagement with potential community needs, although is primarily reactive.
3. **Consulter:** the Board begins to proactively identify project / support opportunities via self-initiated conversations with community
4. **Funder:** as profits grow, the Board begins to contribute larger dollar amounts to community projects, usually with leveraged outcomes involving other third parties (e.g. local government), some identified proactively
5. **Partner:** the Board forms an ongoing relationship with a range of community bodies (e.g. local government and not-for-profits), and starts to develop forward commitment on project funding. Active ongoing future-focused conversations.
6. **Coordinator:** the Board becomes actively involved in identifying and funding projects, as well as establishing and managing third party engagement.
7. **Planner:** the Board assumes an ongoing and vital role in identifying and building plans for the future of their community. Relationships with government are closely aligned, and the Board has input to formal planning structures.
8. **Driver:** the Board is a vital part of future discussions and plans on community. It initiates much of the community activity and is well-connected at all levels (community, local and state government) (McKinlay *et al.* 2012, p. 28)

Together with this role evolution is an increased maturity in thinking around community requirements, a shift from meeting existing tactical 'needs' to "the next level of seeking to determine what are the critical issues facing the community as a whole: an ageing population, youth crime, road safety, etc." (*ibid.*, p. 43).

Incentivise community investment

Introducing a tax incentives for community investments that generate/facilitate economic growth and sustainability within communities.

The ATO and AusIndustry jointly operate an R&D tax incentive, to “encourage more companies to engage in research and development”, and thereby

- Boost competitiveness and improve productivity across the Australian economy
- Encourage industry to conduct R&D that may not otherwise have been conducted
- Provide business with more predictable, less complex support
- Improve the incentive for smaller firms to engage in R&D (Australian Taxation Office 2012).

Given the substantial economic benefits that flow from well-managed and genuine community investments, those private sector investments that meet pre-established criteria of community need, benefit, ownership and community co-investment should be subject to a similarly structured Community Investment Tax Incentive.

The Community Investment Tax Incentive would have the objectives of:

- Improving productivity and socio-economic resilience across the Australian economy;
- Encouraging private sector co-investment in community-based growth opportunities that might not otherwise be funded;
- Providing communities with less complex support for their investments; and
- Improving the incentive for investors to engage in community-building activities

Deloitte Access Economics: The potential for the Community Strengthening Index

The Community Strengthening Index tool used by the Bank allows for the user to input a range of required information on each investment, and the tool then estimates the economic, social and environmental benefits to the community where the investment occurs. The tool can be used in advance of the investment as a decision making tool (to optimise the scale and type of investment in a community), and retrospectively to assess benefits after the investment has occurred.

Aside from direct usage by the **Community Bank**® branches and their Boards, the Community Strengthening Index tool enables the Bank to

- Track, record, categorise and report on the community investments
- Assess the effectiveness of community investments, and produce more comprehensive reporting for internal use and partners
- Enhance working relationships across all levels of government through greater access to collective data
- Create a data set and sample of social and environmental outcomes that currently have no universally accepted unit of measurement.

As such, the Index represents a Bank investment that builds capability both for the **Community Bank**® branches and the Bank itself.

Measurement

The Community Strengthening Index (CSI) has created an independently tested and verified suite of metrics to measure socio-economic performance and impact for community investments. High-rating investments under this Index generate genuine economic growth for the communities in which they are implemented, and as such, support the prosperity and resilience of those communities.

This suite of tried and tested metrics could be used in conjunction with other known attributes of successful community investments (e.g. community co-investment, community ownership, etc.) to rigorously scope proposed investments to ensure targeting of national socio-economic outcomes through local level design and implementation.

The adoption of a Community Investment Tax Incentive for Community Investments that rate highly on the CSI would encourage external parties and communities to invest locally, driving long-term and sustainable benefits from both the regional and national economic perspective.

Rationale

It has been well-established over the course of this submission that local banking capability delivers substantial and ongoing socio-economic advantage to the community, as well as flow-on effects to the broader economy.

Where this banking capability is established as a result of community investment - specifically for the purpose of community sustainability – and clearly delivers on that purpose, the vehicle used should qualify for the above tax concession.

The Wentworth Federal Court Ruling³ established that banking institutions established for community service purposes were income tax exempt, as long as they did not have any shareholders to whom they were paying dividends or capital. This is the legal situation with the Wentworth **Community Bank**[®] as it operates under a company limited by guarantee structure, which is typically prohibited from paying dividends or capital to members.

Wentworth is still to all intents and purposes owned by community members: but they are strictly speaking creditors of the bank, who provided loans to the bank at its inception in order to establish its start-up capital. These members are paid interest by the bank as the return on that loan.

The vast majority of community-owned banks do not utilise this structure, and it is an approach that is costly, counter-intuitive and time-consuming to implement retrospectively. Nevertheless, all other community-owned banks are established specifically for the service of their local community, and although shareholders may be paid dividends, these are explicitly capped at a minority of profits. All other profits are either retained by the company for future development, or reinvested in the local community.

Despite the fact that community-owned banks therefore demonstrate in substance, if not in form, the same commitment to community service as those banks modelled on the Wentworth structure, the ATO in 2012 delivered a ruling that community-owned banks with community shareholders are not eligible for income tax exemption.

Wentworth Community Bank[®] Income Tax Exemption

In 2011, the Federal Court ruled that the Wentworth District Capital Limited Company (Owner of Wentworth **Community Bank**[®] branch) was income tax exempt. This ruling was based on the following interpretation:

The entity was established for community service purposes (in this case, the provision of local banking services, particularly as other banking service providers had left the area).

Given that Wentworth operates under a company limited by guarantee structure, it was argued that the entity was not carried on for the purpose or gain of individual members (a company limited by guarantee is typically prohibited from paying dividends or capital to members).

Wentworth's structure is the same as only four other community-owned and operated branches in the Bendigo and Adelaide Bank **Community Bank**[®] network. All other **Community Bank**[®] branches are companies limited by shares, with their local community members constituting the shareholders. Companies limited by shares can pay some dividends or capital to shareholders in limited circumstances, and it is this distinction that handicaps the argument for tax exemption for the majority of **Community Bank**[®] branches.

However, all **Community Bank**[®] branches are clearly established specifically for community service purposes, and this community service is the main or dominant purpose of establishment. The provision of local banking services is a practical and tangible help to the community, and is "provided for a reward" only to the extent that those profits flow back into the community.

³ The details of the ruling are available at <http://www.ato.gov.au/rba/content/?ffi=/misc/rba/content/1012517832210.htm>; see also Perram J., [2011] FCAFC 42 at paragraph 40; [2010] FCA 862 at paragraph 63.

Winning community business

The Collie **Community Bank**[®] branch was established in 2001, and profitable by 2006. To date it has invested more than \$2.5 million in the Collie community.

At first, profits were used to fund sporting clubs and community groups for events and activities across Collie, but by 2007, the Collie **Community Bank**[®] Board was looking to leverage funds through building relationships with local, state and federal government. The Board has since undertaken many projects in partnership with private and public sector agencies, including:

- Establishing a \$100,000 emergency relief fund at the Shire's disposal to deal with fire or flood;
- Investing \$500,000 towards an art gallery developed with the local and State Governments;
- Providing investment of \$100,000 towards local psychology services with the federal government;
- Contributing \$150,000 towards the Bunbury \$42m Coronary and Cancer Care unit, working with a private and public sector program;
- Investing \$40,000 with the local Chamber of Commerce to provide CBD offices;
- Injecting \$125,000 in the new Ronald McDonald House (a \$21 million project) in Perth – a contribution anticipated to grow to approximately \$250,000 as the rest of the WA **Community Bank**[®] branches are also planning to support the project.

The **Community Bank**[®] branch establishment in Collie has delivered dividends to the area, creating a virtuous cycle as community members move their business to a branch that they see delivers real community benefits.

A notable example was the recent transfer of most of the Collie Shire Council's investment funds (\$4.9 million) to the Collie **Community Bank**[®] branch, following council's adoption of a revised investment policy that includes a 'community benefit factor' clause (Heston 2012).

Given the success of the **Community Bank**[®] model in generating proven and self-perpetuating benefit for its immediate community, the region and the national economy, it does not make sense for the organisations to be treated in the same way as any other corporate entity. The Wentworth Federal Court Ruling confirmed this in substance.

The **Community Bank**[®] model has been developed by building the prosperity of its customers and community as well as its shareholders. As discussed above, it behoves the financial system to promote ways of incentivising banks to nurture local economic outcomes, rather than regulation and policy forcing centralisation of banking services. A more favourable taxation treatment of banks that are owned by a broad shareholder base from the local community and whose main focus is the prosperity of the community is an ideal opportunity to make the case.

The Inquiry should recommend the introduction of taxation incentives to support community investments and community-owned companies dedicated to the maintenance of banking in their local community, in recognition of their substantial service to their local community and the broader economy.

Enable multi-service community hubs

Developing partnerships between government and community for the establishment of multi-service community hubs where many service providers can share infrastructure, thereby leveraging efficiencies and making marginal areas profitable.

Many smaller or more isolated communities are incapable of commercially sustaining a standalone banking service. Rather than abandon these local economies altogether, a community business centre model is under development, which distributes the costs of business establishment across multiple service providers that will all use the same facilities.

The Business Centre model is based around co-location of business-writing and advice-based services with other community services. These services may be professional services (such as local accountants, solicitors etc.), government or not-for-profit agencies.

Combining a number of services in the single facility creates several advantages from a service provider perspective. It defrays the costs of office establishment, maintenance and infrastructure, and provides alternative staff coverage options to offset staffing costs. It also creates a more convenient and compelling value proposition for consumers (as a one-stop shop), and for many providers, could enable the maintenance of a local presence that might otherwise be commercially unviable.

The model also provides transactional capability to communities that may not be able to sustain the capital requirements needed for start-up and ongoing operations.

This Business Centre Model potentially presents a feasible financial option for smaller communities to establish a viable **banking capability** in their own right, with an emphasis on:

- Containing capital requirements,
- Reducing risk of sustained losses creating a challenged long-term position,
- Enhanced ability to achieve sustainable profitability,
- Improved choice of model according to local circumstances,
- Encouraging a collaborative approach with other local service providers,
- Establishing a flexible model that can be expanded or invested in at a later date, if commercial feasibility allows.

The Inquiry should recommend that the Government work with communities and relevant parties in the financial system to investigate alternative delivery models for banking and other services that create value for the local community as well as efficiencies for providers.

The First Community Hub

The Ringwood East **Community Bank**[®] branch was opened in 2003, and by 2005 was instrumental in the launch of the Heathcote **Community Bank**[®] branch.

The East Ringwood Area in Victoria has a high level of disadvantaged and physically challenged youths. In November 2009, a local Community Group forum identified the need for a Community Hub to provide one-stop access to the variety of local support services, and to encourage collaboration among service providers.

The Board acquired premises to house the **Ringwood and Heathmont Community Bank**[®] branches, and through a partnership with Maroondah City Council and local business initiatives extended use of the site to establish a Community Hub for the local area.

The facility is now utilised by the **Community Bank**[®] branches and numerous community social, recreational, educational and planning groups. The premises sit as an asset on the **Community Bank**[®] branches' balance sheet.

The Community Hub is also investigating the provision of specialist autism advice and support services from the local Irabina Childhood Autism Service to be accessed by the Port Lincoln **Community Bank**[®] branch through in-house video-conferencing facilities.

If successful, this relationship would provide a strong precedent for the leveraging of specialist services across communities, particularly pertinent for those communities at a geographical or socio-economic disadvantage to more centralised and affluent branches.

3. Support innovative solutions

Creating and supporting innovative solutions to address underserved market demand

Following the GFC, most financial system participants have become relatively risk-averse, leading to a lower appetite for innovative solutions, and limited interest in addressing the more complex or resource-intensive customer segments.

Rather than simply subsidising those segments that are underserved, government should support the development of innovative solutions to satisfy unmet market demand, through

- Introducing new commercially-driven mechanisms to address more complex socio-economic issues,
- Providing temporary support for new vehicles to facilitate their acceptance by the broader investment community.

Potential solutions for government consideration include:

- **Homesafe Solutions**, a debt-free equity release product for senior Australians, market-tested but requiring additional support to broaden distribution and encourage external investment;
- **Kids Super**, an investment mechanism that encourages social equity, supports financial literacy and improves productivity for future generations;
- Leverage of the **unclaimed public monies** to enable profit-generating financing for community investments, small businesses and social enterprise.

Australia faces a host of macro-economic challenges that require long-term and far-sighted focus and investment. However, long-term socio-economic solutions have the potential to suffer from the natural flow-on effects of the short-term thinking engendered by current market and political lifecycles.

This recommendation presents specific solutions that can leverage political and market requirements into commercially-sound vehicles that deliver tangible socio-economic benefit over the longer term.

Homesafe Solutions

One of the greatest challenges facing Australia is an ageing population. By 2050 the proportion of people aged over 65 will almost double to 13 per cent of the entire population, with the number of very old (over 84 years) projected to more than quadruple to 1.8 million (Australian Government 2010, p.10).

Australia's ageing population will result in substantial financial pressures from increased demand on infrastructure, government services (e.g. age-related pensions and aged care) and rising health costs. Predicted government spending associated with meeting public demand varies, but is consistently forecast to result in spending exceeding revenue by around 2.75 per cent of GDP as of 2049-50 (*ibid.*, p. 37).

Unlocking equity for an ageing population

Australia's ageing population also has the distinction of having one of the highest proportions of homeowners internationally: 83 per cent of the population aged 65 and over are homeowners (Bradbury 2008, p. 9). This demographic is 'asset-rich but cash-poor', with most of their savings entombed in the family home. Thus not only do many seniors not have the financial liquidity they need to fund their increasing health and care requirements, but nationally there is a build-up of hundreds of billions of dollars of capital that is locked into property, rather than improving the flow of funds through the economy.

Despite recommendations to Government (e.g. Productivity Commission 2011, p. 115), there has been inadequate investment in mechanisms that release home equity back into the economy while keeping the home owner protected. The banking industry has created a limited range of debt-driven equity release products. However, these are largely unattractive from a consumer perspective, as the consumer is left vulnerable to fluctuating interest rates and property prices, with their own longevity increasing the erosion of equity in their home as interest is capitalised to the original debt (ASIC 2009).

One alternative is a unique debt-free equity release mechanism that enables eligible senior home owners to sell a fixed proportion of the future sales proceeds of their home, in exchange for an up-front cash amount.

This mechanism is designed to create security and certainty for consumers, who can live in their home with complete autonomy and control until such point as they are ready to dispose of it (i.e. through public sale, transfer to heirs, etc). At this point, the investor is paid their share of the sales proceeds.

This offering is thus fundamentally different to reverse mortgages and other debt-based equity release products, in that it involves a one-off sale, rather than a loan with compounding interest rates that erode the owner's equity in the home over time. The mechanism provides certainty to the senior

Deloitte Access Economics: The value of Homesafe Solutions

Many older Australians have not been long-term participants of Australia's compulsory superannuation regime and as such reach retirement with far more money saved as equity in their houses than they have in their superannuation funds.

The Commonwealth needs people who can afford to co-contribute to the cost of caring for Australia's ageing population. The largest untapped source of funds for co-contribution is locked up in the family home.

Debt-free equity release grants access to these resources without requiring the home to be sold or new debt to be incurred. The main obstacle to making this product more widely available is resolving the concerns of long-term investors.

This could be resolved with government support - either making a market in the securities by buying and selling them itself or alternatively selling "put options" against the securities to private investors or other alternate solutions.

The government stands to gain from supporting the market for Trust securities because this will release stored home equity which is then available to fund private co-contribution to the cost of aged care.

The worst-case outcome for government is that it holds a portfolio of claims on its elderly citizens' houses. But these can be sold off over time, just like Commonwealth land, as the demographic "bubble" passes through.

Debt-free equity release is an innovative solution to a pressing problem facing government. To reap the benefits, government will need to seed the solution with financial and possibly also regulatory support. But the government as well as Australia's elderly homeowners will be the beneficiaries.

homeowner in that they know the maximum share of the sales proceeds that the product provider will receive. There is protection for the homeowner in the event the home is sold earlier than expected, and from missing out on windfall gains should the property appreciate very strongly.

This product is available only from Homesafe Solutions, a joint venture between Bendigo and Adelaide Bank and Athy Pty. Ltd. The Homesafe Trust, which funds this product, holds over \$300 million in residential equity and to date has been funded wholly by Bendigo and Adelaide Bank.

Investment issues

The challenge with new mechanisms such as the one described above is that they create a new asset class for institutional investors: pooled residential property assets. The funding of this debt-free transaction requires long-term investors seeking an exposure to residential property on a pooled basis. These investors must accept both the longevity risk and investment / property risk of the asset.

Although investors across both the public and private sectors are interested in this mechanism and understand its potential, the fact that it constitutes a fundamentally new asset class in a risk-averse market creates a reluctance for any party to make the first external investment.

Opportunity

The debt-free home equity release product is constructed to deliver a strong value proposition to the user, and addresses several of the key challenges facing the government in unlocking capital in residential equity and increasing the potential for seniors to self-fund their retirement.

Residential Mortgage-Backed Securities (RMBS)

The Government has successfully intervened in investor markets previously, in the case of Residential Mortgage-Backed Securities (RMBS).

During the US sub-prime mortgage crisis, the Australian RMBS market suffered a substantial reduction in the availability of funding. In response, the government established the Australian Office of Financial Management (AOFM) RMBS investment program in 2008 to provide temporary assistance to ensure liquidity in the market.

Over subsequent years the AOFM invested \$16 billion in the purchase of RMBS issues. This investment was released in small portions to encourage and support transactions in the market. Proposals were made by the arranger to the AOFM on a reverse enquiry basis.

The AOFM programme allowed targeted allocations to smaller lenders, fostering issuance and renewal in the market. Once investor confidence had returned, the government ceased investment in April 2013, leaving the \$45 billion market to operate with private sector investment.

This mode of government intervention and support provides a strong precedent for similar intervention in other asset classes that have the potential to serve the national interest.

Over the next ten to twenty years, it is unlikely that voluntary savings and the superannuation guarantee contribution will provide significant relief to the Government's need to fund the age pension. Debt-free equity release has the potential to substantially mitigate the Government's need for increased funding to address the aged demographic. It meets latent demand for products to enable the aged to fund their own retirement, facilitates ageing-in-place, and also unlocks the capital currently dormant in seniors' homes, improving productivity.

The Government has intervened in previous situations (e.g. Residential Mortgage-Backed Securities, 2008-13) where the private sector market has not supported the needs of the broader economy. This mechanism addresses a clear case of market need, and yet equally clearly the market is not willing to invest at this early stage in its lifecycle.

The Government should therefore intervene to normalise this new class of pooled residential assets, in order to provide funding to address constituency demand, broaden product distribution and availability, and build investor

confidence in the asset class. When private sector investment reaches a level where the Government is confident that the asset class is sufficiently established, the Government can withdraw from investment.

The Inquiry should recommend that the Government invests in the Homesafe Solutions Trust.

Kids Super

Kids Super is a multi-faceted program designed to achieve the enhanced financial and social well-being of young Australians, while also enabling the broader national aspirations of intergenerational prosperity.

Kids Super complements the Government's agenda to achieve economic growth through increased participation and productivity. Economic growth will increase the quality of life for Australians, and provide the fiscal resources to address the long-term challenges to national prosperity.

The problem

Financial inclusion is a major issue for Australia, with a growing proportion of the population effectively excluded from core financial products and services. A recent report noted

*[T]here is a large unmet need for access to affordable and appropriate products.
...Overall, the efforts to address financial exclusion in Australia appear to be dwarfed by the scale of the problem.*

(Connolly 2013, p. 7.)

Financial inclusion is defined as existing where "individuals lack access to appropriate and affordable financial services and products", with these services and products being a transaction account, general insurance and a moderate amount of credit. For nearly 20 per cent of the population, the costs associated with these basic products are prohibitive, as they represent over 10 per cent of their annual income (*ibid.* 2013, p. 7).

There are longer-term implications for society from these figures. Higher income growth and quality of life are associated with higher private saving rates (Loayza 2000, p.393); increased private household savings also reduce reliance on government social services, and decrease associated government expenditure. This is of particular value to Australia as it begins to experience the consequences of an ageing population (i.e. increased financial social and environmental demands and costs), and a decreasing number of working tax payers to fund government spending.

Financial literacy is a crucial prerequisite for constructive participation in both the financial system, and the broader economy. Financially literate consumers, when compared to financially illiterate consumers, tend to:

- Have more savings, and save more for retirement;
- Borrow more prudently and actively manage debt;
- Be more active in financial markets, understand their customer rights, and more accurately choose financial products suitable for their needs
- Plan their finances and budget (Capuano & Ramsay 2011, pp. 14-27).

Financially literate individuals also benefit the economy and community as they:

- Save more for retirement, reducing the burden on government subsidised social services
- Are more likely to have sufficient insurance coverage, reducing the burden on the economy for losses and reduced business activity
- Are more prepared for cyclical changes in the market
- Demand better value and quality from financial products, increasing product competition, innovation and quality among financial institutions, and
- Better understand financial policies of government and financial institutions (*ibid.*, pp. 28-31).

There is clearly a need for a more proactive approach to both financial literacy and product development by banks and the financial system in general. While financial literacy is a cause increasingly and rightly supported by many of the banks (ASIC 2013), product development for the underserved receives less attention.

There are new requirements being put into place that will oblige banks to direct socio-economically disadvantaged customers towards their lowest-cost products, and many of the major banks offer free savings accounts. However, in the main, the returns generated by more creative products are insufficient to motivate investment, despite market demand.

Financial literacy and inclusion represent both an issue and an improvement opportunity for the financial system and Australia as a whole.

The solution

Kids Super consists of two separate interlocking mechanisms: the individual Kids Super accounts, and a sovereign wealth fund (SWF).

Mechanism 1: Kids Super Accounts

All Australians born after the introduction of Kids Super would receive a Kids Super Account with \$3000⁴. The account would be vested in the child, and only accessible by the child once they had reached age 18.

The account would operate similar to a superannuation or trust account, which would be invested in the Kids Super Fund (Mechanism 2) to achieve capital growth. Private co-contribution to accounts could be encouraged via tax and savings incentives. The account would yield capital growth on the initial deposit and co-contributions through investment earnings. The final account balance at age 18 for individuals would ideally be a minimum of \$10,000.

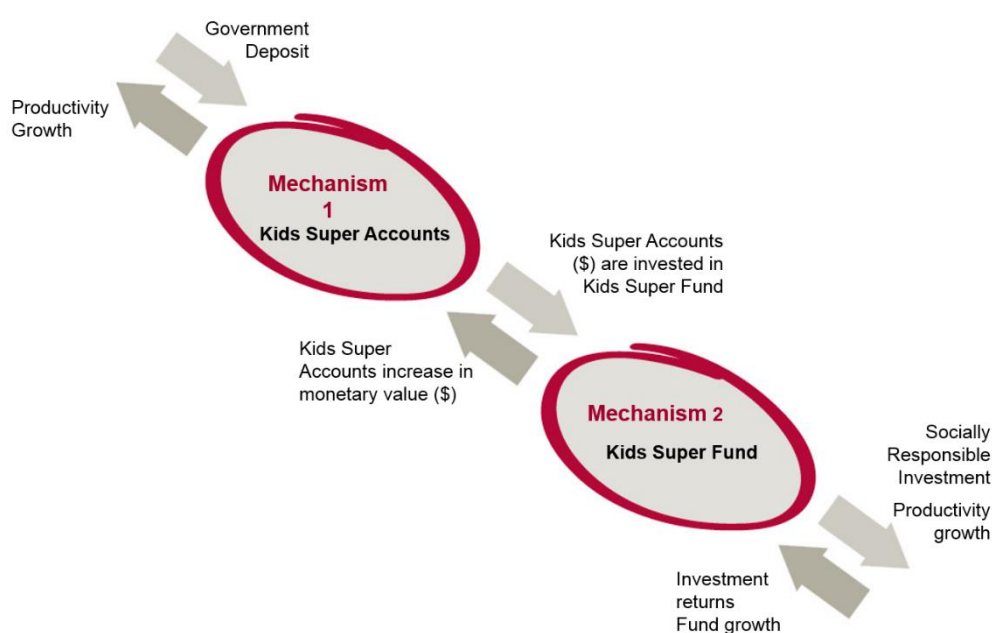


Figure 2: Kids Super Mechanisms

Account holders would be required to complete basic financial training and demonstrate basic financial literacy in order to access their money on turning 18 years of age, as demonstrable financial literacy ensures individuals have the basic skills and knowledge to effectively manage their money (Capuano & Ramsay 2011, pp. 28-31).

Financial institutions would provide financial literacy training, advice and assistance to support both the attainment of funds and the subsequent expenditure.

⁴ A suggested figure, indexed over time to ensure parity with inflation.

Accredited expenditure guidelines would ensure that account monies were used for expenses related to home ownership, education and training or business ownership.

These expenditure areas complement the Government's agenda to enhance Australian productivity and labour force participation, thereby improving national social and economic sustainability.

Mechanism 2: Kids Super Fund

A sovereign wealth fund (SWF) is a government-owned investment fund composed of financial assets (e.g. stocks, bonds, property, etc.), specifically designed to mitigate this short-term investment focus. Australia already has one SWF: the Future Fund, established by the Howard Government to meet unfunded government employee pension liabilities arising after 2020. The primary functions of an SWF are to stabilise the country's economy through diversification and to generate wealth for future generations.

The introduction of a new Sovereign Wealth Fund – the Kids Super Fund - focused on both addressing longer-term intergenerational issues and also investing in generational improvements in financial literacy and productivity, would represent a substantial contribution to Australia's future. This Fund represents an ideal vehicle for long-term savings to cope with expenditure arising from e.g. the ageing population, international competition and other long-term inter-generational challenges facing Australia.

The Kids Super Fund would be a transparent and bi-partisan supported Fund, owned by the Commonwealth, and operated to invest wealth for the benefit of future generations of Australians.

All Kids Super Accounts would be invested in the Kids Super Fund. This Fund is the financial centrepiece of the Kids Super program, generating the required capital growth to drive Kids Super Accounts. The Kids Super Fund investment strategy would include Socially Responsible Investment practices, to distinguish it from other sovereign wealth funds in its focus on both capital growth and social impact.

The opportunity

Government's key strategy for addressing many of the longer-term issues facing Australia today is to drive economic growth through increased productivity and participation. The Kids Super program complements this approach by bringing together financial and intellectual resources to improve economic growth while also providing longer-term funding. The Kids Super program has the potential to result in multiple outcomes benefiting all Australians.

For investors, the Kids Super Fund structure represents a safe medium-term debt management vehicle that is shorter in term, and hence more accessible, than superannuation.

The Kids Super Account structure benefits all young Australians by ensuring an equal financial opportunity at adulthood – regardless of socio-economic status at birth – through start-up capital for critical expenses, establishing incentivised savings patterns from a young age, together with access to financial literacy training. These outcomes offer lifetime benefits for an individual's financial wellbeing (e.g. increased consumption, better quality of life, greater savings and enhanced financial self-reliance).

Engagement in the provision of financial literacy training, and financial advice and support for young Australians at such a crucial juncture will also drive benefits for the finance industry. Institutions working closely with account holders will build strong relationships across the full gamut of demographics for the age group, generating increased understanding into a highly valuable customer segment. When combined with the accredited expenditure options, these relationships and insights should encourage the development of innovative products and services for this challenging demographic.

Finally, the individual expenditure associated with Kids Super Accounts would generate broad socio-economic benefits, through outcomes such as increased labour force skill levels and participation, and increased productivity.

Summary

The Kids Super initiative is a sustainable long-term enabler of solutions to economic, social and environmental challenges facing Australia. Collectively, the two mechanisms of the program enable the growth of economic, intellectual and social resources to support the productive engagement of young Australians in the economy, and foster improved socio-economic resilience and prosperity in Australia.

This initiative would require support throughout all aspects of the financial system, from regulators to investors to banks, consumers, educators and fund managers. The Inquiry has the unique opportunity to engage a multi-stakeholder forum in recommending the financial system's support of a genuinely sustainable and internationally innovative model for socio-economic change.

The Inquiry should support the establishment of a Sovereign Wealth Fund and associated accounts for young Australians, in order to improve financial inclusion, embed financial literacy, engage the banking industry's capability for socio-economic benefit and address the longer-term intergenerational challenges facing Australia.

Using unclaimed monies to support underserved segments

Government should establish an independent Investment Board to transparently manage a proportion of the income from unclaimed public monies through commercially-focused investment in underserved areas of the community.

Unclaimed money, accumulated from citizens' dormant financial accounts, is currently paid by the relevant financial institutions to ASIC, which then transfers it into The Commonwealth of Australia Consolidated Revenue Fund.

This capital would be more transparently managed in the interests of the customers for whom it is held by an independent board, comprised of financial institution representatives, with deep investment management capability, and a charter to pursue socio-economic growth.

This managing body would be charged with directing a proportion of the unclaimed money capital pool into investments that

- Support the self-sustaining growth of communities, small businesses and social enterprise,
- Provide a commercial return
- Improve national productivity and socio-economic resilience.

Background

Australian unclaimed money at 31 March 2014 stood at approximately \$1.5 billion (FindUnclaimedMoney.com.au 2014)⁵, accumulated nationally from uncashed cheques, savings accounts, inheritances, share dividends, payroll cheques, tax returns, refunds, insurance policies, security deposits, lotto winnings and state revenue offices.

This money is sourced from:

- Authorised Deposit Taking institutions;
- Life Insurance companies & benefit fund friendly societies
- Institutions providing first home saver accounts; and
- Companies with unclaimed monies & property.

Unclaimed monies originally were assets left untouched by the owner for a period of seven years, but in October 2012, the Federal Government passed legislation amending this period to three years.

ASIC currently manages these funds on behalf of the Federal Government, but there is limited transparency or accountability with respect to their handling of this capital pool sourced from individual Australians' personal finances.

Structure and approach

Under this proposal, the public's unclaimed money would be transparently managed and put to the service of the greater public to whom its composite monies belong.

In this proposed structure, the Reserve Bank of Australia would be nominated as the independent custodian of these public funds until such time as the customer seeks rebate of funds from their financial institution or other corporation governed by the Unclaimed Monies Public Fund and legislated acts. [RBA's assumption of this function may require legislative amendment in order to extend its legislative powers to act as custodian of unclaimed monies.]

The Fund would require regulatory supervision to ensure best practice management, governance and reporting. ASIC should retain its current administrative functions but channel unclaimed money received to the new Fund, rather than the Consolidated Revenue Fund.

⁵ Unclaimed public money total is calculated across eight government databases plus the all the entities which contribute to the ASIC Unclaimed Monies Public Fund. This includes: ADI Funds, Life Insurance, First Home Savers, Corporation Act (one database); State and Territory Government funds (eight databases).

The Investment Board would be established as an independent entity to manage the Fund. This Board would be comprised of members from those financial institutions and businesses with a direct and ongoing custodial relationship with the customers and owners of the unclaimed money. The Board would have no political membership or links, enabling it to remain independent of Federal and state governments and related strategic governance and economic strategies.

One of the Board's core responsibilities would be to invest in Australian communities, small business and social enterprise, where funds would be profitably and productively engaged to drive socio-economic prosperity from the ground up.

It is proposed that the Board's initial injection of capital funding would be in the order of 20 per cent of unclaimed funds and that subsequent funding would sit at 15 to 20 per cent of the total unclaimed monies pool per annum. The remainder of the unclaimed money would effectively act as a preserved investment for the customers of the businesses and financial institutions who have contributed to the fund over the years, and are entitled to reclaim their monies in the future⁶.

The Board would manage the targeted capital funding distribution to eligible community programs, small businesses and social enterprises, which would apply for strategic lending to progress and strengthen their organisation's sustainability and growth.

Eligibility would be assessed on metrics and criteria relative to the various applicants (e.g. Community Strengthening Index metrics for community investments), and contingent on applicants submitting their applications in collaboration with and through their financial institution partner.

Funds would be granted to the successful applicants through their financial institutions. This process would leverage existing capability and relationships already established, ensure business case rigour and feasibility, and build insight and competencies on both sides.

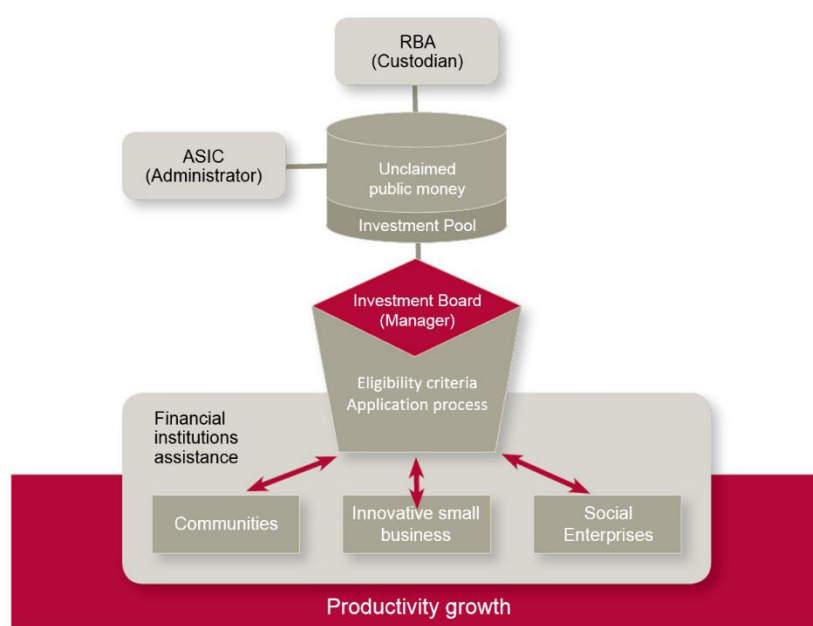


Figure 3: Overview structure

Beneficiaries

Communities, small business and social enterprise are targeted by this initiative because they are underserved by existing banking approaches, yet are powerful drivers of socio-economic growth and national productivity. The support of local financial institutions in their application has the potential to build recipients' capability and create longer-term benefit for their organisation. It will also require financial institutions to build insight and relationships in the recipient segment, encouraging the development of tailored and innovative products and services.

⁶ The change of legislation in December 2012 included the introduction of interest to be paid to customers reclaiming their funds. Interest calculations commence from July 2013, regardless of the date at which the money became officially 'unclaimed'. (ASIC 2013b)

Communities

This initiative would create a new and stable access point for community funding, and by requiring application in conjunction with a financial institution, encourage communities to work closely with their local service provider and build stronger relationships in the financial system.

Application assessment criteria could leverage the Community Strengthening Index metrics, together with other known indicators of community investment success (e.g. co-funding, local sourcing, etc.), to ensure that investment is commercially feasible and generates genuine socio-economic benefits within the community.

From the Board and government perspective, there is the potential to use applications to develop insight into community needs nationally, identifying opportunities for leveraging investment across multiple areas and building greater inter-community networking, a key characteristic of resilience.

Small businesses

This initiative would support the financing of innovative SMEs struggling to meet standardised banking requirements. By requiring banks to partner with SMEs for the application procedure, the application process helps to build capability on both sides. SMEs will gain increased exposure to the financial system, develop greater financial competency and improved banking relationships. Banks will in turn improve their capacity and capability for tailored product development and service delivery for a customer segment that is traditionally difficult to service profitably.

Social enterprise

A recent research project at the Queensland University of Technology (Barraket *et al.* 2010, p.16) defined social enterprises as organisations that:

- a. Are led by an economic, social, cultural, or environmental mission consistent with a public or community benefit;
- b. Trade to fulfil their mission;
- c. Derive a substantial portion of their income from trade; and
- d. Reinvest the majority of their profit/surplus in the fulfilment of their mission.

There are an estimated 20,000 social enterprises in Australia, focusing on a wide variety of missions and serving many beneficiaries. For these enterprises, earned income (including contracted income from Government, won in competitive tenders) represents approximately 85 per cent of their revenue, with the remnants coming from contributions and grants (more common amongst the younger organisations). The majority focus on local and regional needs, and fulfil a public and community benefit (*ibid.*, pp.17-29).

These social enterprises represent a relatively new form of business model that empowers people to address those needs that most impact them in a way that both creates trade and is self-sustaining. This emphasis on self-sufficiency is well-aligned with the increasing need for resilient structures in the wake of current budget cuts to many community-based services areas that have traditionally enjoyed government support.

Social enterprises appear somewhat more operationally-focused than many commercial businesses of their size, with nearly twice the incidence of business planning and performance measurement use than mainstream ABS business respondents. They also represent a high level of innovation within their processes, business development and customer service delivery. However, social enterprises are generally less well-connected with mainstream business development and business networks than their commercial counterparts (*ibid.*, pp. 32-35).

A majority of social enterprises are not-for-profit organisations, members of a sector that contributes a great deal not only to the beneficiaries of its services, but to the Australian economy in general. The Australian not-for-profit sector generates in the order of four per cent of GDP and represents over eight per cent of total Australian employment (Productivity Commission, 2010, p. XXVI). It receives

approximately seven billion dollars in donations and \$25bn in direct government funding annually, and about half the sector's income is from services delivered or sales of goods (ABS 2009).

The sector certainly relies on government and private sector funding, but at the same time, is largely self-sustaining, with the bulk of operating expenses covered by their own income generation. However many NFPs require more insight and support than conventional lenders have available, and therefore find it difficult to access capital for their development or expansion (Productivity Commission 2010, pp. 184-193). There is a clear mismatch between finance services required by NFPs and what is available.

Case study: VIC - The Range Children's Centre

With more than 200 children on the waiting list for The Range Children's Centre, in Melbourne's inner south-west, the parent-run Management Committee decided to add another room, and offer an extra 11 places of high quality childcare to the community.

The problem was funding. The local council owned the building, not the centre. The council was happy to contribute, but wouldn't sign off on the deal until The Range secured its own share. Other banks wanted the building as security, which didn't work when the council owned the building. They also expected committee members to guarantee the loan, not recognising the members were volunteers.

The Range already used Community Sector Banking for its daily banking needs and so approached them to talk through the project. Community Sector Banking (CSB) is a Community Development Financial Institution established as a joint venture between Bendigo and Adelaide Bank and Community 21, a group of 20 leading not-for-profit organisations.

CSB understood that the centre didn't own the building, and was governed by volunteers. They knew the project was not only financially sound but good for the community. After looking carefully into the centre's financials, CSB offered finance in two sections – a loan, and an overdraft.

The loan approval led to the final go-ahead from council, and construction is now underway on the extension. The extra places offered in the new room have already been filled. A project rejected by other banks was embraced by Community Sector Banking, and will help relieve the critical shortage of quality childcare places available locally.

NFPs often struggle to establish reliable revenue streams that can be used to service debt, given the mismatch between standard banking product terms and the government contracts which represent their income stream. Providing collateral, a key requirement for most standard financing products, is also an issue: smaller NFPs may have difficulty in developing an asset base to leverage, and many NFPs have ownership and governance arrangements that complicate the leverage of any asset base available.

In addition, much like SMEs, many NFPs lack the capability and capacity to develop compelling business, financial or strategic plans without substantial advice and support from their financial services provider. This makes them time-consuming and costly in comparison with other potential clients, and also inhibits their ability to access alternative funding sources e.g. grants.

There is an urgent need within this sector to inject new capital and create growth opportunities through consistent revenue generation and investment. NFPs require strong, long-term relationships with their financial institutions to provide financial advice and support.

The introduction of funding specifically focused on social enterprises encourages NFPs to approach their challenges from a commercial perspective, becoming proactive in their approaches to serving the constituencies that they benefit. Although this may represent a shift in thinking for some NFPs, the process will serve to challenge the sector, and also the financial institutions with whom they will be required to work through the application process.

Once again, the financial institutions that partner with these organisations will build insight and capability through the application process, improving the opportunities for more innovative offerings for the sector.

Summary

The establishment of a new fund comprised of the public's unclaimed money, together with an independent, industry-based management board creates a more transparent and proactive approach to the government's handling of individual citizens' unclaimed funds.

Managing the fund to drive investment in underserved segments of the community creates a more robust and sustainable model for socio-economic growth than the more traditional grants and subsidies approach available from government. Investment will focus on those opportunities that build self-sufficiency and resilience, and demonstrate the innovation and commitment that is required for increased productivity.

The engagement of financial institutions in both the management of the fund and as support for the application process increases banking insight and understanding in sectors that may otherwise be overlooked. This in turn increases the likelihood of innovative solutions and services being developed to address these more complex customer needs.

And aside from the obvious benefits of funding, the recipient organisations develop closer relationships with their local banking representatives, and improve capability with respect to meeting the commercial requirements for funding.

Finally, this initiative supports the bi-partisan government agenda of driving growth through grass-roots empowerment. It improves productivity and social resilience by fostering the sustainability and growth of sectors that are often underserved by the market, but are fundamental to national economic prosperity.

This submission recommends that the Inquiry introduces a national fund that makes transparent the accountable management of existing public monies, and directs the income towards commercially-founded investment in communities, small businesses and social enterprise.

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