



CUSTOMER  
OWNED  
BANKING  
ASSOCIATION

# Submission to the Financial System Inquiry

March 2014

## Introduction

On behalf of Australia's credit unions, building societies and mutual banks, the Customer Owned Banking Association (COBA) appreciates the opportunity to contribute to the Financial System Inquiry.

The Inquiry's examination of how the financial system can be positioned to best meet Australia's evolving needs and support Australia's economic growth is not only worthwhile, it is well overdue.

The strong performance of Australia's financial system during and after the Global Financial Crisis (GFC) is masking an unhealthy and worsening trend: the increasing dominance of four systemically important banks and the medium to long-term risks that this poses to competition, diversity and stability.

With over four million members, Australia's 83 credit unions, 10 customer-owned banks and 7 customer-owned building societies provide competition and choice in the consumer banking market. Collectively, COBA's member institutions rank fifth behind the four major banks (Commonwealth Bank, Westpac, NAB & ANZ) in share of household deposits and resident assets.

Customer-owned banking institutions serve a number of niche communities, including regional areas and particular industries or occupations, such as teachers, police and defence personnel, and the wider Australian community.

Customer-owned banking is distinguished by:

- Prioritising customer benefit over profit maximisation;
- Conservative business models and prudent risk management; and
- Deep community engagement and strong customer loyalty.

Our sector has been steadily evolving via mergers over a long period of time and this trend is continuing, with fewer but larger individual institutions in a growing sector. More recently, some larger credit unions and building societies have opted to re-brand as banks while retaining the customer-owned governance model of 'one member, one vote'.

Customer-owned banking offers a genuine alternative for Australian consumers, with potential to increase competitive pressure in other retail banking markets such as small business (SME) lending.

COBA looks forward to engaging with the Financial System Inquiry on these issues.

### ***Who is COBA?***

The Customer Owned Banking Association brand has replaced Abacus - Australian Mutuals as the industry advocate for Australia's customer-owned banking sector. It is owned by its 99 member institutions: 81 credit unions, 7 building societies, 10 mutual banks and 1 other; and represents 13 friendly societies through the Friendly Societies of Australia and a number of affiliate members.

COBA provides representation and advocacy on behalf of its members, along with expert advisory and support services, such as compliance, research and fraud prevention services.

**If you have any queries regarding this submission, please contact Mark Degotardi, Head of Public Affairs, on 02 8035 8441 or [mdegotardi@coba.asn.au](mailto:mdegotardi@coba.asn.au).**

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## **Attachment A**

### ***Competitive Dynamics in Retail Banking: An International Comparison***

## **Attachment B**

### ***Equitable Taxation of Customer Owned Banking***

# 1 Executive Summary

The retail banking market is currently dominated by four major banks across Australia. Sustainable competition, diversity and plurality are under threat – a threat that poses risks to the stability of the banking market, the Australian economy in general and to consumers.

The Australian banking market has shown itself to be resilient through the GFC. Despite this resilience, the GFC had profound impacts on competition, as efforts of Government and regulators to stabilise the financial system during the GFC favoured the major banks over smaller lending institutions.

It is time to get the balance right between competition and stability and to recognise the risk that market concentration poses to the stability of the retail banking sector. Measures to address distortions in funding costs and to deliver competitive neutrality for different business models are needed to restore sustainable competition and long-term stability, to re-establish equity and to ensure consumers have sufficient choice in banking providers and products.

These measures have some urgency because Australia has the most concentrated banking sector of any G20 country and is home to four of the eight most profitable banks in the world. The Australian economy is the third most reliant in the world on the performance of its top three banks, surpassed only by the UK and France. At 10.8 per cent of the economy, the financial services sector is approximately the size of the mining sector and media/telecommunications sector combined.

Previous Governments have not acted strongly enough to address the competition problem despite irrefutable evidence that the banking market is too concentrated. A string of Parliamentary inquiries since 2008 have expressed concern about the conduct and growing domination of the major banks. The IMF found in 2012 that the four major banks have grown faster than the banking sector as a whole since the GFC, have pricing power and enjoy a funding cost advantage partly derived from implicit government support.

It is time to act.

It is critical that we ensure that a sector of this size is efficient, competitive and stable.

Only genuine competition in the banking market can deliver the pricing, service and innovation that Australian consumers, small businesses and other users need.

Only genuine competition can provide the Australian banking sector with the resilience and diversity that will ensure the strength of the Australian economy over the longer term. The challenge for the FSI is to tackle this problem and to provide the framework that will allow for genuine competition to the major banks.

The previous inquiry – the Wallis inquiry – took important steps to ensure the strength and resilience of the banking sector. The basic architecture of the regulatory framework established by Wallis – the “twin peaks” model, with APRA responsible for prudential regulation of financial institutions and ASIC responsible for market conduct regulation and consumer protection – remains sound.

However, some changes to the way regulators operate within this framework are recommended to better recognise and accommodate the benefits of diversity and to deliver competitive neutrality.

The current regulatory framework has failed to provide competitive neutrality. Strong action is needed to rectify:

- The implicit Government guarantee that provides the major banks with a large and unacceptable free subsidy on their funding costs;
- Prudential regulatory settings, including on capital, liquidity, marketing and levies which artificially tilt the playing field in favour of the largest Authorised Deposit-taking Institutions (ADIs);
- A company tax and dividend imputation system which fails to accommodate the customer-owned model.

***“The customer-owned model is durable and successful and contributes to financial system stability. Our model is entitled to nothing less – and nothing more – than competitive neutrality.”***

The customer-owned model is durable and successful and contributes to financial system stability. Our model is entitled to nothing less – and nothing more – than competitive neutrality.

As argued in the attached report *Competitive Dynamics in Retail Banking: An International Comparison*, relative to other G20 countries, and particularly those of Germany, US and Canada, the Australian regulatory framework over the past 12 years has failed to accommodate the differences in the customer-owned banking model.

“In fact, Australia is unique in that it’s the only G20 market we are aware of that does *not* have differentiated regulations and/or supervision for its financial cooperatives or savings banks. A potential result of this is Australian mutual ADIs have a smaller market share in assets, deposits and SME markets than their peer jurisdictions in the US, Canada and Germany. There are significant stability, pricing and service benefits to Australian consumers by having a larger mutual ADI and savings bank sector. When the big 4 banks have an implicit government guarantee it’s a false claim that the regulatory environment is based on a single set of rules for a level playing field.”

The GFC has proved that diversity and plurality in banking is a strength for the financial system and contributes to stability. Customer-owned banking institutions around the globe – e.g. credit unions in the US and Canada, co-operative banks in Europe, and customer-owned ADIs in Australia – performed comparatively well. IMF research findings – that co-operative banks are less volatile than commercial banks because they earn less in good times and lose less in bad times – were put to the test in the GFC and proved to be accurate. The customer-owned model is inherently conservative and stable, compared to profit-maximising banking institutions.

***“The increasing domination of the market by four systemically important banks is simultaneously weakening competition and compromising financial system stability. It is an intractable problem that will only get worse unless it is addressed with some urgency.”***

The FSI is an opportunity to refresh and reshape the regulatory framework to promote competition and choice without compromising stability. The increasing domination of the market by four systemically important banks is simultaneously weakening competition and compromising financial system stability. It is an intractable problem that will only get worse unless it is addressed with some urgency.

COBA's proposals for consideration by the FSI include:

- A temporary levy on domestic systemically important banks (D-SIBs) to apply until a credible resolution regime is in place for D-SIBs so that they no longer benefit from an unfair funding cost advantage derived from an implicit taxpayer guarantee;
- Recalibration of the capital requirements for smaller ADIs that narrows the unjustifiable gap in risk weights of low risk residential mortgage portfolios;
- Redrafting of APRA's objectives to increase the priority given to diversity, plurality and competition and review of the legislative and regulatory regime to ensure that it equitably accommodates customer-owned ADIs;
- Equitable taxation of the customer-owned banking model;
- Fairer taxation of deposits to end the distortionary treatment of the safest, simplest savings vehicle and increase banking system stability; and
- A more effective disclosure regime to ensure consumers are able to make a genuine choice about their banking services provider.

Australian consumers are looking to the FSI to create a regulatory policy framework that enhances competition and diversity. Only this environment will provide sustainable diversity in the banking market and provide Australian consumers with more competition and choice for their banking needs.

## 2 Summary of Recommendations

### **Competitive Neutrality**

*Impose a levy on D-SIBs reflecting the credit ratings uplift they receive due to an implicit government guarantee.*

*Reduce the unfair advantage major banks gain in terms of regulatory capital requirement for residential lending portfolios.*

*Provide equitable tax treatment of franking credits for the customer-owned model by allowing institutions to issue a frankable debt deposit product.*

*Accommodate the customer-owned model in the prudential regulatory framework by allowing customer-owned ADIs to issue a form of CET1 capital.*

*Provide more consistent treatment of RMBS for regulatory liquidity purposes between MLH ADIs and LCR ADIs.*

### **Regulatory objectives**

*Give increased weighting in the legislative objectives of regulators to promote diversity and plurality in the banking market.*

*Revise APRA's objectives to increase the legislative weighting given to competitive neutrality and competition.*

*Increase APRA's accountability to Parliament through scrutiny by the House of Representatives Economics Committee.*

### **Informed consumers**

*Introduce effective disclosure requirements to ensure consumers understand the difference between an ADI and a non-ADI and between an independent competitor and a major bank sub-brand.*

*Modernise regulatory banking terminology by changing 'Authorised Deposit-taking Institution' to 'Authorised Banking Institution'.*

### **Tax system**

*Reduce the unfair tax burden on deposits.*

### **Financial sector levies**

*Recast the APRA levies framework to allocate levies more closely to systemic risk.*

*Introduce more effective measures to ensure APRA's costs are efficient.*

### **Funding**

*Regulatory settings must recognise the importance of securitisation in enhancing competition and choice in the mortgage market.*

*Regulators should be more proactive and vigilant about risks to consumers and competition arising from conflicts of interests in large vertically-integrated businesses.*

### **SME lending**

*Regulatory settings for ADIs engaging in SME lending should be more balanced and less restrictive.*



## 3 Customer-owned banking

### 3.1 Sector Overview

The customer-owned banking sector comprises 83 credit unions, 10 mutual banks and 7 mutual building societies serving more than four million Australians.

Customer-owned banking institutions are Authorised Deposit-taking Institutions (ADIs) under the *Banking Act 1959* and public companies and Australian Financial Services Licensees under the *Corporations Act 2001*.

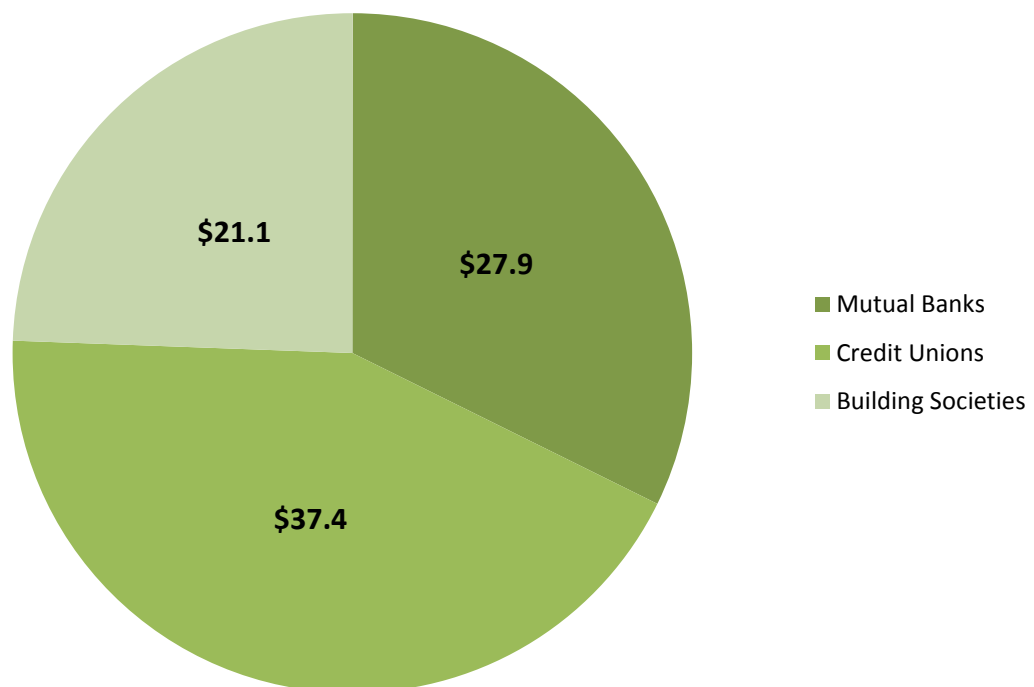
Unlike listed ADIs, customer-owned banking institutions are owned by their members, not shareholders, and abide by the principle of “one member, one vote.” As such, customer-owned banking institutions exist solely to serve their members, and do not face the conflicting priorities of providing quality services to members while maximising returns to shareholders.

Our sector is characterised by strong balance sheets, conservative business models, strong customer loyalty and community involvement. The strengths of our sector are strengths for the financial system, contributing to stability and genuine consumer choice.

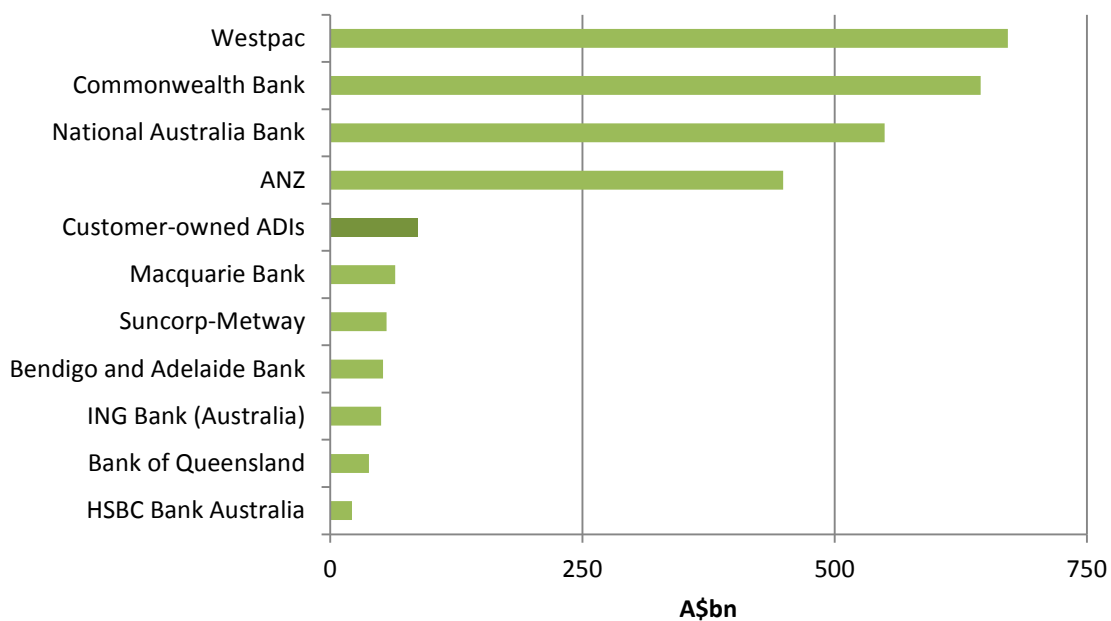
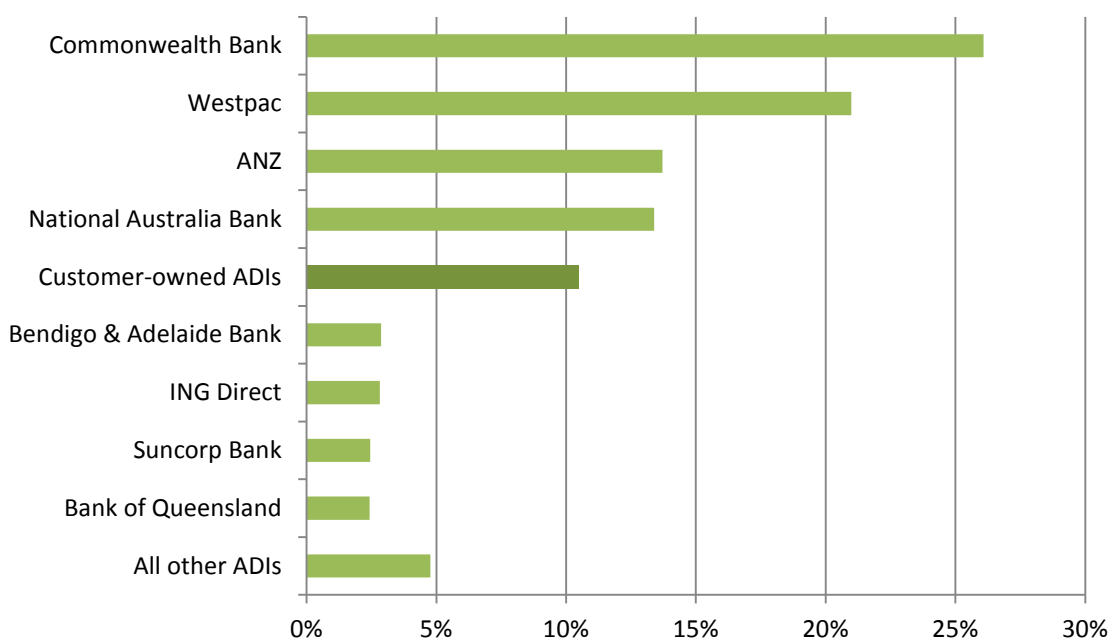
Customer-owned banking institutions have \$86 billion in total assets and collectively rank fifth behind the four major banks in share of the household deposits market.

The customer-owned banking sector is comparatively large in global terms, ranking third behind only the US and Canada. The sector is well placed to make a stronger contribution to the competitiveness of the banking sector if changes to regulatory settings are made which allow it to compete on an equal footing with the listed sector.

**Chart 1 – Customer-owned ADI assets (\$bn)<sup>1</sup>**



<sup>1</sup> Source: APRA, Quarterly ADI Performance, Dec 2013; APRA, Monthly Banking Statistics, Dec 2013; COBA adjustments

**Chart 2 – Total Resident Assets<sup>2</sup>****Chart 3 – Household Deposits<sup>3</sup>**

Customer-owned banking institutions are subject to the same corporate and prudential regulatory frameworks as listed banks but their ethos is fundamentally different.

Customer-owned banking institutions exist to meet the needs of their customers and their communities rather than to maximise returns for shareholders. Customer-owned banking institutions operate on the governance principle of 'one member, one vote.' While customer-owned ADIs generate profits to create capital and to invest in improving products and services, this is not their

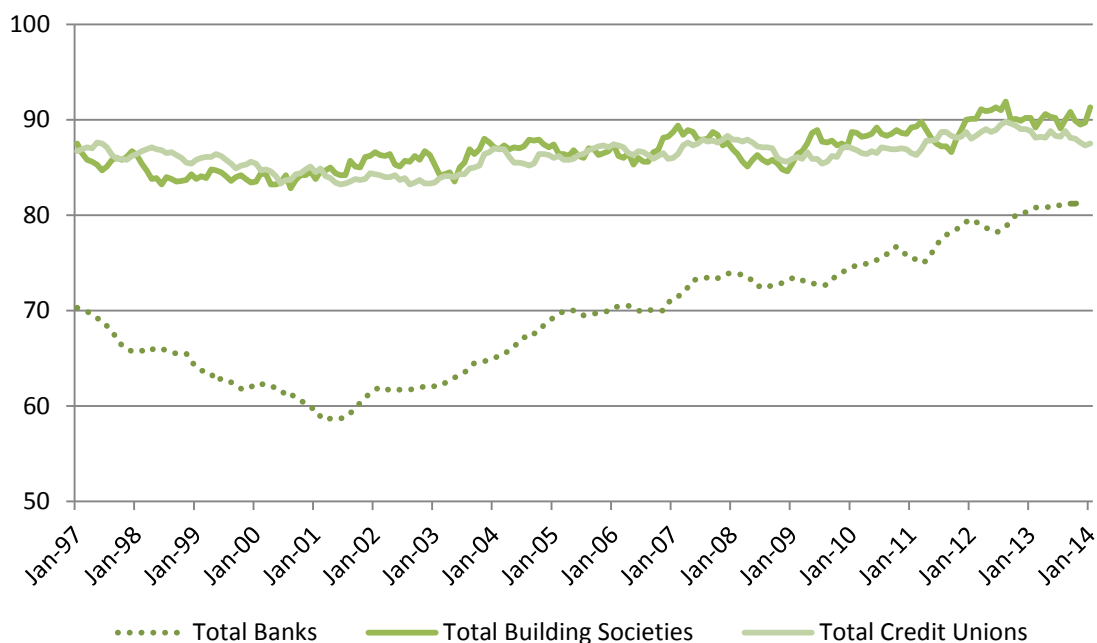
<sup>2</sup> Source: APRA, Quarterly ADI Performance, Dec 2013; APRA, Monthly Banking Statistics, Dec 2013

<sup>3</sup> Source: APRA, Quarterly ADI Performance, Dec 2013; APRA, Monthly Banking Statistics, Dec 2013

primary purpose. This distinction is reflected in the Corporations Act<sup>4</sup> which requires that customer owned ADIs are not to be companies run for the purpose of yielding a return to shareholders.

The sector's singular focus on its customers is demonstrated by market-leading customer satisfaction ratings.

**Chart 4 – Customer Satisfaction<sup>5</sup>**



Customer-owned banking institutions have a national, regional or local focus and serve communities in education, police, defence, indigenous Australia or particular industries and employers.

Australia's largest customer-owned banking institution is CUA with \$10.2 billion in assets and over 400,000 customers. The smallest is Newcom Colliery Employees Credit Union with \$3 million in assets and 300 customers. B&E has been serving regional Tasmania for 143 years and is the oldest customer-owned ADI while the newest customer-owned ADI is Traditional Credit Union, established 20 years ago to serve remote Aboriginal communities in the Northern Territory.

Customer-owned banking institutions have a proud history of serving both metropolitan and regional communities. The head offices of eight of the 10 largest customer-owned banking institutions are outside Sydney and Melbourne and are important economic and social contributors to those communities. Customer owned banking institutions are also represented across hundreds of regional and rural communities throughout Australia.

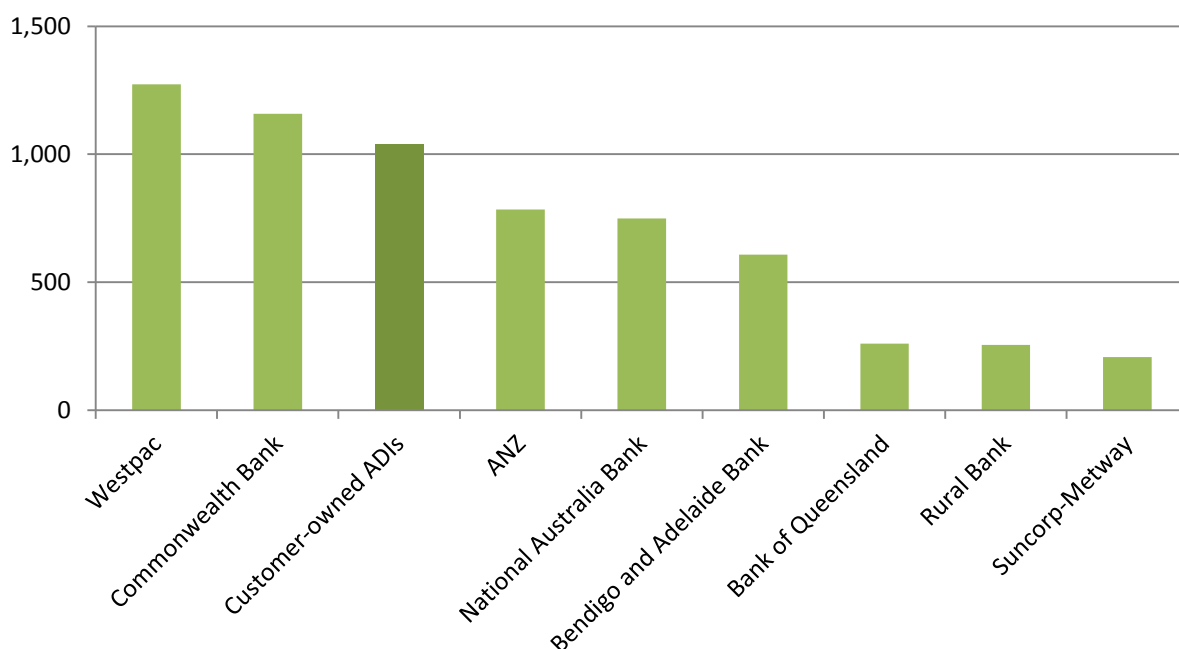
<sup>4</sup> ASIC Regulatory Guide 147: Mutuality - Financial institutions

<sup>5</sup> Source: Roy Morgan Research, Customer Satisfaction: Consumer Banking in Australia Monthly Report, Australians 14+, 6 month average

**Table 1: Head Office Locations of Largest Customer-Owned ADIs**

Institution	Head Office Location
CUA	Brisbane
Heritage Bank	Toowoomba
Newcastle Permanent Building Society	Newcastle
People's Choice	Adelaide
Greater Building Society	Newcastle
IMB	Wollongong
Teachers Mutual Bank	Sydney
Beyond Bank	Adelaide
bankmecu	Melbourne
P&N Bank	Perth

The customer-owned banking sector has 1,041 branches, ranking behind CBA and Westpac but ahead of ANZ and NAB. Our sector's share of total ADI branches is 16 per cent, compared to CBA's 20 per cent, Westpac's 18 per cent and ANZ and NAB on 12 per cent.

**Chart 5 – ADI Branches<sup>6</sup>**

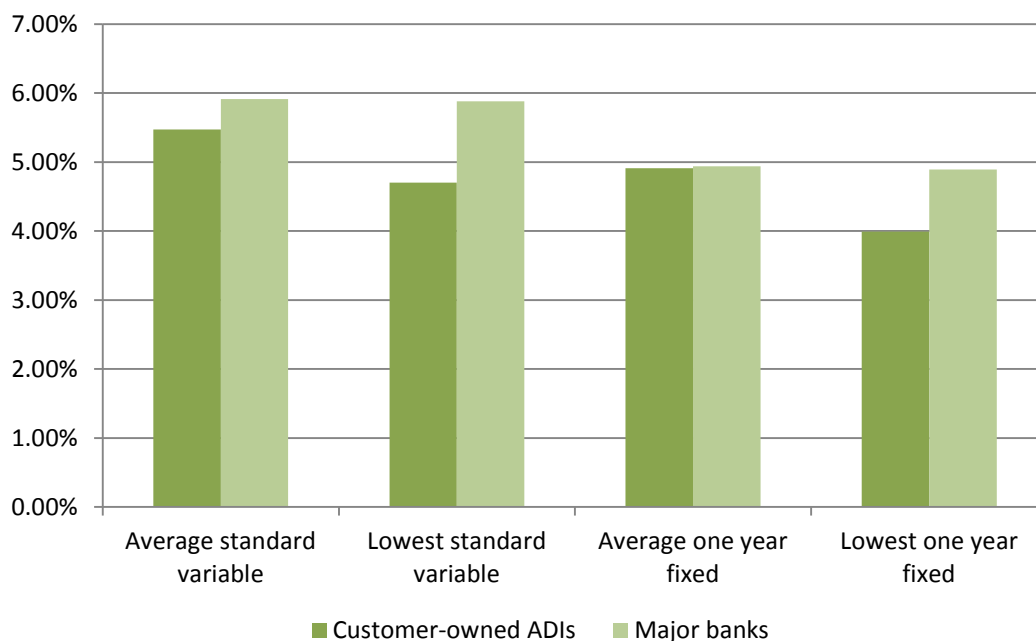
Most customer-owned banking institutions are partners in the rediATM network, giving them access to a national network of more than 3,000 ATMs.<sup>7</sup> This gives our sector a level of ATM coverage similar to the major banks<sup>8</sup> and gives our customers access to one of the largest direct charge free ATM networks in Australia.

Customer-owned banking institutions offer the full range of retail banking products and services and provide highly competitive pricing on key products such as home loans, credit cards, personal loans and deposits.

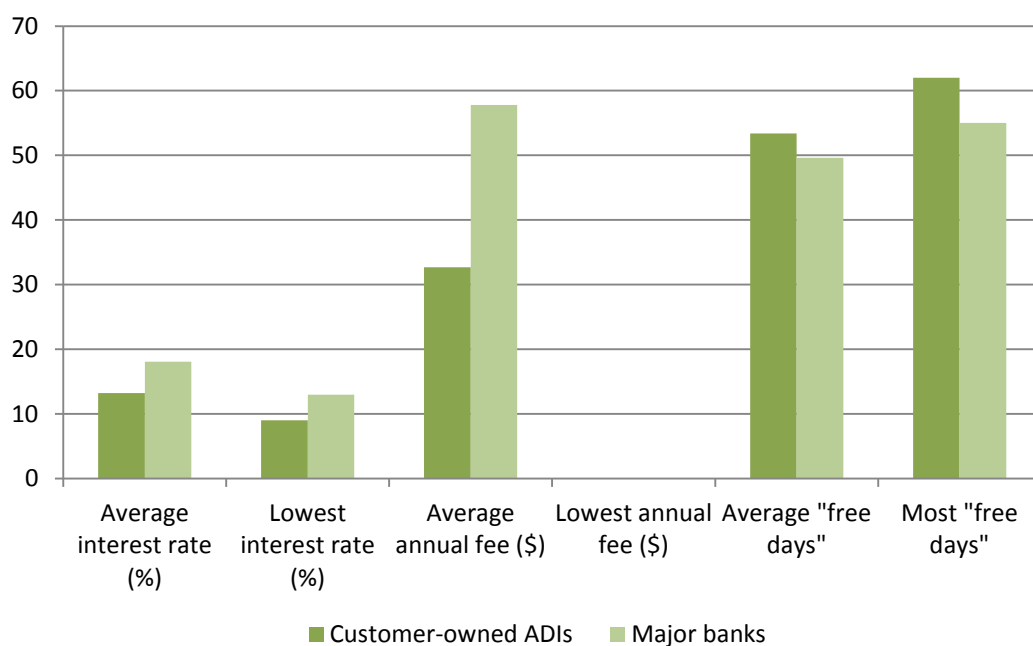
<sup>6</sup> Source: APRA, Points of Presence, June 2013; COBA Adjustments

<sup>7</sup> <http://www.rediatm.com.au/>

<sup>8</sup> APRA, Points of Presence, June 2013;

**Chart 6 – Mortgage Interest Rates<sup>9</sup>**

Competitive pricing for consumers includes consistently lower average standard variable home loan rates than the major banks and sharply lower average credit card rates.<sup>10</sup>

**Chart 7 – Credit Card Rates and Conditions<sup>11</sup>**

<sup>9</sup> Source: Canstar

<sup>10</sup> Based on Infochoice analysis of Cannex data over a period of ten years, customer owned ADIs had consistently lower advertised average standard variable home loan and credit card rates than the major four banks.

<sup>11</sup> Source: Canstar. Figures refer to standard personal credit cards (unsecured). Gold, platinum and premium cards are excluded for comparative purposes.

### 3.2 Aggregation models

The customer-owned banking sector uses aggregation models to gain access to economies of scale and to larger networks and systems, to increase stability and lower risk, and to pursue the sector's community development goals. Regulatory frameworks that enable aggregation are critical to the sector's ability to compete with the major banks.

Examples of these aggregation models include Cuscal, Indue, ASL, CUFSS, Data Action, TAS, AMG and CUFA. Cuscal, Indue and ASL are also all ADIs.



**Cuscal** provides transactional banking, liquidity and capital management products and superannuation solutions to more than 150 specialist financial services institutions across Australia, including the majority of credit unions. Cuscal provides access to Australian capital markets, payment systems, card schemes, inter-institutional settlement arrangements, and a national ATM network (rediATM).



**Indue** was also established by credit unions and provides a range of wholesale payment solutions and card products to its credit union customers and other customers, including building societies, mortgage originators and boutique banks. Indue's core payment products include direct entry, BPAY, chequing, ATMs and EFTPOS.



**ASL** - Australian Settlements Ltd - was formed in 1993 as a mutual organisation by building societies to provide settlement services and allow them to participate in the various financial sector clearing streams. Through the aggregation of members' transactions ASL is able to significantly reduce transaction costs associated with settling cheque, direct entry, scheme card, BPAY and other financial transactions.



**CUFSS** is the customer-owned sector's self-funded and operated emergency liquidity support scheme. It is certified by APRA under s11CB of the *Banking Act 1959* and its objectives are to: protect the interests of depositors; and, to promote financial sector stability, particularly in relation to mutual ADIs. CUFSS membership comprises 82 mutual ADIs and Cuscal.



**TAS** - Transaction Solutions Ltd - was established in 1989 by a group of credit unions to provide them with the information technology services needed to run their operations. Today, the company has 46 customer-owned clients and provides hosted services for critical applications such as core banking systems, collaboration platforms, websites and unified communications.



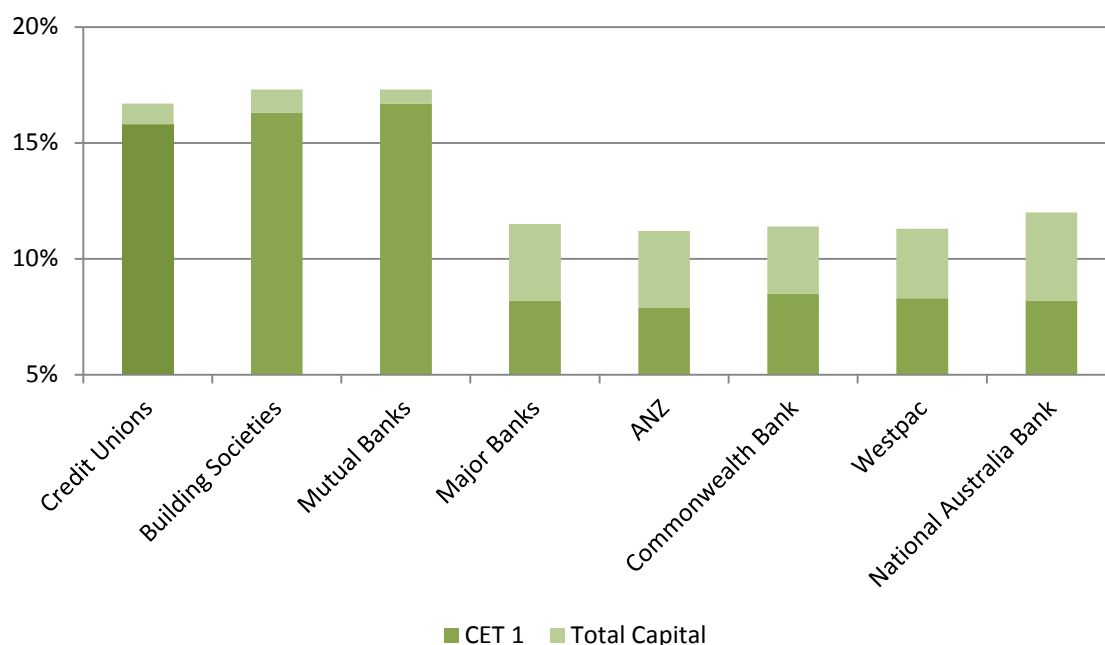
**Data Action** is an Adelaide-based technology services company and is unique in this market as a provider of both software solutions and hosted services. The majority of DA's clients are credit unions and mutual banks.

**AMG** - Australian Mutual Group - comprises around a quarter of the sector by number, with total assets of more than \$10 billion, working together to unlock the benefits of aggregation in accessing funding. The AMG has established a bankruptcy remote special purpose trust to tap wholesale debt and capital markets.

### 3.3 Responsible and ethical lenders underpinning system diversity and stability

The customer-owned model is inherently sustainable and stable, compared to profit-maximising banking institutions. As at December 2013, credit unions, building societies and mutual banks had capital adequacy ratios of 16.7, 17.3 and 17.3 per cent respectively, significantly above the major bank average of 11.5 per cent. Furthermore, the majority of capital held by the customer-owned banking sector is CET 1, which is the highest quality form of regulatory capital. Our sector's holdings of CET 1 capital are roughly twice as high as the major banks (16 per cent versus 8 per cent).

**Chart 8 – Capital Adequacy<sup>12</sup>**



In a Special Comment issued in February 2014<sup>13</sup>, ratings agency Moody's said the sector's "sound" credit standing is supported by customer loyalty, strong balance sheets and conservative business models.

"A linchpin of the sector's credit profile is the mutual ownership structure which emphasises the interests of members over profit maximisation. This provides the mutual sector with the flexibility to forego growth to conserve capital when operating conditions are volatile. We view this to be a key stabilising element through asset cycles. This flexibility also allows the sector to largely maintain its low-risk business model that is centred on prime residential mortgages.

"Despite their small size, many mutuals are able to sustain their franchises focusing on specific niches. For example, Victoria Teachers Mutual Bank targets Victoria's education sector, while Newcastle Permanent Building Society focuses on the Hunter region of New South Wales. Mutual franchises emphasise specific customer sets, community involvement, and customer service, which support their strong customer satisfaction metrics.

"The mutual sector also enjoys consistently stronger asset quality than the listed bank sector, due to its heavy focus on residential mortgages, which have historically performed better than commercial loans. Furthermore, even within their mortgage portfolios, mutual

<sup>12</sup> Source: APRA, Quarterly ADI Performance, Dec 2013; Major Bank Basel III Pillar 3 Disclosures, Dec 2013

<sup>13</sup> Australia's Mutual Financial Institutions: Competition Remains a Key Challenge, Moody's, 3 Feb 2014

institutions tend to outperform the broader market in terms of arrears, suggesting their underwriting criteria are generally at the conservative end of the spectrum...”

In the wake of the GFC, APRA chairman John Laker told the customer-owned banking sector’s 2009 convention that:

“The Australian community, perhaps more than ever, wants genuine choice in its financial services but an assurance, at the same time, that its financial institutions can stay the course. Mutuals know now, after two years in battlefield conditions, they can provide that assurance and offer that choice.”<sup>14</sup>

Any inquiry into systemic risk and the level of competition in the domestic banking market needs to take account of the positive contribution that a strong, domestic co-operative or customer-owned banking sector plays in improving systemic stability. This role is in addition to the important role of providing consumers with competition, service and choice.

As highlighted in the attached report *“Competitive Dynamics in Retail Banking: An International Comparison”*, and discussed further in section 5.1 below, research and experience during the GFC demonstrates that the presence of a strong customer-owned banking sector is a positive contributor to systemic stability.

Support for this position can be found in various reviews, including a 2007 IMF Working Paper that concluded that cooperative banking institutions are more stable than commercial banks, due to lower volatility in returns across credit cycles. The results were derived using data from 16,500 commercial banks, cooperative banks and savings banks over a 10 year period (1994-2004), subsequently demonstrated through the GFC period.

As noted in the attached report, cooperative banks and credit unions in Germany and the U.S. had fewer losses and lent more of their assets during the GFC than commercial banks. These non-profit maximising institutions proved the academic hypothesis true as important countercyclical lenders for the real economy during the GFC. Between 2008 and mid-2011 there were 85 credit unions that failed in the US or 1 per cent of credit unions compared to 369 failures, or 5 per cent of banks.

Additional research from the Centre for European Policy Studies in 2010 – on cooperative banks in seven European countries with significant cooperative bank presence (Netherlands, France, Germany, Italy, Finland, Spain and Austria) – reached similar conclusions regarding co-operative banks being more stable than commercial banks. In France and Netherlands differences between cooperative and commercial banks’ stability were reported as “astounding” by the researchers.

The factors that play into this greater level of stability include the longer term planning and business cycle of customer-owned banking institutions, which are not subject to short term pressures of capital markets; the stability of retail funding franchise, limiting exposure to wholesale funding; and the stakeholder driven governance model and focus on “triple bottom line” results.

In Australia the customer-owned banking sector has demonstrated:

- Lower earnings volatility over the past 35 quarters, compared to major banks;
- Consistently higher levels of capitalisation than the major banks; and
- Significantly lower credit impairment than the major banks.

We contend that a competitive customer-owned banking sector actually improves stability by pushing back against the systemic risks inherent in a system dominated by a small number of very large listed banking institutions.

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<sup>14</sup> Mutuals after turbulent times, John Laker, APRA, 9 Nov 2009



### 3.4 Customer-owned banking sector since the GFC

The customer-owned sector emerged from the GFC in good shape, due to prudent lending, strong risk management and reliance on deposits for funding.

APRA chair John Laker observed at COBA's 2009 convention that the Australian banking system — underpinned by the Government guarantee arrangements — was able to support economic growth through the crisis because it had the liquidity, capital resources and confidence to do so.

"This is not just a story of our largest banking institutions," Dr Laker said. "It is the story, as well, of our credit unions and building societies. Some simple facts confirm this. Over the past two years:

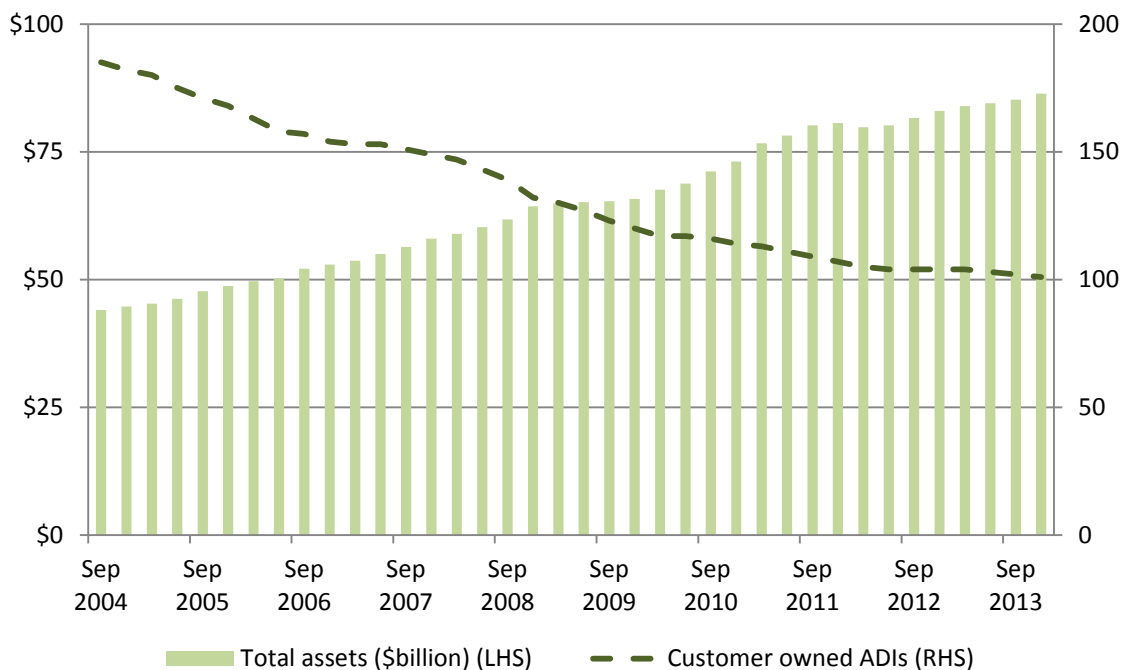
- no credit union or building society has breached APRA's prudential capital requirements or, for that matter, any other key prudential requirements;
- no credit union or building society has left the industry under circumstances of *force majeure*;
- more positively, credit unions and building societies as a group have continued to grow their balance sheets by pursuing sensible lending opportunities; and
- credit unions and building societies, again as a group, continued to earn solid profits, totalling just over \$300 million in 2008/09. This figure is much lower than in previous years — the inevitable outcome of Australia's economic slowdown, margin pressures and the tough competitive environment — but a good result in difficult times."<sup>15</sup>

A long-term trend of consolidation continues to deliver fewer but larger customer-owned banking institutions and overall sector growth. The consolidation process is effected by mergers between customer-owned banking institutions. There are very few exits from the sector in the form of demutualisation. In the last decade, only three credit unions have demutualised.<sup>16</sup>

***"The customer-owned sector emerged from the GFC in good shape, due to prudent lending, strong risk management and reliance on deposits for funding."***

<sup>15</sup> Mutuals after turbulent times, John Laker, APRA, 9 Nov 2009

<sup>16</sup> Statewest 2006, MyState 2009, Goldfield 2012.

**Chart 9 – Strategic Consolidation Leads to Growth<sup>17</sup>**

While our sector has continued to grow both through and since the GFC, at the same time the regulatory settings put in place in the name of stability during this period have entrenched the dominant position of the major banks and impacted on our market share. This issue is discussed further in Chapter 4.

### 3.5 Emergence of mutual banks

The concept of a mutual bank was introduced by the previous government as part of its “Competitive and Sustainable Banking System Package.” credit unions or building societies are now able to make an application to APRA to be re-branded as a “mutual bank.” While these institutions are now “banks,” they remain customer owned and they continue to follow the principles of mutuality, serving customer owners rather than maximising profits.

The customer-owned banking sector now includes 10 banks, with two more due to join their ranks later this year.

<sup>17</sup> Source: APRA, Quarterly ADI Performance, Dec 2013

APRA requires an ADI seeking to rebrand as a 'bank' to hold at least \$50 million in Tier 1 capital. Many large customer-owned banking institutions with Tier 1 capital well in excess of this threshold have not rebranded as banks. However, the option to rebrand has typically been driven by growth strategies and the view that the term 'bank' is better understood by consumers than the terms 'credit union' or 'building society'.



Announcing its new branding in September 2011, Australia's first customer-owned bank bankmecu said being a bank would allow it to reach out to a new group of younger customers for whom the idea of a customer-owned bank appeals.

Rebranding in 2011, Australia's biggest customer-owned bank, Heritage Bank, said it had outgrown the term 'building society'. "We are now able to provide the same range of financial products and services as a bank. Our members think of us as their bank, and that's how many other people see us as well."

The most recent entrant to the category, in 2013, P&N Bank said "research showed that up to 65 per cent of West Australians did not consider us as a banking alternative because of the barriers of our name association with police and nurses and confusion surrounding the safety and offerings of a credit union. While Police & Nurses Credit Society already held a banking license to operate as a credit union, a significant percentage of the public were not aware that we had the same government guarantees and regulations as the big banks."

### 3.6 Community Contribution

Customer-owned banking institutions make important and significant contributions to the communities where they operate.

To look at community contributions made by particular sectors, the London Benchmarking Group (LBG) Model "...provides a comprehensive and consistent set of measures for corporate community investment professionals to determine their organisation's contribution to the community...",<sup>18</sup> and is "the internationally recognised standard for measuring corporate community investment."<sup>19</sup> The use of a standardised methodology allows "like for like" comparisons to be made between the community contributions of different organisations.

More than 300 companies have adopted the LBG model globally,<sup>20</sup> as have almost 50 businesses in Australia and New Zealand.<sup>21</sup> Members in this region include two of the major banks (ANZ and NAB) and one customer-owned banking institution (Teachers Mutual Bank).

***"Customer-owned banking institutions don't just provide better outcomes for their customers, they also provide better outcomes for their communities."***

In measuring community contributions as a percentage of pre-tax profits, contributions at a global level averaged 1.70 per cent. For companies in the Australia New Zealand region, this figure was lower (0.59 per cent) and for the eight financial companies in the Australia New Zealand region the figure was lower again (0.35 per cent). In contrast, the result for Teachers Mutual Bank was 4.10 per cent, more than 10 times higher than the average result achieved by its peers.

Teachers Mutual Bank is far from an isolated case in our sector. In a recent survey of our member institutions, we collected data on the individual community contributions they make. While these members have not generally used the LBG methodology to make these calculations, the figures reported are nonetheless indicative of the significant contributions customer-owned banking makes to the communities where it operates.

**Table 2: Sample of community contributions by customer owned ADIs**

<b>Institution</b>	<b>Community Contribution<sup>22</sup></b>
<b>Holiday Coast Credit Union</b>	8.3%
<b>The Capricornian</b>	8.1%
<b>Family First Credit Union</b>	7.8%
<b>WAW Credit Union</b>	6.8%
<b>Queensland Country Credit Union</b>	6.2%
<b>People's Choice Credit Union</b>	4.9%
<b>Victoria Teachers Mutual Bank</b>	4.9%
<b>Beyond Bank</b>	4.8%
<b>Encompass Credit Union</b>	4.6%
<b>Maritime, Mining &amp; Power Credit Union</b>	4.5%

Our customer-owned model is a different approach to the major banks. Our ability to focus on customers and communities means we can better deliver:

- Ethical, socially responsible banking with greater flexibility for local decision-making based on the needs of local communities, and
- A focus on local employment and investment and community partnerships that stimulate the local economy and support community groups, organisations and charities.

<sup>18</sup> <http://www.lbg-australia.com/>

<sup>19</sup> <http://www.lbg-online.net/about-lbg.aspx>

<sup>20</sup> <http://www.lbg-online.net/global-network.aspx>

<sup>21</sup> <http://www.lbg-australia.com/member/>

<sup>22</sup> Expressed as a percentage of pre-tax profits

We recognise that the well-being of the customer-owned banking sector, the local community and the individual are all linked. As a result, our decision-making looks to support the people that live in the communities in which we operate – it is not focused on the needs of external shareholders. This means we are focused on the long term health of our communities and therefore able to deliver prudent, responsible and ethical financial services.

### **Box 1 – Examples of Community Contributions**

#### ***The People's Choice Community Lottery<sup>23</sup>***

For 30 years People's Choice Credit Union has run a Community Lottery which helps not-for-profit organisations reach their financial goals through a simple fundraising activity that is administered and paid for by People's Choice and its business and media partners.

People's Choice organises the prizes, the tickets and the administration so community groups pocket 100 per cent of each and every \$2 ticket they sell.

The award-winning Lottery has raised more than \$11 million for over 1500 not-for-profits, and it's estimated that a quarter of a million volunteers and members from these organisations contribute to the success of the lottery each year.

In 2014, 900,000 tickets are being sold by 1000 community groups across Australia, with a potential return of \$1.8 million to the community. There are 212 prizes on offer, valued at \$360,000.

#### ***The Defence Bank Foundation<sup>24</sup>***

The Defence Bank Foundation was established to provide care, assistance, education and equipment to assist members and ex-members of the Australian Defence Force and their dependents who suffer injury, disability, sickness or are disadvantaged.

The Foundation aims to give back to the Defence community where it's most needed, in a way which complements and enhances the support already provided by the ADF and other major charities supporting the Defence community.

#### ***Greater Charitable Foundation<sup>25</sup>***

The Greater's customers and its staff have a proud tradition of supporting charities and community organisations. The Greater Charitable Foundation formalises and takes this support to a new level.

The Greater made an initial allocation of \$1 million to the Foundation and is continuing to fund the Foundation from its profits on an on-going basis.

The Foundation funds significant projects that will make a lasting difference to the lives of people within the Greater's area of operations. It partners with Australian-based charitable organisations to fund practical initiatives which directly support families and communities.

#### ***bankmecu's Conservation Landbank<sup>26</sup>***

The Conservation Landbank project was established by bankmecu to offset their business impact.

As part of its commitment to create a sustainable future, bankmecu purchased five properties situated in Victoria's west Wimmera region – with a total size equivalent to 464 MCGs.

<sup>23</sup> <http://www.peopleschoicecu.com.au/library/Community%20Lottery%20A5%20proposal%20EMAIL3.pdf>

<sup>24</sup> <http://www.defencebank.com.au/defence-bank-foundation>

<sup>25</sup> <http://www.greater.com.au/About-Us/Community/Charitable-Foundation.aspx>

<sup>26</sup> <http://www.bankmecu.com.au/why-bank-with-us/conservation-landbank.html>

The Conservation Landbank enables bankmecu to offset the loss of biodiversity resulting from new homes it finances and to offset the carbon emissions generated by cars it finances. The Bank does this by restoring endemic vegetation and protecting habitat on its properties. bankmecu has appointed Landcare Australia to project manage the Conservation Landbank, while Trust for Nature oversees the quality of conservation works through its Covenant program.

Customer-owned banking institutions don't just provide better outcomes for their customers, they also provide better outcomes for their communities.

## 4 Banking since Wallis: impacts on competition

There has been significant change in the banking sector since the Wallis Inquiry. That inquiry established the framework for a stable banking system, a framework put to the test in the last decade with the emergence of the GFC. Whilst Australia's banking system has weathered the GFC, there have been serious impacts on competition in the banking sector, which, if not addressed, may undermine the stability of the Australian economy and the ability of Australians to get competitive and diverse retail banking products.

Australia has the most concentrated banking sector of any G20 country and is home to four of the eight most profitable banks in the world. (See the attached paper *Competitive Dynamics in Retail Banking: An International Comparison*). According to the OECD, the Australian economy is the third most reliant in the world on the performance of its top three banks, surpassed only by the United Kingdom and France.

At 10.8 per cent of the economy, the financial services sector is approximately the size of the mining sector and media/telecommunications sector combined.

It is critical that we ensure that a sector of this size is efficient and competitive.

### 4.1 Competition in Banking

Competitive pressure in lending markets has declined with the exit of foreign banks and non-ADI lenders. Government guarantees, explicit and implicit, have become an important factor in funding markets, particularly since the GFC.

In 2012, COBA (then *Abacus – Australian Mutuals*) commissioned a report from Deloitte Access Economics (DAE) on the state of competition in the banking market. The DAE report *Competition in Banking*<sup>27</sup>, signed by Wallis Inquiry member Professor Ian Harper, found that:

- The GFC has upset the balance between competition and stability;
- The efforts of government and regulators to stabilise the financial system during the GFC favoured the major banks over smaller lending institutions; and
- Addressing the distortions in funding costs and regulatory burdens between the major banks and the smaller lenders can help to restore competition in banking markets.

The DAE paper found that credit unions, building societies and customer-owned banks emerged from the GFC in reasonably good shape, due to their prudent lending standards, conservative attitudes towards risk, and reliance on deposits rather than wholesale markets for funding.

“However, mutuals now find themselves at a competitive disadvantage to the major banks, resulting from increased funding costs and other impediments to competition,” the DAE paper says. “Addressing the distortions in funding costs and regulatory burdens between the major banks and the smaller lenders can help to restore competition in banking markets.”

“A banking system that is not competitive will have significant implications for consumers. Lack of competitive pressures will lead to higher prices for services, limited choice, and ultimately lower levels of borrowing and deposits for consumers. Without competition, there will also be weaker incentives for innovation and improvements in products/services. A

<sup>27</sup> <http://www.customerownedbanking.asn.au/view-2012-media-releases/815-australia-needs-independent-inquiry-into-financial-system->

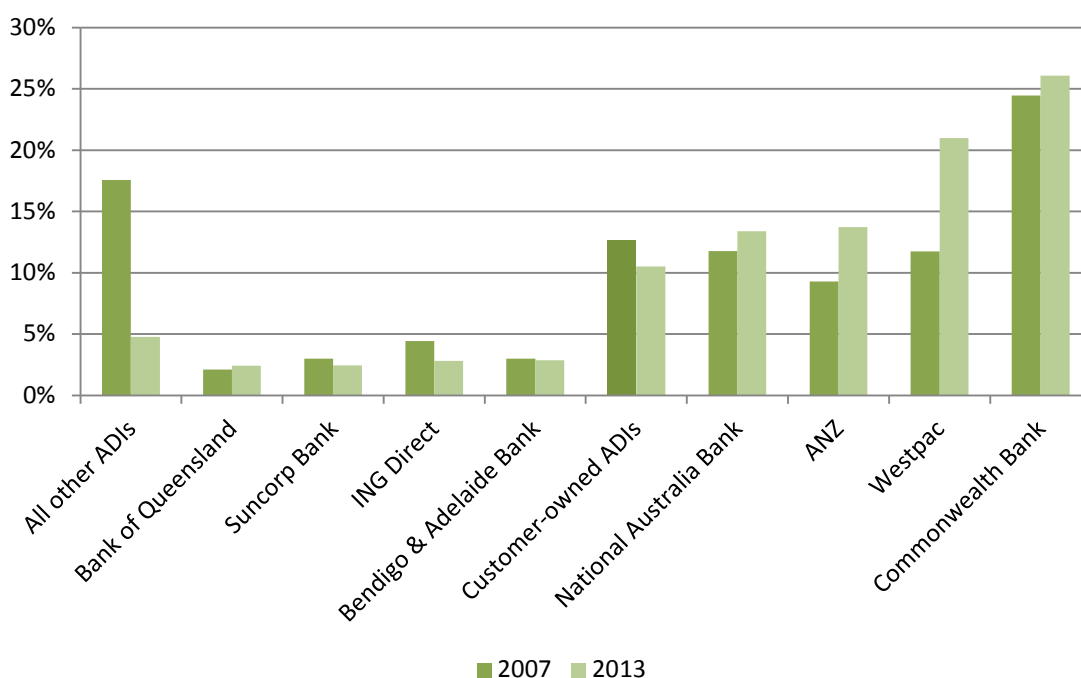
diminishing presence for mutuals will reduce choice and access to financial services in Australia. The major banks will become even more 'too big to fail'."

The IMF's November 2012 *Financial System Stability Assessment* on Australia<sup>28</sup> found that the four major banks:

- Hold 80 per cent of banking assets and 88 per cent of residential mortgages;
- Are highly interconnected;
- Have grown faster than the banking sector as a whole since the GFC;
- Have pricing power; and
- Are highly profitable, enjoying a funding cost advantage derived partly from implicit government support and earning larger net interest margins than smaller banks and international peers.

The customer-owned sector maintains a significant share of the household deposits market but our sector's ranking has fallen from second in 2007 to fifth today. Similarly, our share of assets has fallen from 3.5 per cent in 2005 to 2.9 per cent today.

**Chart 10 – Household Deposits (percentage of market)<sup>29</sup>**



A string of Parliamentary inquiries since 2008 have expressed concern about the dominance of the major banks.

"While there is no doubt that the big four aggressively compete with the other players in the market, including foreign-owned banks, the credit unions, building societies and the non-banking sector, there is some uncertainty as to whether the big four are actively competing with each other." *House of Representatives Committee report 2008.*<sup>30</sup>

<sup>28</sup> <http://www.apra.gov.au/AboutAPRA/Publications/Documents/cr12308%5B1%5D.pdf>

<sup>29</sup> Source: APRA, Quarterly ADI Performance, Dec 2013

<sup>30</sup> House of Representatives Standing Committee on Economics, Report on Competition in the banking and non-banking sectors, November 2008



"...the Australian banking market is now, by some criteria, the most concentrated it has been for more than a century." *Senate Committee report 2009*.<sup>31</sup>

"Close consideration needs to be given to shifting the balance between stability and competition back toward the latter as conditions improve." *Senate Committee report 2009*.<sup>32</sup>

"Given the degree to which regional Australia relies on mutual ADIs, the Committee is concerned about the potential for decreased competition in the regional banking sector." *House of Representatives Committee report 2009*.<sup>33</sup>

"The goal of discouraging banks from unduly increasing interest rate margins at the expense of homebuyers can be better achieved by measures to make the market more competitive, such as the recent initiative by the Government to facilitate customers moving between banks." *Senate Committee report 2009*.<sup>34</sup>

"The net effect...has led to a more concentrated banking market than existed prior to the financial crisis, with the 'big four' banks increasing their dominance across most if not all banking markets. The committee considers that this increase in concentration has the potential for consequent undesirable impacts on competition. Accordingly, as the threat to stability posed by the GFC subsides, it is appropriate that priority turn more to achieving an appropriate longer term balance between stability and competition." *Senate Committee report 2011*.<sup>35</sup>

"While Australia's post-global financial crisis banking system scores well for stability, and there are competitive forces within the sector, there remains concern about the overall state of competition." – *Senate Committee report November 2012*.<sup>36</sup>

Since the GFC, banking has become the only sector of the Australian economy that is subject to anti-price signalling laws. The Explanatory Memorandum<sup>37</sup> for the 2011 laws refers specifically to "major banks" and says anti-competitive price signalling and other information exchanges:

"...most typically arise and have the greatest detriment in markets which exhibit oligopolistic features and can be as harmful to competition and consumers as explicit cartel behaviour. In an oligopolistic market businesses are not 'price takers', as they have a degree of market power and impact on market outcomes and the decisions of competitors. Accordingly, oligopolists are able to take advantage of increased transparency as it enables them to better predict or anticipate the conduct of their competitors and thus align themselves to it, to the detriment of consumers and the economy."

Despite lower funding costs and economies of scale, the major banks' advertised standard variable rates continue to be higher than the home loan rates in the customer-owned banking sector.

**Table 3: Comparison of Home Loan and Deposit Interest Rates**

	Major banks	Customer-owned	Difference
<b>Average Home Loan</b> <sup>38</sup>	5.91%	5.47%	0.44%
<b>Lowest Home Loan</b>	5.88%	4.70%	1.18%
<b>Average Term Deposit</b> <sup>39</sup>	3.10%	3.23%	0.13%
<b>Highest Term Deposit</b>	3.15%	3.80%	0.65%

<sup>31</sup> Senate Economics References Committee, Report on Bank Mergers, September 2009

<sup>32</sup> Senate Economics References Committee, Report on FCS, September 2009

<sup>33</sup> House of Representatives I, T, RD & LG Committee, Impact of GFC on Regional Australia, Nov 2009

<sup>34</sup> Senate Economics Legislation Committee, Banking Amendment (Keeping Banks Accountable) Bill, Nov 2009

<sup>35</sup> Senate Economics References Committee, Report on Competition within the Australian Banking Sector, May 2011

<sup>36</sup> Senate Economic References Committee, Report on the post-GFC Banking Sector, November 2012

<sup>37</sup> *Competition and Consumer Amendment Act (No 1) 2011* Explanatory Memorandum

<sup>38</sup> Comparisons of the Standard Variable Rate – source: Canstar Cannex

<sup>39</sup> Comparisons of a \$10,000 3 month Term Deposit – source: Canstar Cannex

The ACCC chairman Rod Sims commented in 2012 that the major banks feel protected from others entering the market and that makes for arrangements that are too cosy for consumers. Mr Sims said: “Normally four players in a market leads to a lot of competitive activity. In the banking sector it seems to need more because even though there are four of them there is a lack of full and effective competition.”<sup>40</sup>

In late 2013, APRA formally designated the four major banks as “systemically important”.<sup>41</sup>

“Systemically important financial institutions (SIFIs) are institutions of such size, market importance and interconnectedness that their distress or failure would cause significant dislocation in the financial system and adverse economic consequences. The ‘too-big-to-fail’ problem arises when the threatened failure of a SIFI leaves public authorities with no option but to bail it out using public funds to avoid financial instability and economic damage. As the Basel Committee argued, the moral hazard associated with implicit guarantees derived from the perceived expectation of government support can encourage SIFIs to take excessive risks, reduces market discipline and creates competitive distortions, further increasing the probability of distress in the future. As a result, the direct cost of support associated with moral hazard is borne by taxpayers, representing a large and unacceptable implicit public subsidy of private enterprise.”

There is no doubt that there is insufficient competition within the retail banking sector. The issue that needs further examination is what role the legislative and regulatory framework plays in preventing more competition and how the Government might re-adjust the policy settings to create a more open and equitable retail banking market.

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<sup>40</sup> ACCC says more banks should open in Australia Sunday Herald Sun 22 January 2012

<sup>41</sup> Information Paper – Domestic systemically important banks in Australia, APRA December 2013

## 5 Getting the Policy Settings Right

*“The Inquiry will refresh the philosophy, principles and objectives underpinning the development of a well-functioning financial system...”*

A well-functioning financial system is one:

- That accommodates diversity and different business models;
- That promotes competition and competitive neutrality;
- Where regulatory frameworks are principles-based and risk-based;
- Which facilitates innovation and flexibility; and
- Where consumers are confident and informed.

Competition must be based on a level playing field and must be sustainable if consumers, small businesses and other end-users of the financial system are to benefit in terms of choice, pricing, service and innovation.

The ‘twin peaks’ model, with APRA responsible for prudential regulation of financial institutions and ASIC responsible for market conduct regulation in the financial sector, remains appropriate.

However, significant changes are needed to the policy and regulatory framework to recognise and better accommodate the benefits of diversity and to deliver genuine competitive neutrality.

***“Competition must be based on a level playing field and must be sustainable if consumers, small businesses and other end-users of the financial system are to benefit in terms of choice, pricing, service and innovation.”***

### 5.1 Diversity & Plurality

The GFC has proved that diversity and plurality in banking is a strength for the financial system and contributes to stability. Customer-owned banking institutions around the globe – e.g. credit unions in the US and Canada, co-operative banks in Europe – performed comparatively well during the GFC.

Australian customer-owned banking institutions were able to “stay the course” in “battlefield conditions.”

A strong customer-owned sector is one marker of a diverse banking market but other examples - provided by listed banks - include Bendigo Bank’s community bank model and Bank of Queensland’s owner-manager franchise model.

A 2014 paper<sup>42</sup> by the US credit union think-tank Filene Research Institute says that, like co-operative and mutual banks in Europe, credit unions in the US were more resilient during the global financial turmoil than their competitors.

“Several reasons have been posited for this superior performance:

- A relatively low risk appetite.
- Relatively higher capitalisation.
- A predominant focus on retail lending and deposits.

<sup>42</sup> Credit Union Capital Adequacy: What’s New and What’s Next? Filene Research Institute, Feb 2014

- An informational advantage arising from long-standing borrower relationships.
- Greater member-borrower commitment to repayment.

“From 2008 through mid-2011 there were 85 US credit union failures, just over 1 per cent of the 7,400 total credit unions operating at year-end 2007. During the same period 369 banks failed, about 5 per cent of the year-end 2007 total.”

The performance of customer-owned ADIs in Australia has been even stronger than that of their international counterparts.

European policy centre Sustainable Architecture for Finance in Europe (SAFE) says the GFC generated the insight that in the area of banking there can be too much profit orientation, too much profit pressure emanating from the capital market on listed banks and too much financial sophistication.

“Working together these factors can lead to banks accepting and even generating too much risk for themselves as institutions and for society. Local and regional banks are less risky and this contributes to the stability of entire financial systems. Their contribution to financial system stability might suggest that from an overall perspective they might simply be the better banks. However, such a claim would go much too far. But the converse is also not true. The ‘modern’ view that all financial systems should resemble as much as possible the model of a financial system in which capital markets are the most important force and in which banks are large, private, purely shareholder-oriented and exchange-listed corporations has been severely discredited by the experiences from the recent financial crisis. We simply do not know which type of bank and which structure of a financial system are better under different circumstances. This agnostic position leads to the argument of diversity.”<sup>43</sup>

The UK’s Centre for Financial and Management Studies has drafted a diversity index to assist policy-makers to measure changes in the diversity of the financial system. The Centre says one of the key findings of post GFC research is that diversity is an important and hitherto neglected source of systemic stability and resilience.

“Diversity is a multifaceted concept including differences in: corporate forms and objectives; firm size and the degree of competition; funding strategies and business models; and geographic spread.”

“The main systemic benefits to be derived through diversity were found by Ayedi *et al.* (2009, 2010) to include:

- Systemic stability by virtue of having institutions that manage risk differently (and through the lower risk-appetite of mutual and co-operative banks).
- Enhanced competition via different business models.
- Mutual and co-operative banks tend to be less prone to short-termism via the pressure of maximising shareholder value over a short time horizon.
- Mutual and co-operative banks are more likely to be locally based.”<sup>44</sup>

While diversity and plurality in the banking sector should be encouraged, the regulatory framework in Australia makes it very difficult for new entrants to become ADIs. While we recognise the importance of a sound prudential framework and a stable and secure banking sector, it is important to assess whether the current barriers to entry for new competitors are appropriate. COBA believes

<sup>43</sup> Savings Banks & Cooperative Banks in Europe, SAFE Policy Centre, Aug 2013

<sup>44</sup> Measuring Diversity in Financial Services Markets: A Diversity Index, Centre for Financial & Management Studies (UK) April 2013

further review of the entry requirements for new competitor ADIs is warranted – in the customer-owned ADI market, there has been no new entrants for over a decade.

**Recommendation: Give increased weighting in the legislative objectives of regulators to promoting diversity and plurality in the banking market.**

## 5.2 Competitive neutrality

The Productivity Commission describes the competitive neutrality principle as sellers of goods and services competing on a level playing field; that is, one provider should not receive an advantage over another due to government regulation.

“Competitive neutrality removes artificial advantages and allows businesses to compete on a basis that offers the best cost and quality combinations to customers. This is likely to result in more effective competition and more efficient outcomes.”<sup>45</sup>

Competitive neutrality means the customer-owned model should be able to compete on equitable terms with the listed model, without being handicapped by unfair treatment and/or subsidies to competitors.

Competitive neutrality does not require identical rules and regulations for all banking institutions. Rather, it requires a principles-based regulatory framework that allows for diversity and recognises the benefits for consumers and overall system stability of accommodating different business models.

The head of the RBA's Financial Stability Department, Luci Ellis, commenting on regulatory consistency, has observed:

“....in ensuring consistency, we do not want to create a monoculture, with all its members being vulnerable to the same risks because they face the same incentives. There is something to be said for allowing some diversity of business models, so the whole system doesn't collapse from a particular shock.”<sup>46</sup>

Competitive neutrality is vitally important in the Australian banking market. It does not currently exist.

COBA has identified a number of areas where the regulatory framework currently fails to provide competitive neutrality to all ADIs. It is these regulatory settings that have helped to entrench the dominant position of the four major banks, and made it far more difficult for other ADIs to compete against them than it should be.

Competitive neutrality is necessary to promote competition and genuine choice. In the absence of positive action by Government and regulators to promote competitive neutrality, the major banks' grip on the banking sector will tighten further.

***“...the customer-owned banking sector is not asking for a ‘free kick’ or a ‘leg up,’ we are simply asking for the opportunity to compete with the major banks on fair and level terms.”***

In recommending changes to address competitive neutrality concerns, the customer-owned banking sector is not asking for a “free kick” or a “leg up,” we are simply asking for the opportunity to

<sup>45</sup> Contribution of the Not-for-Profit Sector. PC Research Report. January 2010

<sup>46</sup> <http://www.rba.gov.au/speeches/2013/sp-so-181013.html>

compete with the major banks on fair and level terms. The customer-owned banking model is durable and successful and is entitled to nothing less – and nothing more - than competitive neutrality.

### *5.2.1 Failures in competitive neutrality*

The main areas where the regulatory framework currently fails to provide for competitive neutrality are:

- The implicit government guarantee which provides the major banks with a large and unacceptable free subsidy on their funding costs;
- Prudential regulatory settings on capital, liquidity, marketing and levies; and
- Company tax and the impact of dividend imputation on the customer-owned model.

Where measures have been introduced in recent years which improve competitive neutrality, it is critical that these be retained. In particular, the Financial Claims Scheme (FCS), with its current cap of \$250,000 is effective in providing both system stability and supporting competition within the ADI sector.

### *5.2.2 The impact of being “too big to fail”*

Major banks gain an unfair cost of funding advantage that flows from ratings agencies and investors factoring in an implicit Government guarantee.

Prior to the GFC, most consumers believed that the major banks were guaranteed by the Government. In addition, wholesale lending markets assumed that because of their too big to fail status, the Australian Government would bail out the largest four banks in the event of failure. This is the implicit guarantee that has underpinned the major banks for some time.

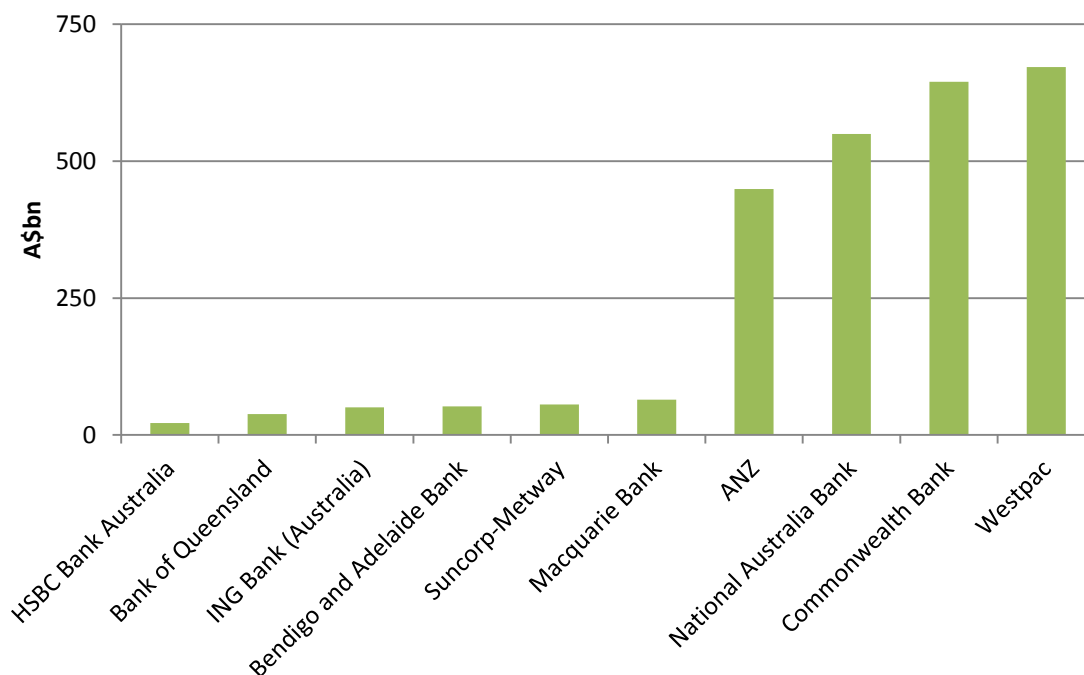
However, during the GFC, this implicit guarantee became an explicit one with the Australian Government and key regulators making it publicly clear that they would not allow our largest banking institutions to fail. This was sound policy at the time of significant disruption to global markets, but it came at a significant cost to competition.

The IMF estimates this funding cost advantage for the major banks rose from 80 basis points to 120 points during the GFC when Government support for the banking system was made more explicit. This is a significant advantage and one provided without cost to our largest four banks.

APRA has formally identified the major banks (total resident assets depicted below)<sup>47</sup> as systemically important banks.

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<sup>47</sup> Information Paper: Domestic Systemically Important Banks in Australia. Dec 2013 APRA

**Chart 11 – Major Banks Dominate Assets<sup>48</sup>**

As noted above, the ‘too-big-to-fail’ problem arises when the threatened failure of a SIFI leaves public authorities with no option but to bail it out using public funds to avoid financial instability and economic damage. The dimensions of the problem include competitive distortions and reduced market discipline flowing from an implicit guarantee.

The unfair funding cost advantage and its impact on competition is only one of the problems posed by systemically important banks. The President of the New York Federal Reserve William Dudley says the second problem is that the funding cost advantage creates incentives for banks to become bigger and more complex and the third problem is that there is a positive feedback loop: as the banking system becomes more concentrated and complex, financial stability risks increase, making the too big to fail problem even worse.<sup>49</sup>

Dudley believes policymakers have three broad sets of choices:

1. building a credible resolution regime and more resilience in the financial system that together reduces the systemic costs of failure sufficiently so that large, complex firms can be allowed to fail;
2. taking steps, such as tougher prudential standards, that further reduce the probability of failure of such firms; or
3. breaking up the too big to fail firms so that no firm is so large that its failure would threaten financial stability in the first place.<sup>50</sup>

Australia has only taken a small step in terms of ‘choice 2’, tougher prudential standards, with APRA imposing an additional capital requirement on our four D-SIBs, which in our view is far too small to adequately respond to the issue. Furthermore, ‘choice 1’, implementing a credible resolution regime, will take a considerable time and there does not appear to be widespread support for ‘choice 3’, breaking up the D-SIBs.

<sup>48</sup> Source: APRA Monthly Banking Statistics, Jan 2014.

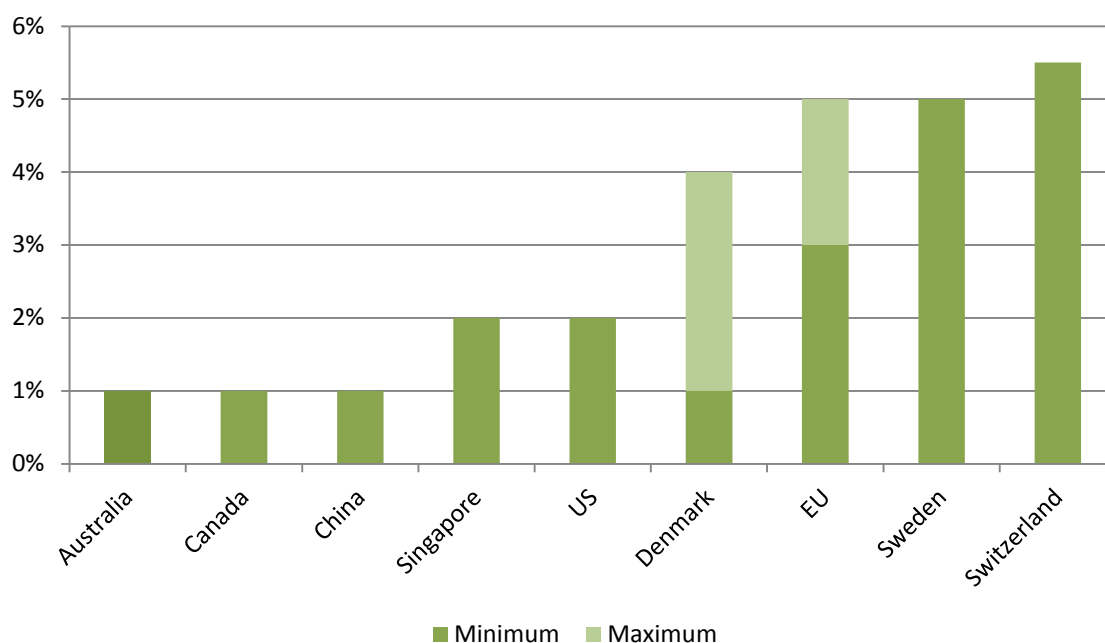
<sup>49</sup> ‘Too big to fail banks have implicit guarantee’ AFR 14 Nov 2013

<sup>50</sup> <http://www.newyorkfed.org/newsevents/speeches/2013/dud131107.html>

### 5.2.2.1 APRA's D-SIB response

APRA's response after formally identifying the major banks as D-SIBs was to impose an additional Higher Loss Absorbency (HLA) capital requirement of one per cent to apply from 2016. This response is at the lower end of the range set by other countries. Switzerland and Sweden have imposed regulatory capital increases of five per cent on their systemically important banks and in the US and Singapore it is two per cent.

**Chart 12 – D-SIB Obligations in Other Countries<sup>51</sup>**



The one per cent HLA requirement does not present a challenge to the major banks. According to Moody's, the major banks will have "no difficulty" meeting the requirement.<sup>52</sup> APRA has indicated it will allow them to absorb the new requirement by reducing their current management capital buffers.

"At 1 January 2016, the management capital buffers of the D-SIBs may be lower than current levels given the additional HLA requirement," APRA says. "APRA considers it reasonable if D-SIBs choose to operate with a relatively lower management capital buffer from 1 January 2016 given the nature and size of the extended capital conservation buffer."<sup>53</sup>

***"In COBA's view, APRA's D-SIB regime is inadequate in tackling the unfair competitive advantage of the major banks."***

In COBA's view, APRA's D-SIB regime is inadequate in tackling the unfair competitive advantage of the major banks.

<sup>51</sup> Information Paper: Domestic Systemically Important Banks in Australia. Dec 2013 APRA

<sup>52</sup> No Immediate Credit Implications from APRA's D-SIB framework. Moody's Sector Comment, 9 January 2014

<sup>53</sup> Information Paper: Domestic Systemically Important Banks in Australia. Dec 2013 APRA



### 5.2.2.2 A more credible response to “Too Big To Fail”

Globally, policy-makers are examining ways to ensure that systemically important banks can be allowed to fail, by some form of ‘bail-in’ by creditors other than shareholders and other contributors of regulatory capital.

A member of the executive board of the Bundesbank Dr Andreas Dombret says the best regulatory solution to the ‘too big to fail’ (TBTF) problem is the credible threat of an institution’s orderly market exit.

“In future, banks have to be able to exit the marketplace without impairing system stability and without the use of taxpayers’ money. Only if this is a credible threat will trust be restored. This is the only way banks’ ability to ‘blackmail’ the taxpayer can be curtailed.”<sup>54</sup>

The Financial Stability Board (FSB), in consultation with standard-setting bodies, is preparing proposals for consideration by the G20 on the adequacy of G-SIFI loss absorbing capacity in resolution.

“To avoid the need for a bailout with public funds a SIFI needs to have sufficient resources to absorb losses in resolution (‘gone concern loss absorbing capacity’ GLAC). An adequate amount of GLAC should facilitate the implementation of a resolution strategy with a recapitalisation at a level that promotes market confidence and, at a minimum, meets going-concern regulatory capital requirements. The FSB will prepare proposals for consideration by end-2014 on the nature, amount, location within the group structure, and possible disclosure of GLAC.”<sup>55</sup>

Ratings agencies such as Standard & Poor’s are watching the development of GLAC proposals but have not changed their view on government support for systemically important banks that leads to the unfair cost of funds advantage enjoyed by D-SIBs.

“Despite the progress made to date in building effective resolution regimes, Standard & Poor’s Ratings Services continues to include uplift in our ratings for government support to many systemically important banks worldwide. For about 75 per cent of the top 100 banks we rate, we include at least one or two notches of uplift in the rating from the bank’s stand-alone credit profile due to government support.

“However, many of these initiatives are still very much a work in progress and others have longer timelines for transition and implementation that last until the end of the decade.”

“Our current view is that the Australian government is one of 12 governments globally of the 86 banking systems where we assign bank ratings that is ‘highly supportive’ to its domestic banking sector. The potential move by the Australian government toward an alternate resolution regime that embraces a concept of senior creditor bail-in could sit uncomfortably with our ‘highly supportive’ designation. This could result in a changing our views concerning government support, which, in turn, would likely be accompanied by downgrades of Australian banks that we currently view as ‘systemically important’.”<sup>56</sup>

Unless issues around the resolution of major financial institutions can be resolved, they will continue to benefit from an unfair and grossly distortionary cost of funds advantage provided by Australian taxpayers. There is no guarantee that proposed GLAC changes will address the issues in a timely fashion, or even that the GLAC proposals will adequately address the competition issue at all. As

<sup>54</sup> Speech by Dr Andreas Dombret, Member of Executive Board of the Deutsche Bundesbank, 9 Nov 2012

<sup>55</sup> Progress and Next Steps Towards Ending TBTF, Report of FSB to G20, Sep 2013

<sup>56</sup> Resolution Plans for Global Banks May Eliminate Government Support for Some, But Progress is Varied. 4 Dec 2013

noted above, the 'too big to fail' problem tends to get worse over time as the funding cost advantage creates incentives for banks to become bigger and more complex.

Given that the GLAC timetable is, at best, unclear, action must be taken to adjust the competitive imbalance in the market caused by the TBTF funding benefit. Taxpayers should not be expected to continue to underwrite the profitability of the major banks. If the implicit guarantee funding advantage is currently unavoidable, measures should be implemented to level the playing field and to compensate taxpayers for the benefit they are providing to the four major banks.

One mechanism to achieve this is to impose a levy on systemically-important banks in response to the benefit they obtain from the implicit guarantee and the risk they pose to the national economy. An annual levy in the range of \$1 billion to \$2 billion would represent a conservative setting, given the difficulty in precisely estimating the benefit of the implicit guarantee. The simplest way to impose the levy would be to apply it to the entire liability base of each D-SIB. Alternatively, the levy could be targeted to their wholesale funding liabilities (total liabilities less retail deposits).

***"If the implicit guarantee funding advantage is currently unavoidable, measures should be implemented to level the playing field and to compensate taxpayers for the benefit they are providing to the four major banks."***

COBA's 2014-15 Pre-Budget submission<sup>57</sup> suggested three options: levies of 4, 6 or 8 basis points. However, COBA acknowledges there is an argument that such a levy should not apply to regulatory capital or to deposits covered by the FCS.

The levy need only apply while D-SIBs enjoy a credit rating uplift due to an implicit guarantee. Indeed, the magnitude of the levy could be determined on an ongoing basis by reference to an analysis of the capital markets and the funding cost advantage they obtain because of their rating uplift. Once a credible resolution framework is in place, with GLAC requirements understood and factored into pricing by investors, the uplift will be removed and the levy may no longer be necessary.

This is not an unfair tax on our largest banking institutions – it is a simple mechanism to restore a competitive imbalance created by TBTF. It reflects the fundamental principle that major banks should be required to make a contribution to government which recognises the financial benefit they derive from a taxpayer funded subsidy. It is also not without international precedent.

The UK Government imposed a levy on larger banking institutions on 1 January 2011 to ensure "banks make a fair contribution in respect of the potential risks they pose to the UK financial system and wider economy."<sup>58</sup> Design of the levy was based on a proposal in an IMF report to the G20.

The UK bank levy was increased from 13 basis points to 14 basis points from 1 January 2014. The levy "currently affects in the region of 30 banking groups and building societies." The aim of the levy's application threshold - £20 billion in liabilities – was "to balance the probability that the firm would impose a systemic risk, which is correlated with size, against the relative burden imposed in order to gather additional revenue at the margin." The levy is intended to raise at least £2½ billion each year. The levy was reviewed in 2013, with UK Government recognising "that wider future

<sup>57</sup> <http://www.customerownedbanking.asn.au/images/stories/submissions/2014/20140131%20COBA%20-%202014-15%20Pre-Budget%20Submission.pdf>

<sup>58</sup> Bank Levy: consultation responses, HM Revenue & Customs (UK) Oct 2010

regulatory changes, such as the EU Bank Recovery and Resolution Directive, have the potential to impact on the operation of the levy.”<sup>59</sup>

**Recommendation: Impose a levy on D-SIBs reflecting the credit ratings uplift they receive due to an implicit government guarantee.**

#### 5.2.2.3 *The proposed FCS Levy: inequitable and anti-competitive*

The previous Australian Government announced a levy on FCS protected deposits to apply from 1 January 2016 to create a Financial Stability Fund (FSF). Imposing a levy on D-SIB liabilities rather than ADI deposits would still deliver a FSF but without imposing a tax on Australian consumer deposits and without the anti-competitive impacts of a deposit levy.

Treasury's Options Stage Regulation Impact Statement (RIS) for the Financial Stability Fund says the FSF is a response to two problems:

- the Government does not have a dedicated and readily accessible pools of assets that could be used to fund resolution activities; and
- ADIs do not currently pay for the right to offer explicitly guaranteed deposit accounts under the FCS.

“The Government is not compensated for the insurance it provides through the FCS,” the RIS says. “In addition, systemically important ADIs do not pay for the benefits they derive from the market-perceived implicit government support which, as the IMF noted in its report on Australia's 2012 Finance Sector Assess Program, include lower funding costs than their competitors.”<sup>60</sup>

The fact the FCS is currently post-funded rather than pre-funded is arguably a “subsidy” for all ADIs compared to non-ADIs but it is competitively neutral within the ADI sector and the FCS “subsidy” to all ADIs is dwarfed by the much larger and grossly distortionary subsidy provided by the implicit guarantee applying only to D-SIBs.

According to one set of estimates<sup>61</sup>, the “subsidy” to ADIs of not having a pre-funded deposit guarantee scheme is much less significant than the subsidies to major banks from the TBTF implicit guarantee, the under-pricing of the RBA's Committed Liquidity Facility, APRA's conservative D-SIB capital requirement and asset risk-weighting concessions. These estimates are published in *A Review of the Hidden Costs and Unintended Side Effects of Explicit and Implicit Government Guarantees of the Australian Financial System* – a paper commissioned by Morgij Analytics and produced by John Watson of Margate Financial Research Solutions.

**Table 4: Cost of Government Guarantees – Morgij Analytics**

<b>Subsidy</b>	<b>Estimated Annualised Dollar Cost</b>
<b>Financial Claims Scheme – absence of ex-ante fee.</b>	\$0.5Billion
<b>Committed Liquidity Facility – under-pricing of fee.</b>	\$4.5Billion
<b>Too Big To Fail implicit government guarantee (funding advantage).</b>	\$2.5Billion
<b>Setting the loss absorbency capital requirement at 1% instead of 3% in line with US, UK and other jurisdictions.</b>	\$1.8Billion
<b>Aggressive RWA calculations for competitive advantage.</b>	\$1.8Billion
<b>Aggregate tax payer funded subsidies.</b>	<b>\$11.1Billion per annum</b>

<sup>59</sup> Bank Levy Review 2013 Summary of Responses, HM Revenue & Customs (UK) Dec 2013

<sup>60</sup> Options Stage RIS – Financial Stability Fund, Treasury, Aug 2013

<sup>61</sup> <http://blog.marqservices.com/wordpress/?p=316> ‘If you're not a DSIB life can be tough’ 20 Feb 2014

Competitive neutrality does not necessarily require identical treatment. A 2012 paper<sup>62</sup> by the US credit union think-tank Filene Research Institute says in Canada, provincially-regulated credit unions have benefited from much higher levels of deposit insurance protection than larger, federally-regulated banks.

“In British Columbia, Alberta, Saskatchewan, and Manitoba, governments have long offered unlimited deposit insurance as a means of improving the competitive balance of their local, home-grown financial institutions relative to the Ontario-based banks. The argument is also made that the federally regulated banks, while operating under a deposit insurance regime with only \$100,000 worth of coverage, effectively benefit from an unlimited deposit guarantee because they are viewed as being ‘too big to fail’. If that view is in fact correct, then higher levels of provincial deposit insurance may serve to level the playing field rather than provide some sort of competitive advantage to the credit union sector.”

The case for an up-front levy on FCS protected deposits is not strong. The current FCS framework is settled and working well in the absence of a deposit levy. Concerns with introducing an upfront levy include:

- Given Australia’s prudential framework, an ex-ante funded scheme is unnecessary and will be costly to administer;
- A flat rate levy on guaranteed deposits would impact smaller ADIs more heavily given their higher reliance on deposits as a source of funding; and
- A new tax on deposits further disadvantages these savings relative to other investments (such as equities and property), and is in complete contradiction to the Henry Review’s recommendation that the tax burden on deposits be reduced.

The current ex-post funding arrangements mean industry is already ultimately responsible for meeting any FCS funding requirements. In the highly unlikely event of an FCS declaration, the existing assets of a wound-up ADI should be able to cover any FCS payments, and in the even rarer scenario of a small shortfall industry would be levied to make up the difference.

While many other countries have ex-ante funded deposit insurance schemes, the prudential frameworks in those countries make it far more likely that deposit insurance will be triggered. Of the 21 Financial Stability Board (FSB) members with a deposit insurance scheme in place in 2012, 16 countries had used their schemes a total of 1,000 times over the past decade, while Australia was one of only 5 countries to have not used their scheme over this period.<sup>63</sup>

Ex-ante funded schemes impose large administrative costs, with the Canadian scheme – which manages assets of less than \$2 billion – costing more than \$300 million to administer over the past 14 years despite there being no claims over this period.

More broadly, the imposition of a flat levy on FCS deposits would also have a detrimental impact on deposit holders and competition. The 2009 Henry Tax Review noted that deposit accounts already receive punitive tax treatment relative to other investment alternatives, and the introduction of a new levy on deposits would further distort

***“While we believe that the deposit levy should not be pursued, if a Financial Stability Fund is to be introduced it should be funded with a D-SIB levy. This approach would be pro-competitive rather than anti-competitive...”***

<sup>62</sup> Keeping an Eye on the Ball: Credit Unions, the Level Playing Field, and Competitive Balance, Filene Research Institute, Feb 2012

<sup>63</sup> Financial Stability Board, *Thematic Review on Deposit Insurance Systems*, Feb 2012, p. 55.

investment decisions away from deposits. The deposit levy also raises equity concerns given that the levy will only apply to the first \$250,000 of each account, meaning smaller deposit holders will be hit more heavily than those with very large accounts.

The proposal will also further undermine competitive neutrality in the banking sector, given that customer-owned ADIs rely more heavily on smaller deposits as a source of funding than the major banks. Deposits make up over 85 per cent of the funding base of customer-owned ADIs compared to 58 per cent for the major banks.<sup>64</sup> In addition, COBA estimates that 88 per cent of the value of customer-owned ADI deposits are FCS protected compared to less than 40 per cent for the major banks. As noted by Treasury:

“As the four major banks make up around three quarters of ADI deposits, the major banks will contribute the most to the fund. However, the levy will have a higher proportionate impact on small ADIs. This is partly due to FCS protected deposits making up a higher proportion of small ADIs funding when compared to the major banks (which make substantial use of wholesale debt).”<sup>65</sup>

As a result of these funding differences, we estimate that a 5 basis point levy could reduce our sector's profits by around 7.5 per cent while reducing the profitability of the major banks by less than one fifth of this amount.

While we believe that the deposit levy should not be pursued, if a Financial Stability Fund is to be introduced it should be funded with a D-SIB levy. This approach would be pro-competitive rather than anti-competitive and the impact on already heavily-taxed depositors would be minimised because major banks would find it hard to pass on the cost of the levy.

### *5.2.3 Company tax and the impact of dividend imputation on the customer-owned model*

An important principle of competitive neutrality is that competitors should be subject to the same effective tax burden. This is not the case for customer-owned banking institutions compared to their listed competitors.

Customer-owned ADIs pay company tax at the standard 30 per cent but their reliance on retained earnings as their main source of regulatory capital makes it difficult for them to release franking credits.

Under the franking credit system, company tax is essentially a withholding tax with the final tax due on a company's distributed profits being determined by the marginal tax rate of the underlying shareholders. The total tax paid on company earnings can be lower than the corporate tax rate if the average marginal tax rate of a company's shareholders is below the corporate tax rate.

***“An important principle of competitive neutrality is that competitors should be subject to the same effective tax burden. This is not the case for customer-owned banking institutions compared to their listed competitors.”***

Where an organisation is unable to pay out earnings and franking credits to its owners, the average tax rate is the company tax rate. This is the case for customer-owned banking institutions. The

<sup>64</sup> APRA, *Quarterly ADI Performance, Dec 2013*, CUFSS.

<sup>65</sup> Treasury's Options Stage Regulation Impact Statement – Establishment of FSF

average tax rate for listed banking institutions is lower because the average marginal tax rate of their shareholders is below 30 per cent.

Customer-owned banking institutions collectively have accumulated franking credits of more than \$1.5 billion and are adding \$150-200 million per year. In the year ending June 2013, customer-owned banking institutions collectively made a pre-tax profit of \$629 million, paying company tax of \$185 million.

The franking credits regime does not contemplate companies that pay tax but then retain, rather than distribute, after-tax profits as a core feature of their business model.

Customer-owned ADIs should be able to pass on to their owners the benefit of having paid company tax, just as non-mutual companies can choose to do. Dividend imputation means company tax is a pre-payment of tax ultimately paid by the company's owners – akin to a withholding tax. Owners of companies that pay dividends are able to benefit from the tax paid by the company through a reduction in their personal taxation liabilities. Owners of companies that don't pay dividends, such as customer-owned ADIs, are not able to benefit in this way. For customer-owned ADIs, franking credits remain locked up, increasing year after year as the company continues to make profits, pay tax and prudently retain those profits as its main source of regulatory capital.

Solutions to the unfair company tax burden on customer-owned ADIs include:

- Allow customer-owned ADIs to issue a frankable debt deposit product; or
- Apply company tax on customer-owned ADIs at a rate that is comparable to the effective tax rate of their listed competitors.

The option of a frankable debt deposit product involves an ordinary deposit product but the interest paid would include a distribution of franking credits that could be used by the depositor to credit against tax payable on the interest. To give effect to this option, tax law would need to be amended to allow customer-owned ADIs to pass on franking credits to their members.

Generally speaking, distributions on an instrument are frankable or deductible, but not both. COBA has received advice on a possible option for legislative change that would allow customer-owned ADIs to issue a frankable debt deposit product. The proposal involves amending the definition of a non-share equity interest in the income tax law. A non-share equity interest is typically legal form debt which has equity characteristics and is frankable. The definition would be amended to include a debt interest that is a deposit in a customer-owned ADI with a minimum term of not less than, say, 12 months. This would mean that interest payments on an eligible deposit would be frankable. For a customer-owned ADI to be able to deduct these interest payments, a further amendment to the tax law would be required. Currently, non-share distributions are non-deductible.

***“The average effective tax rate on the earnings of the major Australian banks is well below the 30 per cent rate paid by customer-owned ADIs.”***

Some financial institutions have found ways to issue instruments with distributions that are deductible and frankable, by issuing the instrument through an overseas branch as debt but marketing the instrument domestically as equity. This has attracted the attention of the Australian Tax Office (ATO) which has sought to bring anti-tax avoidance provisions to bear. CBA issued securities (PERLS V) in New Zealand, obtaining a deduction in New Zealand, but offering Australian residents the imputation benefit. The ATO and CBA fought this through the Federal Court and the High Court and ultimately CBA won the case. The High Court found against the Tax Commissioner



and allowed CBA to make franked distributions on PERLS V securities, partly because the fact the distributions on the CBA notes were deductible in New Zealand was held not to be relevant. In any case, such a structure is not available to customer-owned ADIs.

The alternative option to creating a new frankable debt instrument is to give customer-owned ADIs a company tax rate that is comparable to the effective tax rate of listed banks.

COBA commissioned the Australian Centre for Financial Studies (ACFS) to produce an independent report on the tax treatment of customer-owned ADIs compared to their listed competitors. The report, *Equitable Taxation of Customer Owned Banking* (attached), found:

“While mutual ADIs are obliged to pay company tax, they do not distribute profit by way of dividends on risk capital, except in some limited circumstances subject to an ‘economic relationship test’ and ‘governance relationship test’ set out in ASIC Regulatory Guide 147 *Mutuality – Financial institutions*. Earnings are retained as inter-temporal equity to meet capital requirements and serve the needs of their current and future owner-members. Consequently, the franking credits applying to company taxes paid are accumulated rather than distributed. Hence, as at February 2013, mutual ADIs had accumulated approximately \$1.5 billion in franking credits which, due to the general absence of risk capital, cannot be passed on to the ADIs’ owners.

“Under the franking credit system, company tax is essentially a withholding tax with the final tax due on a company’s distributed profits being determined by the marginal tax rate of the underlying shareholders. Prior to the introduction of rebates in July 2000, franking credits received by investors that could not offset a tax liability remained unused, meaning the company tax rate acted as a lower bound for the effective tax rate on company earnings. With the introduction of cash rebates on unused franking credits, the total tax paid on company earnings can be lower than the corporate tax rate if the average marginal tax rate of a company’s shareholders is below the corporate tax rate. Of course, when an organisation is unable to pay out earnings and franking credits to investors, the average tax rate becomes the company tax rate.”

According to the ACFS report, the average effective tax rate on the earnings of the major Australian banks is well below the 30 per cent rate paid by customer-owned ADIs.

The report calculates the average effective tax rate on the earnings of Australian major banks is between 22.15 per cent and 25.5 per cent.

“This is below the corporate tax rate that applies to mutual ADIs that are unable to distribute franking credits. This discrepancy in effective tax rates creates an uneven playing field and may distort decisions of Australian depositors and borrowers.”

“Previous suggestions aimed at rectifying the competitive distortion caused by the inability of mutual ADIs to release franking credits have focused on instruments and products that would allow for the release of franking credits. What this report has shown is that devising a product that allows a mutual ADI to release franking credits raises a number of challenges.

“An alternative suggestion made in this report to correct the competitive distortion caused by the inability of mutual ADIs to release franking credits is a reduction in the tax rate applied to mutual ADIs. The analysis in this paper suggests that the alternative tax rate approach would not be subject to the challenges in designing a product to release franking credits while allowing competitive neutrality from the perspective of total tax paid.”

While a change to the company tax rate would be one way to address the disparity around franking credits going forward, it would not address the significant build-up of franking credits which already exist within the customer-owned banking sector. For this reason, we believe the stronger policy response remains the introduction of a frankable debt deposit product, given that this will provide a solution around both existing and prospective franking credits.

**Recommendation: Provide equitable tax treatment of franking credits for the customer-owned model by allowing institutions to issue a frankable debt deposit product.**

#### *5.2.4 Prudential regulatory settings: ensuring stability, enabling competition*

The primary role of the prudential regulator is rightly to protect depositors in Australia's regulated banking institutions. It does so by regulating the capital, liquidity, risk management and governance of ADIs.

It is vital, however, that this role pays sufficient attention to stability and competition within the banking sector and that the regulation does not overtly or inadvertently create advantages for one type of institution over another.

As Australia moves increasingly to a global regulatory framework, notably under the Basel regime, it is important that Government and regulators constantly assess the potential for domestic competitive disruptions caused by the adoption of global standards.

We note that a number of other countries have adopted regulatory settings which recognise the differences between the customer-owned banking model and the listed model. Where appropriate, these countries have adjusted their regulatory settings to ensure that they do not unnecessarily constrain the activities of their customer-owned banking sectors.

**Table 5: Regulatory settings in other countries**

	Canada	US	Germany	Australia
Taxation	Taxed at small business rate when applicable	Exempt	Taxed at small business rate when applicable	Higher effective rate than listed ADIs
Capital	CET 1 issuance available	Expect CET 1 available under Basel III	CET 1 issuance available	CET 1 issuance not permitted
Government lending support	Yes	Yes	Yes	No
Inhabitants per ADI	42,000	23,000	42,000	141,000
Market share	4.5% of assets	6% of assets	11% of assets	1.7% of assets

It would appear that by adopting regulatory settings which provide equitable treatment of customer-owned banking institutions, these countries have been able to foster more diverse banking sectors.

##### *5.2.4.1 Risk weighting of assets for regulatory capital*

Major banks are permitted to use a method of calculating their regulatory capital that gives them a significant advantage in the amount of the regulatory capital they are required to hold against residential lending portfolios.



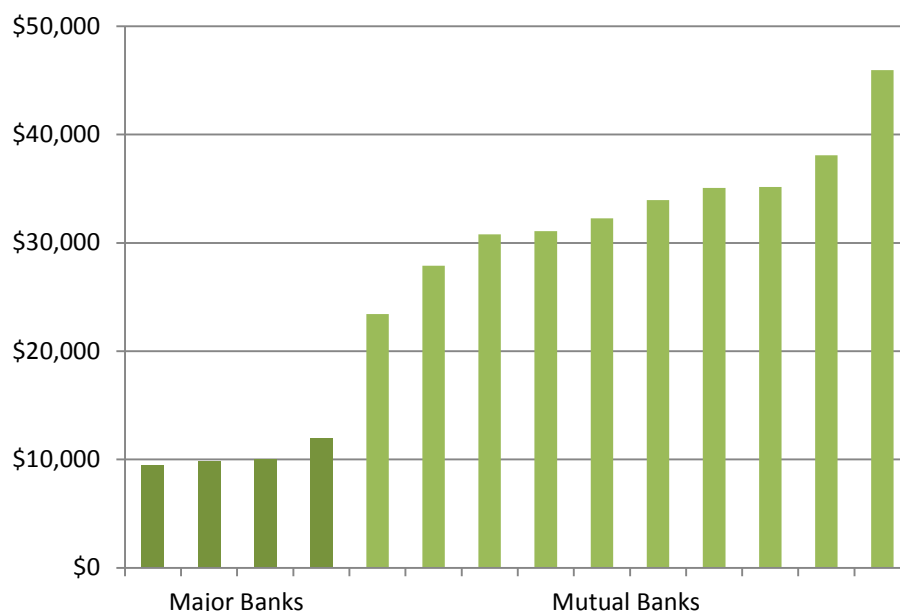
While all other ADIs use the Standardised approach, major banks using the Internal Ratings-based (IRB) approach can hold less than half the capital of their smaller competitors per home loan. ADIs using the Standardised approach must apply a risk weighting of 35 per cent or more on home loans while the major banks can apply a risk weighting as low as 16 per cent.<sup>66</sup>

***“Major banks are permitted to use a method of calculating their regulatory capital that gives them a significant advantage in the amount of the regulatory capital they are required to hold against residential lending portfolios.”***

**Table 6: Capital held against a hypothetical mortgage**

	Major bank	Small ADI
<b>Housing loan</b>	\$500,000	\$500,000
<b>Risk weight</b>	18%	38.5%
<b>RWA</b>	\$90,000	\$192,500
<b>Average capital ratio</b>	11.5%	17.0%
<b>Capital held</b>	\$10,350	\$32,725

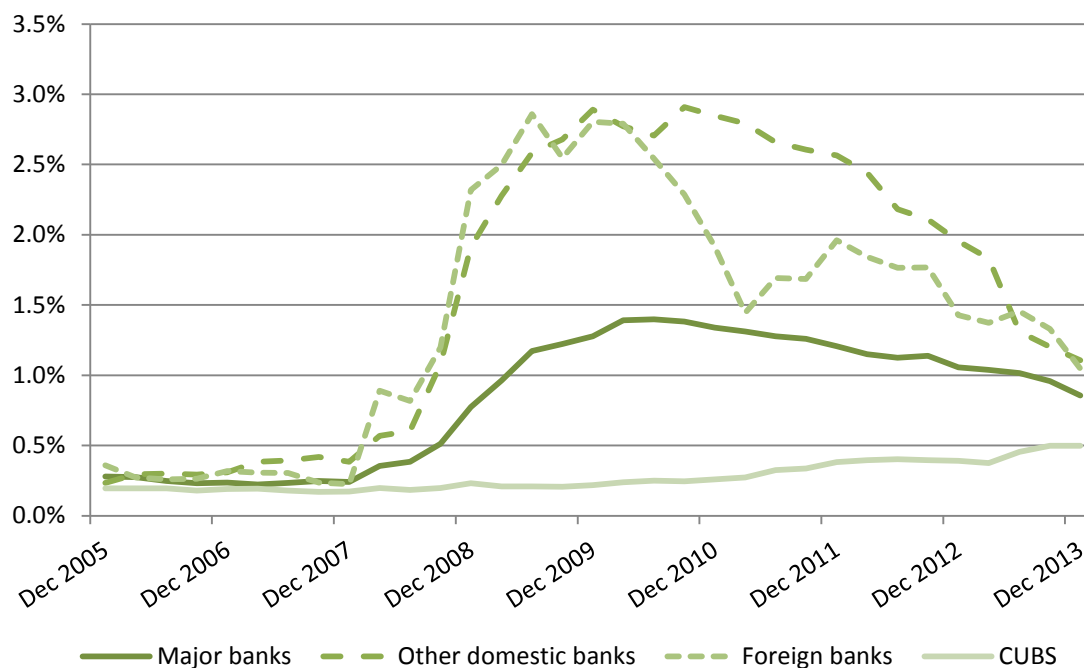
**Chart 13 – Average Capital Held Against \$500,000 Residential Mortgage<sup>67</sup>**



This competitive disadvantage imposed on all smaller lenders in the context of credit risk is particularly anomalous for customer-owned banking institutions because of their strong and sustained track record of prudent lending. Customer-owned banking institutions have consistently delivered lower levels of non-performing loans than the major banks.

<sup>66</sup> <http://www.australianbankingfinance.com/banking/the-problem-in-byres--backyard/>

<sup>67</sup> Source: Basel III Pillar 3 Disclosures, Dec 2013

**Chart 14 – Impaired Facilities as a Percentage of Total Loans<sup>68</sup>**

Significant mortgage arrears were also much lower for the sector during and immediately following the GFC.

**Chart 15 – Comparison of Mortgage Arrears (90+ days)<sup>69</sup>**

As one commentator has observed, a key factor in the major banks' returns is the fact that APRA allows them to hold less than half the capital, and thus have more than twice the leverage, across

<sup>68</sup> Source: APRA, Quarterly ADI Performance, Dec 2013

<sup>69</sup> Source: Standard and Poor's RMBS Arrears Statistics – Australia (Excluding Non-Capital Market Issuance) Dec 2013

their huge home loan books: “so the institutions that in principle pose the greatest systemic risks hold the smallest buffers against future losses.”<sup>70</sup>

In practice, a major bank holds approximately 55 per cent less capital than an ADI operating under the standardised approach for a housing loan (to an identical borrower and residential security), due to risk weighting of approximately 16-18 per cent versus 35 per cent. An additional 1 per cent HLA buffer being applied will result in the major bank holding 50 per cent less capital.

***“Competitive neutrality would be improved by reducing the advantage that the major banks gain under the IRB method.”***

Competitive neutrality would be improved by reducing the advantage that the major banks gain under the IRB method. This could be achieved by narrowing the gap between the capital held by standardised ADIs and advanced IRB ADIs against their residential portfolios.

Clearly, the mechanism could either increase the amount of capital that the major banks are required to hold through the introduction of capital buffers or floors, or alternatively by reducing the standardised risk weights to levels that reflect more closely the risk held in those portfolios.

The second of these alternatives has the advantage of rebalancing the competitive landscape and stimulating potential growth of smaller ADIs without limiting the availability of credit to households across Australia.

**Recommendation: Reduce the unfair advantage major banks gain in terms of regulatory capital requirement for residential lending portfolios.**

#### 5.2.4.2 The committed liquidity facility and regulatory liquidity

In implementing the Basel III liquidity standards in the Australian context, the largest ADIs will be subject to Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) obligations, while smaller ADIs will operate under the Minimum Liquidity Holdings (MLH) framework.

Under the LCR, a large ADI is required to maintain a sufficient level of High Quality Liquid Assets (HQLA) “to meet its liquidity needs for a 30 calendar day time period under a severe liquidity stress scenario.”<sup>71</sup>

***“...Morgij Analytics estimated that this inconsistent treatment provides the major banks with a collective financial advantage worth approximately \$4.5 billion per annum.”***

However, Australia has low levels of HQLA compared to other countries, making it difficult for large ADIs to meet this obligation. For this reason, large ADIs will be able to establish a Committed Liquidity Facility (CLF) with the RBA to meet a portion of their LCR liquidity requirement. Collateral for the CLF comprises a much wider range of assets than HQLA, effectively allowing these ADIs to hold some less liquid (and higher return) assets in their liquidity portfolios, including Residential Mortgage-Backed Securities (RMBS).

APRA has indicated that it will expect CLF collateral

<sup>70</sup> [http://www.afr.com/f/free/blogs/christopher\\_joye/why\\_the\\_big\\_banks\\_will\\_still\\_rule\\_bpwYW1Pm1pT4IHJafApbDL](http://www.afr.com/f/free/blogs/christopher_joye/why_the_big_banks_will_still_rule_bpwYW1Pm1pT4IHJafApbDL)

<sup>71</sup> APRA – APS 210 – p. 13.

to have “an appropriate degree of diversification.”<sup>72</sup> In relation to these less liquid and higher return assets, APRA expects that “ADIs with access to the CLF are likely to hold those assets as part of a well-diversified liquid assets portfolio.”<sup>73</sup>

The CLF will provide a significant benefit to the major banks. Following completion of a trial exercise with LCR ADIs, APRA has determined that the aggregate size of the gap between these ADIs’ liquidity needs and available HQLA assets is \$249 billion. APRA has also indicated that it will provide LCR ADIs with a 10-15 per cent buffer, leading APRA to estimate total CLF availability at \$282 billion.<sup>74</sup>

In contrast, the Basel III liquidity changes have reduced the range of assets that smaller MLH ADIs are able to use in their liquidity portfolios. MLH ADIs were previously allowed to include RMBS in their MLH portfolios but under the new liquidity regime that commenced on 1 January 2014 RMBS are not acceptable.

APRA has acknowledged submissions by COBA and others arguing that competitive neutrality is undermined by making RMBS, ABS and self-securitised assets eligible collateral for the CLF available to a LCR ADIs and not do the same for MLH ADIs, even though MLH ADIs could use such assets to access liquidity via repo transactions with the RBA.

However, the regulator says:

“APRA does not intend to include RMBS and ABS securities in MLH portfolios on the basis, reinforced by experience during the global financial crisis, that these assets are considerably less liquid and more complex than other assets eligible for inclusion as MLH liquids. The introduction of the CLF for scenario analysis ADIs has a different objective: viz, to balance the need to meet a global liquidity standard with the fact that there is an insufficient supply of HQLA in Australia.”<sup>75</sup>

The result of this is that the same repo-eligible RMBS asset has a different regulatory status depending on whether it is held by a LCR ADI or a MLH ADI, with a more favourable treatment being afforded to larger ADIs.

As previously noted, a paper commissioned by Morgij Analytics estimated that this inconsistent treatment provides the major banks with a collective financial advantage worth approximately \$4.5 billion per annum. As the paper notes:

***“...This is another significant financial advantage that the regulatory framework provides the largest ADIs at the expense of the rest of the sector, and further entrenches the dominance of the major banks.”***

“The CLF allows ADIs to originate mortgage assets and create RMBS rather than buying government bonds. With the Bloomberg Australia Sovereign Bond Index having an effective yield of 3.55 per cent as at 10th February 2014 the net spread on mortgage assets or RMBS compared to government bonds is approximately 150bps or 10 times the CLF pricing point of 15bps per annum.”

This is another significant financial advantage that the regulatory framework provides the largest ADIs at the expense of the rest of the sector, and further entrenches the dominance of the major banks.

<sup>72</sup> APRA, Letter to ADIs – *Implementation of the Basel III liquidity framework in Australia*, 30 January 2014, p. 4.

<sup>73</sup> APRA, *Discussion paper – Implementing Basel III liquidity reforms in Australia*, May 2013, p. 8.

<sup>74</sup> APRA, Letter to ADIs – *Implementation of the Basel III liquidity framework in Australia*, 30 January 2014, p. 2.

<sup>75</sup> APRA, *Discussion paper – Implementing Basel III liquidity reforms in Australia*, May 2013, p. 27.

One way to address this problem is to allow RMBS to be part of a diversified MLH portfolio (subject to an appropriate cap on these holdings).

**Recommendation: Provide more consistent treatment of RMBS for regulatory liquidity purposes between MLH ADIs and LCR ADIs.**

#### 5.2.4.3 Access to regulatory capital

Listed ADIs regularly issue regulatory capital, and it is important that customer-owned ADIs also have the capacity to do so. Under Basel II, customer-owned ADIs were able to issue all forms of regulatory capital. Unfortunately, APRA's implementation of the Basel III capital framework does not allow issuance of mutual capital instruments that qualify as CET1 capital, which is the most important type of regulatory capital.

As a consequence, under Basel III, customer-owned ADIs could only raise capital through retained earnings restricting their ability to raise capital more effectively, inhibiting their ability to diversify their capital base and constraining their ability to grow. Whilst APRA has been working with our sector on alternative capital instruments, more work is required to ensure that customer-owned ADIs have better access to a wider range of capital instruments.

***“...Customer-owned ADIs have considerably less flexibility than they had prior to the Basel III reforms. In contrast, listed ADIs have been accommodated ... and are able to issue all forms of regulatory capital...”***

The DAE report *Competition in Banking* found that denying mutuals access to Common Equity Tier 1 instruments could also have the following impacts:

- Customer-owned ADIs will not have the ability to manage and grow their balance sheets flexibly and in a manner that best serves their members' interests;
- Growth will be constrained to the uneven rate at which organic capital can be generated from retained earnings;
- Organic capital will not be able to be generated quickly to respond to sudden increases in capital requirements;
- Customer-owned ADIs will be less able to lend in a downturn and will be less able to provide effective competition to listed banks;
- The competitive disadvantage in relation to banks resulting from lack of access to Common Equity Tier 1 risks reducing supply, and increasing the cost, of credit to customers by the mutual sectors; and
- Ratings agencies may take a negative view of the customer-owned banking sector, given its restricted access to Common Equity Tier 1 capital and its increasing dependence on the economic cycle—this would have a knock-on effect on the ability of customer-owned ADIs to access senior funding.

Customer-owned ADIs have considerably less flexibility than they had prior to the Basel III reforms. In contrast, listed ADIs have been accommodated under the Basel III capital rules and are able to issue all forms of regulatory capital in Australia.

This outcome appears due to APRA taking a highly cautious approach to Basel implementation, and concerns within the prudential regulator that accommodating the customer-owned model may result

in some departure “from its longstanding policy of applying a common set of prudential requirements across the ADI industry.”<sup>76</sup> APRA stated:

“Some other submissions argued that, since the Basel III reforms are global minimum capital requirements for internationally active banks, the reforms should not be applied to all ADIs in Australia. APRA does not accept this argument. Unlike other jurisdictions, banks, credit unions and building societies in Australia are supervised under the same legislative regime and APRA’s longstanding policy is to apply a common set of prudential requirements across the ADI sector. When appropriate, these requirements can take account of an individual ADI’s size, complexity and risk profile. In APRA’s view, the Basel III reforms will improve the regulatory capital framework for ADIs and, in so doing, strengthen the protection available for depositors and the resilience of the Australian banking system as a whole. There are, nonetheless, certain aspects of the Basel III reforms that are problematic for mutually owned ADIs (mutual ADIs).”<sup>77</sup>

The Basel Committee on Banking Supervision (BCBS) prepared rules on capital primarily for listed, internationally focused banks, but incorporated an allowance for ‘national discretion’ in the hands of local regulators. This discretion allows a regulator to adapt certain rules to particular legal forms, such as customer-owned ADIs, due to the different characteristics inherent in their structure and focus.

***“...by applying the rules in such an inflexible manner, they effectively give preferential treatment to the listed sector over the customer-owned sector.”***

The BCBS, when designing the new rules, recognised this by acknowledging that the constitutional and legal structure of mutuals needed to be considered in the context of ‘common shares’ under the CET1 definition.<sup>78</sup> The BCBS took the position of leaving it to each national regulator to make the necessary adjustments. While the BCBS makes reference to this requirement in relation to common shares only, the principle carries equal weight to all relevant aspects of new framework.

However, APRA instead applied the Basel III capital rules to all ADIs without utilising the ‘national discretions’ allowed by the Basel Committee. By taking a less flexible approach than the Basel Committee would have envisaged, APRA has significantly reduced the capacity of customer-owned ADIs to issue regulatory capital.

COBA appreciates the importance of Basel III in enhancing the robustness of the international banking system. Our sector supports the objectives of raising the quality, quantity and consistency of capital in the international banking system. However, by applying the rules in such an inflexible manner, they effectively give preferential treatment to the listed sector over the customer-owned sector. This is a perverse outcome, given that the Basel III capital framework was designed for large, listed, systemically important banks that have a substantial international focus,<sup>79</sup> rather than for smaller, locally-focused mutuals that carry a much lower systemic risk and have limitations on the ways in which they raise capital.

In contrast to the Australian experience, other jurisdictions have successfully accommodated the mutual model into the Basel III capital framework:

<sup>76</sup> Response to Submissions: Implementing Basel III capital reforms in Australia. March 2012 APRA

<sup>77</sup> Response to Submissions: Implementing Basel III capital reforms in Australia. March 2012 APRA

<sup>78</sup> <http://www.bis.org/publ/bcbs189.pdf> page 14

<sup>79</sup> APRA Basel III capital paper, September 2011, page 10 and BIS Basel II publication, paragraph 9 <http://www.bis.org/publ/bcbs118.htm>

- in the UK, Nationwide (a large UK Building Society), has recently launched a CET1 capital offering under Basel III.<sup>80</sup>
- Canadian mutuals<sup>81</sup> are allowed to count member shares and investment shares as the highest form of capital, provided certain conditions are met;<sup>82</sup> and
- European regulators have specifically allowed member shares in mutuals to be considered CET1 capital.<sup>83</sup>

While APRA has acknowledged the need to provide customer-owned ADIs with the capacity to issue AT1 and T2 instruments, the Basel III capital standards took effect in Australia more than a year before APRA provided the sector with this flexibility. Furthermore, customer-owned ADIs remain unable to directly issue CET1 capital. This is despite a Senate Committee recommending in November 2012 that:

***“Failure to provide customer-owned ADIs with the capacity to issue the same forms of capital as listed ADIs will continue to harm competition, choice and diversity for no prudential benefit.”***

“APRA addresses, without further delay, the unique issues Basel III may pose for mutual ADIs as a result of their corporate structure and that it publishes a document which sets out how these problems have been addressed.”<sup>84</sup>

It is essential that listed ADIs and customer-owned ADIs receive equivalent treatment under the Basel III capital rules. Failure to provide customer-owned ADIs with the capacity to issue the same forms of capital as listed ADIs will continue to harm competition, choice and diversity for no prudential benefit.

**Recommendation: Accommodate the customer-owned model in the prudential regulatory framework by allowing customer-owned ADIs to issue a form of CET1 capital.**

#### 5.2.4.4 Use of terms “bank” & “banking”

Customer-owned banking institutions are subject to the same prudential regulatory regime as listed banks but face a number of restrictions around their use of the terms ‘bank’ and ‘banking’.

Banks, credit unions and building societies are all Authorised Deposit-taking Institutions under the *Banking Act 1959* but not all ADIs can describe themselves as banks and APRA is proposing to further restrict use of the term ‘banking’ by some ADIs.

Prior to July 1998, building societies and credit unions looking to convert to banks were required to demutualise. Many of today’s regional banks (Bendigo and Adelaide Bank, Suncorp) and major bank sub-brands (St George, Bank of Melbourne) were originally mutual building societies.

Customer-owned banking institutions wanting to rebrand as banks no longer have to demutualise but they must pass a substance

***“Customer-owned banking institutions are subject to the same prudential regulatory regime as listed banks but face a number of restrictions around their use of the terms ‘bank’ and ‘banking’.”***

<sup>80</sup> <http://your.nationwide.co.uk/your-news/articles/Pages/ccds-issuance.aspx>

<sup>81</sup> Except in Saskatchewan

<sup>82</sup> Dave Grace & Associates, *Competitive Dynamics in Retail Banking: An International Comparison*, March 2014, p. 14.

<sup>83</sup> Dave Grace & Associates, *Competitive Dynamics in Retail Banking: An International Comparison*, March 2014, p. 20.

<sup>84</sup> Senate Economics References Committee, *The post-GFC banking sector*, November 2012, p. xxv.



test, i.e. have at least \$50 million in Tier 1 capital.

To date, 10 mutual banking institutions have re-branded as banks. However, the two largest credit unions and three of the four largest building societies have opted not to rebrand as banks.

The option to re-brand as a bank is not available to smaller customer-owned banking institutions. In contrast, APRA allows major banks to use the term bank in their many sub-brands, despite the fact that these sub-brands are not separate ADIs (e.g. St George, Bank of Melbourne, BankSA, Bankwest, and UBank).

The \$50 million threshold predates the Wallis reforms which led to the formation of APRA and the creation of the ADI concept. The RBA's September 1996 submission to the Wallis Inquiry says the \$50 million threshold was set in 1992 and is broadly consistent with total balance sheet assets of around \$1 billion.

"A relatively high level of minimum Tier 1 capital is one of the simplest and most effective means of discouraging unsuitable shareholders from attempting to gain a banking authority," the RBA said. "In a world where financial institutions of doubtful pedigree are always scouting for opportunities, the minimum capital requirement for a bank is an excellent screening device."<sup>85</sup>

APRA reviewed the \$50 million threshold in 2010 in the context of the previous Government's Competitive and Sustainable Banking System package.

"In its review, after weighing up competition and financial stability concerns, APRA concluded that any lowering of entry standards for new bank entrants, through reducing the minimum capital requirement, would run counter to the general thrust of global reform initiatives to strengthen capital in banking systems and would put at risk the enhanced reputation of the Australian banking system and Australia's regulatory arrangements."<sup>86</sup>

COBA accepts that the substance test for new entrants is long-standing policy but the RBA's 1996 concerns about "unsuitable shareholders" and "financial institutions of doubtful pedigree" do not apply to credit unions and building societies.

Those ADIs that do not have the option of marketing themselves as banks are at a competitive disadvantage. They must comply with an intrusive, constantly-evolving, burdensome regulatory regime to engage in the business of banking but they are denied the option of "bank" branding.

Given that the term 'ADI' is not widely understood, a simple step to improving market awareness of the prudential standing of all regulated banking institutions would be to replace the Banking Act term "Authorised Deposit-taking Institution" with "Authorised Banking Institution".

This amendment would at a stroke also remove uncertainty about the capacity of credit unions and building societies to use the term 'banking'.

***"Those ADIs that do not have the option of marketing themselves as banks are at a competitive disadvantage. They must comply with an intrusive, constantly-evolving, burdensome regulatory regime to engage in the business of banking but they are denied the option of "bank" branding."***

<sup>85</sup> Submission to Financial System Inquiry, 6 September 1996, RBA

<sup>86</sup> APRA Annual Report 2011



APRA issued a discussion paper in 2013 proposing some changes to its rules around the use of the term 'banking', including a new requirement that:

"'banking' may not be used as part of a registered corporate, business or trading name, or as part of an internet domain name by a credit union or building society."<sup>87</sup>

This new restriction is at odds with APRA's stance of allowing credit unions and building societies to use the term 'banking' in marketing and branding material. COBA has strongly objected to the draft proposal but at this stage APRA has not indicated any willingness to withdraw the proposal. In our view, the proposal represents a significant policy shift by APRA, and the change will impact on a large number of our members.

**Recommendation: Modernise regulatory banking terminology by changing 'Authorised Deposit-taking Institution' to 'Authorised Banking Institution'.**

#### 5.2.4.5 Allocating the APRA levy

APRA levies are divided into two components, a restricted component which covers the costs of supervision, and an unrestricted component corresponding to APRA's broader activities such as policy development.<sup>88</sup> While both components are applied on a "dollars per assets" basis, the restricted component is subject to a maximum cap.

According to the original levies memorandum, the existence of a maximum cap "reflects the view that ... beyond a certain size there is no extra cost in regulating an institution."<sup>89</sup> However, there are many examples where the largest ADIs require specialised and additional supervisory effort which is not applicable to smaller ADIs.

Some of APRA's work is exclusively focused on the largest entities within each sector, with no relevance or benefit to the remaining institutions. For example, as part of the global banking reforms, APRA is responsible for implementing the D-SIB framework. The D-SIB framework only applies to the four major banks, and will involve APRA applying "more intensive supervision" to these institutions. The Basel III liquidity reforms are another example of significant policy work in APRA directed almost solely towards larger ADIs.

***"The major banks represent the overwhelming share of risk in the system and industry levies should reflect this."***

In these areas, the prudential regulatory burden exhibits characteristics of diseconomies of scale, with an additional layer of policy intensity and regulatory supervision being applied to financial institutions above a certain size. Unfortunately, the current levy distribution methodology does not give sufficient recognition to the systemic importance of the major banks. The major banks represent the overwhelming share of risk in the system and industry levies should reflect this.

Smaller ADIs already pay a much higher relative cost in complying with APRA's regulatory requirements. The costs to an ADI of meeting APRA's regulatory expectations are relatively fixed, and these costs therefore place a proportionally higher burden on smaller ADIs. The impact this has on competitive neutrality within the sector is only further compounded by a levy methodology that expects smaller ADIs to pay higher proportional costs.

<sup>87</sup> Discussion Paper: Banking Act exemptions and s66 guidelines, April 2013, APRA

<sup>88</sup> Treasury, *Financial industry supervisory levy methodology – Discussion Paper*, April 2013, p. 3.

<sup>89</sup> Explanatory Memorandum, *Financial Sector Levy Bills 1998*, p. 9.

***“Currently, the major banks pay APRA levies of around \$12 per \$1,000,000 in assets compared to around \$60 per \$1,000,000 for customer-owned banking institutions.”***

We believe that the existence of the maximum cap is leading to highly inequitable outcomes. Currently, the major banks pay APRA levies of around \$12 per \$1,000,000 in assets compared to around \$60 per \$1,000,000 for customer-owned banking institutions. While there may be some economies of scale inherent in prudential regulation, imposing a levy on smaller ADIs which is five times as high as that imposed on the major banks appears extreme, and further undermines competitive neutrality in the banking sector.

**Recommendation: Recast the APRA levies framework to allocate levies more closely to systemic risk.**

### 5.2.5 Confident and informed consumers

Consumer perceptions about security and prudential standing are critical factors in the banking market.

The regulatory framework should ensure as far as possible that consumers are able to exercise genuine choice about their banking services provider.

Given relatively low levels of functional literacy, let alone financial literacy, in the community there is a need to make sure that disclosure requirements are appropriately designed and targeted. Weak disclosure obligations allow non-regulated institutions to pose as banking institutions and for major bank sub-brands to pose to as independent competitors.

ASIC's 2011 report *Financial literacy and behavioural change* highlighted an Australian Bureau of Statistics (ABS) survey on adult literacy and life skills, in the areas of document literacy, prose literacy, numeracy and problem solving.

***“Restricting the use of the term ‘banking’ in ADI business names can undermine consumer perceptions about the customer-owned banking sector, and further tilts the regulatory environment in favour of large banks.”***

“The ABS survey found that, of Australians aged 15 to 74, approximately:

- 7 million (47%) had low scores (Level 1 or 2) on the document scale;
- 7 million (46%) had low scores (Level 1 or 2) on the prose scale;
- 7.9 million (53%) had low scores (Level 1 or 2) on the numeracy scale; and
- 10.6 million (70%) had low scores (Level 1 or 2) on the problem-solving scale.

“Given that Level 3 is regarded by the survey developers as the minimum required for individuals to meet the complex demands of everyday life and work in the emerging knowledge-based economy, this result suggests that around half the Australian population lack functional literacy and numeracy skills.”

Restricting the use of the term 'banking' in ADI business names can undermine consumer perceptions about the customer-owned banking sector, and further tilts the regulatory environment in favour of large banks.

Competitive neutrality for ADIs in the deposit market rests heavily on the market understanding that all ADIs are subject to the same regulatory regime, including the FCS that guarantees deposits of up to \$250,000 per person, per ADI.

The UK's version of the FCS is pro-active in raising awareness about depositor protection. The UK's Financial Services Compensation Scheme has a key objective of raising awareness about depositor protection so that the public is reassured their deposits in banks, building societies and credit unions are safe, up to the £85,000 limit.

"The need to build awareness remains high. Research shows that about half of the public are aware of a protection scheme, an increase of more than 30 percentage points since 2008. This is still too low and compares poorly with some of our overseas counterparts. For example, awareness of deposit protection in the US is between 70 and 80% of the population. We aim to achieve this level of awareness in the UK over a number of years, in partnership with the industry, with banks, building societies and credit unions doing most of the heavy lifting supported by targeted marketing by FSCS."<sup>90</sup>

There is no such marketing campaign in relation to Australia's FCS.

The FCS supports competitive neutrality in the banking market and assists smaller ADIs to compete against the major banks.

While the prudential framework in Australia means that the probability of the FCS ever being used in practice is remote, public perceptions around safety are important, and the FCS is a critical aspect of demonstrating that deposits with a customer-owned ADI are just as safe as those held with one of the major banks.

Some groups have suggested that the FCS deposit guarantee cap of \$250,000 is too high. However, we do not believe that any further reduction in the cap is warranted. The current cap is not particularly high by international standards (e.g. the US deposit insurance scheme is \$250,000). Any reduction in the cap would only benefit the major banks and, to some extent, shadow banking institutions offering 'bank-like' products.

***"The current legislative framework is not ensuring that retail banking consumers who want to deal with a regional bank or a non-bank have the opportunity to make a fully-informed choice."***

Competitive neutrality in retail banking depends on consumers understanding that major bank sub-brands are not separate institutions and that so-called 'shadow banks' are not regulated banking institutions.

Consumer research strongly suggests that major banks are getting away with portraying their sub-brands as independent competitors. The current legislative framework is not ensuring that retail banking consumers who want to deal with a regional bank or a non-bank have the opportunity to make a fully-informed choice.

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<sup>90</sup> Plan & Budget 2014/15 Financial Services Compensation Scheme (UK)

This can be corrected by requiring that major bank sub-brands clearly and prominently disclose in all advertising and all customer-facing material that they are owned by a major bank.

Shadow banking institutions, such as debenture issuers, have marketed themselves as offering deposits, savings products and at-call accounts. The occasional high-profile collapse of one of these entities prompts calls for a regulatory crackdown on non-ADIs presenting themselves as regulated banking institutions. However, proposals to ban these 'shadow banks' from using terms such as 'deposit' and 'savings account' and from offering at-call investment products have been repeatedly delayed.

In the interests of competitive neutrality, and consumer protection, a better informed market is needed about the real identity of various entities in the banking market. The regulatory system needs to ensure that consumers understand that there is a bright line between regulated banking institutions and shadow banking institutions.

#### 5.2.5.1 Major bank multi-branding

The position of the four major banks is now so dominant that the majors frame competition in banking as something that occurs only between themselves and within their multiple brands. We have a highly concentrated banking market with a proliferation of major bank sub-brands that create an illusion of diversity and choice.



Major bank multi-brand strategies are intended to:

- lure customers who don't want to bank with a major bank; and/or
- compete on price against genuinely independent competitors without providing any benefit to the bulk of the major bank's existing customers.

Westpac's multi-brand strategy includes regional bank brands and "non-bank" brands. Westpac says "there is a very significant set of customers that would prefer a regional bank over a major bank"<sup>91</sup> and that "RAMS is actually to cater for that component of the community that wants to deal with a non-bank lender."<sup>92</sup>

Westpac's sub-brands include St George, BankSA, Bank of Melbourne and RAMS. NAB has UBank and CBA has BankWest and Aussie Home Loans (AHL). CBA's takeover of AHL means that one of the leading mortgage brokers in the market is subject to the interests of the largest lender in the market.

Consolidation of the mortgage distribution services market in recent years includes NAB's acquisition of the PLAN, Choice and FAST brokerages, trading under the Advantage brand name. Westpac owns

<sup>91</sup> *Multi-brands 'make for happy customers'* Australian Financial Review 3 November 2011

<sup>92</sup> *RAMS to start online deposits* Australian Financial Review 8 November 2011

the RAMS Home Loans network. CBA, in addition to its major stake in AHL, has a significant stake in Mortgage Choice through its ownership of Count Financial.

A national survey<sup>93</sup> of 1,000 Australians was conducted for COBA in late December 2012 by independent company D&M Research. It found that:

- up to 50 per cent of people are unaware of the major banks' ownership of smaller 'competitors', and this figure rises to 80 per cent being unaware that the major banks own certain home lenders; and
- 52 per cent believe that the major banks' ownership of smaller and regional banks is not good for Australia because it gives the major banks too much power and control over the market.

This consumer research strongly suggests that major banks are getting away with portraying their sub-brands as independent competitors.

In addition to the competition and consumer choice concerns with major bank multi-branding, there is a separate consumer protection issue arising from the nature of the deposit guarantee under the FCS. The deposit guarantee cap of \$250,000 applies per account-holder, per ADI. A depositor is highly likely to assume that deposits of \$250,000 in each of Westpac, Bank of Melbourne, St George, BankSA and RAMS would qualify for the deposit guarantee. In fact, only \$250,000 - and not the entire \$1.25m deposited across the Westpac group of brands - would be protected under the FCS.

**Recommendation: Introduce effective disclosure requirements to ensure consumers understand the difference between an ADI and a non-ADI and between an independent competitor and a major bank sub-brand.**

### 5.3 The need for principles and risk based regulation: impact of regulation on competition

Customer-owned banking institutions operate in a highly regulated environment. In addition to being regulated as ADIs under the *Banking Act 1959*, they are also:

- Australian Financial Services Licensees regulated under the *Corporations Act 2001*;
- credit providers licensed under the *National Consumer Credit Protection Act 2009*; and
- reporting entities under the *Anti-Money Laundering/Counter-Terrorism Financing Act 2006*.

All ADIs are subject to the same regulatory framework, meaning that all ADIs face similar compliance burdens and costs in absolute terms.

While recognising that banking is a sector that requires additional regulations beyond those applied to "standard" businesses, the regulatory compliance burden is a significant issue for COBA members. The relentlessly increasing complexity of the regulatory environment is a major challenge for smaller players in the financial services market.

The cost of regulation increases prices for consumers and has a chilling effect on competition and choice. While the benefits of additional regulations are often questionable, there is no doubting that they impose significant additional costs on the sector.

In a recent survey of our members, more than 85 per cent of respondents estimated that their compliance burden had increased over the past three years, while no one believed that regulatory

<sup>93</sup> <http://balancebanking.com.au/wp-content/uploads/2013/02/Abacus-Consumer-Research-Findings.pdf>

compliance burdens had decreased over this period. This increase has been significant, with many institutions forced to employ additional staff to meet these additional burdens.

Regulatory compliance effectively imposes an additional fixed cost on all organisations operating within a sector. As such, the costs of regulatory compliance impose a disproportionately heavy burden on smaller players. Similarly, any additional compliance obligations hit the smallest institutions the hardest, effectively providing the largest players in the sector with a competitive advantage. While we accept that economies of scale are a part of business, excessive regulatory burdens artificially reinforce the advantages of scale and undermine competitive pressures.

This impact is significant and should not be underestimated. A recent study in the US has found that the largest quartile of credit unions bear just one tenth of the regulatory compliance costs borne by the smallest quartile.<sup>94</sup> This same study has also noted that the increasing regulatory burden can also have unintended consequences.

For example, the steady, long-term trend of consolidation in the credit union sector is partly explained by the increasingly heavy regulatory compliance burden. As prudential standards and expectations become increasingly onerous and complicated, it is becoming increasingly difficult for the smallest ADIs to operate. Ironically, additional burdens which are notionally designed to ensure the stability of these organisations can indirectly threaten their longer term viability.

While the smallest ADIs are forced to bear the highest relative costs, these same institutions pose the smallest risks to financial system stability. Given the lower systemic risk that these institutions present (coupled with the more risk averse nature of their operations more generally), it is arguable that the regulatory burden should be lower for customer-owned ADIs than it is for the major banks.

For these reasons, it is essential that appropriate consideration is given to the impact of regulatory changes on smaller ADIs. As US Federal Reserve board chair Janet Yellen has noted, "In writing new rules ... the Fed should continue to limit the regulatory burden for community banks and smaller institutions, taking into account their distinct role and contributions."<sup>95</sup>

Policy makers also need to more effectively assess the need for and the cost of new regulation. Whilst our experience is that regulators and policy makers generally consult widely, the effectiveness of that consultation could be improved. Importantly too, policy makers need to improve their cost benefit assessment processes to ensure that the rationale for the policy remains valid and that there is a net benefit of the regulation to the community.

For example, the development of the consumer credit framework through ASIC and Treasury was unnecessarily cumbersome. Whilst industry generally supported moves to protect consumers from unethical and inappropriate lending, these behaviours were occurring in unregulated, non-ADI sections of the lending market. The consumer credit regime failed to recognise this issue, instead focussing initially on blanket regulation across the entire lending sector. Whilst ADIs were able to get some amendments to the regime to reflect the fact that they were already highly regulated and responsible lenders, the regime still resulted in considerable cost for the ADI sector.

<sup>94</sup> Filene, *Study of the Regulatory Burden for Credit Unions in the US and Canada*

<sup>95</sup> Yellen, *Confirmation Hearing*, 14 November 2013.



As noted previously, the burden of these costs falls most heavily on the smaller ADIs.

In addition, the regime was also implemented too rigidly with:

- Complicated, costly and disproportionate training requirements for staff;
- Additional licensing requirements that were unnecessary for institutions already licensed under the Banking Act;
- Insufficient consideration on the impact of the regime on low value loans to low income households, in some cases forcing those households to go to more costly “pay day” lenders.

Similar examples exist in the implementation of other regulatory regimes including FOFA, AML and the financial services reform package. At times, the cost of these regimes has been amplified by rigid legal interpretations by regulators like ASIC that do not reflect, or extend, the policy intent of the legislation with significant impact on regulated institutions.

There are also significant examples of international regulations being inappropriately applied to smaller domestic institutions, notably the Basel III framework. It is important that regulators consider the diversity of banking institutions when deciding how to apply these frameworks in the domestic context. In the case of Basel III, an overly rigid implementation resulted in the removal of the ability of customer owned ADIs to raise diverse forms of capital – an outcome not intended by Basel III, but with direct and significant impacts on our sector. Government and regulators need to be vigilant that current proposals such as the development of GLAC resolution mechanisms (see above) are not applied to smaller ADIs but are limited solely to those institutions regarded as domestic systemically important banks.

The burden of additional regulations is heaviest for the smallest institutions. Principles based regulations, which are applied in a flexible manner and which take the size and complexity of individual institutions into consideration, can partially offset this disproportionate impact. A one size fits all approach is not effective and it directly impacts on the ability of smaller institutions to compete.

### *5.3.1 Overly prescriptive regulations*

One way to reduce the compliance burden imposed on smaller ADIs is to ensure that regulatory frameworks are less prescriptive and more flexible and outcomes focused. While prescriptive and inflexible rules can reduce decision uncertainty for ADIs and compliance uncertainty for regulators, they are unlikely to lead to optimal outcomes, particularly in changing environments.

Outcome focused regulation is generally accepted to be more effective than prescriptive regulation as it allows regulated institutions to achieve the desired policy outcome in the most cost effective way. For smaller and less complex ADIs in particular, prescriptive standards can be very costly, and a simpler solution can often be found which is capable of delivering a similarly robust outcome. In this way, the regulatory framework is able to recognise and accommodate the differences in size, scale and risk profile between regulated institutions.

Generally, regulators appear to recognise the importance of this issue, with APRA stating that its supervisory approach “allows institutions to use a variety of approaches to comply with high-level principles, rather than APRA seeking to direct an institution through detailed prescription.”<sup>96</sup>

***“One way to reduce the compliance burden imposed on smaller ADIs is to ensure that regulatory frameworks are less prescriptive and more flexible and outcomes focused.”***

However, APRA’s stakeholder surveys would suggest that APRA could improve its performance in this area. In the latest survey, levels of stakeholder agreement were relatively low when it came to the following two statements:

- “APRA’s prudential standards are based on principles rather than detailed prescription”; and
- “During supervisory visits to your organisation, APRA supervisors focus on principles rather than detailed prescription.”<sup>97</sup>

While APRA has acknowledged the value of flexibility in applying the prudential standards, it appears that more could be done to provide this flexibility in practice.

### 5.3.2 Performance of the regulators

In looking at the burden imposed by regulations, the Productivity Commission found that, “regulator culture is crucial,” and that how businesses experience regulation “has as much to do with the engagement approaches of regulators as it does with the regulations.”<sup>98</sup>

This is particularly true when regulations are outcome focused and the regulators can exercise a degree of flexibility and discretion in their application. While we support this flexibility, it is equally important that this be accompanied by an appropriate level of transparency and accountability.

#### 5.3.2.1 APRA’s legislative mandate

In considering the performance and operation of the regulators, it is important to recognise that their activities are constrained by the enabling legislation under which they operate. In this regard, we believe there is merit in considering the appropriateness of APRA’s current legislative mandate.

Section 8(2) of APRA’s enabling legislation states that:

“In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.”

In the interpretation of their operational mandate, APRA has typically promoted financial system stability first, with all other considerations seen as secondary. Whilst this approach was undoubtedly correct at the height of the GFC, the pendulum has swung too far towards stability and away from competition.

A more balanced focus for the prudential regulator was the initial recommendation of the Wallis Inquiry, which stated that the prudential regulator’s charter:

<sup>96</sup> APRA, *Corporate Brochure – Protecting Australia’s depositors, insurance policyholders and superannuation fund members*.

<sup>97</sup> APRA, *APRA Stakeholder Survey – 2013, Report of overall findings*, July 2013, p. 2 & 7.

<sup>98</sup> Productivity Commission, *Regulator Engagement with Small Business*, September 2013, p. 2.



"...should emphasise the need to approach prudential regulation in a way that balances the objectives of promoting financial safety with the need to minimise the adverse effects on efficiency, competition, innovation and competitive neutrality."<sup>99</sup>

Under this framework, the regulator would need to more effectively balance financial stability against other objectives, and importantly, seek to minimise the adverse impacts on competition and competitive neutrality.

**Recommendation: Revise APRA's objectives to increase the legislative weighting given to competitive neutrality and competition.**

### 5.3.2.2 Parliamentary oversight of APRA

As previously noted, it is important that all regulators are accountable and transparent in their operations. Interestingly, while ASIC and the RBA regularly appear before Parliamentary Committees APRA does not.

ASIC appears before the Parliamentary Joint Committee on Corporations and Financial Services, an arrangement which is formalised in ASIC's enabling legislation. Similarly, the RBA appears twice a year before the House of Representatives Standing Committee on Economics. This arrangement is set out in RBA's *Statement on the Conduct of Monetary Policy*.

This is despite the House of Representatives Economics Committee noting back in 1997 that:

"The relationship between the RBA and the APRA will be critical for effective and efficient regulation of the financial services industry. The Committee believes that continued parliamentary scrutiny of both monetary policy and prudential supervision will assist in ensuring the success of the new arrangements. As this Committee has been providing that oversight of prudential supervision and monetary policy over the last five years, the Committee considers it desirable to put in place a similar arrangement for the APRA to that established under the Treasurer's Statement on the Conduct of Monetary Policy. If the Parliament is to be satisfied that the Bank and the APRA are working together effectively, it is essential that both bodies appear before this Committee on a regular basis."

The Committee recommended:

"That the Australian Prudential Regulatory Authority be required to appear before the House of Representatives Standing Committee on Financial Institutions and Public Administration at a public hearing once a year to report on prudential supervision of the financial services industry."

Requiring APRA to regularly appear before the House Economics Committee would improve the regulator's accountability framework and help provide the Parliament, in addition to Senate Estimates hearings, with further assurance that APRA is performing its role effectively.

**Recommendation: Increase APRA's accountability to Parliament through scrutiny by the House of Representatives Economics Committee.**

### 5.3.2.3 Efficiency & APRA levies

Currently, APRA is entirely funded through levies collected from the institutions it regulates. At the same time, the Government is responsible for approving increases in APRA's Budget each year. Under this arrangement, the Government has very little incentive to ensure that the costs of

<sup>99</sup> Wallis, *Financial System Inquiry Final Report*, March 1997, p. 321.

prudential regulation are efficient and that over-regulation does not occur, given that increases in APRA's costs have no impact on the government's budget.

The rapid growth in APRA's Budget since its establishment would suggest that government focus on APRA's costs has been limited. After rapidly scaling up staffing levels in the years following its establishment, APRA reached its target staffing level in 2005-06, and APRA's Budget could have been expected to remain relatively stable from this point onwards. Instead, APRA's costs have increased from \$92.1 million in 2005-06<sup>100</sup> to an estimated \$130.4 million in 2013-14,<sup>101</sup> representing an average annual increase of five per cent and growing at twice the rate of inflation.

Given industry pays the levy, it has a strong incentive to ensure that the costs of the regulator are efficient. Indeed, the original explanatory memorandum to the levies Bills from 1998<sup>102</sup> notes that one of the advantages of imposing levies is that: "this method of funding may also tend to encourage the institutions paying the levy to act as a constraint on empire building or other excessive cost increases on the part of the regulator." However, it is impossible for industry to exert any influence over APRA's overall funding level given that this is approved by Government and is not open to industry consultation.

***"One way to better align incentives could be for growth in industry funding of APRA to be capped at a certain level (for example CPI), with all increases above this to be met by the Government."***

While under-regulation is in no one's interest, it is equally important that a mechanism exists which reduces the incentive for the sector to be over-regulated. As noted in the Government's Cost Recovery Guidelines "while cost recovery can promote efficiency by instilling cost consciousness in the agency and its customers, poorly designed arrangements can create incentives for 'cost padding' and inefficiency."<sup>103</sup>

One way to better align incentives could be for growth in industry funding of APRA to be capped at a certain level (for example CPI), with all increases above this to be met by the Government. Such an approach would ensure that the party responsible for approving APRA's Budget also had an incentive to ensure that it represented an appropriate and efficient allocation of resources.

**Recommendation: Introduce more effective measures ensure APRA's costs are efficient.**

#### 5.3.2.4 Improving the quality of regulations

All businesses benefit from improvements in the overall quality of regulations and regulatory development processes. Initiatives to improve performance in this area are not new or revolutionary, but they are worth noting briefly.

Regulations should be:

- Co-ordinated between regulators to ensure alignment and consistence in regulatory obligations;
- Developed in an open and consultative fashion which provides all stakeholders with an appropriate opportunity to provide feedback;

<sup>100</sup> APRA, *2006 Annual Report*, p. 80.

<sup>101</sup> Treasury & APRA, *Financial Industry Levies for 2013-14*, p. 5.

<sup>102</sup> Explanatory Memorandum, *Financial Sector Levy Bills 1998*

<sup>103</sup> Dept. of Finance and Administration, *Australian Government Cost Recovery Guidelines*, July 2005, p. 47.

- Properly justified to ensure that consumers and industry recognise and understand the rationale and benefits of regulatory requirements; and
- Finalised and released publicly well before taking effect to ensure that industry has sufficient time to implement any new requirements.

Regulation which meets the criteria listed above will promote a competitive and stable financial system that contributes to Australia's productivity growth and will benefit consumers by reducing pressure on costs.

Unfortunately, our members have identified a number of areas where new regulations have fallen short of these ideals. Without being exhaustive:

- Home Loan Key Fact Sheets are only required when requested by the consumer, whereas Credit Card Fact Sheets are mandatory upon application. It is not clear why there are different disclosure obligations placed on these two products.
- An inconsistent approach to both fees and reporting obligations between the ACL and the AFSL.
- Inconsistent approaches to mandating the content and format of customer information documentation, such as the Home Loan Key Fact Sheet, the Credit Card Key Fact Sheet, Reverse Mortgage Information Statement and Tenancy Protection Statement.
- In 2013, implementation of the Reverse Mortgage reforms was due to commence on March 1. However, the regulations which prescribed the content of disclosure documents such as the Reverse Mortgage Information Statement, was not available before this date, which led to confusion and an inability to properly brief staff on the new requirements. Eventually, the implementation date was pushed back from 1 March to 1 June, but organisations were not notified of this change until 1 March.
- Similarly, the final FOFA regulations were released on Friday 28 June 2013, with the regulations taking effect from the following Monday.
- The FATCA legislation with the Inter-Governmental Agreement (IGA) between the US and Australia is yet to be published and Australian legislation is yet to be written, however the requirement to comply with the FATCA legislation commences 1 July 2014.

In addition, the customer-owned ADI experience with regulators shows that in some areas, overly prescriptive and inconsistent approaches can be extremely costly for smaller ADIs. These areas include:

- Over regulation of transfer of business (that is the strategic merger of smaller ADIs) where approval processes for merger documentation are excessively slow and costly without identified consumer or shareholder benefits;
- Approval of capital raisings by ADIs on individual and aggregate bases where the cost of getting regulatory approval for structures is too high and therefore limiting viability of those structures for smaller ADIs.

COBA believes that the regulators could make a greater effort to deliver improvements in these areas. Recent stakeholder surveys support this view – one of the four key weaknesses identified in ASIC's 2013 stakeholder survey was the regulator's ineffectiveness in "reducing the red tape associated with compliance."<sup>104</sup> Similarly, of the 45 questions asked in APRA's 2013 stakeholder survey, stakeholders found APRA's performance weakest when it came to ensuring that "changes to APRA's prudential framework consider the costs of regulation imposed on industry."<sup>105</sup>

These concerns have been echoed in the Annual Reports of our members, which have included comments such as:

<sup>104</sup> ASIC, *Stakeholder Survey 2013*, September 2013.

<sup>105</sup> APRA, *APRA Stakeholder Survey – 2013, Report of overall findings*, July 2013, p. 2.

"The regulations governing banking institutions are set to become significantly more onerous..."

"The cost and restrictions this will place on ... mutual banking institutions we feel is unbalanced and will be counterproductive to supporting diversity and competition in the banking industry."

"..Another pressure is the increasing cost and burden arising from newly imposed compliance and legislation. These new requirements are placing ever increasing costs on your Credit Union. It seems that whenever there is a problem the reaction is a new piece of legislation. This new legislation is imposed without fully understanding the consequences to you the customer."

The Business Council of Australia has also made similar points, noting that "while our key regulators must be independent, they must also operate in an environment with incentives to better understand business and minimise regulatory burdens."<sup>106</sup>

Similarly, it is important that, where appropriate, the regulatory framework facilitates the activities of customer-owned banking institutions. For example, as previously noted in Chapter 3, our sector has a strong history of acting together to gain access to economies of scale. These aggregation models and initiatives should be supported and facilitated by the regulatory environment where possible. Such an approach would improve the capacity of smaller ADIs to compete effectively against large, listed banks.

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<sup>106</sup> Business Council of Australia, *Improving Regulation Requires Sharper Focus on Regulators*, 22 November 2013.

## 6 Taxation of financial arrangements

*“The Inquiry will examine the taxation of financial arrangements, products or institutions to the extent these impinge on the efficient and effective allocation of capital by the financial system, and provide observations that could inform the Tax White Paper.”*

### 6.1 Tax on deposits

ADI deposits are the simplest and safest savings vehicle for Australian households but they are also the most heavily taxed.

The Henry Tax Review found that the real effective marginal tax rate on bank deposits was higher than other investment alternatives, including property, superannuation and shares. For those in higher income tax brackets, the differences in tax rates are dramatic, with bank deposits taxed at an effective rate of around 80 per cent, while the effective tax rate on superannuation was around negative 30 per cent.<sup>107</sup>

It is therefore unsurprising that the Henry Review found that: “There is considerable evidence that tax differences have large effects on which assets a household’s savings are invested in.”<sup>108</sup>

In the current low interest rate environment, the tax differential between deposits and alternative forms of savings has become even starker. With the cash rate currently below the inflation rate, real interest rates are negative, meaning it is difficult for investors to maintain the real value of their cash holdings in pre-tax terms, let alone once tax is taken into account. The effective real tax rate faced by most deposit holders is currently greater than 100 per cent.

With markets currently expecting the cash rate to remain below 2.75 per cent until at least the middle of 2015,<sup>109</sup> it is likely that the real interest rate will remain very low or negative for a considerable period of time, with a corresponding detrimental impact on the real tax rate paid by deposit holders.

The RBA has noted that low interest rates will encourage households to rebalance their portfolios away from interest-bearing assets towards those with higher returns, and the current tax treatment of interest earnings only exacerbates this problem.

Rather than impose dramatically different tax rates on different investments, the Henry Review notes that: “A tax system for the future would tax these different forms of investment as consistently as possible, and also take account of the way inflation affects the effective tax rate on savings.”<sup>110</sup>

This view was supported by the November 2012 Senate Economics Committee report on the post-GFC banking Sector, which recommended that inconsistencies between the taxation of interest on ADI deposits compared to other methods of saving should be addressed.<sup>111</sup>

In response to the Henry Review, the previous Government’s 2010-11 Budget included the announcement of a 50 per cent discount on up to \$1,000 of interest income earned by individuals.

<sup>107</sup> Henry, *Australia’s Future Tax System – Part 2*, December 2009, p. 67.

<sup>108</sup> Henry, *Australia’s Future Tax System – Part 2*, December 2009, p. 68.

<sup>109</sup> ASX, 30 Day Interbank Cash Rate Futures Implied Yield Curve – as at market close on 28 January 2014.

<sup>110</sup> Henry, *Australia’s Future Tax System – Part 2*, December 2009, p. 4.

<sup>111</sup> Senate Economics References Committee, *The post-GFC banking sector*, November 2012, p. 82.

Unfortunately, this measure was twice deferred,<sup>112</sup> before eventually being scrapped in the 2012-13 Budget. In support of the decision to scrap this measure, the Budget papers noted that:

“The Government’s public consultation process involving key sector groups, industry participants and consumer groups revealed concerns with the complexity involved in calculating the discount and its overall effectiveness.”<sup>113</sup>

Given the complexity of the previous Government’s proposed response to this issue, it would be appropriate for the FSI to reconsider the appropriateness of the Henry Review’s initial recommendation regarding the taxation of deposits. Specifically, that the Government “provide a 40 per cent savings income discount to individuals for non-business related net interest income.”<sup>114</sup>

Deposits comprise around 80 per cent of funding for customer-owned ADIs so their unfavourable tax treatment disproportionately impacts on this sector. As such, improving the taxation of deposits in this way would also improve banking competition. As the 2010-11 Budget Overview notes:

***“...improving the tax treatment of deposits has broader benefits, making it easier for individuals to save, and potentially reducing the population’s reliance on government support payments such as the pension.”***

“The discount can be expected to increase the available pool of deposits, which are a particularly important source of funding for smaller banks, building societies and credit unions. This will help them to put more competitive pressure on the big banks over time.”<sup>115</sup>

The Senate Economics Committee also drew attention to these broader benefits, noting that:

“Encouraging domestic deposits would provide banks with a larger source of stable funding, reducing some of the risk from sourcing funds from unstable international wholesale debt markets,” the Senate report said. “Further, an increased pool of deposits may help alleviate any long-term competition implications arising from the major banks encroaching on a funding source relied on by smaller ADIs.”<sup>116</sup>

The recent Basel III liquidity reforms have emphasised the importance of deposits as a safe and stable source of bank funding. Steps to ensure that deposits are not unfairly taxed more heavily than other products would help to increase their supply and thereby help to facilitate improved financial system stability.

Finally, improving the tax treatment of deposits has broader benefits, making it easier for individuals to save, and potentially reducing the population’s reliance on government support payments such as the pension.

**Recommendation: Reduce the unfair tax burden on deposits.**

<sup>112</sup> In the 2010-11 and 2011-12 MYEFO.

<sup>113</sup> Treasury, *2012-13 Budget, Budget Paper 2*, p. 36.

<sup>114</sup> Henry, *Australia’s Future Tax System – Part 2*, December 2009, p. 70.

<sup>115</sup> Treasury, *2010-11 Budget Overview*, May 2010, p. 21.

<sup>116</sup> Senate Economics References Committee, *The post-GFC banking sector*, November 2012, pp. 81-82.

## 6.2 Dividend imputation and the customer-owned model

As previously noted in Chapter 5, (section 5.2.3), listed ADIs are able to distribute franking credits while customer-owned ADIs are severely constrained in their ability to do so. This is a critical competitive neutrality issue as it provides listed ADIs with a significant tax advantage relative to customer-owned ADIs.

Independent research commissioned by COBA has estimated that while customer-owned ADIs face a corporate tax rate of 30 per cent, the ability of listed ADIs to release franking credits means that they face an effective tax rate of between 22.15 per cent and 25.5 per cent.

The FSI should consider what can be done to achieve greater equity in the taxation of customer-owned ADIs compared to their listed counterparts including allowing the more effective release of franking credits and/or adjusting the corporate tax rate for customer-owned ADIs.

## 7 Emerging opportunities and challenges

*“The Inquiry will identify and consider the emerging opportunities and challenges that are likely to drive further change in the global and domestic financial system...”*

This section discusses opportunities and challenges in relation to:

- Superannuation and ADI funding;
- Securitisation; and
- SME lending by customer-owned banking institutions.

### 7.1 Superannuation & ADI funding

The superannuation sector currently holds \$1.8 trillion in assets<sup>117</sup>, with consensus private sector forecasts estimating that the sector will hold \$4.2-\$5 trillion by 2025.<sup>118</sup>

Currently around 15 per cent of all superannuation assets (around \$230 billion) are held as cash and deposits. Assuming asset allocations remain relatively stable, this implies that the total pool of superannuation invested in cash and deposits will top \$600 billion by 2025. Cash holdings by self-managed super funds are closer to 30 per cent.

While superannuation investments in cash and deposits provide a safe and secure option for individuals, deposits are also an important source of funding for ADIs. Customer-owned ADIs offer a competitive choice for investments of this kind, with high interest rates and the protection of the Government's Financial Claims Scheme (FCS).

As such, it is important that there are no artificial barriers which prevent smaller ADIs competing for superannuation funds held as deposits. Unfortunately, there are currently barriers which are potentially artificially reducing superannuation holdings as deposits with customer-owned ADIs, including:

- The high degree of vertical integration within the wealth management industry;
- The inconsistent treatment of deposits under the FCS between different types of superannuation account; and
- A lack of consumer understanding around the importance of diversification, and reducing portfolio risk when approaching retirement.

#### 7.1.1 Vertical integration in wealth management:

Under current arrangements in the superannuation industry, it appears that a number of wealth management funds are largely limiting their cash holdings to products offered by their parent banks.

As reported in the *Sydney Morning Herald* last December, “the investment giants BT, ANZ Cash Management, Colonial and MLC are all funnelling their clients’ money straight upstream into their parent banks.”<sup>119</sup>

The interest rates being paid for these “in house” deposit products are typically well below interest rates available in the broader marketplace. The *Sydney Morning Herald* notes that these holdings

<sup>117</sup> APRA Statistics, December quarter 2013

<sup>118</sup> ASFA, *Superannuation Statistics*, January 2014

<sup>119</sup> SMH, *Cold, hard, unyielding cash: how fund managers for the big four short change you*, 18 December 2013



currently pay interest rates of around 2.4 per cent, well below the rates available on deposits held with customer-owned ADIs, which are currently often above 3 per cent.

By requiring fund managers to give greater consideration to maximising the returns to their clients on investments in particular asset classes, customer-owned ADIs would be better able to compete for this source of funding, diversifying funding options for our sector and delivering better returns to these superannuation account holders.

One possibility would be to compel superannuation fund managers to make their investment decisions in a manner which maximises the risk adjusted returns for their clients. This arrangement could be further strengthened through a standing presumption that a related party deposit is not in the client's best interests, which would mean fund managers would need to positively justify any such arrangements.

APRA has felt it necessary to warn larger ADIs not to make unacceptable assumptions about the behaviour of their related-party entities in terms of cash outflows in an acute stress scenario.

In a recent letter<sup>120</sup>, APRA noted that a number of locally incorporated ADIs highlighted funding from related-party entities as having the potential to reduce cash outflows.

APRA identified prudential concerns with two categories:

- firstly, where an ADI assumed that in a stress situation the related-party entity would not choose to withdraw funds from the ADI even though it had the right to do so; and
- secondly, where the related-party entity entered into a contractual arrangement that significantly impeded its ability to withdraw funds from the ADI without any obvious compensating benefit to that entity.

"APRA cannot accept assumptions relating to the potential behaviour of directors or trustees of related-party entities that are not consistent with their duties and fiduciary obligations, in particular where these are imposed through legislation such as the *Corporations Act 2001* or the *Superannuation Industry (Supervision) Act 1993*. Nor can APRA accept directors or trustees of related-party entities signing legal agreements that are not in the best interests of their own entity, its customers or members."

**Recommendation: Regulators should be more proactive and vigilant about risks to consumers and competition arising from conflicts of interests in large vertically-integrated businesses.**

### 7.1.2 FCS protections and superannuation:

The FCS covers deposits held in some superannuation funds but not others. Under the current arrangements, deposits held by institutional funds are ineligible for coverage under the FCS, while deposits held by the SMSF sector are protected. This anomaly could discourage institutional fund managers from diversifying their cash holdings, and act as an impediment to them seeking the best rate of return on behalf of their clients. It would appear more appropriate for SMSF and non-SMSF superannuation holdings to receive the same protections under the FCS.

While recognising that with institutional superannuation there are complications around identification of the beneficiaries and allocation of the \$250,000 cap on a per person and per institution basis, it would be worth the Financial System Inquiry examining whether these complications can be overcome.

<sup>120</sup> Letter to ADIs subject to the Liquidity Coverage Ratio, APRA, 30 Jan 2014

### 7.1.3 Encouraging superannuation diversification

As previously noted, cash and deposits are an important part of a well-diversified portfolio, and provide a safe and secure option for individuals. In addition, as individuals progress through their careers, cash and deposits become an increasingly important component in reducing volatility, particularly in the years closest to retirement.

The government provides significant tax concessions for superannuation, recognising the importance of people setting aside money during their working lives in order to help fund their retirement.

The FSI Panel should consider the role that superannuation plays in the Australian economy, including:

- The focus on retirement savings versus savings for other life events such as education and home ownership;
- The role (if any) that superannuation should play in funding Australia's growth, including in the banking sector;
- The appropriateness of the vertical integration of banking, superannuation and wealth management activities and whether more restrictions are required.

## 7.2 Securitisation

Securitisation is an important source of funding for smaller ADIs, and a well-functioning securitisation market helps support banking competition. As noted by a recent Senate Inquiry:

"An additional challenge for competition and funding mix diversity is the state of the securitisation market. Prior to the global financial crisis securitisation played a key role in supplying funds for smaller lenders. It therefore helped enable stronger competition in the sector."<sup>121</sup>

Securitisation allows unrated or lower-rated lenders to issue highly rated debt instruments enabling them to compete with the major banks.

The attached paper *Competitive Dynamics in Retail Banking: An International Comparison* finds that "Australia is the only country in our study that does not directly support the liquidity [in lending markets for housing, SMEs and agriculture] via a government-owned development bank (e.g. Canada Mortgage Housing Corp or KfW in Germany) or a government-sponsored entity (the more stable and cooperatively owned Farm Credit Funding Corp of Federal Home Loan Banks)."

Permanent government support for the securitisation market in Australia, based on the Canadian model, has been debated since the GFC. This proposal should now be re-examined given the dominance of the major banks and, in particular, their role in providing warehouse and liquidity facilities underpinning the securitisation market.

Australia does not have many entities that can support securitisation structures and, in the absence of some form of government support, smaller lenders have to deal with the major banks – their direct competitors in home lending.

The Inquiry should revisit Treasury's 2009 view that:

"A Canadian-style program of support to the RMBS market, under which the Government guaranteed RMBS issued by lenders or purchased such RMBS outright using proceeds from

<sup>121</sup> Senate Economics References Committee, *The post-GFC banking sector*, November 2012, pp. xxi-xxii.

the issuance of government-backed debt securities, could potentially enhance smaller lenders' access to funds. However, it is not clear that such an intervention would necessarily result in substantially greater choice and lower interest rates for mortgage borrowers, or that the benefits of the proposal would outweigh the associated risk and costs."<sup>122</sup>

APRA has announced that it intends to shortly commence a review of the securitisation prudential standard (APS 120). APRA has stated that it "would like to see a large and liquid securitisation market supporting competition in Australian home lending."<sup>123</sup>

While APRA has yet to release a formal discussion paper, it has given public indications that it will propose several changes to the prudential standard which would be problematic for the customer-owned banking sector. We are particularly concerned about APRA's proposed changes to warehousing arrangements and multi-seller structures.

Under APRA's proposed changes to the treatment of warehouses, current capital effects would be allowed "provided that underlying assets are term funded within a year." APRA has not provided an indication of why it is proposing this change.

However, such a proposal would make the use of securitisation very difficult for all but our largest members. The fixed costs, (such as legal fees, rating fees and trustee costs) would require a minimum deal size of around \$300 million to be economic. In addition to the fixed costs, investors seek deals that have a spread of investors and smaller deals are therefore less attractive to them. For smaller ADIs, challenges around minimum issue size can be overcome by writing the business over a longer period of time. APRA's proposed one year cut-off would be a significant impediment for our sector, with most members unable to generate sufficient business within a twelve month period to make the use of securitisation economic. At the same time, this proposal is no impediment to the major banks given their much larger size. If such a policy change was adopted by APRA it would be another example of the playing field being tilted in favour of the major banks at the expense of small ADIs.

One way that some of the barriers of scale can be overcome is through aggregation between customer-owned ADIs. In the case of securitisation, this can be achieved through the use of multi-seller structures. Unfortunately, APRA has indicated that it sees "a number of problems" with multi-seller structures and that therefore "the new [prudential standard] is unlikely to accommodate multi-seller structures." We believe it is important that APRA retain an economic multi-seller option which gives small ADIs an opportunity to utilise securitisation as a source of funding.

***"...we are concerned that APRA's proposals around warehousing and multi-seller structures could undermine the capacity of securitisation to support competition."***

In combination, these two proposals would severely constrain the capacity of most customer-owned banking institutions to utilise securitisation. It would appear that in developing these proposals, APRA has focused exclusively on financial stability, with limited thought given to the impact of these changes on competition. However, allowing ADIs to diversify their funding sources is also an important aspect of supporting financial stability, and proposals which prevent smaller ADIs from utilising securitisation undermine this.

<sup>122</sup> Treasury Submission to House of Representative Inquiry into the impact of the GFC on regional Australia, Aug 2009

<sup>123</sup> Littrell, *Prudential Reform in Securitisation*, 11 November 2013, p. 5.

We support APRA's review of the securitisation standard, as this work will form an important part of building a more active securitisation market in Australia. However, we are concerned that APRA's proposals around warehousing and multi-seller structures could undermine the capacity of securitisation to support competition.

**Recommendation: Regulatory settings must recognise the importance of securitisation in enhancing competition and choice in the mortgage market.**

### 7.3 SME lending

Generally speaking, customer-owned banking institutions are focused on consumer banking. However, many customer-owned banking institutions, particularly those based in regional areas, also compete in the small business market.

Customer-owned banking institutions operating in this market have invested in the necessary expertise and product range to compete prudently. They are active, they are lending, and they see an opportunity to provide a personalised level of service for small businesses, and particularly micro businesses, in various regional markets where other lenders are not providing that personalised service.

Small businesses rely more on debt funding than large companies and rely more on the banking sector for that debt financing than large companies, so a competitive banking sector is critical to small businesses.

While the customer-owned banking sector has a small share of small business lending there is significant potential for growth. Customer-owned banking institutions play a significant role in small business lending in other markets. For example, in Canada credit unions and other provincial lenders have approximately 15 per cent of the SME loan market.<sup>124</sup>

While only around \$2 billion of customer-owned ADI lending is categorised as commercial lending,<sup>125</sup> it is likely that some of the \$65 billion<sup>126</sup> of mortgage and personal loans provided by customer-owned banking institutions would be indirectly used to provide funding for small businesses of members.

One of the strengths of the service offering of our sector is the close connection we have with businesses in our communities, particularly regional communities, which is where a significant number of small businesses operate. Regional customer-owned banking institutions have strong local connections and support. For example, in NSW the regional electorates of New England, Calare, Parkes and Hume are all areas where more than 30 per cent of the population are members of a customer-owned banking institution.<sup>127</sup>

While many customer-owned banking institutions choose to stick to consumer banking, many regionally-based institutions are actively competing in the small business market. In a recent survey of our members, more than 50 per cent of respondents indicated that they currently provide small business lending. Small business lending is also a significant part of the business for several customer-owned banking institutions, with roughly a third of members offering small business lending indicating that it represented more than 10 per cent of their business.

<sup>124</sup> Dave Grace & Associates, *Competitive Dynamics in Retail Banking: An International Comparison*, March 2014, p. 13.

<sup>125</sup> RBA – note this data series was discontinued in March 2013.

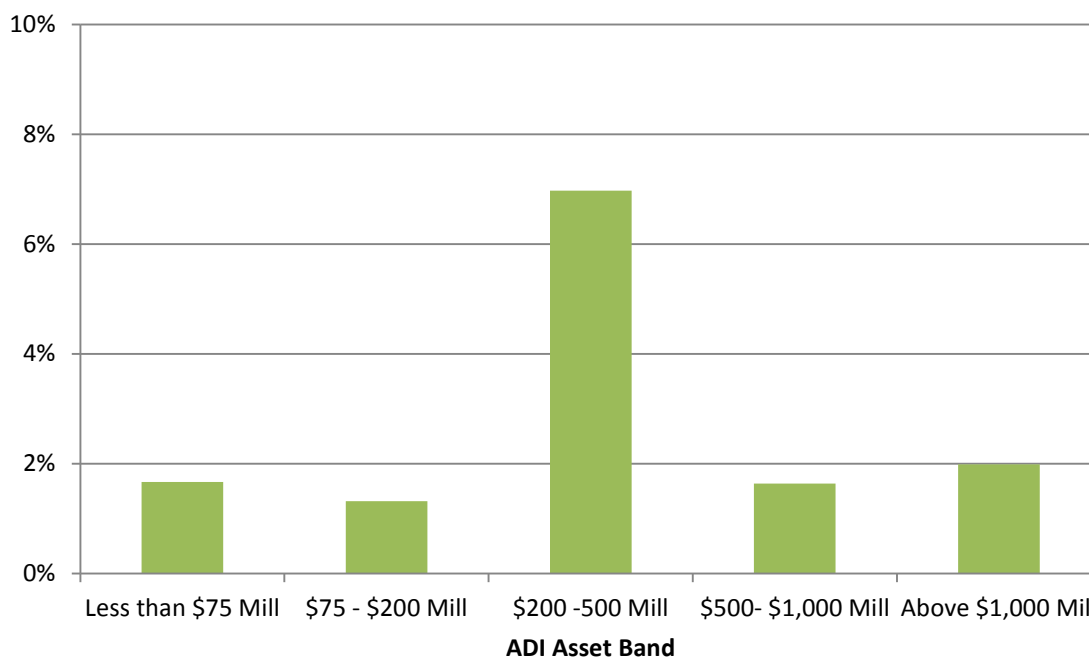
<sup>126</sup> APRA, *Quarterly ADI Performance*, December 2013; COBA Adjustments.

<sup>127</sup> COBA Data

For customer-owned banking institutions that provide small business lending, the main reason given was “to help the small business community” (64 per cent), ahead of “to meet unmet demand in the market” (23 per cent) and “to increase profits” (14 per cent).

A snapshot of commercial lending by credit unions and mutual banks, based on asset size, shows that commercial lending is more common among medium sized institutions, reflecting their prevalence in regional communities.

**Chart 16 – Commercial lending (as a percentage of total loans)<sup>128</sup>**



For members not currently offering small business lending, our survey found that the main impediments were a lack of technical expertise (46 per cent), and the prudential regulator discouraging the ADI from offering small business lending (32 per cent). While our members are small relative to other ADIs, only 9 per cent of those not offering small business lending perceived themselves as too small to do so.

APRA strongly advises boards of customer-owned ADIs not to move into commercial lending without ensuring they have the personnel, expertise and systems to do so prudently. Customer-owned banking institutions understand this position and are appropriately cautious around the decision to become involved in small business lending, recognising that it requires significant investment and an appreciation of new and different risks.

Where a customer-owned ADI makes an assessment that small business lending is an appropriate opportunity for their business to pursue, it is important that APRA provides “in principle” support for such initiatives, subject to appropriate prudential standards being met. It is not the role of the prudential supervisor to actively

***“...the capacity for customer-owned banking institutions to increase competition and choice in the small business lending market depends on the sector’s capacity to access funding and capital, and to compete on a level playing field.*”**

<sup>128</sup> Source: CUFSS Data

discourage small ADIs from operating in this space. Such an approach would be overly risk averse and inevitably result in lower levels of competition in the sector and poorer outcomes for SMEs.

Customer-owned ADIs are well placed to play a more active role in small business lending, and it is important that APRA does not act as an unnecessary constraint on their capacity to enter the sector and offer a competitive alternative to the listed banks. Many of these institutions have a close relationship with their local community and are staffed by locals. The long-term relationships developed give these ADIs a very good understanding of both their customers and local business conditions.

More broadly, the capacity for customer-owned banking institutions to increase competition and choice in the small business lending market depends on the sector's capacity to access funding and capital, and to compete on a level playing field.

**Recommendation: Regulatory settings for ADIs engaging in SME lending should more balanced and less restrictive.**

## 8 Conclusion

This long anticipated Inquiry has the opportunity to provide a vital rebalancing to our financial system. The increasing domination of the market by the four largest banks is simultaneously weakening competition and compromising financial system stability. The current regulatory framework has failed to provide genuine competition within the market and this is ultimately to the detriment of the Australian people.

The current system fails to accommodate the customer-owned model. The customer-owned model is inherently conservative and stable, and delivers important competition to the major banks. Diversity within the banking sector is essential to push back against the systemic risks created by the dominance of the major banks. A good step towards fostering this diversity would be to ensure that the customer-owned banking sector is able to compete with the listed sector on a level playing field.

Government representatives, industry, and consumer groups have expressed concern about the conduct and growing domination of the major banks. Statistics show that the profitability of the biggest four banks has outstripped that of growth in the banking sector as a whole.

COBA calls upon the Inquiry for strong measures to restore balance. Australian consumers are looking to the FSI to create a system that enhances competition and diversity.

We look forward to the outcomes of this Inquiry and will be eager to provide further comment as the opportunity arises.

DAVE GRACE AND ASSOCIATES

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## Competitive Dynamics in Retail Banking: An International Comparison



# Competitive Dynamics in Retail Banking:

## An International Comparison

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March 2014

An Independent Report Prepared for the  
Customer Owned Banking Association

# Competitive Dynamics in Retail Banking: An International Comparison

*“The high fiscal and social costs of major financial instability are such that policymakers will want to err on the side of stability in their approach to the sector. But risk-taking is necessary for economic growth, so the application of safety and soundness regulation needs to be circumscribed somewhat to permit institutions and markets to operate as intended, but not so much as to allow serious problems to develop. This tension is at the core of banking sector regulation. It is also one of the factors affecting competition in the sector.”*

This quote is from the Organization for Economic Cooperation and Development’s (OECD) 2011 report on Bank Competition and Stability. It was prepared for a G20 workshop on the “New Financial Landscape” that was sponsored by the Australian Treasury and Reserve Bank of Australia. While this excerpt was aimed at the G20 community, not Australia, we believe the tension it refers to lies at the heart of the Financial System Inquiry (FSI).

As a firm focused on financial consumer protection and helping middle and low income consumers protect and grow assets, Dave Grace & Associates welcomes Australia’s first fundamental review of the financial system in 17 years. Our submission is regarding the current cost, quality, safety and availability of retail financial services for Australian consumers and how changes in the market could lead to more stability and increased economic growth.

## 1. Executive Summary

While its widely accepted and often criticised that Australia has a highly concentrated banking sector, less research has been focused on how contestable the retail banking sector is and what are the downstream impacts on economic stability and consumer welfare from this concentration. This paper reviews the structure and challenges in the homogeneous Australian retail banking sector, provides three case studies of more diversified and highly resilient retail banking systems in Canada, United States and Germany and concludes with a set of five proposals for the Financial System Inquiry panel to consider should it see a more stable and less costly banking sector as desirous goals.

There are many benefits to the current structure of the Australian retail banking market. Chiefly that supervisors can easily identify and focus resources on where the largest risks are and that the consumers and business have a high degree of confidence that big 4 banks are too important to the economy to fail. The downsides are that the assets of the three largest banks constitute over 150% of gross domestic product, making Australia’s economy one of the most beholden to the stability of its big banks of any G20 country. Equally important from a societal view, this concentration and lack of competition in retail banking appears to have led to dominant pricing with the big 4 banks making up half of the 8 most profitable banks in the world. In addition, despite consumers consistently experiencing better customer satisfaction with mutually-owned authorized deposit-taking institutions (ADI) the deposit market share for mutual ADIs has decreased in the past decade.

As has been shown through multiple academic papers, by the International Monetary Fund and actual experience from other countries during the global financial crisis (GFC), mutual ADIs have less volatile income than commercial banks and are more stable. We tested this in the Australian market using APRA data for the past 9 years and found similar results to other markets.

Mutual ADIs in Australia have a lower share of the deposit market and various loan categories than their mutual peers in Canada, US and Germany. This is highly correlated with the fact that each of the three peer countries, and most G20 nations, have separate rules/policies in place to aid competitive neutrality. These competitively neutral policies affect the legislative and regulatory structures, deposit insurance schemes, liquidity funding mechanisms to support housing, small and medium enterprise (SME) and agricultural access to loans, tax treatment of mutuals and the capital structure of mutuals. These areas are summarized below in figure 1.

*Figure 1. Summary Comparison of Retail Banking Competition*

	Canada	United States	Germany	Australia
<b>Retail Banking Structure</b>	<ul style="list-style-type: none"> <li>• 42,000 inhabitants per ADI</li> <li>• 6 banks – 93% market share of assets</li> <li>• Credit Unions (CUs) – 4.5% of assets (<b>7.8% of deposits, 15% SME</b>) Govt. owned Farm Credit Canada 31% market share of ag finance.</li> <li>• 28 banks, 24 foreign banks, 771 credit unions</li> </ul>	<ul style="list-style-type: none"> <li>• 23,000 inhabitants per ADI</li> <li>• 5 banks – 44% of assets</li> <li>• CUs – 6% of assets (<b>10% of deposits</b>)</li> <li>• 6,890 banks, 6,700 credit unions, 17,121 non-depository mortgage lenders. 60 farm credit cooperatives</li> <li>• Farm credit coops have <b>43% market share in ag lending.</b></li> </ul>	<ul style="list-style-type: none"> <li>• 42,000 inhabitants per ADI</li> <li>• 3 pillar system. Commercial banks 36% share of assets, savings banks 31% of assets, coop banks 11% assets, (<b>20% of deposits, 30% SME</b>).</li> <li>• 1,900 deposit taking financial institutions (1,100 are coop banks)</li> </ul>	<ul style="list-style-type: none"> <li>• 141,000 inhabitants per ADI</li> <li>• 4 banks 78% of assets.</li> <li>• Mutuals 1.7% of assets (<b>3.3% of deposits</b>)</li> <li>• 20 banks, 8 foreign banks, 95 mutual ADIs.</li> </ul>
<b>Legislation/Regulation</b>	Separate provincial legislation, regulations and regulators for credit unions and other non-banks.	Separate state and federal legislation, and regulations for credit unions, community banks, and farm credit associations. Separate regulators for credit unions and farm credit cooperatives	Unique European Cooperatives Act, Federal Cooperatives Act & part of Banking Act. Regulations issued by federal bank regulator with on-site inspections done by system owned “auditing” federations and federal bank regulator. Savings banks have unique public foundation structure.	Same prudential regulator and regulations. No recognizable difference in law or regulations for mutuals.
<b>Deposit Insurance</b>	CUs have separate funds, funding systems and coverage levels. CUs in 4 of 10 provinces	CUs have a separate fund and funding structure than banks. Farm credit coops also	Coop banks and savings banks have separate funds and joint liability structures that	Mutuals have the exact same fund and funding mechanism as

	offer 100% DI coverage. Other provinces are at or above bank levels.	have a separate fund and funding structure.	are different than banks.	banks.
<b>Housing/SME/Ag Funding</b>	Govt owned Canadian Housing Mortgage Corp (CMHC) provides mortgage insurance and purchases conforming loans. CMHC is to support, not compete with other lenders. It can do direct lending to consumers in aboriginal communities.	The cooperatively owned Federal Home Loan Banks and the Farm Credit Funding Corp are government sponsored entities (GSE) that raise debt at favorable rates via GSE designation. In contrast Fannie Mae & Freddie Mac were private listed companies but with the GSE designation. Small Business Admin provides \$3 billion annually in loan guarantees.	Govt owned KfW is a development bank that provides securitization of housing and SME loans. KfW is to support, not compete, with banks.	Short term support of competition in mortgage market via AOFM has ended.
<b>Taxation</b>	CUs taxed at small business rate when applicable.	CUs and farm credit cooperatives are exempt from federal/state income tax	Coop banks taxed at small business rate where applicable.	Credit unions, mutual building societies and mutual banks taxed at corporate rate.
<b>Capital / Basel III</b>	Provincially based standards. Only Quebec has moved to full Basel III for CUs and allows for member shares to be CET1. Other provinces are in process or are sticking with Basel II for now.	Leverage ratio of 7% for CUs. Moving to a modified Basel II/III framework for CUs. Farm Credit Coops use Basel II. Members' shares are part of T1 capital. Moving to modified Basel III and anticipate recognition of members shares as CET1.	Articles 27 & 29 of the European Capital Requirements Regulation and the European Banking Authority's Regulatory Technical Standards recognize member shares as CET1 subject to covenants.	Exact same framework as banks for Basel III. APRA is still considering a form of mutual ADI CET1 as noted in footnote 12 of Basel III.

Sources: Barr 2013, APRA Sept 2013 Quarterly Data, IMF 2011. CUNA Mid-Year Report 2013. EACB 2012.

We conclude encouraging the FSI panel to consider five proposals which would increase stability, lessen countercyclical access to credit for consumers/firms and could improve consumer satisfaction and value in the retail banking market. These include:

- 1) *Explore an explicit 100% guarantee on any public Municipalities', Universities', Schools' or Hospitals' (MUSH) deposits via the Financial Claims Scheme regardless of the ADI.*
- 2) *Create another Account within the Financial Claims Schemes for Mutual ADIs given their Stability.*
- 3) *Support the Real Economy Through Government Support of Securitization/Funding of the Housing, SME and Agricultural Markets.*
- 4) *Implement Significant Countercyclical Capital Charges based on the Potential Exposure.*
- 5) *Implement Differentiated Regulations/ Supervision as recommended by the G20's Global Partnership for Financial Inclusion.*

These proposals would create a fairer banking environment analogous to a golfer's handicap as opposed to ensuring both side of the rugby pitch are exactly the same.

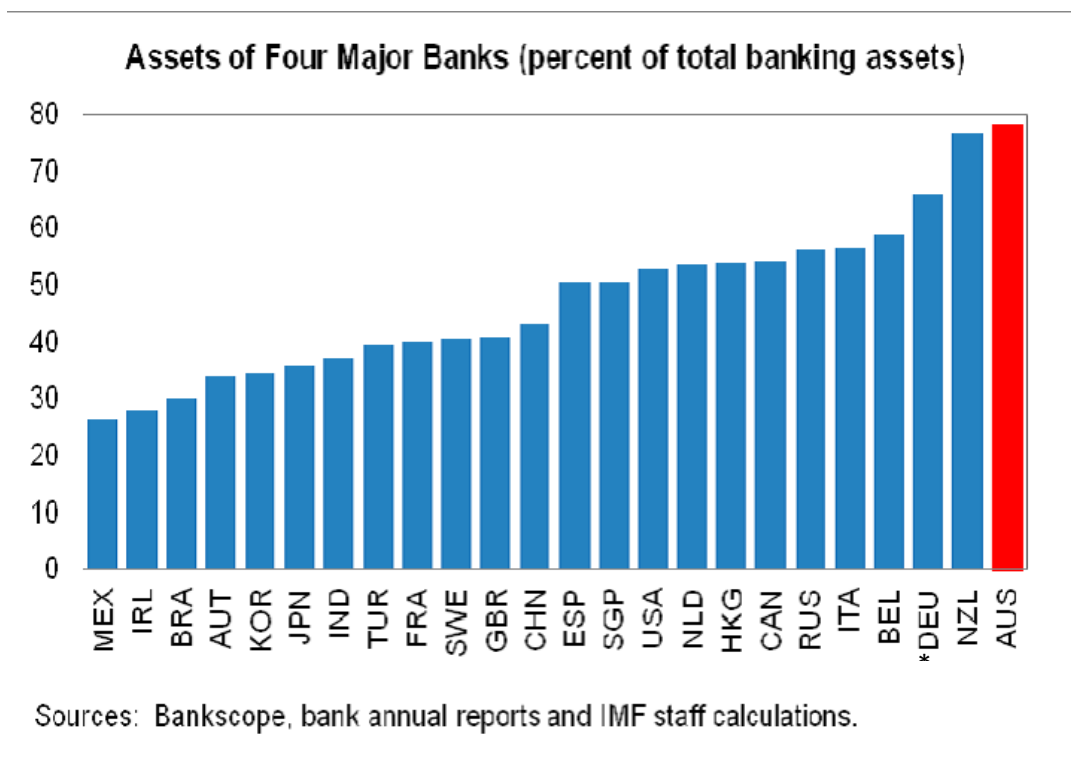
## 2. Overview of Australian Financial System – A Case for Change

The mere fact that the FSI has come to pass is an indication that at some level policymakers understand the need to investigate the case for change within the financial system. However, the headline news for many observers of the Australian financial system has been the apparent stability of the financial sector following the financial crisis. A deeper exploration of the costs for consumers, concentration risks and reliance of the economy on the financial sector paints a more concerning view.

### A. Most Concentrated Banking Sector in the G20

As demonstrated in figure 2 from the International Monetary Fund's (IMF) Financial System Stability Assessment of Australia in 2012, the country has the *most concentrated* banking sector of any G20 country.

Figure 2. Concentration of Banking Sector



\* Two of the banks included under Germany are actually second-tier wholesale banks for the savings banks and cooperative banks with rolled up balance sheets.

Another method to analyze concentration in the retail banking sector is the number of ADIs per inhabitants in a country. While this measure does not directly correspond to financial risk, it does provide a sense of how many people, on average, could be affected by the failure of a single ADI.

*Figure 3. Inhabitants per Authorized Depository Institution*

Country	United States	Canada	Germany	Australia
Inhabitants	23,000	42,000	42,000	141,000

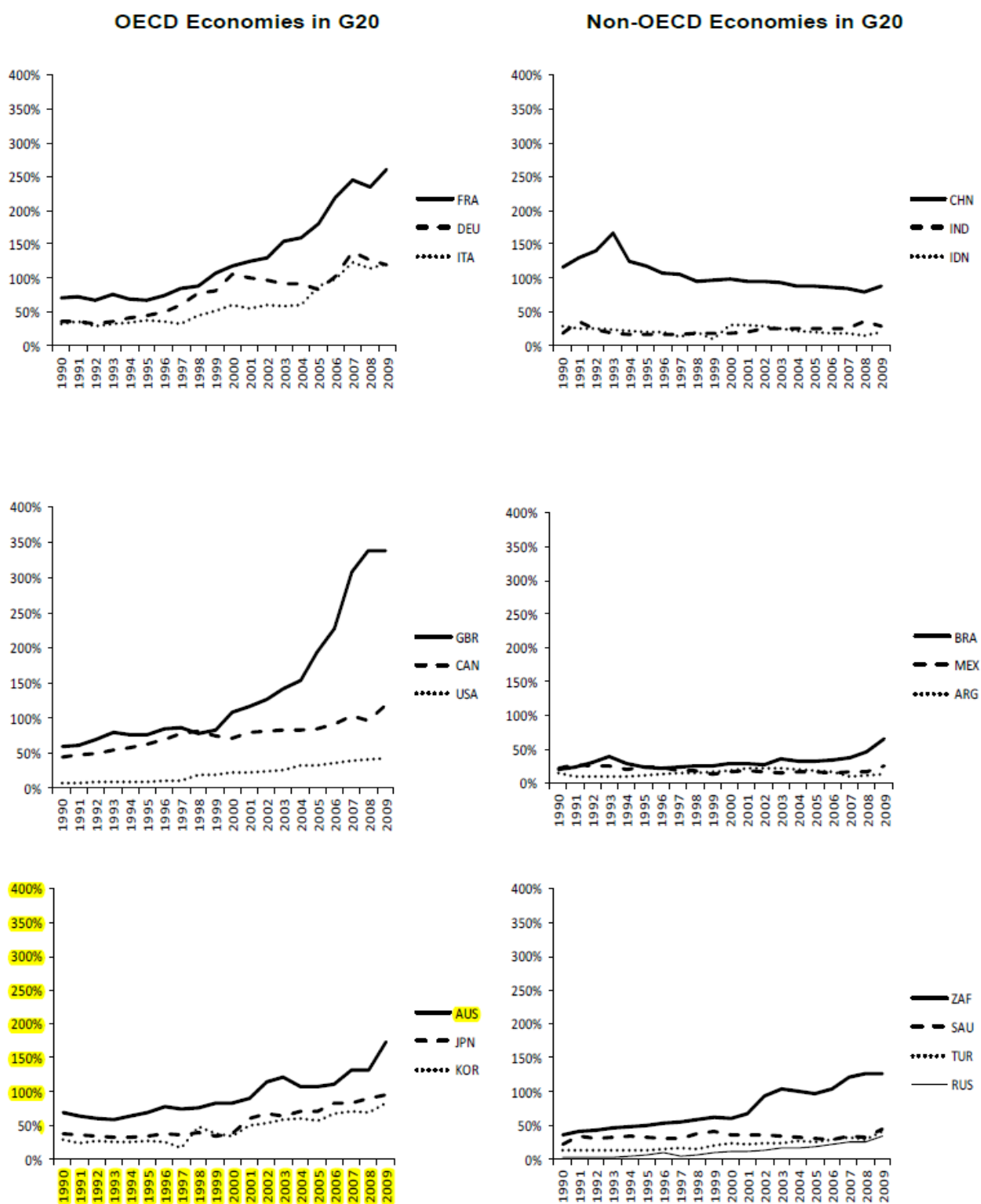
Sources: Official country population estimates, APRA Quarterly Statistics 2013, IMF studies.

This high level of concentration in the banking system, regardless of the measure used, has been broadly acknowledged and often maligned at face value. However, concentration alone is not bad; as it enables supervisors to focus their resources where risks are greatest, affords institutions economies of scale and efficiencies and the implicit guarantee by government of a few big institutions supports depositor confidence. The broader question for consumers is if markets with high banking sector concentration are contestable and if consumers are benefiting from the concentration.

**The Australian financial and insurance sectors have grown the fastest of any major sector in the past 20 years and are now the largest part of the economy to according the Reserve Bank of Australia.** (Battellino, 2010). At 10.8% of the economy, the financial/insurance sector is roughly the size of the mining and media/telecom sectors *combined*. This can become even more problematic where it results in an economy's over reliance on a sector which is notorious for its ability to move in/out of markets quickly based on where it can obtain the most rents.

**The Australian economy is the third most reliant in the world on the performance of its three top banks, only outdone by the UK and France.** (See figure 4) This is according to the OECD's analysis of banking sector concentration by looking at the share of the combined assets of a country's three largest banks as a percentage of gross domestic product (GDP). The potential impact of this for taxpayers is that in practice the Australian government would have few practical options but bailing out a big 4 bank in serious trouble or sending the entire economy into a deep recession.

Figure 4. Total Assets of the largest 3 banks as a share of GDP

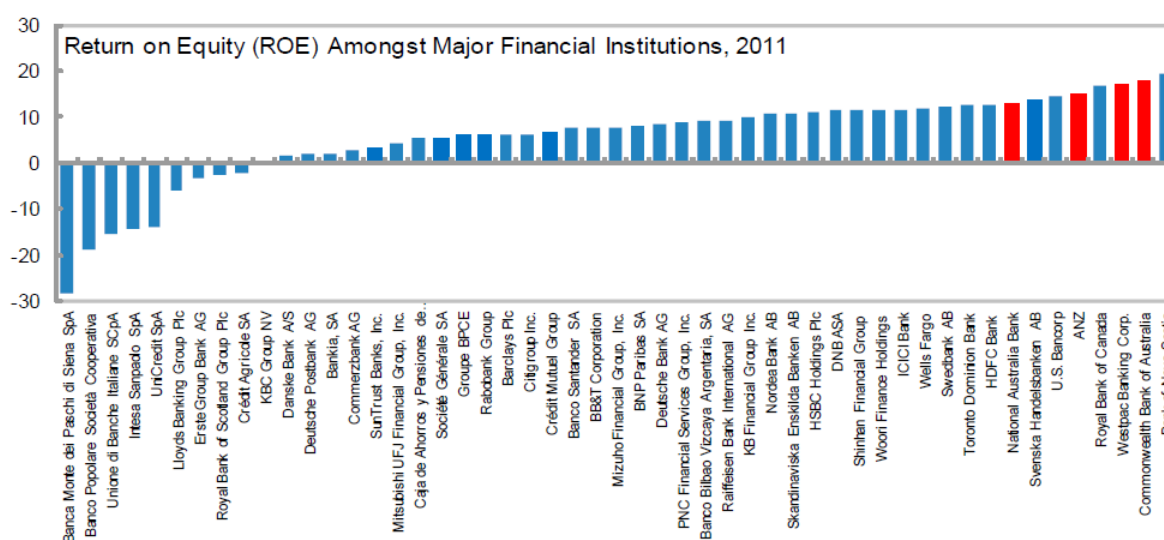


Source: OECD, Bank Competition and Financial Stability 2011.

## B. Do Consumers Benefit in the form of Pricing and Service Quality

**Limited competition in banking makes Australia home to 4 of the 8 most profitable banks in the world.**<sup>1</sup> (See figure 5) While having highly profitable banks may be good if you're a regulator or shareholder, the incomes are ultimately generated from costs to consumers. The big 4 are achieving these profits through efficient operations based on volumes, but as of June 2013 they also had staff salary/benefit expenses ratios that are much higher (55% of operating costs) than mutual ADIs (46% of operating costs). (APRA Quarterly Statistics 2013) Other research from the IMF (Hesse and Cihak 2007) and Federal Reserve Board (Hannan 2002) suggests that the strong presence of non-profit maximizing financial cooperatives does moderate prices on loans or boost rates on savings in a market.

Figure 5. Profitability of Banks Globally



Sources: Australian Bureau of Statistics; Australian Office of Finance Management; Bloomberg; IMF Financial Statistics; and IMF Financial Soundness Indications database.

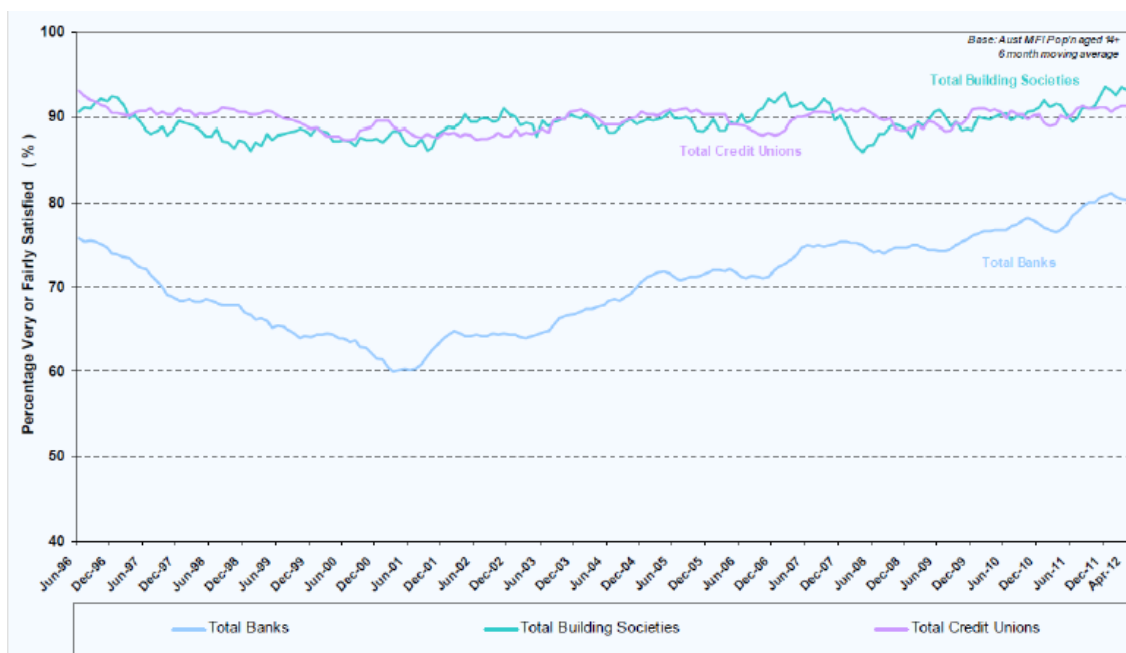
**Higher staff expenses at the big 4 banks does not yield better service.** If the higher profit and higher relative staff expense ratios at commercial banks yielded excellent customer satisfaction scores the argument could be made that consumers were seeking out, and willing to pay for, this customer intimacy or product innovation value proposition. However, the 17 years of data from Roy Morgan Research in figure 6 below suggest otherwise. Roy Morgan Research has been conducting surveys on the levels of customer satisfaction in various types of depository institutions for many years. In every single year mutual ADIs have scored better than the big 4 banks. This is not unique to Australian mutuals as financial cooperatives in [Canada](#) and the U.S. also consistently outperform commercial banks on customer satisfaction and trust. What is unique to Australia is that

<sup>1</sup> We are not making the claim that Australia has the most profitable banking sector in the world, which the Australian Bankers' Association has tried to refute by including data on all banks. Rather using data from the IMF we are highlighting the very high profits of the 4 major banks relative to other large banks globally.



over the past decade mutual ADI's market share of deposits and loans has *decreased* 90 and 30 basis points respectively.

Figure 6. Customer Satisfaction Australian ADIs



Source: Roy Morgan Research 2012.

### C. Analyzing Banking Sector Stability

The IMF's stress tests confirm the big 4 banks have sufficient capital and the ability to absorb financial shocks. This is the result of relatively strong capital, low levels of non-performing loans and decreased reliance on wholesale funding.

The OECD's research in 2011 on bank competition and financial stability found that a common concern among prudential regulators is that too much competition, too fast, could destabilize otherwise big healthy banks. While the perception exists among many prudential supervisors, there is little data to support it.

**The IMF found that cooperative banks were *less volatile* than commercial banks because they earned less in good times and lost less in bad times.** This was the conclusion of a working paper by economists at the IMF that looked at the stability of cooperative banks (including credit unions, and building societies) in 29 developed countries. The results were derived using data from 16,500 commercial banks, cooperative banks and savings banks over a 10 year period (1994-2004). (Hesse and Cihak 2007) The research also found that while a higher share of cooperative banks may improve the average bank's stability in a market, the research also suggests the strong presence of

non-profit maximizing cooperative banks could de-stabilize and help replace commercial banks that are already weak and struggling to compete.<sup>2</sup> This research was put to the test in the GFC and proved to be true.

**Cooperative banks, savings banks and credit unions in Germany and the U.S. had fewer losses and lent more of their assets during the GFC than commercial banks.** These non-profit maximizing institutions proved the academic hypothesis true as important countercyclical lenders for the real economy during the GFC. (IMF 2010, 2011) Between 2008 and mid-2011 there were 85 credit unions that failed in the US or 1% of credit unions compared to 369 failures, or 5% of banks. (Andrews 2014) These differences also bore out in the bank's insurance fund at the FDIC having more losses than credit unions' insurance fund.

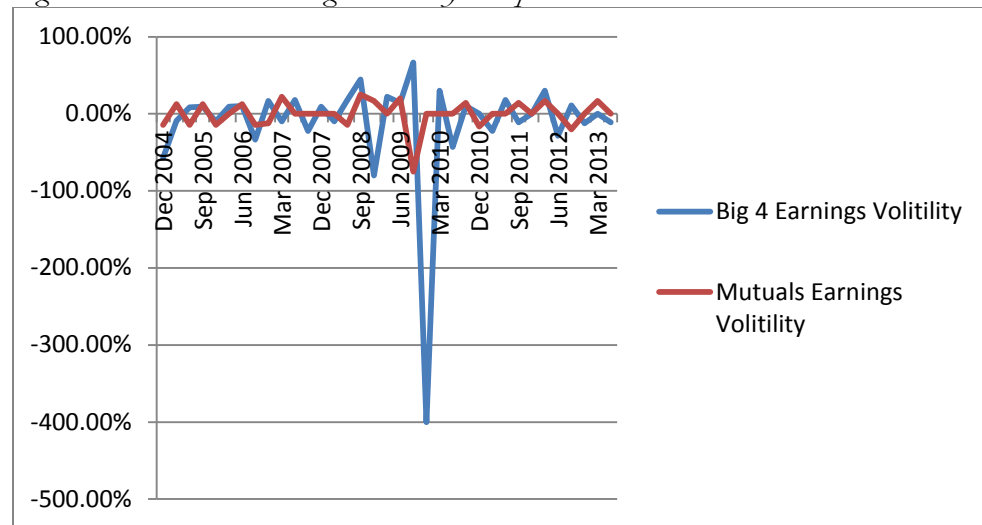
Additional research from the Centre for European Policy Studies in 2010 on cooperative banks in seven European countries with significant cooperative bank presence (Netherlands, France, Germany, Italy, Finland, Spain and Austria) reached similar conclusions regarding cooperative banks being more stable than commercial banks. In France and Netherlands differences between cooperative and commercial banks' stability were described as "astounding" by the researchers at the Centre for European Policy Studies. (Ayadi et. al 2010) The factors that play into this greater level of stability in mutuals are: 1) mutual ADIs are not subject to short-term pressures of the capital markets, 2) their business models are focused on local retail banking and intimate knowledge of members needs with less reliance on wholesale funding, and 3) the stakeholder driven governance structure of mutuals (and savings banks) has a double bottom line focus that moderates risk.

**Australian mutual ADIs have had less earnings volatility than commercial banks over the past 35 quarters as show in figure 7.** Using a similar framework to the IMF's methodology, we observed similar stability of mutual ADIs the previous 9 years in Australia. As such, it's reasonable to conclude that a more pluralistic banking sector comprised of commercial banks, cooperative banks/credit unions and savings banks would be an important countercyclical measure for the Australian economy. This is supported by empirical research in the EU on cooperative banks which found that low competition in a banking market is correlated with low levels of stability. (Fiordelisi and Mare 2013)

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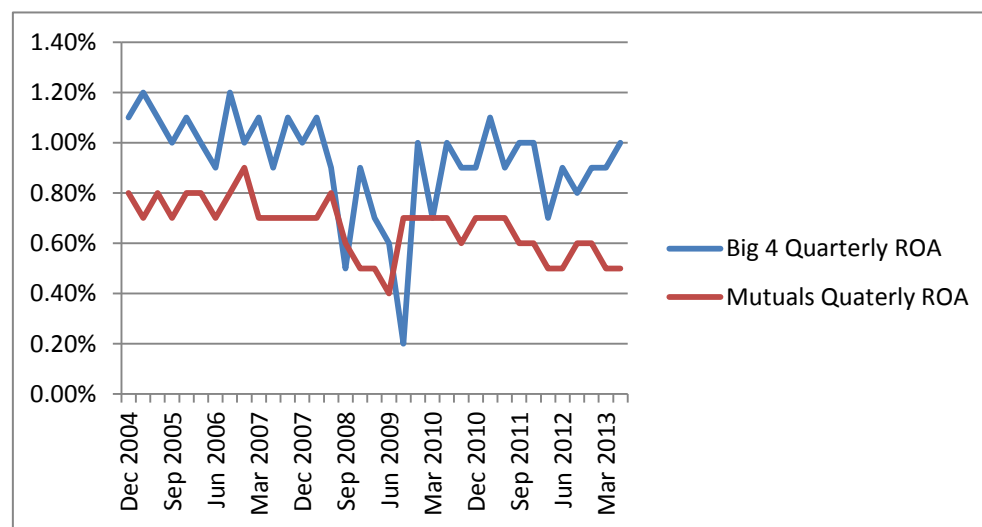
<sup>2</sup> In 2007 the IMF's study also found the lowest share of coop bank branches in OECD European countries in some of the markets that have struggled the most (Greece, Portugal and Spain). The countries with the highest share of cooperative banks were France, Austria, Netherlands, Finland and Germany, i.e., more stable markets during the GFC.

Figure 7. Australian Earnings Volatility Comparison



Quarterly profits measured as a return on assets have also been consistently lower in mutual ADIs than in the big 4 banks as shown in Figure 8. This is consistent with data observed in cooperative financial institutions in North America and Europe as these institutions manage a double bottom line of profits and service to members. At the same time capital ratios are higher in mutual ADIs.

Figure 8. Return on Assets Comparison



**As of September 2013 Australian mutuals had half the level of impaired loans of the major banks (0.5% compared to 1%) but 41% more capital (16.6% to 11.7%).** This is the result of a corporate structure that favors conservatism over dividends. This mismatch in risk is bolstered by a regulatory environment which justifiably allocates most of its resources to the commercial banking sector. APRA often requires higher individualized prudential capital ratios for mutual ADIs than big banks. These higher capital requirements, coupled with fewer avenues to raise capital, and their

higher relative operating costs affects the pricing by mutual ADIs (APRA Quarterly ADI Performance Statistics, September 2013). Approximately 98% of the capital in the mutual sector is Common Equity Tier 1 (CET1) (the highest form of capital).

**With impaired loans at only 0.5% and a CET1 ratio of 16.6%, the Australian mutual sector is probably *over-capitalized*.** Heading into the GFC in December 2007 with a combined CET1 ratio of 11.6% [researchers in the U.S.](#) believed American credit unions were over-capitalized by 30-40%. During the worst of the GFC (December 2009) capital in American credit unions reached a low of 9.77%. After writing off investments in mortgage backed securities by their wholesale credit unions, incurring their own losses and coping with the worst recession in 80 years the American credit union system lost only 1.83% capital -- still giving it a 30% capital cushion above the required capital level.

A similar analysis applied to Australian mutual ADIs would suggest that if a GFC-type tsunami were to land on mutual ADIs and they lost 1.83% of their capital in 2 years (similar to American credit unions), Australian mutual ADIs would still have a capital cushion **40% above** the total capital requirement of 10.5% that is required in Basel III (for internationally active banks). If one were to measure their capital cushion relative to Basel III's Tier 1 capital requirement of 6%, mutual ADIs would likely have a **140% tier 1 capital cushion above the 6% requirement in the depths of a GFC-type recession.**

Such levels of overcapitalization have real impacts on prospects for growth in the real economy and the causes of such overcapitalization in mutual ADIs should be further explored.

### 3. International Examples of Diversified Banking Systems

While the mere existence of the FSI acknowledges the potential for change, it's less clear what that change might look like and how it could benefit consumers and Australia's prospects for economic growth. This section reviews the banking sectors of Canada, Germany and the United States with a particular focus on their community, savings and cooperative banks. These three countries were selected as peer jurisdictions for this study because of the similarity of their economies and cultures to Australia but also because of their performance during the GFC and rebound from it. As shown in figure 2 above, each of these countries has a less concentrated banking sector than Australia.

Summarized below in figure 9 is a comparison between the Australian, Canadian, U.S. and German retail banking markets. The comparison looks at market share of deposits, the legislative/regulatory environment, deposit insurance, government's support for securitization in the housing, SME and agriculture markets, tax policy and capital requirements. Following this summary table, the rest of this section provides details on each component for mutual ADIs in each country.

Figure 9. Comparison of Measures to Support Competitive Neutrality of Mutuals in Retail Banking

	<i>Canada</i>	<i>U.S.</i>	<i>Germany</i>	<i>Australia</i>
<i>Deposit Market Share of Mutuals/ Coops</i>	<b>7.8%</b>	<b>10%</b>	<b>20%</b>	<b>3.3%</b>
<i>Unique Legislation, Regulations &amp; Supervision for Mutuals/ Coops</i>	✓	✓	✓	✗
<i>Separate Deposit Insurance Scheme for Mutual ADIs</i>	✓	✓	✓	✗
<i>Govt's Support of Liquidity/Funding in the Housing, SME and Agriculture Lending</i>	✓	✓	✓	✗
<i>Favorable Tax Treatment for Mutuals/ Coops</i>	✓ ✗	✓	✗	✗
<i>Unique Capital Standards Structure Recognizing Coop Structure</i>	✓	✓ ✗	✓	✗

Sources: Barr 2013, APRA Sept 2013 Quarterly Data, IMF 2011, 2014 CUNA Mid-Year Report 2013. EACB 2012. IADI 2011.

#### A. Canada

The structure of the Canadian retail banking system most resembles that of Australia. Canada has 5 big banks and one mid-sized regional bank that combined have 93% of the

**banking sector assets.** (IMF 2014) The credit unions and other provincial lenders have approximately 5% market share of assets but 7.8% of the domestic deposit market and 15% of the SME loan market. (Credit Union Central of Canada 2013).

### *Retail Banking Structure*

**Like in Australia, Canada has a highly concentrated retail banking system with 28 banks, 24 foreign banks and 771 credit unions (IMF 2014).** Banks concentrate their operations in cities as opposed to rural communities where credit unions have a more important role. In over 900 rural communities in Canada credit unions are the only deposit taking institutions (CCA 2007). In other rural communities Farm Credit Canada and Alberta Treasury Branches (a provincially owned retail financial institution with \$27 billion in assets) are dominant players serving communities that commercial banks do not reach.

### *Regulation/Legislation*

**To support a combined federal and provincially based financial system most non-banks and nearly all credit unions are provincially supervised.** The provincial government supervisors take on different structures across the 10 provinces. The structures allow credit unions to have different powers in different regions. For example, credit unions in British Columbia have the power to offer insurance products where federally chartered banks cannot. In 2012 Canada introduced the first avenue for a cooperative bank to obtain a federal charter, but none have taken advantage of it.

One of the downsides of the existing provincial regulatory arrangements is the challenge of inter-provincial branches for the credit unions. There is a national association of provincial credit union supervisors that coordinates activities, however, all regulation and supervision is provincially based.

### *Deposit Insurance*

**One of the principal reasons why no credit union has taken up the federal cooperative bank charter is because all 4 provinces west of Ontario provide 100% deposit insurance coverage.** In comparison the federal Canadian Deposit Insurance Corp for banks only offers up to C\$100,000 coverage per depositor per institution. In Ontario and Quebec coverage levels for credit unions equal the bank levels but in provinces to the east of Quebec, insurance coverage amounts are generally \$250,000.

Many municipalities, universities, schools and hospitals in Canada have investment policies restricted to the big 5 banks because of their too big to fail status. However, because some provinces have provided 100% guarantees of all credit union deposits these municipalities, universities, schools and hospitals now deposit with credit unions.

### *Housing, SME & Agriculture Funding*

**CMHC plays a significant role in offering mortgage insurance and securitizing home loans.** Since the 1940s Canadian Mortgage Housing Corporation (CMHC), a crown corporation of Canada, has operated to help Canadians buy homes through housing programs, policy work, establishing standards and conducting research. CMHC does not compete in lending directly, except within aboriginal communities. Prior to the GFC there had been some discussions within government of privatizing CMHC with the thought that there was nothing unique that CMHC did that could not be done by the private sector. However, following the GFC, government recognized that by having control of standards for conforming loans purchased or insured by CMHC, it could effectively moderate a credit build up.

**Although encouraging competition in the housing market is not part of CMHC's mandate it does promote competition in housing and other markets.** Smaller financial institutions which cannot easily package and sell loans themselves directly to capital markets find that access to CMHC services, frees up liquidity for additional housing and SME loans where credit unions have a 15% market share.

### *Taxation*

**There is not any specific tax break in Canada for financial cooperatives, unlike the case in the United States and two thirds of the world.** (Credit Union Taxation Report 2009) However, in effect many smaller financial institutions do benefit from a reduced tax rate. Within Canada there are federal and provincial income taxes for business. While the structures vary across provinces, below is the framework for Quebec where credit unions have a 43% market share of deposits. The combined federal and provincial tax rate is either 19% for small businesses, where small is federally defined as below \$15 million in net income and provincially as \$7.5 million in net income. Above these levels the tax rate is 27%. (Dave Grace & Associates 2013) When dividends are distributed to members, either in the form of cash or shares, these dividends are taxable to the member as regular income.

### *Capital/Basel III*

**Unlike in Australia, Canadian credit unions/mutuals have separate and distinct capital rules that take into account the nature of their cooperative structure.** This is not an indication of weaker standards, but they are different. In every province in Canada under Basel II and Basel III (except Saskatchewan<sup>3</sup>) regulators have allowed member shares and investment shares to be counted as the highest quality capital if they meet certain conditions. Their conditions are generally: 1) the credit union has the irrefutable right to refuse redemption of shares, 2) the shares can only be redeemed if such redemption would not cause, or perpetuate, a credit union to be below its regulatory minimum capital ratio, and 3) such redemption is also subject to the regulator's approval. Figure 10 below provides a brief cross country comparison of where and how Basel III is being applied to financial cooperatives. Annex 1 provides additional details in this regard.

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<sup>3</sup> Saskatchewan counts member shares as Additional Tier 1 (AT1) under Basel III.

Figure 10. *Application of Basel III to Financial Cooperatives*

Country & Fin. Coop Supervisory System	Members/ Clients	Total Assets US\$	% of Working Age Pop. Served	Will Basel III Apply To CUs
Australia – Same law and regulators as commercial banks	4.6 M	\$50 B	23.1%	Basel III is being applied. No accommodations for mutuals have been announced.
Canada – Separate provincial regulators.	10.7 M	\$238 B	46.2%	Will Apply with Modifications for Credit Unions
Europe – Co-op banks. Generally same regulation as banks with unique supervisor	176M	\$5 T	35.7%	Will Apply with Modifications for Cooperatives per EU directive
Switzerland - Co-op banks have same regulator as banks	3.7M	\$184B	48%	Will Apply with Modifications for Cooperatives
United States – Credit Unions. Separate federal regulator. Farm Credit Cooperatives also have a separate regulator.	92.2 M	\$1.4 T	43.9%	Regulator has proposed a modified Basel II/III framework for credit unions. Farm credit coop regulator has indicated they will modify Basel III.

## B. United States

There are 6,313 commercial banks, 577 mutual banks, 6,700 credit unions, 60 farm credit cooperatives and over 17,000 non-depository mortgage lenders in the US. This is a large and complex retail banking system. All 50 states have licensing avenues for bank and credit unions and there are 3 federal banking regulators (Federal Reserve, Office of Comptroller Currency and the Federal Deposit Insurance Corp), a federal regulator and deposit insurer for credit unions (the National Credit Union Administration) and a federal regulator and insurer for the farm credit cooperatives (the Farm Credit Administration).

### Size Limiting Measures

Learning from its previous banking crisis and the Great Depression the U.S. has long had measures in place to limit the size of banks. Following the Great Depression measures were enacted through a series of significant changes to the structure of the banking system such as the introduction of the Federal Home Loan Banks (1932), Federal Deposit Insurance (1933) and the Federal Credit Union Act (1934) and limits on interstate banking that have changed over the years. As recently as 2010 the Dodd Frank Wall Street Reform Act reconfirmed and strengthened many of these measures. One modification was to change the limit that any one bank can have from 10% of the nation's deposits to 10% of aggregate consolidated liabilities. Many states also limit a bank from holding more than 30% of the deposits in the state.

The US' Financial Stability Oversight Council (FSOC) studied these concentration limits following the passage of Dodd Frank and affirmed that they “enhance the competitiveness of U.S. financial markets by preventing the increased dominance by a very small number of firms.” (FSOC 2011).



### **Regulation/Legislation**

**There is a long history of unique regulation and legislation for mutual/cooperative ADIs in the US. Credit unions have had their own federal legislation since 1934 and some states and the farm credit cooperatives have had licensing mechanisms for over 100 years.** The first mutual bank was chartered in 1816. Approximately half of the credit unions are licensed at the state level and half at the federal level. Regardless of the licensing structure, the vast majority of them have some oversight by the federal regulator as 97% of credit unions have deposit insurance through the National Credit Union Administration's deposit insurance fund. In addition, there is a long tradition of federal pre-emption over state-based rules. While there is significant similarity between bank and credit union rules in the areas of consumer protection, anti-money laundering and terrorist financing rules, the prudential standards are different between banks and credit unions.

There are also unique rules for wholesale credit unions which serve retail credit unions, there is significant assistance for small credit unions and credit unions (and banks) that serve low income communities.

### **Deposit Insurance**

**Credit unions and farm credit cooperatives have their own separate deposit insurance funds from banks.** A requirement for all credit unions operating within the U.S. is that they obtain deposit insurance. Credit unions cannot be part of the Federal Deposit Insurance Corp's (FDIC) system but they can obtain insurance through the National Credit Union Administration's fund or the private market place. There remains one private deposit insurer that insures approximately 90 credit unions who are part of the private insurance fund. All three of these insurance funds offer the same level of deposit insurance (\$250,000) and the first two funds, not the private fund, have the full faith and credit of the U.S. government backing it should the funds become insolvent as the FDIC's fund has over the years. In addition, the private insurer offers supplemental deposit insurance allowing credit unions to have more than \$250,000 in coverage.

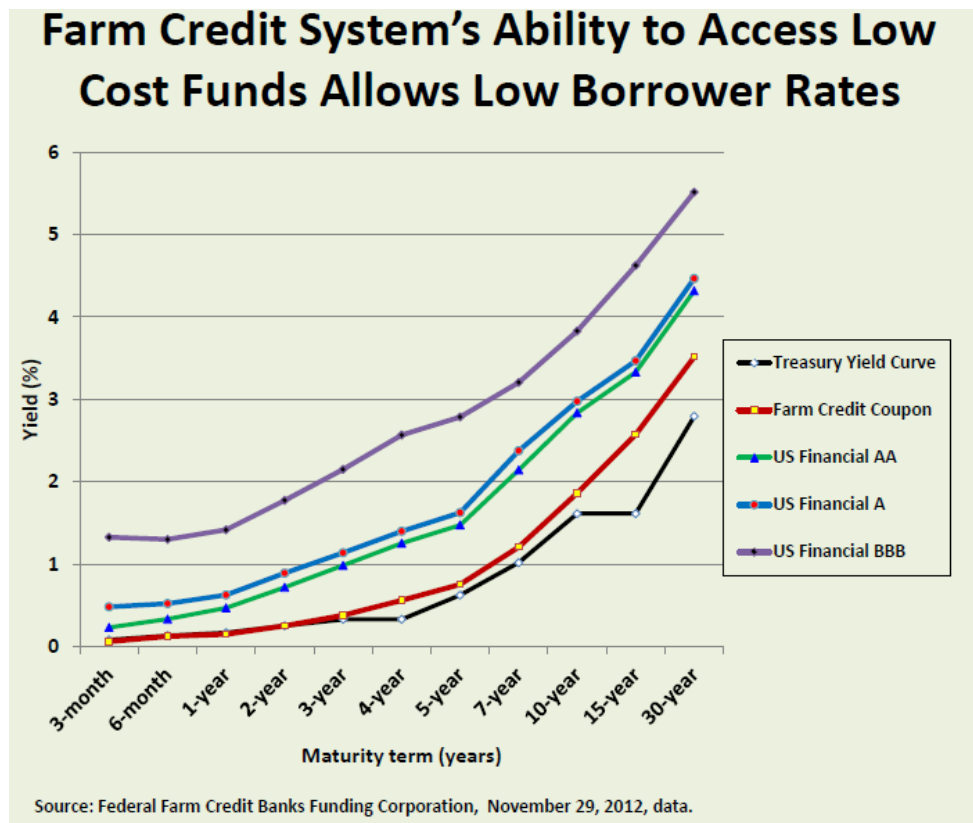
To aid credit unions in the establishment of their fund in the 1970s and 1980s a unique hybrid funding system was created whereby instead of paying premiums annually such as banks do at the FDIC, credit unions are required to hold on deposit with the National Credit Union Share Insurance Fund a deposit equal to 1% of their insurable deposits. Importantly this is a non-withdrawable/non-redeemable investment but remains an asset on the books of the depositing credit union. It is not a premium expense on the credit union's income statement. This hybrid *ex post* and *ex ante* contribution system is less costly in good times for credit unions. At least annually an assessment of the size of the fund is conducted relative to its required equity ratio to determine if additional funds are needed. The National Credit Union Administration can also require premium contributions to cover losses.

Thirty three of the 50 states in the US have specific laws that allow state governments and/or municipalities to place deposits with credit unions. (Courter 2012) However, this is an area that is still developing as public deposits represent only 0.2% of all deposit in US credit unions. In commercial banks public deposits represent 5% of their total deposits (US\$433 billion). (Dopico, and Jackson 2013)

### *Housing, SME & Agriculture Funding*

The U.S. government has long supported national liquidity markets for housing and agricultural lending. Tomes can and have been written on how the U.S. supports the funding and liquidity of its housing, SME and agricultural credit markets. The Federal Home Loan Banks and the Farm Credit Funding Corp are cooperatively owned, government supervised and government sponsored entities (GSE). The fact that they are government sponsored allows them to raise debt in the commercial markets at rates that match the 3-year U.S. Treasury debt and are only 10 basis points above the 10-year Treasury debt. (See figure 11).

*Figure 11. Farm Credit Cooperatives Low Cost Access to Funding*



In contrast to the Farm Credit Cooperative and Federal Home Loan Banks, Fannie Mae & Freddie Mac have been private listed companies since the 1960s and 1980s respectively but still with the GSE designation. In 2007 the U.S. Congressional Research Service indicated:

“In terms of meeting their original congressional objective — to provide liquidity to credit markets on a national, rather than regional or state, basis — the GSEs have been remarkably successful. They are widely credited with (1) serving rural agriculture’s financial requirements, (2) lowering the cost of home mortgages, and (3) increasing liquidity by forging stronger links with general capital markets.”

The subsequent bailout and continued operation of Fannie Mae and Freddie Mac by the US government puts into doubt the cost of meeting some of these objectives.<sup>4</sup> At the same time, observers note the health of the other GSEs, the Federal Home Loan Banks and Farm Credit Cooperatives, during the GFC as yet more evidence to the stability of a cooperative governance structure.

There is a small market (\$500 M annually) for securitization of SME loans in the US, however, the Small Business Administration does provide \$3 billion annually in loan guarantees via financial institutions.<sup>5</sup>

**The Federal Home Loan Banks are private cooperatives with 7,600 lenders as members and do not receive any taxpayer contributions.** They are government sponsored but do not have an explicit government guarantee. Given yield curves on their debt, most market participants implicitly believe there is a government guarantee. The 12 Federal Home Loan Banks have regional territories so as to not compete with each other and they do not compete with their members in retail lending to consumers. They are an efficient way for smaller lenders to access capital markets quickly and cheaply. However, they are not irrelevant for big banks. In fact, in 2013 the 4 biggest borrowers at the Federal Home Loan Banks were the 4 biggest banks in the U.S. While the Federal Home Loan Banks are helpful to most banks, they are critical for small banks. (Federal Home Loan Banks 2014)

### ***Taxation***

**Credit unions, farm credit cooperatives, the Federal Home Loan Banks, Fannie Mae and Freddie Mac are all exempt from paying federal income tax because they are seen as providing a public good.** The latter 4 organizations receive their tax treatment as a result of their GSE status. Credit unions are exempt from income tax because of their service to people of “modest means” and as such are considered private instrumentalities of the government to help it achieve policy outcomes. While all commercial banks pay federal income tax, there are structures available to banks with fewer shareholders that can reduce the tax liabilities for their firm and their shareholders.

### ***Capital/Basel III***

**Farm credit cooperatives and credit unions have different capital standards than commercial banks.** Farm credit cooperatives make active use of members’ shares as a core component of their tier 1 capital under Basel II standards. According to their legislation, these member shares are only redeemable upon approval from the regulator and if redemption would not cause the institution to breach its minimum regulatory capital threshold (8% of risk weighted assets). The Farm Credit Administration is developing a proposal to move towards Basel III and is anticipated to be following

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<sup>4</sup> As of February 2014 Fannie Mae and Freddie Mac had paid back the US government for the full extent of its bailout.

<sup>5</sup> Most US credit unions have a legislative cap of 12.5% of their loans can be to SMEs. Microloans, credit unions with more than 12.5% of their portfolio in SME market at the time of the legislative amendment in 1998 and credit unions serving predominantly low income communities are exempt from the legislative cap. (Federal Credit Union Act, updated April 2013)

the actions in the European Union and footnote 12 of Basel III, which allows members' shares to be considered part of CET1 capital. Credit unions are required by their legislation to have a 6% non-risk weighted leverage ratio to be considered adequately capitalized and 7% requirement to be well capitalized.

As a result of fierce lobbying by banks, this leverage ratio is higher than banks 4% requirement. However, credit unions and farm credit cooperatives did not have a countercyclical capital charge placed upon them similar to all other depository institutions in the Dodd Frank Wall Street Reform Act. On February 27, 2014 the National Credit Union Administration gazetted a [proposal](#) that would create a unique Basel II/III risk based capital standard for credit unions.

## C. Germany

**The three pillars of German banking are private banks (commercial banks 36% share of assets), public banks (savings banks 31% share of assets) and cooperative banks (11% share of assets).** This multi-pillar structure is a core strength of the German banking system and economy. This structure with many smaller institutions and regulators is most analogous to the U.S. There are 280 commercial banks, 439 savings banks, 1,138 cooperative banks and 18 mortgage banks in Germany. (IMF 2011a)

### *Regulation/Legislation*

**Savings banks and cooperative banks have separate and distinct legislation and regulatory arrangements from commercial banks.** Savings banks are established by law as opposed to organizations that are licensed under a law. They are owned by municipalities, or by public foundations, with an obligation to serve all citizens of the area. They are limited in geographic scope and do not compete amongst each other. Cooperative banks are registered as cooperatives and licensed as “credit institutions” with the ability to accept savings.

Bafin and the central bank have the authority to conduct on-site examinations and/or delegate the task to another firm to conduct the exam on their behalf. Both savings banks and cooperative banks have joint supervisory arrangements with the German Financial Supervisory Authority (Bafin). Under the arrangements, auditing federations conduct inspections of their member cooperatives or savings banks for Bafin. The inspections are based on standards and timelines determined by Bafin and the central bank's off-site supervision process. This is a unique arrangement that has stood the test of business cycles, reduces costs to taxpayers, aids stability and supports competitive neutrality in their three pillar banking market.

### *Deposit Insurance*

**There are six different deposit protection schemes in Germany for various types of institutions.** Two schemes are mandatory (one for commercial banks and one for savings banks), three schemes are voluntary for savings and commercial banks and one scheme is for cooperative banks. The schemes for savings and cooperative banks are institutional protection schemes where

there is a cross guarantee at the local, regional and then national level to support an institution from failure. There are also *ex ante* contributions to the funds. All of the schemes adhere to the standards in the European Union (EU) for deposit insurance and the EU standards have largely been influenced by the German market place.

### **Housing/SME Funding**

**A mainstay of the German economy has been a diversified business sector through strong SMEs.** The German government development bank KfW plays a significant role in securitizing SME, auto and housing loans. In addition, for over 100 years covered bonds have provided liquidity to the housing market. This continues today with covered bonds, as opposed to mortgage backed securities, comprising over 90% of the capital market support for the housing market. Most securitized transactions for mortgages or SME lending occurs via the government development bank KfW. (IMF 2011 b)

### **Taxation**

**Cooperative banks themselves pay taxes on income earned from transactions with members and non-members<sup>6</sup> at the same rate as any other business.** The dividends paid to the members are a taxable event for the members and the cooperative banks do not provide additional compensation to cover the tax obligation. For members with large amounts of capital shares the dividends are paid as a bonus dividend which is a tax efficient structure for receipt of the dividend.

### **Capital/Basel III**

**The European Commission and European Banking Authority have made specific provisions allowing members shares in mutuals, cooperatives and savings banks to be considered CET1 in their capital requirements directive and technical standards.** Unlike the Canadian and American financial cooperatives which have completely separate government regulators with their own rules, the German system has a single regulatory authority for all participants in the retail banking space. Within this framework there are differentiated on-site inspection methodologies (i.e., local auditing federations for savings and cooperative banks conduct examinations), separate deposit insurance funds and unique capital and other rules which support the existence of a three pillar model.

Given the strong presence of savings banks and cooperative banks it's not surprising that the IMF finds the profitability of the German retail banking market slightly below EU peers.

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<sup>6</sup> About half of the 30 million clients of German cooperative banks are non-members.

## 4. Proposals: Making Competitive Neutrality Credible

### Summary Observations

**There is scant evidence that the retail banking system in Australia is set up to promote competition and some evidence that it limits competition in favor of medium term stability.** The implicit government guarantee of the big 4 banks in Australia constitutes one of the largest contingent liabilities as a percentage of GDP of any G20 nation. The lack of competition leads to the big 4 banks being some of the most profitable banks in the world. These high profits do not translate into market-leading customer satisfaction levels or capital cushions that are comparable to the less profitable mutuals ADIs.

**In the first 8 months since “tick and flick” was introduced to facilitated simplified account switching for Australian consumers only 16,000 consumers had switched bank accounts.** (News.com.au 2013) After similar reforms were introduced in other countries similar disappointing results prevailed because of consumer inertia, network level barriers to entry and trust issues in banking. Even when consumers are very angry at banks, such as 2011 in the U.S. when a large scale consumer-led movement developed to leave big banks (i.e., Bank Transfer Day), only 600,000 to 1 million consumers transferred their accounts (i.e., about .5% to .8% of all account holders). As such, there is little room to believe that additional financial education programs informing existing commercial bank customers of the benefits of mutual/customer owned or community banks will produce significant results.

### Counter Argument

Although the retail banking market is concentrated, it's stable and allows supervisors to focus their attention on the big risks. The economy has grown well and Australia made it through the GFC comparatively unharmed. The retail banking market has function-specific legislation and rules that create a level playing field for all entities via a single regulator with a single set of rules. The lack of alternatives to the big 4 banks is a result of consumer choice, which should not be dictated.

### Rebuttal

While some tension exists between stability and competition it's not an either or choice. In fact ample practical and theoretical evidence exists showing that certain banking models (cooperative and savings banks) are more stable than commercial banks, all else equal. In addition, as the big 4 banks benefit from an implicit guarantee it is misleading to suggest the environment is based on a level playing field. In most countries, and Australia, mutual ADIs grow relatively slowly and are unlikely to grow fast enough to destabilize the banking sector should competitively neutral policies, similar to other G20 countries, come into effect. The intention is not to claim one governance model superior (or inferior) over another, but rather to enable space for multiple models so as to aid economic stability and consumer value.

### Proposals for Consideration: Providing a Framework for Competition in Australia

We suggest the following reforms be considered in near (1-2 years), mid (2-4 years) and long range (greater than 4 years) to propel future growth in the real economy, limit exposure of the economy to a potential failure of a big 4 bank and provide better priced and higher quality financial service to consumers.

1. *Explore an explicit 100% guarantee on any public Municipalities', Universities', Schools' or Hospitals' (MUSH) deposits via the Financial Claims Scheme regardless of the ADI. (Near-Term)*

This will apply to all ADIs that are members of the scheme. Many of these MUSH accounts have policies that prohibit them from investing in non-rated institutions. Most MUSH entities have asymmetric information on the stability of the banking market which effectively cuts out many of the small ADIs and mutuals that have higher capital, fewer delinquencies, more stable funding and less earnings volatility but lack the implicit government backing or external rating.

The rationale for providing the backing for only government entities' deposits is that the taxpayers are obligated either way for these deposits should they be lost. Insuring such deposits at 100% for all ADIs could be significant for smaller ADIs as is the case in Canada, promote local recycling of funds for economic development and provide some competitive neutrality compared to the debt market advantages the big 4 banks gain because they are in effect government sponsored entities. We believe any moral hazard this could create among smaller entities will be: a) no worse than what exists today for the big 4 banks, b) will be moderated by APRA's oversight, and c) moderated by shareholders that are more numerous than MUSH account holders and have capital/savings at risk.

2. *Create another Account within the Financial Claims Schemes for Mutual ADIs given their Stability. (Mid-Term)*

If the FCS migrates to an *ex ante* contribution mechanism additional research should also be under-taken to determine if two accounts within the Financial Claims Scheme – one for mutual ADIs and one for other ADIs should also be implemented. The risk profiles, business strategies and earning profiles between mutual ADIs and commercial banks are different and should be reflected by the presence of different resolution accounts within the FCS.

Given the low number of ADIs we do not suggest another organization aside from APRA manage the fund. However, experience from other markets has shown that the more stable mutual model can be adversely affected by the co-mingling of resolution funds with larger and more volatile commercial banks.

3. *Support the Real Economy Through Government Support of Securitization/Funding of the Housing, SME and Agricultural Markets (Mid-Term)*

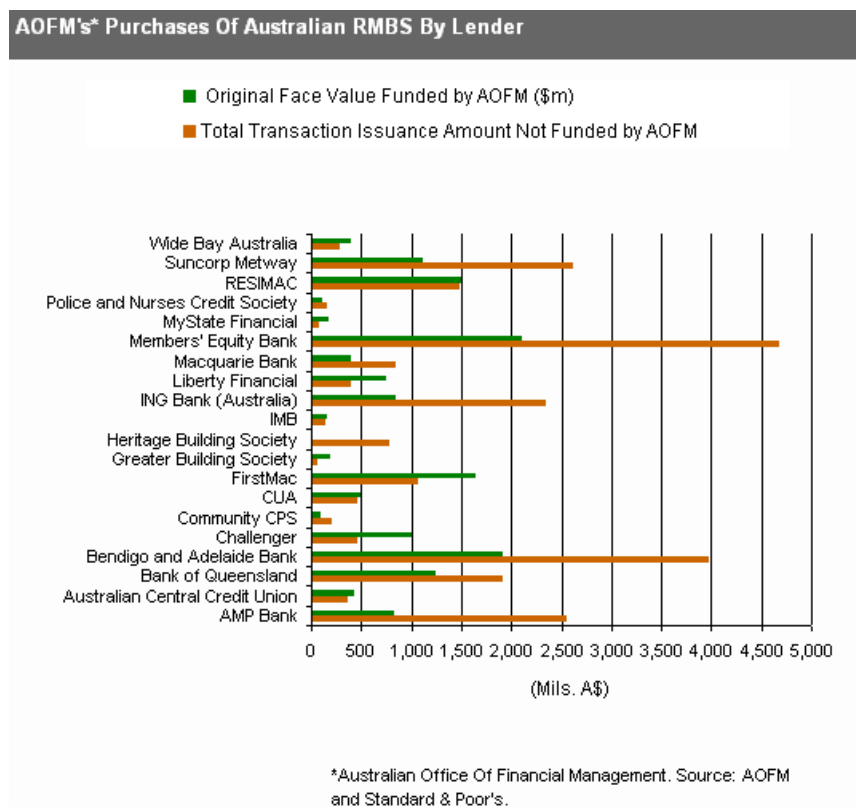
Unlike most G20 economies, Australia's retail banking market does not have sufficient deposits to fund growth. This results in comparatively high levels of wholesale funding that can and did whipsaw the retail banking system. Despite these realities, Australia is the only country in our study that does not directly support the liquidity in these markets via a



government-owned development bank (e.g., Canadian Mortgage Housing Corp or KfW in Germany) or a government sponsored entity (e.g., the more stable and cooperatively owned Farm Credit Funding Corp or Federal Home Loan Banks).

While additional study is needed, best practice suggests that if Australia were to have such an organization (again) that facilitates liquidity support in the housing, SME and agricultural lending markets direct ownership by government or cooperative ownership by its member ADIs, will result in a more conservatively managed institution. While such an organization may provide little capital market access for the big 4 directly, it can be a potential means to underpin funding for smaller participants. (See figure 12 regarding usage of AOFM purchases.)

Figure 12. Experience of Australian Office of Financial Management (AOFM) Usage by Lender



The added benefit of such an institution is that it can also set the de facto market practices for acceptable loan underwriting standards as has been the experience in Canada and the U.S. It also is a rapid way to limit over indebtedness by consumers, SMEs and farms. There are also distinct prudential advantages of supporting the development of a covered bonds market whereby loan originators end up keeping more skin in the game than under traditional securitization practices.



4. *Implement Significant Countercyclical Capital Charges based on the Potential Exposure (Long Term)*

Although Basel III and its predecessors were intended for only internationally active banks, country after country, including Australia, has summarily ignored this. As such, a framework whose structure makes sense for only the big 4 banks is being transposed on the entire retail banking sector. It is nonsensical to impose capital buffer and countercyclical capital charges on institutions with 16.6% CET1, less earning volatility than the big 4 banks, and historic non-performing loans of 0.25%. The big 4 should be incurring capital buffer charges reflective of the fact that the Australian economy is one of the most dependent on the financial sector of any G20 economy. The tendency to apply the same rules, as opposed to proportional rules, to all ADIs has not benefited mutual ADIs or other smaller ADIs over the past 12 years as they've seen their combined market share of retail deposits shrink 9% over period. (Deloitte 2012)

5. *Implement Differentiated Regulations/ Supervision as Recommended by the G20's Global Partnership for Financial Inclusion. (Long Term)*

Relative to other G20 countries, and those of Germany, US and Canada, the Australian regulatory framework over the past 12 years has failed to accommodate the differences in mutual ADIs. In fact, Australia is unique in that it's the only G20 market we are aware of that does *not* have differentiated regulations and/or supervision for its financial cooperatives or savings banks. A potential result of this is Australian mutual ADIs have a smaller market share in assets, deposits and SME markets than their peer jurisdictions in the US, Canada and Germany. There are significant stability, pricing and service benefits to Australian consumers by having a larger mutual ADI and savings bank sector.

When the big 4 banks have an implicit government guarantee it's a false claim that the regulatory environment is based on a single set of rules for a level playing field.

Consideration should be given to truly risk-based and proportional rules. Examples of such an approach could include: 1) differentiated capital rules that allow members' shares to be considered part of CET1 and as they have in the EU and parts of Canada, 2) know your customer and counter terrorist financing standards that are implemented on a risk basis as allowed by the Financial Action Task Force, and 3) individualized prudential capital ratios which are reflective of actual history and probabilities of failure.

**Thank you for the opportunity to comment and upon request we can be available to the FSI panel to provide additional insight or discussion on these points.**

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## About The Author

Dave Grace is the Managing Partner of Dave Grace & Associates, a boutique consulting firm of experienced consultants that specialize in financial sector reform and strengthening. The firm's clients include the International Monetary Fund, the World Bank, Alliance for Financial Inclusion, United Nations, Bill & Melinda Gates Foundation, Filene Research Institute, the largest cooperative bank in the North America (CoBank) and financial cooperatives associations in the U.S., Europe, Caribbean and Australia. Mr. Grace has testified before the US Congress, the Financial Accounting Standards Board and founded/led an association of credit unions in Brussels and an international network of credit unions regulators of which APRA was a founding members. Prior to launching his own firm Mr. Grace worked for the Federal Reserve Bank and the World Council of Credit Unions in senior management roles. He graduated honors in Economics and International Business from St. Louis University and has a graduate degree in International Affairs and Finance from Washington University in St. Louis.

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## Annex 1

### I. INTERNATIONAL COMPARISON

#### FIGURE 1: APPLICATION OF BASEL III TO FINANCIAL COOPERATIVES

##### A. Canada

Throughout Canada, financial cooperative supervision is done primarily at the provincial level and not through the federal banking supervisor, i.e., Office of the Superintendent of Financial Institutions (OSFI). The end of 2012 was the first time a legislative vehicle for the formation of a national credit union or cooperative bank in Canada came into existence. To date no institution has applied for such a national charter. As such one must look to provincial supervisors, not OSFI rules, to determine how Basel III applies to financial cooperatives.

Quantitative impact studies of Basel III for Canadian credit unions indicate that a CET1 capital level of between 7.0% and 11.1% exists across provinces -- well above the 4.5% Basel III standard. Total Tier 1 and 2 capital under the proposed standard is between 11.5% and 14.8% across provinces – well above the 8% minimum. Despite minimal immediate impact on credit unions, some provinces in Canada do not plan on full implementation until 2019 per Basel III's recommendation while others, such as Quebec, moved for implementation by January 2014.

##### 1. Quebec

Within Canada, the Desjardins financial cooperative group is comprised of 376 individual *caisse populaires* serving approximately 72% (or 5.8 million) of the province's 8 million residents. Although they operate principally within the province of Quebec, Desjardins has as many members as all of the credit unions in English-speaking Canada combined. Desjardins is regulated and supervised by the provincial regulator, the *Autorité des Marchés Financiers* (AMF).

In January 2013 the AMF updated its “[Capital Adequacy Guideline](#)” for credit unions to allow for capital shares to be part of CET1. AMF has very similar [Guidelines in French](#) for financial services cooperatives. The Guidelines closely follow the text and paragraph numbering in Basel III. Paragraphs 52 and 53 of the Guidelines specifically allow for credit unions’ “capital shares” to be included in CET1. In these Guidelines AMF has chosen to refer to CET1 as Tier1a which is the functional equivalent and synonymous with CET1.

Local caisses that are part of Desjardins have been issuing permanent shares and surplus shares since 1989 and 2007 respectively. Desjardins’ permanent shares pay variable dividends based on profits, can be transferred to another member or can be redeemed after age 60 (or in hardship cases). Surplus shares are a form of dividend provided to members based on a member’s patronage (i.e., loans, fixed deposits or tax deferred savings volume) with the cooperative. Members

can elect to receive cash or capital shares when profits occur. Members have to hold surplus shares for at least 7 years before redemption.

**Clear [terms and conditions are disclosed](#) for capital shares which are only issued and paid after the financial cooperative is sufficiently capitalized.**

In addition, according to Desjardins' own contractual terms and conditions capital shares can only be redeemed at book value, after 7 years (or in hardship cases), and after a person has reached age 60 and is retired. The capital shares are only transferable to members or redeemable with authorization from the AMF and if the financial cooperative meets its capital requirements. Qualifying shares are the basic \$5 membership share which is required for membership and redeemable upon dissolution, liquidation or exiting the financial cooperative. AMF's Capital Adequacy Guideline allows financial cooperatives to include their "qualifying shares" as part of Tier 2 capital.

**Because of the expectation of redemption created with the age reference for permanent shares, the age and seven-year holding references with surplus shares and the fact these forms of capital were not clearly defined as the most subordinated types of capital, they are being phased out as T1a over ten years.** Desjardins, with approval from the AMF, created a new capital instrument in 2012 called Federation shares. Federation shares will be treated as T1a under the new AMF Capital Guidelines. T1a is the name given to CET1 by the AMF in Quebec. It is the same in all respects as CET1 but also allows for members' federation shares in cooperatives to be part of the highest form of capital. In addition, to ease disclosure and administrative processing these Federation shares will be issued by the Desjardins Federation, not the local caisses. An overview of Desjardins' capital instruments is provided below.

Capital Instrument	Characteristic	Capital Treatment under AMF Basel III Guidelines
Undistributed Surplus Earnings	Year to date income	T1a
Reserves (Retained Earnings)	Accumulated surpluses	T1a
<b>Capital Share Type:</b> - Surplus share	A form of dividend provided to members based on a member's patronage (i.e., loans, fixed deposits or tax deferred savings volume) with the caisse. Members can only receive additional capital shares when profits occur (1\$ par value; 30\$ minimum subscription).	Treated as Tier 1a and subject to phase out over 10 years starting from 2013. Can only be redeemed if the caisse is meeting its minimum regulatory requirement and can only be redeemed at the minimum value between book value and face value, after 7 years (or in hardship cases), and after a person has reached age 60 and is retired or between 50 and 60 and pre-retired.
<b>Capital Share Type:</b> - Permanent Shares	Any member of a credit union is eligible to purchase permanent shares. Members can elect to receive cash or additional permanent shares when profits occur.	Treated as Tier 1a and subject to phase out over 10 years starting from 2013. Can only be redeemed if the caisse is meeting its minimum regulatory

		requirement and can only be redeemed at book value, after 5 years (or in hardship cases: Shares may be redeemed in the death of the member or when liquidation, insolvency or dissolution of the credit union takes place), after a person has reached age 65 and is retired or pre-retired, and at the age of 605.
<b>Capital Share Type:</b> - Federation Capital Shares “F Shares”	To members only, \$10 par value; \$100 minimum subscription. They are the most subordinated form of capital shares and have no anticipated or planned redemption date. They are redeemable by the member from the caisse based on the funds caisse holds in a fiduciary account for redemptions. Additional redemptions beyond the value of the fiduciary account require approval by AMF. Not insured.	T1a except for the monies in the fiduciary account to meet redemptions.
Qualifying shares	Basic \$5 membership share which is required for membership in the caisse and redeemable upon dissolution, liquidation or exiting the financial cooperative.	Treated as Tier 2.
Senior Notes E-J	Subordinated debt. Is not convertible at the point of non-viability.	Tier 2 Capital but being phased out over a 10% year period.

## 2. *British Columbia*

**Financial cooperatives in British Columbia have the largest penetration in English-speaking Canada.** Approximately 36% of all residents of the province are members of a financial cooperative and together these institutions hold US\$57 billion in total assets or 37.5% of all assets of financial cooperatives in Canada. British Columbia includes the nation’s largest financial cooperative, VanCity Savings which has over US\$17 billion in assets. VanCity’s Tier 1 capital comprises 89% of its total capital base and its Tier 2 capital comprises the remaining 11%. VanCity’s retained earnings make up 90% of its Tier 1 capital and member shares, investment shares and patronage share comprise the remaining 10% of Tier 1 capital.

The Financial Institutions Commission of British Columbia updated its [Capital Requirements Regulation](#) in March 2013 via the [Internal Capital Targets](#) Guideline. This new Guideline increases the supervisory target for capital from 8% to 10% but retains the two types of capital from Basel II (i.e., Tier 1 and Tier 2). In addition to retained earnings and year to date profits, credit unions in British Columbia have three types of equity shares:

Type of Equity Share	Characteristic	Capital Treatment
Member Equity Share	Mandatory membership share for saving or borrowing with the CU. By-	Treated as Tier 1 subject to the CU meetings in

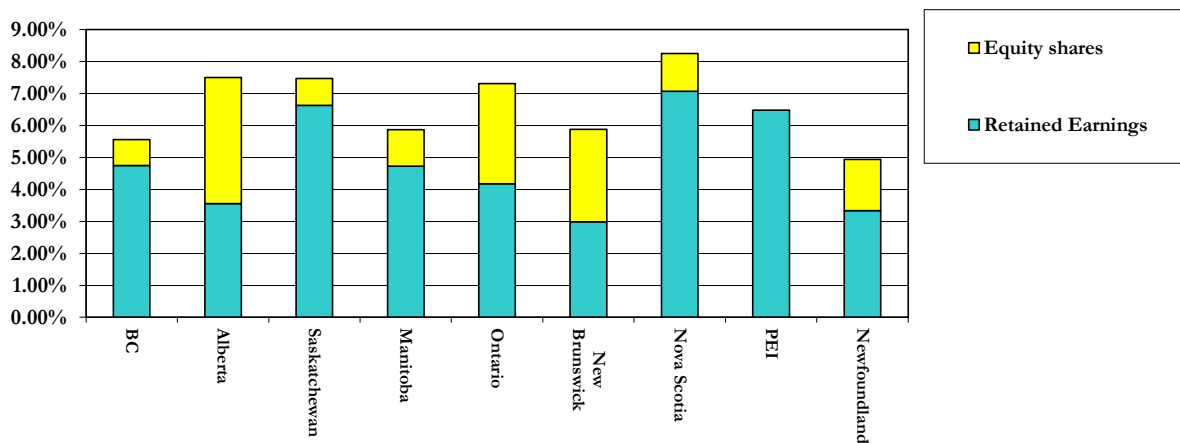
	laws establish minimum amount usually between \$5 to \$25. Not insured.	minimum regulatory requirement.
Investment Equity Share	Voluntary investments made by members. Disclosures required above \$5,000 investment. Not insured.	Treated as Tier 1 subject to the CU meeting its minimum regulatory requirement and no more than 10% can be redeemed in a year.
Patronage Equity Share	Created out of retained earnings and issued to members based on patronage. Not insured.	Treated as Tier 1 subject to the CU meeting its minimum regulatory requirement and no more than 10% can be redeemed in a year.

In light of Basel III, the Guidelines choose to retain the Tier 1 and Tier 2 framework of Basel II as opposed to instituting a CET1 requirement. Within the revised Guidelines the three types of equity shares (i.e., membership, investment and patronage) will continue to be counted as part of Tier 1 capital. These equity shares cannot be redeemed by members if the credit union is below the minimum capital requirement.

### 3. *Ontario*

**Although British Columbia has the largest English-speaking financial cooperative system, on average the financial cooperatives in Ontario rely on capital contributed by members for approximately 30-40% of their capital base --** whereas it makes up about 15% of the capital base in BC. Following British Columbia, Ontario has the second largest financial cooperative sector in English-speaking Canada with 97 credit unions holding US\$30 billion in assets serving 1.3 million people.

**FIGURE 2: COMPOSITION OF CAPITAL BASED IN CANADIAN CREDIT UNIONS**





Type of Cooperative Share	Characteristic	Capital Treatment
Member Shares	Mandatory membership share for saving or borrowing with the CU. By-laws establish minimum amount usually between \$5-\$25. Not insured.	Treated as Tier 1 subject to the CU meetings in minimum regulatory requirement.
Qualifying Shares	Voluntary investment made by members. Not insured.	Treated as Tier 1 subject to: 1) the CU meeting its minimum regulatory requirement, 2) Redeemable in >12 months. Treated as tier 2 the amount redeemable in <12 months
Patronage Shares	Created out of retained earnings and issued to members based on patronage. Not insured.	Treated as Tier 1 subject to: 1) the CU meeting its minimum regulatory requirement, 2) Redeemable in >12 months.

**In Ontario, like British Columbia, in the last 24 months regulators have decided to update their capital guidelines and to retain the Tier 1 and Tier 2 capital distinctions as opposed to introducing CET1.** Tier 1 capital includes retained earnings, contributed surplus<sup>7</sup>, and membership, patronage and qualifying shares redeemable after 12 months. None of these classes of shares are redeemable unless a member withdraws from membership and the credit union is able to meet its minimum capital requirement. At all times the regulator has the right to restrict redemptions of any class of shares if redemptions would impair, or even jeopardise, the capital position of a credit union. This has been the long-standing practice in Ontario under Basel I and II and will continue.

## **B. European Union – Specific information on Germany**

**The German cooperative banking system is structured similar to the FCS with many smaller rural-based retail cooperative banks and a few national wholesale institutions.** Within the German cooperative bank system there are 1,100 retail cooperative banks, two wholesale cooperative banks, seven regional associations and one national association. Together they have 12.6% market share, 1 trillion Euros in assets and serve 16 million members and an additional 14 million clients. These institutions, as much as any cooperative banks in Europe, were strong advocates in achieving the Basel III footnote for cooperatives. As of December 2011 German cooperative banks had a total capital ratio of 17.7% and their capital shares made up 14% of their capital base.

**Capital shares are issued upon admission of new members<sup>8</sup> or by giving existing members the opportunity to buy additional shares.** Normally the number of shares a member can buy is restricted in the cooperative bank's bylaws (for example, a maximum of 10 capital shares per member). Irrespective of the number of shares there is always the principle of "one member, one vote". A member can leave the institution by giving at least 3 months of notice before the end of a

<sup>7</sup> Contributed surplus is income earned from non-operational activities. For example, income earned from the sale of shares above their par value.

<sup>8</sup> It is up to the bylaws of the cooperative regarding whether or not it allows individuals to borrow or save without first becoming a member. A person cannot borrow the money to purchase the members' shares.

year. The capital shares are paid back to the former member within 6 months after the end of the year, after the adoption of an annual financial statement that demonstrates such redemption would not cause the cooperative bank to breach its regulatory capital requirement and upon approval by the cooperative bank's board.

**Dividends are paid in the form of either cash or more shares depending on the member's standing in the cooperative.** There are both capital shares (i.e., the nominal full value of a share -- often 100€) and member shares (i.e., some fraction of a capital share, e.g., 20€). For example, a new member of the cooperative bank only pays the minimum of 20 € of the 100€ capital share. At the end of a financial year a cooperative bank may pay dividends to the members based on his/her patronage with the cooperative bank. If the members' shares are below the nominal value (i.e., 100€) dividends can be paid as additional shares. Dividends are paid in cash when members' shares have reached and are equal to the nominal value of capital shares. Aside from this difference in value there is no difference in substance between members' shares and capital shares. In practice most dividends are paid in cash at a targeted, not guaranteed, rate of approximately 4%.

**Based on changes the European Union has made to Basel III only capital shares are included in CET1.** Member's shares that have not yet reached the nominal capital share level are not considered CET1. Through conversations with a financial cooperative expert at the German Bundesbank, it's recognized that capital shares may be paid back and this would not normally comply with the Basel III requirement that CET1 capital has to be permanent. For this reason Articles 27 and 29 of the European Union's Capital Requirements Regulation were added to recognize capital shares of a cooperative bank as CET1. In July 2013 the European Banking Authority issued its Final draft Regulatory Technical Standards (RTS)<sup>9</sup>. The conditions for redemption require that the cooperative bank is able to fulfill its minimum capital requirement, the capital shares must be available to absorb losses and the bylaws of cooperative banks give its board the irrefutable right to refuse redemption. These restrictions are implemented in the national law or bylaws of the cooperative bank and enforced by the supervisor. Specifically the RTS indicates:

*(b) with respect to Common Equity Tier 1 capital, the institution is able to issue, according to the national applicable law or company statutes, at the level of the legal entity, only capital instruments referred to in Article 29 [See Annex 2 for the text of Article 29] of Regulation (EU) No 575/2013;*

*c) When the holders, which may be members or nonmembers of the institution, of the Common Equity Tier 1 instruments referred to in paragraph (b) have the ability to resign, under the applicable national law, they may also have the right to put the capital instrument back to the institution, subject to the restrictions of the applicable national law, company statutes, of Regulation (EU) No 575/2013 and of this Regulation. This does not prevent the institution from issuing, under applicable national law, Common Equity Tier 1 instruments complying with Article 29 of Regulation (EU) No 575/2013 to members and nonmembers that do not grant a right to put the capital instrument back to the institution.*

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<sup>9</sup> European Banking Authority's Final draft Regulatory Technical Standards.

<http://www.eba.europa.eu/documents/10180/359901/EBA-RTS-2013-02-draft-RTS-on-Own+funds-part-2-Mutuals-cooperatives.pdf/afb3c3ba-1ac9-42b2-9746-6f76575c7c13>

On an annual basis cooperative banks must report to the regulator the *net* amount of share redemption requests. Regardless of whether or not the cooperative bank has made profits or losses in a given year its net redemptions may not exceed 2% of CET1, assuming such redemptions would not cause the cooperative bank to go below its prudential minimum capital requirement. Net redemptions totaling *more than* 2% of CET1 require a cooperative bank to receive additional regulatory approval. Redemptions of members' shares are generally paid in a single lump sum as opposed to over a period of time. In addition, the members must wait until the end of the fiscal year and once the cooperative bank's board has approved such redemptions to receive their funds.

AUSTRALIAN CENTRE FOR FINANCIAL STUDIES

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## Equitable Taxation of Customer Owned Banking

# EQUITABLE TAXATION OF CUSTOMER OWNED BANKING

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## 1. Executive Summary

Customer-owned authorised deposit-taking institutions (Customer-owned ADIs) – credit unions, building societies and mutual banks – continue to be an important alternative to private banks representing around 4.5 million member-owners and approximately 10.5% of retail deposits.

Despite significant changes to the laws governing mutual ADIs, including the abolition of tax-exempt status for credit unions and harmonisation with banking regulations, their non-profit maximization objectives allow them to provide their members with higher deposit rates and lower borrowing costs than those offered by listed banks.

Consequently mutual ADIs offer an attractive alternative to the major banks, and potentially a viable ‘fifth pillar’ in the Australian banking system. While the organizational structure of mutual ADIs, with member-owners rather than shareholder-owners, offers many benefits it also presents a major constraint due to the barriers to mutual ADIs accessing public equity. With limited access to external capital, mutual ADIs are heavily reliant on retained earnings to fund their capital requirements, innovation and growth. As a result the natural growth rate for mutual ADIs is equal to their return on equity. Further, although mutual ADIs pay taxation at the corporate rate, due to the general absence of risk capital they are unable to release the resultant franking credits. (In this regard mutual ADIs are not dissimilar to tax-exempt not-for-profits (NFPs)). As at February 2013, mutual ADIs had accumulated approximately \$1.5 billion in franking credits which are difficult to pass on to the ADIs’ owners.

This presents an uneven playing field where mutual ADIs are paying a higher average effective tax rate on earnings than the major banks, which may have implications for the flow of funds and the pricing decisions of Australian financial institutions. A number of solutions have been suggested to this problem, with the majority focused on designing an instrument by which mutual ADIs can release franking credits to member owners. Such solutions need to: (i) ensure that all members are treated equally; (ii) guard against an intergenerational transfer of accumulated wealth, (iii) avoid diverging interests between instrument holders and member-owners and (iv) have clear quantifiable taxation outcomes. Designing an instrument that meets all four of these requirements has proved challenging.

An alternative suggestion that appears to overcome the issues mentioned above, while promoting competitive neutrality, is an alternative tax rate for mutual ADIs in line with the average effective tax rate paid by the shareholder-owners of the major Australian banks. According to the analysis presented in this report, the average effective tax rate on the earnings of Australian major banks is between 22.15 and 25.5 per cent. Hence, a discounted corporate tax rate for mutual ADIs in this range would resolve the issue of retained franking credits for members of mutual ADIs, allow an equal distribution of benefits to all members and result in a higher natural rate of growth for mutual ADIs.

## 2. Background: The Nature and History of Mutual ADIs

### 2.1 Short History and Role of Mutual ADIs

Mutual institutions or cooperatives began in the early 19<sup>th</sup> century as a means for people of a common bond<sup>1</sup> to pool together resources, expertise and risk. Mutual institutions, particularly in financial services, provide an alternative to privately owned institutions. As “member owned” organisations with a one-member one-vote governance structure, mutuals operate outside the traditional profit maximization framework. A mutual’s customers are also its owners.

Mutual financial institutions operate in many countries around the world.<sup>2</sup> In Australia, mutual financial institutions include mutual authorised deposit-taking institutions (mutual ADIs) and friendly societies. Mutual ADIs, like listed banks, create liquidity by pooling the deposits of savers and providing loans to borrowers. However, while private banks have the objective of maximizing the shareholder value of investors who may have no other engagement with the bank, mutual ADIs have traditionally existed to maximise the wellbeing of their customer members. This can be achieved by offering member-borrowers lower interest rates and member-depositors higher interest rates than those offered by listed banks, supporting local communities, and by offering better service, such as fewer and lower transaction costs, than is available elsewhere.

Currently in Australia, there are 98 mutual ADIs comprised of credit unions (81), building societies (7) and more recently, mutual banks (10). Traditionally, there was a clear distinction between the business models of these institutions, with credit unions specializing in consumer loans and building societies focusing on mortgage finance. However, the introduction of standardised national regulation for building societies and credit unions in 1992 with the *Financial Institutions Code*, for the first time required mutual ADIs to maintain the same minimum capital adequacy ratio of 8 percent of risk-weighted assets as banks. Unlike banks, however, which are able to raise capital by way of share issue, the primary source of new capital for most mutual ADIs lies in retention of surpluses in reserve accounts, thereby increasing the need to generate profits. This requirement led mutual ADIs increasingly to a second objective – maximising reserves.

The drive to maximize reserves to provide capital and funds for growth has led to widespread rationalization and a series of mergers and acquisitions amongst mutual ADIs with the objective of building greater economies of scale to remain competitive with the listed banks. For credit unions, this has also resulted in less strict adherence to the common bond guidelines which until then had determined membership eligibility.

Despite the impact of deregulation on operating models, mutual ADIs maintain a significant presence in Australia, serving around 4.5 million members and accounting for approximately 10.5%<sup>3</sup>

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<sup>1</sup> The common bond refers to a social connection between members of the group for example industrial or geographic.

<sup>2</sup> For example, Srinivasan and King (1998) provide an overview of Credit Unions in the US.

<sup>3</sup> Customer Owned Banking Association estimates (2014), [http://www.customerownedbanking.asn.au/images/stories/factsheets/2014/COB\\_Factsheet\\_Jan\\_2014.pdf](http://www.customerownedbanking.asn.au/images/stories/factsheets/2014/COB_Factsheet_Jan_2014.pdf)



of all Australian household deposits and remain an important alternative to Australia's four major banks.

## 2.2 The Mutual ADI Growth Conundrum

A key competitive advantage of mutual ADIs has been their ability to operate at lower net-interest margins than private banks both due to the absence of a profit maximization objective and (arguably) through a greater ability to assess and monitor the credit risk of loans.<sup>4</sup> While the net-interest margins of mutual ADIs generally remains favourable when compared with private banks (Table 1), recent trends both in global regulation and in the operating models of mutual ADIs have created a conundrum between the rate at which mutual ADIs can grow and their ability to continue to provide favourable net-interest margin spreads.

**Table 1 Loan and Deposit Interest rate comparison: Mutual ADIs and Major Banks**

Standard Variable Loan	Avg (%)	Min (%)	Term Deposit \$10K 3-Month	Avg (%)	Max (%)
4 Major Banks	5.91	5.88	4 Major Banks	3.04	3.25
Credit Unions	5.46	4.7	Credit Unions	3.18	3.75
Building Societies	5.44	4.79	Building Societies	3.46	4
Mutual Banks	5.51	5.07	Mutual Banks	3.45	3.85

*Source: Canstar Cannex, 17 Jan 2014*

First and foremost in this regard has been the introduction of minimum capital requirements. These requirements have meant that ADIs must increase their capital base in order to expand their balance sheet. For non-mutual ADIs this has meant that additional equity or other eligible Tier 1 capital has been raised from investors prior to an expansion in lending. For mutual ADIs who generally do not have equity investors, the eligible capital base can be increased only through retained earnings. This situation results in a natural rate of growth for mutual ADIs that is equal to their return on equity, which can only be increased through: 1) An increase in net-interest margin; 2) An increase in non-interest (fee) income; or 3) A reduction in operating costs

## 3. The Competitive Landscape

### 3.1 The Taxation of customer-owned ADIs

With the introduction of the dividend imputation scheme in 1987, company tax on profits generated by companies in Australia may be attributed, or imputed, to the shareholders by way of a tax credit to reduce the income tax payable on a distribution. This scheme was designed to encourage private ownership of Australian equities by removing the "double taxation" of company profits, first in the hands of the companies and second in the hands of shareholders. It reduces or eliminates the tax disadvantages of distributing dividends to shareholders by only requiring them to pay the difference between the corporate rate and their marginal rate.

<sup>4</sup> See Davis (1997)

While mutual ADIs are obliged to pay company tax<sup>5</sup>, they do not distribute profit by way of dividends on risk capital, except in some limited circumstances subject to an ‘economic relationship test’ and ‘governance relationship test’ set out in ASIC Regulatory Guide 147 *Mutuality – Financial institutions*. Earnings are retained as inter-temporal equity to meet capital requirements and serve the needs of their current and future owner-members. Consequently, the franking credits applying to company taxes paid are accumulated rather than distributed. Hence, as at February 2013, mutual ADIs had accumulated approximately \$1.5 billion in franking credits which, due to the general absence of risk capital, cannot be passed on to the ADIs’ owners. Whether this inability to pass on franking credits constitutes a competitive disadvantage to mutual ADIs is explored below.

Under the franking credit system, company tax is essentially a withholding tax with the final tax due on a company’s distributed profits being determined by the marginal tax rate of the underlying shareholders. Prior to the introduction of rebates in July 2000, franking credits received by investors that could not offset a tax liability remained unused, meaning the company tax rate acted as a lower bound for the effective tax rate on company earnings. With the introduction of cash rebates on unused franking credits, the total tax paid on company earnings can be lower than the corporate tax rate if the average marginal tax rate of a company’s shareholders is below the corporate tax rate. Of course, when an organisation is unable to pay out earnings and franking credits to investors, the average tax rate becomes the company tax rate.

#### **Box 1: The Actual Rate of Tax on Corporate Profits**

Company A and B operate solely in Australia and have profit after tax of \$70. The corporate tax rate for both companies is 30% however the shareholders in company A are all on the highest marginal tax rate of 46.5% while the shareholders of company B are all superannuation funds in the accumulation phase with a tax rate on investment earnings of 15%. Both companies have a dividend payout ratio of 100% and the dividends are fully franked.

Investors in Company A receive a grossed-up fully franked dividend of \$100 of which \$30 is a franking credit representing the tax already paid by Company A. The investors in company A must then pay \$46.50 in tax on the dividend in accordance with their marginal tax rate, leaving them with an after-tax dividend of \$64.50.

Investors in Company B also received a grossed-up fully franked dividend of \$100. The investors in company B then pay \$15.00 in tax on the dividend, leaving them with an after-tax dividend of \$85.00.

The example above shows that the effective tax rate paid on the profits of company A is 46.5% compared to 15% for Company B.

Box 1 shows that under the franking credit system, companies that pay out the majority of earnings as fully franked dividends substitute the company tax rate for the average tax rate of their

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<sup>5</sup> Credit unions have only been required to do so since 1993, a requirement at odds with other countries, including most notably the United States.

underlying investors. Companies that do not pay out dividends and use retained earnings to fund growth are subject to the corporate tax rate. When assessing the competitive distortions that may be caused by the inability for mutual ADIs to release franking credits, it is important to consider two key points:

- If the average marginal tax rate of investors in non-mutual banks is above the corporate tax rate, there is no competitive distortion as non-mutual banks have the option of forgoing dividends and funding growth through retained earnings taxed at the corporate tax rate.
- If the average marginal tax rate of investors in non-mutual banks is below the corporate tax rate, non-mutual banks have an advantage over mutual ADIs as they will choose to pay out the majority of retained earnings as franked dividends<sup>6</sup>, resulting in a rate of tax paid on earnings that is lower than the corporate tax rate.

Competitive distortions caused by the tax system can hinder effective competition and distort the flow of funds between financial institutions and end users. Therefore, it is important to estimate the average effective tax rate of bank shareholders to determine whether the dividend imputation system results in inconsistent tax rates on the earnings of mutual ADIs compared to banks.

### 3.2 Is there a Competitive Distortion?

For the purpose of this analysis, the potential shareholders of the four major Australian Banks<sup>7</sup> have been broken down into five categories as presented in Table 2. Further details on each group and how percentages were estimated are provided below:

**Table 2 Estimated ownership of Australian Major Banks**

	Tax Rate on Dividend Income	Percentage of Australian Bank Ownership
Superannuation Funds		36% - 43%
<i>Accumulation</i>	15%	27% - 32%
<i>Drawdown</i>	0%	9% - 11%
International Investors	30%	44%
NFPs and Charities	0%	2.2%
Individual Australian Investors	34% - 46.5%	18.8% -10.8

#### Superannuation funds

Since the introduction of the Superannuation Guarantee in 1992, the pool of assets held by superannuation funds has grown to more than \$1.8 trillion in December 2013<sup>8</sup>, constituting the fourth largest pool of pension assets in the world. Income on superannuation investments can be taxed at one of two rates, 15% for superannuation accounts in the accumulation phase and tax-free for superannuation accounts in the pension/drawdown phase.

<sup>6</sup> As evidenced by the high dividend payout ratio of banks – find current dividend payout ratio for banks

<sup>7</sup> The major banks described in this report comprise National Australia Bank, Commonwealth Bank, Australia and New Zealand Bank and Westpac.

<sup>8</sup> APRA (2014)

Estimating the total proportion of Australian major bank shares held by Superannuation funds can be done through one of two methods. The first method involves analyzing the shareholder register that banks submit with their annual reports. There are two issues with this method:

1. Superannuation funds do not hold equities directly, rather they are held in trust typically by a nominee company that acts as custodian for the individual account holders.
2. The published share register only includes the holdings of the top 20 shareholders which in the case of banks makes up between 45-60% of total shares.

These issues mean that using this method to estimate the proportion of total Australian major bank shares held by superannuation funds require assumptions both on what proportion of nominee holdings are held on behalf of superannuation funds, and the assumption that no superannuation holdings are outside of the top 20 shareholders. With these caveats, using this method, an estimation of superannuation holdings of listed banks of 43% has been made.<sup>9</sup> However, due to the limitations listed above, the second estimation method provided below is preferred and used in the base scenario.

The second method involves determining the asset allocations of superannuation funds into Australian equities and then making the assumption that, on average, superannuation funds invest according to benchmark weights. Given that superannuation investment in Australian shares makes up a significant proportion (more than a third) of the ASX 200's total market capitalisation, this appears to be a reasonable assumption. Table 2 provides the average asset allocations of superannuation funds to Australian equities as reported by both APRA and the ATO on June 2013. Using these allocations, Table 3 estimates the total value invested by Australian superannuation funds in Australian equities.

**Table 3 Asset Allocation to Australian Equities by Superannuation Funds**

Proportion of assets	Corporate	Industry	Public sector	Retail	Average Institutional Holdings	SMSFs
Australian shares	30%	29%	22%	26%	26%	32%

Source: APRA (2013) and ATO (2013)

Then using market weights as of December 16 2013 and assuming superannuation holdings reflect benchmark weights, Table 4 shows the total proportion of Australian major banks held by superannuation funds which is estimated to be around 36%.

**Table 4 Total Value of Superannuation Investment in Australian Equities**

Fund Type	Assets Under Management December 2013 (\$ billion)	Approximate dollars invested in Australian Shares
<b>Entities with more than four members</b>	<b>1,212.2</b>	315.2
Small APRA funds	2.0	0.6
Single-member ADFs	0.0	0.0
Self-managed super funds	543.4	173.7
Balance of life office statutory funds	45.4	11.8
<b>Total</b>	<b>1,803.1</b>	<b>501.3</b>

Source: APRA (2013) and ACFS Estimates

<sup>9</sup> Calculations are included in Appendix 5

**Table 5 Total Value of Australian major Banks held by Superannuation Funds**

	Market Cap (\$ billion)	Holding value of superannuation funds (\$ billion)	Proportion of total value held by superannuation funds
Commonwealth	119.61	43.52	36.39%
Westpac	96.38	35.07	36.39%
National Australia Bank	78.35	28.51	36.39%
ANZ	83.00	30.20	36.39%

Source: ASX 200 list and ACFS Estimates

As noted above, due to the differing tax rates for superannuation funds in the accumulation phase compared to the drawdown phase it is also important to determine the proportion of total superannuation assets in each phase. A 2010 analysis conducted by Rice Warner for the 2010 Super System Review estimated that 25% of all superannuation assets would be in the drawdown phase in 2014.<sup>10</sup> This figure of 25% has been used for the base scenario estimates used in this report.

### International Investors

The tax paid by international investors on Australian equities can be broken down into two components, the withholding tax that is paid to the Australian Government and any additional tax that may be levied by the government of the resident country of the international investor. For the purpose of this report and the creation of a level playing field for domestic ADIs, it is the tax liability due to the Australian Government that is important and therefore any tax required by international investors is disregarded. The withholding tax paid by international investors is determined by a number of factors.<sup>11</sup>

1. If a dividend received by an international investor is fully franked, there is no withholding tax – total tax paid on earnings is the 30% paid by the company.
2. If a dividend received by an international investor is unfranked, withholding tax is 30% for investors residing in a country that does not have a double taxation agreement with Australia and in most cases 15% for residents of countries who have a double taxation agreement with Australia. – In this case total tax is either 15 or 30% depending on the residency of the investor.

Based on the points above, the total tax due by international investors in Australian bank shares is between 15 and 30%. The base scenario in this report uses the conservative measure of 30%. The proportion of international holdings in Australian bank shares has been calculated from ABS Financial Accounts data<sup>12</sup> to be around 44% (Appendix 3).

### Not for Profits and Charities

A third Australian shareholder investor class is not for profit organisations and charities. These organisations are not taxed on investment income. The investment portfolios of the foundations and endowments that often support these organisations can be crucial to their ongoing viability however

<sup>10</sup> Commonwealth of Australia(2010)

<sup>11</sup> Australian Taxation Office (2014)

<sup>12</sup> ABS 2013

estimating their holdings in Australian bank shares is difficult due to the absence of official statistics on the sector.

The Australian Taxation Office provides data on franking credits received by various investor types from which an overview of the underlying recipients of franking credits can be derived. Table 6 provides an overview of how franking credits were distributed amongst recipients in the 2010-11 fiscal year. This method shows that around 2.2% of all franking credits were received by charities but this did not include franking credits received by charities through trusts or franking credits received by other not-for-profit organisations, suggesting that the actual proportion of Australian bank share ownership by this combined group could be higher. Conversely, these statistics do not include international investors which, if included, would reduce the proportion of share ownership of this group. Therefore, while 2.2% is used as an estimate of the proportional ownership of this group, actual ownership is likely to vary.

**Table 6 Dividend Franking Credits 2010-2011**

Recipient of Franking Credits	Franking Credits (\$million)	% of Total
Individuals (Excluding portion received from trusts)	8,553	36.24
Super (Excluding portion received from trusts)	2,659	11.27
SMSF	2,689	11.39
Trusts	9,090	38.52
Partnerships	89	0.38
Charities	520	2.20
<b>Total</b>	<b>23,600</b>	

Source: Derived from ATO (2010), *Taxation Statistics 2010-2011*,

[http://www.ato.gov.au/uploadedFiles/Content/CR/Research\\_and\\_statistics/In\\_detail/Downloads/cor00345977\\_2011TAXS\\_TATS.pdf](http://www.ato.gov.au/uploadedFiles/Content/CR/Research_and_statistics/In_detail/Downloads/cor00345977_2011TAXS_TATS.pdf)

## Individual Australian Investors

The tax paid by individual Australian Investors on dividend income is dependent on their marginal tax rate.<sup>13</sup> The Australian Tax Office does not disclose the total franking credits received by individual investors according to their tax rate, therefore in order to estimate the average marginal tax paid on franked dividends it is assumed that the relative holdings of listed bank equities between tax brackets is proportionate to the percentage of total tax paid by each bracket. This results in an estimated weighted average marginal tax rate of 38.3% (Table 7).<sup>14</sup>

**Table 7 Division of tax paid between highest tax brackets**

Taxable income	Taxpayers		Net tax payable		Marginal Tax Rate
	No.	%	\$m	%	
\$6,001 - \$37,000	2,908,555	31	5,363	4	19.0%
\$37,001 - \$80,000	4,598,771	49.1	45,637	34.4	34.0%
\$80,001 - \$180,000	1,613,234	17.2	46,940	35.4	38.5%
>180,001 or more	251,397	2.7	34,773	26.2	46.5%
<b>Total</b>	<b>9,374,184</b>	<b>100</b>	<b>132,713</b>	<b>100</b>	<b>38.3% (weighted by tax payable)</b>

Source: Australian Taxation Office (2013) and ACFS calculations

<sup>13</sup> For a breakdown of current marginal tax rates and corresponding income levels see Appendix 4.

<sup>14</sup> These assumptions are used for the base scenario with alternative scenarios provided in Appendix 1

Finally, the percentage of Australian bank shares held by individuals was calculated as the residual holdings not accounted for by other investor types. This resulted in an estimated holding of approximately 11% for the base scenario.

### Estimate of the Average Tax Rate paid on Earnings of Australian Banks

Using the inputs derived in the previous section an estimate of the average tax rate paid on the distributed earnings of Australian banks in our base scenario is calculated in Table 7 below.

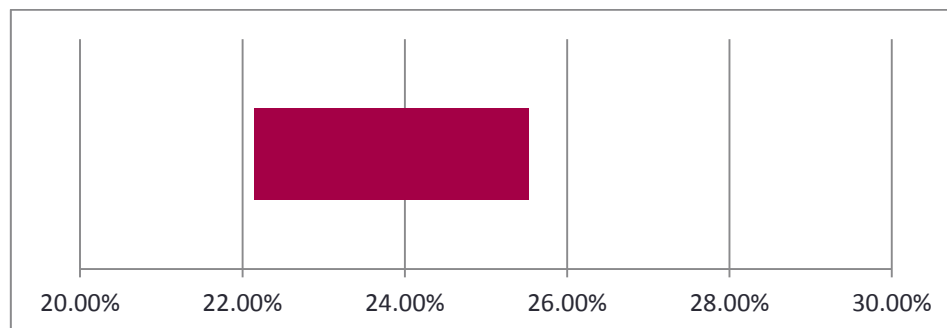
**Table 8 Estimated Average Tax Rate on Bank Earnings: Base Scenario**

Investor Class	Estimated ownership	Tax Rate on Dividends
Superannuation Funds	36%	
Accumulation	27%	15%
Drawdown	9%	0%
International Investors	44%	30%
NFPs and Charities	2%	0%
Individual Australian Investors	18%	38.3%
<b>Estimated Average Tax Rate</b>		<b>24.14%</b>

Source: ACFS estimate

Given the alternative scenarios provided in Appendix 1 across all types of tax payers, Figure 1 provides an estimated range for the average marginal tax rate paid on major bank earnings.

**Figure 1 Estimated range of average tax rate on bank earnings**



Source: ACFS estimate

### Summary

The analysis above suggests that the average effective tax rate on the earnings of Australian major banks is between 22.15% and 25.5%. This is below the corporate tax rate that applies to mutual ADIs that are unable to distribute franking credits. As noted above, this discrepancy in effective tax rates creates an uneven playing field and may distort decisions of Australian depositors and borrowers.

## 4. Options for creating a level playing field: An analysis

The remainder of this report analyses two alternative policy options that may correct the discrepancy in average tax paid by mutual ADIs compared to banks:

1. Making franking credits available to members of mutual ADIs;
2. A lower taxation rate for mutual ADIs.

When assessing the costs and benefits of these alternatives, a number of issues regarding the nature of mutual ADIs must be considered. Primary in this regard is the inter-temporal nature of mutual ADI wealth which has been accumulated over a number of years, not contributed solely by current members. Because of this, any policy change should aim for an equitable outcome for past, current and future members. Secondly, any suggested solution must carefully assess the potential agency and operational problems mutual ADIs could potentially incur as a result of the proposal. This risk stems from the different objectives of the member-owners of mutual ADIs compared with those of the shareholder-owners of private banks.

### 4.1 Making Franking Credits Available to Members

Allowing mutual ADIs to release their franking credits is one solution that has been suggested for rectifying the competitive distortion caused by the imputation system.<sup>15</sup> However, designing a method or instrument by which franking credits can be released poses a number of problems as mutual ADIs generally do not (and in most cases cannot) pay out earnings.<sup>16</sup>

The first question therefore is would it be possible for mutual ADIs to release franking credits to members on a pro-rata basis without an accompanying dividend? To answer this question, the nature of the dividend imputation system, which requires that distributed franking credits be accompanied by imputed income, must be explored. The system allows imputed income to be grossed up by a franking credit, the shareholder subsequently pays tax at their marginal tax rate on the grossed up value. As shown by Davis (2010), in the case that franking credits are released without accompanying imputed income and the recipient is required to pay tax on the assumed grossed up amount, the recipient of the franking credit could acquire a tax liability that exceeds the value of the franking credit received. Therefore, it is likely that if mutual ADIs were allowed to release franking credits directly to members without accompanying imputed income, the credits would only be attractive to members with a marginal tax rate below the corporate tax rate. This would raise issues in regard to providing an equitable outcome for all members.

To overcome this problem, franking credits held by mutual ADIs could be attached to a security that releases imputed income. Under the current regulatory framework, imputed income can only be attached to issued securities that:

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<sup>15</sup> See for example, Davis (2010)

<sup>16</sup> It should be noted that in accordance with ASIC regulatory guide 147, mutual ADIs can issue non-voting “investor shares” which can receive a dividend up to a maximum of 50% of the current years profit but have no residual claim on accumulated surpluses. However, due to the agency and operational problems mentioned, these have not been popular.



1. Are shares in the issuing institution which involve 'at risk' capital
2. Are held for a minimum of 45 days

To meet the first requirement, the issued security must be an un-hedged equity interest in the mutual ADI. Under current legislation, mutual ADIs are technically allowed to issue 'investment shares' which meet this definition and can pay out a maximum of 50% of current year earnings to the holders of these securities however due to potential operational and agency issues actual issuance of these securities has not been common. As noted in a 2013 *ACFS Financial Regulation Discussion Paper*<sup>17</sup>, the issuance of interests in mutual ADIs that have a return that is a function of the earnings generated by the mutual ADI creates a new group of (non-voting) owners with a profit maximization objective at odds with the objectives of existing member-owners. These tensions are the subject of a framework set out in ASIC Regulatory Guide 147: *Mutuality – Financial institutions*.

A second option that has been suggested is changing legislation to allow for franking credits to be attached to the interest payments on eligible debt products issued by mutual ADIs.<sup>18</sup> Allowing mutual ADIs to release franking credits through securities that have payments that are not-contingent on underlying performance of the issuing organisation would resolve the potential agency and operational problems that are likely to result from mutual ADI issuance of the equity like products discussed above. However, to make these instruments viable a notable change would have to be made to current Australian income tax law. Under current Australian income tax law a security is classified as either a debt or equity interest, these classifications are mutually exclusive. This distinction plays a key role in determining whether a distribution is tax deductible by a company (debt) or frankable (equity) but never both<sup>19</sup>. A result of the Australian imputation system is that all forms of capital are on an even playing field from a tax perspective, ultimately they are taxed only at the marginal tax rate of the underlying investor.<sup>20</sup> Therefore, to make a frankable debt instrument attractive to the issuer (when compared with other forms of debt capital), the distributions from the security would have to be both frankable and deductible (F&D). There is a competitive neutrality argument that, should mutual ADIs be permitted to issue F&D securities, these would also be made available to all debt issuing organisations. The question then becomes, would organisations that can already release franking credits through dividend distributions prefer to issue F&D securities? The answer depends on at least two factors:

1. Whether an organisation is currently able to pay out all franking credits with retained earnings.
2. Whether the average marginal tax rate for investors in F&D securities is the same as the average marginal tax rate for investors in ordinary shares.

In regard to the first point above, to the extent that an organisation is able to pay out all franking credits, choosing to attach franking credits to F&D securities rather than to dividends on equity securities would, *ceteris paribus*, have no impact on the total value distributed. However, if an

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<sup>17</sup> Davis (2013)

<sup>18</sup> Pricewaterhouse Coopers (2011)

<sup>19</sup> The Commonwealth Bank of Australia did manage to create a deductible franking security by claiming tax deductibility in New Zealand and issuing franking credits in Australia.

<sup>20</sup> This is in contrast to the classical tax system used in most countries which provides a tax advantage to debt capital.

organisation does not generally pay out all franking credits, attaching left over credits to F&D securities would allow the organisation to pass on the value of the tax paid immediately to investors. The realisation of the value of this tax paid would otherwise be deferred. To explain the second point, if investors in F&D securities were on lower average marginal tax rates than investors in ordinary shares, a company could maximize value by paying out all franking credits to holders of F&D securities. This would reduce the immediate tax liability of ordinary shareholders who in this situation would be on higher marginal tax rates. At the same time, the tax benefit and possible rebate attached to the franking credit is immediately paid by the organisation to the F&D capital providers. *Ceteris paribus*, this would reduce the firm's average cost of capital and maximize shareholder value.

## 4.2 Alternative Tax Rates

Rather than devising an instrument that would allow mutual ADIs to distribute franking credits - which has unclear implications for the operations of mutual ADIs, equitable value creation for all members and in the case of F&D securities, unclear taxation outcomes - an alternative method for addressing the competitive distortion created by the imputation system is adjusting the tax rate applied to mutual ADIs. In Australia, there are already examples of applicable tax rates being contingent on organisational form (eg. trusts compared to corporations) and lower tax rates being applied to organisations that are seen to be achieving an important social objective (eg. superannuation funds). An argument can be made that due to their limited ability to distribute surplus assets or profits to members, mutual ADIs are not dissimilar to tax-exempt not-for-profit (NFP) organisations as described in the Henry Tax Review (2009).<sup>21</sup> One would assume that the exemption from corporate tax available to credit unions prior to 1993 was based on this principle. The counter-argument is that with the relaxation of the common bonds criterion applied by mutual ADIs, and the expansion in services offered, the argument could also be made that because mutual ADIs operate in essentially the same business they should be subject to the same tax rate as listed banks to ensure a level playing field. The international experience suggests that generally the first argument is given priority and mutual ADIs are exempt or subject to a reduced rate of corporate tax. However, even if precedence is given to the level playing field argument, a case can be made for a reduction in the tax rate for mutual ADIs due to the effect of the imputation system on the effective tax rate on the earnings of major banks.

A lower tax rate for mutual ADIs has a number of advantages over designing a product for releasing mutual ADI franking credits and *ceteris paribus*, would lead to an increase in the return on equity of mutual ADIs resulting in an increase in their natural rate of growth. Importantly, a reduced tax rate would not create the same agency or operational issues that would be likely to occur should a mutual ADI issue a new class of Tier 1 eligible capital at risk securities and because the tax rate reduction would apply directly to the earnings of the mutual ADI, it could benefit all members equally.

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<sup>21</sup> Commonwealth of Australia (2010)

## 5. Conclusion

The analysis in this report reveals that the inability of mutual ADIs to release franking credits has resulted in an uneven playing field. With mutual ADIs paying a higher average effective tax rate paid on earnings relative to the major Australian Banks. This distortion could have implications for the efficiency of the Australian financial system by influencing the flow of funds and pricing decisions of different financial institutions. The continued presence of mutual ADIs despite this distortion suggests that the mutual organizational form continues to play an important role in Australian financial services however growth constraints caused by an inability to raise Tier 1 capital without also introducing potential agency and operational issues would appear to be a barrier to mutual ADIs becoming a viable ‘fifth pillar’ in the Australian banking system.

Previous suggestions aimed at rectifying the competitive distortion caused by the inability of mutual ADIs to release franking credits have focused on instruments and products that would allow for the release of franking credits. What this report has shown is that devising a product that allows a mutual ADI to release franking credits raises a number of challenges.

An alternative suggestion made in this report to correct the competitive distortion caused by the inability of mutual ADIs to release franking credits is a reduction in the tax rate applied to mutual ADIs. The analysis in this paper suggests that the alternative tax rate approach would not be subject to the challenges in designing a product to release franking credits while allowing competitive neutrality from the perspective of total tax paid.

An alternative tax rate for different organisational structures is not without precedence in Australia and the argument could be made that a mutual ADI should not be subject to the same tax regime as corporations both due to their non-profit maximizing objectives and based on competitive neutrality due to their inability to release franking credits. Furthermore, the proposed reduction, *ceteris paribus*, would also result in an increase in the natural growth rate of mutual ADIs without having to issue ‘equity like’ capital in the institution.

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## Appendix 1: Average Tax Rate of Banks: Alternative Scenarios

**Estimated Average Tax Rate on Bank Earnings: Using the Shareholder Register approach to determine Superannuation holdings of Australian Major Bank Shares**

Investor Class	Estimated ownership	Tax Rate on Dividends
Superannuation Funds	43%	
Accumulation	32%	15%
Drawdown	11%	0%
International Investors	44%	30%
NFPs and Charities	2%	0%
Individual Australian Investors	11%	38.30%
<b>Estimated Average Tax Rate</b>		<b>22.15%</b>

**Estimated Average Tax Rate on Bank Earnings: Assuming top MRT for individual investors**

Investor Class	Estimated ownership	Tax Rate on Dividends
Superannuation Funds	36%	
Accumulation	27%	15%
Drawdown	9%	0%
International Investors	44%	30%
NFPs and Charities	2%	0%
Individual Australian Investors	18%	46.50%
<b>Estimated Average Tax Rate</b>		<b>25.53%</b>

**Estimated Average Tax Rate on Bank Earnings: Assuming average MRT for individual investors is 38.5%**

Investor Class	Estimated ownership	Tax Rate on Dividends
Superannuation Funds	36%	
Accumulation	27%	15%
Drawdown	9%	0%
International Investors	44%	30%
NFPs and Charities	2%	0%
Individual Australian Investors	18%	38.50%
<b>Estimated Average Tax Rate</b>		<b>24.81%</b>

## Appendix 2: Post-retirement market: Assets

Source: Super System Review: Final Report (2010)

	2014		2019		2024	
	\$M	%	\$M	%	\$M	%
Corporate Funds	6,514	1.4	3,012	0.3	1,239	0.1
Industry Funds	76,113	16.8	193,560	22	367,429	24.8
Public Sector Funds	49,950	11	74,382	8.5	113,304	7.7
Retail Funds	204,305	45	399,486	45.5	675,581	45.7
SMSFs	117,068	25.8	207,698	23.7	321,312	21.7
Total Post Retirement Market	453,950		878,139		1,478,864	
<b>% of all Super Assets</b>		<b>25%</b>		<b>31%</b>		<b>35%</b>

Source: Rice Warner, *Surviving Longevity*, March 2010.

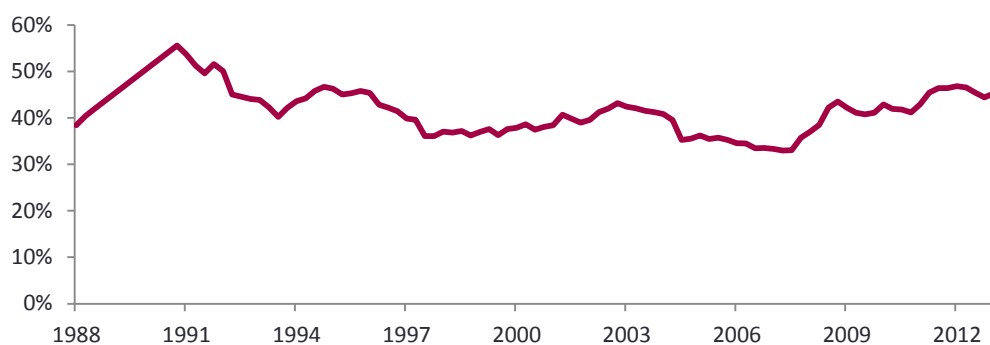
## Appendix 3: Proportion of Total Listed Equities held by International Investors

**Table 9 Proportion of Total Listed Equities held by International Investors (\$ million)**

	Jun-2012	Sep-2012	Dec-2012	Mar-2013	Jun-2013	Sep-2013
Rest of the World Equity Holdings	544,322	576,864	600,138	624,808	609,116	648,132
Total Listed Australian Equities	1,162,684	1,239,798	1,319,908	1,407,610	1,347,509	1,471,336
<b>Proportion</b>	<b>46.8%</b>	<b>46.5%</b>	<b>45.5%</b>	<b>44.4%</b>	<b>45.2%</b>	<b>44.1%</b>

Source: Derived from ABS CAT 5232: Financial Accounts Table 32

**Figure 2 Proportion of Total Listed Equities held by International Investors (1988-2013)**



Source: Derived from ABS CAT 5232: Financial Accounts Table 32

## Appendix 4: Australian Tax Rates and Tax Distribution

Taxable income	Marginal Tax Rate
\$0-\$18,200	0% or \$0
\$18,201 - \$37,000	19.0%
\$37,001 - \$80,000	34%*
\$80,001 - \$180,000	38.5%*
\$180,001 or more	46.5%*

\* Includes Medicare Levy

Source: Australian Taxation Office (2014), <http://www.ato.gov.au/Individuals/Income-and-deductions/How-much-income-tax-you-pay/Individual-income-tax-rates/>

Taxable income	Taxpayers		Net tax payable	
	No.	%	\$m	%
<\$6,000	2,227	0	0	0
\$6,001 - \$37,000	2,908,555	31	5,363	4
\$37,001 - \$80,000	4,598,771	49.1	45,637	34.4
\$80,001 - \$180,000	1,613,234	17.2	46,940	35.4
>180,001 or more	251,397	2.7	34,773	26.2
<b>Total</b>	<b>9,374,184</b>	<b>100</b>	<b>132,713</b>	<b>100</b>



## Appendix 5: Shareholder Register Estimate of Superannuation Bank Shareholdings

### Assumptions

Proportion of nominee and custodian holdings in which underlying investors are superannuation funds	<b>0.85</b>
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### ACFS Calculations

	Percent of total shares held by Nominees and Custodians (%)	Superannuation Holdings (%)
	As per 2013 Annual Report	
Commonwealth	43.96	37.37
Westpac	50.43	42.87
National Australia Bank	52.21	44.38
ANZ	56.17	47.74
	<b>Average superannuation holdings</b>	<b>43.09</b>



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