bankmecu
responsible banking™

Submission to the Financial System Inquiry

31 March 2014

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100% customer owned

Our key message

Banking in Australia in the future needs to be:

- transparent, to inform and protect customers
- diverse, to be innovative and resilient, to enable new business models, and to tackle social and economic issues beyond profitability
- sustainable, to have products and services that account for changing economies, markets, customer needs and technologies, as well as the importance of protecting natural capital.

Customer owned financial institutions already uphold these principles. And we look to the Australian Government to encourage the principles in practice across the whole banking sector.

Our recommendations at a glance

Our recommendations for transparent banking

1. That the inquiry support the five strategic priorities identified by the ASIC review of Australia's National Financial Literacy Strategy, and encourage the Australian Government to ensure the national curriculum addresses the need for students to be more financially literate.
2. That the inquiry recommend the Australian Government require all bank sub-brand advertising to reveal the owner bank, with the owner bank name and sub-brand shown with equal prominence.
3. That the inquiry recommend the Australian Government and its agencies bank only with authorised deposit taking institutions that produce an integrated corporate report and/or sustainability report.

Our recommendations for diverse banking

4. That the inquiry consider determining a growth target for non-major market share that would underpin a diverse and resilient banking market. At the least, the Australian Government should have a policy position on the fifth pillar banking sector.
5. That the inquiry recommend the Australian Government establish, as a priority, policy that encourages a diversity of banking institutions.
6. That the inquiry recommend the Australian Government commit to a policy position of competitive neutrality.

Continued

Our recommendations at a glance … continued

Our recommendations for sustainable banking

7. That the inquiry recommend the Australian Government give a 40 per cent tax concession on all interest earning products, in line with the Henry Review findings.
8. That the inquiry recommend a review of superannuation fund and bond regulations to encourage investment in bonds.
9. That the inquiry consider how to establish a more liquid and active domestic bond market. In particular, it should recommend the Australian Government establish policy that stimulates the bond markets, and consider the regulatory and disclosure barriers to that stimulation.
10. That the inquiry recommend the Australian Government require APRA, ASIC and the ATO to facilitate the development of a Common Equity Tier 1 non-voting capital instrument that pays a franked coupon, for issue by customer owned financial institutions.
11. That the inquiry recommend the Australian Government consider allowing customer owned financial institutions to offer a frankable and deductible debt deposit product.

About bankmecu

bankmecu is a new kind of bank in Australia—a customer owned bank. This means we put our customers first because they also own the bank.

What we do

We provide our customers with value for money, responsible banking, insurance and financial planning solutions, as well as superior service in a profitable and sustainable way.

Why we matter

We are different from investor owned banks because we are customer centric. So, we answer to a different philosophy, and we align our values with our stakeholders' expectations of sustainable economic wellbeing.

We genuinely seek to integrate a sustainable approach into everything that we do, from our organisational culture, to our operations and our innovative products and services. This approach means ensuring we meet our stakeholders' economic, social and environmental performance expectations. It also means we look to protect, sustain and enhance the financial, human and natural capital needed to develop **bankmecu** into the future.

Yet, we don't see responsible banking as a balancing act—we don't trade off financial discipline and profitability to achieve strong community and environmental outcomes. We run a lean and efficient business, and we have strong profits as a result.

But our decision making can take in a time horizon longer than a quarterly or half yearly profit reporting period. And, being customer owned, we can focus on delivering value without taking excessive risks or looking for ever-increasing returns for investor shareholders. In other words, we can create shared value, including profit, because we generate positive community and environmental outcomes rather than thinking of them as incidental.

What we envision …

We want to be the pre-eminent customer owned banking brand in Australia. We want to be considered a challenger brand representing thought leadership in responsible banking. So, we are always looking to articulate what we stand for.

This submission reflects our objective of advocating our values in a relevant way for a modern banking environment. In particular, it highlights our concern that global environmental and economic issues mean Australia needs a broader measure of 'progress' and prosperity than economic growth alone.

… and seeing it in action

For us, the key to enacting our vision is to unify our business strategy and our values.

An example is our Community Investment Program, whereby we use our profitability to create value for our community sector customers and the communities they serve. Under the program, we allocate up to 4 per cent of annual after tax profit to invest in community related initiatives. Over the years, this program has invested in science, education, social housing, community resilience and sustainability. It has also helped develop the financial and governance capabilities of many not-for-profit organisations serving our nation.

Read more about us in appendix A.

Note: **bankmecu** is a member of the Australian Bankers' Association and the Customer Owned Banking Association. We contributed to their respective inquiry submissions, and also that of the regional banks. All of these submissions are referenced here.

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Principles for banking in Australia

Post the financial crisis, the economic mood is cautious but keen for renewal. It is a good time to set the principles that underpin how the financial system moves forward in Australia: while the banking sector has weathered the global financial crisis robustly, and has contributed significantly to Australians' wealth, it needs to embrace innovation and opportunities. In this submission, we offer a values based premise to underpin how banks take on this challenge.

In summary, we consider the following three principles can strengthen banks' relationships with all their stakeholders (shareholders, customers, community and the environment) for both economic and social prosperity:

Principle 1. Banks need to be transparent.

Principle 2. The banking sector needs to be diverse.

Principle 3. The banking sector needs to be sustainable.

These principles can underpin public policy, regulatory frameworks and banks' own management. And they can inject Australia's financial system with greater competition, innovation, resilience and self-governance, but also a productive vision.

What we know about these principles in action

The three principles are already intrinsic to the operations of customer owned financial institutions around the world. And they are not exclusive of the profit motives of investor owned banking institutions.

They allow a triple bottom line approach. As noted by the Global Alliance for Banking on Values (GABV, p. 11), sustainable banks focus 'simultaneously on people, planet and prosperity … They don't just avoid doing harm, they actively use finance to do good'.

These principles work only if they are embedded in every level of a bank. In other words, principles are useless unless banks use them to define their cultures and put them to work in their planning, policy making, operations, incentive programs, performance reporting and self-evaluation. They have to be a priority consideration for a bank's every decision. They operate in tandem, not alone. They are three proponents of the one outcome: user focused, responsible, profitable and sustainable banking.

They are a self-regulating tool, because they promote the protection of consumers.

Do they help banks meet user needs? Yes!

A banking sector that is transparent, diverse and sustainable is necessarily an inclusive one. To uphold its principles, it has to engage with its users at both a local and macro level. It does so in three main ways.

First, it serves the real economy—the householders that spend and save, and the businesses that provide goods and services. And the closer a bank connects to its community, the better it can respond to that community's immediate economic needs and risks. In other words, the financial system has a role in serving the 'real economy' and not just the financial markets (GABV, p. 2).

Second, it can underpin broader economic stability and growth. All banks share the objective of contributing to the country's economic health via their lending, investing and advising. But their value assumptions will drive how they choose to generate their profit, and whether they use fiscal management approaches that are more or less risky to their stakeholders. So, while banks are 'a critical enabler of economic activity and growth', and 'the current system works well and … it is imperative that its strengths are preserved' (Australian Bankers' Association 2014, p. 11), consumers would benefit even more if transparency, diversity and sustainability propelled the success of these economic functions. In other words, Australia needs to do more than preserve the strengths and benefits of the current financial system: it needs to fine tune them in a way that better engages the system with its users and the future economy.

Third, it can help address social and environmental issues too. Australia faces many changes that already are affecting our economy: the ageing of the Australian population, the growing significance of the Asian region, the growing impact of digital technology, climate change impacts, and the increasing scarcity and cost of natural resources (Australian Bankers' Association 2014, p. 15). These influences require a response from Australia's government and financial sector, in terms of policy, regulation and business strategy.

As an example, banks can do more than maximise profit; they can help people solve problems by giving them access to finance. Financial inclusion is a worthy goal of a democratic and developed society, but many banks treat it as a low priority. To illustrate, consider the financial difficulty faced by people with a disability, and their carers. Disability presents individuals and families with enormous financial challenges, and yet the financial services sector offers them little support by way of education or truly accessible services and products.

Community finance, micro credit (emergency credit, for example), specialised mortgage products, social investments, specialist financial advice and planning—these are all potential strategies for broadening a bank's inclusion of all its customers. They can support the government's goals for the National Disability Insurance Scheme. And they can help address the bleak picture noted in the recent report *Financial inclusion*:

> *Around 4 million people in Australia live with disability, and nearly 5.5 million people aged 15 to 64 years are primary carers (Social Policy Research Centre 2005). The impact of these circumstances across a lifetime is stark—people with disability and their carers are among the poorest in our community … It is important to begin to understand and disseminate what people living in such circumstances know and*

need. While some aspects of financial inclusion, such as income support and, increasingly, workforce participation, are at least discussed, the un-level playing field in the financial services sector is not. The financial services sector needs to be informed by lived experience, to design services and products … which can open up opportunities from which people with disability and their families are currently excluded. (Drew 2013)

The inquiry may consider recommending the Australian Government fund research into the current state of financial inclusion, the possibilities for encouraging greater inclusion, and the outcomes of doing so. This example shows how the inquiry, while looking to improve regulatory structures and policy to help banks better fund the economy, may also look to improve banks' contribution to Australia's social and environmental future.

How we want to see the principles in action

Here we outline how the Australian Government and banks in Australia can practise the three principles by embedding them in the operations of the financial system.

Transparency in banking

Transparency is critical to banks. It helps protect consumers, and it drives an inclusive approach to governance. We consider improved transparency is required in three areas:

1. better educating and informing consumers
2. identifying banks' ownership of sub-brands
3. banks' reporting on their sustainability.

The education of consumers is already a government priority, as evidenced by the National Financial Literacy Strategy. In the 2013 ASIC review of that strategy, consultation revealed the following important messages:

- improving financial literacy is an ongoing process, and achieving positive behaviour change requires a multi-pronged approach
- consumers' financial decision making reflects cultural factors as well as structural ones
- the state of financial literacy in Australia links to broader frameworks for consumer protection, the regulation of financial markets, and social and financial inclusion
- Australians need help to prepare better for retirement and make sound financial decisions
- changes to the *Privacy Act 1988* and the introduction of the National Disability Insurance Scheme have implications for financial literacy
- financial literacy initiatives interact with many federal and state policies, including education, consumer affairs, financial services and social welfare (ASIC 2013, pp. 4–6).

We agree with these messages. And we consider the Australian compulsory superannuation scheme makes it particularly important that all Australians receive basic financial education to help them plan for retirement.

We thus support the five strategic priorities identified by the review for formulating the 2014–17 national financial literacy strategy (ASIC 2013, pp. 5–6):

1. Educate the next generation through the formal education system.
2. Increase the use of trustworthy sources of information, tools and resources.
3. Deliver quality targeted guidance and support.
4. Strengthen coordination and partnerships.
5. Improve research, measurement and evaluation.

An outcome of these priorities could be, for example, government funding for a focused cooperative research centre. This thinking is already underway at RMIT University, which is working to establish a Cooperative Research Centre focused on finding cross-sectorial and sustainable solutions to financial exclusion (RMIT University 2014, slide1).

Recommendation 1

That the inquiry support the five strategic priorities identified by the ASIC review of Australia's National Financial Literacy Strategy, and encourage the Australian Government to ensure the national curriculum addresses the need for students to be more financially literate.

The transparency of sub-brands is a concern of consumers. An Australian survey (Essential Research 2012) found around half of the respondents perceive the existence of smaller banks makes no or little difference to consumer choice. But the majority supported bank ownership disclosure. That is, consumers perceive limited competition in the banking sector, and they understand many smaller banks are not real options but merely sub-brands. Regardless, they want to know more about who owns the big and small banks—who is managing Australians' money?

In addition there is a gap in consumer education regarding the operation of the Government's $250,000 deposit guarantee through the Financial Claims Scheme (FCS) as it relates to ADIs with wholly-owned subsidiaries operating as sub-brands. The FCS guarantees deposits up to $250,000 per account holder, per ADI, which means that consumers with deposits adding up to more than $250,000 spread across sub-brands (For example, with Westpac and its St George, BankSA, RAMS and Bank of Melbourne brands) are not provided with the same level of depositor protection that would apply if their funds were deposited across different ADIs. Concern arises from the fact that there is no evidence of this being clearly disclosed to consumers by the relevant banks nor readily available or clearly stated on consumer or regulators' websites.

Recommendation 2

That the inquiry recommend the Australian Government require all bank sub-brand advertising to reveal the owner bank, with the owner bank name and sub-brand shown with equal prominence.

Banks' reporting on their sustainability should interest consumers and government, helping both make banking choices. What business leaders choose to measure and report reflects their corporate values, governance culture and strategic direction. So, integrated corporate reporting or sustainability reporting can signal how a bank prioritises the economic, social, environmental and governance aspects of its operations and the actions of its customers.

Globally, investors and communities are calling for greater corporate transparency, encouraging companies to measure and report a more holistic picture of how they create shareholder value—so-called integrated reporting, or IR. The IR approach recognises companies operate as a complex interdependence of economic, social, cultural and environmental inputs, performance and impacts. And that an emphasis on all outcomes, not just profit, actually reinforces business strategies.

Ultimately, IR is about improved and more complete communication that helps a bank forge stronger connections with its customers. At **bankmecu,** from our first sustainability report in 2004, we've worked each year to report more cohesively on the multiple dimensions of the business. In 2012 we produced our first integrated report (winner of two categories at the Australasian Reporting Awards), which required significantly shifting our thinking and breaking down internal silos. We think the Australian government should support this shift in all banks, encouraging the effort by banking with those authorised deposit taking institutions (ADIs) that produce an annual integrated corporate or sustainability report.

Recommendation 3

That the inquiry recommend the Australian Government and its agencies bank only with authorised deposit taking institutions that produce an integrated corporate report and/or sustainability report.

Diversity in banking

The case for a diverse banking sector is overwhelming. A report prepared for the Customer Owned Banking Association researched the downstream impacts of a highly concentrated banking sector on economic stability and consumer welfare:

> *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. … 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.* (Dave Grace & Associates 2014, pp. 1–2)

Similarly, a Centre for Financial and Management Studies (UK) report argued:

> *The case for diversity and plurality in the financial system is greater than the case for any particular model, and in the absence of a perfect model, the best option is to encourage diversity, which has generic advantages in terms of firstly enhanced competition (and hence consumer welfare) that derives through different business models, and secondly systemic stability where, for example, one of the factors that lay behind the 2007-08 credit crunch was that individual institutions had been diversifying and while this might be thought to reduce risk, it does not if all are diversifying in the same way, which instead makes the system as a whole become less diversified.* (Michie & Oughton 2013, pp. 8–9)

And it noted government acknowledgement of diversity's importance:

> *Recent research on financial stability and economic welfare has highlighted the role of 'diversity' in promoting stability and improving the competitiveness of the financial sector. This research has been influential in shaping policy; for example, in 2010 the UK Government specified the promotion of diversity in financial services as a policy objective.* (Michie & Oughton 2013, Abstract)

Yet, just as the report found the United Kingdom is 'no closer to creating the conditions of diversity that have been identified as constituting an important component of avoiding a repeat of the credit crunch' (Michie & Oughton 2013, Abstract), so too is meaningful diversity absent from Australia.

While a large number of ADIs and banking products are available in the Australian market, we have an oligopoly that holds approximately 80 per cent of banking assets and an 85 per cent share of the home loan market, and enjoys a significant funding advantage due to its 'too big to fail' status. The major banks dictate the market share available to the rest of the market; if they wished, they could exercise market power supported by their artificially low cost of funds to further squeeze small banks. This situation may be compounded by prudential regulators' concern that 'too much competition, too fast, could destabilise otherwise big, healthy banks', when in fact 'there is little data to support this perception' (OECD 2011, quoted in Dave Grace & Associates 2014, p. 8).

This perception issue is complex. Public policy is often called to balance stability and competition, yet the current focus on stability has led to a sectorial concentration that is risking banks' efficiency. In other words, the real trade-off from overemphasising stability is not so much the reduced competition as the knock-on effect on efficiency. The regional banks' submission (Pegasus 2014, p. 2) also noted this issue, and argued such problematic outcomes of reduced competition will grow unless smaller ADIs can present a better competitive constraint on the large banks:

> *The basic elements exist that signal competition problems: high market concentration, higher barriers to entry and large sunk costs, high profitability by institutions with the largest market share, high margins and high price-to-book ratios. … While there is no doubt as to the financial viability of the smaller ADIs, including the regional banks, the question is whether they can be sufficiently robust to represent a real competitive constraint on the largest banks. If they are not strengthened, then the competitive situation will decline further. Addressing costs is a key issue.* (Pegasus 2014, p. 69)

The call to address costs is part of multiple changes needed to produce a level playing field for the different tiers of banking. Government policy and regulation must value those different tiers, which enhance consumer benefits by offering different products and services, and contributing to a competitive market that is necessarily more efficient. So, alongside ensuring stability, the government must create a regulatory environment that encourages banks to be efficient, innovative and focused on their end users. Again, the regional banks' submission supported this approach (Pegasus 2014, pp. 2–4).

This change of mindset cannot occur unless the Australian Government makes it a priority (for example, guiding APRA to apply its mandate in a more balanced way) and does not mainly focus on stability. Without a re-direction of government policy, Australia depends almost entirely on the major banks for that stability (and at the expense of other desirable objectives for the financial system). Further, ironically, evidence suggests cooperative banks are more stable than commercial banks. The International Monetary Fund found:

> *… cooperative banks in advanced economies and emerging markets have higher z-scores than commercial banks and (to a smaller extent) savings banks, suggesting that cooperative banks are more stable. This finding, perhaps somewhat surprising at first, is due to the much lower volatility of the cooperative banks' returns, which more than offsets their relatively lower profitability and capitalization. We suggest that this observed lower variability of returns, and therefore the higher z-scores, may be caused by the fact that cooperative banks in normal times pass on most of their returns to customers, but are also able to recoup that surplus in weaker times.* (Heese & Čihák 2007, p. 18)

Research for the Customer Owned Banking Association had similar findings:

> *As has been shown through multiple academic papers, by the International Monetary Fund and actual experience from other countries during the global financial crisis, 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.* (Dave Grace & Associates 2014, p. 2)

Recommendation 4

That the inquiry consider determining a growth target for non-major market share that would underpin a diverse and resilient banking market. At the least, the Australian Government should have a policy position on the fifth pillar banking sector.

Importantly, we do not consider the market power that comes from scale is the real problem. Rather, the major banks' protected status creates competitive distortions in the market, and moral hazard (as discussed in the regional banks' submission to this inquiry: Pegasus Economics 2014, section 5).

The majors can access funding on preferential terms because funding providers (bond markets and wholesale funder) understand the Australian Government will not allow the banks' insolvency. Further, as noted above, the majors enjoy higher credit ratings because rating agencies give more weight to those banks' 'too big to fail' status. Further, advance modelling techniques—known as the Internal Ratings-Based (IRB) approach—used by larger banks allow them to hold lower levels of capital against risk weighted assets, relative to smaller and customer owned financial institutions hold.

We accept we have to compete, to run our own race, and in no way do we look to handicap the major banks. We do not suggest cutting off the normal competitive advantages that come with scale. Neither are we looking for regulatory exemptions that favour small banks. Rather, we seek competitive neutrality as far as possible. Such a position includes the government committing to make policy that encourages negative neutrality. As noted in research conducted for the Customer Owned Banking Association:

> *While some tension exists between stability and competition, it's not an either or choice. … In most countries, and Australia, mutual ADIs … are unlikely to grow fast enough to destabilise the banking sector should competitively neutral policies, similar to other G20 countries, come into effect. The intention is not to claim one governance model is superior (or inferior) over another, but rather to* ***enable space for multiple models so as to aid economic stability and consumer value*** *[our emphasis].* (Dave Grace & Associates 2014, p. 21)

Certainly, the customer owned model is a valuable, proven global banking option: it delivers competition, it offers choice to consumers, and it is market leading in servicing and satisfying customers. It thus deserves to be a priority consideration as this inquiry examines the effectiveness of the current regulatory regime. In particular, we agree with the Customer Owned Banking Association's call to achieve competitive neutrality by interrogating the implicit government guarantee to the big banks, the failure of the company tax and dividend imputation system to accommodate the customer owned banking model, and the prudential regulatory settings that artificially 'tilt the playing field in favour of the largest ADIs' (Customer Owned Banking Association 2014, pp. 5–6).

Recommendation 5

That the inquiry recommend the Australian Government establish, as a priority, policy that encourages a diversity of banking institutions.

Recommendation 6

That the inquiry recommend the Australian Government commit to a policy position of competitive neutrality.

In summary, the regional banks' (Pegasus 2014) and Customer Owned Banking Association's submissions to this inquiry canvas how to deal with the market consequences of the 'too big to fail' scenario. We support their endeavours to prioritise the issue, and we seek for the government (via APRA) to look beyond the current default position to acknowledge the value of diversity in banking.

Sustainability in banking

The Australia Institute summarised the outlook for Australia and globally:

> *As we begin the 21st century, new dilemmas confront our society and our planet. Unprecedented levels of consumption co-exist with extreme poverty. Through new technology we are more connected than we have ever been, yet civic engagement is declining. Environmental neglect continues despite heightened ecological awareness. A better balance is urgently needed.* (Richardson 2012, Introduction)

This is not a scenario that will allow banks to ignore how they ensure their longevity or how they contribute to the broader sustainability of Australia's population and environment. We thus talk here about sustainability in three senses: (1) the ability of banks, and smaller banks in particular, to access funding; (2) the ability of banking products and services to be useful and relevant in the long term by adjusting to changing economies, markets, customer needs and technologies, and (3) banks' attempts to offset the environmental impact of their operations and the actions of their customers.

In terms of banks' access of funding and the functionality of their products and services, we consider the following areas are problematic:

1. the taxation of deposits
2. the significant exposure of superannuation funds to equity investments
3. the small and relatively illiquid retail bond market and secondary market
4. access to Tier 1 capital, and the inability of customer owned financial institutions to equitably distribute franking credits

We discuss them in turn below.

1. Taxation of deposits

The Customer Owned Banking Association's submission to the inquiry explains this issue:

> *ADI deposits are the simplest and safest savings vehicles for Australian households but they are also the most heavily taxed. … 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".*

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… it would be appropriate for the FSI to consider 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". (Customer Owned Banking Association 2014, pp. 62–3)

We support this view, and also agree with the Customer Owned Banking Association (2014, p. 63) that the current tax treatment of deposits has a disproportionate effect on customer owned financial institutions (for which deposits comprise around 80 per cent of funding, and almost 100 per cent for **bankmecu**).

Recommendation 7

That the inquiry recommend the Australian Government give a 40 per cent tax concession on all interest earning products, in line with the Henry Review findings.

2. Superannuation funds

We support the Australian Bankers' Association's view that the superannuation funds are heavily weighted towards equity investments and can play a greater role in funding the economy. In particular:

The banking industry fully appreciates that the superannuation funds' priority is to provide retirement benefits to members. The industry supports providing investment opportunities that improve funding, consistent with this goal. Accordingly, a review of the market to determine if there are changes to both superannuation funds and the types of bonds on offer that would result in superannuation funds holding more bonds may be of great benefit. The potential benefits from creating investment opportunities for superannuation funds in terms of facilitating growth for Australia is worthy of the Inquiry's full attention. (Australian Bankers' Association 2014, p. 65)

Recommendation 8

That the inquiry recommend a review of superannuation fund and bond regulations to encourage investment in bonds.

3. Small, relatively illiquid retail bond market

The two main barriers to the retail bond market for customer owned financial institutions are (1) our issues (either individually or collectively) may be too small to be cost effective and (2) we are not rated highly enough. It is also for these reasons that customer owned financial institutions cannot feasibly access international debt markets at reasonable cost. We consider the Australian Government can play a positive role in developing and growing the domestic bond market, and should make this growth a policy priority.

An efficient and liquid domestic bond market will assist all Australian banks. In particular, it will provide an alternative source of funding for customer owned financial institutions that rely heavily on retail deposits. To start, the government could consider regulatory and disclosure barriers. Treasury began this work in 2011, with its draft paper *Development of the retail bond market: streamlining liability and disclosure requirements.* The Australian Bankers' Association (2014, pp. 60-61) agrees this work should continue.

Recommendation 9

That the inquiry consider how to establish a more liquid and active domestic bond market. In particular, it should recommend the Australian Government establish policy that stimulates the bond markets, and consider the regulatory and disclosure barriers to that stimulation.

4. Access to common equity Tier 1 (CET1) capital and franking credits

Customer owned financial institutions cannot raise extra capital by issuing market value shares. The ownership of **bankmecu**, for example, consists of $5 shares, which are treated for regulatory and accounting purposes as a debt rather than an equity instrument and with each customer able to hold only one share. This structure, like similar structures in other customer owned financial institutions, means we rely almost exclusively on retained profits to provide Tier 1 capital support for growth in the lending book.

Further, customer owned financial institutions are unlikely to pay dividends, because each customer can only hold one share, and a dividend payment would not recognise customers contribute differently to the financial strength of the bank. So, they do not use this most common method of accessing franking credits.

One possible solution to both these issues is to develop Tier 1 capital instruments that do not carry voting rights and that pay a franked coupon. Other financial institutions in Australia have used similar hybrid instruments. The development of such an instrument for customer owned financial institutions would require the coordination and cooperation of APRA, ASIC and the ATO. But the effort is warranted, because this type of capital instrument is crucial to the growth of the customer owned banking sector. We support COBA's argument that:

> *It is essential that listed ADIs and customer owned ADIs receive equivalent treatment under 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.* (COBA 2014, P. 47)

Without it, the sector will not be able to compete with listed entities. We urge the inquiry to consider the development of mutual financial institutions in Europe, where this sector represents up to 60 per cent of the retail bank market and provides strong and stable competition to listed entities. The growth of many of these mutual financial institutions is facilitated by their access to Tier 1 capital instruments outside member share capital.

The fact that customer owned financial institutions in Australia cannot distribute franking credits in the same way as listed ADIs do to external shareholders also undermines competitive neutrality in the market. The Customer Owned Banking Association articulates a potential policy response as 'the introduction of a frankable debt deposit product, given that this will provide a solution around both existing and prospective franking credit" (COBA 2014, p. 40) Such a product would also be useful in rebalancing competitive neutrality and also helping address the sector's reliance on retail deposits as its main source of funding.

The Australian Centre for Financial Studies noted most solutions to the uneven playing field focus on an instrument by which mutual ADIs can release franking credits to member owners, and explained:

… 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. (Australian Centre for Financial Studies 2014, p. 3)

Recommendation 10

That the inquiry recommend the Australian Government require APRA, ASIC and the ATO to facilitate the development of a Common Equity Tier 1 non-voting capital instrument that pays a franked coupon, for issue by customer owned financial institutions.

Recommendation 11

That the inquiry recommend the Australian Government consider allowing customer owned financial institutions to offer a frankable and deductible debt deposit product.

In terms of environmental sustainability, we have led the way in Australia in developing financial products with inbuilt sustainability incentives. Examples are our goGreen® home and car loans, which offer better rates for more sustainably designed homes and environmentally efficient and safe motor vehicles. Another example is our Conservation Landbank (see the following case study).

We would support government policy that encourages such direct action sustainability initiatives by all banks.

Case study: bankmecu's Conservation Landbank

In 2008 **bankmecu** purchased the first of five properties in the West Wimmera region of Victoria to create our Conservation Landbank—a world first for a financial institution. By buying and re-vegetating non-productive farm land, we offset the greenhouse gas emissions generated by the bank's operations and the cars that we finance.

This project also allows us to offset the loss of biodiversity resulting from new homes that we finance. If, for example, a customer purchases a block of land at 650 square metres, we allocate the equivalent amount of land for protection and/or re-vegetation in the Landbank.

By signing a conservation covenant over these properties, we have created an environmental asset that will be protected in perpetuity, and owned by our customers.

Appendix A: More about bankmecu

Our heritage can be traced back to the mid 1800s in Europe when the first people's banks were established by bringing people together to pool their money for the benefit of all. Today, hundreds of millions of people around the world bank with customer owned financial institutions.

We are Australia's strongest customer owned bank. That success has grown from a conservative and more responsible approach to banking, and from our customers' strong support. We listen to our customers, and their attitudes and values help guide how we decide to invest their money in the community, environment and more responsible banking products and services.

We offer our customers:

- exemplary personal service
- better interest rates and lower fees. Since 2003, our customers have been collectively better off banking with us than with the major four banks (Cannex report 2003–12).
- a more responsible approach to banking. People want to bank with someone they can trust with their money and trust to act ethically.
- banking products and services that help our customers achieve their financial goals while taking steps to live more sustainably.

In 2010 *Ethical Investor* recognised us as Australia's most sustainable small company of the year.

We live our values

- We treat our customers with dignity and respect.
- We value, encourage and support our employees.
- We operate ethically and with integrity.
- We apply prudent financial and business practices.
- We are economically, environmentally and socially responsible.

We also uphold the cooperative principles of mutuality

bankmecu proudly supports the following principles of mutuality, shared by all financial cooperatives around the world:

- open and voluntary accounts
- democratic control
- non-discrimination
- service to customers
- building of financial stability
- ongoing education
- cooperation among cooperatives
- social responsibility.

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