Submission to the 2014 Murray Financial System Inquiry

March 2014

cua®

ABN 44 087 650 959 AFSL and Australian credit licence 238317

Contents

Executive Summary

CUA strongly supports this Inquiry into the financial system and would welcome the opportunity to elaborate on aspects of this submission directly to the Inquiry's members.

CUA is Australia's largest customer-owned financial institution with over 400,000 customers, a branch network across most states and more than $10 billion in consolidated assets.

CUA is proud of its credit union credentials and believes that it, and other members of the customer-owned sector (mutuals), offers Australian consumers a viable and competitive alternative to the publicly listed banking model.

CUA has been undertaking a transformational investment in systems, technology, products and people in order to sharpen its competitive offering. Coupled with others in the mutual sector, this combined investment has the potential to be a dramatic force for competition in financial services for the benefit of the consumer and the economy at large. For this to be achieved attention will be required to a range of issues largely falling under the ambit of competitive neutrality.

CUA considers the major failings in competitive neutrality to be in the areas of:

1. Capital and funding disadvantages
2. Regulatory impositions
3. Amendment to the Banking Act
4. Multi-branding
5. Use of franking credits
6. Government Deposit Guarantee levy

CUA raises these issues not as special assistance to a marginal sector but rather as justifiable and necessary actions to level an increasingly skewed playing field for the benefit of a potentially competitive mutual sector. Consumers will be net winners from these.

Introduction

CUA is pleased to make this submission to the Government's Financial System Inquiry (FSI). This represents a once in a generation opportunity to examine the sector and adjust settings in order to bring greater efficiency for the benefit of consumers at large and the overall national interest. Although the FSI's terms of reference are broad ranging CUA is restricting its comments to aspects of competition in line with its charter and the focus of its activities. In this regard, CUA is taking the opportunity to present its 'competition credentials' to the FSI in order to demonstrate the validity of the customer owned sector's claims to provide a significant alternative to the listed banks. Given the customer-owned sector's large (100) membership and diversity of size it is inevitable that there will be different views on the competitive landscape. However, it is important that such different assessments not be interpreted as fundamental disagreements within the sector. The sector is as one in the belief that the major banks have been accorded special treatment by successive governments and the regulators and that this has worked to the detriment of the mutual sector.

CUA will not be seeking to convince the Inquiry that the financial services sector is lacking competition. In comparison to some other sectors such as grocery, retail and the home-ware sectors, the financial services sector is, on the face of it, relatively well serviced through a combination of the Big 4 banks, tier two banks, the customer owned sector and the non-banks. However, it is the quality of competition (i.e. the drive for innovation and pricing pressure) that is the issue from CUA's point of view, rather than the totality of competition. In this regard, CUA does view the dominance of the Big 4 as unhealthy for the financial services sector (almost 90% of mortgages are held by the Big 4) and believes the Government should seek to ensure that competitive neutrality principles apply in the sector. We consciously use this term as the Government's Competitive Neutrality principles have been instrumental in ensuring even competition between public and privately owned businesses. This seems to be a valid analogy in terms of the Big 4 versus the customer-owned sector.

CUA is not pleading that a special case exists for the mutual industry or that the major banks should be hobbled, but rather that it is in the national interest, and specifically the consumers' interest, for the financial services sector to be a level playing field. The customer-owned sector has a track record of innovation and competitiveness and the sector's natural process of amalgamation has the potential to throw up exciting alternatives to the major banks. CUA is happy to stand on its own two feet but to realise its, and the mutual sector's, potential will require attention to the competitive landscape by the Government and the industry regulators.

CUA in Context

General

CUA is Australia's largest customer-owned financial institution, providing an extensive range of everyday banking products and services to customers across the country. CUA has a long and proud history providing banking and financial services to Australians, growing out of several small Queensland based credit unions in the 1940s with just 180 members. Since then, through the amalgamation of more than 160 credit unions, we have become Australia's largest customer-owned financial institution, with more than 400,000 customers and more than $10 billion in consolidated assets.

We are 100 per cent owned by our customers, so all profits are reinvested to deliver more capital for growth, more competitive products, better interest rates and lower fees, rather than being paid out as dividends to shareholders. This fundamentally puts the customer front of centre for CUA. CUA's customer proposition revolves around competitive pricing, products, service and a sense of community (i.e. a sense of ownership, of alignment of values, and of achievement). CUA consistently invests significant funds in order to make a positive contribution to the community. These funds assist a range of worthwhile charities and community partnerships. Recently a three year partnership with SIDS and Kids was announced, bringing CUA's financial resources and its enthusiastic staff to the assistance of this vital cause.

We have a significant presence through branches across Queensland, New South Wales, Australian Capital Territory, Victoria and Western Australia. Our customers have direct-charge free access to over 3,000 ATMs across the country through the rediATM network – one of the largest in Australia.

A snapshot of CUA as at 31 December 2013 (NB. 1H FY14 results referenced are unaudited)	
Number of customers	Over 400,000
Staff numbers	Approx. 1,000
National branch Network	60 branches across QLD, NSW, ACT, VIC & WA
Contact centre (Australia)	CUA Direct in 2 locations
Australia-wide ATM Network (Via Cuscal)	Direct-charge free access to 3,849 ATMs
Consolidated Assets	$10.2 billion
Retail deposits	$6.8 billion
Reportable NPAT	$27.9 million
Capital adequacy	14.8%

Innovative and Entrepreneurial

CUA's long-standing strategy has been, and remains, to develop as a legitimate alternative to the listed banks. This ambition accords strongly with our credit union status where we are owned by our customers/members and exist to provide a genuine banking alternative where customers really matter. We proactively promote greater competition in the market to ensure customers get the best deal possible.

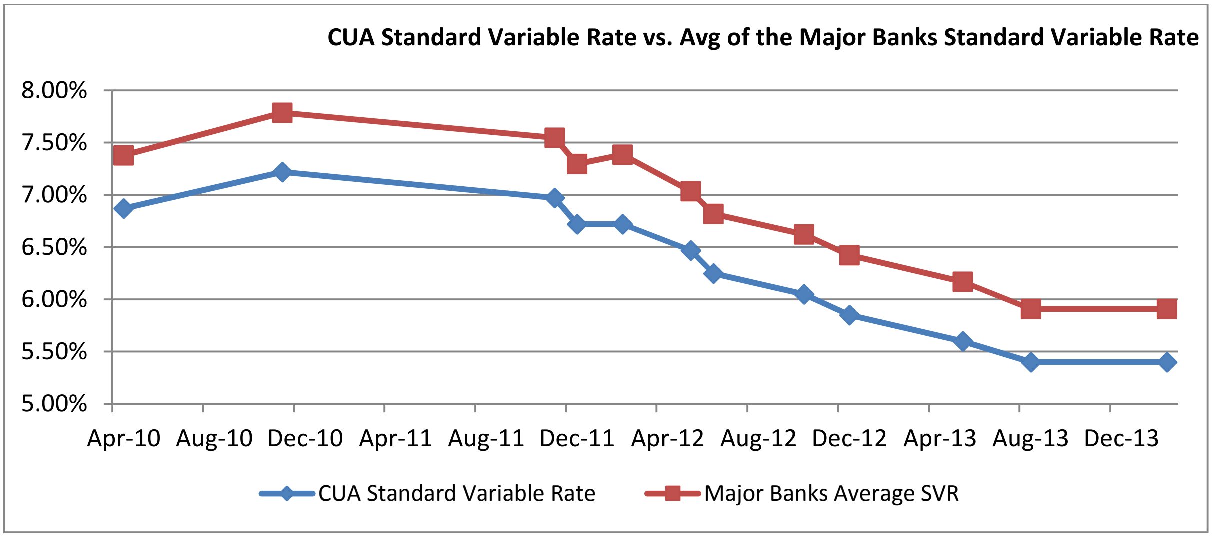
An integral part of CUA's strategy has been to invest heavily in those areas vital to securing a competitive edge – IT systems, technological and product innovation, customer service, and people. We believe our investment has been sector leading and has provided CUA with the results to justify our ambitions. At the same time we have continued to invest heavily in the communities which support CUA.

CUA's competitive claims can be substantiated both through the acknowledgement of our peers and by our results. For example, the award-winning CUA Rate Breaker Home Loan Package (AB+F Innovative Mortgage Product of the Year 2013; CANSTAR 5-star rating; Australian Lending Awards 2014 Best Mutual Lender and Best Innovator),which offers a rate 100 basis points below the average rate of the Big Four. This follows CUA's Term Deposits which were awarded CANSTAR Best Value Term Deposits for Credit Unions in 2012 and 2013. CUA is also a finalist in the 'Legacy and ecosystem transformation' category at the international Celent Model Bank Awards 2014.

The availability of market leading and innovative products has contributed to continually stronger results for CUA over recent years. Over FY 2013, the total number of loans settled by CUA increased by a record $332.6million to $1.86billion, up 21% on the previous corresponding period. Over FY2013, we also had a record year for housing issues which saw us outperform the system and grow ahead of the market. This is despite operating in a market which had been experiencing the lowest housing growth in 36 years. This momentum has been continued into FY2014 and we confidently expect another record year for home loans.

In addition to this, CUA's Standard Variable Home Loan has consistently maintained a price differential of more than half a per cent (0.5%) lower than the average of the Big 4 banks' equivalent SVHL products for more than three years.

cua



In April 2013 CUA engaged CANSTAR to undertake a broader product comparison of the pricing of our product portfolio against the major institutions in Australia. The institutions included in the comparison were broken into two categories: Majors: ANZ; Commonwealth Bank; NAB and Westpac, and 2nd Tier: Bank of Melbourne; BOQ; Bankwest; Bendigo Adelaide Bank; St George Bank and Suncorp Bank. The purpose of this Historical Price Comparison was to identify areas where CUA has provided a better return for their customers and prospective customers.

CANSTAR undertook an evaluation of the relative differences between the interest rates on offer by CUA against the rates offered by competitors. This was conducted over a two-year period beginning March 2011. The key findings from this research support CUA's positioning as a competitive alternative to the Big 4 banks:

- CUA's car and personal loan interest rates have been lower than the major banks since March 2011.
- CUA is currently providing the highest rates against all of the terms and deposit amounts considered. In addition, this positioning has been held for up to 26 months (6-month term deposits).
- CUA's Standard Variable Rate (SVR) has been lower than the major and 2nd tier institutions since March 2011.
- CUA's 3-year fixed interest rate has been lower than the major institutions since September 2011.
- CUA's Rate Breaker Home Loan has had a lower interest rate than its competitors since July 2012 on loans below $500,000

To further develop our business and to widen and attract a younger demographic to our customer base, CUA strategically created the Youth eSaver online savings account for 10-17 year olds. This recent product offering filled a hole in our product suite and a niche in the industry as a whole, with a number of key features that are not currently offered by competitors. This online savings account has been effective in attracting and securing a younger customer base to CUA.

Other initiatives have included:

- Made a significant investment in implementing a new core banking system which gives us greater flexibility, scalability and efficiencies, supports our strategy for growth and support us and our customers into the future.
- The establishment of a dedicated Innovation function to embed innovation as part of CUA's culture.
- A significant investment in new style branches in order to improve the customer experience. While branches have become less important in terms of overall transaction numbers they are still important for high value transactions and personalised customer service.
- A re-engagement with the broking community through a dedicated broker function.
- CUA's social media platforms have increasingly become an interactive and responsive customer engagement channel, with a dedicated team. CUA is rated 6th among global credit unions for social media presence and in late 2013 was 71st overall for all global banks and credit unions.

Competition Issues

CUA believes there have been fundamental changes within the Australian banking system over the period since the GFC stemming both from structural changes within the industry facilitated by an accommodative competition regulator, and a regulatory system which has consistently favoured the larger banks at the expense of smaller competitors including the customer owned sector. Many commentators have pointed out that post GFC there has been a competition price paid for greater financial system stability. CUA believes the time is now right to rectify this situation. A first step in this process would be for the Government to make a commitment to examine issues which have been identified by CUA and others in the sector as anti-competitive. In this regard, CUA offers the following examples of areas where an adjustment to the playing field is justified.

Capital and Funding

Capital building and the cost of funding issues are important for any financial institution. CUA retains a high quality book with over 95% of assets being secured against residential property and has also maintained an exemplary credit performance in comparison to the listed ADIs. CUA does not foresee any issues in meeting the core regulatory ratios required within Basel III. CUA's capital is currently at a healthy level (14.8% capital adequacy ratio) in line with CUA's prudential approach to risk taking and capital levels. In addition, the conservative capital management plan employed by CUA ensures that CUA operates within a prescribed level above the minimum regulatory requirement.

Due to this prudent approach the additional Basel III capital buffers as applied by APRA will, at some point, necessarily lead CUA to increase capital levels in order to retain the present capital cushion. As a mutual CUA already makes a 100% profit allocation to capital and would need to be able to issue capital compliant instruments in order to quickly increase capital holdings. Discussions with APRA on this issue have been held over several years. It now appears APRA is on the verge of authorising customer-owned ADI issuance of Basel III compliant Additional Tier 1 (AT1) and Tier 2 (T2) instruments. While this outcome is pleasing CUA notes that it will still be unable to issue a capital instrument that qualifies as Common Equity Tier 1 (CET1) in the ordinary course of business rather than only in a conversion scenario such as non-viability. This is not the case for listed ADIs which can quite quickly raise capital through the issuing of compliant capital instruments. CUA believes APRA should quickly conclude its deliberations on an appropriate CET1 instrument for mutuals.

A further capital issue CUA considers discriminatory to the customer-owned sector is the risk weighting of assets for regulatory capital. The Standardised approach used by mutuals against the Internal ratings based approach used by the major banks can result in a risk weighting differential of 35% versus 16%. It is difficult to understand the rationale behind this disadvantage as the mutual sector has a strong track record of prudent lending. We would point out here that the mutual sector was blameless in terms of the risk taking which directly contributed to the excesses which fed the GFC.

Like other large customer-owned ADIs CUA has sought a market rating in order to improve access to sources of wholesale funding. In this regard, many commentators including the IMF have concluded that the Big 4 banks receive an unfair funding advantage that flows from rating agencies and investors factoring in an implicit Government guarantee i.e. 'Too Big to Fail'. APRA has formally identified the Big 4 as systemically important banks under the Basel III reforms and has imposed an additional 1% Higher Loss Absorbency (HLA) capital requirement. Other countries have imposed a higher HLA requirement (Switzerland and Sweden at 5% and in the EU, US and Singapore it is 2%). We do not seek to have the Government impose a levy on the Big 4 banks to address this funding advantage but believe that APRA should be asked to look again at the adequacy of the HLA of 1% from the point of view of competitive neutrality.

Regulation

CUA accepts that a heavy regulatory and compliance burden is the price Australia pays for a world class financial services system. As the largest mutual CUA is well placed to meet the considerable costs involved with regulation but is conscious that aspects of the burden fall more heavily on smaller players in the customer-owned sector. An example of this is the imposition of a levy system by APRA on ADIs which results in the customer-owned sector paying a levy effectively five times the rate of the big banks on a per-asset basis. The rationale for this appears to be that as all ADIs are subject to the same regulatory burden the financial burden should be structured similarly. This effectively ignores the reality of a vibrant mutual sector comprising some 100 ADIs varying in size from small regional credit unions to large nationally structured mutual banks, credit unions and building societies.

Levy payments to APRA should reflect the resources impact of each institution on APRA. This should result in the elimination of the payments cap presently placed by APRA on contributions from the Big 4.

Amendment of the Banking Act

Under Government and APRA policy the option of changing status to a bank has always been available to CUA. However, CUA has chosen not to officially operate as a 'bank'. CUA is a credit union and proud of this. CUA clearly meets all the attributes, prudential regulation and provides all the products of a bank so our simple proposition is to be able to call ourselves a provider of 'banking' services while retaining our Credit Union branding. Under an APRA 2013 policy discussion paper this does not appear possible going forward. If APRA confirms this advice, as appears likely, CUA is expecting to be unable to use 'banking' in our registered corporate name or internet domain name and possibly also as part of our branding.

CUA believes our Credit Union branding is important in conveying an alternative model to consumers. It is a point of differentiation which our research has shown to be important but it needs to backed-up with the ability to clearly articulate that to all intents mutuals operate and are regulated as 'banks'.

This issue has a real potential to fundamentally split the customer-owned sector. Mutuals forced to opt for 'bank' branding (even 'mutual bank') will possibly be seen by consumers as a 'safer bet' than other mutuals, growing the disparity which exists under current APRA guidelines. That the two largest credit unions have opted not to rebrand as banks shows that this is a significant issue for the sector.

To be clear, CUA wishes an amendment to the Banking Act to change the classification of Authorised Deposit Taking Institutions (ADI) to Authorised Banking Institutions (ABI).

Greater market transparency: multi-branding

Competition is a good thing for consumers. This truism underpins our economic model. Problems occur, however, where competition is diminished or illusory. CUA believes that all of these problems exist today in the Australian financial services market and that the consumer is poorer as a result.

Australia has the most concentrated banking sector in the world (verified by the IMF November 2012 IMF Country Report 12/308). Our Big 4 banks hold 80% of banking assets and 88% of residential mortgages. While these percentages vary from month to month, the general trend since the GFC has been an increase in the level of concentration. This growth was supercharged by the acquisition of smaller banks and some of the non-bank sector and the ability of our majors to see off any challenge from overseas banks.

Even a casual observer will also be aware that these same four banks are increasing their profitability. This is the result of an oligopolistic dominance, a 'too big to be allowed to fail' perception from government, and a funding cost advantage allowing a larger net interest margin than smaller competitors.

CUA believes this issue should be a concern for the Government and for consumers. A sectoral dominance such as the Big 4 banks enjoy is good for shareholders of those institutions and for regulators which favour the stability it brings, but not good for the economy as a whole, not good for competitors and ultimately not good for individual consumers.

Recent research conducted for the customer-owned sector confirms that a high percentage of Australians are unaware (over 80%) that the Big 4 own some other mainstream home loan lenders. And this is the nub of the issue around the strategy of certain banks to engage in multi-branding.

CUA has expressed concerns to our regulators that when Westpac advertises for Bank of Melbourne and BankSA it conveys a misleading impression to consumers by making Westpac's ultimate ownership of both brands obscure. Consumers should not have to bring forensic skills to the task of finding true alternatives to the Big 4 banks. Ultimate ownership should be reasonably apparent in advertising for example, not hidden in the finest of fine print. Unfortunately, Westpac represents only one of a number of examples of institutions in the banking sector using similar lack of disclosure.

There is also a practical aspect to CUA's concerns around a misleading perception of independence. Consumers seeking to place deposits may not be aware that the government guarantee only applies to the licensed entity i.e. that they have a government guarantee of $250,000 for the aggregate of their holdings with the Bank of Melbourne, Bank SA Westpac and St George (for example), not $250,000 with each. Would this not seem pertinent for the selection of where to place further investments?

The ACCC has not seen the issue as relevant to its responsibilities. ASIC responds that there is no legislative basis for it to force divulgence on the banks and that it is difficult to interpret the advertising as misleading or deceptive. The only option available to mutuals is to press the Government to institute a positive disclosure requirement. This would be a case where more regulation would be a good thing.

Franking Credits

Mutual ADIs pay company tax just like listed banks but because of their structure do not have the same capacity to distribute franking credits. Listed banks distribute franking credits to shareholders via dividends. Mutuals provide benefits to their shareholders (i.e. their customers) in the form of pricing and service with profits added to reserves in order to boost their ability to grow the business. Customer-owned ADIs should be able to pass on to their owners the benefits of having paid company tax, just as non-mutual companies can choose to do. Not to allow this means members of mutuals are indirectly double taxed.

Mutual ADIs have been exploring with Treasury ways to unlock franking credits for the benefit of their members, including options to attach franking credits to deposit, or deposit-like, products. These discussions have been protracted with no sign of a positive outcome for mutuals.

Introduction of a mechanism to allow mutual ADIs to release franking credits would strengthen the attraction of the mutual model by delivering a significant new tangible benefit to membership – one that members have effectively already paid for through the corporate taxation of each mutual's profit. One suggestion worth exploring has been developed by the Australian Centre for Financial Studies. This involves the option of allowing mutuals to pay their fees, if any, for the Financial Claims Scheme (see below) by way of cancellation of franking credits. This represents a low-cost (revenue forgone) option for the Government. A further option, linked to the funding issue explored earlier, would be to allow mutuals to issue bonds with franking credits attached.

Government Deposit Guarantee (Financial Claims Scheme)

The FCS came about as an appropriate government response to the GFC and has been kept as a permanent feature of the financial services landscape, albeit at a reduced level of $250,000. The guarantee applies to all ADIs regardless of their size, credit rating or structure. It has been useful for the customer-owned sector as a way of addressing the perception, resulting as a hangover from the GFC, that the major banks are somehow more secure. This is despite CUA (and the rest of the customer-owned sector) being profitable, appropriately capitalised and liquid, and with the same level of regulation by APRA and ASIC as the major banks.

The previous Government introduced a levy on ADIs which is to be used to assist meeting costs of an ADI failure. The levy will start on 1 January 2016 and will be set at 0.05% on deposits. CUA sees little need for a pre-financed fund in order to avoid a budget hit arising from a banking failure in Australia. This is a remote possibility in the customer-owned sector as mutuals have shown an ability to consolidate in order to avoid just such a scenario.

CUA's Recommendations

CUA wishes to make the following ranked recommendations to the Financial System Inquiry:

1. That the Government reinforces its support for the customer-owned sector by undertaking to examine anti-competitive issues which impinge on the sector.

2. APRA fast tracks its examination and introduction of a suitable Common Equity Tier 1 capital instrument for mutuals.

3. That the Government maintain the existing Deposit Guarantee at the level of $250,000 and that the proposed levy on deposits be abandoned or offset against franking credits.

4. Reclassify ADIs to ABIs to remove the distinction between 'banks' and 'non-banks' to enable mutuals to communicate and raise consumer awareness of their core function – banking.

5. That the Government introduce a positive disclosure requirement on all ADIs to the effect that ultimate ownership of all sub-brands is readily apparent to consumers.

6. That the Government complete the assessment of how the customer-owned sector can utilise franking credits.

7. APRA looks at standardising or reducing the scale of the risk weighting of assets for regulatory capital to eliminate or reduce the disadvantage to the mutual sector.

8. Noting moves in other jurisdictions and their financial system risk, APRA to re-examine the Higher Loss Absorbency capital requirement on the major banks with a view to increasing the current 1% capital requirement.

9. APRA to examine the levy system on ADIs with a view to ensuring levies more fully reflect net assets.