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Messers David Murray, Kevin Davis, Craig Dunn,
Carolyn Hewson, Brian McNamee
Committee of Members,
Financial Sector Inquiry,
The Treasury,
Langton Crescent, PARKES, ACT 2000

12th April 2014

Dear Sirs/Madam,

Financial Sector Inquiry

I congratulate you on your appointment by the government to conduct an inquiry into the financial system with the ultimate objective of recommending a competitive, efficient, flexible and fair policy that would contribute to growth and productivity in the economy.
I practise as a Chartered Accountant and act as an internal as well as external auditor to several corporations. My particular concern is in relation to a credit union, an approved deposit institution (ADI) for whom I act as internal auditor.

My understanding is that the primary goal of this Inquiry is to examine " how the financial system could be positioned to best meet Australia's evolving need and support Australia's economic growth" Hence, the task is to develop recommendations that foster a system that is competitive, efficient, flexible, stable and fair. Ian Harper, during the Wallis Inquiry of 1996 made a comment, "for the Inquiry to have a meaningful outcome, it must tap into the issues that households feel strongly about.

Since the GFC in 2008, there has always been recommendations on alternative ways of savings which has resulted in substantial investments being deposited with ADIs. Deposits have increased substantially from about 40% prior to the GFC to about 60% at present. However, there has been little or no recommendations on changes to rules for lending for smaller ADIs, such as the credit union I currently audit. This increase in deposits has resulted in a build up of liquidity which does very little to assist in the growth of the ADI. I understand from press readings that even Mr Murray has acknowledged that "efficiency should be the focus". If so, this can only be achieved by cutting the excessive regulatory burden which is crippling Australia in financial sectors of business.

Smaller ADIs are required to hold a larger amount of capital against their home loan mortgages as opposed to the big 4 Banks. Big banks enjoy lower levels of capital requirement on the premise that they have superior control systems or they are 'too big to fail'. There is also this implied guarantee that they will be bailed out by the government in the event of a disaster. This is grossly unfair to the small credit unions who are required to compete to provide interest rates similar to the banks for their members. Despite this disadvantage of unfair competition, they have managed to support the mums and dads in their everyday life who seek funds to buy their home or to fund their retirement by taking reverse mortgages (as the current pension is insufficient to support themselves).

The problem is that the substantial liquidity these small ADIs are required to hold to comply with the unusually large capital adequacy requirements under the Standardised Approach established by APRA, as opposed to the so called Advanced Approach afforded to the big banks, is archaic in thinking. The big banks, despite the fact that they may argue that they have better controls, actually carry bigger risks compared to these small credit unions as they have commercial loans, foreign transactions, syndicated financing, etc.whereas a smaller ADI only has loans associated with residential homes. To require them to comply with this unfounded perception that they carry high risks and hence, restrict them on lending by imposing higher capital requirement to be held

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is not only unfair but has a crippling effect toward the objective of trying to promote growth and productivity. Let me provide an example of a situation with a small ADI that I currently review.

Assets		*Risk weights per APRA*	*Risk*
Weighted			
Loans	$35mil	Reverse Mortgages 50%, Home Mortgages 35% Personal Loans 100% (usually small up to $15,000)	$15.5mil
Liquids	$38mil	Risk weighted 20% to 50% based on claim periods	$18.0mil
Total	**$73mil**		**$33.5mil**

Capital	**$5mil**
Capital as % of Risk Weighted Assets	***14.9%***
Minimum APRA requirement	**15.0%**

This credit union which has $38million in liquidity (most of it held with the big banks) has failed its Capital Adequacy Requirement under APRA's Standardised Approach. As a result, it:

(i) is unable to lend further as well as breathed upon heavily by APRA,
(ii) has to increase capital reserves or find further capital to be compliant, and
(iii) has $38million is sitting in liquidity which cannot be used for lending purposes.

This is a ridiculous situation bearing in mind that the $38million is held with the Big Banks or Treasury Bonds which cannot be used. Where is the major risk when this entity has only residential home loan mortgages and liquids in big banks? Common sense of relaxing the capital adequacy rules and a release of say, a further $10million of the $38million being able to be lent out would result in the following:

Current interest on $10mil with Big Banks (3% of $10mil)	$300,000
Interest Income achieved on Lending (say 5.99% of $10mil)	$599,000
Additional Revenue which increases capital reserves	***$299,000***

The above accomplishes both an increase in productivity as well as growth in capital and assets, which is the ultimate result we are endeavouring to achieve as opposed to paralysing this ADI with archaic blanket rules, administered at times by very inexperienced staff members of Regulatory Authorities, who seldom have the capacity to exercise judgement in these situations.

Regulatory Requirements vs Productivity

It is imperative that we have legislation to regulate the finance sector or we can end up with disasters. There is a relationship between Regulatory Compliance and Productivity. When regulatory burden is high, productivity or growth is low and vice versa. This is because more time is spent on solving regulatory and bureaucratic issues which leaves little time to focus on growth. But we know that total lack of Regulatory Controls can lead to corporate failures. So, there should be a basic minimum level that must be adhered to. However, there is a disparity in minimum regulatory capital requirement between Big Banks and small ADIs. Excessive regulatory controls on small ADIs lead to unwarranted loss in productivity when compared to the bigger banks. Consequently, the basic minimum regulatory capital requirement has to be relaxed to a more acceptable level so as to not affect growth or productivity. Appendix 1 demonstrates the *Relationship and the Effects of Excessive Regulatory Compliance Requirement on Growth or Productivity*

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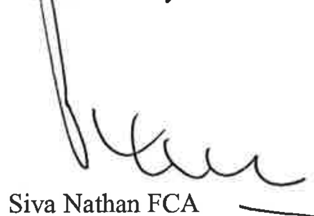
Conclusion
There tends to be an overdependence on a computer generated standardised approach. It should be appreciated that the Boards of Directors of smaller ADIs are also very capable of generating innovative concepts and ideas. Reverse Mortgages were first initiated by this very small Credit Union (who have very capable directors) well before any of the big 4 indulged in it. They had a lot of challenges getting it passed by APRA, being classed as risky.
Risk should be made acceptable so long as there is adherence to a minimum set of regulations, the return is appropriate and the risk is assessed and managed correctly. The present capital adequacy requirement curtails and cripples progress of smaller ADIs. It should be noted that the staff of regulators (in this case APRA) have seldom been in business and therefore do not possess the experience or acumen to evaluate a venture or project proposed by a Board fairly. I have encountered APRA staff who follow rules blindly and have no capability or aptitude to understand the dynamics of a situation properly. It becomes a powerplay of "We are APRA, follow the rules or you are castigated or deemed noncompliant." Seeking safeguards or attempting to impose controls to avoid downfall of an ADI is fine but blind application of controls and rules, without accepting the fact that the very rule might be flawed and stifles growth is ignorance and stupidity.
It is acknowledged, undoubtedly, all ADIs must be regulated. Jeffrey Carmichael, chairman of APRA (and also a former Wallis Inquiry panel member) talked about giving regulators more flexibility to look at shadow banking and issues that "creep around the edges" However, I am unsure if this is being practised. Regulators must have flexibility and act equally responsibly and should consider the circumstances surrounding every situation and:

(i) Have considered minimum acceptable regulatory conditions that should be imposed that would not unfairly stifle growth or productivity, as opposed to using a blanket rule for all ADIs
(ii) If unsure about approving a new idea or concept proposed by an ADI, they should refer this to a panel set by APRA ,comprising competent businessmen (not bureaucrats or academics only)to consider whether the proposal is acceptable and set revised minimum criteria that would be fair
(iii) Make it an essential requisite to have always evaluated 'regulation versus growth or productivity'

In conclusion, if the ultimate goal or objective of this inquiry is to cater for Australia's evolving needs and support the country's economic growth, restriction on smaller ADIs must be lifted or relaxed. The low risk exposure of residential loans is not commensurate with the capital restriction placed on them. Even the RBA says the Murray Inquiry should focus on small businesses. There has been close to 9 Parliamentary enquiries since the GFC and all report that mortgage residential lending policies are adequate and does not pose much risk. The high level of capital adequacy that small credit unions are required to hold is unwarranted, bearing in mind the relatively low risk attached to domestic residential mortgages. Being a patriotic Australian, I would like to see our country grow rather than being inundated with regulations emanating from insufficient thought.

Yours sincerely



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APPENDIX 1: EFFECTS OF EXCESSIVE REGULATORY COMPLIANCE REQUIREMENT ON GROWTH/ PRODUCTIVITY