cua™

26 August 2014

Mr David Murray AO
Chair
Financial System Inquiry
VIA FSI WEBSITE

Dear Mr Murray

CUA wishes to take advantage of your interim Financial System Inquiry report's call for second round submissions. In this submission CUA addresses the report's observation concerning competition and the associated observations relating to capital requirements for lending, around the 'too big to fail' issue, and the Financial Claims Scheme.

**Competition**

CUA was pleased that the interim FSI report observed that the financial services industry was concentrated. Indeed, in our view 'dominated' may be a more accurate descriptor. CUA accepts that competition exists in financial services, and at certain times there is an impression that competition is intense. This impression is misleading as much of the activity amounts to an occasional tussle for market share amongst the major four banks with collateral damage to the market share of the Tier Two banks and the customer-owned sector. The major banks are however fundamentally similar in their approach to the market and hence diversity and innovation are diminishing. In this regard, we would hope that your final report draws attention to the possible market distortion from the trend towards vertical integration of mortgage brokers and the ACCC's failure to address the trend.

A further distortion of competition is the multi-banding strategies by several of the major banks. The Interim FSI report makes a pertinent observation of disclosure in the area of consumer outcomes and conduct regulation, viz *"Although disclosure is an important part of the regulatory regime for providing financial products and services, it alone has not been sufficient to enable consumers to make informed decisions and purchase products and services that meet their needs."* This comment could equally apply to the multi-branding approach which sees major banks passing off sub-brands as alternatives to the Big 4. Disclosure of ownership is not apparent to consumers and consequently informed decisions cannot be made.

In our view the oligopolistic dominance of the major banks needs to be acknowledged and steps taken to maintain appropriate diversity by levelling the playing field in a regulatory sense. This is justified, not as support for the mutual sector, but rather as support for Australian consumers. In this regard, CUA considers that your Interim report has correctly identified several issues which go to the heart of competitive neutrality within financial services.

**Risk Weighting for Loans**

This disadvantage to the mutual sector was raised by a number of submissions to the FSI. The major banks have grown to their dominant position by virtue of accommodative and protective government policy over many years.  The major banks gain excessive benefits by applying the Internal Ratings-based (IRB) risk weighting approach compared to other ADIs which are required to use the Standardised approach.  The practical effect is to require mutuals to apply twice as much capital against a home mortgage as a major bank.

To put this in perspective, CUA with an excellent record on loan delinquencies compared to the major banks, with none of the options for raising capital that are available to the majors, yet with safeguards and systems sufficient to satisfy the rating agencies, is effectively required to carry a major disincentive to growth in its battle with the big banks.

Of the six options identified by the interim FSI report CUA considers that the correct way forward would see APRA working closely to assist smaller ADIs in a structured or tiered manner to achieve IRB accreditation.  No weakening of IRB standards would be required, rather a gradual increase in the risk assessment capabilities of the sector, reducing the risk weighting disadvantage over an agreed timeframe.  This would be a boost to the mutual sector, demonstrate that the Government is keen to level the playing field, and give an incentive to the institutions involved to undertake the necessary investment in systems and people.

The net effect of such a change from CUA's viewpoint would be to provide assurance that additional capital was available to support growth arising from CUA's increasing competitiveness.  In addition, capital freed up could support increased credit availability in sectors where CUA is presently under represented, such as the SME sector.  It would also add to CUA's ability to continue its very considerable investment in technology.

An associated measure with an important capital benefit for mutuals would be for APRA to fast-track its examination and introduction of a suitable Common Equity Tier 1 capital instrument.

**Too Big To Fail (TBTF)**

In its original submission to the FSI CUA argued that the major banks received a funding cost advantage as their systemic importance meant that rating agencies reflect implicit government support in their ratings.  CUA was not alone in calling for an increased capital contribution from the major banks to reflect their status as systemically important.  Indeed this was a conclusion from the IMF in its 2012 report on Australia's Financial System Stability Assessment, viz *"…..a higher loss absorbency requirement for systemic institutions should be considered."*

An increased capital requirement on the major banks will not, in itself, provide a levelling of the playing field in terms of funding costs.  Indeed, as you acknowledged in your recent National Press Club address, increased capital will likely have the perverse effect of improving the rating outcomes for the major banks.  Nevertheless, it will have the twin effects of ensuring shareholders bear some of the costs from reduced returns as the additional capital is built-up (having, of course, already benefitted over a number of years from the funding cost advantage), while ensuring that systemically important banks have a greater capital buffer against collapse.

Is this approach a sufficient response to the TBTF issue?  It will certainly act to reduce the likelihood of the taxpayer having to bail out systemically important banks.  What it will not do is to address the associated issue of 'moral hazard' arising from the implicit government guarantee, i.e. a belief by management that ultimately they will not have to pay for their mistakes, the taxpayer will pick up the tab (thereby ‘privatising the profits and socialising the losses’).

The issue of possibly ring-fencing the retail activities of the major banks was raised in your Interim report in view of its use in a number of international jurisdictions. In CUA’s view this would be an appropriate response to the moral hazard issue as the most significant avenue for reckless profiteering is attached to trading activities. By clearly separating these from usual banking activities, the potential drawdown of taxpayer funds for bail-outs must be significantly reduced.

**Financial Claims Scheme (FCS)**

In our original submission to the FSI CUA noted that the FCS 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 regulation by APRA and ASIC like the major banks.

Perceptions can be difficult to change and the FCS has, from a mutual perspective, certainly acted as a leveller in the fight to attract deposits. It can be viewed as a rare government initiative which benefits smaller ADIs. Having already been reduced by 75% we see little justification for a further reduction. In the same way, the current post-funding of the FCS has been in place for seven years and this remains appropriate. To change this to an ex-ante approach, as the previous Government intended, will create unnecessary bureaucracy and an associated administration and cost burden on a sector already saddled with an excessive level of costs.

**Conclusion**

At a time when the Big 4 continue to break profit records your Inquiry into the Financial Sector takes on ever increasing relevance. While having the impression that the customer-owned sector is a side-show in the Interim report, CUA is never-the-less supportive of a number of preliminary observations around important issues of capital and funding. We would hope that your final report turns these observations into recommendations.

We would finish by acknowledging that your Interim report mentions that the other main issue of interest to CUA, the use of presently redundant Franking Credits, is more appropriately taken up in the Government’s forthcoming review of taxation.

CUA will be happy to provide further elaboration of any issue raised above.

Yours sincerely

Chris Whitehead
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