1 Margaret St
Sydney NSW 2000

GPO Box 4720
Sydney NSW 2001

TEL (02) 8299 9000
FAX (02) 8299 9607

Association of Building Societies and Credit Unions

31 July 2009

Mr John Hawkins
Secretary
Senate Economics Committee
Parliament House
Canberra ACT 2600

economics.sen@aph.gov.au

Dear Mr Hawkins,

Abacus - Australian Mutuals appreciates the opportunity to contribute to the Committee's inquiry into the "Bank Funding Guarantees".

The guarantee of ADI deposits of up to $1 million is strongly supported by Abacus.

We would be happy to appear before the Committee to discuss our submission.

Executive Summary

The Government's response to the global financial crisis has delivered much needed stability and confidence to the core of the Australian financial system – the Authorised Deposit-taking Institution (ADI) sector.

Abacus supports continuation of the deposit guarantee for deposits of up to $1 million and looks forward to engaging with Government on transitional arrangements to apply after the initial three-year operation of the guarantee in the current Financial Claims Scheme structure.

The deposit guarantee has played an important stabilising role and has brought certainty and peace of mind to Australian depositors.

The *Guarantee Scheme for Large Deposits and Wholesale Funding* has also played an important stabilising role and has enabled those ADIs using the scheme to maintain the flow of credit to the Australian economy.

However, the fee structure of the *Guarantee Scheme for Large Deposits and Wholesale Funding* is anti-competitive and has had the unintended effect of further strengthening the competitive position of the four major banks relative to other ADIs.

Abacus seeks refinements to the fee structure to better balance stability and competition objectives.

The deposit guarantee and the *Guarantee Scheme for Large Deposits and Wholesale Funding* were introduced in the context of a global crisis.

Any exit from the *Guarantee Scheme for Large Deposits and Wholesale Funding* should be gradual and implemented in a coordinated way with other countries in an atmosphere of international cooperation.

Introduction

Abacus – Australian Mutuals is the industry body for credit unions and mutual building societies, mutual Authorised Deposit-taking Institutions (ADIs).

There are 117 credit unions and 9 mutual building societies, with total assets of more than $65 billion, serving 4.6 million Australians.

Mutual ADIs hold around 12 per cent of the household deposits market and around 7 per cent of the new home loan market.

Mutual ADIs strongly and consistently outperform the major banks in customer satisfaction surveys. This reflects the mutual model, where there is no tension between customers and shareholders. A mutual ADI's customers are its owners.

Mutual ADIs are strongly represented outside capital cities, with 60 Abacus members being headquartered in regional centres and country towns.

Throughout the global financial crisis, the mutual ADI sector has performed strongly and continues to provide vital competition and choice against the major banks. (See Attachment for more detail on mutual ADI sector.)

Deposit guarantee

The Government's announcement of the deposit guarantee was timely and decisive in ensuring the stability of the ADI sector.

Even though there was no flight of deposits from credit unions or mutual building societies, there was rising community anxiety due to unrelenting bad news from overseas. No ADI wants to see any want of confidence in any other ADI because all ADIs rely on the confidence of depositors and the announcement of the deposit guarantee was a welcome measure.

Confidence in the financial system was becoming fragile leading up to the Government's announcement. The Australian Prudential Regulation Authority (APRA) has commented that some depositors were becoming unsettled.

ADIs provide Australia's payments system and are trusted with the household savings, wages, welfare payments and pensions of Australians.

This is why ADIs are supervised by APRA and are subject to strict, legally enforceable prudential standards on capital, liquidity, risk management and governance.

Providers of savings and investment products that compete with ADI deposits are not subject to these standards.

Even if the guarantee of ADI deposits had not been introduced, large numbers of investors in non-ADI products seeking to exit those products in the context of the global financial crisis would still have created liquidity problems in those non-ADI products. It is misleading to suggest that the guarantee of deposits is the main cause of liquidity problems in non-ADI funds. APRA and the RBA have advised this inquiry that the trend of outflows from mortgage trusts was well established from early in 2008, with a large mortgage trust suspending redemptions as early as March 2008.

APRA has indicated it is just as vigilant, if not more so, now that its role is effectively protecting taxpayers as well as depositors.

The global financial crisis cast new light on perceptions about the safety and security of various investment options.

Local councils trusted the opinions of credit rating agencies rather than Australia's prudential regulatory system and chose to invest in AAA-rated exotic securities when they would have been better off depositing funds in an unrated mutual ADI.

A decade since the implementation of the Wallis reforms put all deposit-takers on an equal regulatory footing, Abacus members still regularly encounter perceptions that banks are safer than other ADIs.

As the crisis deepened in the second half of 2008, numerous "experts" engaging in public debate about the safety of customer deposits were frequently and alarmingly wrong about the Australian prudential regulatory framework for deposit-taking institutions. Given that these public commentators did not understand the prudential status of ADIs, the general public's level of understanding is a matter of significant concern. If consumers are not informed they can't make informed choices about where to seek a home loan or a competitive return on a deposit.

Major banks are able to exploit community ignorance about the status of other deposit-takers and lenders to profit from a so-called "flight to quality".

Effective consumer choice relies on consumers being well informed.

Given the enormous advantage major banks already have in terms of size and marketing power, and the impact of the global financial crisis on competition, Abacus sees a pressing need to educate the community about the prudential regulatory framework for deposit-taking and the ADI concept.

Abacus recommends a public information campaign explaining the ADI concept and encouraging retail banking consumers to "shop around" with confidence in the ADI sector. Such a campaign would have particular value in the context of any transition away from the current deposit guarantee arrangements after 2011.

At this stage, Abacus does not wish to nominate the optimal future cap for the Financial Claims Scheme for ADI deposits. This should be the outcome of careful deliberation in the lead up to October 2011 with the objective of optimising competition and choice and avoiding instability.

Abacus will continue to consult with our member ADIs on this subject.

Guarantee Scheme for Large Deposits and Wholesale Funding

The fee structure for the *Guarantee Scheme for Large Deposits and Wholesale Funding* requires mutual ADIs to pay 150 basis points for the guarantee while the four major banks pay 70 basis points.

This differential has been amplified by the dramatic fall in official interest rates since the Guarantee Scheme was introduced: 150 basis points is now half the official cash rate.

Operation of the Scheme has also revealed that lower rated ADIs are in effect penalised twice, as the market has required an additional premium from them on top of the higher fee payable to the Government even though the debt carries the Government's AAA rated guarantee.

The first problem that arises from the differential fee structure is that it is all but locking out mutual ADIs from accessing government guaranteed wholesale funding and guaranteed large deposits.

The second problem is the signal it sends to all depositors about the prudential regulatory framework.

Mutual ADIs rely heavily on deposits for funding but in recent years many mutual ADIs, and particularly larger mutual ADIs, have been able to increase their growth in mortgage lending by effective use of securitisation.

The Government's support for the RMBS market by directing the Australian Office of Financial Management to purchase residential mortgage backed securities (RMBS) has been welcome. Three Abacus members – Credit Union Australia, Australian Central Credit Union and Greater Building Society – have been able to participate in the program.

However, further action is needed if the securitisation market is to re-emerge as an important source of competition in home lending.

In order to put competitive pressure on major banks in the interests of Australian households and small businesses, mutual ADIs need to be able to access wholesale funding, either directly in the case of large mutual ADIs, or indirectly through aggregation vehicles in the case of smaller mutual ADIs.

This is critical to support our capacity to increase loan growth. While our member institutions are highly liquid (over 18.5% liquidity) they are naturally cautious of the potential for deposit market disruption, and also face prudential limits on accelerating loan growth without access to diversified funding sources to supplement retail deposit funding.

Current market conditions mean mutual ADIs have little prospect of accessing wholesale funding without the guarantee and only one Abacus member has raised funds with the guarantee. Heritage Building Society announced recently the successful placement of $400 million guaranteed notes into the wholesale debt markets.

As noted above, the second problem with the differential fee structure is that the use of ratings by credit ratings agencies to determine the Scheme fees increases the competitive advantage of major banks by effectively equating the ratings system with the prudential regulatory framework. The implication, quite damaging to competition and choice, is that there are three tiers of ADIs.

The record of the ratings agencies in the lead up to the global financial crisis does not justify giving them status as arbiters of the prudential standing of Australian deposit-takers.

Unrated Australian mutual ADIs have proven themselves to be prudentially stronger than highly rated global banks. Globally, credit unions have demonstrated their resilience and prudent practices compared with more complex and riskier larger financial institutions.

Most mutual ADIs do not have credit ratings because they have never needed a credit rating for their deposit-taking activities. A credit rating – being an opinion, purchased from an external agency, about a company's creditworthiness for debt instruments – has to date only been necessary for gaining direct access to capital and wholesale debt markets.

There is now a growing risk that an agency rating will become a requirement for ADIs competing in the high value deposits market after the transition away from the current guarantee arrangements. This is a worrying development for competition in retail banking and will serve only to benefit the major banks.

In the meantime, the tiered fee structure means the major banks dominate the market for guaranteed large deposits.

The purpose of the guarantee scheme for large deposits and wholesale funding is to promote financial system stability and to promote confidence and certainty in Australian financial institutions.[1]

In debate on the guarantee scheme legislation in the Senate on 26 November 2008, the Minister for Superannuation and Corporate Law said: *"This is not a measure for the big end of town, for the big four banks - this is a measure for all banks, credit unions and building societies, and it is a measure for the Australian economy and society as a whole."*

The scheme is not meant to give a massive competitive advantage to the big four banks.

KPMG commented recently that the fee structure "has clearly placed the building societies, credit unions and regionals at a comparative disadvantage to the major banks. This is compounded by the higher credit spread demanded by the market for funding smaller institutions," KPMG said in a recent update.[2]

The House of Representatives Standing Committee on Economics commented in a report last year that the big four banks "aggressively compete with other players in the market" but "there is some uncertainty as to whether the big four are actively competing with each other."[3]

The chairman of the Australian Competition and Consumer Commission, Mr Graeme Samuel, issued a public warning recently about the dominance of the big four banks. "We are becoming increasingly concerned that the banking system is becoming less and less competitive and that will ultimately reflect itself in costs to consumers in terms of interest rates, margins on loans and deposits," Mr Samuel said.[4]

Abacus understands the fee structure for the scheme specifically reflects advice from the Council of Australian Regulators – APRA, RBA, ASIC and Treasury. We are concerned that the Council focused entirely on the stability objective and gave little weight initially to the impact on competition of the fee structure.

Both the ACCC and the RBA have since publicly acknowledged that the fee structure is having a negative impact on competition.

---

[1] Explanatory Memorandum, Guarantee Scheme for Large Deposits and Wholesale Funding Appropriation Bill 2008
[2] Regional banks, credit unions and building societies 2009 – UPDATE. KPMG July 2009.
[3] Inquiry into competition in the banking and non-banking sectors, November 2008
[4] *Samuel warns on bank mergers* AFR 14 April 2009.

APRA and the RBA have advised this inquiry that the fee structure's differential is relatively large compared to other countries. Other countries have altered their guarantee arrangements when required.

Abacus recommends consideration of the following policy proposals to respond to the serious threat now posed to competition and choice in the retail banking market.

We suggest measures to facilitate access to funding by mutual ADIs by:

- Removing anti-competitive aspects of the Government's fee arrangements for the guarantee of large deposits and wholesale funding; and
- Taking further action to revive securitisation markets.

Removing anti-competitive aspects of the fee could be achieved by changing the fee structure to:

- Introduce a flat fee for the guarantee; or
- Introduce a flat fee for the guarantee of large deposits and reduce the differential between the fees for the guarantee of wholesale funding.

A further option is a flat fee for the guarantee of large deposits of up to $5 million, with the differential fees applying to deposits (and wholesale funding) of more than $5 million. This would be pro-competitive and would also have a prudential benefit in the event of any further shock to depositor confidence.

In order to revive securitisation as a funding source for home lenders, Abacus recommends consideration of the Canadian Mortgage Bond (CMB) Scheme as a model for adopting in Australia.

Canada's CMB scheme has provided lower cost mortgage funding to financial institutions and has resulted in savings to borrowers as a result of the pass through by financial institutions of a large percentage of this cost of funds advantage, according to an evaluation by KPMG

Further, the scheme has increased the availability of mortgage funding for smaller lenders, and this was probably a factor in enabling them to maintain their share of a rapidly growing market leading to more than doubling their annual volumes of mortgage approvals during the evaluation period (2001-06).

In an "addendum" to the June 2008 report, KPMG made the following observations about the CMB program and the disruption to markets caused by the onset of the global financial crisis:

- The cost of funds advantage of the CMB program has increased significantly since the evaluation study period;
- The program has played a stabilising role in Canadian mortgage markets since late 2007 by providing a reliable funding source, and this has been particularly important for smaller lenders who have fewer alternatives in this environment compared to the big five banks; and
- Through its support for smaller lenders, the CMB program has enhanced the competitiveness of the mortgage market.

Canada's CMB program is well designed and does not pose the risks of the US Freddie Mac and Fannie Mae schemes. It provides a model for effective use of Government guarantees with policy settings that specifically promote competition.

Like Australia, Canada has a strong credit union sector in a banking market dominated by a few big banks. Canadian credit unions access the CMB program through aggregator bodies that say the program has been "*extremely effective at easing liquidity concerns*" and has become a "*very significant*" source of funding.

Abacus also supports consideration of alternative models to revive the securitisation market, including models that address liquidity risk for investors in addition to credit risk.

Impact on interest rates

The major banks' average funding costs have fallen by 330 basis points since September 2008, somewhat less than the 425 basis point fall in the official cash rate, according to analysis by the RBA in its June 2009 Bulletin.

The RBA says the major banks have reduced the variable housing rate by an average of 385 basis points. Personal loan rates have fallen by 170 basis points and small business loans by 230 basis points.

Intense competition amongst ADIs for deposits has been a feature of the global financial crisis as other sources of funding have dried up (eg. securitisation) or become much more expensive (eg. wholesale funding).

It should not be overlooked that this has been a very good outcome for risk-averse savers who have invested in deposits.

The table below compares September 2008 and July 2009 home loan and term deposit interests rates.

Standard Variable Rates

Average	12-Sep-08	21-Jul-09	
Big Five	9.36	5.78	-3.58
Credit Unions	9.00	5.55	-3.45
Building Societies	8.98	5.45	-3.53

Term Deposit Rates

TD $10,000 3-Month	12-Sep-08	21-Jul-09	
5 major banks	5.50	3.16	-2.34
5 Foreign banks	6.71	2.84	-3.87
Credit Unions	6.56	3.15	-3.41
Building Societies	7.24	3.64	-3.60

TD $10,000, 6-month	12-Sep-08	21-Jul-09	
5 Major	6.83	3.60	-3.23
5 Foreign	6.74	3.05	-3.69
Credit Unions	6.87	3.17	-3.70
Building Societies	7.10	3.83	-3.28

Aggressive competition for deposits will persevere as long as the cost of alternative funding sources remains high. When conditions normalise, competition for deposits may abate but is likely to remain more intense than prior to the global financial crisis as major banks permanently increase the proportion of their funding that comes from deposits.

As conditions normalise, investors who require a greater return than that available from deposits will shift funds from deposits to products provided by entities not regulated by APRA.

Conclusion

The decision to implement these measures - the ADI deposit guarantee and *Guarantee Scheme for Large Deposits and Wholesale Funding* - was, and continues to be, supported by Abacus.

However, the fee structure of the Guarantee Scheme should be revisited urgently to avoid a continuing erosion of competition in the retail banking market.

Mutual ADIs are performing well in difficult times and the mutual ADI sector continues to grow. However, the growth rate of the major banks is outstripping our sector and therefore gradually reducing our sector's share of lending and deposit-taking markets.

Policy makers should take note of KPMG's conclusion this month that "the difficulties in competing with the majors in terms of cost of funding will make it very difficult for both the regionals and the building societies and credit unions to expand rapidly."

"Having said that, these institutions have a great track record of high customer satisfaction and loyalty. Provided they continue to focus on customer service there is no reason why they cannot continue to flourish in their existing markets," KPMG said.[5]

Abacus urges a new priority for pro-competitive policy settings in the retail banking market.

I can be contacted on 02 6232 6666 or 0418 213 025 or at llawler@abacus.org.au.

Yours sincerely,

LUKE LAWLER
Acting Head of Public Affairs

[5] Regional banks, credit unions and building societies 2009 – UPDATE. KPMG July 2009.

Australian Credit Unions & Mutual Building Societies

FACTS AND FIGURES AT A GLANCE

SIZE	
Numbers	> 117 credit unions > 9 mutual building societies
Assets and Growth	> Collectively, our sector has more than $70 billion in assets[1]. > Credit unions' on-balance sheet assets reached $45.8bn in March 2009, growing by 10% annually while mutual building societies' on-balance sheet assets amounted to $18.5bn in the same period.
Market Share	> Hold approximately 7% of the new home loan market and 12% of household deposits. > Collectively, credit unions and mutual building societies are the fourth largest holder of household deposits in Australia.
Population Penetration	> We serve over 4.6 million members - close to 1 in 5 of the total population > Population penetration (members as a proportion of the total population) is highest in SA (36%), Tasmania (36%), and NSW (28%)
STRENGTH	
Customer Satisfaction	> 85.7% of credit union and 88.5% of building society members reported high satisfaction in May 2009. > Credit unions and mutual building societies consistently out-perform banks (majors 71.4% and total banks 72.9% in May 2009).
Competitive Advantages	> Mutual structure means no tension between servicing customers and external shareholders – customers (members) are the owners > Better placed than most to satisfy key needs of consumers, that is: - member focus - sense of community / belonging - honesty and integrity - guidance - simplicity > Competitively priced > Close to half of all members are outside capital cities, approx. one quarter of which are in regional cities and three quarters in rural areas
Strong Regulation	> All credit unions and building societies (and banks) are Authorised Deposit-taking Institutions (ADIs), regulated under the *Banking Act*. We meet the same high standards of prudential regulation as banks with full regulatory oversight by APRA, the prudential regulator. > The Government has guaranteed all deposits of up to $1 million at all Australian credit unions and building societies (and banks). For deposits of more than $1 million, an optional government guarantee is available for a fee.
PRODUCTS	
Product Range	> Mutual ADIs offer a full range of personal banking services; smaller ones provide more limited facilities
Product Usage	> More members now using their CU as their main financial institution – 14.2% had six or more products with their CU in June 2001; by March 2009 this was up to 24.1% (i.e., a 70% increase in 8 years)

[1] Based on June 2008 annual reports.

Abacus Australian Mutuals

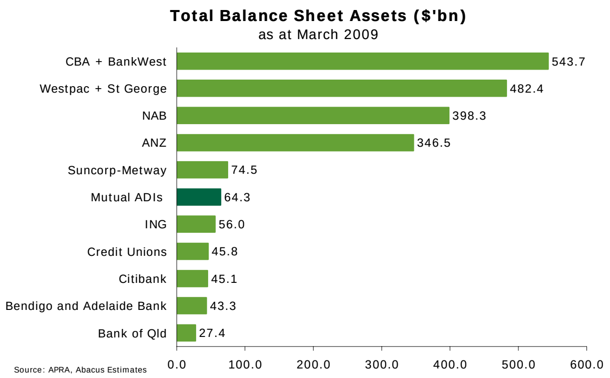
Mutual ADIs

There are 117 credit unions and 9 mutual building societies in Australia – ranging from small ADIs through to the largest credit union with over $6bn in assets. Collectively, the industry has more than $70bn in assets.

Credit unions and mutual building societies are customer owned – operating under the mutual principles of one member one vote, an equal share in the say of the credit union, and with the purpose of member and community benefit at the forefront of their operations.

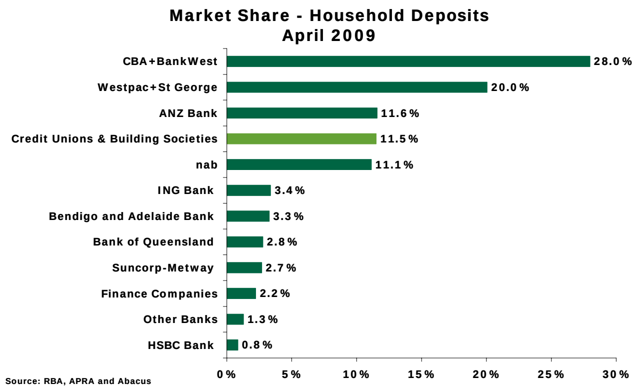
Market Share

Collectively, credit unions and mutual building societies sit behind the five major banks and Suncorp-Metway in terms of total on-balance sheet assets.



(Source: APRA)

Mutual ADIs hold approximately 7% of the new home loan market. As a group, credit unions and mutual building societies are the fourth largest deposit gathering force after CBA, Westpac and ANZ reaching almost 12.0% market share.



(Source: APRA, RBA)

Products and Services

Credit unions and mutual building societies offer a full range of personal banking services with smaller ones providing more limited facilities.

Credit unions and mutual building societies charge less than the major banks in interest rates as shown in the following table.

Standard Variable Home Loan Rates by Lenders (as listed by CANNEX)

29-Jun-09

Standard Variable	Average	Min
5 Majors	5.78	5.74
Credit Unions	5.56	4.81
Building Societies	5.45	5.09

(Source: Canstar Cannex)

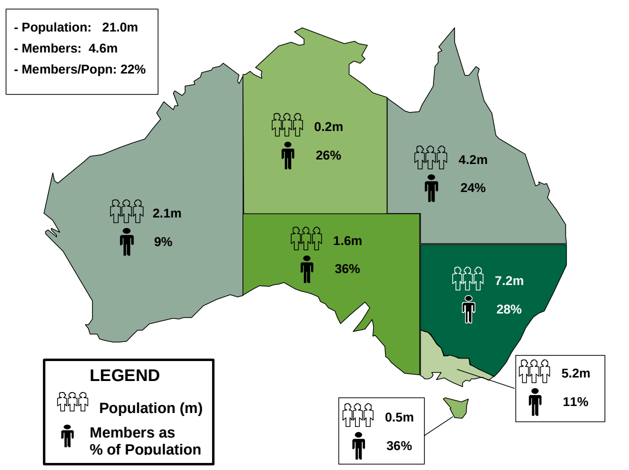
An ASIC survey released early in 2008 also reported that credit unions and mutual building societies charge, on average, the lowest overall loan fees in the lending market.

Similarly, we offer attractive deposit rates on saving investment accounts and 30-day term deposits as at 29 June 2009, offering between 74 and 125 basis points higher than the major banks.

In May 2009, 85.7% of credit unions' and 88.5% of building societies members were satisfied, consistently out-perform banks (majors 71.4% and total banks 72.9% in May 2009).

Strong country coverage

As at June 2008, Australia's total population was 21 million, of which 4.6 million (22%) were credit union or mutual building society members.



(Source: MMD)

Population penetration (members as a proportion of the total population) highest in SA (36%), Tasmania (36%), and NSW (28%)