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Association of Building Societies and Credit Unions

Abacus
Australian Mutuals

28 February 2011

Dr Ian Holland
Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Parliament House
Canberra ACT 2600
corporations.joint@aph.gov.au

Dear Dr Holland,

Access for Small and Medium Business to Finance

Thank you for your invitation to *Abacus – Australian Mutuals* to make a submission to the Committee's inquiry into Access for Small and Medium Business to Finance.

Many Abacus members lend to small businesses and some Abacus members have a strong focus on small business lending and see significant potential for growth. At the end of 2010, loans to small businesses by credit unions totalled $1.4 billion and loans to small businesses by building societies totalled $0.9 billion.

This submission includes some material, updated where necessary, provided to the Senate Economics Committee in April 2010 for that Committee's inquiry into Access of Small Business to Finance.

I can be contacted on 02 6232 6666 or 0418 213 025 to discuss any aspect of this submission.

Yours sincerely,

LUKE LAWLER
Senior Adviser, Policy & Public Affairs

Executive Summary

Abacus – Australian Mutuals is the industry body for the mutual banking sector comprising 104 credit unions and 9 mutual building societies with 4.5 million members and total assets of $72 billion.

Credit unions and mutual building societies are Authorised Deposit-taking Institutions (ADIs) regulated by APRA under the *Banking Act 1959* and provide a full range of retail banking services.

Generally speaking, mutual banking institutions are focused on consumer banking. However, many mutual banking institutions, particularly those based in regional areas, also compete in the small business market. These credit unions and building societies have invested in the necessary expertise and product range to compete in the business banking market. They are active, they are lending, and they see an opportunity to provide a personalised level of service for small businesses, and particularly micro businesses, in various regional markets where other lenders are not providing that personalised service.

Mutual banking institutions offer highly competitive products for small business. Canstar Cannex data shows that 4 of the 10 lowest interest rate business overdrafts secured by residential property are offered by Abacus members. For business transaction accounts, 7 of the top 10 rated products are offered by Abacus members. For business online saving accounts, 3 of the 10 highest interest rate products are offered by Abacus members.

The Mutual Banking Code of Practice (MBCOP) explicitly applies to small business members[1] as well as individuals. The MBCOP sets high standards in a range of areas beyond those required by law, as an expression of the value mutual ADIs place on improving the financial wellbeing of their members and communities. The number one promise in the MBCOP is: "We will always act honestly and with integrity, and will treat you fairly and reasonably in all our dealings with you."

Small businesses rely more on debt funding than large companies and rely more on the banking sector for that debt funding than large companies, so a competitive banking sector is critical to small businesses.

Abacus is engaged with the Government and other stakeholders to implement pro-competitive measures announced in the Government December 2010 policy statement *Competitive and Sustainable Banking.*

The measures are divided into three streams and will have short to medium term and longer term effects.

Abacus strongly supports the Government's undertaking to "put mutuals and smaller banks at the centre of the *Bank on a Better Deal* campaign, including introducing a new official 'Government Protected Deposits' symbol."

This important initiative is for a national community awareness and education campaign to properly inform consumers about the safe and competitive alternatives mutuals and smaller banks offer to the big banks.

The campaign and forthcoming related announcement about the future level of the cap applying to deposits under the Financial Claims Scheme (FCS) are important factors for smaller banking institutions in maintaining and expanding access to funding.

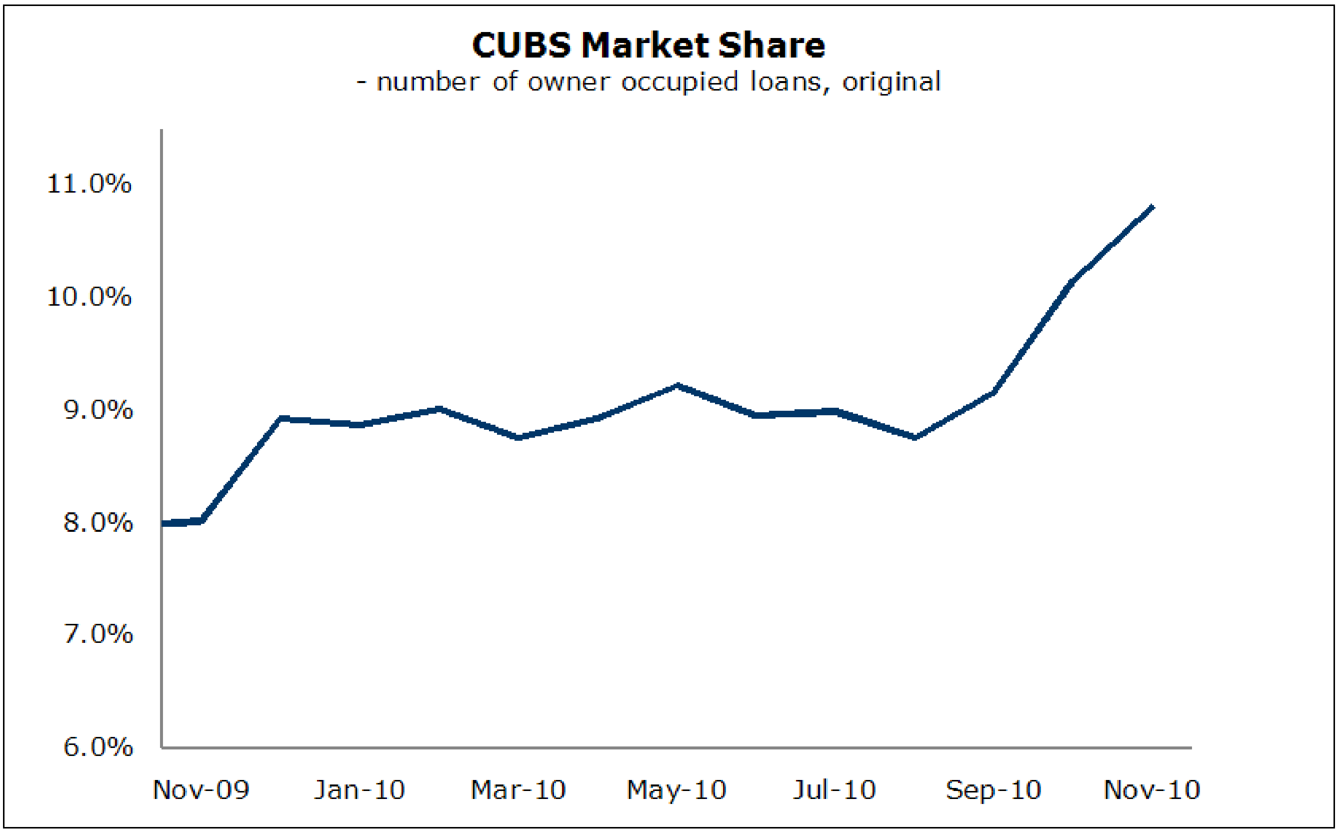
[1] "Small Business" is defined in the MBCOP as: A business having fewer than: a) 100 full-time (or equivalent) people if it involves the manufacture of goods; or, b) in any other case, 20 full time (or equivalent) people.

Access to funding at a competitive price is critical for smaller banking institutions to be able to apply competitive pressure on the major banks in markets such as small business lending.

Mutual banking sector & small business

The mutual banking sector has a small share of small business lending but its position in consumer banking markets indicates significant potential for growth.

Credit unions and building societies collectively hold an 11.4 per cent share of the household deposits market, a 10.9 per cent and growing share of new home loan market (see graph below), and have more branches than the Commonwealth Bank. Credit unions and building societies consistently record market-leading customer satisfaction ratings.



(Source: Australian Bureau of Statistics)

While only $2.3 billion of mutual ADI lending is categorised as commercial lending, it is likely that some of the $56 billion of mortgage and personal loans provided by mutual ADIs would be indirectly used to provide funding for small businesses of members.

Approximately 35 per cent of small businesses operate in regional areas. Regional credit unions and building societies have strong local connections and support. For example in NSW, in the Hunter region, 76 per cent of the population are members of a credit union or mutual building society; in the Illawarra, it is 60 per cent; in Northern NSW 55 per cent; North Coast 46 per cent; South Coast 42 per cent; and, Central West 41 per cent.

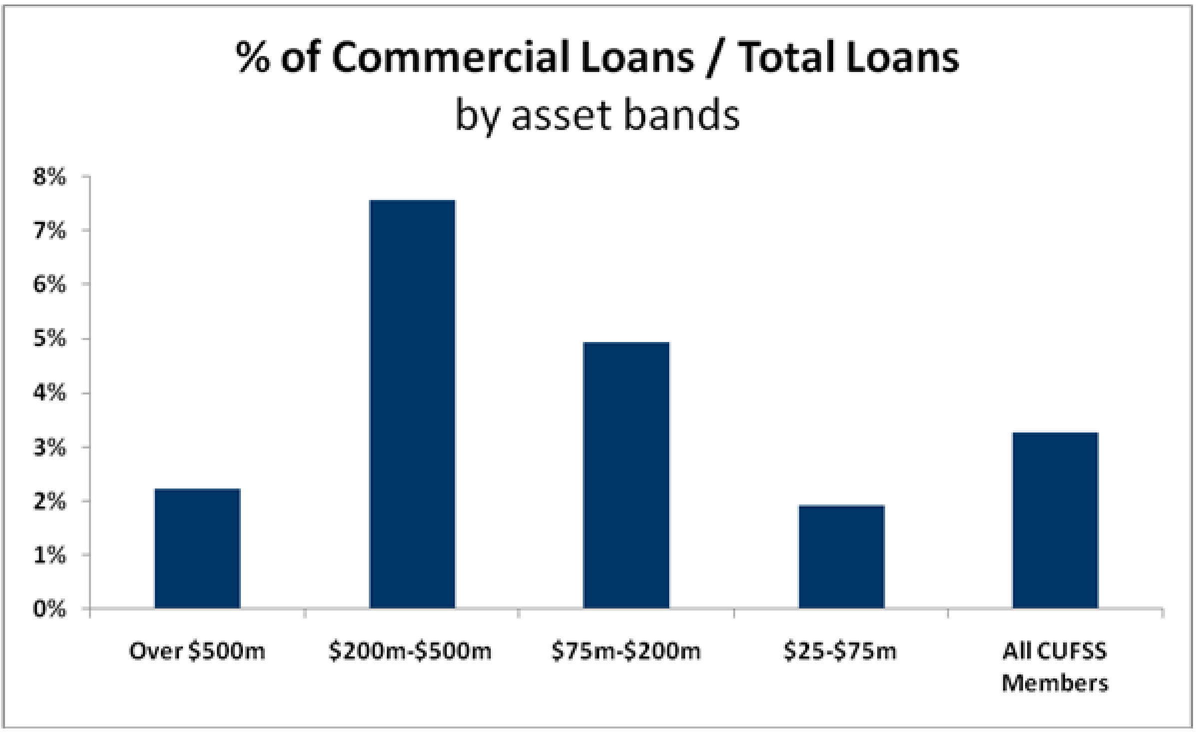
While many mutual banking institutions choose to stick to consumer banking, many regionally-based credit unions and building societies are actively competing in the small business market. Two regionally-based credit unions each have around one-third of their loans with small businesses.

Other mutual banking institutions are cautiously entering the small business market, recognising that it requires significant investment and an appreciation of new and different risks.

APRA strongly advises mutual ADI boards not to allow their institution to move into commercial lending without ensuring they have the personnel, expertise and systems to do so prudently.

APRA's position is that assessing, pricing and securing commercial exposures requires a set of skills distinct from those required for assessing standard mortgages and personal lending. APRA requires ADIs to have robust product development processes to analyse new lines of business before products are formally endorsed and launched.

A snapshot of commercial lending by credit unions (below), based on asset size, shows that commercial lending is more common among medium sized credit unions, reflecting the prevalence of medium-sized credit unions in regional communities.



(Source: Credit Union Financial Support System (CUFSS))

<u>Feedback by Abacus members:</u>

> "Commercial lending requires a different and more complex skill-set to assess and administer. APRA are vigilant in ensuring that we do have these skills. I don't have a problem with this because commercial loans must be reviewed regularly to satisfy ourselves that there hasn't been any deterioration in the member's business."

> "Well performed and credentialled businesses are still able to negotiate good deals. The banks continue to be ruthless in 'pricing out' enterprises they see as carrying extra risk. All too often we are seen as a lender of last resort."

> "All local banks are keen to increase their business banking market share. The business community needs educating about the benefits of banking with a credit union. We need to change market perceptions about credit unions and business banking."

"More public support is needed from Government and regulators that credit unions are well supervised and are safe and secure. Local regional councils have expressed an interest in investing with the credit union however there are stumbling blocks with local government policy requiring an institution to have a credit rating."

"We're currently developing our business banking strategy for [our] merged entity and we see a great opportunity to increase our exposure to this segment."

"Competition is alive and well in the small business segment particularly from the major banks who all lately seem to be promoting how well they now look after small business. We've found we can compete with the major banks and 2nd tier lenders in this segment based on their past lack of regard for small business, which has led to business owners seeking alternatives. Although we don't see ourselves competing in the corporate finance market, we are competitive in the small business segment. We try to differentiate ourselves by provision of friendly, personal service, in addition to providing competitive and flexible products."

"The [building] society is looking to grow the business banking lending book over time and we will continue to focus on micro business."

"Generally the rates and fees offered are competitive but what differs markedly between finance providers in this market is the service distribution model. Some of the majors have centralised the management of this sector to some location, either domestically or overseas, thus the applicants may not be able to sit down with a business banking manager but rather have to undertake the application process and any follow-up via phone, e-mail or internet. The society offers face-to-face access for our members via our branches and business banking managers."

"We see members of the business community every day looking for viable alternatives to the mainstream banks. They want something that is large enough to meet the financial needs of their business but also offers excellent value and makes good financial sense."

"Barriers to entry of new lenders to small business are: obtaining necessary expertise; establishing products and services required by borrowers; cost and logistics of setting up a distribution model and having representatives where they're needed; costs of changes required to IT systems; and, marketing costs to establish a presence."

"An area that could lead to an improvement in our ability to satisfy demand for small business lending could be through provision of assistance to small business owners in preparation of business plans and financial forecasts. A well prepared and researched application stands a much better chance of favourable consideration than one which lacks suitable preparation. We find that many applicants aren't sufficiently informed about requirements of financiers. We only lend against tangible property or cash security and often get asked for finance of up to $500,000 where the applicant doesn't have any security available. Some sort of education program would be beneficial."

"Possibly you could look at some form of qualification that someone looking to start a business needed to hold, covering the basics of running a business including staff management, stock/debtor/creditor control, and preparing an application for finance."

Profile & Funding

As noted above, the capacity of mutual banking institutions to increase competition and choice in the small business lending market depends on the sector increasing its profile and maintaining and expanding its access to funding.

Promotion of mutual banking option
It is not widely understood that credit unions and building societies are subject to exactly the same strict, legally-enforceable, prudential regulatory framework as banks and that many mutual banking institutions compete with banks in the small business lending market.

Major banks continue to benefit from entrenched misconceptions about the regulatory framework and from customer inertia arising from the perception that there is no real choice in the banking market.

The *Bank on a Better Deal* campaign will help to educate consumers about the prudential standing of all banking institutions and that genuine choice exists beyond the four major banks and their increasingly large brand portfolios. Major bank brands now include St George, Bankwest, UBank, RAMS and Aussie Home Loans (1/3 owned by CBA).

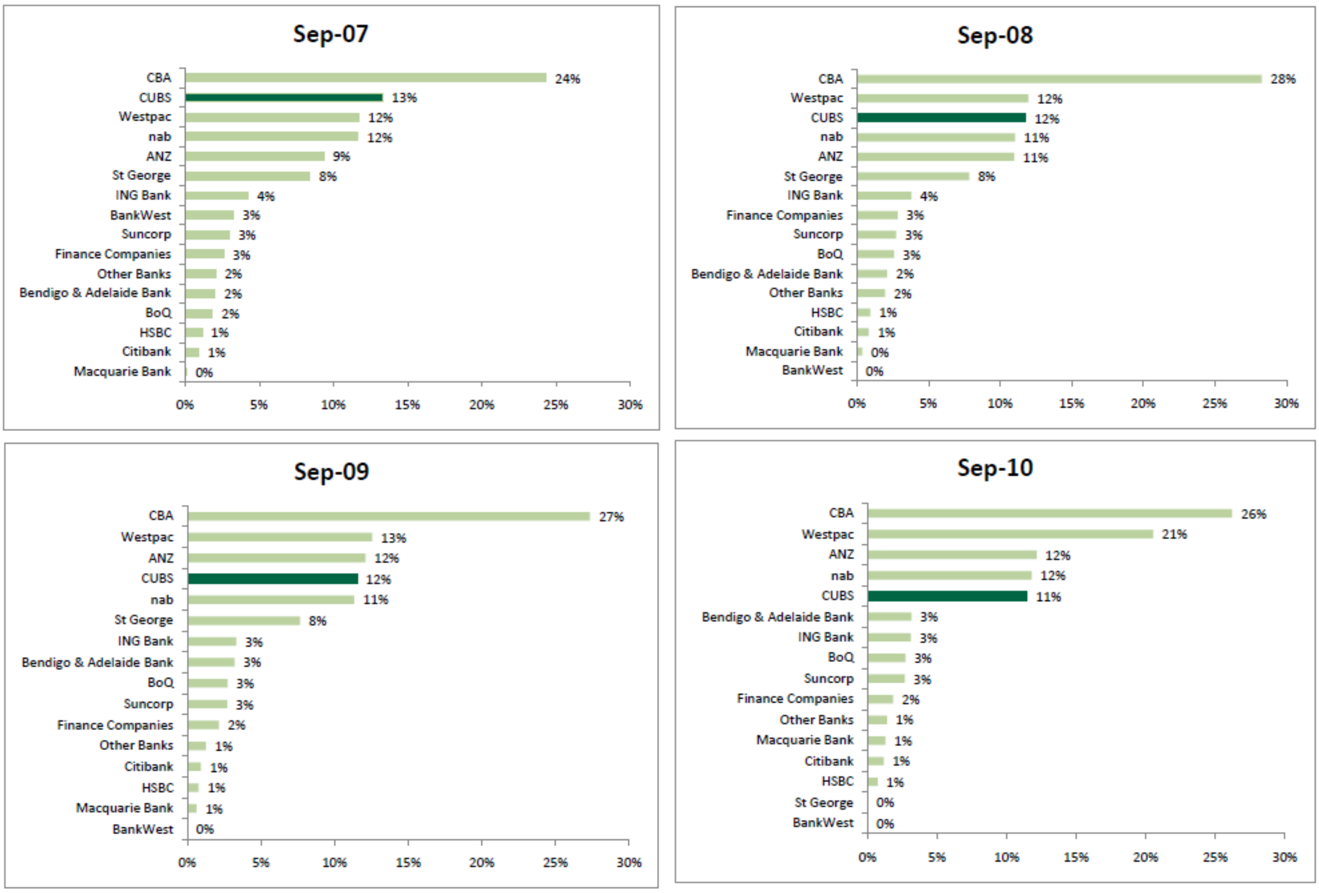
Importance of deposits for funding
The guarantee of deposits of up to $1 million under the FCS was a decisive and welcome intervention by the Government in 2008 and remains a pro-competitive measure that has delivered peace of mind to depositors and stability to the core of the financial system. It has also helped smaller banking institutions to defend their share of the deposits market from the major banks.

Credit unions and building societies have always been predominantly funded by retail deposits. As a percentage of total assets for credit unions and building societies, deposits are just over 85 percent. The comparable figure for major banks is around 60 per cent.

The proportion of mutual sector funding made up of deposits has increased since before the global financial crisis as a result of the collapse of the securitisation market.

While credit unions and building societies have been able to grow their deposits, bank mergers and stronger growth by the major banks has seen the mutual banking sector's market share in household deposits slip from second place in 2007 to fifth place today.

Market Share in Household Deposits



(Source: RBA and APRA)

One of the major banks told an earlier Parliamentary inquiry that "in the absence of a guarantee, it is more likely that a greater share of deposit funds would have flowed to larger ADIs (with relatively higher credit ratings) on the basis of the perceived greater security of these funds."[2]

Bank of Queensland CEO David Liddy recently told the Senate inquiry into competition in banking that:

> "The four major banks are unique not just in terms of their size in the banking market; they are also now the biggest players in the insurance, wealth management and financial advisory markets. It could be argued that they already have an implied guarantee from the government, as they are systemically important and too big to fail."[3]

Major banks can be expected to exploit the perception they are too big to fail in the context of the current review of the cap applying to deposits under the FCS.

> "Australia's big four banks, which increased their dominance of the financial system during the global financial crisis, are determined to use their higher credit ratings to gain a market advantage over small, less highly rated financial institutions. One major bank has already made it clear to this columnist that when the guarantee comes off…it will be

[2] Westpac submission to Senate Inquiry into banking funding guarantees, 13 July 2009

[3] Hearing of Senate Economics committee, 9 Feb 2011

> heavily advertising its financial strength in order to win a bigger share of bank deposits."[4]

The per-depositor cap for FCS should be maintained at $1 million after 11 October this year because any reduction will only benefit the major banks and reduce competition. The deposit guarantee poses no risk to taxpayers because:

> 1. the prudential regulatory framework ensures that it is highly likely that the remaining assets of a failed institution will be sufficient to recover funds paid out under the FCS to depositors; and
>
> 2. in the unlikely event of there being a shortfall, regulated banking institutions will be levied to make up the difference.

The price of entry to the FCS is an extremely tough prudential regulatory regime. Entities that wish to compete on a level playing field with banking institutions are welcome to submit to the same requirements on capital, liquidity, risk-management, reporting, auditing and governance.

Prudentially-regulated banking institutions also meet the cost of this 'first line' of depositor protection because they pay the costs of regulation via ordinary industry levies. APRA chair John Laker has stated that APRA's "supervisory intensity will be as strong, if not stronger, now with the government guarantee in place as it was beforehand."[5]

The prudential regulatory framework protects all depositors. The FCS provides a large proportion of those depositors with an early access facility in case, however remote, of an ADI failing.

Importantly for competition in retail banking, the $1m cap is reassuring for larger depositors, e.g. local government and non-government organisations, that are important sources of funding for smaller banking institutions. APRA and others have noted from recent experience that 'runs' are generally not caused by depositors with very small amounts.[6]

Investors with more than $1 million to deposit are more likely to be able to contribute to the market discipline necessary for an effective deposit insurance scheme. Setting the cap at that level, though relatively high by international standards, gives credibility to the limits of the scheme. A cap lower than $1 million is less likely to be taken seriously as a genuine limit in any future crisis. This is particularly valid in the Australian context because of the long-standing 'implicit' deposit guarantee arrangements that applied until October 2008.

Market discipline will also continue to be imposed by creditors not covered by the FCS and by shareholders. The deposit guarantee protects depositors, not shareholders. Excessive risk-taking by profit-maximising banking institutions is constrained by a combination of market discipline and prudential regulation. Unlisted mutual banking institutions do not have the same motivation to maximise profits as listed banks, so there is not the same incentive to take excessive risk in our sector. The focus of mutual banking institutions is demonstrated by their market-leading customer satisfaction ratings and their long track record of responsible lending.

Conclusion

Because small businesses rely more on debt funding than large companies and rely more on the banking sector for that debt funding than large companies, a competitive banking sector is vital for a healthy small business sector.

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[4] *Chanticleer* column, *Australian Financial Review,* 23 August 2010

[5] John Laker, Senate Economics Committee Hansard 23 October 2008

[6] Evidence by APRA executive Keith Chapman, 28 July 2009, and FSI member Ian Harper, 14 August 2009, Senate Economics Committee inquiry into bank funding guarantees.

The Government has announced a range of measures to promote a more competitive banking market and Abacus is supportive of those measures and is engaging with Treasury and other stakeholders on their implementation.

However, in the short term at least, deposits remain overwhelmingly the most important source of funding for mutual banking institutions.

The cap applying to deposits under the FCS is a factor influencing access to certain depositors and also price in the deposits market. Therefore, in the interests of maintaining and expanding access to funding by credit unions and building societies to allow them to apply competitive pressure to major banks in lending markets, Abacus supports maintaining the cap applying to deposits under the FCS at $1 million after 11 October 2011.

28 February 2011