28 August 2001

The Secretary
House of Representatives
Standing Committee on Economics,
Finance and Public Administration
Parliament House
CANBERRA ACT 2600

Dear Sir/Madam

INQUIRY INTO BANKING SUPERVISION

The NCUA and its members appreciate the opportunity to make this submission to the Committee in relation to its inquiry into APRA's supervision of the banking sector. From the outset, it is important to emphasise a number of key points about credit unions.

The NCUA endorses the concept of a single prudential regulator supervising all ADIs. Credit Unions are however concerned that this could lead to a "one size fits all" approach to supervision and regulation. This perception is highlighted by the Committee's call for submissions where it states, "... associated with APRA's supervision of banks ..." We assume that this reference to banks is actually a reference to all ADIs and that credit unions are included.

Credit unions are distinctly different from most other authorised deposit-taking institutions (ADIs) in that they are mutual "not-for-profit" organisations. The primary concern of credit unions is to provide low cost retail financial services to members. Profit is a secondary motive and is only pursued to facilitate future growth.

Credit Unions fulfil an essential role in the Australian community. Their continued success proves that it is possible to provide low cost financial services to members whilst concurrently pursuing community-based objectives. In fact, the existence of a number of credit unions' is due entirely to the inability or unwillingness of other ADIs to service parts of the community.

Summary

The following are the core issues discussed in this submission:

* Levy cap is inappropriate and potentially disadvantageous to smaller ADIs;
* Risk weighting for residential mortgages should be lowered to reflect the actual risk;
* Proposed changes to prudential standards provide advantages to larger institutions; and
* There is a need to develop an appropriate form of share capital for credit unions which allows for growth through equity capital funding but which preserves a credit union's mutuality.

Levy cap

We agree that the most desirable form of funding for a regulator like APRA is a levy on those organisations being supervised, provided that:
* all institutions are treated equitably; and
* the funding burden reflects the cost of supervision (the degree of supervision being positively correlated with the risk posed by the particular institution(s)).

The current arrangement does not appear to satisfy these two qualifications. Firstly, the existence of a "maximum amount payable" by a cap on levies results in smaller institutions paying a much greater percentage per dollar of assets than the largest institutions.

A further problem would arise as a result of mergers between ADIs over $8 billion in assets, which is where the present cap of $1 million cuts in. Total levies will be reduced by $1 million for each merger of ADIs over $8 billion in assets. For example, if St George Bank (assets of $48,241 million) and BankWest (assets of $19,856 million) merge to form a bank with $65,000 million in assets (approximately). The merged entity pays its next levy of $1,005,000 (the prescribed maximum). This sees a levy reduction of $1,005,000 in comparison to the pre-merger entities.

There are two possible implications (a) APRA will 'lose' $1 million in levies and will spend the same amount on supervision for the much larger merged entity, as it did on one of the pre-merger entities (that is, $1 million worth), or (b) the funding shortfall will be sourced from all other ADIs by an increased levy rate, payable by all ADIs less than $8 billion. It is considered highly inappropriate to expect smaller ADIs to make up a shortfall in such circumstances.

A staggered levy system seems appropriate; where for every dollar of assets over a given set of threshold amounts, the institution pays a progressively lower percentage (but with no maximum).

Secondly, there should be a direct relationship between:
* the risk that the institution poses;
* the amount of supervision necessary; and
* the funding burden for that supervision.

It is acknowledged that there is, and should be, a minimum "price of entry" for all ADIs. This covers APRA's administration costs in relation to each ADI and a base level supervision cost for all institutions. Beyond this, each dollar of levy charged should be directly proportional to the risk posed by the ADI. Much of APRA's overheads come from the sophisticated supervision requirements caused by the complex/exotic operations of the larger and internationally operating ADIs.

The following points are worth noting:
* in the March 2001 quarter, credit unions had a weighted average total eligible capital/risk weighted assets of 14.7% and an average liquidity ratio of 20.1% (versus the 8% and 9% prescribed minima respectively);
* credit unions have no trading book and are therefore only exposed to systemic risk. Credit unions do not deal in comparatively high risk financial instruments (e.g. derivatives); and
* the majority of credit unions hold loan portfolios dominated by

residential mortgages (which historically have low default rates). Weighted average impaired assets as a percentage of total assets for credit unions is 0.5% and trending down.

We believe that the conceptual nexus between risk and supervision has not been fully considered in the case of credit unions and that the funding burden should reflect the actual risk that credit unions pose to the financial system ie $23 billion of a total of $834 billion in assets.

Risk weighting for residential mortgages

APRA's Prudential Standards have the stated objective of ensuring "that all locally incorporated ADIs maintain a level of capital that is consistent with the risks to which they are exposed from their activities." It is our contention that a 50% risk weighting for residential mortgages is not consistent with this objective.

The implication of a 50% risk weight is:

* that half of all loans secured by residential mortgage are considered risky; or
* that if enforcement action was to occur, half of the outstanding amount may not be recovered.

Evidence provides a different picture:

* The weighted average of impaired assets as a percentage of total assets for all credit unions is 0.5%. APRA's own definition states "for building societies and credit unions, impaired assets are defined as loans, advances or overdrawn savings accounts that are at least 90 days in arrears. A large proportion of these loans are well secured and the risk of default is very low."
* Loan to valuation ratios (LVR) are limited to 80% (or less) unless the loan is 100% mortgage insured through a lenders mortgage insurer (LMI). Therefore, the worse case is where a borrower defaults and has LVR of 80% (because if a borrower defaulted with an LVR>80% the outstanding amount would be 100% mortgage insured). In this instance, the lender has $10 coverage for every $8 outstanding; meaning, when default does occur, loss is very unlikely.
* Prudential standards provide specific criteria for classifying eligible residential mortgages and these ensure that, if default occurs, the ADI is highly likely to recover the outstanding amount.

In short, the risk of default is very low, the loss suffered if default occurs is also very low and the assets held as security against default are of an acceptable quality. There appears to be little reason to support the current risk weighting of 50%.

The current residential mortgage risk weighting appears all the more curious when compared to the 100% risk weighting for unsecured loans. Loans secured by residential mortgage are far less risky than the respective weightings suggest. Both default and loss are much more likely with unsecured loans.

It is understood that APRA agree that residential mortgages should have a lower risk weighting and have advised that representations to this effect are being made to the Basel Committee.

A weighting of between 20% and 30% would appear to be more appropriate for loans secured by residential mortgage.

Proposed new prudential standards

The NCUA believes that it is the role of APRA to provide a level regulatory 'playing field' for all types of institutions. Banks, credit unions and building societies each have different origins and roles within the community that must be provided for.

We believe that the draft prudential standards being developed by the Basel Committee could provide an unfair advantage to larger organisations. Institutions that adopt approved risk management methodologies may be permitted to maintain lower regulatory capital levels than institutions that choose the standardised approach to credit risk.

There are several reasons why this poses problems:

* credit unions are usually comparatively small mutual organisations that have low fees and interest margins sufficient only to service member needs;
* the resources required to develop, test and maintain sophisticated risk management models are prohibitive for smaller ADIs; and
* it is questionable whether such models would make a significant difference given the nature of credit union operations. Credit unions do not have trading books and are not involved with risky, speculative or highly leveraged financial instruments (e.g. futures, options, sub-investment grade bonds, etc).

Credit unions might therefore be required to hold the maximum prescribed level of capital whilst larger multinational banks would be permitted to hold much lower levels of capital.

The Basel Committee is developing a risk weighting concept designed for multinational banks and APRA may end up applying this uniformly to all ADIs. Credit unions are different organisations to banks and should not be penalised for being so.

It would be most inappropriate for government (and regulators) to be seen to be discriminating against small not-for-profit mutuals in favour of large commercial banks; especially given the lack of popularity of banks within the broader community.

To prevent inconsistent treatment, it is proposed that the current regulatory capital requirement system be maintained for all ADIs.

Share capital for credit unions

Credit unions continue to face growth limitations due to the absence of a form of equity capital that preserves their mutuality. We have raised this here because it is a challenge that all credit unions face; not because it is an issue that APRA has failed to address.

Policy Statement 147 outlines ASIC's approach to mutuality. APRA has confirmed that it will adopt this policy. Part C of this document sets out the essential tests that must be satisfied before ASIC (and APRA) will view an institution as a mutual. They are the "economic relationship test" and the "governance relationship test."

For mutuals, the economic and governance relationship tests rule out conventional share market equity (ie ordinary shares) as a source of capital. It does not do this explicitly, but by precluding many of the attractive features of ordinary shares.

Policy Statement 147, and its approach to mutuality, affects the attractiveness of ordinary shares as equity capital for credit unions in the following ways:

* shares are restricted to members;
* shareholders would be entitled to only one vote (conferred by membership), irrespective of the size of their shareholding;
* listing on the ASX is precluded;
* no liquid market for shares; and
* with no liquid market, there would be no prospect of capital gain on a share.

As noted earlier, this conflict between equity funding and mutuality has been raised in this submission because it is a factor limiting the growth of credit unions. We would appreciate the Committee's cooperation in promoting further discussion in relation to this issue.

Again we thank the Committee for the opportunity to comment on the progress of banking supervision in Australia. We hope that our thoughts are of some assistance. If you have any questions regarding this submission please do not hesitate to contact me on telephone 07 3870 3877 or via e-mail ncua@creditlink.com.au.

Yours sincerely
Philip Elliott
Chief Executive Officer
NATIONAL CREDIT UNION ASSOCIATION INC.

NB: hard copy to follow

per:
Shari Hindmarsh
Personal Assistant to CEO (NCUA)
PH: 07 3870 3877
FAX: 07 3870 3343
shindmarsh@creditlink.com.au