Community CPS Australia

SUBMISSION 17

By Email: <economics.reps@aph.gov.au>

11 July 2008

The Secretary
House of Representatives Standing Committee on Economics
PO Box 6021
PARLIAMENT HOUSE
CANBERRA ACT 2600

Dear Mr Zinkel

Thank you for your letter of 6 June 2008 inviting Community CPS Australia ('Community CPS') to make a submission to the Committee's Inquiry into competition in the banking and non-banking sectors in Australia.

I have attached Community CPS' submission to the Inquiry. The submission represents the views of Community CPS and is not submitted on behalf of the credit union industry.

Please contact Mr Gianni Milani on 08 8205 8808 or gmilani@communitycps.com.au if you would like further information in relation to the Community CPS submission.

Yours sincerely

KEVIN BENGER
Chief Executive Officer

Community CPS Australia Ltd
Adelaide 44 Waymouth Street Adelaide SA 5000, GPO Box 1430 Adelaide SA 5001. Telephone: 13 25 85 Facsimile: (08) 8231 3060
Canberra 105 Mawson Drive Mawson ACT 2607, Locked Bag 1000 Mawson ACT 2607. Telephone: 13 25 85 Facsimile: (02) 6286 0560
ABN 15 087 651 143 AFSL 237856
Email: member@communitycps.com.au Website: www.communitycps.com.au

Community CPS Australia Limited ('Community CPS') submission: House of Representatives Standing Committee on Economics ('Committee') Inquiry into competition in the banking and non-banking sectors in Australia

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For further information, please contact:
Mr Gianni Milani, Chief Governance Officer and Company Secretary
Community CPS Australia Limited
GPO Box 1430
ADELAIDE SA 5000
Telephone: 08 8205 8808
E-mail: gmilani@communitycps.com.au

1. INTRODUCTION

Community CPS is a credit union that has a special relationship with its members and whilst small and possibly considered insignificant in the financial services sector it provides useful competition in the areas it operates in.

South Australia, the Australian Capital Territory and associated regional areas do not have major financial institutions with a head office presence and therefore are more reliant on smaller institutions to raise issues related to consumers in their region.

Competition is welcome and has been a driver in achieving better outcomes for consumers. It has also attracted unhealthy practices to the financial services factor which has and will have serious ramifications to this important part of the Australian economy.

To assist smaller contributors to the financial services sector governments should be vigilant when considering the cost of regulation, product development, unregulated entrants and different structures such as mutual entities.

2. BACK GROUND INFORMATION - COMMUNITY CPS

Community CPS is an Authorised Deposit-taking Institution ('ADI') and is the sixth largest credit union in Australia which was formed in 2006 following the merger of CPS Credit Union (S.A.) Ltd. and CPS Credit Union Co-operative (ACT) Ltd. It has membership across Australia with a concentration in SA, ACT, and regional NSW. This base of over 140,000 Members has access to 21 branches throughout Adelaide and Canberra, regional South Australia and regional New South Wales.

Community CPS also provides wealth management, accounting, taxation and business finance broking services through its Eastwoods subsidiaries and has established a number of community foundation funds to support the local communities in which it operates.

As at 31 December 2007, Community CPS had assets under management of $1.5 billion and additional funds under advice of over $320 million invested through its wealth management subsidiary – Eastwoods Wealth Management Pty Limited. Community CPS represents a significant, yet unique financial services provider in these markets.

3. INQUIRY DEFINITIONS

The Committee has used the terms 'banking and non banking sectors'. We question the meaning of these terms because there is considerable confusion in the market. It is suggested that the Committee, in the first instance, clarify what is meant by these terms. For example, retail banking – does this refer to the banks only? If yes, then why exclude those non bank ADIs that carry on the business of banking. If the term is all inclusive that is, banks, building societies and credit unions, then what does the Committee mean by the non-banking sector?

This is a very important point because Community CPS and other non bank ADIs are placed at an immediate disadvantage by the use of terms such as 'non bank'. Furthermore, we propose that such terminology only serves to entrench the banks position in the market. It is not what the institution 'thinks' that is relevant, it is what the general public perceive from the use of the terminology.

4. INDUSTRY ISSUES

4.1 Industry Barriers

There are relatively few barriers to entry into the financial services market and entities that are not financial institutions are readily able to give the impression to consumers that they are ADIs. This is detrimental to investors and borrowers as has been shown by recent losses of investors' life savings and loose borrowing standards by some entities. It is unacceptable to adopt a "buyer beware" stance when the majority of consumers do not have the financial expertise or knowledge to differentiate a regulated entity from one that is not. How many people understand the requirements a corporation must meet for it to be authorised under the Banking Act 1959 to conduct business as an ADI?

If consumers are to be protected then all industry participants must be subject to similar prudential standards and disclosure requirements. Is it fair that ADIs are subject to a multitude of APRA Prudential Standards and other stringent compliance 'regimes such as the Uniform Consumer Credit Code and Financial Services and Markets provisions of the Corporations Act when certain other unregulated institutions appear not to be subject to these stringent requirements?

The industry is comprised of regulated and non regulated providers. The regulated providers (known as ADIs) and are subject to a rigorous regulatory regime. The non regulated providers appear to have a reasonably free hand in the delivery of services and products and in many cases the regulatory environment supports this. For example the FSR legislation only deals with liability (i.e. savings) products and does not deal with asset based (i.e. credit) products. This has allowed some industry participants such as mortgage brokers to flourish to the disadvantage of some ADIs, the consumer and the community at large. Furthermore some ADIs have used non regulated organisations to extend their market penetration without being subjected to the regulatory requirements that might otherwise apply. This not only creates an uneven playing field but also places the normally conservative financial sector at risk.

4.2 Competition

Competition is fierce, unfair and not regulated. This is evidenced by the declining interest margin experienced by credit unions. The interest margin for credit unions has decreased from 4.34% in June 2000 to 3.21% in March 2008.

Some entities are able to operate at lower margins because they can take advantage of the infrastructure paid for by other entities. For example, a new market entrant can provide a small range of financial services and rely on banks to provide the branching structure. These entities "cherry pick" the most profitable products and services and the banks and credit unions provide the branch networks with lower profitability due to the costs of operating these substantial branch networks.

Branch networks remain an essential part of the financial system, particularly for the elderly and disadvantaged. They are also part of the current community fabric.

4.3 Recognition of credit unions

It appears that governments and regulators in Australia conspire to ensure that credit unions cannot compete with the banks. Mutual organisations such as credit unions are not recognised as is the case in the U.K. Mutuals are unable to raise capital, utilise the substantial amount of franking credits through the payment of dividends and must comply with the same extensive compliance regimes that apply to the major banks which have access to substantially more resources than do the smaller mutual organisations.

The number of credit unions has declined from 215 in June 2000 to 137 in March 2008 due to intensive competition, over-regulation and the inability to re-capitalise during periods of market stress. Whilst this, in some cases, has meant the financial strengthening of the credit unions they play an important role in competition as an alternative to the banking sector yet are being driven out of the system.

Recent surveys have revealed that customers of banks tend to remain with 'their' bank primarily due to the degree of difficulty in changing financial institutions but also because of a perception of trust in relation to banks which is perpetuated, as mentioned previously, by current legislation. Credit unions should have greater capacity to raise capital to assist them being perceived as sound and trustworthy financial institutions and an alternative to the banks. It should be noted that there has not been a collapse of a credit union within Australia.

4.4 Risk of over regulation

As an example the FSR 'regime' requires staff working for an ADI to have certain minimum competencies. Staff of an ADI, when providing a term deposit to a customer/member, must provide a comprehensive product disclosure statement (PDS) even though a term deposit is a basic type of financial product which most people have an understanding of. However, a broker selling a loan for a house does not need to satisfy similar competency or disclosure requirements and this does not make sense. The obvious links between the failures both in Australia and the practices of unregulated brokers seems to have escaped the attention of government and the regulators.

Due to the recent failure of companies that have used investors funds unwisely there is a likelihood of more regulation to protect investors but history shows that this is usually mis-guided and reduces the capacity of honest and ethical institutions to compete. There is no legislation that will protect people from dishonest organisations unless there is a safety net where all industry participants contribute to a common fund. There is a real risk that further 'blanket' regulation will unjustly impose further obligations on ADIs who are fully compliant with existing compliance requirements and may fail to accomplish the objective of protecting consumers from organisations that pay little heed to operating with integrity, honesty and in an ethical manner.

4.5 Relevance of credit unions

Credit unions play a valuable role and conduct their business in an ethical manner in the heavily regulated financial services sector which is, monitored by a number of regulators. They have assisted when banks withdrew from communities and provide an attractive alternative when all banks appear to be the same and have common products and services.

There continues to be significant innovation in the industry but compliance obligations stifle much needed product development whilst seemingly ignoring products and services which appear to be questionable such as reverse mortgages and the provision of bundled personal products that add to the home loan burden. The associated risks are high but there is no requirement to even disclose the risks to the consumer.

A number of previous comments in this submission demonstrate the relevance of credit unions. Credit unions:

- are willing to operate at the micro level:
- are able focus on regional communities;

- have the capacity to innovate (eg credit unions were the first financial institutions to introduce ATM's in Australia); and
- can return benefits back to the communities of the areas they operate in based on their success. Community CPS with its various Funds established under the Community CPS Foundation is a good example.

4.6 Fraud risk

The lack of resources to address fraud, particularly electronic fraud, will continue to restrict the lowering of costs through the use of technology to offer banking products and services.

5 Developments in regards to products, providers and distribution channels

There is significant competition in the development of products, distribution channels, and between providers. Retail financial services are becoming more commoditised and therefore many industry participants are adopting a stance that volume growth will maintain profitability in a period of significant interest margin contraction. Other industry participants are adopting a relationship strategy where product development takes the form of delivering on a need for the customer/member as distinct from opportunistic offers that are simply profit generators. In the past product innovation has focussed on the asset side of the balance sheet (i.e. credit products) and this has resulted in instances where consumers have been hurt by unregulated and unscrupulous operators. Overall we believe that product innovation by regulated ADIs has been to the benefit of the consumer. An example is the Community CPS parent equity home loan that enables families who are willing to use the equity in their home to help their children purchase their own home.

In recent times there have been instances where the opportunity for innovation has been negatively impacted by the approach taken by government. An example is the requirements associated with the First Home Owner Savings Account. Instead of this account being designed as a simple easy to operate account it contains numerous requirements that will make it too onerous for many smaller institutions to implement and offer to consumers. This will help entrench the larger institutions in the deposit and home lending markets.

Furthermore, if the First Home Owner Savings Account is too complex resulting in many ADIs not offering this account, it may create an opportunity for superannuation funds to compete for retail deposits. It is important to apply the same taxation treatment in relation to specific products offered by ADIs if they are to effectively compete with superannuation funds. This is an example of how the differential tax treatment of products/services offered by different types of entities can create un unfair competitive environment.

In contrast, the deposit account that Community CPS established to cater for the government's interest deeming requirements is relatively simple and Community CPS was not impacted to the same extent that it will be in providing a First Home Owner Savings Account.

The important point made here is that the government could have set up an account structure for the First Home Owner Savings Account that was much simpler thereby delivering and achieving real outcomes for the consumer and creating an account which institutions would embrace. This only serves to reinforce the importance and need for good government policy. Poor regulation will damage the thrust of such policy and limit competition.

The recent developments in relation to account switching, while addressing issues concerning the ability of consumers to easily shift their accounts, has the potential to place larger institutions at a distinct advantage. Large institutions have the ability to heavily market their products and while competition may exist between the larger market participants the smaller operators may be placed at a disadvantage in this situation.

6. Disclosure and Activity Associated Entities

It is suggested that there has been significant change in the retail banking environment, with numerous financial institutions reducing the burden of the stringent regulatory environment, by the use of unregulated mortgage brokers.

Mortgage brokers have allowed many financial institutions to increase their market penetration reach under the umbrella of providing consumers with better access to finance. However, the broking sector is not regulated and there is ample evidence about the unethical practices adopted by some brokers.

The use of brokers has allowed financial institutions to write significant volumes of loans without the regulatory oversight of their 'agent' brokers. It is contended that this may have been to the disadvantage of some consumers. It seems that where unregulated entities are used the level of disclosure in relation to commissions and the true holder of the mortgage is limited. Many brokers do not advertise as brokers but as home loan providers.

7. Current State of the Retail Banking and Non-Banking Institutions

Compared to other international jurisdictions, the Australian financial system appears to be sound. This has been attributed to the sound structure of the regulatory framework. However, one needs to be mindful that the current position is founded on a substantial period of good economic conditions in Australia. The question remains as to whether the Australian market has been truly tested as a result of the global financial crisis, the continuing falls in the share market and restricted access to the wholesale funding markets.

The government encourages competition but it administers all institutions on the same basis without recognition of the differing corporate structures. While the need for sound financial institutions is paramount, there can exist the threat of institutions with different corporate structures being captured into a regulatory environment that is skewed towards a regulatory regime that caters for larger institutions. Mutual organisations are unique in that the owners, customers and members are one. Unfortunately regulators may not appreciate this in their administration of the sector. Regulatory capture can result in limiting competition within the sector as different corporate structures will not be encouraged to operate. Having financial institutions that are different and have different corporate structures and philosophies should be encouraged.

8. Banking services available to rural and regional communities

The declining level of services provided in the rural and regional areas of Australia is a result of economic rationalism encouraged by Federal and State Governments. An example is the shifting of medical facilities from key towns to the "Regional Hubs". In many cases the people within the towns are not better serviced by having to go to these hubs.

As key government offices are "rationalised" it contributes to the reduction in the population of those towns. For the Government it is self-fulfilling and for private enterprise it becomes economic reality to review their services and if the required rates of return are not being achieved to remove those services.

There is a Government expectation for private enterprise to assume the community obligations it has deserted. If the community is to benefit there is a need for Governments and the private sector to work together because if the private sector in Australia inherits community obligations then it cannot compete in the global economy.

Community CPS would like to offer facilities within more rural areas but it is constrained because the ability to generate an adequate profit margin is limited. It is treated like a bank by the regulators and must satisfy all of the APRA Prudential Standards. An option would be for governments to provide a subsidy based on a per person basis which would provide the basic infrastructure with the community contributing for any additional services it might like based on the preferred financial institution's cost structure.

We believe that however unpalatable it may be for the rural communities they will have to accept a change in the way their banking business needs to be conducted.

From a personal banking viewpoint the use of ATM's and EFTPOS, Internet and Home Banking and Interactive Voice Response facilities (the electronic options) will form the basis of most interaction with a financial institution. The scope for face-to-face interaction with a teller is reduced due to cost pressures unless it can be provided as a shared service between the financial institution and another entity. (e.g. Chemist, Local Government, newsagent etc)

8.1 Options for expansion of banking facilities through non-traditional channels including new technologies.

One of the most crucial aspects of expanding these facilities is for the telecommunications infrastructure to be improved so that the likes of broadband facilities and highly reliable fast access/data lines are in place. The reason for this is that technological solutions offer the potential to provide enhanced services via means such as:

- ***EFTPOS terminals*** - could be more versatile and friendly if there was access to higher speed lines; and
- ***video based facilities*** - The use of video based facilities could allow someone in a Call Centre/office in a different geographic location to conduct interviews, assist with the use of Internet Home Banking, or ATM's that act like cash drawers. Video could provide the face-to-face connection which has greater significance within rural and regional areas.

Community CPS has self-directed touch screens within all its branches which allow access to its Internet Home Banking and Website. With quality high speed connections or broad band these devices could be installed in appropriate locations therefore allowing access to a broader range of people, particularly those who do not have their own/or access to a Personal Computer.

9. Likely Drivers of Future Change

The drivers of change in the future will arise from both societal and industry/market change.

9.1 Major societal drivers of change

The major societal drivers of change will be:

- ***Aging population*** – Australia's population is skewed towards the older generations with a contracting younger age category. This will impact on the supply of product as well as the increasing competition for youth type business as institutions attempt to secure relationships for the future;
- ***High levels of household debt*** – this will adversely impact on the demand for credit and the resultant impact on margins. Suppliers of financial services will be attracted to

low credit risk consumers. However there will be an increasing number of consumers that will require debt assistance;

- ***Climate change and oil crisis*** - will influence consumers demand for and supply of goods with the flow-on effects of how they are financed. It may affect the capacity of consumers to drive to a banking facility and may in fact accelerate the need to a technology based solution; and
- ***Competition for labour*** – Financial institutions will be impacted by the aging population and the supply of labour as the workforce ages.

9.2 Major industry drivers of change

The major industry drivers of change will be:

New technology – this will impact institutions in their ability to invest for the future and the manner in which technology will break down the intermediation process. The use of prepaid cards to by pass the traditional financial institution will challenge many organisations;

Regulation and compliance – the burden of regulation and compliance on many smaller institutions is resulting in some organisations simply merging as the burden is too great;

Competition and margin contraction – The economic imperatives will flow through to and impact on the demand for finance and many market participants will respond with price reductions (lending) or price increases (deposits) to continue to maintain market share. This will increase the pressure on interest margins; and

Uneven Playing Field – With the barriers to entry into the financial services market being broken down there are a number of market participants (unregulated) that have entered the market without the prudential requirements that other market participants are confronted with. This has rendered the competitive environment inconsistent and to the disadvantage of a number of institutions that seek to build meaningful relationships with their members/customers and not conduct business simply for profit motives.