Financial System Inquiry

Discussion Paper: Competitive Neutrality in the Retail Banking Market

COBA Public Affairs
February 2014

Introduction

This discussion paper is one of a series produced by COBA to generate discussion and debate and to prompt feedback to inform our submission to the Financial System Inquiry (FSI).

The Productivity Commission describes the competitive neutrality principle as sellers of goods and services competing on a level playing field; that is, one provider should not receive an advantage over another due to government regulation.

> "Competitive neutrality removes artificial advantages and allows businesses to compete on a basis that offers the best cost and quality combinations to customers. This is likely to result in more effective competition and more efficient outcomes."[1]

Competitive neutrality means the customer-owned model should be able to compete on equitable terms with the listed model, without being handicapped by unfair treatment and/or subsidies to competitors.

Competitive neutrality does not require identical rules and regulations for all banking institutions. Rather, it requires a principles-based regulatory framework that allows for diversity and recognises the benefits for consumers and overall system stability of accommodating different business models.

The head of the RBA's Financial Stability Department, commenting on regulatory consistency, has observed:

> "….in ensuring consistency, we do not want to create a monoculture, with all its members being vulnerable to the same risks because they face the same incentives. There is something to be said for allowing some diversity of business models, so the whole system doesn't collapse from a particular shock."[2]

Competitive neutrality is vitally important in the Australian banking market due to the dominance of the four major banks.

The big four banks:

- benefit from "a large and unacceptable implicit public subsidy";[3]
- arguably don't compete aggressively with one another while competing aggressively against smaller players;[4]
- are part of the only sector in Australia subject to anti-price signalling laws because of anti-competitive behaviour;[5] and
- feel they are protected from others entering the market and "that makes for arrangements that are too cosy for consumers".[6]

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[1] Contribution of the Not-for-Profit Sector. PC Research Report. January 2010
[2] http://www.rba.gov.au/speeches/2013/sp-so-181013.html
[3] http://www.apra.gov.au/MediaReleases/Pages/13_40.aspx
[4]http://www.aph.gov.au/parliamentary_business/committees/house_of_representatives_committees?url=economics/banking08/report.htm
[5] http://www.australiancompetitionlaw.org/legislation/2011pricesignalling.html#swan
[6] http://www.news.com.au/national/big-four-warned-on-rates/story-e6frfkp9-1226250341341

The customer-owned banking sector, which collectively ranks fifth after the major banks in its share of household deposits, is a key contributor to competition, choice and stability in the Australian banking market.

Credit ratings agency Moody's this month[7] outlined the strengths of the customer owned model, including strong balance sheets, conservative business models and an above-average degree of customer loyalty.

> "Mutuals tend to deemphasise profit maximization in favour of providing value to members," Moody's says.
>
> "Mutual franchises emphasise specific customer sets, community involvement and customer service, which support their strong customer satisfaction metrics.
>
> "The mutual sector also enjoys consistently stronger asset quality than the listed bank sector..[and]..boasts a very high level of capitalisation."

The customer-owned banking model is durable and successful and is entitled to nothing less and nothing more than competitive neutrality.

In the absence of positive action by the Government and regulators to promote competition and genuine choice in the banking market, the major banks will continue to get bigger and the associated risks to the financial stability will continue to increase.

COBA has identified multiple examples of failure to provide competitive neutrality to customer-owned banking institutions. These are outlined below. When reviewing this discussion paper, COBA members and other stakeholders are asked to keep in mind that:

- it is intended to stimulate discussion about the merits (or otherwise) of the material put forward and to draw evidence, illustrative material and case studies;
- it is not intended to be a comprehensive 'wish list' of all issues facing the sector;
- not all topics COBA will cover in our submission to the FSI are captured in this discussion paper; and
- COBA's submission will provide further context around these issues, including an overview of the sector and its contribution to the community.

Comments and feedback on this paper should be provided to Pia Brunner at pbrunner@coba.asn.au by 28 February 2014.

Luke Lawler
A/Head of Public Affairs
7 February 2014

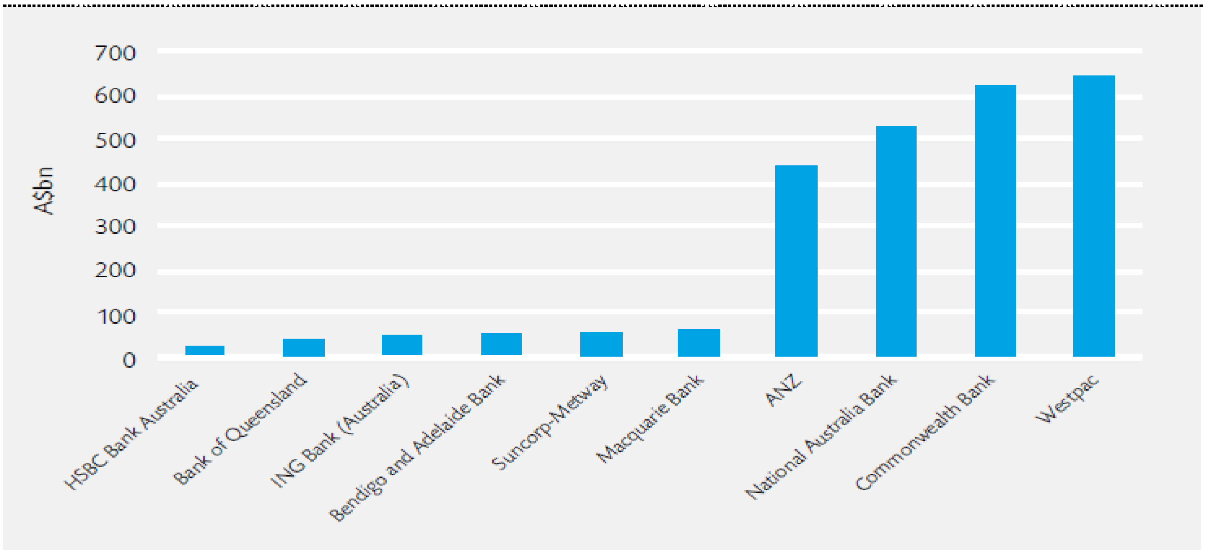
[7] *"Australia's Mutual Financial Institutions: Competition Remains a Key Challenge"*

MAJOR BANKS' UNFAIR FUNDING COST ADVANTAGE

Major banks gain an unfair cost of funding advantage that flows from ratings agencies and investors factoring in an implicit Government guarantee.

The IMF estimates this funding cost advantage rose from 80 basis points to 120 points during the GFC when government support for the banking system was made more explicit.

APRA has formally identified the big four banks (total resident assets depicted below)[8] as systemically important banks.



> "Systemically important financial institutions (SIFIs) are institutions of such size, market importance and interconnectedness that their distress or failure would cause significant dislocation in the financial system and adverse economic consequences," APRA says.
>
> "The 'too-big-to-fail' problem arises when the threatened failure of a SIFI leaves public authorities with no option but to bail it out using public funds to avoid financial instability and economic damage. As the Basel Committee argued, the moral hazard associated with implicit guarantees derived from the perceived expectation of government support can encourage SIFIs to take excessive risks, reduces market discipline and creates competitive distortions, further increasing the probability of distress in the future. As a result, the direct cost of support associated with moral hazard is borne by taxpayers, representing a large and unacceptable implicit public subsidy of private enterprise."[9]

The unfair funding cost advantage and its impact on competition is only one of the problems posed by SIFIs. The President of the New York Federal Reserve William Dudley says the second problem is that the funding cost advantage creates incentives for banks to

[8] Information Paper: Domestic Systemically Important Banks in Australia. Dec 2013 APRA
[9] Ibid

become bigger and more complex and the third problem is that there is a positive feedback loop: as the banking system becomes more concentrated and complex, financial stability risks increase, making the too big to fail problem even worse.[10]

Dudley believes policymakers have three broad sets of choices:

1) building a credible resolution regime and more resilience in the financial system that together reduces the systemic costs of failure sufficiently so that large, complex firms can be allowed to fail;
2) taking steps, such as tougher prudential standards, that further reduce the probability of failure of such firms; or
3) breaking up the too big to fail firms so that no firm is so large that its failure would threaten financial stability in the first place.[11]

APRA's response to Australia's four domestic systemically important banks (D-SIBs) is to impose an additional Higher Loss Absorbency (HLA) capital requirement of one per cent to apply from 2016. This response is at the lower end of the range set by other countries. Switzerland and Sweden have imposed regulatory capital increases of five per cent on their systemically important banks and in the EU, the US and Singapore it is two per cent.

The one per cent HLA requirement does not present a challenge to the big four banks. According to Moody's, the major banks will have "no difficulty" meeting the requirement."[12] APRA has indicated it will allow them to absorb the new requirement by reducing their current management capital buffers.

> "At 1 January 2016, the management capital buffers of the D-SIBs may be lower than current levels given the additional HLA requirement," APRA says. "APRA considers it reasonable if D-SIBs choose to operate with a relatively lower management capital buffer from 1 January 2016 given the nature and size of the extended capital conservation buffer."[13]

In COBA's view, APRA's D-SIB regime does not go far enough in tackling the unfair competitive advantage of the big four. The "too big to fail" issue must not be put in the "too hard to fix" basket.

In the UK, the leader of the Opposition Labour Party says Britain has one of the most concentrated banking systems in the world and is promising to:

- impose market share limits for any one bank; and
- create two new "sizeable and competitive banks to challenge the existing high street banks."[14]

COBA does not advocate breaking up the major banks or imposing market share limits for any single bank.

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[10] 'Too big to fail banks have implicit guarantee' AFR 14 Nov 2013
[11] http://www.newyorkfed.org/newsevents/speeches/2013/dud131107.html
[12] No Immediate Credit Implications from APRA's D-SIB framework. Moody's Sector Comment, 9 January 2014
[13] Information Paper: Domestic Systemically Important Banks in Australia. Dec 2013 APRA
[14] http://www.newstatesman.com/2014/01/ed-miliband-speech-cost-living-and-banking-reform-full-text

However, we support imposing a levy on systemically-important banks in response to the benefit they obtain from the implicit guarantee and the risk they pose to the national economy. An annual levy in the range of $1 billion to $2 billion would represent a conservative setting, given the difficulty in precisely estimating the benefit of the implicit guarantee. The simplest way to impose the levy would be to apply it to the entire liability base of each D-SIB.

Policy Options

- *Apply a levy on D-SIBs to reflect the 'implicit guarantee' and the risk D-SIBs pose to the economy*
- *Further increase regulatory capital (e.g Switzerland and Sweden, 5 per cent; EU, US, Singapore 2 per cent)*

RISK WEIGHTING OF ASSETS FOR REGULATORY CAPITAL

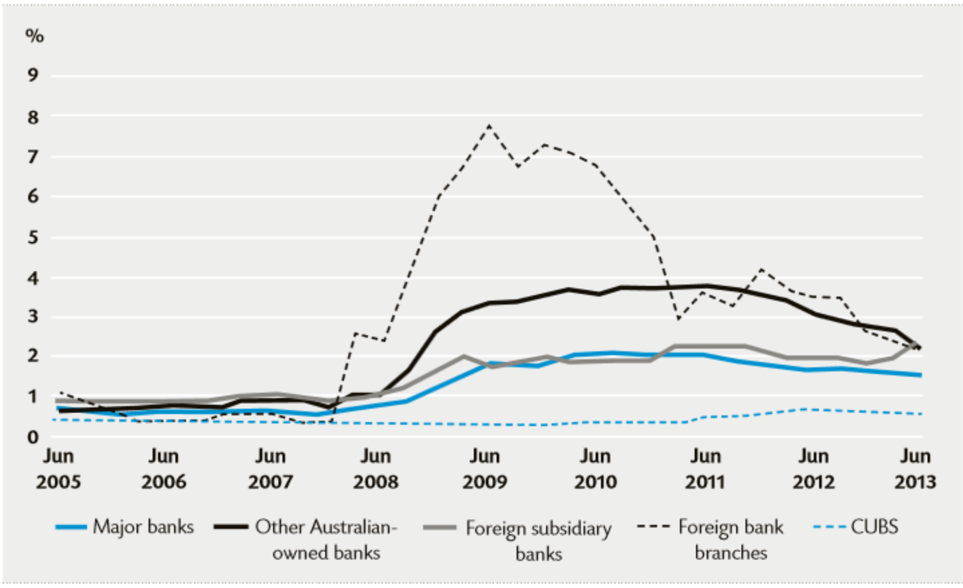
Major banks are permitted to use a method of calculating their regulatory capital that gives them a significant advantage in the amount of the regulatory capital they are required to hold against home loans.

While all other ADIs use the Standardised approach, major banks using the Internal Ratings-based (IRB) approach can hold less than half the capital than their smaller competitors per home loan. ADIs using the Standardised approach must apply a risk weighting of 35 per cent on home loans while a big four bank can apply a risk weighting as low as 16 per cent.

	Major bank	**Small ADI**
Housing loan	$100	$100
Risk weight	16%	35%
RWA	$16	$35
Assumed capital ratio	13.5%	13.5%
Capital held	$2.16	$4.73

This competitive disadvantage imposed on all smaller lenders in the context of credit risk is particularly anomalous for customer-owned banking institutions because of their strong and sustained track record of prudent lending. Customer-owned banking institutions have consistently delivered lower levels of non-performing loans than the major banks.

Non-performing loans as a percentage of total loans:



Source: APRA

As one commentator has observed, a key factor in big banks' returns is the fact that APRA allows them to hold less than half the capital, and thus have more than twice the leverage, across their huge home loan books: "so the institutions that in principle pose the greatest systemic risks hold the smallest buffers against future losses."[15]

In practice, a major bank holds approximately 55 per cent less capital than an ADI operating under the standardised approach for a housing loan (to an identical borrower and residential security), due to risk weighting of approximately 16-18 per cent versus 35 per cent. An additional 1 per cent HLA buffer being applied will result in the major bank holding 50 per cent less capital.

APRA should level the playing field by reducing the advantage that the major banks gain under the IRB method.

Policy Option

- *Lower the standardised rate to a level lower than 35%*

RMBS FOR REGULATORY LIQUIDITY

ADIs subject to APRA's Minimum Liquidity Holdings (MLH) regime are unable to use RMBS in their MLH portfolios while larger ADIs, including the major banks, will be able to use RMBS for regulatory liquidity purposes.

[15] http://www.afr.com/f/free/blogs/christopher_joye/why_the_big_banks_will_still_rule_bpwYW1Pm1pT4lHJafApbDL

Liquidity Coverage Ratio (LCR) ADIs that can use RMBS for regulatory liquidity purposes will be able to generate higher returns from their regulatory liquidity portfolios. Indeed, APRA expects that ADIs with access to the RBA's Committed Liquidity Facility (CLF) are likely to hold those assets as part of a well-diversified liquid assets portfolio.[16]

MLH ADIs were previously allowed to include RMBS in their MLH portfolios but under the new liquidity regime that commenced on 1 January 2014 RMBS are not acceptable

> "on the basis, reinforced by experience during the global financial crisis, that these assets are considerably less liquid and more complex than other assets eligible for inclusion as MLH liquids."[17]

APRA has acknowledged submissions by COBA and others that it would not be fair to include RMBS, ABS and self-securitised assets as eligible collateral for the CLF available to a LCR ADI and not to do so for MLH ADIs, even though they could use such assets to access liquidity via repo transactions with the RBA.

However, the regulator will not lift the ban on RMBS in MLH portfolios and says:

> "The introduction of the CLF for scenario analysis ADIs has a different objective: viz, to balance the need to meet a global liquidity standard with the fact that there is an insufficient supply of HQLA in Australia."[18]

The unfair outcome is that the same repo-eligible RMBS asset has a different regulatory status depending on whether it is held by a LCR ADI or a MLH ADI.

A more competitively neutral framework would provide an explicit regulatory benefit for MLH ADIs that have a self-securitisation repo facility with the RBA.

***Policy Options**:*

- *APRA to provide explicit regulatory benefit to MLH ADIs that have implemented a self-securitisation repo arrangement with the RBA and to allow some proportion of repo-eligible RMBS in MLH portfolios*

REGULATORY CAPITAL INSTRUMENTS FOR MUTUALS

APRA's implementation of the Basel III capital framework does not allow issuance of mutual capital instruments that qualify as CET1 capital – the most important category of capital.

APRA's implementation of Basel III capital changes in Australia has resulted in customer-owned banking institutions effectively being unable to issue capital instruments (a restriction which has not applied to listed ADIs). Customer-owned ADIs have considerably less capital flexibility than they had prior to the Basel III reforms, despite the fact the

[16] Discussion Paper: Implementing Basel III liquidity reforms in Australia, May 2013, APRA
[17] Ibid
[18] Ibid

reforms are aimed squarely at internationally active large listed banks, not small domestic, consumer-focused mutual ADIs.

After more than two years of consultations with APRA and ASIC, COBA is close to an AT1/T2 solution, but mutual ADIs will still be unable to issue CET 1 capital (except on emergency conversion of AT1/T2 instruments).

In contrast, other jurisdictions have successfully accommodated the mutual model into the Basel III capital framework. For example, in the UK, Nationwide (a large UK Building Society), has recently launched a CET1 capital offering under Basel III.[19]

APRA has taken a highly cautious approach, worried that accommodating the customer-owned model may result in some departure "from its longstanding policy of applying a common set of prudential requirements across the ADI industry."[20]

> "Some other submissions argued that, since the Basel III reforms are global minimum capital requirements for internationally active banks, the reforms should not be applied to all ADIs in Australia. APRA does not accept this argument. Unlike other jurisdictions, banks, credit unions and building societies in Australia are supervised under the same legislative regime and APRA's longstanding policy is to apply a common set of prudential requirements across the ADI sector. When appropriate, these requirements can take account of an individual ADI's size, complexity and risk profile. In APRA's view, the Basel III reforms will improve the regulatory capital framework for ADIs and, in so doing, strengthen the protection available for depositors and the resilience of the Australian banking system as a whole. There are, nonetheless, certain aspects of the Basel III reforms that are problematic for mutually owned ADIs (mutual ADIs). APRA intends to consult separately with mutual ADIs on these aspects."[21]

APRA has been so concerned to avoid developing two-tiered capital standards that it has *reduced* regulatory capital options for customer-owned banking institutions.

Policy options:

- *APRA to more effectively balance applying its policy of 'common set of standards' with accommodating the mutual model*
- *APRA to allow customer-owned banking institutions to issue CET1 capital instruments*

[19] http://your.nationwide.co.uk/your-news/articles/Pages/ccds-issuance.aspx
[20] Response to Submissions: Implementing Basel III capital reforms in Australia. March 2012 APRA
[21] Ibid

UNFAIR TAXATION OF CUSTOMER-OWNED MODEL

Customer-owned ADIs' reliance on retained earnings as their main source of regulatory capital makes it difficult for them to release franking credits.

Customer-owned banking institutions collectively have accumulated franking credits of more than $1.5 billion and are adding $150-200 million per year. In the year ending June 2013, customer-owned banking institutions collectively made a pre-tax profit of $629 million, paying company tax of $185 million.

The franking credits regime does not contemplate companies that pay tax but then retain, rather than distribute, after-tax profits as a core feature of their business model.

Customer-owned ADIs should be able to pass on to their owners the benefit of having paid company tax, just as non-mutual companies can choose to do. Dividend imputation means company tax is a pre-payment of tax ultimately paid by the company's owners – akin to a withholding tax. Owners of companies that pay dividends are able to benefit from the tax paid by the company by a reduction in their personal taxation liabilities. Owners of companies that don't pay dividends, such as customer-owned ADIs, are not able to benefit in this way. For mutual ADIs, franking credits remain locked up, increasing year after year as the company continues to make profits, pay tax and prudently retain those profits as its main source of regulatory capital.

It has been argued that:

> "the overall taxation of [listed] bank income is ultimately at a rate equal to the shareholder's individual tax rate – which given the dominance of superannuation funds as investors perhaps averages in the region of 15 per cent. But for credit unions it is at the company tax rate of 30 per cent.[22]

Policy options:

- *Allow mutual ADIs to distribute franking credits via a 'frankable' deposit product*
- *Reduce the company tax rate for mutual ADIs to the average rate paid by listed bank shareholders*

RESTRICTIONS ON USE OF 'BANK' & 'BANKING'

Customer-owned banking institutions are subject to the same prudential regulatory regime as listed banks but face a number of restrictions around their use of the terms 'bank' and 'banking'.

Banks, credit unions and building societies are all Authorised Deposit-taking Institutions under the *Banking Act 1959* but not all ADIs can describe themselves as banks and APRA is proposing to further restrict use of the term 'banking' by some ADIs.

[22] ACFS paper FRDP 2010-06 "What is 'fair' taxation of credit unions?"

Prior to July 1998, building societies and credit unions looking to convert to banks were required to demutualise. Many of today's regional banks (Bendigo and Adelaide Bank, Suncorp) and major bank sub-brands (St George, Bank of Melbourne) were originally mutual building societies.

Customer-owned banking institutions wanting to rebrand as banks no longer have to demutualise but they must pass a substance test, i.e. have at least $50 million in Tier 1 capital.

To date, 10 mutual banking institutions have re-branded as banks. However, the two largest credit unions and three of the four largest building societies have opted not to rebrand as banks.

The option to re-brand as a bank is not available to smaller customer-owned banking institutions. In contrast, APRA allows major banks to use the term bank in their many sub-brands, despite the fact that these sub-brands are not separate ADIs (e.g. St George, Bank of Melbourne, BankSA, Bankwest, UBank).

The $50 million threshold predates the Wallis reforms which led to the formation of APRA and the creation of the ADI concept. The RBA's September 1996 submission to the Wallis Inquiry says the $50 million threshold was set in 1992 and is broadly consistent with total balance sheet assets of around $1 billion.

> "A relatively high level of minimum Tier 1 capital is one of the simplest and most effective means of discouraging unsuitable shareholders from attempting to gain a banking authority," the RBA said. "In a world where financial institutions of doubtful pedigree are always scouting for opportunities, the minimum capital requirement for a bank is an excellent screening device."[23]

APRA reviewed the $50 million threshold in 2010 in the context of the previous Government's *Competitive and Sustainable Banking System* package.

> "In its review, after weighing up competition and financial stability concerns, APRA concluded that any lowering of entry standards for new bank entrants, through reducing the minimum capital requirement, would run counter to the general thrust of global reform initiatives to strengthen capital in banking systems and would put at risk the enhanced reputation of the Australian banking system and Australia's regulatory arrangements."[24]

COBA accepts that the substance test for new entrants is long-standing policy but the RBA's 1996 concerns about "unsuitable shareholders" and "financial institutions of doubtful pedigree" do not apply to credit unions and building societies.

[23] Submission to Financial System Inquiry, 6 September 1996, RBA
[24] APRA Annual Report 2011

Those ADIs that do not have the option of marketing themselves as banks are at a competitive disadvantage. They must comply with an intrusive, constantly-evolving, burdensome regulatory regime to engage in the business of banking but they are denied the option of seeking a branding benefit.

Given that the term 'ADI' is not widely understood, a simple step to improving market awareness of the prudential standing of all regulated banking institutions would be to replace the Banking Act term "Authorised Deposit-taking Institution" with "Authorised Banking Institution".

This amendment would at a stroke also remove uncertainty about the capacity of credit unions and building societies to use the term 'banking'.

APRA issued a discussion paper in 2013 proposing some changes to its rules around the use of the term 'banking', including a new requirement that:

> "'banking' may not be used as part of a registered corporate, business or trading name, or as part of an internet domain name by a credit union or building society." [25]

This new restriction is at odds with APRA's stance of allowing credit unions and building societies to use the term 'banking' in marketing and branding material. COBA has strongly objected to the draft proposal but at this stage APRA has not indicated any willingness to withdraw the proposal. In our view, the proposal represents a significant policy shift by APRA, and the change will impact on a large number of our members.

Changes of this kind are far from merely cosmetic. Consumer perceptions about security and prudential standing are critical factors in the banking market. Restricting the use of the term 'banking' in business names can undermine consumer perceptions about the customer owned banking sector, and further tilts the regulatory environment in favour of large banks.

Competitive neutrality for ADIs in the deposit market rests heavily on the market understanding that all ADIs are subject to the same regulatory regime, including the Financial Claims Scheme that guarantees deposits of up to $250,000 per person, per ADI.

The UK's version of the Financial Claims Scheme is pro-active in raising awareness about depositor protection. The UK's Financial Services Compensation Scheme has a key objective of raising awareness about depositor protection so that the public is reassured their deposits in banks, building societies and credit unions are safe, up to the £85,000 limit.

> "The need to build awareness remains high. Research shows that about half of the public are aware of a protection scheme, an increase of more than 30 percentage points since 2008. This is still too low and compares poorly with some of our overseas counterparts. For example, awareness of deposit protection in the US is between 70 and 80% of the population. We aim to achieve this level of awareness in the UK over a number of years, in partnership with the industry, with banks, building

[25] Discussion Paper: Banking Act exemptions and s66 guidelines, April 2013, APRA

> societies and credit unions doing most of the heavy lifting supported by targeted marketing by FSCS."[26]

There is no such marketing campaign in relation to Australia's Financial Claims Scheme.

Policy options:

- *Amend Banking Act to replace ADI with ABI*
- *Government and regulators to more actively and effectively raise awareness of the Financial Claims Scheme*

CONFIDENT & INFORMED CONSUMERS: MAJOR BANK SUB-BRANDS & SHADOW BANKING INSTITUTIONS

Competitive neutrality in retail banking depends on consumers understanding that major bank sub-brands are not separate institutions and that so-called 'shadow banks' are not regulated banking institutions.

Major bank multi-brand strategies are intended to:

- lure customers who don't want to bank with a major bank; and/or
- compete on price against genuinely independent competitors without providing any benefit to the bulk of the major bank's existing customers.

Consumer research strongly suggests that major banks are getting away with portraying their sub-brands as independent competitors. The current legislative framework is not ensuring that retail banking consumers who want to deal with a regional bank or a non-bank have the opportunity to make a fully-informed choice.

This can be corrected by requiring that major bank sub-brands clearly and prominently disclose in all advertising and all customer-facing material that they are owned by a major bank.

Shadow banking institutions, such as debenture issuers, have marketed themselves as offering deposits, savings products and at-call accounts. The occasional high-profile collapse of one of these entities prompts calls for a regulatory crackdown on non-ADIs presenting themselves as regulated banking institutions. However, proposals to ban these 'shadow banks' from using terms such as 'deposit' and 'savings account' and from offering at-call investment products have been repeatedly delayed.

In the interests of competitive neutrality, and consumer protection, a better informed market is needed about the real identity of various entities in the banking market.

[26] Plan & Budget 2014/15 Financial Services Compensation Scheme (UK)

Policy options:

- *More effective disclosure of the real identity of major bank sub-brands*
- *Ban "shadow banks", such as debenture issuers, from posing as regulated banking institutions*

UNFAIR APRA LEVIES

APRA levies are divided into two components, a restricted component which covers the costs of supervision, and an unrestricted component corresponding to APRA's broader activities such as policy development.[27] While both components are applied on a "dollars per assets" basis, the restricted component is subject to a maximum cap.

According to the original levies memorandum, the existence of a maximum cap "reflects the view that ... beyond a certain size there is no extra cost in regulating an institution."[28] However, there are many examples where the largest ADIs require specialised and additional supervisory effort which is not applicable to smaller ADIs.

Some of APRA's work is exclusively focused on the largest entities within each sector, with no relevance or benefit to the remaining institutions. For example, as part of the global banking reforms, APRA is responsible for implementing the Domestic Systemically Important Banks (D-SIB) framework. The D-SIB framework only applies to the four major banks, and will involve APRA applying "more intensive supervision" to these institutions. The Basel III liquidity reforms are another example of significant policy work in APRA directed almost solely towards larger ADIs.

In these areas, the prudential regulatory burden exhibits characteristics of diseconomies of scale, with an additional layer of policy intensity and regulatory supervision being applied to financial institutions above a certain size. Unfortunately, the current levy distribution methodology only recognises the cost savings that larger ADIs present APRA, without giving similar consideration to the additional costs that their size also imposes.

Smaller ADIs already pay a much higher relative cost in complying with APRA's regulatory requirements. The costs to an ADI of meeting APRA's regulatory expectations are relatively fixed, and these costs therefore place a proportionally higher burden on smaller ADIs. The impact this has on competitive neutrality within the sector is only further compounded by a levy methodology that expects smaller ADIs to pay higher proportional costs.

We believe that the existence of the maximum cap is leading to highly inequitable outcomes. Currently, the big four banks pay APRA levies of around $12 per $1,000,000 in assets compared to around $60 per $1,000,000 for customer-owned banking institutions. The smallest banking institutions are paying five times the rate of the big banks on a per-assets basis. This is not a level playing field.

[27] Treasury, *Financial industry supervisory levy methodology – Discussion Paper,* April 2013, p. 3.
[28] Explanatory Memorandum, *Financial Sector Levy Bills 1998,* p. 9.

Policy option:

- *Revise the APRA levies formula to ensure D-SIBs pay a fairer share*

FINANCIAL STABILITY FUND LEVY

The previous Government announced the establishment of a Financial Stability Fund, through a levy on ADIs which is to be used to meet the costs of a failure of an ADI. The levy will start on 1 January, 2016 and will be set at 0.05 per cent on deposits of up to $250,000.

While some other countries have introduced deposit levies, it is questionable whether a levy is appropriate in the Australian context. The current Financial Claims Scheme (FCS) insurance framework is working well in the absence of a deposit levy. Concerns with introducing an upfront levy include:

- establishing a fund that may never be needed is inefficient, and running such a fund will be administratively expensive (and government recovery of this expense would impose further unnecessary costs on industry); and
- a new tax on deposits further disadvantages these savings relative to other investments (such as equities and property) and is in complete contradiction to the Henry Review's recommendation that the tax burden on deposits be reduced.

A levy on deposits will also have a disproportionate impact on smaller ADIs. Smaller ADIs relying more heavily on 'protected' deposits than major banks will be adversely affected.

> "As the four major banks make up around three quarters of ADI deposits, the major banks will contribute the most to the fund. However, the levy will have a higher proportionate impact on small ADIs. This is partly due to FCS protected deposits making up a higher proportion of small ADIs funding when compared to the major banks (which make substantial use of wholesale debt)."[29]

COBA estimates that deposits comprise more than 85% of our sector's funding base compared to 60% for the major banks. In addition, we estimate that 88% of the value of mutual ADI deposits are FCS protected compared to less than 40% for the major banks.

Policy options:

- *Do not proceed with the introduction of the levy on FCS protected deposits*
- *Impose a levy on D-SIBs to reflect the 'implicit guarantee' and the risk D-SIBs pose to the economy*

[29] Treasury's Options Stage Regulation Impact Statement – Establishment of FSF

ACCOMMODATION OF AGGREGATION INITIATIVES

Customer-owned banking institutions, particularly credit unions, have a history of acting together to gain access to economies of scale. Aggregation models should be supported and facilitated by the regulatory environment to allow smaller ADIs to compete more effectively against large, listed banks.

Aggregation proposals to raise funding or regulatory capital should not face undue resistance and delay from the regulator but this is what happened to the Australian Mutual Group (AMG) of 17 customer-owned banking institutions seeking approval from APRA for a capital raising initiative. The AMG's proposal was subject to unreasonable delays.

Based on feedback from advisers, AMG believes its transaction received much heavier scrutiny and interrogation than similar proposals submitted by major banks.

The AMG made 9 formal submissions to APRA in response to matters raised by APRA's technical division.

> "Each time we addressed the items raised by APRA, only to have the documents rejected in the next round on completely new matters, not previously raised. There was an apparent disconnect between local regulators and the technical division. Assurances of support and priority by our supervisor were not consistent with the approach of the technical team. In fact, the technical team became incredibly pedantic to the point of rejecting drafts of the documents based on typographical errors."

AMG produced 23 versions of the key documents and costs blew out by more than 50 per cent.

Policy option:

- *Introduce more effective accountability mechanisms for regulators such as APRA*

Comments and feedback on this paper should be provided to Pia Brunner at pbrunner@coba.asn.au by 28 February 2014.

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