CUSTOMER OWNED BANKING ASSOCIATION

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Budget Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

Via online: www.treasury.gov.au

Dear Sir/Madam

COBA 2017-18 Pre-Budget submission

COBA appreciates the opportunity to provide the Government with our views regarding priorities for the 2017-18 Budget.

COBA represents mutual banks, credit unions and building societies. Customer-owned banking institutions have four million customers, 10% of the household deposits market, $103 billion in total assets and are the proven alternative to listed banks in the retail banking market.

COBA requests the Government to take action in the 2017-18 Budget to address the urgent need to promote competition in banking.

In 2014 the Financial System Inquiry (FSI) final report warned about Australia's concentrated banking market and that this concentration "creates risks to both the stability and degree of competition in the Australian financial system."[1]

Two years later, the House of Representatives Economics Committee described Australia's banking market as an oligopoly where the major banks have significant market power that they use to the detriment of consumers. The Committee found that a lack of competition in banking has significant adverse consequences for the economy and consumers.[2]

Action is needed to identify and remove barriers to competition in banking and to provide a level playing field for competitors to the major banks.

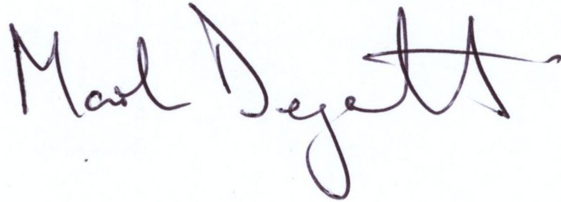
COBA urges the Government to announce the following measures in the 2017-18 Budget:

1. Funding to bring forward a review by the Productivity Commission of competition in the banking market, to report by the end of 2017.
2. A company tax rate for customer-owned banking institutions that matches the effective tax rate of major banks of between 22% and 25%.
3. Expand GST RITC item 16 'credit union services' to accommodate mutual building societies and mutual banks that are former mutual building societies.

[1] FSI Final Report, Nov 2014, p3
[2] Review of the major banks, First Report, House Economics Committee, Nov 2016, p23

These measures, along with implementation of key FSI recommendations, will help deliver a more competitive banking market for the benefit of consumers and the wider economy. The proposals are described in more detail below. Please do not hesitate to contact me on 02 8035 8441 or Luke Lawler on 02 8035 8448 to discuss any aspect of this submission.

Yours sincerely,



MARK DEGOTARDI
Chief Executive Officer

Funding for accelerated PC Review of Competition

There is an urgent need for well-considered measures to promote competition in banking.

In testimony before the House of Representatives Economics Committee in 2016, the ACCC and ASIC both expressed concern about competition in banking.

ACCC chairman Rod Sims said:

- there is a lack of robust competition
- banking is a cornerstone of the market economy and if competition is not strong in the financial sector, there are adverse effects for the economy
- market share of the major banks has gone up over the last 10 to 15 years and their profitability has gone up during that period.

ASIC chairman Greg Medcraft said:

- the banking market is an oligopoly, where a small number of firms have the large majority of market share and exercise market power
- competition has declined since the global financial crisis and we have a more concentrated banking sector
- we have a lack of competition.

The House Economics Committee report found:

- Australia’s banking sector is an oligopoly
- Australia’s four major banks have significant pricing power, higher than average returns on equity and large market shares
- A lack of competition in Australia’s banking sector has significant adverse consequences for the Australian economy and consumers. It:
    - creates issues around banks being perceived as too-big-to-fail (TBTF) (such as moral hazard)
    - reduces incentives for the major banks to innovate and invest in new infrastructure, and
    - can allow banks to use their pricing power to extract excess profits from consumers.

In the wake of this House Committee inquiry, further Parliamentary inquiries are underway into aspects of the banking market, including consumer protection.

However, what is sorely needed is a prompt, expert review to identify the barriers to a more competitive market and measures to overcome those barriers and deliver a more competitive market.

In its response to the FSI, the Government agreed to implement periodic reviews of competition in the financial sector. COBA requests allocation of funding to enable the Productivity Commission to complete the first such review by the end of 2017. The Government’s current commitment is to “*task* the Productivity Commission to review the state of competition in the financial system by the end of 2017”. There is no explicit commitment for this review to be *completed* by the end of 2017.[3]

COBA recently commissioned Deloitte Access Economics (DAE) to assess implementation of FSI recommendations 1, 2, 3 and 30 on regulatory capital and competition. DAE’s report[4] highlights that significant work remains on implementing these key recommendations and proposes a draft terms of reference for a Productivity Commission review of competition.

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[3] PC Deputy Chair Karen Chester, Senate Estimates Committee hearing 20 Oct 2016

[4] http://www.customerownedbanking.asn.au/media-a-resources/media-release-alerts/1217-banking-reform-report-card-could-do-better

COBA welcomes DAE's suggestion that the Productivity Commission review should consider whether regulators' rules and procedures are creating inappropriate barriers to competition and whether there is appropriate regard to other business models, including the customer owned model.

The DAE report mentions two examples of regulator decision-making affecting competition:

- APRA's approach to regulatory capital instruments for customer-owned banking institutions, and
- APRA's application of the cap on investor lending growth.

The case for an accelerated timetable for the Productivity Commission review of competition in the banking market is underlined by the House Economics Committee's finding that it is "very surprising that no Australian government has completed a wholesale review of competition in the banking sector in recent times."

> "More surprising, however, is that despite the ACCC's clear concerns about the level of banking competition, it has acknowledged not closely monitoring the sector because 'the RBA, APRA and ASIC are...observing the banks.' None of these regulators, however, have a clear mandate to promote competition in the financial sector."[5]

In the UK, the prudential regulator (PRA) and the financial conduct regulator (FCA) are required to facilitate competition. The PRA in 2016 published its first Annual Competition Report[6] and the FCA in 2017 is doing a study of the UK mortgage market to determine whether competition is working well or whether remedies are needed.

> "A mortgage is a significant product for a large number of consumers; for many it represents the biggest financial commitment of their life. The mortgage sector also plays a vital role in the UK economy, so it is important that competition in this sector works effectively. Effective competition creates incentives for firms to operate as efficiently as possible, providing benefits to consumers in the form of lower prices and improvements in quality, service or choice. We are keen to ensure that competition in the mortgage sector is healthy and working to the benefit of consumers."[7]

COBA's view is that the enduring solution to concerns about the banking market is action to promote sustainable competition so that poor conduct is swiftly punished by loss of market share.

Recommendation 1:

The Government should provide funding so that the Productivity Commission can undertake a review of competition in the banking market and report by the end of 2017.

Competitively neutral tax rate for customer-owned banking institutions

An important principle of competitive neutrality is that competitors should be subject to the same effective tax burden.

Customer-owned banking institutions are subject to the 30% company tax like listed banks but bear a heavier tax burden than listed banks. This is because the company tax regime and dividend imputation regime do not accommodate companies that retain,

[5] Review of the major banks, First Report, House Economics Committee, Nov 2016 , p23
[6] http://www.bankofengland.co.uk/publications/Documents/annualreport/2016/compreport.pdf
[7] https://www.fca.org.uk/publication/market-studies/ms16-02-1.pdf

rather than distribute, after-tax profits. This is the business model of customer-owned banking institutions, as set out in ASIC Regulatory Guide 147 *Mutuality: Financial institutions.*[8]

Customer-owned banking institutions are focused on providing excellent products, pricing and service to their customers and do not have to pay dividends to a separate group of shareholders. Regulatory capital for customer-owned banking institutions is mainly retained earnings. The growth rate of customer-owned banking institutions is largely determined by growth in their retained earnings.

Under the dividend imputation regime, company tax is essentially a withholding tax with the final tax due on a company's distributed profits being determined by the marginal tax rate of the shareholders. The total tax paid on company earnings is lower than the company tax rate if the average marginal tax rate of a company's shareholders is below the company tax rate.

Where a company is unable to distribute earnings and franking credits to its owners, the average tax rate is the company rate. This is the case for customer-owned banking institutions. The average tax for listed banking institutions is lower because the average tax rate of their shareholders is below 30%.

The final report of the FSI commented on these impacts of dividend imputation:

> "For investors (including superannuation funds) subject to low tax rates, the value of imputation credits received may exceed tax payable. Unused credits are fully refundable to these investors, with negative consequences for Government revenue.
>
> "Mutuals cannot distribute franking credits, unlike institutions with more traditional company structures. This may adversely affect mutuals' cost of capital, with implications for competition in banking."[9]

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 September 2016, customer-owned banking institutions collectively made a pre-tax profit of $680.9 million, paying company tax of $187 million.

Owners of companies that pay dividends are able to benefit from the tax paid by the company through a reduction (or refund) in their personal or entity taxation liabilities. Owners of companies that don't pay dividends are not able to benefit in this way. For customer-owned banking institutions, franking credits remain locked up, increasing year after year as the company continues to make profits, pay tax and prudently retain those after-tax profits as its main source of regulatory capital.

This problem could be addressed in two ways:

- provide a mechanism, such as a frankable debt deposit product, for customer-owned banking institutions to release franking credits while continuing to rely on retained earnings for regulatory capital, or
- apply company tax on customer-owned banking institutions at a rate that is comparable to the effective tax rate of their listed competitors.

These options are discussed in a report commissioned by COBA from the Australian Centre for Financial Studies (ACFS) *Equitable Taxation of Customer Owned Banking.*[10]

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[8] http://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-147-mutuality-financial-institutions/
[9] FSI Final Report, Nov 2014, p278
[10] http://www.customerownedbanking.asn.au/images/stories/submissions/2014/Attach%20B%20-%20Equitable%20Taxation%20of%20Customer%20Owned%20Banking.pdf

We recommend that the Government should apply company tax on customer-owned banking institutions at a rate that is comparable to the effective tax rate of their listed competitors.

The ACFS report found that the average tax rate paid on the earnings of the major Australian banks is well below the 30% rate paid by customer-owned banking institutions. The report says "this discrepancy in effective tax rates creates an uneven playing field and may distort decisions of Australian depositors and borrowers."

The effective tax rate on major bank earnings, according to the ACFS report, is between 22.15% and 25.5%.

The report says "a discounted corporate tax rate for mutual ADIs in this range would resolve the issue of retained franking credits for members of mutual ADIs, allow an equal distribution of the benefits to all members and result in a higher natural rate of growth for mutuals ADIs."

A discounted company tax rate of 23.5% for customer-owned banking institutions in the year to September 2016 would have allowed the sector additional retained earnings of around $51 million.

As a simple illustration of the impact, assuming a regulatory capital ratio of 10%, an additional $51 million in regulatory capital would have enabled the sector to increase home lending by $1.45 billion.

Alternatively, the additional retained earnings could be applied to investment in technology, innovation, customer service or our sector's communities.

COBA welcomes the Government's Enterprise Tax Plan to reduce the company tax rate for all companies to 25 per cent over 10 years. However, this staged reform will not solve our sector's competitive-neutrality problem. Furthermore, measures to promote competition in the retail banking market need to be implemented on a more urgent timeframe.

Delivering competitive neutrality to taxation of customer-owned banking institutions will not only be a strong signal of government recognition for the customer-owned business model but will benefit all consumers through a more competitive retail banking market.

Recommendation 2:

The Government should amend the company tax rate for customer-owned banking institutions to match the effective tax rate of major banks of between 22% and 25%.

Reduce the anti-competitive impact of GST input taxing for financial services

Under the GST, financial supplies such as the core products of COBA members, i.e. loans and deposits, are input taxed.

Input taxing is inherently anti-competitive because large banks have the capacity to lower their tax burden in ways that are unavailable to smaller banking institutions. This problem was well understood at the time of the introduction of the GST.

A Treasury paper from 1999 *The Application of Goods and Services Tax to Financial Services*[11] outlined the so-called "self-supply bias":

> "Input taxing financial supplies means that financial service providers have an insourcing — or self-supply — bias for business inputs used to make financial supplies. For example, if a financial service provider insources its accounting services, these services would not be subject to GST.
>
> "However, if the financial service provider outsources these services, in the absence of special rules, GST would be payable on the full value of that service and the financial service provider would not be entitled to an input tax credit. A higher effective tax burden would be faced by smaller financial supply providers who outsource proportionately more of their business inputs. Larger market participants generally have a greater ability to insource services.
>
> "For example, smaller financial service providers, such as credit unions or building societies, would have less scope to insource mortgage valuation services than would a large bank. Therefore, input taxing financial supplies has important implications for the relative competitiveness of different segments of the financial sector."

The 2009 *Henry Tax Review* also noted this problem and associated efficiency costs, including:

> "..businesses organising themselves to 'self-supply' goods and services to reduce the tax payable on their inputs. This gives large, vertically integrated businesses an advantage over smaller competitors."[12]

At the time of introducing the GST, the Government responded to the self-supply bias of input taxing by allowing financial institutions to claim back some of the GST paid on certain inputs in the form of a 75% 'reduced input tax credit' (RITC).

The Explanatory Statement for the RITC regulations says the benefits of the RITC approach include "reduced bias to insource" and "lower compliance costs for smaller entities." (See illustration below of how RITCs are intended to neutralise the self-supply bias.) The list of RITCs includes a supply to a credit union by an entity owned by two or more credit unions. This item was modified by regulation[13] in 2012 to accommodate mutual banks who formerly were credit unions but have not changed their ownership structure. However, the historical anomaly of excluding mutual building societies from the scope of the item has not been corrected.

The efficacy of RITC item 16 in reducing the anti-competitive impact of input taxing is under severe stress due to developments in the customer-owned sector over the past decade. The failure to accommodate mutual building societies and mutual building societies that have rebranded as banks in RITC item 16 is increasingly rendering the item ineffectual as a measure to improve the competitive position of customer-owned banking institutions.

This is compromising the customer-owned banking sector's capacity to increase competitive pressure on the major banks. The major banks dwarf individual customer-owned banking institutions and have an unmatched capacity to minimise their GST burden by self-supplying key inputs.

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[11] http://archive.treasury.gov.au/documents/693/PDF/gst.pdf
[12]http://taxreview.treasury.gov.au/content/downloads/final_report_part_2/AFTS_Final_Report_Part_2_Vol_1_Consolidated.pdf
[13] http://www.austlii.edu.au/au/legis/cth/num_reg_es/antsastar20124n215o2012683.html

Relevant developments in the customer-owned banking sector include continuing mergers, including mergers between credit unions and building societies, and credit unions and building societies rebranding as mutual banks.[14]

The underlying mutual corporate structure of credit unions and mutual building societies does not change in mergers between these entities or in rebranding as mutual banks. The ownership structure of a mutual banking institution – bank, building society or credit union – is the same and is set out in ASIC Regulatory Guide 147 *Mutuality: Financial institutions.*[15] APRA's quarterly statistics publication on ADIs includes all these entities in the category 'mutual ADIs'.

At the time RITC item 16 was drafted, representation of the customer-owned banking sector was split between bodies who spoke for credit unions and bodies who spoke for building societies. Now, the sector is represented by one body, COBA, and the composition of the sector has been transformed by the emergence of mutual banks.

COBA is owned by its members and because the membership includes building societies and building societies that have rebranded as mutual banks, services provided by COBA do not qualify under RITC item 16. COBA's services include many that are typically self-supplied by major banks, including government and regulator relations, media services, regulatory compliance advice, legal advice, research and market intelligence and support to fight fraud and financial crime.

COBA also provides performance benchmarking services. The Performance Framework allows participating members to see how they are tracking against industry peers on a range of key KPIs. This is another recent initiative demonstrating collaboration in the sector.

Other aggregator bodies that supply data-processing services to credit unions and former credit unions now trading as mutual banks would lose eligibility under RITC 16 if just one of their owners merged with a building society or with a mutual bank that was formerly a building society.

For example, a Sydney-based credit union recently merged with a Wollongong-based bank. Sutherland Credit Union (*The Shire – Local Banking*) is no longer entitled to claim RITCs in relation to item 16 as it is now part of IMB Bank, a mutual bank that was a former building society. Further, if this credit union was an owner of an entity that provides services that qualify under item 16, all credit unions purchasing those services would now be ineligible to claim those RITCs.

Expanding RITC item 16 to accommodate building societies and former building societies now trading as mutual banks would not only protect existing aggregator bodies, it would provide critical momentum to participation by customer-owned banking institutions in new aggregation initiatives.

COBA members have recently established a shared services company and an innovation incubator. These entities replicate services that major banks can and do provide in-house. The shared services company will enable participating customer-owned banking institutions to access economies of scale, talent and technology and to reduce transaction and product development costs. The innovation incubator will enable participating customer-owned banking institutions to collaborate on new ideas to take advantage of technology and data to develop and bring new and better products to the retail banking market.

The current scope of RITC item 16 is a barrier to participation in these initiatives.

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[14] The four building societies listed on APRA's ADI register are all customer-owned ADIs. Four of the ADIs listed as Australian owned banks are customer-owned former building societies. Thirteen of the ADIs listed as Australian-owned banks are customer-owned former credit unions. There are 58 credit unions listed on APRA's ADI register.

[15] http://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-147-mutuality-financial-institutions/

It is critically important to competition and innovation in retail banking to remove barriers to collaboration between customer-owned banking institutions.

Restricting the scope of RITC item 16 to credit unions and former credit unions now trading as banks means the item is less and less effective in reducing the anti-competitive effect of GST input taxing. A modest expansion in the scope of RITC item 16 to cover the eight customer-owned ADIs that are building societies or former building societies would update and revitalise this important pro-competitive measure.

Recommendation 3:

The Government should amend RITC item 16 so the term 'credit union' is replaced with 'customer-owned banking institution operating under the ownership structure set out in ASIC Regulatory Guide 147 *Mutuality: Financial institutions.'*

Illustration of how RITCs neutralise the self-bias incentive for an input taxed entity[16]

	Out-sourced (no RITC)	In house	Out-sourced (RITC available)
Material inputs (excluding GST)	$500	$500	$500
Net GST (after any input tax credit entitlement)	na	$50	na
Value added (wages and profit)	$1,500	$1,500	$1,500
Total cost (excluding GST)	$2,000	$2,000	$2,000
GST	$200	na	$200
RITC @ 75 per cent	na	na	$150
Price/cost (incl. GST)	$2,200	$2,050	$2,050

In the example above, it can be seen that in the absence of an RITC the input taxed entity would face a cost of $2,200 if it out sourced the supply of the service (column A) compared with a cost of only $2,050 if it was able to source the service in house (column B). This demonstrates the clear incentive for self-supply. However, where the input taxed entity is entitled to a RITC for the acquisition from the out-sourced suppler (column C), the alternative cost would be the same to having self-supplied the service and the input taxed supplier would be neutral in whether to out- source the acquisition or acquire it in house.

[16] 2009 Treasury consultation paper *Review of the GST Financial Supply Provisions.*