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Loan, Nick

From: Adler, Damien
Sent: Tuesday, 28 September 2010 12:18 PM
To: Kaur, Kanwaljit
Cc: Loan, Nick; Dickson, Tom; Burston, Matthew
Subject: ABACUS letter ~~[SEC=IN-CONFIDENCE]~~
Attachments: Abacus letter.pdf

Security Classification: ~~IN-CONFIDENCE~~

Hi Kanwaljit,

As discussed this morning, please find attached the recent letter from ABACUS where they raise the 'bank' naming proposal and a few others. They also raised these ideas in their 2010-11 Budget Submission.

Kind regards,

Damien Adler

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Association of Building Societies and Credit Unions

Abacus
Australian Mutuals

2 July 2010

The Hon Wayne Swan MP
Deputy Prime Minister
Treasurer
Parliament House
CANBERRA 2600

Dear Deputy Prime Minister

We appreciate your ongoing support for the mutual banking sector and our sector's capacity to provide competition and choice in the Australian retail banking market.

Our sector's role has become more important due to the diminution of competition caused by the global financial crisis and exit of non-ADI lenders.

Credit unions and building societies have 4.5 million members, $72 billion in assets, around 9 per cent of the new home loan market and around 11 per cent of the household deposits market.

I seek your support for some measures to enhance our sector's competitive potential by delivering genuine regulatory neutrality among regulated banking institutions.

I understand that the Council of Financial Regulators is currently considering the future of the Financial Claims Scheme (FCS), including transitional arrangements and the appropriate cap for the deposit guarantee.

We propose:

- Maintaining the FCS cap for deposits at $1 million beyond October 2011, and at least until the prudential standing all authorised banking institutions is better understood;
- An effective public awareness campaign about the prudential regulatory framework and the FCS;
- Changing the Banking Act term 'Authorised Deposit-taking Institution' to 'Authorised Banking Institution'; and,
- Allowing all regulated banking institutions unrestricted use of the terms 'bank' and 'banking'.

These proposals are consistent with the *Core Principles for Effective Deposit Insurance Systems.*[1] The principal objectives of the FCS are to contribute to the stability of the financial system and protect deposits but the FCS is also an important factor in promoting competition.

[1] *Core Principles for Effective Deposit Insurance Systems* Bank for International Settlements & International Association of Deposit Insurers, June 2009

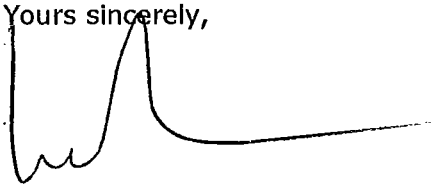
Changes to the language of banking regulation are far from merely cosmetic. Consumer perceptions about security and prudential standing are critical factors in the banking market. The changes we propose increase the capacity of smaller banking institutions to deliver simple, cut-through messages to the market that they are subject to the same regulatory standards as major banks and that their depositors are covered by the FCS.

These changes will help smaller banking institutions to continue to deliver competition and choice and a vibrant, diverse retail banking market.

These changes would also improve APRA's capacity to meet its statutory obligation "to balance the objectives of financial safety and efficiency, *competition, contestability and competitive neutrality*".[2]

The attached submission sets out our proposals in more detail.

Yours sincerely,



LOUISE PETSCHLER
Chief Executive Officer

[2] *Australian Prudential Regulation Authority Act 1998*, Section 8(2).

PROMOTING COMPETITION AND COMPETITIVE NEUTRALITY IN RETAIL BANKING AND FINANCIAL SYSTEM STABILITY

SUBMISSION BY *ABACUS – AUSTRALIAN MUTUALS*

Retail banking market

A major bank CEO recently described Australia's banking industry as an "oligopoly"[3]. An oligopoly occurs when a particular market is controlled by a small group of firms. The Australian banking market is an oligopoly, where barriers to entry are high[4], and the market is "now, by some criteria, the most concentrated it has been for a century"[5].

Major banks had by late 2009 lifted their net interest margins 20-25 basis points above pre-crisis levels.[6]

More competition is needed to drive down retail banking prices, and to promote innovation and real choice.

As the Treasurer recently noted[7], credit unions and building societies meet the same high standards of prudential regulation as banks, as they are supervised by APRA in the same way.

> "All deposits held with a credit union or building society are backed by the Government's Financial Claims Scheme up to $1 million – just like bank deposits – with this cap being reviewed for all in October 2011. So Australians can have absolute confidence in the safety of their money wherever their deposit is held."

However, there is persistent evidence that major banks continue to benefit from entrenched misconceptions about the regulatory framework and the scope of the FCS.

Consumer perceptions
Recent research by Brand Central[8] confirms that major banks are seen as stronger and more reliable than smaller banking institutions.

The survey found that bank customers believe credit unions and building societies behave more responsibly than the major banks, but they are still more likely to take their business to the big four lenders because customers think the major players will be around longer. (This is despite the fact building societies have been around for more than 100 years and credit unions for more than 60 years.)

Consumers can make judgements about security and stability only if they are informed.

A key finding of a June 2009 survey[9] of consumer attitudes about the guarantee of "bank deposits" was that 15 per cent of adults were not aware of the guarantee.

The other key findings of the IFSA survey provided to the Senate Economics Committee into the deposit and wholesale funding guarantees were:

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[3] *Clyne warns of risks in refusing to change* The Australian, 8 April 2010.
[4] Public competition assessment, 'Westpac Banking Corporation – proposed acquisition of St George Bank Limited', ACCC, 13 August 2008
[5] Senate Economics References Committee, Report on Bank Mergers, September 2009
[6] *Recent developments in Banks' Funding Costs and Lending Rates* RBA Bulletin March Quarter 2010
[7] Australian Mutuals Safe and Competitive, 28 Mar 2010
[8] *Stability attracts customers* Australian Financial Review 16 April 2009
[9] *IFSA: The Government's Guarantee on Bank Deposits* Investment Trends, June 2009

- When asked how long the guarantee would last, only 8 per cent stated it would last 2.5 to 3 years, 50 per cent for a shorter duration, 6 per cent thought it would last longer and 18 per cent said they didn't know;

- Only about a quarter (28 per cent) correctly said that the guarantee covers $1 million, 29 per cent thought it covered a smaller amount and 14 per cent a larger amount; and

- 30 per cent say they would feel comfortable investing money in banks with no guarantee after the global financial crisis has passed.

Research by CoreData[10] reported in March 2010 indicated that "mutuals are considered the least secure segment for retail deposits in Australia". The research indicated that only 13.7 per cent of respondents consider deposits held by credit unions and building societies to be 'very secure' while 13.9 per cent considered mutual deposits to be 'somewhat not secure'. In contrast, 49.5 per cent of respondents considered a deposit with a big four bank as 'very secure' and only 4.5 per cent considered deposits with the big four 'somewhat not secure'.

"It's clear from these results that Australians have not understood the deposit guarantee, perceiving safety based on the size and awareness of a banking brand," CoreData said.

According to findings by Sweeney Research[11] for the current national industry promotion campaign for credit unions and building societies, negative associations for credit unions and building societies include the perception that they are not backed by the Federal Government guarantee. Key barriers to switching to a credit union or building society include "many consumers are hesitant to move beyond the security of the Big 4 banks" and "overcoming the perception that credit unions and building societies are not being backed by the Federal Government guarantee."

"Credit unions and building societies are generally better regarded than banks on most of the attitudinal measures included for testing. However, perceptions of accessibility, financial expertise and the security of credit unions and building societies are clearly inferior to banking institutions," according to the Sweeney Research work.

According to a Datamonitor survey[12] of depositors' reasons for choosing their main account provider, depositors rank safety and stability ahead of other factors such as service, location of branches, and recommendations by friends and colleagues.

These findings, consistently appearing across a range of consumer surveys, indicate a clear need to raise public awareness about the prudential regulatory framework and the FCS.

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[10] *Misunderstood Mutuals* Burningpants, CoreData, March 2010 http://www.burning-pants.com/2010/03/misunderstood-mutuals/

[11] *Advertising Concept Testing – Credit union and building society group.* Sweeney Research, October 2009

[12] Datamonitor survey, Market Scan 2010, Abacus, March 2010

Financial Claims Scheme

The guarantee of deposits of up to $1 million under the FCS was a decisive and welcome intervention by the Government in 2008 and remains a pro-competitive measure that has delivered peace of mind to depositors and stability to the core of the financial system.

Public misunderstanding about the institutional scope of the guarantee probably contributed to the slower growth of deposits in credit unions and building societies compared to major banks in the September-November period of 2008. Public nervousness and perceptions of safety and security clearly also played a role in the major banks managing to capture the bulk of funds redirected from higher risk investments over the course of the most unstable period of the global financial crisis.

While credit unions and building societies grew their deposit balances steadily over 2009, the much stronger performance of the major banks has seen the mutual banking sector's market share slip from third place (behind CBA and Westpac) a year ago to fifth place (just behind ANZ and NAB) in December 2009. (See **Appendix A** for more detail on deposit trends.)

Westpac has commented that "in the absence of a guarantee, it is more likely that a greater share of deposit funds would have flowed to larger ADIs (with relatively higher credit ratings) on the basis of the perceived greater security of these funds."[13]

The 'flight to quality' in the deposits market was accompanied by a similar trend in lending. One of the factors behind the 'flight to quality' by borrowers was the performance of "non-bank lenders" – the category of lender financed entirely from wholesale markets – that were unable to lower mortgage rates in line with moves in official rates. Mutual ADIs suffer collateral reputational damage when identified in the "non-bank lender" category by borrowers opting for the perceived security of "banks".

Westpac's chairman Ted Evans commented recently that Westpac's out-of-cycle rate rise in December 2009 was partly because the bank was attracting too many mortgages.[14] Consumers are paying dearly for their misconceptions about the banking market, as indicated by research by InfoChoice.com.au published in the *Sunday Telegraph*: "Assuming a $300,000 home loan, $10,000 in an instant access savings account, a $25,000 car loan and $3,000 on a credit card, a customer with Westpac is $4615 a year worse off than a consumer with the best value products."[15]

Abacus recognises that our own industry needs to work more effectively and co-operatively to increase our market recognition and consumer awareness. That is why credit unions and building societies have embarked on their largest ever industry promotion campaign. However, we are competing against enormous businesses with colossal marketing budgets that benefit from entrenched misconceptions about the prudential regulatory framework. CBA's 2009 advertising budget was estimated to be $65-70 million, Westpac's $55-60 million and ANZ's $45-50 million.[16]

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

[14] *Rate rises tipped for five years* Australian Financial Review 23 March 2010

[15] *How the banks rank* Sunday Telegraph 7 February 2010

[16] *Plenty of pruning among top 25* Australian Financial Review 29 March 2010

One of the *Core Principles for Effective Deposit Insurance Systems* is that it is essential that the public be informed on an ongoing basis about the benefits and limitations of the deposit insurance system. (See **Appendix B** for comparison of the FCS and the Australian prudential framework with the *Core Principles*.)

Abacus recommends the per-depositor cap for FCS should be maintained at $1 million beyond October 2011, and at least until the prudential standing and competitive offering of non-major banking institutions is better understood. The $1 million per depositor cap, guaranteed by the Government, poses no risk to the taxpayer because:

1. the prudential regulatory framework ensures that it is highly likely that the remaining assets of a failed institution will be sufficient to recover funds paid out under the FCS to depositors; and

2. in the unlikely event of there being a shortfall, banking institutions will be levied to make up the difference.

The FCS reduces the risk of a 'run' on a banking institution by unsophisticated depositors on the basis of often uninformed market rumours. The price of entry to the FCS for the banking institution is an extremely tough prudential regulatory regime. Entities that wish to compete on a level playing field with banking institutions are welcome to submit to the same requirements on capital, liquidity, risk-management, reporting, auditing and governance.

Prudentially-regulated banking institutions also meet the cost of this "first line" of depositor protection because they pay the costs of regulation via ordinary industry levies.

The perception that major banks are too big to fail is an anti-competitive factor in the banking market. This perception has been strengthened as a result of the GFC because, internationally, there have been many real examples of governments bailing out large banks. The FCS levels the playing field for large and small banking institutions and is a pro-competitive factor. Any reduction in the FCS cap from $1 million will benefit the four major banks to the competitive detriment of other regulated banking institutions. Rather than being seen as a risk to the taxpayer, the FCS should be seen for what it is – a no cost reassurance to depositors and an early access facility for depositors' funds in the event of an institution failing.

Importantly for competition in retail banking, the $1m cap is reassuring for larger depositors, e.g. local governments and non-government organisations, that are important sources of funding for smaller banking institutions. APRA and others have noted from recent experience that 'runs' are generally not caused by depositors with very small amounts.[17]

A $1 million cap does not appear excessive when compared to the median house price in Sydney in the March quarter 2010 of $609,300.[18] Average amounts held in deposits are much lower than $1 million but households, i.e. unsophisticated investors, will from time to time have much larger amounts held in regulated banking institutions. The vast majority of these depositors are extremely unlikely to have the skills and capacity to be able to assess and monitor the prudential standing of a financial institution.

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

[18] http://news.domain.com.au/domain/real-estate-news/sydney-still-top-of-the-property-ladder-but-rivals-are-closing-gap-20100429-tu7e.html

Investors with more than $1 million to deposit are more likely to be able to contribute to the market discipline necessary for an effective deposit insurance scheme. Setting the cap at that level, though relatively high by international standards, gives credibility to the limits of the scheme.

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

A cap lower than $1 million is less likely to be taken seriously as a genuine limit. This is particularly valid in the Australian context because of the long-standing 'implicit' deposit guarantee arrangements that applied until October 2008. The Council of Financial Regulators took the view prior to the global financial crisis that this system, rather than an explicit FCS, was more likely to be subject to moral hazard.[19]

RBA research in 2006 showed that 60 per cent of respondents were of the view that there was a guarantee of deposits or that it was likely (or highly likely) that the Government would step in to ensure either full or partial repayment of the funds in their main deposit account. Only 10 percent were of the opinion that their main deposit account was not guaranteed and that, in the event of a failure, the government was unlikely to step in.[20]

Setting the cap at a credibly high level is important to a successful permanent transition from the pre-existing implicit blanket guarantee.

The RBA's 2006 survey asked respondents to identify the supervisor of banks, building societies and credit unions from a multiple choice list. Only 14 per cent correctly said that APRA was the supervisor, slightly more than the 10 per cent who thought it was the Australian Bankers' Association.

The OECD has observed that effective consumer protection requires that the public properly understand existing arrangements and is aware of the extent of and limits to existing compensation arrangements and that simplicity is valuable in promoting public understanding.[21]

A relatively high cap of $1 million for the FCS is not only stark and simple, it is also a credible limit on the 'early access' dimension of the depositor safety net.

A 2009 Senate Economics Committee report referred to an IMF survey showing average coverage levels in pre-crisis deposit insurance schemes at around one to two times per capita GDP (around $100,000 in the Australian context). However, the IMF noted that this "is only a statistical description of deposit insurance systems and is not meant to be considered as a desired design feature."[22]

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[19] *Financial Stability Review* RBA Sep 2006
[20] *Financial Stability Review* RBA Mar 2006
[21] *Financial Turbulence: Some Lessons Regarding Deposit Insurance* Sebastian Schich OECD 2008
[22] *Government measures to address confidence concerns in the financial sector - The Financial Claims Scheme and the Guarantee Scheme for Large Deposits and Wholesale Funding* Senate Economics Committee Sep 2009

Abacus notes that major banks and non-ADI industry bodies have argued for a lower cap.

Major banks are seeking to preserve the competitive advantage they obtain from depositor misconceptions that they are safer simpler because they bigger than their competitors.

Non-ADI industry bodies have argued that financial products that are "close substitutes" to deposits are disadvantaged by being outside the FCS. However, such products are not direct competitors with deposits if issuers of such products are not subject to prudential supervision and requirements on capital, liquidity, risk-management, reporting, auditing and governance.

Any reduction of the $1 million cap, eg. to $500,000, should be implemented only with safeguards to minimise negative impacts on stability and competition. These would include a transition period with an effective public awareness campaign about the prudential regulatory framework and the scope of the FCS.

Under the *Core Principles for Effective Deposit Insurance Systems,* public awareness of deposit insurance, its existence and how it works (including the level and scope of coverage and how the claims process operates), plays a significant role in underpinning a sound deposit insurance system.

> "All deposit insurers should promote public awareness about the deposit insurance system on an ongoing basis to maintain and strengthen public confidence. The objectives of the public awareness program should be clearly set out and consistent with the public policy objectives and mandate of a deposit insurer. When designing a public awareness program, deposit insurers should clearly define the principal target audience groups and subgroups (eg the general public, depositors, member banks etc). Employing a wide variety of tools and channels of communication can help ensure that the deposit insurers' messages are conveyed to the target audience.
>
> "In general, the deposit insurer should be the primary party responsible for promoting public awareness about deposit insurance and should work closely with member banks and other safety net participants to ensure consistency in the information provided and maximise synergies. All these bodies and their staff have a role to play.
>
> "Budgets for public awareness programs should be determined on the basis of the desired level of visibility and awareness about deposit insurance among the target audience. And, it is an effective practice for a deposit insurer to conduct a regular independent evaluation of awareness levels."

Competition is needed in retail banking to drive efficiency, innovation and productivity but competition depends on effective consumer choice. Informed consumers are empowered and motivated consumers.

The creation of a single licensing regime for banking institutions a decade ago was aimed at promoting competition and choice. It is time for a renewed effort at explaining the prudential regulatory system, including by making some changes to the language of regulation, to achieve a genuine level playing field.

Promoting the prudential regulatory framework

"Authorised Banking Institutions"
All ADIs - credit unions, building societies and banks - are subject to the same strict prudential regulatory regime, with the same set of strict, legally-enforceable prudential standards covering capital, liquidity, risk management and governance.

ADIs are subject to rigorous and close supervision by APRA, which requires the ADI to comply with a range of requirements contained in Prudential Standards and provide comprehensive data to APRA under Reporting Standards. APRA has a range of powers it can exercise should an ADI not comply with any of the requirements imposed by APRA.[23]

"Banking business" is defined in the *Banking Act 1959* as both taking money on deposit (otherwise than as part-payment for identified goods or services) and making advances of money.

This is what all ADIs do.

However, using its powers under s66 of the Banking Act, APRA restricts use of the terms 'bank' and 'banking' to a minority of ADIs. ADIs that have at least $50 million in Tier 1 capital can apply to call themselves banks.[24]

The $50 million hurdle has been in place since 1992 and was seen by the RBA, APRA's predecessor as banking prudential regulator, as a "means of discouraging unsuitable shareholders from attempting to gain a banking authority."[25] The RBA's 1996 submission to the Financial System Inquiry (FSI) said that 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."

The RBA at that time also took the view that to "provide the relatively broad range of services expected of banks requires sufficient capital to acquire the necessary expertise and technology, and to generate the required degree of confidence."

The FSI's final report in 1997 adopted the position that a "continuing distinction between banks and other DTIs remains relevant in an international setting and in distinguishing those entities large enough to maintain an exchange settlement account with the RBA from other, smaller DTIs."[26]The FSI said "authority to use the word 'bank' in its brand should be reserved for licensed DTIs which meet two additional conditions: satisfy a minimum capital requirement as prescribed by the [APRA] from time to time (the Committee suggests retention of the current $50 million): and, have an exchange settlement account with the RBA."

Abacus argues that in 2010 the continuing restrictions around the term 'bank' and 'banking' that exclude the majority of regulated banking institutions have long outlived their original rationale. Allowing only a minority of regulated banking institutions free use of the terms 'bank' and 'banking' is unjustified and anti-competitive.

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[23] *How to apply for ADI authority* APRA website http://www.apra.gov.au/ADI/ADI-authorisation-applications.cfm
[24] *ADI authorisation guidelines* APRA website http://www.apra.gov.au/ADI/upload/ADI-Guidelines-11-4-08.pdf
[25] RBA submission to Financial System (Wallis) Inquiry, 1996
[26] Financial System Inquiry Final Report March 1997 (Wallis Report).

The original distinction between 'banks' and other deposit-taking institutions, based on an arbitrary level of capital and a vague concept that a 'relatively broad range of services [is] expected of banks', was never well-founded and is now clearly anachronistic.

The RBA's successor as prudential regulator, APRA, has a much wider and stronger array of powers to screen out "doubtful" and "unsuitable" applicants for a banking licence. These include prudential standards on governance and 'fit and proper' requirements for directors and senior managers. APRA's powers have been strengthened and extended since it was established in 1999 and will be further enhanced under measures proposed in the Financial Sector Legislation Amendment (Prudential Refinements and Other Measures) Bill 2010.

With regard to exchange settlement accounts (ESAs), smaller banking institutions, such as credit unions and building societies, do not need to hold an ESA with the RBA because they can access settlement services and the payments system through providers such as Cuscal, Indue and ASL. However, a number of Abacus member banking institutions have exercised their option to become ESA holders.[27]

Credit unions and mutual building societies, as customer-owned institutions, obviously value their distinct identity from banks but the reality is the terms "bank" and "banking" are well understood in the community. The term "ADI" is not well understood a decade after it entered the statute books. The term is barely used even in Government publications:

- the Report on Australia's Future Tax System released on 2 May 2010 recommends a tax cut for interest income but refers to "*bank* accounts" and "*bank* deposits";[28] and
- ASIC's June 2010 updated regulatory guide on advertising of debentures and unsecured notes refers throughout to "*bank deposits*"[29].

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 full competitive benefit of achieving compliance.

A simple step to improving market awareness of the prudential standing of all regulated banking institutions - and therefore contestability, competition and choice – would be to replace the term "Authorised Deposit-taking Institution" with "Authorised Banking Institution".

"Mutual Banks"

There are 27 mutual ADIs that have at least $50 million in Tier 1 capital (though as far as Abacus is aware, none have to date opted to apply to call themselves a "bank"). The majority of mutual ADIs are currently ineligible, due to APRA policy, to apply to use the term "bank". Credit unions and building societies have APRA's express consent to use the term "banking". They may use the term "banking" in relation to "the banking activities of the building society or credit union if the word is not used in a misleading or deceptive way."[30]

However, new uncertainty about the scope of this consent was raised last year when APRA indicated to one Abacus member ADI that a complaint had been lodged about the

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[27] Greater Building Society, Heritage Building Society, IMB Ltd, Police Department Employees Credit Union.
[28] Australia's Future Tax System, Report to theTreasurer, Part One, Overview, December 2009
[29] ASIC Regulatory Guide 156
[30] Guidelines – Implementation of Section 66 of the Banking Act 1959. APRA January 2006. http://www.apra.gov.au/ADI/upload/Guidelines-Implementation-of-Section-66-of-the-Banking-Act-1959.pdf

ADI's use of the word "banking" in its marketing material and that the ADI could be in breach of section 66.

APRA should allow all ADIs the non-compulsory option of marketing themselves as "banks". This would enable Abacus members to exercise the option of marketing themselves as "mutual banks" to the market generally or to market segments where the terms "credit union" or "building society" are less effective.

These changes to the Banking Act and APRA's approach would give mutual banking institutions greater capacity to cut through misconceptions that they are not as safe as listed banks and that they are not covered by the FCS.

It is unlikely that all mutual banking institutions will embrace the term "mutual bank". Abacus members with very strong brand strength in their regional areas and other market niches have no need or desire to use the term bank in their core markets.

The objective of the change is to enable all regulated banking institutions, whether listed or customer-owned, to effectively promote their status as prudentially-regulated entities covered by the FCS.

Genuine regulatory neutrality does not mean any loss of diversity in the banking market. The key distinguishing factor of mutual banking institutions is their strong customer focus, as demonstrated by their consistent market-leading performance in customer satisfaction surveys.

Prior to 1998, building societies seeking to become "banks" were required to demutualise. Most building societies that converted to banks in the 1980s and 90s have since merged with other banks and disappeared completely or continue to exist only as part of a major bank's brand strategy. These include St George Bank, Advance Bank, Challenge Bank, Bank of Melbourne, Tasmania Bank, Metway Bank, and Adelaide Bank.

The Productivity Commission's June 2010 Draft Report on regulatory burdens on business and consumer services discusses this issue in a section entitled 'Bank – what's in a name.'

> "Historically banks in Australia have usually been larger businesses than building societies or credit unions and might, therefore, be thought to offer a greater level of security and a wider range of services. But that is not always the case. The largest building societies and credit unions (such as Credit Union Australia, Heritage Building Society, Newcastle Permanent Building Society and IMB) are larger than, or of similar size to, the smallest Australian owned banks (Members Equity Bank and AMP Bank).
>
> "It would seem, *prima facie*, that there is little beyond the name 'bank' to distinguish some credit unions and building societies from banks. It would be useful to remove any unnecessary restrictions which limit the ability of building societies and credit unions to compete with banks on a level playing field. The current restrictions on the use of terms such as 'bank' by other ADIs could be reconsidered."

Conclusion

The FCS is generally consistent with the Core Principles for Effective Deposit Insurance Systems, though there is a need for a public awareness campaign in line with Principle 12.

The FCS cap for deposits should be retained at the credible, stark and easily understood level of $1 million to promote stability and mitigate moral hazard.

Retaining the cap at $1 million is also pro-competitive because it helps level the playing field for smaller banking institutions and new entrants.

The dominant position of the major banks in Australia's highly concentrated banking market has become even more entrenched due to the global financial crisis.

Abacus acknowledges the critically important role of the now-closed *Guarantee Scheme for Large Deposits and Wholesale Funding* in ensuring the flow of credit in the Australian economy during the global financial crisis.

However, the scheme's unfair fee structure meant that the scheme disproportionately benefited the major banks. The fee for major banks was 70 basis points compared to 150 basis points for the vast majority of regulated banking institutions. The RBA has confirmed that the differential in the fee structure was "relatively large by international standards" and that the fee paid by the major banks was "at the low end of the international range."[31]

Fees flowing to the Government from the scheme are estimated to total $5.5 billion. As argued in previous submissions by Abacus, diverting a small fraction of this windfall revenue to a pro-competitive public awareness campaign about the prudential regulatory framework and the FCS would help level the playing field in banking.

Louise Petschler, CEO, 02 8299 9036
Mark Degotardi, Head of Public Affairs, 02 8299 9053
Luke Lawler, Senior Adviser – Policy & Public Affairs, 02 6232 6666

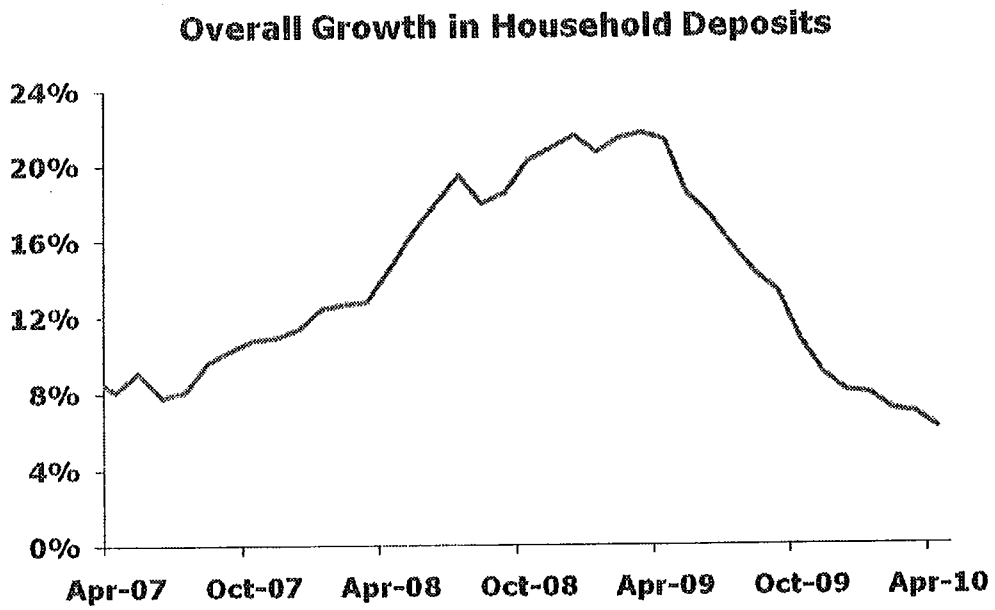
2 July 2010

[31] RBA Bulletin, March Quarter 2010

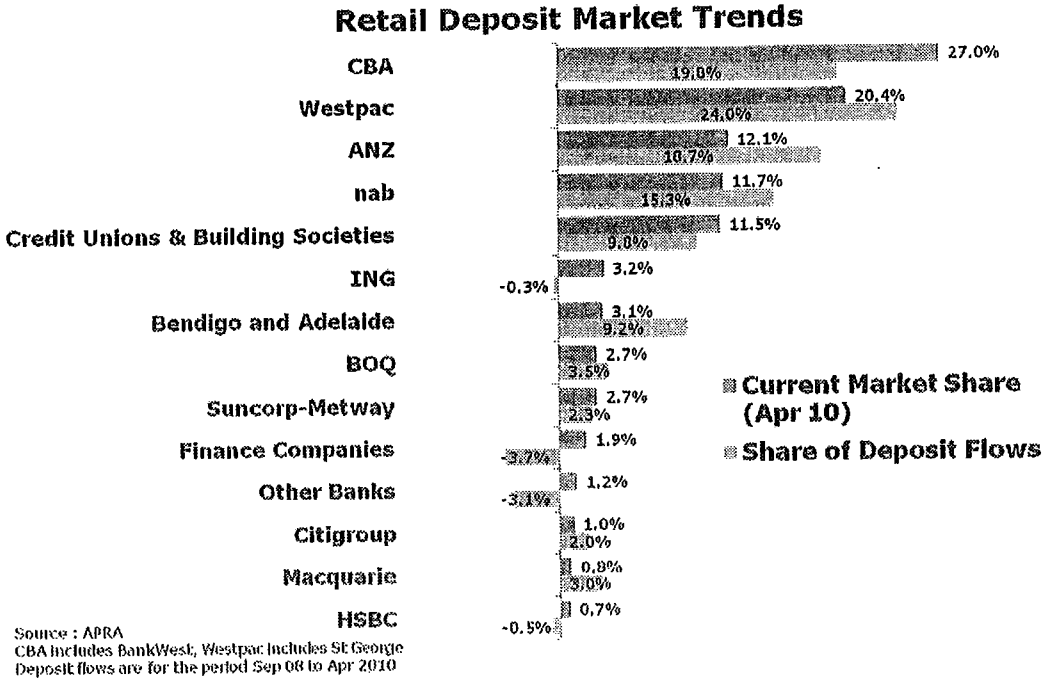
APPENDIX A

Deposit market trends

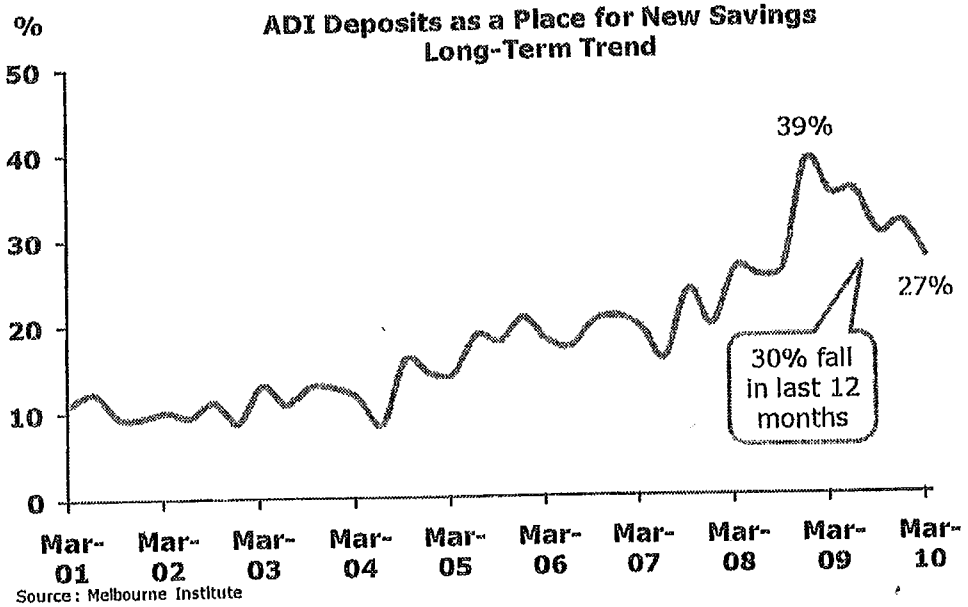
A flight to safety was already evident in the lead up to the announcement of the deposit guarantee. Growth rates of 20% pa continued through 2009 and have sharply fallen back to normal levels.



All major banks except CBA attracted deposits in excess of their market share. Credit unions and building societies have grown at close to the rate expected by reference to their market share.



Consumers have more recently re-appraised their risk profiles and are again looking at other asset classes, despite abnormally high deposit rates.



Credit unions and building societies in aggregate have expanded their deposit portfolios by 13% from September 2008, before the deposit guarantee was announced, to the present. The retail deposit market has grown by 16% over the same period, so market share of credit unions and building societies has fallen from 11.6% to 11.4% as a consequence. This below system growth indicates that, at industry level, credit unions and building societies have managed their liquidity and funding risks by building deposits, but have not done better than the market overall as would have been the case if outlier high interest rates had been on offer.

Further evidence that this growth has been achieved in the context of sensible risk management principles lies in trends for interest expense. Over the period that deposit balances rose by 13%, total interest expense fell by 24% between September 2008 and March 2010 as official and market rates were reduced significantly.

Paragraph 47 (1)(b)
(commercially valuable information)

Paragraph 47(1)(b)
(commercially valuable information)

Conclusions

The deposit market grew at unprecedented rates through the GFC, leading up to and after the deposit guarantee was announced. This growth has now returned to normal levels.

Major banks were the real winners in this environment, with most extending their market shares. If moral hazard of having the guarantee was in evidence, a broader spread of deposit takers would have been using price to build deposits.

Credit unions and building societies have benefited from these deposit market dynamics, adding over $7.5bn in balances or an increase of 13%. While credit unions and building societies have a strong reputation for offering better rates to members compared with banks, these are offered in the context of prudential approaches to liquidity, funding and financial performance risk.

Confidential data held by Abacus shows credit unions have seen growth across a range of different sized deposits with only a slight change in the mix across the portfolio when comparing pre and post retail deposit guarantee data.

Close to 90% of all deposits held by credit unions are under $1m.

APPENDIX B

Core Principles for Effective Deposit Insurance Systems

Bank for International Settlements
International Association of Deposit Insurers

1. Public policy objectives: the first step in adopting a deposit insurance system or reforming an existing system is to specify appropriate public policy objectives that it is expected to achieve. These objectives should be formally specified and well integrated into the design of the deposit insurance system. The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and protect depositors.	FCS legislation second reading speech: ensure confidence in Australian financial institutions is maintained; in the event an institution fails, will provide deposits in ADIs with timely access to their funds
2. Mitigating moral hazard: Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net.	Limited to ADI deposits of up to $1m. Large depositors, i.e. more than $1m, outside FCS have incentive to impose market discipline on ADIs, along with other creditors and shareholders who are also outside the FCS. Relatively high cap, i.e. $1m, is credible, so large depositors are convinced the FCS is limited. Setting the cap at a credibly high level is important to a successful permanent transition from the pre-existing implicit blanket guarantee. Strong prudential regulatory framework, regularly strengthened and enhanced (APRA, Treasury) Strong financial stability regulator and central banker (RBA) Strong corporate regulatory and disclosure framework (ASIC, ASX) Unlisted mutual banking institutions are not motivated to take excessive risks to generate excessive returns.
3. Mandate: It is critical that the mandate selected for a deposit insurer be clear and formally specified and that there be consistency between the stated public policy objectives and the powers and responsibilities given to the deposit insurer.	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS

4. Powers: A deposit insurer should have all the powers necessary to fulfil its mandate and these powers should be formally specified. All deposit insurers require the power to finance reimbursements, enter into contracts, set internal operating budgets and procedures, and access timely and accurate information to ensure that they can meet their obligations.	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS
5. Governance: The deposit insurer should be operationally independent, transparent, accountable and insulated from undue political and industry influence.	APRA is an operational independent statutory authority with 3-member executive group responsible for determining APRA's goals, priorities and strategies.
6. Relationship with other safety-net participants: A framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety net participants. Such information should be accurate and timely (subject to confidentiality when required). Information sharing and co-ordination arrangements should be formalised.	APRA has formalised frameworks in place with other safety net participants - RBA, ASIC and Treasury – including as members of the Council of Financial Regulators
7. Cross-border issues: Provided confidentiality is ensured, all relevant information should be exchanged between deposit insurers in different jurisdictions and possibly between deposit insurers and other foreign safety-net participants when appropriate. In circumstances where more than one deposit insurer will be responsible for coverage, it is important to determine which deposit insurer or insurers will be responsible for the reimbursement process. The deposit insurance already provided by the home country system should be recognised in the determination of levies and premiums.	APRA is a member of the International Association of Deposit Insurers. APRA is active internationally and has memoranda of understanding with many of its counterpart prudential regulators.

8. Compulsory membership: Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits from those deemed most in need of protection (eg. retail and small business depositors) to avoid adverse selection.	All ADIs are 'members' of FCS
9. Coverage: Policymakers should define clearly in law, prudential regulations or by-laws what an insurable deposit is. The level of coverage should be limited but credible and be capable of being quickly determined. It should cover adequately the large majority of depositors to meet the public policy objectives of the system and be internally consistent with other deposit insurance system design features.	The FCS applies to ADI deposits of up to $1 million on a per-account holder, per-ADI basis. Protected deposits are defined in the Banking Act and regulations
10. Transitioning from blanket guarantee to a limited coverage deposit insurance system: When a country decides to transition from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as a country's circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long, notably an increase in moral hazard. Policymakers should pay particular attention to public attitudes and expectations during the transition period.	Transition was achieved in less than two weeks; 12 Oct 2008 announcement of guarantee of all deposits; 24 Oct 2008 announcement fee-free guarantee applies only to deposits up to $1 million from 28 Nov 2010; 7 Feb 2010 announcement of closure of large deposits and wholesale funding guarantee from 31 Mar 2010.

11. Funding: A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system. For deposit insurance systems (whether ex-ante, ex-post or hybrid) utilising risk adjusted differential premium systems, the criteria used in the risk-adjusted differential premium system should be transparent to all participants. As well, all necessary resources should be in place to administer the risk-adjusted differential premium system appropriately.	APRA is funded by industry levies on ADIs and other supervised entities. As part of the FCS arrangements, the Government has made a standing appropriation for funds to be available for FCS purposes. From October 2011, the appropriation is for a maximum amount of $20 billion for payouts to account-holders at any one time and $100 million for expenses relating to the administration of the FCS. The former amount would be used to pay account-holders in the first instance, with this amount to be repaid to the Government from the liquidation of the ADI. Payments made under the FCS are covered by the depositor preference provisions in the Banking Act, such that the assets in Australia of the ADI in winding up must first be applied to repay amounts paid under the FCS. If the assets of the ADI are insufficient to meet the amounts paid under the FCS (including expenses incurred in administering the FCS), an industry levy may be imposed to cover any shortfall.
12. Public awareness: In order for a deposit insurance system to be effective it is essential that the public be informed on an ongoing basis about the benefits and limitations of the depositor insurance system.	As argued in this submission, there is strong case for action on this principle.
13. Legal protection: The deposit insurer and individuals working for the deposit insurer should be protected against lawsuits for their decisions and actions taken in "good faith" while discharging their mandates. However, individuals must be required to follow appropriate conflict-of-interest rules and codes of conduct to ensure they remain accountable. Legal protection should be defined in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified.	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS

14. Dealing with parties at fault in a bank failure: A deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure.	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS
15. Early detection and timely intervention and resolution: The deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks. The determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and on the basis of well defined criteria by safety-net participants with the operational independence and power to act.	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS
16. Effective resolution processes: Effective failure-resolution processes should: facilitate the ability of the deposit insurer to meet its obligations including reimbursement of depositors promptly and accurately and on an equitable basis; minimise resolution costs and disruption of markets; maximise recoveries on assets; and, reinforce discipline through legal actions in cases of negligence or other wrongdoings. In addition, the deposit insurer or other relevant financial system safety-net participant should have the authority to establish a flexible mechanism to help preserve critical banking functions by facilitating the acquisition by an appropriate body of the assets and the assumption of the liabilities of a failed bank (eg. providing depositors with continuous access to their funds and maintaining clearing and settlement activities).	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS. APRA works closely with the RBA. RBA has responsibility for stability of financial system.

17. Reimbursing depositors: The deposit insurance system should give depositors prompt access to their insured funds. Therefore, the deposit insurer should be notified or informed sufficiently in advance of the conditions under which a reimbursement may be required and be provided with access to depositor information in advance. Depositors should have a legal right to reimbursement up to the coverage limit and should know when and under what conditions the deposit insurer will start the payment process, the time frame over which payments will take place, whether any advance or interim payments will be made as well as the applicable coverage limits.	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS. APRA's intention is to provide accountholders with access to their deposits up to the FCS limit as soon as possible following the declaration of the FCS.
18. Recoveries: The deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits.	APRA is scheme administrator; APRA has strong prudential regulation and crisis management powers and specific powers to administer the FCS