Submission To

THE INQUIRY INTO THE REGULATION OF AUSTRALIAN FINANCIAL INSTITUTIONS

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on behalf of the members
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Submission By

Bananacoast Community Credit Union Ltd

<u>Executive Summary</u>:

The Bananacoast Community Credit Union submits the following paper which represents the views of its Board and its members. The reasons for the Credit Union submitting an individual submission, set out in detail in Appendix III of this submission, centre on the need for a community response to the vital issues under consideration by your Inquiry.

The arguments and recommendations set forth in this submission can be summarised as follows:

1. *Ensuring the most efficient and cost effective service for users, consistent with financial market stability, prudence, integrity and fairness*

   - There is an expectation by the community of a *public benefit* consideration in the regulatory approach to the financial system. There is a considerable justification for this expectation;

   - This expectation stems from the favourable position afforded to the major banks by the community;

   - This expectation is being met, and can continue to be met, by the financial system through its Credit Union Sector;

   - Credit Unions can only deliver *public benefit* on behalf of the financial system if their *mutual* status is recognised and allowed for in all legislation that is applied to them, including prudential regulation and Taxation laws;

   - If that recognition is not forthcoming and the *playing field* continues to be tilted in favour of corporate sector banking institutions, Credit Unions will be forced to mutate to a form of hybrid corporation, the community's *public benefit* expectation will be ignored and public confidence in the financial system will sink to a low ebb.

2. *The Most Appropriate Systems for Regulation and Supervision of Financial Institutions:*

   - The regulatory and supervisory culture and attitude applied to Credit Unions must be the same culture and attitudinal approach as applied to the banking system but which recognised the distinctive differences between a Credit Union and a Bank. This includes prudential standards that facilitate rather than choke the growth and development of Credit Unions.

   - This is best achieved through:

* the abolition of The Australian Financial Institutions Commission [AFIC] and its regulatory and supervisory roles being taken over by the Reserve Bank. [Including the liquidity support scheme and the authority to recommend necessary legislative and/or regulatory changes to the Ministerial Council];

* the on-site inspectorate role of State Supervisory Authorities [SSAs] being assigned to Auditors with a Reserve Bank Auditing Authority [issued under a graduated accreditation system to be introduced];

* State Supervisory Authorities [SSAs] retaining their role of monitoring Credit Unions, taking an extended proactive role in their development and imposing remedial action [such as placing a society under direction, compelling amalgamations etc] where deemed necessary by the SSA, the Accredited Auditor and/or the Reserve Bank;

* retention of the distinct State-based Financial Institutions Legislation;

* a single regulator [the Reserve Bank] for Deposit Taking Financial Intermediaries rather than a “super regulator”. This is premised on the need for the retention of regulatory competition which fosters a low cost but highly innovative and progressive community of regulators.

3. *Ownership - The Future Direction of the Credit Union Sector*

- The submission includes a recent work by a Credit Union Study Group on the European Co-operative-Banking Networks which concentrates on the development, by Credit Unions and Credit Co-operatives, of a *second-tier B*ank or Banks both as liquidity combines and to provide those universal banking services that individual Credit Unions are unable, for reasons of comparative size or otherwise, to provide for their members.

- The submission stresses the importance of these models as an option for development of Australia’s Credit Union Sector and argues that provision must be made to allow the formation of such a Bank should the Credit Union Sector move to adopt this option at some time in the future.

Our Credit Union Board and Members believe that the propositions and arguments put forward in this submission are both relevant and crucial to the deliberations and outcomes of this Inquiry and request the opportunity to expound further on these proposals and arguments, before the Inquiry at a time convenient to it.

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1. Ensuring the most efficient and cost effective service for users, consistent with financial market stability, prudence, integrity and fairness

The Essential Role of Credit Unions in the Australian Financial System:

It is our contention that until such times as emphasis on the *public benefit* aspect of banking is put **in equilibrium** to the privileges given to the deposit taking, financial intermediaries, public confidence in the integrity of Australia's financial system will be at a low ebb.

This equilibrium in *public benefit* viz-a-viz *institutional privilege* can best be provided by the retention and growth of a viable, strong network of mutual, Co-operative Credit Unions as that sector of the financial system designated to provide (on its behalf) the necessary and appropriate balance.

A recognition that the System can fulfil its *public benefit* obligations through offering the community a choice of full retail banking through one of its divisions [The Credit Union Sector], that has a statutory responsibility to provide essential *public benefit* elements, has the potential to maintain the full confidence of the community, in the System as a whole.

This recognition will be even more important if the Inquiry is to recommend favourably in relation to the arguments for further concentration of financial power though acquisitions and mergers. Such a focus on Credit Union potential would give this Inquiry scope to dispel predictions that "*the Wallis Committee will labour hard but [there are fears] it is destined to bring forth only a mouse.*" ①

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① The Bottom Line ***Wallis is the Inquiry We Didn't Need*** . Article by Max Walsh - Sydney Morning Herald 8th August, 1996 at pages 25 and 30.

Recognition and pragmatic support for Credit Unions as the best DTI ingredient for competition at the *coal face* of retail banking will guarantee the

Inquiry's relevance to the future direction of the Nation's financial intermediation system.

Major Banks' Privileges

The major banks in Australia represent an *Oligopoly* [a word that, though not found in standard dictionaries, has apparently been adopted as a "bank speak*"* euphemism for "*limited* cartel"] among Deposit Taking Institutions [DTI's]. While there have been some feeble attempts in the past decade to widen the membership of this *Oligopoly* there is no doubt that the good-will and assets of the four major Deposit Taking Institutions have been built to their current levels during periods when this cartel was strongest and when it was most stringently enforced by the State.

So, the current ability of the 'four majors' to dominate the DTI banking market in Australia has been given to them by the State (ie. the State representing the Community). This determination by Government to maintain the banking *Oligopoly* has affected Credit Unions and Co-operative Credit Societies dramatically from as far back as the 1860's when the colonial banks pressured the Government in N.S.W. to include a prohibition on the formation of co-operative Banks in the *Industrial & Provident Societies Act*. [That prohibition remained on the Statute Books well into this century].

The most recent legislative "prohibitions" on the growth of Credit Unions and Co-operative Credit Societies were: the *Australian Financial Institutions Code, 1992* which, through an *ad hoc* set of prudential standards, imposed a regime limiting the growth and competitive potential of Credit Unions; and *The Taxation [Deficit Reduction] Act, 1993* which by stripping Credit Unions of their Mutual Status under the Income Tax Assessment Act [which had previously been re-enforced by Section 23G], imposed a double taxation of the annual surplus thus severely limiting capital growth and, consequently, the ability to extend their business.②

② For a more detailed explanation of the inequitable application of this provision of the Taxation (Deficit Reduction) Act, 1993 see Appendix 1 to this Submission.

These Statutory instruments, in practice, have a collective effect of preventing the formation of any new Credit Unions in Australia. In fact, had these provisions applied earlier in the century there would be no Credit Unions in this country.

Amendments to the taxation provisions were implemented at the behest of the major Banks [though with attendant compilations of sophistry] which, in a period of public disquiet over their poor commercial performance, were able to counterbalance their inability to correct their inefficiencies by having the Government quash further growth of the most effective, emerging competitive force in the DTI field. The AFIC Code was a response to the collapse of the Farrow Group, despite the fact that it was not a true mutual.

In addressing this question of privilege of the four majors, Ferguson, MD of Bankers Trust, Sydney told a 1991 banking symposium that the ultimate privilege accorded to Banks is that they have been allowed to enjoy substantially higher returns available in the deregulated market with the attendant risks being borne, to a large extent, by the community generally rather than by the shareholders.

He asserted as follows: "*We can see that there has been a period of lagged recognition of falling interest rates by banks at the retail and small corporate level designed to rebuild damaged bank equity. The effect of this is, at least in the short term, to inhibit the intent of monetary policy and cause* ***parts of the community, rather than the shareholders, to bear the brunt of bad lending decisions****..........It is apparent this problem is a reflection of the oligopoly structure of Australian Banking which has its greatest power in the retail sector."* ③

The *lag* period of recognition of interest rate reductions is being continued by most of the major Banks after the current [August, 1996] drop in the *official rate* with the *lag* time being up to eight weeks. In this instance they seem to be blaming their computer system limitations for the *lag* period.

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③ Ferguson, R   ***Banking Deregulation - A Virtue or a Necessity***? in Proceedings of a Conference-The Deregulation of Financial Intermediaries.. Ed. Macfarlane I, Research Department, Reserve Bank of Australia - 1991

This has meant that Management, Boards and Shareholders have suffered few of the consequences of poor Bank management [many would argue they were well rewarded for the managerial ineptitude of the late 1980's] - *customer pays, management stays*.

Some point to the fact that, unlike the experience in many other countries, no impost was made on the *public* purse as a result any Bank failure during the crisis period of the late 80's and early 90's. Never-the-less it must be recognised that the System allows Banks' losses to be *socialised* while profits are *capitalised*. There is little difference between Government making good bank losses from its revenue and a government that allows those losses to be recouped directly from the community through the imposts of a banking *oligopoly* with Government backing.

The traditional role of Government regulation as a protective mechanism for the *oligopoly* carries considerable benefit even after supporting regulatory instruments have been withdrawn. For example, for more than a decade after the abolition of the 3.5% regulated ceiling on Pass-Book Savings Accounts, all but one of the major Banks continued to apply the 3.5% ceiling to those accounts [such accounts representing over 4% of their total deposits].④ This was commercially achievable because of the years of *customer conditioning* built up by the subject regulatory period. The same can be said of most of the $14.7 billion [RBA Bulletin - FI Statistics for May, 1996] held on deposit by Banks in respect of which they pay no interest at all.

Ferguson rightly concluded, in relation to the major Banks, that "*There is a tendency for any long-term holders of privilege to not concede or appreciate the advantages of that privilege*". ⑤

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④ Harper I — ***Bank Deregulation in Australia: Choice and Diversity, Gainers and Losers*** in Proceedings of a Conference -The Deregulation of Financial Intermediaries.. Ed. Macfarlane I, Research Department, Reserve Bank of Australia - 1991

⑤ Ferguson et. al.

Why has Government Continued to Re-enforce this Privileged Position of the Major Banks:?

The protection of depositor funds is an essential element of the *public benefit* aspect of banking. The *too big to fall* theory applied to the four major Banks can account for a great deal of the Government's reluctance to limit the privileges of those Banks.

A large part of a Banks' insurance against failure is the ease with which it is able to raise capital. Equity investors fully understand the covertly privileged position of the major Banks and of Governments' determination to ensure they remain viable. This umbrella of implied Government patronage adds a premium to the shares of these Banks and makes those shares much more attractive to institutional (trustee type) investors in particular.

So the Community (through its Government) makes a gift to shareholders of a *put option* on each major Bank's market capitalisation.

While there are good economic reasons why a Government should adopt a stance that facilitates capital raising by Banks, never-the-less this must be recognised as an *institutional benefit* given to those banks by the Community.

This *benefit* contrasts sharply with a seeming determination by the previous Government to impede the growth of capital in Credit Unions, the only DTI's that have a statutory responsibility to provide a *public benefit*.

It seems ironic that in an era when a Bank account and a banking relationship were, for many people, ***an option*** the banking system acted with considerable integrity and a consciousness of the privileges bestowed on it by the community, while now, when those accounts and relationships are ***a necessity*** for all adults, the service ethos of banking institutions has been so severely diluted. It is equally ironic that Governments seem to have been impervious to this drift.

Should the Privileged Position of the Major Banks have a Counterbalancing Obligation?

A licence is a permit to do something that would not otherwise be permissible under the law. Banking requires a licence. At the dawn of the system licenses were issued on the basis that, in return for providing a *public benefit*, institutions would be able to carry on the business of banking, in a prudentially sound manner, at a profit to their owners. By stealth, the *obligation* of public benefit has been superseded solely by the *right* to make a profit from banking.

The arguments for *public benefit* should **not be confused with** the *social contract theory of banking* which was the focus of the debates on Bank Nationalisation in the later 1940's and early 1950's and which was put forward again (though in more rational argument) to the *Martin Inquiry* in the submission of The Australian Consumers' Association, the Australian Federation of Consumer Organisations and the Australian Financial Counselling & Credit Reform Association. ⑥

The Prices Surveillance Authority [PSA] was commissioned by the Federal Government to conduct an inquiry, among other things, into this very issue. In its Report [issued in July 1995], while stopping short of suggesting Banks should be required to provide cost-free services to disadvantaged members of the community, it did criticise the *charges mix* in banking and recommended that banking services broadly reflect costs. This was an indication of a view that the system did have some form of contract with the community, at least to act equitably and with integrity.

The *Social Contract Theory of Banking* is in fact applied to Credit Unions, both through their natural objectives and through legislative stipulation. The Code ⑦ requires, inter alia:

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⑥ Carver, L. ***Banking in the Public Interest: The Public Benefit Requirements of the Australian Banking Industry***. Submission to the House of Representatives Standing Committee on Finance and Public Administration. Part III

⑦ **The Financial Institutions Code, 1992 -** See PART 3, *Division* 1 - *Principles,* Section 108 (2), Part B - *Credit Unions,* Clause (i)

that membership is to be open and voluntary and non-discriminatory, and that Credit Unions have an obligation to improve the economic and social well-being of all members, to extend their vision to individual members and the larger community in which they work and reside, to extend their service to all those who need and can use it and to take their decisions with full regard for the interest of the broader community within which a Credit Union and its members reside.

It is apparent that the *public benefit* obligation of the system extends beyond offering the community a system which is stable and prudentially sound.

Credit Unions, as a Sector of the Financial System, are ideally placed to act as that *System's* vehicle for fulfilling an essential element of its *public benefit* obligation. A strong, vibrant network of Credit Unions would offer the community an alternative in those areas of retail banking where the major players have proven less responsive to public demands.

To achieve this goal:

1. Credit Unions must be given some community consideration in relation to their capital accumulation. Credit Unions do not seek the same extensive privileges that Banks have been (and still are) given to strengthen their capital position;

2. it must be recognised that Credit Unions can only increase their capital by increasing their reserves;

3. it must also be recognised that Credit Unions can only increase their reserves through retention of profits;

4. it must be recognised that Credit Unions do not [because of their distinctive, *mutual* nature and because of supporting statutory prohibitions] pay dividends on shares and consequently the retention of profits does not add any premium value to the proprietorship of the member/owners of the Credit Union;
5. it must be recognised that Credit Unions' *mutual* status is essential to their ability to fulfil their *social contract* obligations and that any dilution of their *mutual* position will have a consequential effect in limiting their ability to meet those obligations;

6. it must be recognised that Section 23G of the Income Tax Assessment Act was repealed so as to allow Banks a competitive edge, during a *catch-up* period, to strengthen their equity after the crisis of the late 80's and early 90's. That *catch-up* period has fulfilled its objective and the taxation impost, designed to slow Credit Union growth, must now be withdrawn;

7. it must be recognised that the prudential standards which discriminate against Credit Unions must be replaced immediately with standards comparable to those applied to Banks but which recognise the unique nature of Credit Unions; i.e. those Standards which artificially limit the business activities of Credit Unions (commercial lending) and stultify growth through an emphasis on the maintenance of artificially high capital and liquidity ratios;

8. it must be recognised that unless an adjustment is made to restore the *status quo* [in relation to both **6** & **7** above] then existing Credit Unions will not be able grow to meet the increasing demand for their services & no new credit unions will be able to be developed, despite the extensive community demand for same; and

9. it must be recognised that Credit Unions are unique and different from Banks and must retain their current distinctive and separate legislation. While changes are needed to regulatory and supervisory arrangements for Credit Unions these can be achieved through simple amendments to the current code and its supplementary legislation.

Is the primary role of the government in the <u>Financial System</u> to protect and strengthen the interests of the <u>equity investors</u> in financial institutions or is it to ensure the system works for the public benefit? Which of these two is the *means to an end* and which is the *end* itself. We believe this is the first question for determination by the Wallis Inquiry and one which is of the utmost importance to the future of this Nation's economy.

If it is a major objective of the Inquiry to make recommendations on the formulation of a system which best offers the most efficient and cost effective services for **users** then Credit Unions' potential must be seriously and objectively considered.

An understanding of the nature of mutuality is essential to the debate on external capital.

In a corporate situation the emphasis is to work the assets of the company so as to ensure shareholders of a maximum return on their investment. This is provided both through dividends on shares and on capital gains acquired through an increase in the value of those shares in the market place where they are traded. Therefore, in a banking situation, there is a constant pressure on management to gain the maximum profit, **for the organisation**, on deposits held and advances made while using the minimum possible resources.

In a mutual organisation the emphasis is on providing the best possible services to members. Therefore there is a constant pressure on

Credit Union management to maximise the returns on members deposits and minimise the cost of loans to members, as an essential part of this service ethic. The organisation must use whatever resources that are required to maintain the maximum level and quality of service possible, within the limits of its means. All the profits, except those required to be retained as a guarantee of depositor safety, are distributed back in rebates as interest credits.

The democratic principles in these organisations are just one mechanism to ensure this objective is achieved. Most important is the formula for distribution of the annual surplus and the prohibition on trading of shares for profit. Once the organisation allows shares to be traded for a premium it is no longer a mutual society. The pressure on management is immediately changed to one that emphasises maximising the profit to shareholders, in order to make share issues as attractive as possible to investors. Once this occurs the *service to members* ethic is lost and the organisation is simply a hybrid company. Losing a little bit of one's mutuality is like becoming a little bit pregnant.

If external equity investors are allowed then Credit Union mutation to a full corporate form is only a matter of time.

While the Terms of Reference for this Inquiry may exclude specific recommendations on tax reform it must be recognised that the taxation issue raised here is not a Government revenue issue but a competition issue. Continuation of the present punitive elements of the taxation system applied to Credit Unions will not only deprive the community of the important potential of these societies to provide it with *efficient and cost effective services* but give credence to the perception that the *playing field* is tilted to favour the Big Four Banks.

Credit Unions recognise the historical right of Government to use the taxation law as an instrument of public policy as well as a revenue raising mechanism. However, if it is government policy to eradicate *mutual C*redit Unions, it should state this openly and allow proper community debate. As Davis points out, "*What is of concern however, is that such developments [Credit Union mutation to a non-mutual form] are likely to occur as a by-product of unsuited tax and regulatory policies, rather than as a result of a conscious recognition of any need for institutional change*". ⑧

2. The Most Appropriate Systems for Regulation and Supervision of Financial Institutions:

The focus of regulation and supervision of most financial institutions in Australia has changed markedly over the past decade. It has evolved from a micro approach that exercised control over portfolio composition, interest rates, permissible risk-taking activity etc, to a macro approach that

⑧ Davis, K ***Last Days of the Credit Union?*** JASSA - September, 1995

imposes capital adequacy and liquidity standards and monitors compliance with same. The latter system of supervision also places great emphasis on financial institutions developing their own effective and responsible, internal risk management policies and procedures.

The change to a more liberal regulatory and supervisory focus has been applied only to Banks and not to Credit Unions and other mutual, Deposit-Taking Institutions. The Australian Financial Institutions Code, 1992 and its supporting *state-based* legislation, empower [and require] the regulators to focus both on both the micro and macro approaches mentioned above.

2.1 Regulation of Credit Unions

Regulation of Credit Unions has, since the implementation of the recommendations of the Brady Committee, been *ad hoc* and shoddy. Scores of flaws were detected in the drafting of the legislation (and regulations), within twelve months of the Code's passage through the Parliaments of the various States while the prudential standards were not premised on any rationale understanding or exploration of the nature of the institutions to which they were to pertain.

In introducing capital adequacy standards for Credit Unions The Australian Financial Institutions Commission [AFIC] developed a hybrid of the risk weighted capital adequacy requirements applied by the Reserve to the Banks it supervises without taking any account of the quintessential differences between a Credit Union and a Bank. AFIC's adaptation of these standards has produced some anomalies that have impacted quite harshly and unjustly on Credit Unions.

Some examples are: (i) 75% must be Tier 1 capital (capital requirement being 8% of risk weighted assets), while the requirement for Banks and Building Societies is 50% (tier 2 capital for banks can contain *upper tier* capital for an amount equal to 50% of Tier 1 capital); (ii) 60% of assets must be held in the form of loans to members; and (iii) Credit Unions are required to maintain 7% of their total liabilities as prime liquid assets and to maintain a further 6% of operational liquidity; and (iv) limitation on commercial lending to 10% of a Credit Union's loan portfolio.

Taylor and Stanford [9] have correctly pointed out that *in both formal and actual terms, the role of a depositor in a mutual society is quite different from that of a depositor in a proprietary company. In a mutual society [Credit Union] the depositor is a member of the society, has voting rights and is entitled to share in the profits of the society [through maximising returns on deposits and reducing interest on loans]; hence, the role of depositor and equity participant is blurred. A depositor in a proprietary company, such as one of the Big Four banks or Building Society listed on the Stock Exchange, has no right to participate in the profit of the company. A depositor in a mutual society bears, and should bear, a greater degree of risk than a depositor in a proprietary company. Hence, mutual societies should have a lesser, rather than greater, prudential standard than a proprietary company."*

Ken Davis, Department of Accounting and Finance, University of Melbourne [10], has rightly argued that:

- the concept of and rationale for capital adequacy requirements for Credit Unions has not been adequately justified by the Australian Supervisory Authorities;
- capital adequacy requirements arbitrarily limit Credit Union growth rates and focus management attention upon financial targets not necessarily consistent with Credit Unions' goals;
- the specific capital ratios chosen by AFIC are excessively high for Credit Unions specialising in retail financial activities; and
- the common bond membership and product specialisation of Credit Unions can lead to significant liquidity fluctuations which compound problems of meeting capital requirements.

There certainly seems to have been unintended consequences of the regulatory capital requirement provisions of this legislation that have dramatically and permanently changed the nature of the Non-Bank Financial

⑨ Taylor, P & Stanford J. *NBFI Non-bank or Non-anything?* JASSA June, 1994 [Pages 22-26]

⑩ Davis, K.T. ***Prudential Regulation and Australian Credit Unions***. Australian Journal of Management June, 1994 [Pages 31-46]

Institution [NBFI] sector. Many Building Societies, for example, have met the challenge of additional capital requirements by converting to Banks while others have abandoned their mutual status, introduced tradeable shares and, in some instances, converted to Companies.

In Credit Unions, capital adequacy provisions enforce an apparent policy decision that asset growth can only be permitted when there is an expansion in the Credit Union's capital reserves. In fact these requirements serve to limit the natural growth of Credit Unions. To achieve a surplus appropriate for healthy growth a Credit Union is under pressure to lend at high rates of interest and pay a lower than market rate on deposits, which is counter productive in terms of attracting new business. Banks, on the other hand, can resort to new equity investment to capitalise on any new growth opportunities.

Further, these capital adequacy requirements make liquid assets (not being in the form of a financial accommodation to members) very attractive to the Managers of Credit Unions.

We can see here that there is a constant pressure on Credit Unions to consider the potential of permanent capital. If appropriate measures are not taken and Credit Unions embrace this type of equity then, by erosion, they will go down the same route as most Building Societies have in the past i.e. a gradual transition from community owned and controlled *mutual* institutions, to a mixture of both and, then, emerge as shareholder owned corporations.

The statutory prohibition on Credit Unions issuing tradeable shares has provided only a temporary assurance of the continuance of their community ownership and control.

While the Prudential Standards being applied to individual Credit Unions are artificially restrictive the supervision and standards applied to the *central banking* and *services corporations* of the Credit Union sector are moving the other way.

AFIC is proposing alterations to the prudential standards for Special Service Providers (SSP's) which create a potential to weaken existing standards and create standards which are inadequate and fraught with danger for the whole system. AFIC proposes to remove the set capital adequacy requirement for SSP's and give itself the authority to set a base capital requirement on a case-by-case basis. This will, of course, empower AFIC to prop-up shaky SSP's or, if it is so inclined, dilute the competitive ability of an SSP by arbitrarily applying tougher standards than those applied to its competitor.

These actions could then be taken without any need to circularise or inform the sector or give the sector any opportunity to canvass or comment (as was the intention of the Parliament when the Code was enacted) on what would be, effectively, a new (and perhaps dangerous) prudential standard.

This is a demonstration of how an inexperienced and naive supervisory body can, albeit with the most honest intention, subvert the spirit of the legislation it is commissioned to administer. The historical *dust-bin* of failed financial institutions is full of corpses whose demise has been hastened by bureaucracies that thought they had a better understanding of the finance industry and the economy than either the Parliament or others involved in that industry.

This is happening at a time when the Council of Financial Supervisors is moving towards ensuring that the remainder of the finance sector's conglomerates and holding companies are properly and effectively supervised.

The AFIC bureaucracy lacks the experience, historical knowledge, regulatory-skill, public recognition and public confidence of its Reserve Bank counterpart. The current strength and stability of the Credit Union sector can be directly attributed to the self-discipline that has evolved within these organisations through a long apprenticeship in self-supervision.

While a return to those days may not be feasible, or desirable, there is certainly adequate evidence to support a recommendation that the current regulatory responsibilities of AFIC be passed to the Reserve Bank:
i.e. (i) establishing prudential standards for NBFIs and SSPs; (ii) working with State Supervisory Authorities (SSAs) and *accredited external auditors* to ensure those Standards are uniformly adhered to by NBFIs; and (iii) reviewing the pertinent legislation & regulations and making necessary recommendations for change to the governments of the States.

The supervisory role of AFIC in relation to SSPs could be quite adequately fulfilled by the Reserve Bank. The question of the optimum system for *supervision* of Credit Unions is dealt with in the next section.

Our organisation is of the view that Credit Union legislation should remain State based. Credit Unions are an important, emerging force in regional banking and State Governments are much better situated to respond quickly to changing circumstances in the regions. Unlike Banks a Credit Union's operational territory (or *common bond)* is, in most cases, fixed to a State based group or region.

Further, there should be considerable reluctance on the part of the Commonwealth Government to extend the implicit Government (banking) guarantee to the Credit Union sector and a reluctance to create any situation where there is a even a *suggestion* of possible moral recourse. Credit Unions do not need Government backing to gain public confidence.

There seems to be a general view that a recommendation for establishment of a **Super Regulator**, by the Inquiry, is a *fait accompli.* However, our Credit Union feels compelled to warn against the concentration of supervisory power into the hands of a single body. Competition among regulators (being separate regulatory cultures) is as essential as competition among institutions. This competition between regulators induces efficiency in operation and cost. It also stimulates innovation.

Deposit taking intermediaries are essentially different to other financial intermediaries. The blurring that has occurred in recent times with all types of products being offered by all types of institutions has, by stealth rather than design, diluted this essential difference. The establishment of a single regulator will only serve to re-enforce this blur without offering any advantage.

2.2 Supervision of Credit Unions

The current supervision system tends to be interventionist, in terms of the day-to-day activities of these institutions. This is a continuance of the historical role of the various states' Registrars in the supervision of NBFIs. It is common practice in Europe for Co-operative Banks and Credit Unions to have *external auditors*, **accredited by the Nation's Central Bank**, accept the primary supervisory role for those institutions.

In these models the *external auditor* is responsible for the *on-site* supervisory functions currently undertaken by Australian SSAs in respect of Credit Unions. The adoption of this system would prevent the current duplication [Credit Unions being subject to on-site audit by their external auditor and on-site audit by their SSA]. Such a change would save both money and physical resources and strengthen the current system by freeing-up the SSA to pursue a more pro-active role in monitoring Credit Unions and assisting in further development of the Sector.

The Auditor would, under such a system, provide on-going reports to both the SSA and the Reserve Bank. There could also be varying grades of the *FI auditing credential*, dependent on experience of individual auditors and the size and resources of auditing firms - the grade of credential authorising *external auditors* for a major Bank might well be different to that credential required to audit a Credit Union with assets, say, under $50 million.

The success of this system would be dependent on the Reserve Bank, as the issuer of these credentials, having absolute authority to withdraw the credential or refuse to renew same [they could made subject to renewal every, say, 3 years] where there is the least suspicion of any unsuitable practices. The fear of losing accreditation would be the very best discipline to ensure the professional integrity of *auditing* practitioners.

This model should also be considered for Banks. Many banking supervisors and commentators have, for some time, advocated a greater role for external auditors. It would seem that this system has overcome the perceived danger of *auditors* becoming captives of their client institutions by making the *supervisor* a dual client of the *auditor* (along with the Bank).

This mechanism should be coupled with the *market-friendly* supervision advocated by the Reserve Bank's Deputy Governor [11] which "*harnesses and builds on the disciplinary processes of the market instead of imposing separate, parallel sets of rules*" This suggested approach includes building up an internal-organisational culture of prudent risk-management which must be a *real* rather than an *illusionary* culture, if it is to work.

It is interesting to note, in this regard, that within the DG Banking co-operative network in Germany the member credit societies have developed a risk *Rating* for each member organisation which determines the rate at which liquid funds are made available to that Society, by the Group - this imposes both a discipline and an incentive to raise standards, as the member/owners of each Credit Co-operative monitor **their** Society's *Rating* very closely and call management to account at general meetings of the Society.

3. On the Future Direction of the Credit Union Sector - Ownership

There are very strong reasons why the Credit Union Sector in Australia should consider developing a second-tier Bank as has been the case with its kindred institutions in Europe.

Co-operative Credit Societies in almost every country in Western Europe and Asia have banded together to develop at least one second-tier Bank both as a liquidity combine and as body capable of undertaking those member service tasks which individual Societies, for reasons of comparative size or otherwise, are unable to undertake alone.

[11] Thompson G. J. ***The RBA Perspective - Self-Regulation*** - Address to the Australian Financial Markets Association - Self-Regulatory/compliance Seminar - 31 July, 1996 [Reserve Bank 1996].

These Banks include some of the biggest and most stable Banks in the world: Duetschgenosenshaftsbanken (DG), Germany (owned by 2,700 urban and rural Credit Co-operatives); Rabobank Nederland (owned by 595 Credit Co-operatives in the Netherlands); and Credit Agricole (2,920 primary

Credit Co-operatives, having 5.86 million individual members), are amongst the largest. Austria has two such *second-tier B*anks (owned by separate groups of Credit Co-operatives - one rural and one urban) as does Belgium. Finland, Denmark, Italy, Luxembourg, Spain & Portugal all have similar system networks. The *second-tier* Bank, Norinchunkin, owned by Japan's Credit Co-operatives is that Country's eighth largest Bank.

While the *primary* Credit Co-operatives are governed on the one-person one-vote system the *second-tier Banks* owned by those *primary societies* have voting and other rights attached to each share held.

In most cases, these *multi-tiered* Credit Co-operative networks, are presented on a consolidated basis with the National Central Bank supervising the *second tier* Bank and making it responsible for compliance by its member Credit Co-operatives.

When revised, the Bank ownership stipulations need to take account of this style of structure and governance, to give Credit Unions in this Country the flexibility to develop a multi-tiered banking structure, should the sector decide to do so at some point in the future.

Appendix II of this submission gives a brief overview of some important aspects of the European Co-operative Banking System and we have also attached a two volume report by a Credit Union study group that recently visited Europe for an on-site examination of a number of these national networks.

APPENDIX I

The Taxation of Credit Unions

The issue of taxation is the most pressing for the movement at this point in its development and unless a fresh approach is taken by Government to this problem then Credit Unions in this Country will alter both in character and in terms of their ability to grow and provide on-going competition in the market.

In character and form Credit Unions are uniquely different from all other financial institutions in this Country but the previous Government failed to recognise this difference and continued to treat Credit Unions as some form of hybrid corporation. In fact, the Credit Union form considerably predates the modern corporation form. Laws (including taxation laws), if they are to be equitable and promote economic growth, must adopt a different formula to take account of these differences, while achieving a common outcome.

The members (shareholders) of a Company increase their personal wealth by ensuring their corporate entity has **both** earnings on capital investment and capital growth. The assets of the company increase in value through its retaining all or part of those earnings and through any rise in the market value of the goodwill or physical assets of the company. This increase in asset value causes an increase in the "proprietorship" of the owners which is reflected in an increase in the value of their shares which can be sold for a cash profit on a stock exchange or otherwise.

In a Credit Union, members' personal wealth cannot increase through earnings on their capital investment (Credit Unions pay no dividends on shares) or any increase in the proprietorship of the individual members (members' shares are always worth only their par value and cannot be traded).

Strict prudential standards imposed on Credit Unions, by national legislation, require high levels of capital adequacy [8% of risk weighted assets of which 75% must be tier one capital]. Retained profits are the only real source of capital available to Credit Unions as permanent shares are neither permitted by current legislation nor possible if Credit Unions are to remain truly mutual societies.

Corporations, for which the 'entity based' taxation laws have been framed, are geared towards facilitating capital raising in the open market. Franking was a mechanism to ensure that the members of a company and the company itself were regarded as one and the same and thus distributed profits were taxed once. Thus, the taxation laws were amended in such a way as to make it easier for companies to attract capital.

The real capital in Credit Unions is retained earnings. The members forgo any entitlement to a share in the profits so that the Credit Union can grow its capital base and thus increase the number of members to whom the Credit Union is allowed, by law, to provide services. The Members have no entitlement to any share in the capital base of the Credit Union and cannot trade their shares for a premium.

Members do not own the capital in the proprietorship sense. If they leave the Credit Union they are refunded the par value of their shares. If ever the Credit Union were to be wound-up the full value of any taxation allowance that caused the capital to grow would be taxed again as income and the Australian community would not then have forgone any taxation revenue by having allowed the formulation of laws which apply a formula that takes account of the unique difference of these Credit associations.

It is significant that Section 23 of the Income Tax Assessment Act allows a tax exemption for Trusts that provide a benefit for “a large or significant” proportion of the community. We suggest that this is more relevant to the nature of a Credit Union than the corporations definition that has been applied ad hoc to those entities. A Credit Union has all the hallmarks of such a Trust.

It seems only just that the Parliament should recognise this unique difference in the nature of Credit Union Capital and create taxation laws that take this difference into account.

This inequity could be partially addressed by reducing each Credit Union entity’s taxation rate by a percentage equivalent to the value of the franking credit that would have attached to dividends had the Credit Union’s surplus been able to have been distributed.

This bench-mark is suggested simply because it seems to represent a figure that the Parliament has already recognised as justly applicable in recognition of the ‘oneness’ of a private sector company and its shareholders. It is an amount which differentiates between the *dividend* which is exempted from further tax and the *retained capital* which is taxed again when a shareholder in a company sells his or her shares at some premium that reflects the value of those retained earnings.

As previously stated, the only way a member of a Credit Union would ever be entitled to a share of earnings would be in the event of the Credit Union being wound-up, in which case **all** the cumulative, taxed, earnings of the Credit Union (*retained as capital*) would again be subject to taxation after distribution.

Allowing Credit Unions a deduction equivalent to the amount of the franking credit would simply be a *forward* recognition of that phenomena.

It would recognise that, at the end-of-the-day tax would be collected on all the accumulated income of the Credit Union. So, if part of the annual income was exempt from annual taxation, as proposed, tax would still be payable as part of the cumulative earnings **when those earnings were distributed [in the case of a wind-up]**. The remaining accumulated earnings, already taxed on an annual basis, would have a second tax applied when distributed. Then, the ratio of annual income taxed **once** to annual income taxed **twice** [first as annual income then again as income when the reserves were distributed], would be in much the same proportion as the ratio applied in company situations, as outlined above.

There are very good reasons why the growth of Credit Unions should be fostered by the Australian Community. Firstly they are owned by Australians - their very nature demands this. Secondly, the funds generated within a Credit Union are invested in Australia (not in off-shore activity which, among other things, allows general financial corporations to minimise tax) and, in the case of Community Credit Unions, in the Regions where those funds were generated - this is a paramount consideration in any strategy to develop regional Australia and prevent the drift of capital (and industrial & commercial investment made with this capital) to the metropolis areas. Thirdly, there is little competition in the field of retail banking and even though some limited competition exists in the housing mortgage market, there is no sign of any increased competition in the general banking field - bank branches are closing down and more and more remote services are being forced onto the general public.

Credit Unions are designed to serve their communities (to provide a benefit to a significant proportion of the community) and this is recognised in the AFIC Legislation which stipulates "C*redit Unions have an obligation to improve the economic and social well-being of all members, to extend this vision to individual members and the larger community in which they work and reside, to extend their service to all those who need and can use it and to take their decisions with full regard for the interest of the broader community within which a Credit Union and its members reside.[Australian Financial Institutions Code - Part III].*

It seems Credit Unions have obligations but no rights - an obligation to be different but no right to be treated in a way that recognises the inherent difference from a general money making private enterprise.

Appendix II

The European Co-operative Banking System

The Co-operative Banking Systems of Western Europe have three constituent elements: *Primary Credit Societies [Credit Unions]* being Co-operative Societies owned and democratically controlled by their members; *Secondary Banking Combines* owned and controlled by the Primary Societies; and *Utility Associations* also owned and controlled by the Primary Co-operative Societies.

(1) The Primary Credit Societies: Every *Primary Society* is recognised, registered and regulated by its National and/or State Government. In many cases the Society holds a Banking Licence and acts as a U*niversal Bank* for its members and some non-member clients. In other cases the Society is registered under special Co-operative Credit Laws and is titled a Credit Union, Co-operative Credit Society or, in a few cases, Building Society. These different labels affixed to the *primary* societies are simply an indication of their operational methodology and not a reflection of any difference in their fundamental nature

The *Primary* Societies are Co-operative Credit Societies whose governance and corporate ideology emanate from concepts developed by the German founders: Hermann Schulze-Delitzsch, William Haas and Friederich Raiffeisen. These principles were outlined in Raiffeisen's work *Credit Unions as a Remedy for the Poverty of Rural and Industrial Workers and Artisans.* Printed in eight languages this work spread the Credit Co-operative organisational model and its ideology of *prosperity through frugality, self-help, self responsibility, and self-administration* throughout Europe, Asia, Africa and the Americas. It is from the title of this work that the term *Credit Union* was taken. In every case the *Primary Society* is owned by its members who elect a Supervisory Board on the basis of each member having one vote irrespective of that individual's shareholding in the Society.

The Supervisory Board appoints, and oversees the activities of, a Board of Management. In each case the Co-operative Banks (*Primary* & *Secondary*) have two General Managers of equal rank and status. The dual CEO system is common in European Banking and seems designed so one can 'keep an eye' on the other.

The emphasis, in distributing any surplus income, is on rebating to members and clients on the basis of the volume of business done with the Society. Healthy dividends are paid on shares but they cannot be traded for profit.

Each society has a commitment to improving the social lot and economic prosperity of its members and places considerable emphasis on the provision, by the Society, of a high level of education and information pertinent to all matters which are considered relevant to the pursuit of the goals of the Co-operative.

The *primary societies* in each Country have developed secondary organisations which they own and govern and with which they work co-operatively to ensure they are able to provide *universal financial/banking services* to their members and non-member clients.

(2) The Secondary Banks:

The *Primary* Societies - Banks or Credit Unions - have worked in collaboration to establish *Secondary Banks* which are wholly owned by the *Primary* Societies to undertake those member-service tasks that for reasons of comparative size or otherwise, they are unable to undertake alone. These *Secondary Banks*, in most cases, also trade as U*niversal Banks* and service clients other than their member/owner *Primary* Societies. In Germany, for example, the third tier *Secondary Bank* has been ceded, by the *Primary* Societies, exclusivity in marketing financial services to the Nation's top 500 Corporations. Each *Primary* and *Secondary* Banking Institution has a clearly defined market and geographic area of operations to which it limits itself, by agreement.

The *Secondary Banks* are in some instances *Regional Banks* (Second Tier Banks) and in other cases a *National Bank* (as either a Second Tier or Third Tier Bank). Again using the German example we see, there, three *Regional Banks* wholly owned by the *Primary* Societies. These *Regional Banks* own a *National Bank* (DG Bank) and this *National* Bank also acts as a Regional Bank in those areas not serviced by its' three owner-banks. So, in this case the *Primary Societies* ownership of the *National Co-operative Bank* is indirect - through their ownership of the *Regional Banks.*

In The Netherlands, on the other hand, there are no *Regional Banks* forming part of the Co-operative Banking Network and the *National Bank* (Rabobank) is a Second Tier Bank directly owned by the *Primary* Societies.

Most National Co-operative Banking Networks in *continental* Europe follow one or other of these two *Secondary Banking* models.

So the *Secondary Banks* have three distinct functions: on the instructions of a *Primary Society,* to perform such tasks or provide clients services that are too big or too complex for that *Primary* Society [e.g. Banking Services to substantial business clients, International Banking services etc]; at the request of a *Primary Society,* the syndication of any *Primary Society* client loans (too big for it to handle singularly) among a number of willing primary societies; and act as a *Universal Bank* to the Nation's largest Corporations and other clients not catered for by the *Primary Societies.*

Every *Secondary Bank* studied has developed a sophisticated and successful network of ***subsidiary bodies*** to deliver specific services to their members or to maximise the return potential on their members funds - Insurance Companies, Mortgage Brokerage Firms, Funds Management Subsidiaries, Merchant Banking bodies are but a few.

These Co-operative Networks of *Primary* and *Secondary* Banks are among the largest and most successful banking institutions in the world. The German Network DG Bank (Duetschgenosenshaftsbanken) is, on a consolidated basis, the world's largest bank.

(3) Utility Associations:

There are three major types of utility *Association* owned and controlled by the Co-operative Banking Networks: *National* Representative *Associations; International Associations;* and *International Banking Support Associations.*

Every national co-operative banking network has its own *National* representative *Association* that provides it with: representation to Government; management of Bank Deposit Guarantee Funds for the benefit of the members and clients of the *Primary Societies;* and the independent management of some statutory instruments for self-regulation - e.g. Auditing Federations.

In terms of Government representation these *National Associations* have been very successful in acting as a conduit between government and the *Co-operative Banking Network.* Governments in all these European Countries are very conscious of the economic and social importance of the *Co-operative Banking Networks.* Governments consult with the Associations in all matters affecting banking and monetary policy. Each nations' Central Bank places great store in the collaborative approach of the Co-operative Banking Associations in working with Government, on a partnership basis, for the national good.

It is patently clear that Government in those countries see many advantages in having a co-operative financial network that can be supervised through a central institution. *The principal institution through which Government supervises the Primary Societies is the Secondary Bank.* Thus, the Associations are also useful to Government as a central point of reference in their dealings with the *Network.*

National Associations, in many cases, manage National Deposit Protection Schemes. The most common form is a pool of funds accumulated by small annual levies on the *Primary* Societies. The Fund then offers to members and clients of the *Primary Societies* an insurance against loss for a fixed amount - usually the equivalent of about $A30,000.

The most common Statutory *Self Regulatory* function carried out by the Associations is the Audit facility. In many European Countries the law requires each Co-operative Financial Institution to be audited by its Association's Banking Audit Department. The *Primary* Society, in some cases, has a choice of Associations but cannot evade the requirement to be audited in this way.

Many of the *National Associations* also provide Management recruitment facilities and conduct Management and Employee Training Institutes from which the *Primary* Societies recruit their staff.

The various European Co-operative Banking Networks own and control a representative Association that guards their interests at the European Parliament and the European Community Bureaucracies in Brussels. This organisation is called the *Groupement des Banques Cooperative de la CE* (The Association of Cooperative Banks of the European Community). It is purely a lobby group for the Co-operative Banks to ensure their interests are protected in the forging of the European Union. It has been very successful in its work on behalf of the various Co-operative Banking

Networks. Issues like the Standard Currency (ECU), cross-border banking etc. are all subjects relevant to this organisation.

Many of the Co-operative Banking Networks are also represented in other International Associations - The International Raiffeisen Union, The International Co-operative Alliance and smaller bodies.

Additionally, UNICO, is an *international banking support body*, to which many of these Banking Networks subscribe. It is owned by the Networks and provides training in international and co-operative banking techniques and strategies and provides international banking intermediary services for its member/owner Co-operative Banks.

BANANACOAST COMMUNITY CREDIT UNION LTD

Submission to
the
Wallis Inquiry

Why an Individual Submission from Bananacoast Community Credit Union?

Bananacoast Community Credit Union is a regionally based, purely mutual, Community Credit Union governed by its 41,000 members through a democratically elected Board. The membership demands that the Credit Union be conducted for the Community's benefit and charges management to do all in its power to ensure a legislative and regulatory environment that recognises and enforces the right of Communities to operate their own autonomous, mutual Credit Co-operative. It insists that the wealth in those Credit Co-operatives, accumulated by previous generations, is to be preserved to work for the benefit of future generations.

A Credit Union *is not* the property of its Association, its Managers, its Board and most certainly not to its regulators, supervisors or the Government of the day. The physical assets, reserves and *good-will* in Credit Unions have been built-up by a generation of members who either represent only a small proportion of the current membership or who are no longer present in the membership at all. The current generation of members has been entrusted with considerable wealth and a valuable business infrastructure to use for their individual benefit during their membership and then to pass those assets in trust for successive generations of Australians living in the community or working among the group that the Credit Union was designed to serve. Each generation is answerable to posterity not only for what it has done but for what it could have done but did not do.

The membership of this Credit Union believes that the issues under consideration by the Wallis Inquiry are far too crucial to the survival of the Credit Union Movement to be entrusted solely to an industry Association. Associations often gain a life of their own and can develop egocentric commercial goals that are at odds with the medium and long-term social objectives of their members and/or their members' constituencies.

This problem is exacerbated by the fact that Credit Union management (drawn mostly from the private sector), see their prime responsibility as being the commercial success of their organisation and tend to look at issues from a raw commercial perspective while not always taking proper account of the socio-economic ethos of their organisation. Consequently, Associations often reflect views which are an amalgam of the views of their own management and those of Credit Union Managers rather than the rank and file members of Credit Unions.

The presence and activity of our Credit Union within the community puts it in an ideal position to collect individual members views and present them to the Inquiry so as to give it a unique opportunity to hear the voice of the community on these vital issues.

The issues at stake are not only industry, commercial issues but community issues. The outcomes of the Inquiry will have a long term effect on the lives of all Australians. If, because of regulatory structures, mutual Financial Societies [Credit Unions], which are the strongest mutuals left in the Country, are forced to mutate into a separate structural form, in order to survive the new regulatory *order*, then it will be a clear signal to all Australians of a covert prohibition on *mutuality* as a form of organising their own affairs.