Submission to Productivity Commission

Review of Regulatory Burdens – *Business and Consumer Services*

31 March 2010

Association of Building Societies and Credit Unions

Abacus
Australian Mutuals

INTRODUCTION

Abacus – Australian Mutuals is the industry body for customer-owned financial institutions, representing 105 credit unions, 9 mutual building societies and 25 friendly societies.

Our member institutions serve 6 million Australians, hold total assets of $70 billion, and vary widely by asset size and customer base.

Credit unions and mutual building societies are Authorised Deposit-taking Institutions (ADIs) regulated by APRA under the *Banking Act 1959* and provide a full range of consumer banking services. Friendly societies provide investment and insurance services to members to assist in planning for life events. Most societies are registered under the *Life Insurance Act 1995* and regulated by APRA.

Abacus members are also:

- Australian Financial Services Licensees regulated by ASIC under the *Corporations Act 2001*;
- prospective Australian Credit Licensees under the National Consumer Credit Protection legislation; and
- reporting entities regulated by AUSTRAC under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006.*

Abacus member ADIs subscribe to the *Electronic Funds Transfer Code of Conduct* and the *Mutual Banking Code of Practice*.

Abacus member institutions provide significant competition and choice in their markets. Credit unions and building societies collectively hold an 11.4 per cent share of the household deposits market, an 8.6 per cent share of new home loan market, and have more branches than the Commonwealth Bank. Credit unions and building societies consistently record market-leading customer satisfaction ratings.

The regulatory compliance burden is a significant issue for Abacus members. The relentlessly increasing complexity of the regulatory environment is a major challenge for smaller players in the financial services market. The high fixed costs of regulatory compliance impose a disproportionately heavy burden on smaller players.

The cost of regulation increases prices for consumers and has a chilling effect on competition and choice. The steady, long-term trend of consolidation in the credit union sector (see graphic, p10) is partly explained by the increasingly heavy regulatory compliance burden. While the sector's asset base continues to grow, diversity is diminishing.

The activity of banking, i.e. taking deposits to fund loans which are kept on the balance sheet, is subject to three separate regulatory regimes: APRA's prudential regulation framework; ASIC's AFSL regime; and, the new national consumer credit regime.

Credit unions and building societies have a long and consistent track record of responsible lending and excellent customer service. The additional regulatory burden imposed by financial services licensing and credit licensing has not advanced the interests of credit union and building society customers.

Reducing the regulatory compliance burden will enhance the capacity of mutual banking institutions to apply competitive pressure in a banking market:

- that is "now, by some criteria, the most concentrated it has been for a century";[1]
- where competitors have exited and "generally when you've got less competition you'll have higher prices being charged";[2] and
- where barriers to entry are high.[3]

[1] Senate Economics References Committee, Report on Bank Mergers, September 2009

[2] ACCC chairman Graeme Samuel interview, ABC TV *Inside Business* 6 December 2009

[3] Public competition assessment, 'Westpac Banking Corporation – proposed acquisition of St George Bank Limited', ACCC 13 August 2008

This submission is divided into sections covering the three main regulators (APRA, ASIC and AUSTRAC), a section on other regulatory issues and a final section with feedback and general observations from Abacus members about regulation and regulators.

PRUDENTIAL REGULATION

'Bank' and 'banking': Replace ADI with a more meaningful term

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

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. The $50 million hurdle has been in place since 1992 and was originally designed as a "means of discouraging unsuitable shareholders from attempting to gain a banking authority."[4]

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. 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 global best practice prudential regulatory 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".

[4] RBA submission to Financial System (Wallis) Inquiry, 1996

Abacus recommends that the term "Authorised Deposit-taking Institution" should be replaced in the Banking Act with "Authorised Banking Institution".

'Bank' and 'banking': use of the term bank

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."[5]

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 ADI's use of the word "banking" in its marketing material and that the ADI could be in breach of section 66. The regulatory environment should not contribute to uncertainty for businesses and consumers.

Regulations that prevent institutions that are authorised to engage in "banking" from marketing themselves in that light are unnecessarily burdensome, complex and redundant.

Abacus recommends that APRA should remove the $50 million hurdle to give all ADIs the non-compulsory option of marketing themselves as "banks". This would enable Abacus members to exercise the choice of calling themselves "mutual banks".

These changes will improve APRA's capacity "to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality".[6]

APRA stakeholder survey

[5] Guidelines – Implementation of Section 66 of the Banking Act 1959. APRA January 2006.

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

APRA's 2009 stakeholder survey[7] indicated some areas for improvement in the regulatory framework and the regulator's approach.

"Areas scoring lowest and which may benefit from attention are consideration of the cost of regulation, harmonisation across regulatory authorities and across standards, as well as APRA's statistical collection process, particularly the system used to collect data – D2A," the survey report says.

"Smaller entities and those in specialised niches find that a single framework is difficult to work with," the report says. "For them, the cost of regulation and allocation of compliance resources is a considerable burden with little perceived value."

Abacus notes that the lowest scoring item in the survey was the proposition that: *"Changes to the framework consider the costs of regulation imposed on industry."* More than a third of respondents (34.2 per cent) disagreed with this statement and, of these, 7.9 per cent "strongly" disagreed.

Abacus recommends that APRA should give a strong and clear commitment to addressing these "areas for improvement."

Abacus member feedback:

"APRA require access to your external auditors/actuaries and they can and are allowed to make requests of them and we are left to foot the bill. Whilst I do not have a problem with APRA wanting to verify matters with such parties, I have a fundamental problem with (A) a lack of courtesy as they don't inform you that the request has been made until your external third party advises you, and (B) the shotgun approach they adopt. Their letters are couched in very general terms and hence can result in a scope that is unnecessarily wider than required."

FINANCIAL SERVICES & CREDIT

All Abacus members are Australian Financial Services Licensees and all Abacus ADI members will be Australian Credit Licensees.

The AFSL regime continues to be a costly drag on Abacus members (for example, see Abacus member feedback below on applying for an AFSL amendment) who are now preparing for the new credit licensing regime.

"Working your way through the maze of credit reform laws can be difficult and frustrating," says a national legal firm promoting its new Credit Reform Compliance Management Register. "We have managed to simplify over 1000 pages of legislation into a 128 page comprehensive register."

There has been some "streamlining" in the credit licensing process for ADIs but the extent and value of the streamlining, while appreciated by Abacus and its members, is indicated by the somewhat tokenistic 10 per cent discount on the application fee.

Once the credit licensing has commenced, licensees will be subject to the same regulatory culture that has mishandled the AFSL regime. Licensing obligations include 'fit and proper' requirements, compliance arrangements, and training and competency. These are all replicated in the prudential and AFSL regimes.

ASIC does have the opportunity to mitigate some of the negative effects of the FSR regime by adopting the approach it has taken for credit licensee training to training for AFSL Tier 2 financial products.

ASIC's prescriptive AFSL training policy, Regulatory Guide 146, has already been amended at least twice to take a more realistic approach to basic deposit products. ASIC should go further and remove the prescription for all simple products – deposits (including FHSA deposit accounts), non-cash payment products, general insurance, and consumer credit insurance – in line with the approach taken in *Regulatory Guide 206: Credit licensing: Competence and training.*

[7] APRA stakeholder survey 2009 – Report of overall findings September 2009

Regulatory Guide 206 says: "Generally, we think that you should determine for yourself what is appropriate initial and ongoing training for your representatives, and embed this in your recruitment and training systems. The diversity of roles in the credit industry requires a flexible approach to representative training. Therefore, we have not set specific educational prerequisites or ongoing training requirements for credit representatives. We expect you to ensure that your representatives are suitably qualified to perform the role that they are employed to perform."

The 2006 final report[8] of the Australian Government's Regulation Taskforce looked at the FSR regime and recommended "amending the training required for staff involved in the sale of different financial services products to improve consistency and achieve a closer alignment between the inherent risks of a product and training obligations."

The Finance Industry Council of Australia wrote to the then Assistant Treasurer and to Treasury in December 2007 seeking changes to the treatment of simple products.

"We believe the law currently imposes unnecessarily stringent compliance obligations on simple products," the letter said. "It is our view that standardisation of compliance obligations across simple products should be undertaken, including consideration of the disclosure obligations, training requirements and general advice warning applicable to simple products. This approach would reduce unnecessary compliance costs for industry, remove unnecessary complexity within the regulatory framework applicable to simple products and improve interactions between financial service providers and their clients."

Abacus recommends that Treasury and ASIC should give priority to reducing unnecessary regulation of simple products.

<u>Abacus member feedback:</u>

AFSL issues

"We are in the process of preparing an application to amend our AFSL to include superannuation as a product. According to external legal advice, ASIC requires that when we apply to amend to include one additional product we effectively have to apply for our existing products as well and subsequently provide all the required proofs. For example, in the business description proof we have to answer 12 questions on each and every product that we offer. One of the questions is how much revenue we expect to generate from these products. In respect of insurance, non-cash payments and some other products where profits/revenue can be quantified we can provide the information. But it is a particularly daft question to ask in respect of deposits unless you count the profit we make from utilising depositor funds for the lending side of our business. In all, all the products we have on our AFSL does not even equate to 9 per cent of total revenue. Requesting information from ASIC is also legalistic in that, if we want to access a copy of our 2003/4 licence application, we have to do a Privacy Act application. Resource-wise, we have three people working on it as well as utilising people from various departments who may have knowledge we require to populate the forms. All three people are in the top 8 per cent pay bracket in the company and it is chewing up a significant amount of time. Apart from that we have briefed [a legal firm] to provide us with advice on some aspects of the AFSL variation and they will be reviewing our application before it is submitted to ASIC. As you can imagine, that will be a great cost as well."

"FSR is the classic example of complex and burdensome legislation that I believe hasn't hit its mark in terms of consumer advice and awareness and understanding. Particularly as it relates to basic deposit products, it added a huge cost to our operations – forms, brochures, training, compliance programs, board reporting, audits etc. It is over prescriptive and still consumes a lot of our time particularly around breach reporting."

Credit issues

"An issue that might be small in the overall scheme of things, but nonetheless demonstrates the lack of regard for our circumstances and

[8] *Rethinking Regulation* Regulation Taskforce 7 April 2006

cumulative impact of the myriad of government regulation is that under the regime we will be required to lodge a compliance return. Rather than one arm of ASIC getting into 'lock-step' with another they are going to have the annual credit compliance return due on the anniversary of the issuance of the licence. Now that can be any date between 1 July 2010 and 31 December 2010 – so rather than lengthening or shortening the reporting period for the first year of the licence to being the reporting date in line with our current obligations under the Corps Act they introduce another reporting date."

AML/CTF & AUSTRAC

The AML/CTF regime is intended to have a "risk-based" approach but there is a considerable element of prescription that gives rise to unintended consequences.

For example, AUSTRAC recently advised stakeholders about an issue with the record-keeping obligations. Under the Act, if a record of information is made by a reporting entity relating to the provision of a designated service, that record must be retained for a period of seven years – unless the record is exempted under AML/CTF Rules.

AUSTRAC considers that CCTV footage is a 'record of information' for the purposes of the Act and therefore must be kept under the record-keeping requirements of the Act.

"However, AUSTRAC recognises that such an obligation may impose an unnecessary financial and administrative burden on industry, and it is therefore proposed to exempt such records from the AML/CTF Act, except where that record relates to a suspicious matter report submitted to AUSTRAC," AUSTRAC says.

The exemption, as far as it goes, is welcome, but this example illustrates the scope of AML/CTF regime.

Abacus supports the recommendation made by the Australian Bankers' Association for the insertion of a provision into the AML/CTF Act to require that its obligations, and those imposed by the AML/CTF Rules, are subject to an over-arching risk-based approach.

AUSTRAC's survey[9] of AML/CTF compliance officers found the two most significant issues faced by compliance officers are:

- staff training; and
- difficulty in maintaining their own knowledge about AML/CTF and keeping up to date with legislative change.

"AUSTRAC is looking into these matters, particularly in relation to small reporting entities," the survey report says.

However, at the same time AUSTRAC is concerned that AML/CTF compliance officers are not spending enough time on AML/CTF matters. "AUSTRAC urges entities to review the amount of time they spend on AML/CTF matters, especially as entities implement policies and procedures for ongoing customer due diligence and reporting under the AML/CTF Act," the survey report says.

Abacus members continue to complain that while they are required to vigilantly carry out their AML/CTF obligations to verify customer identity and carry out ongoing customer due diligence they are not provided with the means to do so.

Reporting entities would be in a much stronger position to effectively meet their AML/CTF obligations to verify identity if they had access to the National Document Verification Service to verify documents provided by customers. Such access would be on the basis of a 'match/no match' response via a secure, on-line system. Government-issued documents used to verify identity include passport, driver's licence, birth certificate and citizenship certificate.

Abacus recommends that the Government should ease the AML/CTF regulatory compliance burden by giving reporting entities access to the National Document Verification Service.

[9] AML/CTF Compliance officers in Australia, AUSTRAC survey series – no.1, March 2010

The Government could also assist reporting entities to meet their regulatory obligations by centralising relevant information on the AUSTRAC website, such as information on the RBA website about sanctions against various individuals and countries and information on the DFAT website about proscribed persons and entities.

Abacus member feedback:

"A draft ruling that comes into force with the AML/CTF Rules on January 2011 will require us to collect and verify information relating to the identity of third parties undertaking all threshold transactions. One has to ask why? What purpose can this serve for the thousands of threshold transaction reports lodged annually? I could understand the request if the transaction was subject to a suspicion or other concern but not the general body of legitimate transactions reported. This impost will cause us considerable cost in compliance as we will need to modify our retail banking system, our staff will have an additional burden in collection, there will likely be adverse reaction from the third party, we do not yet know how to handle a situation where the information request is refused and we will need to modify our process to include this information in our threshold reports."

"While we support all attempts by Government to streamline and automate our interactions with the regulators, it is incumbent upon Government to ensure that their systems and processes are user friendly and that time is not wasted. I recently completed a Suspicious Matter Report in relation to an AML/CTF issue with AUSTRAC. I did so on-line which assists AUSTRAC to integrate the information into its systems. However, because of the unstable nature of the on-line form it took me more than 1 hour to complete the process. I could have completed the paper-based form in 5-10 minutes."

"For all our efforts on AML/CTF, effectively being the Government's watchdogs, the problem lies in the fact that we provide all the information to AUSTRAC but we get no feedback back – i.e. did we alert them to a terrorist or fraudster?"

"The legislation is becoming more and more prescriptive over time. While all the original intent was to be less prescriptive and rely on risk assessments of reporting entities, recent new and draft rule changes are moving these goalposts. This increased prescription make it all the more difficult to understand and comply with the added complexity."

OTHER REGULATORY ISSUES

GST distortion

A measure introduced to counter the anti-competitive impact of the GST in the financial services industry is becoming redundant and urgently needs updating.

GST reduced input tax credits (RITCs) were introduced to address the bias creating by GST input taxing to in-source certain acquired inputs. This bias favours large financial institutions with the capacity to in-source. Smaller financial institutions such as credit unions and building societies do not have this capacity.

Abacus lodged a proposal with Treasury in July 2009 to amend the existing RITC item 16 "Credit union services" so that the item covers mutual building societies as well as credit unions. Abacus is owned by credit unions and mutual building societies and provides a wide range of services to its members. These include public affairs representation, government and regulator relations, media representation, regulatory compliance advice and support, research and market intelligence, and support to fight fraud and financial crime.

A large bank can self-supply these services and reduce its GST burden and therefore can gain a competitive advantage on smaller competitors whose business models and industry structures have always involved significant outsourcing. These business models and industry structures existed before the introduction of the GST and continue to develop and evolve today.

Credit unions and building societies also obtain commercial services, such as treasury management and payments system access, from a

range of industry-owned service providers. Again, a large bank can self-supply these services and reduce its GST burden.

RITC item 16 "Credit union services" currently only applies to supplies to credit unions provided by an entity wholly owned by two or more credit unions. Since the RITC framework was legislated the consumer banking market has undergone significant change, including continuing consolidation among mutual ADIs and the rationalisation of industry support bodies. These changes include the prospect of mergers between credit unions and mutual building societies.

What has not changed is the self-supply bias of GST input taxing.

The policy intent of RITC item 16 is not being fulfilled due to the narrow definition of the item and the evolution of the mutual ADI sector. Services provided by Abacus to mutual ADIs that assist mutual ADIs to compete with major banks carry the full GST burden whereas the same services provided in-house by a major bank do not bear this burden. This further tilts the playing field in favour of big banks.

Amendments are needed to preserve the original policy rationale for RITC item 16 and to reflect changes in the mutual ADI sector.

Abacus recommends that RITC item 16 should be amended to cover supplies to a credit union or mutual building society by an entity majority owned by two or more credit unions or mutual building societies.

First Home Saver Accounts

Abacus seeks an amendment to a rule affecting First Home Saver Accounts that is unnecessarily limiting the commercial potential and consumer benefit of this savings product.

According to APRA, in December 2009 only 18 ADIs and one RSE were offering FHSAs, including 13 mutual ADIs. Only two of the four major banks are offering the product, and no friendly societies – institutions who would ordinarily welcome the opportunity to offer a medium-term savings product such as this – are offering this product.

The Government estimated in early 2008 that FHSAs would hold around $4 billion in savings after four years. The amount in FHSAs as at September 2009, $43.9 million, is just over one per cent of this anticipated amount.

The most consistent issue that appears in feedback to Abacus from credit unions and building societies about FHSAs is that the four-year 'lock-up' requirement is too long and is the single most important disincentive for savers.

Abacus recommends that the Government should remove or reduce the period of time during which savings in FHSAs can't be withdrawn. The Government contribution is incentive enough to ensure that savers contribute over a number of years. A minimum period is an unnecessary disincentive and penalises savers who have the opportunity to buy a house within the 'lock-up' period.

State and Territory legislation

NSW Funeral Funds Act

Friendly societies seek amendments to the NSW Funeral Funds Act to remove regulatory duplication for those friendly societies operating in NSW that offer funeral insurance and funeral bonds.

These APRA-regulated friendly societies must also answer to the NSW Office of Fair Trading, with overlapping and sometimes conflicting reporting and other regulatory obligations.

Key stakeholders agree that the matter needs to be dealt with but we are concerned at the lack of progress despite meetings and correspondence since November 2007.

OH&S legislation

Abacus members are concerned about inconsistent laws on occupational health and safety.

"OH&S legislation differs in every State and Territory making it a nightmare for a national entity to ensure that it complies in each jurisdiction," says an Abacus member ADI. "Yes there are moves afoot to produce national OH&S legislation but progress to date has been far from encouraging and there are likely to remain certain aspects outside the national accepted regime."

Abacus recommends a higher priority for national OH&S reform.

GENERAL OBSERVATIONS ON REGULATORY ENVIRONMENT AND REGULATOR CULTURE

Abacus member feedback:

"Regulators are 'objective blinkered'. That is, they have a singular focus on their own patch and do not need to understand the full range of objectives and obligations that ADIs must manage. This can lead to conflicting obligations and counter-productive action. Keeping up to date with changing regulatory obligations is a massive burden for small ADIs (i.e. all credit unions and building societies) that lack the scale to employ specialist resources. Credit unions and building societies employ dedicated generalists who do their best to stay across the full and exploding range of obligations."

"On approval processes and timely decision-making, our experience is that APRA is generally OK but ASIC and AUSTRAC are bureaucratic organisations with no interest in the operational imperatives of their 'clients'. Re unnecessary heavy-handedness, again APRA is generally OK but ASIC and AUSTRAC can be heavy handed as they appear to simply 'apply the rules' without any regard to how ridiculous the consequence may be."

"The term 'scalability' seems to be a new creation which is intended to mean that while it is acknowledged that there might a regulatory burden that it only falls on those who, firstly, deserve it, and, secondly, at a level that is commensurate with the regulated entity's capacity to both understand it and absorb the costs. Both propositions miss the underlying point, and that is as a regulated entity you can only determine whether, and on what basis, you can 'scalably' apply the regulatory obligations after you have first determined whether they apply to you in the first place - a monumental task in and of itself – and secondly generally the legislation does not apply on an exceptions basis but rather requires a 'one size fits all' approach which results in obligations being applied to all circumstances. And even if you have determined that the full force of the regulated obligation does not apply to the particular circumstance you will probably still need to document the reasons why – which is probably more onerous a process than simply applying the regulatory obligation in the first place."

"While regulators generally do provide some interpretative information on the legislation they administer, our experience indicates that it is largely impossible to obtain more detailed advice from them when requested and the general response is 'we do not provide legal advice'. It is my view that the regulator should be mandated to provide whatever reasonable clarification is requested by those subject to the legislation and that mandate should be included in the legislation itself."

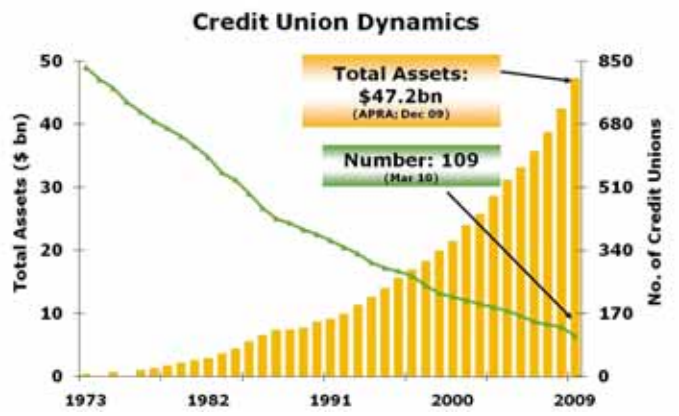
"Our experience in dealing with the various regulators has been reasonably good. We have had in recent years a range of inspections including APRA, AUSTRAC, ATO and ASIC. The regulators have been reasonable and somewhat pragmatic in their approach to issues raised to date but it would be fair to say that the regulators call the shots with little opportunity for a regulated entity to disagree."

"The fact is that regulators do not consider size in terms of compliance, processes and procedures. They have the same requirements of an organisation regardless of size – hence an organisation which has 100 people is required to maintain the same requirements as that of a company with 1000 employees. As an example, APRA now requires all Life Companies (including friendly societies) to have a Remuneration Policy and Board Remuneration Committee (minimum of 3 independent board members). As an organisation with 6 directors, and other Board committees, this is a stretch for us. However, APRA is not prepared to provide a general waiver based on size or any other criteria unless we write in and they will then consider exemption from such a committee although that role must still be performed by an approved body."

"There has to be recognition that small is not necessarily bad but the overwhelming feeling you get when you deal with regulators is that small

means more vulnerable and therefore greater risk and potentially more problems. So the solution for them is to give us a hard time and make more requests. The end result is that the cost of the provision of these requests, the amount of time that valuable resources are required to spend to satisfy the regulator is disproportionate to the time one should be devoting to the actual business."

"The ever changing pace of compliance and regulation – proposed changes to the prudential standards again (there have been changes every few months) and it is hard work keeping on top of them when you have limited resources."



Abacus members also made the following suggestions to improve the regulatory approach:

- focus more on actual consumer behaviour - 'Will consumers read this disclosure document? Will they understand it?';
- focus on the regulatory objective, rather than box-ticking;
- allow governance credits where an entity is well run, with an emphasis on flexibility over prescription; and
- understand the regulated businesses and the impact of regulatory requirements.

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