JIM MURPHY

EXECUTIVE DIRECTOR, MARKETS GROUP,

AUSTRALIAN TREASURY

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Good afternoon.

It is a pleasure to be able to join you today to discuss the role that credit unions and building societies play in Australia's banking sector. I'd like to thank Abacus for the opportunity to speak with you.

About 4.5 million Australians choose to do their banking with a credit union or building society. I count myself among your satisfied customers, having been a credit union member for over 20 years. I greatly value the service and competitive rates I receive from my credit union.

As a central policy agency, Treasury needs to ensure that the long-term challenges facing Australia are not sidelined by more immediate and urgent issues.

And Australia is facing some significant challenges.

The Government's third Intergenerational Report highlighted some of the challenges in relation to demographic change and an ageing population... economic infrastructure... and climate change.

To help us meet these challenges, we need a safe and efficient financial system. A safe and efficient financial system is also important from a wellbeing perspective, given the role the financial sector plays in people's lives.

For Australia's financial system to be both efficient and safe, it is important that we have competition between providers of financial services, backed up by a sound prudential regulation framework.

So I will start by looking at the important role mutuals play in the Australian financial sector. However, given Abacus's theme of *New Decade, New Directions*, I would also like to explore your vision of future directions for the sector, and will come back to this subject.

Importance of credit unions and building societies to the banking sector and the Australian community

Credit unions and building societies generally conduct what is sometimes referred to as "basic banking" — in other words, accepting deposits and providing relatively low-risk loans. This model has a long history and has certainly stood the test of time.

In fact, I understand that building societies first appeared in Australia in the 1850s. Credit unions are a more recent innovation, with the first credit unions being established in Australia shortly after the Second World War. The basic banking model has been tested many times, most recently by the global financial crisis.

Australia currently has just over 100 credit unions and nine mutual building societies. These institutions collectively hold over $73 billion in assets, and 11.5 per cent of household deposits.

An important feature of mutual banking institutions is that about half of them are based outside capital cities. This shows the important role your sector plays in meeting the banking needs of rural and regional Australia.

It's also noteworthy that your sector consistently outperforms the banks when it comes to customer satisfaction.

These statistics give an indication of the diversity of your sector, the significant range of banking options you offer, and the high quality of your services. It helps to explain why so many millions of Australians rely on credit unions and building societies to meet their banking needs. But it also points to the competitive potential of your business model.

The credit union and building society sector remains well-capitalised, with aggregate total capital ratios of around 16 per cent. These capital ratios have actually improved over the last decade-and-a-half.

Mutual lenders comply with the same prudential requirements as the major banks, and are regulated by APRA and ASIC in a virtually identical manner to the banks. As I'm sure you are aware, solid prudential regulation has been one of the cornerstones of Australia's strong response to the global downturn.

In talking about the importance of your sector, I would also like to mention that Wayne Swan recently appointed Australian Central Credit Union CEO, Peter Evers, to the Government's Financial Sector Advisory Council. The Council represents a key source of financial sector advice to the Government, and the appointment of Mr Evers reflects the importance the Treasurer places on your sector.

Impact of the Global Financial Crisis

Like the rest of Australia's banking sector, credit unions and building societies stood up well to the rigours of the global financial crisis. They remained profitable through the turbulence, and no Australian credit union or building society failed as a result of it. That testifies to the strength, not only of APRA's prudential regime, but perhaps more importantly, your business model. A business model that, as I have already noted, is embraced by over four million Australians.

Compare that situation with Europe. Although European mutuals largely escaped the problems that hit many large European banks, some building societies that diversified into riskier lending practices collapsed or came close to the brink. Mutuals in France and Germany lost billions on risky loans and investments.

But, as you would all be aware, the global financial crisis did trigger some changes in the structure of Australia's banking sector.

The closure of securitisation markets during the crisis had a major impact on a range of lending institutions. Some were forced to reduce their lending operations. Some were acquired by the major banks. And some were forced to scale back their activities in the sector.

The crisis also focused international attention on prudential regulation. Reforming international financial regulations has become a high priority for the G20. New rules are currently being developed to create a more robustly regulated global financial system. This process will take some time to play out and changes will be implemented gradually. But they will enhance the resilience of the banking sector — and in doing so, strengthen confidence in it.

The changes to Australia's banking sector wrought by the crisis also contributed to raising community concerns about a perceived lack of banking competition.

But the changes have also led to a greater appreciation of the important role that credit unions and building societies play in bolstering competition. With their low fees and friendly service, mutuals provide a strong alternative to the banks — one that is widely valued in the community. Your organisations provide diversity within the banking sector, giving customers the opportunity to choose to do their banking with an organisation other than a bank.

With this in mind, I would like to suggest that recent changes in Australia's banking sector have created an opportunity for you. An opportunity to raise your profile, as you are currently doing through your media campaign, and to grow your share of the lending market.

Government initiatives to support mutuals

As I have already outlined, the Government is very conscious of the role that mutuals play in meeting the banking needs of millions of Australians and in bolstering banking competition.

The Government guarantee of retail deposits served to enhance confidence in authorised deposit-taking institutions and uphold the stability of the Australian financial system.

The Financial Claims Scheme guarantees all deposits in Australian ADIs, up to the value of $1 million per depositor, per institution. It is estimated that this covers 99.5 per cent of Australian depositors.

ADIs pay no up-front fees for protection under the Financial Claims Scheme. If an ADI becomes insolvent, then the Australian Prudential Regulation Authority pays out depositors' entitlements and recovers its costs through a claim on the insolvent ADI's assets. ADIs only pay for protection through an industry levy, in the unlikely event that the assets of the ADI are insufficient to meet APRA's claim.

The Financial Claims Scheme was introduced in October 2008, at a time of significant turmoil in financial markets. The announcement of the scheme in early October 2008 helped to support the deposit funding base of smaller ADIs throughout the crisis.

It is also worth noting that, because credit unions and building societies raise more of their funding through deposits than other ADIs, a larger portion of their funding is guaranteed automatically, and for free, under the Financial Claims Scheme.

The Government has stated that it will review the cap from October 2011, and this process is underway. The Government is well aware of the important role that the scheme has played in bolstering consumer confidence in banking and upholding financial system stability.

In response to the closure of securitisation markets, the Government committed up to $16 billion to be invested in AAA-rated residential mortgage backed securities to support competition in the residential mortgage lending market from smaller lenders.

To date, the Australian Office of Financial Management has invested in RMBS deals undertaken by three credit unions and three building societies.

Through this investment, these lenders have been able to raise around $2.9 billion to fund new mortgages, with the AOFM support totalling $1.5 billion. This has enabled these lenders to maintain competitive interest rates, higher lending volumes and higher market shares than would otherwise be the case.

In the 2010 Budget, the Government announced that it will provide savers with a tax discount equal to 50 per cent of the interest earned on deposits up to $500 from 2012-13, rising to $1000 in 2013-14. Given that deposits are a key source of funding for small lenders, this initiative should help to reduce the funding costs of mutuals and support your lending business.

The Government’s Account Switching Package supports competition by increasing consumer awareness of financial service products and costs, and making it easier for customers who want to change providers.

The better informed consumers are of the benefits of banking with credit unions and building societies, and the easier it is to switch accounts, the greater the potential business for you.

Potential challenges for the sector

Although it is clear that our financial system has emerged from the global financial crisis in better shape than most advanced economies, the Government is well aware that Australian mutuals face significant burdens.

For example, competition for deposits has intensified. This appears to have been driven by Australian banks strengthening their balance sheets and improving their liquidity positions by increasing their share of funding from deposits. Banks have also reduced their reliance on short-term wholesale funding, replacing it with long-term wholesale debt and deposit funding sources.

As I have mentioned, your business model has demonstrated its strengths. But I wonder whether this strength could be limiting the potential of your sector. There appears to be some consumer dissatisfaction with the level of banking competition. And yet, despite the very different approach taken by your organisations, we have not seen a big switch away from the banks.

This raises the question — are credit unions and building societies destined to remain in the shadow of the banks, or can you make your organisations a more dynamic force in banking?

Are there new products, new product lines, or new ways of doing business you could adopt to enhance your relative importance in the banking sector?

In asking these questions, I am aware of APRA requirements that institutions not introduce new lines of business without careful consideration, and without ensuring they have the expertise to do so. While these requirements are prudent, they do not preclude product innovation.

Is there a need for consolidation?

Historically, it is the smaller players which have generated the most significant competitive pressure in Australia's banking sector. They have helped significantly in creating a strong competitive dynamic.

A sustained recovery in financial markets means that the smaller institutions will be in a position to increase their market share.

However, the significant economies of scale that exist for a range of banking operations mean that, in the longer term, we are likely to see continued consolidation in the sector.

One example of these economies is that, in raising funds in wholesale funding markets, larger institutions are able to issue significantly higher volumes at better prices.

There are also economies of scale in areas such as risk-pooling, distribution and branch networks, staff training, computer systems, and advertising.

Economies of scale can benefit consumers by lowering the average cost of bank products. But it is important that consolidation does not lead to lessened competition. There are important safeguards under legislation, implemented by the Treasurer and Australian Competition and Consumer Commission, to prevent this from occurring.

Given that the major banks are such large enterprises and that some of your institutions are quite small, one inevitable question is whether your sector needs consolidation in order to pose strong competition to the banks.

Is this a path you wish to consider?

I'd add that two of the large South Australian credit unions, Savings and Loans, and Australian Central, are currently undergoing a merger. If the new identity is approved at the AGM later this month, it will be named the People's Credit Union.

However, even if all of Australia's credit unions and building societies consolidated into one single enterprise, that institution would still only hold a small proportion of the total banking market. And perhaps the relatively small size of your institutions is one of the key attractions for customers.

I’m aware that you are considering approaches designed to overcome the relatively small size of your institutions, such as the aggregated balance sheet model. Perhaps working in concert with many other institutions in this way poses a possible alternative to consolidation.

One new initiative is Gateway Credit Union’s partnership with the Yellow Brick Road wealth management firm. As I understand the arrangement, Yellow Brick Road home loans are financed by Gateway. This expands Gateway’s product distribution network and enables it to more fully employ its deposits in lending activity. This would appear to also help Gateway compete for new business. Is this distribution model something that could be more widely applied by your institutions?

I would welcome your views on these issues and an idea of what you see as the future direction of your sector during the question and answer session.

A changing regulatory landscape

As I mentioned earlier, the global financial crisis focused attention on prudential regulation. Let me assure you that the Government carefully balances the need for new regulation against the costs that it will impose on business. However, it is clear that a robust and resilient financial sector is a precondition for prosperity, and that prudential regulation plays a central role in achieving this.

With a new focus on prudential regulation, your organisations will need to keep pace with any future changes and ensure that you have the appropriate skills to deal with them.

The need to better inform potential customers

I'm also aware of your current media campaign, "It all comes back to our members", which promotes the benefits of credit unions and building societies.

This campaign comes in the wash-up from the global financial crisis that saw some banking customers switch to what they considered the safe haven of the major banks.

This is a common phenomenon in times of financial turmoil, both here and abroad, and is not a true reflection of the prudential safety of credit unions and building societies. It may partly reflect the public debate about the major banks being "too big to fail".

I appreciate that your information campaign promotes the fact that your institutions are prudentially supervised by APRA, just like the banks.

On that note, I would also suggest that you inform customers that deposits with your organisations are guaranteed by the Federal Government through the Financial Claims Scheme. Better informed consumers may help your industry to realise its full potential.

Like you, the Government has an interest in ensuring that the public is well informed on these matters. Clearly, I cannot say what the Government may agree to do in the future. But I look forward to hearing your views on whether you see a role for us in educating the public.

Conclusion

No matter what path credit unions and building societies take, one thing is certain — they will continue to provide millions of Australians with a real alternative to the major banks. And those Australians not currently banking with you would do well to consider what you have to offer.

Thank you again for the opportunity to discuss these issues and I look forward to your comments and questions.