CUSTOMER OWNED BANKING ASSOCIATION

30 January 2019

Budget Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

Via online: prebudgetsubs@treasury.gov.au

Dear Sir/Madam

**COBA 2019-20 Pre-Budget submission: amend GST RITC Item 16**

COBA appreciates the opportunity to provide the Government with our views regarding priorities for the 2019-20 Budget. In this submission we propose a simple step to promote competition in retail banking.

COBA represents mutual banks, credit unions and building societies. These institutions all share the same mutual ownership structure with the various naming differences due to marketing or historical reasons.

Our sector is comprised of 73 individual institutions serving four million customers and providing important consumer choice in a market dominated by four very large banks. Each one of the major banks has total assets 8 to 9 times larger than the total assets of the entire customer owned banking sector. The largest customer owned banking institution is 1.5% the size of the largest major bank.

COBA requests the Government to take action in the 2019-20 Budget to promote competition in banking by amending GST Reduced Input Tax Credit (RITC) Item 16 'Credit union services' to also cover mutual building societies and mutual banks that were formerly building societies.

This will address an anomaly in legislative settings affecting customer owned banking institutions and will be consistent with the high priority the Government is giving to measures to promote the competitive capacity of our sector.

Amending GST RITC Item 16 as requested will encourage greater collaboration within the customer owned banking sector and help our sector to become a stronger competitive force in banking.

We note that a Treasury Ministerial Brief (attached) dated 16 March 2017 and published on Treasury's website on 22 December 2017 in response to a Freedom of Information Request stated that:

> "the policy rationale, of levelling the playing field between credit unions and other financial institutions may no longer be relevant."

As discussed further below, we strongly disagree with this suggestion. The need to promote competition in banking by levelling the playing field is just as relevant today as it was when RITC item 16 was first implemented.

Given the state of the banking market, policymakers should be taking all reasonable opportunities to promote the competitive capacity of existing smaller players in banking. Effective competition will drive innovation in product offerings, improvements in product quality and variety, greater efficiency and lower prices, for the benefit of business and consumers.

Please do not hesitate to contact me on 02 8035 8441 or Luke Lawler on 02 8035 8448 to discuss any aspect of this submission.

Yours sincerely,

**MICHAEL LAWRENCE**
**Chief Executive Officer**

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

**Recommendation:** The Government should amend RITC Item 16 so the item applies to all mutual ADIs, i.e. credit unions, mutual banks and building societies.

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

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

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

The Explanatory Statement for the RITC regulations says the benefits of the RITC approach include "reduced bias to insource" and "lower compliance costs for smaller entities."

Recognising the benefits of collaboration between smaller banking institutions, the list of RITC items includes a supply to a credit union by an entity owned by two or more credit unions. This item was modified by regulation[1] in 2012 to accommodate mutual banks that formerly were credit unions but have re-branded as mutual banks without changing their ownership structure.

However, the anomaly of excluding mutual building societies from the scope of the item has not been corrected.

The failure to accommodate mutual building societies and mutual banks that formerly were building societies has created an artificial and arbitrary barrier to greater collaboration and cooperation in the mutual banking sector.

Removing this barrier would be consistent with the high priority the Government is giving to measures to promote competition in banking and to promote the competitive capacity of the customer owned banking sector.

Legislation to provide a simpler and clearer definition of a mutual company in the *Corporations Act 2001* is expected to be introduced into Parliament soon. Until that legislation is passed, mutual ADIs can continue to be defined as ADIs operating under a mutual corporate structure in accordance with ASIC Regulatory Guide 147 *Mutuality – Financial institutions.* [2]

### Is RITC item 16 "no longer relevant"?

A Treasury Ministerial Brief dated 16 March 2017 and published on Treasury's website on 22 December 2017 in response to a Freedom of Information Request stated that:

> "We do not support extending [the RITC scheme] as the policy rationale, of levelling the playing field between credit unions and other financial institutions may no longer be relevant."
>
> "The scheme was originally intended to recognise that credit unions were, at the time, typically small entities that needed to outsource more services than other financial institutions, and thus should be entitled to an RITC in respect of those services.

[1] http://www.austlii.edu.au/au/legis/cth/num_reg_es/antsastar20124n215o2012683.html

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

> "However, the policy rationale for maintaining the scheme become progressively weaker as the industry consolidates and these entities become larger and the need to outsource is reduced."

COBA strongly disagrees with these statements.

The need to level the playing field between small and large banking institutions is highly relevant.

Credit unions and other customer owned banking institutions such as mutual banks and building societies are tiny compared to major banks.

The need for smaller banking institutions to outsource various inputs is as strong as ever.

The need for smaller banking institutions to collaborate to increase their capacity to apply competitive pressure on major banks is as strong as ever.

Outsourcing continues to play a critical role in supporting the operating model of customer owned banking institutions. COBA institutions rely heavily on third-party service providers for their core banking system and information technology service requirements (such as the management of information assets and technical assurance).

The customer owned banking sector's reliance on outsourcing reflects the fact that our institutions do not have the scale and vast internal resources of major banks.

There has been a longstanding trend of consolidation in the customer-owned banking sector but despite this, as noted above, each one of the major banks has total assets 8 to 9 times larger than the total assets of the entire customer owned banking sector.

Outsourcing and collaboration are critical elements in assisting our sector to enhance its competitive potential.

For example, our sector's reliance on outsourcing was appropriately recognised by the Australian Prudential Regulation Authority (APRA) last year, in terms of the transition relief it provided on implementing APRA's new Prudential Standard CPS 234 Information Security (CPS 234), which mandates minimum information security requirements for APRA-regulated entities.

COBA's submission to APRA last year raised significant concerns with APRA's proposed transition deadline of 1 July 2019 for the third-party assurance requirements of CPS 234 – due to the significant reliance on outsourcing – and requested a transition time extension from APRA.

APRA's response to submissions and final CPS 234, released in November 2018, acknowledged the use of third parties, and that "it would be difficult, if not impossible, to comply without the need to break or renegotiate contracts with third parties; this was deemed impractical, time consuming and potentially costly". On this basis, APRA provided a transition time extension of up to 12 months (i.e. 1 July 2020).

**Competition in banking**

Australia's banking sector is an established oligopoly with a long tail of smaller providers, according to the Productivity Commission's (PC) June 2018 report *Competition in the Australian Financial System* (see Figure 1 below from the PC report).

The PC found that the relative size of major banks is such that only if all other banks in Australia were to merge, would they be able to rival either of the biggest two.

> "The four major banks as a group hold substantial market power, as a result of their size, strong brands and broad geographical reach. This is substantially supported by regulatory settings, which contribute to the major banks' structural advantages. As a result, the major banks have the ability to pass on cost increases and set prices that maintain high levels of profitability — with minimal loss of market share."

The PC found that the major banks' market power is a defining feature of the financial system.

> "There is evidence that [the major banks] have sustained prices above competitive levels, offered inferior quality products to some groups of customers (particularly those customers unlikely to change providers), subsumed much of the broker industry and taken action that would inhibit the expansion of smaller competitors in some markets. All are indicators of the use of market power to the detriment of consumers."

The PC found that what allows market power to be sustained in Australia's financial system is a combination of features evident in the way providers, consumers and regulators operate:

- market power as a result of established presence
- market power as a result of regulatory arrangement
- market power as a result of funding advantage and operational efficiency
- market power reinforced by integration, and
- market power reinforced by consumer inertia.

The PC also found that:

- neither foreign entrants nor fintechs appear to pose a substantial threat to major banks' dominant positions, i.e. more entrants alone are not a panacea to drive sustained competition across Australia's financial system, and
- a substantial gap also remains between the average operating costs of Australia's major banks and its smaller institutions.

The Australian Competition and Consumer Commission (ACCC) also sees the banking market as oligopoly where the major banks use their power to stifle competition.

According to the ACCC's November 2018 *Residential Mortgage Pricing Inquiry Final Report,* the major banks have an "accommodative and synchronised" approach to pricing:

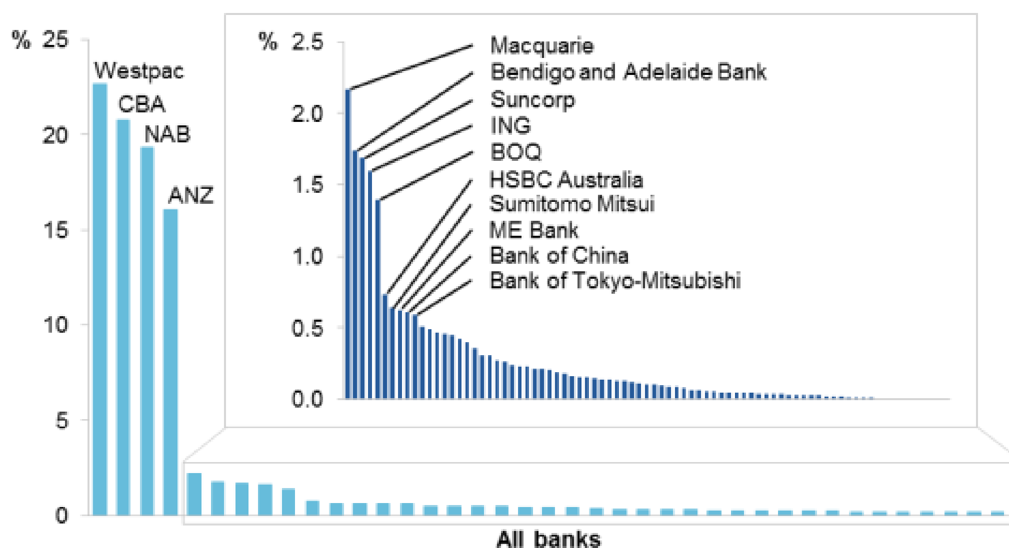
> "Building on the signs of a lack of vigorous price competition set out in the Interim Report, we observe that opaque discretionary pricing by the Inquiry Banks stifled price competition during the price monitoring period.
>
> "We consider that the big four banks profit from the suppression of borrower incentives to shop around and lack strong incentives to make prices more transparent."

The September 2018 Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry found that competition within the banking industry is weak and barriers to entering the industry are high.

> "To participate in the economy, to participate in everyday life, Australians need a bank account. But they are reluctant to change banks. Each of the four largest banks is a powerful player in the market.
>
> "Important deterrents to misconduct are, therefore, missing from the banking industry. Competitive pressures are slight."

As noted above, given the state of the banking market, policymakers should be taking all reasonable opportunities to promote the competitive capacity of existing smaller players in banking. Effective competition will drive innovation in product offerings, improvements in product quality and variety, greater efficiency and lower prices, for the benefit of business and consumers.

Figure 1 **Banking and insurance are dominated by large players — and long tails of other providers**[a,b]




**Need to collaborate**
Collaboration to access economies of scale is a long-standing feature of the customer owned banking sector.

The three biggest opportunities to improve performance identified by respondents to KPMG's 2018 survey[3] of COBA member institutions were:

1. Improving efficiency (27.7 percent)
2. More collaboration with alliance partners (23.4 percent)
3. More collaboration with peers (17.0 percent)

The prudential regulator APRA is a strong supporter of collaboration within our sector. APRA chairman Wayne Byres views tackling costs as critical to our sector becoming a stronger competitive force in banking:

> "If the mutual sector could just halve the cost gap with the major banks, for example, it would potentially be able to generate a very similar return on assets, changing the competitive dynamics quite considerably. To be clear, that does not automatically mean more consolidation is the answer, but at the least I would encourage you to work collaboratively and cooperatively on ways to generate the scale efficiencies likely to be needed to really change the competitive landscape."[4]

**Impact of sector consolidation**
As noted above, relevant developments in the customer-owned banking sector include continuing consolidation. This consolidation includes mergers between credit unions and building societies, and credit unions and former building societies that have rebranded as mutual banks.

The underlying mutual corporate structure of credit unions and mutual building societies does not change in mergers between these entities or in rebranding as mutual banks. The ownership structure of a mutual banking institution – bank, building society or credit union – is the same and is set out in ASIC

[3] https://home.kpmg/content/dam/kpmg/au/pdf/2018/mutuals-industry-review-2018.pdf

[4] https://www.apra.gov.au/media-centre/speeches/individual-challenges-and-mutual-opportunities

Regulatory Guide 147 *Mutuality: Financial institutions.* APRA's quarterly statistics publication on ADIs includes all these entities in the category 'mutual ADIs'.

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

Our sector has several aggregator bodies owned by our members that provide a wide range of critical business inputs. These bodies are unable to be jointly-owned by both credit unions and building societies (or mutual banks that formerly were building societies) due to the anomaly in the RITC regulations. For example, aggregator bodies that supply data-processing services to credit unions and former credit unions now trading as mutual banks would lose eligibility under RITC Item 16 if just one of their owners merged with a building society or with a mutual bank that was formerly a building society.

This anomaly is a significant barrier to future collaboration. For example, four of the ten largest institutions in our sector are building societies or mutual banks that are former building societies. Collectively, these ten institutions cover more than 65 per cent of sector assets and if they were able to work together more effectively they would be able to significantly improve their economies of scale.

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

COBA also provides performance benchmarking services, allowing participating member institutions to see how they are tracking against industry peers on a range of KPIs. This initiative demonstrates the ongoing appetite for collaboration in the sector.

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

Restricting the scope of RITC Item 16 to credit unions and former credit unions now trading as banks means the item is less and less effective in reducing the anti-competitive effect of GST input taxing.

A modest expansion in the scope of RITC Item 16 to cover the eight customer-owned ADIs[5] that are building societies or former building societies would update and revitalise this important pro-competitive measure.

Increased RITCs for customer owned banking institutions will have an impact on GST revenue but this impact is likely to be minor. For example, COBA's membership and service fees are in the order of $5.5 million including GST and if COBA's services were eligible under an amended RITC Item 16, the RITC amount would be in the order of $375,000. This is negligible compared to the total estimated 'cost' of $850 million in 2017-18 for all RITC items relating to financial supplies, reported in Treasury's Tax Expenditures Statement 2017.[6]

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[5] Heritage Bank, IMB Bank, Greater Bank, Hume Bank, Bank of us, Newcastle Permanent Building Society, Maitland Mutual Building Society & Australian Unity Bank.

[6] https://static.treasury.gov.au/uploads/sites/1/2018/01/2017-TES.pdf

## Background

**Illustration of how RITCs neutralise the self-bias incentive for an input taxed entity[7]**

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

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

A Treasury paper from 1999 *The Application of Goods and Services Tax to Financial Services*[8] outlined the so-called “self-supply bias” and highlighted the anti-competitive impact on smaller financial service providers:

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

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

> “…businesses organising themselves to ‘self-supply’ goods and services to reduce the tax payable on their inputs. This gives large, vertically integrated businesses an advantage over smaller competitors.” [9]

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[7] 2009 Treasury consultation paper *Review of the GST Financial Supply Provisions.*

[8] http://archive.treasury.gov.au/documents/693/PDF/gst.pdf

[9] http://taxreview.treasury.gov.au/content/downloads/final_report_part_2/AFTS_Final_Report_Part_2_Vol_1_Consolidated.pdf

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# TREASURY MINISTERIAL BRIEF

16 March 2017 PDR No.

## Extension of the GST reduced input tax credit for 'credit union services'

*Key points*

- COBA is proposing that the reduced input tax credit (RITC) scheme, currently available to credit unions including those rebranded as banks, be extended to mutual building societies and mutual banks (that are former mutual building societies).
- We do not support extending the scheme as the policy rational, of levelling the playing field between credit unions and other financial institutions may no longer be relevant.
- The States and Territories also do not support the proposal on the same basis and we have advised COBA of their views.

*Background*

- The scheme was originally intended to recognise that credit unions were, at the time, typically small entities that needed to outsource more services than other financial institutions, and thus should be entitled to an RITC in respect of those services.
- However, the policy rational for maintaining the scheme becomes progressively weaker as the industry consolidates and these entities become larger and the need to outsource is reduced.
- Financial supplies (e.g. loans and bank accounts) are input taxed, meaning that no GST is charged on the final supply, but neither can the supplier claim input tax credits in respect of the acquisitions made to produce those supplies.
- The scheme allows credit unions, including those that have rebranded as banks, to claim a refund of 75 per cent of the GST paid on acquisitions that relate to their financial supplies. Examples of such acquisitions include loans services, transaction banking, cash management services, insurance services and debt collection services.
- Extending the scheme would have a cost to GST revenue. Under the *Intergovernmental Agreement on Federal Financial Relations*, changes to the GST base require the unanimous agreement from the States and Territories.

*Talking points*

- I appreciate your concerns about the input tax treatment of financial supplies.
- As you are aware, changes to the GST require the unanimous agreement of the States and Territories.
- Your proposal has been considered by State and Territory officials. However, they did not express support for the proposal and I understand Treasury has advised you of their views.

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