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BUSINESS COUNCIL
OF CO-OPERATIVES AND MUTUALS

Submission to the Financial System Inquiry

March 2014

About this submission

The Business Council of Co-operatives and Mutuals is an association of the chief executives of Australia's leading member-owned and member-based businesses, which promotes the role of co-operative and mutual businesses in the economy and community development of Australia.

We welcome the government's decision to undertake this Financial System Inquiry examining how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth.

The BCCM acknowledges the government's steps to consult with a broad range of stakeholders and we appreciate the opportunity to make a submission outlining what we believe is the critical role of financial mutuals including customer owned banks, credit unions and building societies in providing for effective competition and genuine consumer choice "for an efficient, competitive and flexible financial system, consistent with financial stability, prudence, public confidence and capacity to meet the needs of users."

In particular this submission examines the state of domestic competition in the financial system and the outcomes for consumers.

Please direct all queries with regard to this submission to the Business Council of Co-operatives and Mutuals.

Yours sincerely,

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Summary

This submission is made by the Business Council of Co-operatives and Mutuals (BCCM), on behalf of Australia's co-operative and mutual member-based businesses and is focused on the issues of domestic competition and consumer outcomes in the Australian financial system.

Co-operatives and mutuals are the 'quiet achievers' in the Australian economy. There are over 1700 registered co-operatives in Australia. Despite the relatively small number of co-operatives compared with companies, eight in ten Australians are members or customers of a co-operative or member-based business including more than four million members of financial mutuals.

Co-operatives and mutuals aim to generate a profit or surplus and like other business enterprises they must make prudent business decisions. However, profits from the enterprise are channeled back into the business in the form of improved services or lower costs to users. This method of doing business is in stark contrast to the imperative of profit maximisation for the benefit of remote or disengaged shareholders that is characteristic of other corporate entities.

Co-operatives and mutuals deliver high levels of customer service and satisfaction largely due to their reinvestment in the services to their members. Moreover, in communities or markets where the potential for profit taking is either low or non-existent a co-operatively owned entity is likely to be the only viable means of providing services.

This submission asserts that financial mutuals (including customer owned banks, credit unions and building societies) provide essential market diversity in a sector that is highly concentrated in terms of ownership and market share.

There is a compelling case that competition in the financial system would be improved if more financial institutions of diverse structures including mutual ADIs had an increased share of the market.

In general the presence of co-operative and mutual businesses in the economy increases the contestability of products and services and improves service quality and value for money across markets, including better delivery of services to the regions. As member-owned and member-based businesses, they engage users in the control and management and provide for localised accountability.

Background

A. ABOUT THE ORGANISATION MAKING THIS SUBMISSION

The BCCM was formed in 2013 as a legacy of the United Nations 2012 International Year of Co-operatives to promote awareness of the contribution of member-owned and member based businesses to Australia's economic and community development.

The BCCM brings together the entire range of co-operatively and mutually owned enterprises across many industry sectors from agriculture, motoring and retail, to health, housing and financial services. The BCCM engages with government on the benefits of the co-operative business model for building dynamic local economies, sustainable, local employment, community reinvestment and community-generated, self-help solutions to shared needs.

The Board of the BCCM includes the chief executive officers of leading Australian co-operative and mutual businesses. The Chairman of the BCCM is Dr Andrew Crane, CEO of Australia's largest co-operative, CBH Group. Dr Crane has been appointed to the B20 group, which advises the government on the business agenda during Australia's G20 Presidency in 2014.

B. ABOUT THE SECTOR

The co-operative and mutual sector in Australia is historically important and economically significant yet largely under-recognised.

Since their height, mutuals have retained their historical and traditional role of providing collective mechanisms to address social issues such as financial inclusion and health insurance.

In a recent National Press Club address[1] to the BCCM Making it Mutual national workshop, the Minister for Social services, the Hon. Kevin Andrews MP noted:

"As you know there was a time in Australia when mutualism was the most dynamic social and economic movement.

In the second half of the nineteenth century, Australians, imbued by an egalitarian spirit of pragmatism and independence, pioneered mutuals and friendly societies across the six colonies.

Found in every community, these institutions were voluntary and self-regulating. They offered employment, health, funeral and other insurance by pooling small amounts of money or income to protect themselves from the vagaries of economics and happenstance."

Member-based businesses today are big business in Australia. Eight in ten Australians is a member of at least one co-operatively owned or mutually owned enterprise such as a customer owned bank, a member-owned super fund or roadside assistance organisation.

Over 13 million Australians belong more than 1700 co-operatives and mutuals throughout the country. Financial mutuals serve around 4.5 million Australians. The member owned industry superannuation funds manage around $400 billion in assets. Co-operative Bulk Handling provides $3 billion a year in services to the farmers who collectively own it and The Co-op (University Co-op Bookshop) has around 1.5 million members. However, despite the overwhelming majority of Australians already being members of a co-op or mutual, only 16 per cent realise it. Similarly, while brands like the NRMA, AustralianSuper and Murray Goulburn dairy are household names, only 10 per cent of Australians could name a co-op or mutual. [2]

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[1] National Press Club address to the Business Council of Co-operatives and Mutuals "Make it Mutual" Workshop, 17 March 2014. Online: http://kevinandrews.com.au/media/national-press-club-address-to-the-bccm-make-it-mutual-workshop-17-march-2014

[2] Denniss, R & Baker, D (2012) "Who knew Australians were so co-operative: The size and scope of mutually owned co-ops in Australia", The Australia Institute. Online: http://www.tai.org.au/node/1902

"Co-ops and mutuals are hiding in full view of the consumers who say they want an alternative …"[3]

The important role of member-owned and member-based businesses is underlined by the performance of mutuals in the 2013 BRW Top 500 privately owned companies. The report *"Mutual Ownership within Australia's Top 500 Private Companies*", found although mutually owned businesses made up only 12.4 per cent of the total 500 firms in the BRW list, they represented 70 per cent of the top 20 companies by annual turnover and reported an annual average turnover in FY2012/13 of around $1.85 billion. Their annual average growth in turnover over the previous year was 48 per cent. In terms of company structures, those with mutual ownership outperformed all company structures.[4]

Defining co-operatives and mutuals

Co-operatives and mutuals possess characteristics that are common with all businesses however it is the defining attributes, which makes them distinctive.

In Australia co-operatives are independent organisations, which seek to operate in a financially sustainable way, they have a concern for community, and are voluntary and open organisations, which engage with communities through their membership. Co-operatives and mutuals typically have long-term sustainable and collaborative strategies, which means that they have resilience when economic conditions worsen.

The report "*Resilience in a downturn: The power of financial cooperatives"*, [5] released by the Cooperative Branch of the International Labour Organisation in 2013, notes that financial co-operatives have fared better compared to all banks in times of crisis. Savings and credit co-operatives, co-operative banks and credit unions have grown, kept credit flowing especially to small and medium sized enterprises, and remained stable across regions of the world while (indirectly) creating employment. It is their unique combination of member ownership, control and benefit that is at the heart of their resilience and that provides a series of advantages over its competitors.

Financial co-operatives represent a large slice of the global banking market.

Worldwide, co-operatives are the second biggest banking network, serving 870 million people. 45 per cent of their branches are in rural areas, compared with an average of 26 per cent for all banks. The European co-operative banks are particularly effective; they have

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[3] Denniss, R, "Co-ops Offer Alternative", The Canberra Times, 27 October 2012. Online: http://www.canberratimes.com.au/opinion/coops-offer-alternative-20121026-28au3.html

[4] Mazzarol, T (2013) "Mutual Ownership within Australia's Top 500 Private Companies," Sustainable Cooperative Enterprise Research Program White Paper 001, Online: https://theconversation.com/the-forgotten-role-of-mutual-ownership-within-australias-leading-private-companies-18282

[5] Birchall, J (2013) "Resilience in a downturn: The power of financial cooperatives," Online: http://www.ilo.org/empent/Publications/WCMS_207768/lang--en/index.htm

nearly 70,000 branches, reaching into all parts of both the urban and rural economies. They have maintained a huge automatic teller machine (ATM) network, while other banks have cut theirs back. The successors to the Raiffeisen movement are particularly good at serving rural communities. For instance, 32 per cent of the branches of the 'banche di credito' (credit banks) in Italy are in areas with fewer than 5000 inhabitants.

This pattern is consistent with Australian financial mutuals.

The KPMG *Mutuals: 2013 Building a platform for growth*, survey notes: "While the Mutuals represent only 2 percent of total assets (Mutuals and major banks), branch numbers accounted for 21 percent of total branches. The proportionally higher number of Mutual branches (relative to their total assets) is due to the Mutuals' belief in the traditional branch driving higher customer satisfaction."[6]

Following the Global Finance Crisis (GFC) – the co-creation of commercial and social value endemic to co-operative business has been picked up by the private sector with Harvard Professors Porter and Kramer encouraging businesses to create shared value (CSV) – postulating that businesses can achieve competitive advantage and long-term viability by addressing social needs.

Porter and Kramer challenge businesses to reconceive products and markets, increase productivity in the value chain, and enable the development of clusters of stakeholders – and in doing so generate both commercial and social value. Because of their unique structure, Australian co-operative and mutual businesses including financial mutuals are well positioned to create shared value.

What is a financial mutual?

The essential elements are ownership, control and benefit.

"The customers own the co-operative, with each person having one member-share. The co-operative does not belong just to the current cohort of members but is an intergenerational endowment held in the business for the benefit of current and future members. Membership is not transferable, and so there is no market for shares.

"As members, the customers are an integral part of the governance structure, with powers derived from personal membership. The customers are also the main beneficiaries. The main purpose of the business is to benefit the members rather than to maximise profit. Their focus is on long-term relationships with their customer-owners, not on making profits for shareholders.

"It follows from these distinctive features that financial co-operatives should be stable and risk-averse. The banking crisis of 2008 was a great test of this hypothesis."[7]

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[6] KPMG "*Mutuals: 2013 Building a platform for growth"*, Financial Institutions Performance Survey, p10.

[7] Birchall, J (2013) "Resilience in a downturn: The power of financial cooperatives," Online: http://www.ilo.org/empent/Publications/WCMS_207768/lang--en/index.htm pp 1-2

The ILO report *"Resilience in a downturn: The power of financial cooperatives"* found the European co-operative banks have come out of the crisis very well.

"Seven of them are in the top 50 safest banks in the world, and across Europe, they exceed the minimum legal capital ratio requirement of eight per cent, with an average ratio of about 9 per cent. This is reflected in very good credit ratings, which range between AA- and AAA for the largest co-operative banking groups. For credit unions, the worldwide picture is one of strong growth during the period from 2007 to 2010.

"Savings increased by only 1 per cent in 2008 but then by 15 per cent in 2009, and another 7.3 per cent in 2010. This is an increase of almost a quarter on 2007. Loans decreased very slightly in 2008 then grew by 7.6 per cent and 5.3 per cent over the next two years, making a total increase over the three years of more than 13 per cent. Crucially, reserves increased by over 14 per cent, indicating that the system is in good health and that risks are being kept low."[8]

Australian financial mutuals

Mutual Authorised Deposit-Taking Institutions (ADIs) begin with a natural advantage; namely that 'social good' is at the core of the business model.

The introduction to the 2012 Oliver Wyman report *"Tier 3 Banking in Australia"* notes: "Created as much to solve a social as a financial issue, in a world where banks limited credit and membership was local, Australia's mutual organisations were built on, and still enjoy, a reputation as the friendly banking alternative.

"Mutuals possess the distinguishing characteristic of being owned by, and run for the benefit of their members. They vary radically in size, geographic and sometimes industry focus, but their constitutions are tied by a common purpose centred around member and community benefit; each member who satisfies the voting member criteria holds one vote, regardless of investment level. This common legal ownership structure and socially-based value proposition enable the mutuals – comprising building societies, credit unions and mutual banks – to collectively present themselves as a "sector" (Tier 3) in their own right."

"Tier 3 today accounts for just 3% market share of assets. Despite efforts to enhance competition, and a general reduction in public trust in major financial institutions, the relative shares of the four major banks (Tier 1), regionals and direct players (Tier 2), and the mutual sector have not materially changed.

[By comparison, France's co-operative banks have 44 per cent of the deposits market and 46 per cent of the loans. In the Netherlands it is 40 per cent and 29 per cent respectively and in Italy 34 per cent and 31.9 per cent].

[8] Ibid, pp28-29

"The sector does however remain a significant part of the retail banking landscape; with 11% of Australian household deposits, across more than one hundred institutions, it claims aggregate membership of approximately 4.5 million people"[9]

The KPMG Mutuals: 2013 report notes that despite intense competition, there is an increased confidence in the industry's ability to grow based on the financial mutuals' value proposition supported by increasingly improved technology capabilities.

"Their commitment to the community remains a fundamental component of their value proposition. Sixty-one percent believe that community involvement is a key differentiator, and 20 percent consider it their reason for existence. Together the industry contributed over $12.9 million to local and national charities in 2013 in the form of donations and sponsorships."[10]

"The Mutuals have continued to maintain strong capital adequacy ratios during 2013, with an average of 17.9 percent (17.4 percent in 2012). The reasons for continued high capital ratios remain consistent with prior years, being:

• continued profitability

• conservative risk appetite

• minimal capital management transactions."[11]

KPMG expects effective capital management funding plans, growth and profitability to contribute to ongoing prudential strength of the Mutuals.

"Despite seeing a 3.6 per cent decrease in the number of branches in 2013, the Mutuals have increased the number of employees by 1.5 per cent. Personnel expenses remain the most significant expense for the Mutuals, representing 44.5 per cent of total operating costs. This is in line with the Mutuals focus on enhancing customer experience, increasing staff knowledge and their desire to grow."[12]

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[9] Oliver Wyman (2012) "Tier 3 Banking in Australia: Will the real customer champions please stand up?" p4.

[10] KPMG, "Mutuals: 2013", op cit, p2.

[11] Ibid, p13.

[12] Ibid, p20.

Key differentiators

Mutual organisations can offer a compelling and credible differentiating value proposition by providing members with unique additional benefits related to their status as owners.

Customer ownership is regarded as a true differentiator for financial mutuals. Mutuals reinvest profits back into the business to provide more competitive products, services and fees.

"There is opportunity for the industry to turn such differentiators to their advantage and convert high customer satisfaction into greater product penetration."[13]

This opportunity where capitalised leads to product innovation which can have community, environmental, social as well as consumer benefits. Examples are green loans, community banking, and product and service innovations like ATM networks and prepaid cards.

Financial mutuals can innovate in the interests of members based on a lower return on investment threshold, which might otherwise stymie innovation.

As profit maximising companies aiming for very high rates of return, "the banks were choosing not to invest in operations that would have been profitable, but were not able to reach profit hurdles of 18 to 20 per cent, or 26 to 29 per cent before tax. One consequence was that the big banks closed branches that were still profitable, but not profitable enough."

"This is a serious problem and is not unique to banks. Investment is a major contributor to Australia's economic growth and the rise in living standards over time. In a competitive market we expect that businesses will invest so long as they make a reasonable return. However, the banks put such a high hurdle on investments that they ignore investment opportunities that would otherwise contribute to overall wellbeing in Australia."[14]

The mutual sector can genuinely champion the customer.

Deloitte's *"The Mutual ADI of the Future: Thrive*" report notes: "Mutual ADIs should be collectively and assertively promoting the industry's position to attract a growing chorus within the community seeking 'something more' than every-increasing shareholder returns."

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[13] KPMG, "Mutuals: 2013", op cit, p26.
[14] Richardson, D (2012) "The rise and rise of the big banks: Concentration of ownership", The Australia Institute. Online: http://www.tai.org.au/node/1926 pp20-21.

In Australia, as in other countries with a vibrant mutual sector, Tier 3 institutions advertise among the most competitive mortgage and deposit prices on the market. In terms of customer satisfaction the industry outperforms the listed sector, a pattern consistent with the UK.

Competition, ownership and consumers

Corporate diversity is a key ingredient in de-risking the economy from market volatility, and providing for a strong, resilient, sustainable and equitable market economy.

This submission questions the assumption that we have a competitive and diverse financial services sector and that we have effective competition in the market.

Competition in the provision of services can be a force to encourage quality and efficient pricing. The co-operative model can and does manage to provide equitable access to financial services at lower prices in a long-term, sustainable manner.

The BCCM believes that the Financial System Inquiry should consider the important role that mutuals play in financial service delivery and a strong and competitive financial system that is consumer (user) focused and contributes to the overall productivity and growth of the Australian economy.

The Inquiry should examine the level of competition in the sector to decide if the market functions efficiently and effectively; and where government can use either facilitation and/or regulation to achieve these goals.

Concentration and common ownership

Since the trend towards deregulation in the 1980s the mutual banks, credit unions and building societies have experienced smaller and smaller shares of the total market.

In the mid-1990s the big four banks accounted for almost two thirds of all bank lending and about two thirds of home loans. That has now increased to over 80 per cent of total lending and almost 90 per cent of home lending.

This is despite industry benchmarking, Canstar and Moody's, finding financial mutuals consistently competitive or cheaper.

Economies of scale in banking, means size itself, generates a competitive advantage. Nevertheless, a number of mutual banks, credit unions and building societies often offer very competitive interest rates vis-à-vis those of the large banks.

According to the IMF Australia has the most concentrated banking industry (of the countries the IMF chose to compare with Australia) as well as the most profitable. The IMF November 2012 Financial System Stability Assessment of Australia found the four major banks held 80 per cent of all banking assets and 88 per cent of residential mortgages and are highly interconnected.

The Australia Institute report on the concentration of bank ownership in Australia[15] noted: "On average, over 53 per cent of each big bank is owned by shareholders that are among the top 20 shareholders in all the big banks."

Moreover, ownership figures for the second tier banks, the big regionals, show they are also owned by the same organisations that own the big four. The issue of concentration is complicated by the fact that the major shareholders sit behind nominee companies so that cross-ownership cannot be determined by the lay-consumer who is looking for a genuine market alternative.

Effective competition is more important in the context of global deregulatory trends since the function of regulating markets is shifting back to the market/consumers away from the regulators.

A ready consumer alternative to listed banks exists in the existence of financial mutuals. By shopping around and comparing the costs of banking with the different providers consumers can exercise choice. Therefore the strategy of the large banks to promote different 'brands' despite being owned by the same parent company can have adverse or perverse consequences for consumers if the aim is find an independent banking services provider. Similarly this practice effects competition if the aim is to diversify the market.

Consumers require market information in order to act on consumer choice. Whilst regulation in markets might be seen as a brake on genuine competition, so too lack of access to full and transparent market information might be seen to create an information asymmetry which acts as a brake on the exercise of consumer choice to drive a competitive market.

To redress this information asymmetry, requires listed banks to publicly note their largest shareholders and to distinguish actual ownership from ownership by a nominee company. Banks should also make consumers aware of their ownership of sub-brands.

Conclusion

Corporate diversity is a key ingredient in de-risking the economy from market volatility, and providing for a strong, resilient, sustainable and equitable market economy. Financial mutuals being structured around member/customer ownership contribute vital diversity to a highly concentrated financial system. Effective competition drives productivity, innovation and user focus. Therefore any brakes, regulatory or consumer related, on effective competition, should be a key focus of examinations of the Financial System Inquiry.

[15] Richardson, D (2012) "The rise and rise of the big banks: Concentration of ownership", The Australia Institute. Online: http://www.tai.org.au/node/1926