16 April 1999

Dr Alan Preston
The Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Dr Preston

CUSCAL Submission to the Review of Business Taxation

The Credit Union Movement strongly supports the Government's goal of moving towards a 30 per cent company tax rate.

A 30 per cent company tax rate would be a major structural reform which would stimulate even faster economic growth, particularly in the services sector where most new jobs are being created.

Credit unions rely on retained earnings for their capital. A lower company tax rate means more capital, which will give credit unions the capacity to expand and improve their services. This would mean more lending and/or more jobs and/or more branches.

As an illustration of the potential benefit, a 30 per cent tax rate would have added $8 million to the Credit Union Movement's bottom line in 1997-98 — enough to meet the operating costs (excluding staff costs) of another 160 branches, half in non-metropolitan areas.

A lower company tax rate will bolster the Government's financial sector reforms and will help Australia's financial services markets achieve world's best status.

Subject to the implementation of measures to reduce the anti-competitive impact of GST 'input taxing', credit unions aim to expand their share of the household and small business banking markets.

A lower company tax rate will help credit unions build on their record of innovation and customer service to provide more competition and choice in retail financial services.

Credit Union Movement

Credit unions have been providing financial services to Australian households for more than half a century.

The Credit Union Movement's 3.5 million customer base is second only to that of the Commonwealth Bank. Credit unions are member-owned financial institutions serving groups of Australians who may live in the same community, work for the same employer, belong to the same profession, or share the same ethnic origin.

Credit union members are serviced by more than 1700 branches and agencies. They also have access to almost 9,000 ATMs that are part of the nationwide ATM network of banks, credit unions and building societies. This represents 98% of all Australian ATMs.

The Credit Union Movement, including Credit Union Services Corporation (CUSCAL), also provides direct employment to around 8,600 Australians.

In recent years, credit unions have experienced strong growth. The asset base of credit unions has doubled in the past five years and membership has increased by almost half a million. There are currently 237 credit unions with total assets of $19 billion. In terms of assets, the Credit Union Movement ranks seventh, behind NAB, CBA, Westpac, ANZ, St George and Suncorp Metway. While individual credit unions are relatively small, the Credit Union Movement is considerably larger than most regional banks and the building society sector.

Credit unions have grown strongly in recent years amidst a very cluttered and competitive financial system. They have grown because there has been a need, and indeed a preference, for their services as a genuine alternative to the major banks. They have also grown because they have done things differently — with an emphasis on personal service and customer needs rather than profit.

Credit unions are determined to maintain their status as mutuals, not least because it is a strong distinguishing factor in a crowded market. The Reserve Bank, in its January 1999 Bulletin, commented: *"Some mutually owned institutions have decided against demutualising for a variety of reasons. Relatively small institutions, in particular, may place members' benefits - such as lower fees and charges, reduced interest rate spreads and higher bonuses on life policies — above other commercial considerations. Further reasons to retain a mutual status might be to preserve the character of the organization. This might be a strong motive for organizations with an active membership or one with a regional focus. A mutual structure can also reduce conflicting objectives of customers (seeking to maximize benefits from services of the company) and shareholders (seeking to maximize profits)."*

CUSCAL

Consistent with their mutual and co-operative character, the growth of credit unions has relied critically on the aggregation of industry resources and the outsourcing of major supplies in order to maximize economies of scale. As stand-alone institutions, credit unions would not have the capacity to compete with the major banks. They would not be able to provide the full range of financial services or offer them at a competitive price.

CUSCAL, which is the major national credit union body, was established for the sole purpose of assisting its member credit unions to provide competitively-priced services to their customers. This structure is not unique to Australia. It exists all over the world in countries with credit unions and co-operative banks.

The CUSCAL Group of companies provides a wide range of business services to credit unions, including: liquidity management, funds management, financial advice, insurance services, securitisation services, data processing, settlement services, legal services, marketing and publications, management and consultancy services, IT servicing and software development, recruitment, valuation and conveyancing, research and strategic planning, media monitoring, Government representation, leasing and training.

Wallis Inquiry

The Wallis Inquiry into the Financial Sector found that credit unions had been among the leaders in the financial services marketplace on service, innovation and pricing. The Inquiry found that, given a reformed regulatory environment, credit unions were capable of increasing market contestability and consumer choice.

The Government has adopted the recommendations of the Wallis Report and, with the co-operation of the States and Territories, aims to put credit unions on an equal competitive footing with banks on 1 July 1999.

Commenting on the Wallis Inquiry's recommendations, Inquiry Chairman Stan Wallis said:

> *"In terms of the national deposit taking market we are clearly envisaging more players emerging into that scene. We're setting up a framework where it will be easier for organizations to become deposit takers at the lower levels of the system, out in a regional sense."*

Releasing the Report, Treasurer Peter Costello said:

> *"I think that the great message for rural and regional Australia is that if we can get the regulatory system right we can grow new institutions for rural and regional Australia."*

Well ahead of implementation of the Wallis reforms, credit unions have been delivering improved choice and quality of financial services in regional Australia. Assisted by fieldwork carried out by the Commonwealth and CUSCAL-funded CreditCare project, credit unions have set up 46 branches and agencies in country towns in NSW, Qld, Victoria and WA during the last three years.

Credit unions are increasing their support for small business. In the past, credit unions have been discouraged from lending to small business by an arbitrary ceiling on commercial lending imposed by their regulatory system. The 'ten per cent of assets' limit reduced credit unions' incentive to gain expertise in small business lending. However, once the Wallis reforms are fully implemented on 1 July 1999 such across-the-board restrictions will be removed. Credit unions will be able to choose to compete actively in the small business lending market. Anticipating the removal of these restrictions, many credit unions have already significantly expanded their lending to small business. Annual growth, by quarter on corresponding quarter, in small business lending by credit unions over the past five quarters has been at least 15% and as high as 38.5%. Since March 1997 total small business lending by credit unions has increased by 37% from $389 million to $532 million.

Credit Union Capital

Like banks, credit unions are required for prudential reasons to hold capital of at least 8 per cent of their risk weighted assets.

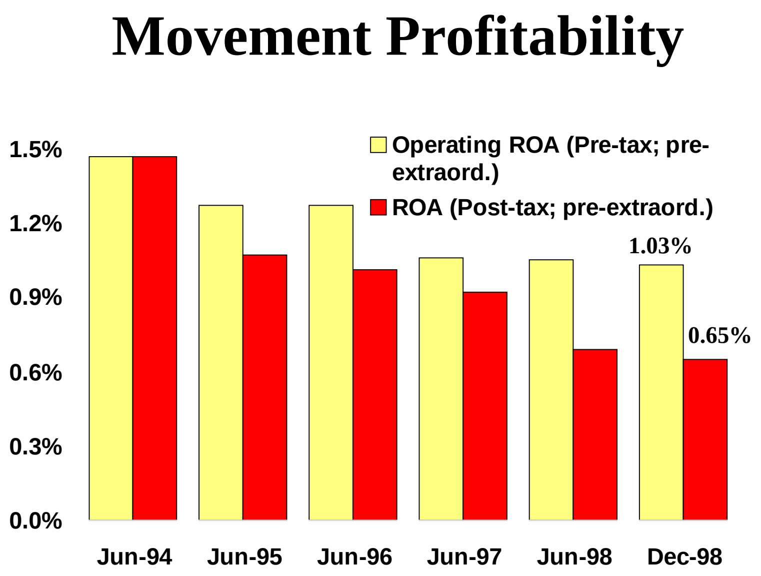
Unlike banks, credit unions are capitalised by the transfer of trading surpluses to reserves. The growth of credit unions is constrained by their surpluses, which are already modest by corporate standards. A credit union capitalised at the minimum level approved by its regulator cannot increase its assets faster than its surpluses, without seeking to raise external capital.

The Credit Union Movement is currently considering options that will allow credit unions to raise external capital using innovative structures that retain the mutual characteristics of credit unions. However, not all credit unions will need to issue capital, nor will all have the desire to do so in the immediate future. Most credit unions are capitalised well in excess of regulatory requirements. At December 1998, the total capital adequacy ratio for the Credit Union Movement was 14.88 per cent.

Between 1974 and 1994, credit unions were exempt from company tax on the interest income from their members. Removal of the exemption was announced in the 1993 Commonwealth Budget.

After a phase-in period, full taxation of credit unions (other than very small credit unions) became effective in July 1997 and the capacity of credit unions to build their reserves was reduced by 36 per cent.

As indicated by the graph below showing the industry's return on assets, full taxation has been a significant new impost on the industry.



Lower tax rate — quantifying the benefit

In 1997-98 the Credit Union Movement's operating profit was $178 million. The amount of company tax paid was $61 million. A cut in the company tax rate to 30 per cent would have reduced the tax bill to $53 million. The extra $8 million could have been used by credit unions to:

- underpin an increase in lending activity; and/or
- boost employment; and/or
- increase the number of branches, particularly in regional Australia.

Assuming the Movement's present capital adequacy ratios were to be maintained, an extra $8 million in capital would support:

- additional housing finance of $200m (loans that are 50% risk weighted for capital adequacy purposes), equating to around 1,750 new home loans (average home loan for 'other lenders' — which includes credit unions — is $114,000: *Source ABS*); or
- additional personal finance of $100m (loans that are 100% risk weighted for capital adequacy purposes). This equates to around 8,300 new personal loans for cars, which is the dominant purpose for which credit unions approve personal loans (average car personal loan approved is $12,000: *Source ABS*).

Alternatively, an additional $8 million could cover the costs around 190 additional staff in the Movement or meet the operating costs (excluding staff costs) of up to 160 additional branches. Around 51 per cent of the Movement's 1,100 branches are located in non-metropolitan areas. Therefore, such a boost in overall branch numbers could lead to more than 80 new credit union branches being established in non-metropolitan areas. This would have direct and indirect employment and general economic advantages for rural and regional areas.

GST 'input taxing'

A New Tax System says reform to business taxation "offers the prospect of a stable, simpler and more coherent business tax system with greater integrity — a system providing fairer, more equitable outcomes, less scope for tax avoidance and the basis for more robust investment decisions and a lower company tax rate."

The Credit Union Movement endorses these goals and wider tax reform objectives of *A New Tax System.*

However, the potential benefits to credit unions from tax reform and from the Wallis reforms will not be realised unless the unintended consequences of the Government's GST legislation are addressed. The input taxing model, as currently proposed in the GST legislation, will destroy credit unions' capacity to compete with large banks.

Consultations are continuing between the financial services sector and Treasury on GST "technical design issues."

CUSCAL has pressed for the bias against outsourcing implicit in ‘input taxing’ to be given top priority in discussions. This is now the major issue under consideration, with a number of options canvassed to address its anti-competitive impact. These options are consistent with the approach proposed in CUSCAL’s submission to the Senate GST Inquiry: *“The only way to reduce the unrecoverable GST liability of credit unions is either to expand the category of supplies that is to be treated as ‘input-taxed’ or to permit credit unions to treat some of their taxable inputs as ‘creditable acquisitions’.”*

A number of proposals are under discussion in a constructive atmosphere. However, the Government has not yet given any firm indication it will act on any proposals arising from the consultation process.

A level playing field

After many years of concerted effort, credit unions have overturned discriminatory and anti-competitive laws which previously benefited banks over other financial institutions. Once the new regulatory structure recommended by the Wallis Inquiry is in place, credit unions will be able to compete on equal terms without unfair regulatory restrictions.

Credit unions expect and support the same objective from reforms to taxation.

At an economy-wide level, the Government’s reforms to indirect taxation will level the playing field between service industries and producers of goods. *A New Tax System* will reduce tax on manufacturers, miners and farmers while increasing tax on most service industries.

Cutting the company tax rate to 30 per cent, while benefiting all industries, will assist the rapidly growing service industries bear the increased indirect tax burden.

We accept, as stated in *A Platform for Consultation*, that:

> *“Without the removal, or substantial reduction, of accelerated depreciation, there is clearly limited scope for company rate reductions.”*

Yours sincerely

DAVE TAYLOR
General Manager Public Affairs & Governance