19 May 2017

Mr Greg Hammond OAM
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By email: coopsandmutualreview@treasury.gov.au

Dear Sir

Turnbull Government consultation on member-owned firm legislation and regulation – Submission by the Australian Mutual Group

The Australian Mutual Group ("**AMG**") is grateful for the opportunity to make this submission to the Independent Facilitator appointed by the Turnbull Government to conduct consultations on potential legislative and regulatory reforms to support cooperatives, mutual associations and member-owned firms in Australia "*so they can invest, grow and employ more Australians*" (the "**Consultation**").

We note that the Terms of Reference for the Consultation provide that the Independent Facilitator will review the Senate Economic References Committee report on *Cooperative, Mutual and Member-owned Firms* ("**Senate Report**") (including the submissions which informed the Senate Report) and the draft response of the Turnbull Government to the Senate Report, regarding the following:

1. what regulatory and legislative barriers currently exist which impede Commonwealth-registered cooperatives and mutuals from accessing capital and how significant those barriers are; and
2. the pros and cons of inserting a definition of "mutual enterprise" into the *Corporations Act 2001* (Cth) ("**Corporations Act**").

This submission responds primarily to issue (1). We have included brief comments at the end of our submission in response to issue (2).

About the Australian Mutual Group (AMG)

The AMG consists of 10 member-owned Authorised Deposit-taking Institutions ("**mutual ADIs**") in Australia, who together serve approximately one million members through 150 branches and service centres across Australia. These mutual ADIs have served their communities for nearly 70 years, and today have over $30 billion in consolidated assets. They play a significant role in Australia's financial system. The members of the AMG are listed in Appendix 1.

Mutual ADIs provide cost-effective banking and related services to their members, being the general public in the regions in which they operate and particular professions, trades and industries. They offer Australians an alternative to the larger non-mutual banks for a range of financial, investment and

insurance products. Importantly, because of their distinctive structure, mutually owned ADIs offer an alternative form of banking which is guided by the ethos of maximising value for customers as mutual owners of the ADI, rather than maximising profits for external stakeholders. This, of course, goes to the heart of the issue – it is difficult for mutuals to raise capital, because if they accept investment from external stakeholders who expect a return, then whether or not the mutual is being run in the interests of traditional members becomes questionable. Mutual ADIs contribute to the strength of Australia's financial system and will be able to make a greater contribution if the barriers they face in raising capital are reduced or removed altogether.

Improving access of mutual ADIs to capital

We submit that the ability of mutual ADIs to access capital will be improved if:

- they are able to issue mutual equity interests ("**MEIs**") (or another similar type of equity instrument) directly (subject to the requirements of the Australian Prudential Regulation Authority ("**APRA**") relating to MEIs being amended as discussed below); and
- the process of having the terms of regulatory capital instruments issued by mutual ADIs approved by APRA is made more efficient.

1 Mutual ADIs should be able to issue MEIs directly

1.1 Mutual ADIs currently face difficulty raising capital

The nature of mutual ADIs limits their ability to access capital and grow their businesses. Membership in a mutual ADI is designed to provide access to the services offered rather than participation in a profit-making enterprise. Members are generally limited to acquiring a single member share with a nominal capital contribution.[1] Further, the capital contribution of each member is usually repayable at the election of the member, and as a result member shares in mutual ADIs cannot satisfy the requirements of Attachment B to APS 111[2] for inclusion in Common Equity Tier 1 Capital. Mutual ADIs are unable to issue ordinary shares and are therefore limited to relying on retained earnings or raising capital by issuing debt and hybrid instruments.

Retained earnings are accumulated slowly, due to the highly competitive pricing offered to members and constant investment back into local communities. Debt capital represents an expensive source of capital for mutual ADIs and there are prudential limitations on the amount of a mutual ADI's capital which can comprise subordinated debt. Interest payments burden the free cashflow of mutual ADIs, which typically have narrower margins than the major banks. Excessive debt can undermine the historical capital strength of mutual ADIs.

Stable capital structures with relatively low funding costs have enabled mutual ADIs to provide accessible and competitive products and services, and this should not be placed at risk through excessive debt issuance. However, a lack of access to capital limits the flexibility of mutual ADIs to expand services to a growing population, to make major investments in infrastructure at a time of technological disruption, and to compete with the larger non-mutual banks in an increasingly open marketplace. This is itself a risk to the long term ability of mutual ADIs to provide products and services to their members. In this submission, we outline how regulatory change can improve mutual ADIs' access to high quality capital.

[1] Increasingly, no consideration is attached to member shares. For example, Credit Union Australia no longer requires members to pay any amount for their member shares.

[2] References to APS 111 in this submission are to the APRA Prudential Standard APS 111 - Capital Adequacy: Measurement of Capital as made on 8 April 2014.

1.2 APS 111 already provides for a suitable capital instrument in MEIs

Equity and equity-like instruments can provide high quality capital for a mutual ADI. Just as with the larger non-mutual banks, issuing equity instruments provides mutual ADIs with loss-absorbing capital and flexibility on distributions.

APS 111 provides for MEIs in the Common Equity Tier 1 Capital of a mutual ADI.[3] However, MEIs can only be issued on conversion of an eligible Additional Tier 1 Capital instrument or Tier 2 Capital instrument.[4] We submit that mutual ADIs ought to be able to issue MEIs directly (i.e. not only on conversion of capital instruments), and we note that we have recently been consulting with APRA on this.

MEIs share many of the characteristics of ordinary share capital, in that they represent the most subordinated claim in liquidation, are perpetual and never repaid, carry no fixed obligation to make distributions and are neither secured nor guaranteed. Distributions can only be made out of certain items including retained earnings, and non-payment of a distribution is not an event of default (although over time investors may assess the value of MEIs by reference to historical distribution decisions). Further, MEIs rank equally with members' interests which constitute Common Equity Tier 1 Capital of the mutual ADI, but their entitlement to claim on assets in a winding up of the mutual ADI is limited to the subscription price paid for the host capital instrument.[5] These general features make MEIs an ideal component of the capital structure of a mutual ADI.

MEIs, as currently designed, protect member control over the business of the mutual ADI. Equal participation is a fundamental feature of mutual associations and member-owned firms, and MEIs do not affect such participation because they carry no voting or other rights beyond a claim on surplus assets of the mutual ADI for face value.[6]

There is potential for an issuance of MEIs by a mutual ADI to be beneficial for its members. As the face value has been contributed to the capital of the mutual ADI, and a holder's claim on surplus assets is limited to face value, an MEI does not dilute the interests of members in the capital of the mutual. As a result of the cap on claims to surplus assets, the rights of MEI holders may actually be inferior to those of members. Members must benefit when their mutual ADI is able to raise capital with a lower cost than debt funding on inferior terms to member shares. As mutual ADIs cannot otherwise issue common equity, an issuance of MEIs would provide permanent capital of the highest quality in the capital structure. Regulatory oversight of individual issues would be preserved, as APRA approval would still be required for the issue terms of MEIs.[7] We submit that the MEI is a suitable instrument for improving the access of mutual ADIs to capital.

1.3 The issue of MEIs should not trigger demutualisation

The issuance of equity instruments by a mutual does in theory run counter to the purpose and objects of a mutual enterprise (as mentioned above in the section describing the Australian Mutual Group) and it follows that an issue of MEIs could lead to a demutualisation of a mutual ADI. In our view, however, the features of MEIs support mutuality and the issuance of MEIs by a mutual ADI should not trigger its demutualisation under Part 5 of Schedule 4 of the *Corporations Act*.

[3] Paragraph 19(b) of APS 111.
[4] Paragraph 2 of Attachment K to APS 111.
[5] At present, the notional price paid, being the aggregate face value of the Additional Tier 1 or Tier 2 Capital Instruments which converted into the relevant MEIs: paragraph 5(b) of Attachment K to APS 111.
[6] Paragraph 12 of Attachment K to APS 111.
[7] Paragraph 13(b) of Attachment K to APS 111.

As a result of the rights attached to MEIs, holders of MEIs support the success of mutual ADIs without compromising member control over decisions or undermining the services provided to members. The issuance of MEIs contributes capital with few conditions or restrictions. As MEIs do not carry the right to vote, each member continues to have an equal say in the conduct of the mutual ADI. Holders of MEIs do not participate in any surplus on a winding up beyond the nominal value of the MEIs, so holders have a limited interest in influencing a winding up. The discretionary nature of MEIs means that holders of MEIs may benefit from a mutual ADI operating profitably, but those distributions would be proportionate to the contribution of capital. Holders have limited scope for influencing the priorities and distribution policies of a mutual ADI without voting rights.

Demutualisation is triggered if any of the events in clause 29(1) of Schedule 4 occur (unless an exemption has been issued by the Australian Securities and Investments Commission ("**ASIC**") under clause 30(2)). This includes where there is a modification of the constitution of a mutual ADI that would have the effect of otherwise varying or cancelling rights so that Part 2F.2 (class rights) of the *Corporations Act* applies.[8]

If issuance of MEIs is not already permitted, the constitution of a mutual ADI may generally be amended to permit their issuance without varying the rights of existing members. This is because:

- the issue of MEIs does not affect the priority of existing members to receive dividends, as typically members are not entitled to receive dividends, and holders of other Tier 1 instruments are not subordinated to MEI holders;
- on a winding up of the mutual ADI, holders of MEIs are entitled to be paid an amount from any surplus assets after all debts, preferred entitlements, member shares and other Tier 1 capital instruments have been paid, but this amount is capped at the amount paid to subscribe for the host capital instrument.[9] As this subordinated right of repayment is limited to the capital which has been contributed in exchange for the MEIs, it should not be considered to vary the rights of members, because the right of members to the surplus is unchanged, as is the priority of members in a winding up. While equal participation with members may affect the commercial enjoyment of the members (by diluting the surplus assets available to be paid on member shares), the rights of members are not varied or cancelled;[10] and
- MEIs do not have voting rights, and therefore cannot impact the voting rights held by members.

It follows that amendments to a mutual ADI's constitution to permit the issuance of MEIs should not trigger demutualisation.

1.4 APS 111 should be amended to allow for direct issuance of MEIs

Despite the general suitability of MEIs for issuance by mutual ADIs, current APRA standards do not permit their direct issuance. Instead, MEIs may only be issued on conversion of

[8] Clause 29(1)(d) of Schedule 4.

[9] Presently, the face value of the Additional Tier 1 or Tier 2 Capital instruments prior to conversion. APS 111 may be amended accordingly.

[10] Case law that addresses the circumstances when a variation of members' rights will occur for purposes of constitutional or statutory requirements that require a class vote make it clear that the determination of whether or not there is a variation of rights depends upon an interpretation of the relevant terminology used in the constitutional or statutory provision. In this context, a variation of rights is generally considered to be a variation of the rights afforded to the member as a legal matter, not a change that might affect the commercial enjoyment of those rights (see *White v Bristol Airplane Co* [1953] Ch 65 and *Re John Smith's Tadcaster Brewery* [1953] Ch 308).

Additional Tier 1 Capital or Tier 2 Capital instruments.[11] We respectfully submit that this restriction should be lifted.

While a number of features are shared with Additional Tier 1 Capital and Tier 2 Capital, MEIs are a stronger form of capital. They provide a mutual ADI with Common Equity Tier 1 Capital, offering a permanent commitment of funds with ultimate loss absorption but without fixed distributions. As described in section 1.1 above, it is very difficult for mutual ADIs to build Common Equity Tier 1 Capital other than through the accumulation of earnings. Tier 2 Capital is less suitable due to the ongoing interest burden, while the issuance of Additional Tier 1 Capital with a conversion to MEIs is limited and is unnecessarily complex in circumstances where MEIs could be issued at the outset. It is also important for mutual ADIs to have similar funding options to the larger non-mutual banks, and allowing the direct issuance of MEIs means that mutual ADIs will be able to issue a form of capital which is similar to the ordinary shares which the larger banks can issue.

The developments in overseas jurisdictions covered in section 1.5 below demonstrate that raising capital through the issuance of equity instruments is not necessarily incompatible with the purpose and objects of mutual firms.

APS 111 would require only minimal amendment to enable MEIs to be issued directly. Given the existence of this instrument, which has already been subjected to considerable review and scrutiny by regulators and industry, it is appropriate that direct issuance be permitted (with certain modifications) in preference to the creation of another type of instrument (although we would also be in favour of other types of equity instruments being created for issuance by mutual ADIs).

We understand that APRA is currently consulting with industry on MEIs. In particular, APRA is aware of the interest in direct issuance and the consequential amendments that would be required. We look forward to the outcome of this consultation.

1.5 MEIs do have limitations, which may impact on their marketability

Notwithstanding the attractiveness of MEIs in a mutual ADI's capital structure outline above, they are not a perfect solution for access to capital. In particular, the features of MEIs that make them attractive to mutual ADIs are likely to impact on their attractiveness to prospective investors. Attachment K to APS 111, which sets out the main requirements of the terms of an MEI, provides limited flexibility to mutual ADIs on their terms.

For example, the claim of holders of MEIs to the surplus assets of a mutual ADI must be no more than the price paid for those interests (actual or notional) – that is, MEIs with equal rights to surplus assets cannot be issued. Despite this cap, the claims of MEI holders rank equally and proportionally with members' interests constituting Common Equity Tier 1 Capital, in circumstances where members' capital contributions (being the subscription price for member shares) have already been paid out as senior claims. It may be difficult to convince prospective investors to assume the high risk of MEIs with such limited potential reward, in the absence of a track record of dividend payments.

An MEI with proportional (uncapped) rights to surplus assets would not prevent the interest from being included in the Common Equity Tier 1 Capital of an institution, as such a feature would be consistent with ordinary share capital in a non-mutual institution. Although this

[11] Paragraph 2 of Attachment K to APS 111

would cause the MEI to have very similar rights to member shares, consideration should be given to whether such rights would trigger demutualisation.[12]

Similarly, MEIs carry no voting rights. Combined with the face value cap on claims to surplus assets, these features may lead prospective investors to "price in" the risk of having no legal control over their investment. This will result in interests being issued on less favourable terms, and may result in an unsuccessful issue due to a lack of investor interest.

Developments overseas demonstrate that MEIs are not the only possible design for capital issuance. The *Mutuals' Deferred Shares Act 2015* (UK) provides a framework for the creation and regulation of "deferred shares" to be issued by a friendly society or mutual insurer in the United Kingdom. These are instruments that would not be redeemable at the election of the holders, would be subordinated to creditors of the mutual, and confer at most one vote per holder (even if the holder is also a member).[13] These limitations can preserve the principles of equal control of member-owned mutual ADIs, while still facilitating participation in decisions concerning the business of the mutual ADI by those contributing valuable capital. The critical features of MEIs and mutual deferred shares may briefly be compared:

Mutual Equity Interests	**UK Mutual Deferred Shares**[14]
No voting rights	Only one vote per shareholder, with some restrictions (cannot vote to demutualise)
Distributions are discretionary and are broadly limited to surpluses	Distributions are discretionary, or (in the case of preference deferred shares) discretionary provided that distributions are paid to preference deferred shareholders ahead of non-shareholder members, and are broadly limited to surpluses
Holders have a claim on surplus assets capped at the nominal value of their MEIs	Ordinary deferred shareholders have a proportional claim on surplus assets, while preference deferred shareholders have a claim capped at the nominal value of their shares
In a winding up, holders rank equally and proportionally with members' interests, subject to the cap	In a winding up, holders of ordinary deferred shares rank equally with non-shareholder members, while holders of preference deferred shares rank ahead only of non-shareholder members and are subject to the cap

In Canada, legislation at provincial level provides for the capital structure of credit unions. In Ontario, the *Credit Unions and Caisses Populaires Act* provides for dividend-bearing membership shares, of which members may own more than one, as well as additional classes of shares which do not carry voting rights or rights to capital on dissolution.[15] In British Columbia, the *Credit Union Incorporation Act* provides for membership shares of which a maximum of 1000 may be issued to any member, as well as additional classes of shares, all

[12] We understand that it has been suggested that, as the claims of holders of MEIs are capped at the face value of the interests, holders should receive priority over members in respect of surplus assets. We note that such a proposal would appear to modify the rights of existing members, and therefore may not be possible without demutualisation.

[13] *Mutuals' Deferred Shares Act 2015* (UK) ss 1-2.

[14] N.B. we understand that consultation is ongoing and that the regulations to implement mutual deferred shares remain in draft form. See HM Treasury, "*Mutual deferred shares: consultation on technical policy details*" (August 2016) available at <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/543804/mutual_deferred_shares_consultation_august_2016.pdf>.

[15] Credit Unions and Caisses Populaires Act, 1994, S.O. 1994, c. 11, ss 51-53.1, as at 5 May 2017.

of which may receive dividends and a share of surplus assets on winding up, but each member has at most one vote.[16] In Manitoba, the *Credit Unions and Caisses Populaires Act* allows for each member to own more than one common share, on which dividends may be paid and which rank last in a winding up, and which carry no voting rights except as to certain resolutions affecting the rights of shareholders.[17] The Canadian federal *Bank Act* now includes provisions for federal credit unions which allow members to own more than one membership share (each of which may receive dividends and carries an equal right to surplus assets on dissolution), although membership shares may be redeemed.[18]

These legislative and regulatory developments show that the strength of the mutual association can be preserved while issuing equity interests with rights to capital, or allowing members to hold multiple dividend-bearing member shares or other instruments. Additional flexibility in the design of the MEI may be desirable. We submit that a mutually-owned ADI should be permitted to issue an MEI (or similar capital instrument) with equal residual rights to capital on a winding up as members, and with a single vote (per holder) at meetings (noting that providing for the issuance of such an instrument may trigger a demutualisation under the *Corporations Act* and so reform of the demutualisation provisions of the *Corporations Act* would need to be explored). This may increase the attractiveness (and hence improve the terms) of issues, as the rights attached to MEIs will then be closer to the rights attached to ordinary shares in banks and other corporations. Provided that a holder of multiple MEIs only has one vote, we do not consider it necessary to place any cap on the number of MEIs that may be held by an individual holder, as mutuality is preserved by equal participation in decision-making. The issuance of MEIs is not currently limited to existing members, and we do not consider it necessary to restrict issuance if only one vote is conferred on each MEI holder. No individual MEI holder would be able to wield a disproportionate influence over decisions of the mutual ADI, and the objects of a mutual ADI can be properly pursued in collaboration with passive investors contributing only capital.

1.6 Attachment K to APS 111 should be reviewed and amended in consultation with APRA

Although we believe that the MEI is generally a suitable capital instrument for mutual ADIs, we believe that the requirements for MEIs in Attachment K to APS 111 would benefit from clarification. This submission does not suggest amendments to the relevant requirements but we would be happy to suggest amendments as part of the ongoing consultations with APRA.

One of our members has for the last two years been consulting with APRA in relation to its proposal to issue Additional Tier 1 Capital instruments (convertible to MEIs at the point of non-viability). We believe that APRA's approval should be given soon, as there are only a small number of non-substantive issues left to be resolved. During this consultation with APRA, particularly with respect to the proposed terms of the MEIs ("**Proposed Terms**"), the following key issues with Attachment K to APS 111 have been identified:

- Paragraph 4 of Attachment K requires MEIs to rank equally and proportionately with "members' interests forming part of the issuer's Common Equity Tier 1 Capital (if any)". Paragraph 6 of Attachment K makes it clear that (1) retained earnings and undistributed current year earnings are not members' interests, (2) although member shares are members' interests, they do not form part of Common Equity Tier 1 Capital and (3) investor shares issued under ASIC's *Regulatory Guide 147* are members' interests forming part of Common Equity Tier 1 Capital where those investor shares meet the requirements of Attachment B to APS 111 (criteria for classification as ordinary shares). As mutual ADIs do not issue investor shares which satisfy Attachment B to APS 111 and

[16] Credit Union Incorporation Act, RSBC 1996, c. 82, ss 36.1, 44, 55.1, 70, as at 26 April 2017.
[17] The Credit Unions and Caisses Populaires Act, 1986, C.C.S.M., c. C301, ss 23, 25, 31, 35, as at 9 May 2017.
[18] Bank Act, S.C. 1991, c. 46, s 79.1.

do not issue any other instruments that would meet these requirements, there are in fact no members' interests which MEIs would rank equally with. The provisions in paragraphs 4 and 6 are generally very technical, and settling the Proposed Terms with APRA so as to satisfy these paragraphs has taken a considerable amount of time and a number of revisions.

- Paragraph 5 provides that a holder of MEIs is entitled to a claim on residual assets proportional to its share of the sum of (i) the aggregate notional price paid for all MEIs and (ii) the aggregate subscription price paid for all other members' interests (whether or not forming part of the issuer's Common Equity Tier 1 Capital), subject to (a) all senior claims having been satisfied first and (b) a cap equal to the aggregate nominal value of the host capital instrument prior to its conversion into MEIs. The intention of paragraph 5 appears to be that, after members' share capital is repaid and any other senior claims are satisfied, holders of MEIs can recover the notional price of those interests from surplus assets (subject to the cap), but we believe this could be made clearer, given the number of issues raised by APRA on the Proposed Terms. Particular issues identified in relation to paragraph 5 are as follows:
  - how to determine the proportion of surplus assets holders of MEIs are entitled to and ensure that the issuance of MEIs does not trigger a demutualisation, given that the Constitutions of mutual ADIs generally provide for surplus assets to be divided between members;
  - it is difficult to calculate the relevant proportions where there is no consideration attached to member shares, and this proportionality may be unfair to holders of MEIs when any consideration attached to member shares has by this stage already been paid out;
  - which members' interests are to be included in calculating the share of an MEI holder – ultimately we have included member shares only, although paragraph 5 together with paragraph 6 suggests that investor shares which satisfy Attachment B of APS 111 ought to be included in that calculation (they have not been included in any event because mutual ADIs do not issue them); and
  - what are "residual assets" – we have used the term "surplus assets" in the Proposed Terms.

We understand that APRA is considering these and other paragraphs of Attachment K and is seeking to address these issues. We have included a copy of the Proposed Terms in Appendix 2 showing where the requirements of Attachment K (and the relevant requirements of Attachment B) are satisfied, for your information.

1.7 Disclosure requirements need to be clarified with ASIC

An offering of MEIs to retail investors would require the mutual ADI to comply with the disclosure requirements in Part 6D.2 of the *Corporations Act*. As mutual ADIs are often based in regional areas and are raising only small amounts, it is important for them to be able to raise capital from retail investors in their local communities.

Although the requirements of Part 6D.2 of the *Corporations Act* are clear to us, and permit, for example, the offering of capital instruments (and the MEIs into which they may convert) via an "offer information statement",[19] we understand that ASIC may not be amenable to the use of an offer information statement for offerings of these types of instruments. If ASIC does not allow mutual ADIs to offer these types of instruments via short form disclosure documents

[19] Where certain requirements are satisfied, the principal requirement being that the issuer must not raise more than $10 million (in total, across all issues by the issuer) using an offer information statement: *Corporations Act 2001* (Cth) s 709(4).

(where technically permitted under Part 6D.2), the preparation of a full prospectus would be the only alternative. The production of a full prospectus comes at a very high cost which is disproportionate to the relatively small amounts of capital which mutual ADIs are often seeking to raise.

In small retail offers where the *Corporations Act* permits the use of an offer information statement, investors are often members of the mutual ADI who are familiar with its business, and are investing small amounts. The business and risks of a small mutual ADI are well understood, and a decision to invest is not likely to be based on the additional information included in a prospectus. A balance needs to be found between providing adequate disclosure to prospective investors and ensuring that the cost of an issue does not become prohibitive for mutual ADIs.

1.8 Tax debt / equity rules require amendment

An issue with the debt/equity rules in Division 974 of the *Income Tax Assessment Act 1997* (Cth) ("**ITAA 1997**") has been identified in relation to Tier 2 Capital instruments convertible to MEIs and we understand that the Customer-Owned Banking Association ("**COBA**") has, together with our legal advisers, King & Wood Mallesons ("**KWM**"), made submissions to Treasury in relation to the amendments which COBA and KWM believe are required. The following paragraphs are included to ensure that the Independent Facilitator is also aware of this issue, because it constitutes another barrier to raising capital.

The legal characterisation of a particular interest in an entity as either debt or equity can determine the tax treatment of a return on that interest or instrument. Generally speaking, returns on debt interests are deductible but not frankable while returns on equity instruments are frankable but not deductible.

The debt/equity rules in Division 974 of the ITAA 1997 establish a regime for determining whether a particular interest constitutes a debt or equity instrument.

One of the defining features of a debt interest as established in section 974-20 of the ITAA 1997 is the existence of "an effectively non-contingent obligation ("**ENCO**") to provide a financial benefit." An ENCO is defined in section 974-135. Regulations 974-135A through F provide further guidance in relation to the application of section 974-135 to specific interests including Tier 2 Capital instruments.

Since the existence of a non-viability trigger event (which is required to be included in a complying Tier 2 Capital instrument) can arguably prevent that instrument from qualifying as a debt instrument on the basis that the existence of the non-viability provision causes a return on the instrument to cease being "effectively non-contingent", a new Regulation 974-135F was made in 2012.[20]

Regulation 974-135F relevantly provides that an obligation to pay the principal or interest on a "term subordinated note" (as defined in the regulation and which definition most Tier 2 Capital instruments would satisfy) does not cease to be effectively non-contingent merely because it is subject to a "non-viability condition". A "non-viability condition" is a condition that has the effect that:

> *the note must be written off or converted into ordinary shares of the issuer of the note or a parent entity of the issuer if a non-viability trigger event occurs.*

Regulation 974-135F can only apply where the non-viability provision results in a conversion into "ordinary shares" rather than any other form of interest, such as an MEI. We understand that the Australian Tax Office is unable to consider that an MEI designed in accordance with

[20] *Income Tax Assessment Amendment Regulation 2012 (No. 2)* (Cth) SLI 2012 No. 310 F2012L02398.

the relevant criteria in APS 111 would fall within the meaning of the term "ordinary shares" for the purposes of Regulation 974-135F since such MEIs lack features ordinarily associated with ordinary shares such as voting rights.

As mentioned above, submissions have been made to Treasury to have Regulation 974-135F changed to include a reference to MEIs, given that there are no sound policy reasons for conferring more favourable tax treatment (i.e. the ability to deduct interest payments) on banks which issue Tier 2 Capital instruments compared to mutual ADIs which issue the same instruments.

2 A simplification of the APRA and ASIC processes for approval of capital instruments would improve the access of mutual ADIs to capital

Australian mutual ADIs vary in size and geographical reach. Some have as few as 1,700 members and $12 million in assets under management.[21] Small mutual ADIs serve local communities which would not otherwise have access to bank branches and customers who through irregular income or narrow credit history might not otherwise be offered loans by major banks. As a result of their limited scale, it is all the more important that small mutual ADIs have access to cost-effective capital to enable them to manage their capital structure and make investments to remain competitive.

The current regulatory regime for the issuance of regulatory capital instruments (including MEIs) is disproportionately burdensome for small mutual ADIs. The process of seeking approvals for an issue (including disclosure documents) and constitution amendments can take months or even years. The cost of this lengthy process is too great for mutual ADIs and has a disproportionate adverse impact on their businesses.

Whilst we understand that APRA and ASIC must have oversight to ensure that regulatory capital and disclosure requirements are met, the delays and costs associated with the approval processes have over the last five to ten years been considerable and there is no doubt that these delays and costs have contributed to the difficulties which mutual ADIs face in accessing capital.

A number of factors contribute to these delays and costs. As terms of instruments require APRA approval, constitutions require amendment and the APRA requirements in relation to MEIs are still largely untested, the documentation process is more complex as compared with the process for the larger non-mutual banks. As mentioned in section 1.6, interpretation of Attachment K to APS 111 has been challenging. Similarly, uncertainty as to regulator requirements for disclosures has led to delays.[22]

Delays also result from the number of parties required to be involved in the process, as legal and accounting opinions to APRA's satisfaction are required, and lawyers are also required to assist with preparing and revising documents in response to APRA comments.

The cost of issuance is plainly a concern both to issuers and to regulators. It is undesirable that the issue of high quality capital be significantly more expensive and time consuming than issuing Tier 2 capital or senior debt. In the HM Treasury consultation paper on mutual deferred shares, industry estimates on the cost of mutual deferred share issues were disclosed as being £100,000, with large mutuals expected to raise £70-100 million for a net cost of approximately 0.1%.[23]

[21] Gympie Credit Union.

[22] Please see section 1.7 above.

[23] HM Treasury, "Mutual deferred shares: consultation on technical policy details" (August 2016) available at <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/543804/mutual_deferred_shares_consultation_august_2016.pdf> at [3.3].

In our experience, that estimate would fall short of the cost of an initial issue of Additional Tier 1 Capital instruments converting to MEIs, after professional opinions and APRA and ASIC approvals are obtained (assuming a retail issue). As mutual ADIs tend to have smaller internal regulatory teams as compared to banks, the costs associated with the use of external advisors is typically material. Further, the amount raised by a mutual ADI is likely to be considerably lower than the suggested raisings by large UK mutual associations, and as a result the costs may materially impact the choice of capital.

For small mutual ADIs seeking to raise less than $10 million, the costs may be disproportionate to the point of rendering the capital raising unviable. We would suggest that such a raising would be feasible if costs were approximately $100,000, but that would require a significant reduction in current costs. A special purpose disclosure regime for mutual ADIs might be appropriate, given that their activities are confined by their constitutions and the industry is relatively well understood. Such a regime could be designed to minimise the information which must be manually prepared. However, there is a risk that introducing an additional disclosure regime will simply make mutual ADIs more reliant on external advisers. If MEIs are infeasible, a smaller mutual ADI will be forced to rely on lower quality capital. While an offer information statement will save some costs over a prospectus,[24] the lifetime limit of $10 million for issuances under an offer information statement limits the long-term usefulness of this option (assuming that ASIC will even permit an offer information statement to be used).

Innovative models have emerged to defray these costs. In 2006, a group of 21 mutual ADIs (including many from the AMG) collaborated to collectively issue regulatory capital through a special purpose vehicle, in a project co-ordinated by ABN AMRO and CUNA Mutual Group's Australian subsidiary. Under this model, each mutual ADI issued regulatory capital to the special purpose vehicle, which in turn issued instruments with corresponding terms to investors. The CUNA Mutual issue achieved substantial cost savings for the individual credit unions taking part, and gave them access to capital which might not have been issued individually due to the prohibitive costs. This approach has since been repeated (a similar structure was used by a group of mutual ADIs to issue Lower Tier 2 capital subordinated notes in 2012) and it is currently the most viable option for capital raisings by small mutual ADIs.

Although cooperative issues may be the only viable option for smaller mutual ADIs, they are not a complete solution. While substantial costs are saved, the time to issue may actually be greater due to the number of issuers involved and the added complexity of the special purpose vehicle. This approach is also relatively inflexible: in particular, a sufficient number of mutual ADIs must be ready to issue at the same time. If instruments are later redeemed, the redemption process can be difficult.

Ultimately, an easier and more efficient regulatory approval process would improve access to capital for mutual ADIs, and costs will be reduced once the industry gains experience with MEIs. We appreciate APRA's current consideration of potential amendments to Attachment K to APS 111.

Insertion of a definition of "mutual enterprise" into the Corporations Act

We understand that the Independent Facilitator is considering the insertion of a definition of "mutual enterprise" into the Corporations Act in the context of direct issuance of MEIs, in response to a concern raised by APRA that if direct issuance of MEIs is permitted, it must be clear that MEIs may only be issued by mutual ADIs. We agree that the issuance of MEIs should be restricted to mutual ADIs and we consider that, should the concept of a mutual enterprise be introduced into the Corporations Act, it would provide an opportunity for a tailored short form disclosure regime to be

[24] Provided it is acceptable to ASIC. Please see also our comments in section 1.7 above.

introduced into Part 6D of the Corporations Act (for the issuance of capital instruments and MEIs by mutual ADIs). We would be very supportive of the introduction of such a regime.

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In order to improve the access of mutual ADIs to capital, both the design of suitable capital instruments and the cost of their issuance must be carefully considered. Mutual ADIs should have access to high quality, permanent capital to maintain their strong capital position. We welcome consideration of legislative and regulatory change to achieve this goal.

We thank the Independent Facilitator for the opportunity to make this submission, and we would be pleased to take part in discussions to further share our experiences.

Yours sincerely

Dave Taylor
on behalf of the Australian Mutual Group

Appendix 1

The following mutual ADIs of the Australian Mutual Group thank the Independent Facilitator for the opportunity to make this submission.

- Bank Australia Limited (formerly bankmecu)
- Community Mutual Limited (trading as Regional Australia Bank)
- Credit Union Australia Limited
- EECU Limited (trading as Nexus Mutual)
- Ford Co-operative Credit Society Limited
- G & C Mutual Bank Limited
- Teachers Mutual Bank Limited (trading as Firefighters Mutual Bank, Teachers Mutual Bank and UniBank)
- Unity Bank Limited
- Victoria Teachers Limited (trading as Victoria Teachers Mutual Bank)
- Warwick Credit Union Limited

Appendix 2: Proposed MEI Terms

Please see attached