Bank Australia

RESPONSIBLE BANKING

CASE STUDY: Growth and access to capital

Submission to reforms for cooperatives, mutuals and member-owned firms

19 May 2017

About Bank Australia

Bank Australia is a different kind of bank. We are a customer owned responsible bank, driven by the purpose of creating mutual prosperity for our customers, the community and the environment.

While making a profit is important, we believe the business of banking should serve people and that money should also be put to good use by creating a positive social, environmental and cultural impact.

We are 100% owned by customers and we are 100% Australian based. This allows us to put profits back into creating jobs in Australia, providing better rates and lower fees for our customers while investing in projects that have meaningful, positive impacts through the Bank Australia Impact Fund.

Being owned by our customers means we act only in their long term best interests. We respect their views, which is why our customers each have an equal say in how we go about our business.

We changed our name to Bank Australia in 2015 but customers have been banking with us since 1957 and today over 130,000 people and community sector organisations choose to bank with us.

Our submission

The joint communique by the Business Council of Co-operatives and Mutuals (BCCM) and the Customer Owned Banking Association (COBA) discusses the technical and policy rationale for enabling access to Common Equity Tier 1 capital. As a member of both BCCM and COBA, Bank Australia supports the arguments put forward in the joint communique, a copy of which is appended to this submission.

As the joint communique states:

> *'The structure of co-operatives and mutuals means there are fewer capital raising options than investor owned companies. Capital options need to be consistent with their member-owned business model and which enhance their competitive capacity.*
>
> *Issuing ordinary shares like a listed company would undermine their mutual status and their commitment to serving their member-owners.*
>
> *Alternative structures for raising capital are necessary, and will require regulatory or legislative action.'*

The opportunity for reform is not a binary choice between regulatory or legislative action and we urge the review to support both of the Senate Inquiry's recommendations to enable cooperatives and mutuals to enjoy maximum flexibility in raising additional working capital.

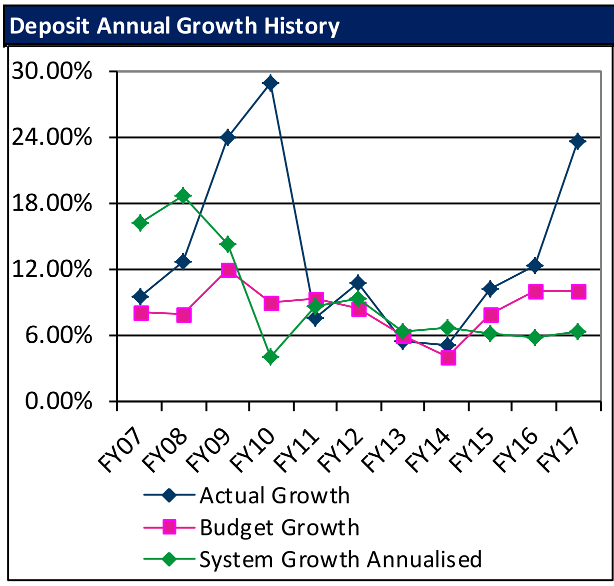
The focus of Bank Australia's submission is to illustrate the impacts that the lack of access to capital has in a practical sense on the ability of customer owned banks to grow and provide a greater level of competition to the major banks.

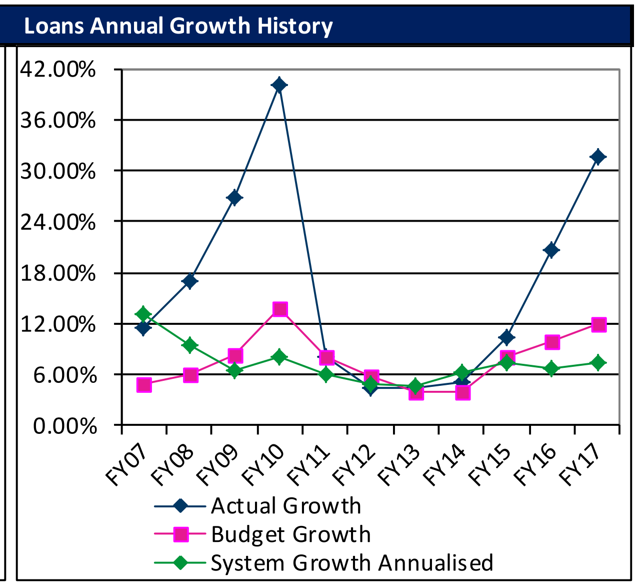
Realising the opportunity for growth

At a time when the banking sector is experiencing a trust deficit, customer owned banks can provide a viable alternative for consumers. The customer owned model provides inherent protections for customers, and guards against some of the issues driving consumer dissatisfaction of the wider banking sector. Every decision made by Bank Australia must balance equitably the needs of depositors and borrowers who are all owners of the bank, not only prioritise the short term interests of external investors.

In recent years Bank Australia has actively pursued and experienced a significant level of growth in its assets as more consumers seek alternatives to the major, investor owned banks. We seek to grow, not for growth's sake, but to increase the positive impact we can have on the prosperity of our customers and to address the societal and environmental issues that they care about.

In the 12 months to 31 December 2016, Bank Australia's assets grew by $560 million to $4.3 billion, with loans growing by 21.14% and deposits by 17.07%. It is expected that assets will grow to beyond $5 billion by the end of the 2017 financial year.





Note: FY17 based on actual reported growth at April 2017 annualised.

This growth has not come at the cost of sacrificing our responsible banking principles, or lowering our credit assessment standards. Proof of this is demonstrated through the bank's delinquency rate which has fallen by 37.5% to 0.13% and write offs for bad and doubtful debts has reduced by 71.3% to $207,000 in comparison to half-year ended 31 December 2015.

At its strategic planning session in April 2017, Bank Australia's board set an ambitious target to grow to $20 billion in assets by 2025.

Whilst we believe our customer proposition and consumer demand can support this level of growth in assets, Bank Australia forecasts that without access to additional external capital, we will hit a growth ceiling at $13 billion in assets in that time frame. The ability to issue both Tier 2 and Tier 1 capital is key in Bank Australia reaching its potential and having the scope and confidence to invest in initiatives that support this growth such as technology and capability.

Without access to other means of raising capital, our ability to continue to grow and provide increased competition in the banking sector is constrained. Bank Australia is a fast growing and viable business that will soon experience the constraints imposed by the lack of access to capital.

As a values based bank, serving the real economy and with a truly customer centric business model there are no plans to demutualise in order to access capital markets via a listing on the Australian Stock Exchange. There is sufficient evidence regarding the trust gap in banking to prefer the current mutual ownership model but with a modernised framework via legislative and regulatory change to access alternate and diverse forms of external capital in order to support responsible investment and growth.

Those mutual banks that have “normalised” their businesses via a demutualisation and listing on a stock exchange either no longer exist in their own right today (having been acquired by larger banks) or the few who remain have not evidenced breakthrough strategies that create additional value for owners/shareholders by simply being listed entities.

Investment example: Growing regional jobs

Bank Australia is a significant employer in regional Victoria, with the majority of its customer service and lending operations based in regional areas. We currently employ 140 people in Victoria’s Latrobe Valley, an area currently experiencing the challenges of a transitioning economy as illustrated by the recent closure of the Hazelwood power station and coal mine.

To service the current and future growth we expect to achieve, expansion of our customer service operations is critical, with a strong preference to see regional areas benefit from this growth. For example, Bank Australia has engaged KPMG to conduct a feasibility study to assess the options for expansion in the Latrobe Valley, potentially creating up to 160 new jobs in the region by 2025.

This expansion will enable Bank Australia to provide 24/7 customer care through modernised customer service and lending operations. The flow on benefits to the region include increased employment in the area, which translates into a further $10 million per annum of income for the local economy.

The required investment to achieve this expansion including the development of a new campus style premises that would also house community organisations has been forecast by KPMG to be $23.9 million, equating to approximately 5.4% of the total customer owned reserves (capital) of $443.62 million as at 31 December 2016.

Again while the business case and the bank’s strategic direction supports this investment, a decision to significantly reduce the bank’s currently available capital to expand our presence in Gippsland and create jobs needs to be balanced against the compliance implications of being capital constrained and the need to make other investments to support growth such as technology.

Conclusion

This submission has sought to demonstrate that the ability for Bank Australia to invest in capability for growth and to secure a larger asset portfolio is constrained by the current lack of readily accessible capital due to the bank’s ownership structure. The bank’s ownership structure is core to its values based approach to responsible banking and its competitive advantage.

Providing genuine, viable, and strong alternatives to consumers is critical to increasing competition, diversity and resilience in the banking sector and in the economy more broadly. Customer owned banks can provide that alternative should the regulatory and legislative landscape enable a true level playing field.

JOINT BRIEFING NOTE BCCM/COBA

Raising Capital in Co-operatives and Mutuals

Overview
Mutuals and co-operatives are a strong component of the Australian economy. In an increasingly competitive business environment they need adequate access to capital to fund their growth and development.

The structure of co-operatives and mutuals means there are fewer capital raising options than investor owned companies. Capital options need to be consistent with their member-owned business model and which enhance their competitive capacity.

Issuing ordinary shares like a listed company would undermine their mutual status and their commitment to serving their member-owners.

Alternative structures for raising capital are necessary, and will require regulatory or legislative action. BCCM and COBA believe the Federal Government and regulators should act with greater urgency to increase the capital raising options for these firms and BCCM and COBA are working together to achieve this outcome.

The Senate Economic References Committee Inquiry
The Senate Economic References Committee agreed with the above view and recommended that mutuals and co-operatives should have more options to raise capital.

Two recommendations from the inquiry specifically addressed this issue, being:

> ***Recommendation 16***
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> *The committee recommends that APRA set a target date for the outcome of discussions with the co-operative and mutuals sector on issues of capital raising and bring those discussions to a timely conclusion.*
>
> ***Recommendation 17***
>
> *The committee recommends that the Commonwealth Government examine proposals to amend the Corporations Act 2001 to provide co-operative and mutual enterprises with a mechanism to enable them access to a broader range of capital raising and investment opportunities.*

Recommendation 16 is specifically concerned with regulatory capital (i.e. capital instruments that qualify as regulatory capital within APRA's prudential framework) for APRA regulated entities such as mutual ADIs.

Recommendation 17 requires legislation for an entirely new Mutual Capital Instrument (MCI) designed to be used as working capital, that any Federally registered mutual may issue.

A summary of what these two recommendations mean

1. Implementing Rec 16: CET1 instruments for mutual ADIs

Mutual ADIs are permitted under APRA's prudential standards to issue capital instruments that qualify as Additional Tier 1 (equity) or Tier 2 (debt) but are not currently permitted by APRA to directly issue the highest quality capital instruments, Common Equity Tier 1 (CET1).

The mutual sector is discussing with APRA some amendments to the prudential standards to allow mutual ADIs to directly issue CET1 instruments.

The potential basis for a mutual ADI CET1 instrument already exists in the prudential framework: the Mutual Equity Interest (MEI) concept (see Attachment K, APS 111). The MEI concept has been part of the prudential framework since 2014 and is consistent with principles of mutuality set out in ASIC Regulatory Guide 147 *Mutuality: Financial institutions.*

MEIs can currently only be created if a mutual ADI issuing Additional Tier 1 or Tier 2 capital experiences a 'trigger event' (e.g. APRA declaring the ADI non-viable) that causes the AT1/T2 security to convert to an MEI.

However, the proposal is to amend the prudential standards to allow mutual ADIs to **directly issue MEIs**, with some modifications to the existing MEI definition to make it more consistent with Regulatory Guide 147.

Mutual ADIs are public companies under the *Corporations Act 2001* and already have capacity under the Act to issue equity and debt instruments, depending on their individual constitutions. Some mutual ADIs issued equity instruments that qualified as regulatory capital prior to APRA's changes to the prudential framework in 2012.

Our objective, under this Recommendation, is to maximise flexibility for mutual ADIs to directly issue CET1 instruments to retail or wholesale investor markets in accordance with their own governance and strategic objectives. This proposal requires amendment of the APRA prudential standards but does not require legislative change.

2. Implementing Recommendation 17: Mutual Capital Instrument (MCI) to apply to all Federally registered mutuals

The intention of this proposal is to permit **all** mutuals or co-operatives federally registered under the Corporations Act, to issue a capital instrument that may be used to raise additional working capital for business development and growth. Such an instrument could be created through an amendment to the Corporations Act 2001. It will be available as an option that mutuals registered as companies limited by shares, limited by guarantee, and limited by shares or guarantee could issue.

The MCI will be an 'equity like' security in that will be permanent, loss absorbing, investment capital. It would have certain minimum characteristics (e.g. rank behind all creditors) but that each mutual would be able to determine other features to suit their business. This will enable APRA regulated mutuals to design terms that will qualify MCI as CET1 and others to be more flexible in their approach.

The new capital instrument will mirror similar provisions that exist in Canada, UK and the Netherlands, bringing Australian law into line with these jurisdictions. MCI will retain features consistent with the mutual purpose of such a business by limiting voting rights, to ensure that member control is maintained.

A collective effort

BCCM and COBA are working together to achieve positive outcomes for the sector and are committed to collaborating on the initiatives, sharing skills and information and to supporting all of the Senate Inquiry recommendations equally.

BCCM and COBA believe it is important to pursue the legislative and regulatory outcomes concurrently and are working together to this end. COBA is a member of BCCM's capital project as a funding partner to strengthen collaboration on this important work. BCCM and COBA are committed to working closely together on the Hammond Inquiry to ensure we maximise the opportunity provided by this review.

BCCM and COBA are committed to a growing and thriving co-operative and mutual sector, to narrowing the regulatory gaps between our members and investor-owned firms, and to championing the benefits for Australia of a strong co-operative and mutual sector.

May 2017