COBA submission to the Review of Reforms for Cooperatives, Mutuals & Member-owned firms

19 May 2017

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Executive Summary

COBA appreciates the opportunity to provide this submission on barriers which impede our members from accessing capital and on the pros and cons of inserting a definition of 'mutual enterprise' into the *Corporations Act 2001.*

We speak on behalf of our member banking institutions but as part of the wider cooperatives and mutual sector, and as a member of the Business Council of Co-operatives and Mutuals, we support measures to help all of our peer enterprises to grow and thrive.

As prudentially-regulated entities, our members' focus in relation to accessing capital is on regulatory capital, i.e. capital that qualifies as regulatory capital for the purposes of APRA's regulatory regime.

Customer owned banking institutions are confronted with regulatory and legislative barriers to accessing regulatory capital. These barriers must be removed to enable customer owned banking institutions to:

- increase their rate of growth
- take opportunities
- compete more effectively, and
- increase their investment in technology.

Other barriers to accessing capital that are not in scope of this review are the constitutions of individual entities and practical issues such as marketability of instruments.

COBA seeks the removal of the barriers identified below as soon as possible but we recognise that removal of some barriers is more easily and more quickly achieved. More fundamental and enduring reform, such as defining a mutual enterprise in the Corporations Act, is a more complex challenge requiring agreement across diverse stakeholders. We urge the review to support removal of all barriers but to take care that its recommendations do not unnecessarily delay progress on work that is already underway, such as allowing direct issuance of CET1 instruments for COBA members.

Direct issuance of CET1

Customer owned banking institutions are not permitted under APRA's prudential framework to directly issue capital instruments that qualify as the highest quality form of regulatory capital: Common Equity Tier 1 (CET1). The only directly-issuable capital instruments that qualify as CET1 are 'ordinary shares'. Customer owned banking institutions cannot issue ordinary shares without demutualising.

APRA recently publicly confirmed it is "working to develop a suitable framework for issuance of CET1 capital instruments by mutually-owned ADIs, which would meet APRA's prudential expectations for the highest quality of capital. If viable, this may enable mutual ADIs to raise equity directly and enhance their capital management flexibility, which was also a recommendation of the Senate Economics References Committee's report *Cooperative, mutual and member-owned firms*. This work is expected to progress to formal industry consultation around the middle of 2017."[1]

COBA is proposing to APRA a number of modifications to Prudential Standard APS 111 *Capital Adequacy: Measurement of Capital* to allow for direct issuance of Mutual Equity Interests (MEI) and streamlining of the existing MEI concept.

[1] http://www.apra.gov.au/Insight/Pages/insight-issue1-2017.html

Recommendation 1: That the review encourages APRA to continue to give priority to amending its prudential standards to allow mutual ADIs to directly issue CET1 instruments, recognising the need for these instruments to be simple and marketable, and that ASIC is supportive and facilitative of this process.

Tier 2 conversion instruments

Tier 2 capital instruments that convert into MEI in a trigger event are not treated as debt because the MEI concept is not accommodated in tax regulations that apply to Tier 2 instruments that convert into ordinary shares. The lack of recognition of MEI in the relevant tax regulations means that it is not viable for customer owned banking institutions to issue Tier 2 instruments that convert into MEIs.

The tax regulations need to be amended to accommodate MEI. COBA has raised this issue with Treasury and with the office of the Minister for Revenue and Financial Services.

Recommendation 2: That the review supports prompt amendment of tax regulations to accommodate MEI.

Uncertainty about Part 5 'Demutualisation' provisions

Under Part 5 of Schedule 4 of the Corporations Act, any issue of shares by a customer owned banking institution potentially creates the risk that ASIC will deem the share issue is a demutualisation of the company. ASIC has the power to rule that a share issue is not a demutualisation but entities can't be absolutely certain of ASIC's view on any particular proposal.

ASIC's view on the MEI concept and the demutualisation provisions is set out in its 15 April 2014 letter to COBA (attached). Although this letter provides comfort that ASIC considers that MEI are consistent with the tests of mutuality in ASIC Regulatory Guide 147 *Mutuality – Financial institutions* (RG 147), uncertainty remains for individual entities and particular proposals.

More clarity and certainty is needed for customer owned banking institutions that issuing MEIs will not trigger the demutualisation provisions.

This could be achieved by:

- ASIC adopting a more explicitly supportive approach to customer owned banking institutions wishing to issue capital instruments that are consistent with the mutuality tests in RG 147, or
- legislative changes to reduce ASIC's discretion and provide greater certainty.

COBA has been generally supportive of the mutuality tests in RG 147 but it is now time for a debate within our sector and the wider mutual and co-operatives sector about the features that are the essence of mutuality.

Agreement on the key features of mutuality will allow for a definition of mutuality to be inserted into the Corporations Act and this is a highly desirable objective.

A definition of mutuality within the Corporations Act will:

- provide clarity for stakeholders, including regulators, to distinguish mutual companies from investor-owned companies (e.g. for the purposes of regimes such as taxation, financial services regulation and prudential regulation)
- provide capacity to adapt other elements of the Corporations Act, e.g. directors' duties, to the mutual model
- improve capacity to promote the distinct identity, size, scope and contribution of the mutual sector, and
- give 'transferring financial institutions' more certainty about the 'demutualisation' provisions in the existing Part 5 of Schedule 4 of the Corporations Act.

Recommendation 3: That the review recommends that the Government agree in-principle to insert a definition of mutual enterprise in the Corporations Act and that this definition be determined in consultation with the mutual sector.

Regulator processes

COBA members have experienced unacceptable delays in obtaining decisions from regulators about proposals to issue regulatory capital instruments.

This failure of process is a barrier to accessing capital because of the cost in terms of legal and tax advice and the diversion of internal resources over unreasonably lengthy periods.

Recommendation 4: That the review recommends that the Government introduces, through service charters or Statement of Expectations, the following requirements on regulators:

- **minimum service standards relating to capital instrument approvals, including timelines for feedback and a 'no suprises' policy, and**
- **accountability mechanisms for these standards.**

Future barriers

COBA is confident this review will help remove the barriers cited above but new barriers may emerge as the regulatory framework is changed in future. To address this, COBA believes the Government must take steps to improve regulators' consideration of how their regulations impact on the mutual model.

This should take the form of a corporate diversity clause in regulator mandates which requires relevant regulators (APRA and ASIC) to consider and briefly outline the impacts of their regulatory decisions on mutuals.

Such a requirement does not suggest that regulators do not currently consider the mutual model, however, such consideration should be institutionalised and considered to be 'part of the job'.

Recommendation 5: That the review recommends that the Government introduces a corporate diversity clause into regulator mandates to ensure that ASIC and APRA explicitly consider the mutual structure when developing regulation. This clause should include an accountability mechanism that requires regulators to assess and report if there are any different impacts on mutual ADIs (including if there are none).

About the Customer Owned Banking Sector

The customer owned banking sector comprises 19 mutual banks, 57 credit unions and four building societies. Mutual banks are former credit unions and building societies that have obtained APRA's permission to rebrand as banks.

Australia's mutual banks, credit unions and building societies provide a genuinely consumer focused way of banking. We bring a fundamentally different model to the market, a model where customer interests always comes first.

Customer-owned banking is distinguished by:

- prioritising customer benefit over profit maximisation
- conservative business models and prudent risk management, and
- a deep community engagement and strong customer loyalty.

The Financial System Inquiry (FSI) found that: "To build confidence and trust in the financial system, firms need to take steps to create a culture that focuses on consumer interests." The FSI specifically recommended that the interests of financial firms should be aligned with those of consumers.

The customer owned model achieves this alignment and this is reflected in the sector's market-leading customer satisfaction ratings, highly competitive pricing and community focus.

Customer owned banking institutions are:

- public companies incorporated under the Corporations Act
  - limited by shares, or
  - limited by shares and guarantee
- Authorised Deposit-taking Institutions regulated by APRA under the Banking Act 1959
- AFS licensees and credit licensees regulated by ASIC under the Corporations Act and the national credit legislation.

Customer owned banking institutions are liable for company tax and in the year to December 2016 they paid company tax of $183 million on profit before tax of $669 million.[2]

The customer owned banking sector has total assets of $104 billion and total equity of $8.2 billion. This equity is mainly in the form of retained earnings built up over time.

Incorporation

Before 1 July 1999 credit unions and building societies were registered and regulated under the respective Financial Institutions Code of each State and Territory. On 1 July 1999 the registration and regulation of these financial institutions were transferred to the then Corporations Law. These financial institutions are referred to as "transferring financial institutions" in Schedule 4 to the Act.

Registration under the Corporations Act meant that credit unions and building societies changed their corporate form into one limited by:

- shares
- guarantee, or
- shares and guarantee.

[2] APRA Quarterly ADI Performance statistics, December 2016

Company structure of customer owned banking institutions[3]

	No.
Company limited by shares	72
Company limited by shares & guarantee	8
Company limited by guarantee	0

Member shares

When a person becomes a member of a credit union, or a mutual bank that was formerly a credit union, a member share is issued to that person for a nominal price, and the member share entitles the person to use the services of the credit union and generally to vote on member resolutions. Member shares are withdrawable upon cessation of a person's membership of a credit union, in which case the nominal price paid for the member share is generally repaid.

A "member share" for the purposes of the Act has the characteristics set out in subregulation 12.8.03(2) of the *Corporations Regulations 2001*, namely:

(a) it is not an "enhanced disclosure" security; and

(b) it has a fixed value; and

(c) it is held by a single person, or 2 or more persons jointly; and

(d) it entitles the holder, or joint holders, to use services provided by the financial institution; and

(e) it is not transferable or transmissible, or is only transferable or transmissible to a person or body specified in the rules or constitution of the financial institution in circumstances stated in the rules or constitution.

Member shares do not qualify as regulatory capital because they do not have the loss absorbency characteristics required under APRA's prudential standards.

Mutuality

As part of the transfer of credit unions and building societies to the then 'Corporations Law', it was considered desirable to carry over into the new framework some aspects of the State-based framework regarding demutualisation.

Part 5 of Schedule 4 of the Corporations Act, sets out:

- comprehensive disclosure requirements to ensure members are fully informed so they can make a sound judgement about whether the demutualisation proposal is in their best interests
- a prohibition on unconscionable and/or misleading conduct relating to a demutualisation, and various civil remedies and other enforcement mechanisms relating to the prohibition, and
- process and notice requirements.

[3] Based on mutual ADI data from ASIC company register

The Explanatory Memorandum to the enabling legislation[4] says Part 5 "does not attempt to identify with precision the characteristics of a mutual structure. A number of characteristics may tend to signal that a company is mutual, but not all of them are necessary."

"The approach taken is to apply Part 5 to all unlisted transferring financial institutions at first instance, and give ASIC exemption powers so that the requirements will only apply to relevant types of entities and modification proposals."

Subclause 30(3) of Part 5 says: In determining whether the company has a mutual structure, ASIC may take into account:

(a) the particular structure, circumstances and history of the company; and

(b) whether:

(i) each customer of the company (for example an account holder, mortgagor or policy holder) is required to be a member of the company; or

(ii) each member (or joint membership) has only 1 vote; and

(c) any other relevant matter in relation to the company or its members.

Subclause 30(4) of Part 5 says: In determining whether the proposed modification or share issue will result in or allow a modification of the mutual structure of the company, ASIC must take into account whether the proposed modification or share issue would have the effect of converting the company into a company run for the purpose of yielding a return to shareholders.

ASIC Regulatory Guide 147 *Mutuality – Financial institutions* (RG 147) was published in 2000 to describe how ASIC would use its exemption powers under Part 5 and how ASIC will decide whether a company has a mutual structure.

RG 147 says: "We consider that an organisation has a mutual structure for the purposes of our policy only if the company and its members meet two tests: (a) an economic relationship test; and (b) a governance relationship test."

Importantly, the policy expressly allows for a mutual company to issue 'investor shares'. In its policy proposal paper leading up to RG 147, ASIC said: "We recognise the need for mutuals to raise capital to compete in the current financial environment, and also recognise the need for capital injection to be rewarded by access to the distributable surplus of a mutual."

[4] Financial Sector Reform (Amendments and Transitional Provisions) Bill (No.1) 1999

Importance of access to capital

Access to capital, particularly regulatory capital, is critical to our sector's capacity to compete and grow.

Customer owned banking institutions have traditionally relied on retained earnings for their regulatory capital, supplemented to a limited degree by the issuance of capital instruments.

The capacity for our sector to issue regulatory capital instruments was severely restricted by APRA's implementation of the Basel III framework.

For our sector to be able to provide effective competition in the retail banking market, we need to increase our market share. As noted in independent research[5] commissioned by COBA in 2012, this depends on our absolute access to funding, mainly deposits, the cost of funding and our access to regulatory capital and the cost of regulatory capital.

This 2012 paper by Deloitte Access Economics pointed out that denying our sector access to Common Equity Tier 1 instruments could have the following impacts:

- mutuals will not have the ability to manage and grow their balance sheets flexibly and in a manner that best serves their members' interests
- growth will be constrained to the uneven rate at which organic capital can be generated from retained earnings
- organic capital will not be able to be generated quickly to respond to sudden increases in capital requirements
- mutuals will be less able to lend in a downturn and will be less able to provide effective competition to listed banks
- the competitive disadvantage in relation to banks resulting from lack of access to Common Equity Tier 1 risks reducing supply, and increasing the cost, of credit to customers by the mutual sectors, and
- ratings agencies may take a negative view of the mutuals sector, given its restricted access to Common Equity Tier 1 capital and its increasing dependence on the economic cycle—this would have a knock-on effect on the ability of mutuals to access senior funding.

Greater access to regulatory capital means that customer-owned banking institutions are able to grow more quickly and undertake important investments, while remaining well capitalised. This allows our sector to write more loans and provide better quality services to current and prospective members. This increases competition in the banking sector.

Conceptually, an ADI's regulatory capital represents its ability to absorb losses without becoming insolvent.

APRA sets rules through its prudential standards about the minimum amount of capital that an ADI must hold and the quality of this capital. Under APRA's capital framework, ADIs must quantify their credit, market and operational risks. For customer-owned banking institutions, the most significant risk is credit risk, reflecting their focus on mortgages and personal loans.

APRA's rules measure credit risk as the risk-weighted sum of an ADI's individual credit exposures (its assets). Conceptually, risk weighted assets (RWA) can grow by increasing risk (i.e. moving into 'riskier' activities such as business lending) or increasing assets (i.e. writing more loans). APRA applies its capital adequacy ratios to an ADI's RWA to determine its minimum regulatory capital levels. This makes regulatory capital a binding constraint that stops an ADI from growing too quickly relative to their capital.

[5] *Competition in Banking* (Abacus – Australian Mutuals) Deloitte Access Economics, June 2012

If an ADI is able to grow its capital, then it is able to grow its RWA and therefore its loans to members. At present, customer-owned institutions are largely restricted to increasing capital via retained earnings, which means they can only grow their loans in line with their post-tax profits.

In order to protect capital quality, the capital framework requires CET1 regulatory capital deductions for certain critically-important investments, such as information technology (IT) assets.[6] This means that an ADI investing $60 million in IT assets to provide better services to its customers must deduct this amount from its regulatory capital over the life of the IT asset. Equity positions in other entities such as peer-to-peer lenders attract a similar deduction.

Delaying such investments is not an option. They are essential to be able provide the product and service offerings required to meet customer expectations of a contemporary retail bank.

The inability of a mutual ADI to raise capital in a timely way to offset these regulatory capital deductions means such investments severely constrain their ability to grow their loan books. For example, $60 million in capital can underpin more than $1.1 billion in mortgages.[7] A mutual ADI has to choose between pursuing asset growth or IT investment—a choice that a non-mutual can avoid by issuing ordinary shares to raise CET1 capital.

Recent revisions to the prudential framework highlight the importance of being able to issue CET 1 capital rather than other forms of regulatory capital (Additional Tier 1 and Tier 2 capital). For example, APRA's proposed large exposures framework now measures large exposures relative to CET1 capital rather than Total Capital, which further increases the importance of CET1 capital.

CET1 also forms the basis of the key adjusted capital ratios used by credit rating agencies. Rating agencies highlight capital-issuing restrictions on mutuals as negatives. Moody's notes that one COBA member "does not have the flexibility to raise additional common equity" while another COBA member has "limited ability to raise additional regulatory capital."

For more information on the benefits of CET1 capital issuance for mutual ADIs and past regulatory capital issuance by our sector, see attachment: COBA discussion paper *CET1 instruments for mutual ADIs, September 2016.*

[6] The principle underlying APRA's approach is that intangible assets are not readily available to absorb losses and protect depositors if an ADI comes under stress.
[7] Assuming a mortgage risk weight of 35% and a capital adequacy ratio of 15%.

Current access to Regulatory Capital

APRA's implementation of the Basel III framework has resulted in customer owned banking institutions having reduced capacity to issue regulatory capital instruments compared to the Basel II regime.

Regulatory capital instruments issued by mutual ADIs prior to APRA's changes to the capital framework no longer qualify as regulatory capital and have been, or are being, amortised.

Customer owned banking institutions do not have access to the full range of regulatory capital options available to their investor-owned peers.

APRA's regulatory framework defines total regulatory capital as the sum of three different capital elements — Common Equity Tier 1 (CET1), Additional Tier 1 (AT1) and Tier 2 Capital (T2).

To be Basel III-compliant, AT1 and T2 instruments must have a 'principal loss absorption' mechanism where in a trigger event[8] the instrument either: converts to ordinary shares or writes off. This results in five different types of regulatory capital instruments (direct issue CET1, convertible AT1, write-off AT1, convertible T2 and write-off T2).

Post APRA's implementation of the Basel III capital framework, and prior to 2014, customer owned banking institutions could only access two of these five types of capital (AT1 and T2 that writes off). As mutuals, they are unable to issue ordinary shares (CET1) or issue instruments that converted into ordinary shares (convertible AT1/T2).[9]

In 2014, APRA amended its prudential standards to allow mutuals to issue instruments which convert into 'mutual equity interests' (MEI) which are considered by APRA to be the ordinary share-equivalent (CET1) for customer owned banking institutions.

Since 2014, no customer owned banking institution has issued any such convertible instruments.[10] This is likely due to the complexity of a convertible instrument being magnified by the uncertainty of MEI. It is difficult to design and sell an instrument that converts into something that does not currently exist. Non-mutuals do not have this problem as their post-conversion instrument (the ordinary share) already exists and has an extensive performance history. For convertible Tier 2 debt instruments, there is the separate issue of MEI not being accommodated in relevant tax regulations and therefore the inability to treat interest repayments as deductible debt servicing costs.

The only feasible option for mutuals to issue regulatory capital is via 'write-off' instruments. Two customer owned banking institutions have issued T2 'write-off' instruments since 2012. These 'write-off' instruments are rare in Australia with the major banks, the regionals and other smaller banks primarily issuing instruments that convert into ordinary shares.

The table below uses a 'traffic light' system to show the limited options for customer owned banking institutions to issue regulatory capital instruments.

[8] For example, APRA declaring the ADI to be non-viable.
[9] APRA's 13 October 2013 letter on Mutual Equity Interests "Conversion into ordinary shares is not possible for mutually owned ADIs (mutuals) due to their mutual corporate structure."
[10] One COBA member has been in the process of preparing to issue such an instrument for almost two years and has encountered lengthy delays in obtaining feedback and approvals from APRA.

Summary of customer-owned banking institutions access to Basel III capital instruments

Loss Absorption…	**Writes off**	**Converts into ordinary shares/MEI**
Common Equity Tier 1 (equity)	No direct issue	
Additional Tier 1 (debt/equity)	Yes	into MEI, but difficult due to unknown nature of the MEI
Tier 2 (debt)	Yes	into MEI, but unfavourable tax treatment due to out of date tax regulations

Regulatory and legislative barriers

Barrier 1: APS111 does not allow direct issue CET1 for customer-owned banking institutions

As noted in the previous section, customer-owned banking institutions are permitted under APRA's prudential standards to issue capital instruments that qualify as AT1 (equity) or T2 (debt) instruments but are not permitted by APRA to directly issue the highest quality capital instruments, CET1.

For investor-owned companies, the ordinary share is their CET1 equivalent. The Basel Committee's criteria (and therefore APRA's) for CET1 instruments is based on ordinary shares of listed banks. Customer-owned banking institutions are unable to issue ordinary shares without demutualising and therefore are not able to access direct issue CET1 instruments under the current framework.

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 RG147.

APRA's APS111 prudential standard prevents the direct issue of MEIs:

> "Mutual equity interests can only be issued in accordance with the contractual terms of an eligible Additional Tier 1 Capital instrument (refer to Attachment E) or an eligible Tier 2 Capital instrument (refer to Attachment H)."[11]

Furthermore, APRA publicly acknowledges that the creation of MEIs (and therefore a CET1 instrument) is a rare event.

> "Mutual equity interests are contingent in nature, in that they are only created from conversions of AT1 and T2 Capital instruments in extreme circumstances."[12]

The MEI as it currently stands has proved to be of limited utility to customer-owned banking institutions. Given the importance of CET1 in the regulatory framework, it is essential that customer-owned banking institutions must be able to directly issue a CET1 instrument.

A satisfactory outcome on this matter is long overdue. The Senate Mutuals Inquiry recommendation to APRA of March 2016 was preceded in November 2012 by a recommendation from the same Senate Committee that: "APRA addresses, without further delay, the unique issues Basel III may pose for mutual ADIs as a result of their corporate structure and that it publishes a document which sets out how these problems have been addressed."[13]

Encouragingly, since the March 2016 Senate Mutual Inquiry recommendation, APRA has indicated a new willingness to engage positively with COBA and COBA members on changes to the prudential framework to allow for direct issuance of CET1 instruments.

COBA provided APRA with an initial discussion paper in September 2016 and has subsequently provided further detailed feedback to APRA in response to questions from APRA in an 'informal' consultation process.

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[11] APS 111 Capital Adequacy Attachment K para X
[12] APRA's 13 October 2013 letter on Mutual Equity Interests
[13] http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Completed_inquiries/2010-13/postGFCbanking/report/index

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APRA publicly confirmed this work in its publication *Insight, Issue One 2017*[14]:

> "APRA is also working to develop a suitable framework for issuance of Common Equity Tier 1 capital instruments by mutually-owned ADIs, which would meet APRA's prudential expectations for the highest quality of capital. If viable, this may enable customer-owned banking institutions to raise equity directly and enhance their capital management flexibility, which was also a recommendation of the Senate Economics References *Committee's report Cooperative, mutual and member-owned firms.* This work is expected to progress to formal industry consultation around the middle of 2017."

The current MEI concept already includes some exemptions from the Basel III 'ordinary share' definition but COBA is seeking some further changes to improve the concept and allow for mutual ADI CET1 instruments that are simple and marketable. We propose the following modifications:

- ability to cap dividends in line with *both* of the current caps in RG147, i.e. capped by reference to a benchmark or capped at a percentage of profits
  - this is modest change from the current MEI concept which already allows for the percentage of profits cap
- better recognition of the difference between member claims and investor claims on residual assets, including the ability to give seniority to the capped claim of investors.

It is desirable, for a range of reasons, to allow issuers the flexibility to rank the entitlement of MEI holders to a return of all or some of their *contributed capital* ahead of the entitlement of members to retained earnings. There is no 'upside' to MEI holders in return for being the most subordinated claim because the maximum claim they have on residual assets is capped at the nominal amount of capital they have contributed. Our suggested approach maintains the status of MEIs as the most subordinated CET1 *instrument*. Practically, there is very little difference in actual outcomes for MEI holders and members in allowing priority for MEI holders compared to outcomes from the current MEI definition in APS 111. However, allowing priority for MEI holders has significant benefits because it provides for a framework that is clearer, more certain and more orderly. It is also consistent with RG 147 and it does not affect members' rights to retained earnings.

Recommendation 1: That the review encourages APRA to continue to give priority to amending its prudential standards to allow mutual ADIs to directly issue CET1 instruments, recognising the need for these instruments to be simple and marketable, and that ASIC is supportive and facilitative of this process.

Barrier 2: Tax regulations do not cover Tier 2 debt that converts into MEI

Customer-owned banking institutions are unable to issue convertible Tier 2 debt instruments in a cost effective manner. This is due to these instruments being considered as equity (contingent) rather than debt (non-contingent) for income tax purposes.

Government regulations provide an exemption to treat convertible debt instruments as debt if they convert to ordinary shares, however, customer-owned banking institutions' instruments convert into MEI so do not fit this exemption. Tax regulations must be revised to allow customer-owned banking institutions to receive the same treatment as their ordinary share-issuing peers.

Under Basel III, Additional Tier 1, and Tier 2 instruments of an ADI must be capable of absorbing losses if APRA determines that it is 'non-viable'.

[14] http://www.apra.gov.au/Insight/Pages/insight-issue1-2017.html

Under this requirement, these regulatory capital instruments must include a 'loss absorbency' clause that allows the instrument to be written off or converted to ordinary shares.

This 'non-viability' clause results in certain Tier 2 instruments (currently classified as debt) to be treated as equity interests under income tax rules as 'contingent' obligations. Returns on contingent instruments are not deductible. This means ADIs would be issuing debt where interest payments are not tax deductible.

To address this, the Government passed the *Income Tax Assessment Amendment Regulation 2012 (No.2)* containing Regulation 974-135F. This regulation allows instruments that convert from debt to ordinary shares in a non-viability event to still be considered as debt (non-contingent). This allows ADIs to deduct the interest costs from their tax liability.

However, customer-owned banking institutions cannot take advantage of this regulation as our instruments convert into MEI, not ordinary shares, and MEI are not included in the tax regulations. This means our instruments do not have deductible interest costs, which makes these instruments uneconomical. This is despite the fact that, for the purposes of the Basel III capital framework, the MEI is equivalent to an investor-owned ADI's ordinary share.

COBA understands that five customer-owned banking institutions are currently considering Tier 2 issuance in the near future, including instruments that would convert into MEIs. However, they are stopped from doing so due to the unequal tax treatment of these convertible instruments.

The tax regulations need to be amended to accommodate MEI, to remedy the oversight that has occurred due to the regulation being introduced in 2012 well before the introduction of the MEI in 2014.

COBA has raised this issue with Treasury and with the office of the Minister for Revenue and Financial Services.

Recommendation 2: That the review supports prompt amendment of tax regulations to accommodate MEI.

Barrier 3: Uncertainty about exemptions from demutualisation provisions

Customer-owned banking institutions issuing regulatory capital instruments could trigger demutualisation disclosure and process requirements, even if they have no intention to demutualise.

These companies must then go through a costly process to provide notice of a meeting or consent process and a number of documents to members and ASIC including a disclosure statement, an estimate of the financial benefits and an independent expert's report.

For larger mutual ADIs, this exercise will potentially costs millions of dollars.

Further, it would be a significant challenge to explain to members that a proposal is not a demutualisation even though the process and disclosure requirements are subject to the 'Demutualisation' section of the Corporations Act.

As noted above, ASIC can exempt companies from the Part 5 'Demutualisation' requirements. However, the regime leaves significant uncertainty for companies and significant discretion for ASIC about this exemption power.

We note the following observations in ASIC'S Consultation Paper 10 Mutuality[15] that led to RG 147:

- The demutualisation regime has "low triggers".
- "A company might trigger the application of Part 5 whether or not demutualisation is the intended result."
- The demutualisation regime triggers "are sufficiently low that any variation of members' rights or any issue share issue requiring member approval may invoke clause 29."
- "Where a proposal may diminish mutuality, but not materially, only partial relief from Part 5 requirements may be granted."
- "If the proposal has the potential to distribute surplus to non members or to investor members only, at a cost to mutual members, ASIC may determine not to grant an exemption. Of course, this does not mean that the proposal cannot go ahead. It just means that full disclosure must be made when member approval is sought."
- "The thresholds that trigger this demutualisation regime are quite low and in many cases a company will trigger Part 5 with no intention to demutualise."

RG 147 is ASIC's attempt to provide as much certainty as possible about its use of the exemption powers: "RG 147.27 A company may trigger the disclosure obligations in Part 5 whether or not they are intending to demutualise. If a change to a mutual company's constitution or a share issue does not, and is not intended to, result in a demutualisation, the company can apply for an exemption under Clause 30(2). It will normally do so because it is unnecessary, inconvenient or expensive to comply with the enhanced disclosure requirements."

It is important to acknowledge that despite the low triggers and the uncertainty, a number of customer owned banking institutions have successfully negotiated the regime to issue equity regulatory capital instruments - prior to APRA's Basel III changes. (See attachment COBA discussion paper *CET1 instruments for mutual ADIs, September 2016.)*

With the introduction of the MEI concept to the prudential regime, ASIC issued a letter to COBA (attached) for distribution to COBA members setting out ASIC's views on the application of Part 5 to "draft MEI capital instrument."

This 15 April 2014 letter provides a degree of comfort for customer owned banking institutions but significant uncertainty remains.

> "ASIC understand that the demutualisation provisions will not necessarily be triggered by a proposal either to amend the constitution of a mutual ADI to allow the entity to issue MEI capital instruments, or by a proposal to issue MEI capital instruments themselves. This will need to be assessed by individual mutual ADIs on a case by case basis and will depend on the terms of the individual mutual ADI's constitution and terms of the MEI capital instrument."
>
> "If a mutual ADI considers the demutualisation provisions are triggered in relation to an MEI capital instrument proposal, the mutual ADI may make an application to ASIC for relief from the demutualisation provisions. If ASIC receives such an application, ASIC is likely to exempt the mutual ADI from the demutualisation provisions if the proposed MEI is in the same terms as the draft MEI capital instrument. ASIC has assisted APRA in the formulation of the draft MEI capital instrument and considers that the proposed features and requirements of the draft MEI capital instrument align with the elements of the 'economic relationship' and 'governance relationship' tests in Regulatory Guide 147 Mutuality – *Financial institutions."*

[15] http://www.asic.gov.au/regulatory-resources/find-a-document/consultation-papers/cp-10-mutuality/

It would be desirable if customer owned banking institutions had greater clarity and certainty that issuing regulatory capital instruments that are consistent with the tests of mutuality will not trigger the demutualisation provisions.

This could be achieved by:

- ASIC adopting a more explicitly supportive approach to customer owned banking institutions wishing to issue capital instruments that are consistent with the mutuality tests in RG 147, or
- legislative changes to reduce ASIC's discretion and provide greater certainty.

A legislative solution to the uncertainty about what does, and what does not, constitute a demutualisation could be achieved by amending the Corporations Act to insert a definition of a mutual enterprise (see further discussion below).

Recommendation 3: That the review recommends that the Government agree in-principle to insert a definition of mutual enterprise in the Corporations Act and that this definition be determined in consultation with the mutual sector.

Barrier 4: Regulator processes

COBA members have experienced unacceptable delays in obtaining decisions from regulators about proposals to issue regulatory capital instruments.

This failure of process is a barrier to accessing capital because of the cost in terms of legal and tax advice and the diversion of internal resources over unreasonably lengthy periods.

With APRA, COBA members have endured endlessly iterative processes involving different divisions of the regulator. When COBA members seek to address the regulator's initial concerns in their follow-up proposals, members have had experiences where a regulator has, surprisingly, come back with further concerns that were not raised in the initial proposal. This highly iterative process means that COBA members must incur significant costs to pay for the taxation, legal and advisory professionals (as well as the use of internal resources) to continually go over these documents without having any certainty about whether any issue is truly 'closed'.

In the most extreme case, one COBA member has been in the process of preparing to issue a capital instrument for almost two years and has encountered lengthy delays in obtaining feedback and approvals from APRA and a lack of support from ASIC.

APRA advised the Senate Mutuals Inquiry that the timeframe to endorse an instrument can range considerably depending on the complexity of the instrument. "Simple instruments that replicate previously-approved instruments can be dealt with relatively quickly, whereas those that set important precedents require time and attention. In the case of mutual ADI instruments, with few capital instruments issued, it is to be expected that precedent setting decisions will be made."

APRA provided the Senate Mutuals Inquiry with an example of this process involving a non-CET1 instrument which took six month and 12 iterations.

As noted above, in another case the process has taken two years.

While some uncertainty may be expected in relation to decision-making on novel instruments, most of this uncertainty is due to a failure of process. There is a clear need to improve regulators' internal governance and accountability in decision-making on capital instruments.

Recommendation 4: That the review recommends that the Government introduces, through service charters or Statement of Expectations, the following requirements on regulators:

- **minimum service standards relating to capital instrument approvals, including timelines for feedback and a 'no suprises' policy, and**
- **accountability mechanisms for these standards.**

Preventing future barriers

While the review recommendations will address current barriers that exist to mutuals' access to capital, future barriers may still arise in the regulatory environment. To address this, COBA believes the Government must take steps to improve regulators' consideration of how their decisions impact on the mutual model.

While in many cases, regulators such as APRA and ASIC consider the impact of their regulation on customer-owned banking institutions due to the relative size of these institutions, they do not necessarily account for differences due to our mutual corporate structure.

COBA believes that the recent focus on competition in the banking sector has led to greater appreciation amongst all stakeholders of the value of the mutual model, which prioritises customer rather than investor needs.

This is an opportunity to seize the moment and hardwire into regulator mandates the need to take into account the customer owned model.

In the United Kingdom, ASIC's peer regulator the Financial Conduct Authority (FCA) and APRA's peer the Prudential Regulatory Authority (PRA) are required to apply a number of regulatory principles when exercising their functions. One of these principles relates to corporate diversity:

> "the desirability where appropriate of each regulator exercising its functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons subject to requirements imposed by or under this Act"[16]

This was modified in 2016 to explicitly include consideration of mutuals.[17] The FCA and PRA are required under law to report on their performance in meeting the corporate diversity obligation in relation to mutual.[18]

This 'before the fact' consideration is likely to greatly reduce the need for 'after the fact' corrections to account for mutuals.

The concept of evaluating the differential impacts on different groups is not unfamiliar to Australian regulators. It is clear that in many cases our regulators take into account size when considering the impact and design of regulation. This makes sense as regulation, due to its fixed costs, disproportionately affects smaller entities.

For example, APRA outlines the potential of a graduated prudential regime for smaller ADIs:

> "In particular, given the complexity of the forthcoming Basel reforms, there may be efficiencies to be gained through the introduction of a graduated capital adequacy framework for smaller ADIs with very simple business models."

APRA's failure to accommodate customer owned ADIs in the CET1 framework is a good example of a regulator prioritising uniformity of its framework over diversity in the regulated community.

APRA's response to feedback on its Basel III implementation discussion paper in 2012 indicates a reluctance to depart from a policy of common prudential requirements, which is particularly concerning given these requirements are predominately written for investor-owned institutions, i.e. listed banks:

[16] Financial Services Act 2012: 3B Regulatory principles to be applied by both regulators
[17] Bank of England and Financial Services Act 2016
[18] See Part 9A, section 138K of the Financial Services Act 2012

> "Another theme in submissions was that the Basel III reforms presented particular difficulties for ADIs with a mutual corporate structure, which are unable to issue ordinary shares. APRA acknowledges this concern and will consult separately with customer-owned banking institutions on the issues raised. However, it does not see these issues as a reason for departing from its longstanding policy of applying a common set of prudential requirements across the ADI industry."[19]

A similar theme emerges from APRA's 15 April 2014 *Letter to all mutually owned ADIs on Mutual equity interests*, which provides a framework for convertible capital instruments but not the direct issue of the highest quality instruments.

> "Mutual equity interests are contingent in nature, in that they are only created from conversions of AT1 and T2 Capital instruments in extreme circumstances. The direct issue by mutually owned ADIs of CET1 capital instruments other than ordinary shares raises more complex concerns, associated with the interaction of Basel III requirements, demutualisation provisions in the Corporations Act and the needs of potential investors vis-à-vis existing members of mutually owned ADIs."

APRA is a busy regulator with expanding regulatory responsibilities so it is challenging to obtain the necessary attention and resources from the regulator on 'novel' matters such as CET1 capital for mutual ADIs.

In August 2012, APRA's then head of policy Charles Littrell acknowledged that the Basel III rules on capital (designed to apply to internationally active banks) and the link to ordinary shares "does not work particularly well for mutuals." Mr Littrell told the Senate Economics Committee that APRA was working with COBA and that: "We will come up with something that will not necessarily be received joyfully but will achieve the outcome."[20]

In February 2016, Mr Littrell's successor Pat Brennan appeared before Senate Mutuals Inquiry and said that the MEI conversion option for AT1 and T2 instruments was "our attempt to accommodate the mutuals within the capital framework." Mr Brennan described it as an "interim" measure and conceded: "It is not necessarily easy to use." Mr Brennan also conceded that some overseas jurisdictions "have found a way to accommodate the mutual in ways that APRA has not."

As noted above, COBA is encouraged by the current level of engagement by APRA on changing the capital framework to allow mutual ADIs to issue CET1 instruments. However, the delays and lack of priority plaguing this matter over recent years may have been avoided if our key regulators were subject to a corporate diversity clause in their mandates.

What is needed is a permanent change to the mindset of regulators in relation to accommodating the customer-owned model.

We are hopeful that this review will assist in the removal of current capital barriers, but we also seek reform to ensure that mutuals operate in a regulatory environment that does not disadvantage them on the basis of their corporate model.

COBA believes that this should take the form of a corporate diversity clause which requires relevant regulators (APRA and ASIC) to consider and report on the impacts of their regulation on mutuals.

Such a requirement does not suggest that regulators do not currently consider the mutual model, however, such consideration must be institutionalised and considered to be 'part of the job'.

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[19] APRA discussion paper: Implementing Basel III capital reforms in Australia 2012
[20] Senate Economics Committee inquiry into Post-GFC Banking Sector

A corporate diversity requirement will extend this consideration beyond any current Government priorities and ensure that mutuals' access to fair regulatory treatment does not rely on the familiarity or sympathy of incumbent staff with the mutual model.

Recommendation 5: That the review recommends that the Government introduces a corporate diversity clause into regulator mandates to ensure that ASIC and APRA explicitly consider the mutual structure when developing regulation. This clause should include an accountability mechanism that requires regulators to assess and report if there are any different impacts on mutual ADIs (including if there are none).

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Pros and cons of a definition

For COBA, the starting point for discussion about the pros and cons of inserting a definition of "mutual enterprise" into the Corporations Act is RG 147.

However, the mutuality tests in RG 147:

- may no longer be relevant to today's customer owned banking sector, and
- may be unsuitable for the broader community of mutuals, co-operatives and member-owned firms.

There is no consensus within COBA's membership that the RG 147 tests could be the basis for a legislated definition of mutuality and some COBA members consider the tests to be inappropriate and overly restrictive.

It is a simple fact that RG 147 was drafted last century.

Our sector was closely involved in consultation on the drafting of RG 147 and its existence stems from the Federal Parliament agreeing to accept aspects of the State-based regime previously applying to customer owned banking institutions.

The Explanatory Memorandum to the legislation that enabled the transfer of customer owned banking institutions to the Corporations Law notes that the Corporations Law at the time (1999) did not contain special provisions concerning demutualisations.

> "In particular, ASIC does not have power to issue binding standards. However, given the nature of the transferring financial institutions it is considered desirable, in the interests of protecting the rights of members of transferring financial institutions, to carry over into the Corporations Law framework some aspects of the regulatory framework regarding demutualisation which applied under the previous governing Codes."

According to ASIC's consultation paper leading to RG 147, mutuality fundamentally involves a commonality of interest between an entity's owners and customers.

> "The Courts have held that there are two characteristics which are usually found in a mutual organisation: effectively, that every member must have a voice in the administration of the association and any surplus must ultimately come back to the members."

The paper notes the risk of competing claims between investor shareholders and customers, e.g. raising prices to maximise profits versus running a service to members or payment of dividends versus subsidisation of product related expenses

> "When considering a proposed constitutional modification or share issue, ASIC assesses whether the proposal would result in the company being run for the purpose of yielding a return to shareholders. To this end, ASIC analyses the relationship between the company and its members by reference to the economic relationship test and the governance relationship test, both of which contain a number of limbs.
>
> "In recognition of the fact that some mutual companies have, or will seek to have, a mixture of ordinary members and investor shareholder members, ASIC will apply this purpose test to mean 'dominant' purpose. A company may seek to yield a return to shareholders and remain a mutual, provided that such a return to shareholders does not become the dominant purpose. The principles of mutuality will be considered in arriving at a determination as to what a company's dominant purpose it. For example, if a company substantially meets both the governance and economic relationship

tests, it is likely that the company has a dominant purpose to provide services to members, and not a dominant purpose of yielding a return to investor shareholders."

COBA has been generally supportive of the mutuality tests in RG 147 but it is now time for a debate within our sector and the wider mutual and co-operatives sector about the features that are the essence of mutuality.

Agreement on the key features of mutuality will allow for a definition of mutuality to be inserted into the Corporations Act and this is a highly desirable objective.

A definition of mutuality within the Corporations Act will:

- provide clarity for stakeholders, including regulators, to distinguish mutual companies from investor-owned companies (e.g. for the purposes of regimes such as taxation, financial services regulation and prudential regulation)
- provide capacity to adapt other elements of the Corporations Act, e.g. directors' duties, to the mutual model
- improve capacity to promote the distinct identity, size, scope and contribution of the mutual sector, and
- give 'transferring financial institutions' more certainty about the 'demutualisation' provisions in the existing Part 5 of Schedule 4 of the Corporations Act.

Defining mutuality in statute will allow the sector to more easily pursue policy that provides fair treatment for member-owned organisations. Stakeholders and regulators will be able to 'ring fence' treatments for mutuals without worrying that they will be exploited by non-mutuals. However, COBA recognises that any definition will need the flexibility to cover the broad range of mutuals, i.e. customer-owned, employee-owned, producer-owned, and various combinations of these.

Debate about the meaning of mutuality opens up many possibilities for the mutual sector and allow the sector to revisit the discussion of how the presence of investors alongside 'members' can work with the mutual model.

Without capacity to attract investors, the mutual sector cannot increase its growth rate and take opportunities to improve its performance in terms of its offering to members.

However, there are obvious risks to the mutual model if the position of investors compared to members is not carefully balanced. The current regime for 'transferring financial institutions' prohibits a mutual from restructuring in a way that "would have the effect of converting the company into a company run for the purpose of yielding a return to shareholders."

A definition of mutuality must be well-considered and many internal and external stakeholders will have a view and must be allowed the opportunity to have their view taken into account.

This debate is yet to really begin.

Factors that require examination include:

- the potential for reduced flexibility for mutual companies from a 'black letter law' definition, including unintended consequences and transition costs, and
- the risk of becoming isolated in a legislative ghetto outside the mainstream.

COBA is also concerned to avoid any distraction and delay from progress that can be achieved in the short term in removing barriers to raising capital.

While the need for a definition of mutuality in the Corporations Act is clear, the terms of the definition require further discussion. A recommendation that supports the need for a 'mutual

enterprise' definition will give the customer owned banking sector and the wider mutuals' sector the certainty to justify committing time and resources to a complex policy discussion.

However, COBA emphasises that removal of some of the current barriers to capital raising by customer owned banking institutions can be achieved on a much shorter timeframe. These current barriers either already have a working definition of 'mutual ADI' or do not require a definition. There is no need to wait for the drafting and implementation of a new definition of 'mutual enterprise' in the Corporations Act before:

- amending APRA's prudential framework to allow for direct issuance of CET1 instruments,
- amending tax regulations to remedy the T2 conversion instrument problem, and
- requiring regulators to improve their approval processes for mutual ADI capital instruments.

Contacts

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Attachments

COBA discussion paper *CET1 instruments for mutual ADIs, September 2016*

ASIC letter on MEIs, April 2014

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CET1 instruments for mutual ADIs

Discussion Paper for COBA/APRA liaison meeting
12 September 2016

1. Summary of problem & solution
2. Background on Mutual Equity Interests
3. Benefits of CET1 issuance capacity
4. Mutual ADI past regulatory capital issuance
5. Next step?

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1. Summary of problem & solution

Problem:
Mutual ADIs do not have capacity under the prudential standards to directly issue, on a 'going concern' basis, CET1 instruments.

Listed banks regularly issue CET1 capital instruments, and it is important that mutual ADIs also have the capacity to do so while preserving their mutual model. Having the option to raise capital in addition to retained earnings allows for more ambitious growth targets, diversifies funding options and provides capacity to seize acquisition opportunities and invest in technology and innovation.

Prior to the Basel III changes to the prudential framework, mutual ADIs did have capacity to issue the highest quality capital instruments and did issue such instruments.

APRA's prudential framework has fallen behind comparable jurisdictions, i.e. Europe and the UK, where mutual banking institutions have been given capacity to issue CET1 instruments. Canada is also taking steps to deliver this capacity.

Solution:
Amend prudential standards to allow mutual ADIs to directly issue CET1 instruments that are consistent with the mutual model. This can be achieved by removing the current prohibition on the direct issuance of mutual equity interests (MEIs) and modifying the definition of MEIs in APS 111 *Capital Adequacy: Measurement of Capital* to better align with ASIC's Regulatory Guide 147 *Mutuality - Financial institutions.*

This involves allowing issuers of MEIs two options for capping dividends, i.e. placing a ceiling but not a floor on discretionary dividend payments. Currently under APS111, MEI issuers can apply only one cap, i.e. a percentage of profits.

Regulatory Guide 147 requires that dividends that can be paid to holders of mutual ADI investor shares must:

(i) be limited by reference to an independent and objectively verifiable external benchmark or mechanism such as the bank bill swap rate or a stock exchange index, and be payable only out of that year's profits; **or**

(ii) not be more than a fixed percentage of the company's annual profit after tax in any year, and be payable only out of that year's profits. The fixed percentage cannot be more than 50%.

Distributions on the revised MEIs must also meet a number of criteria to ensure that they are fully discretionary, including:

- There are no circumstances where distributions are obligatory (APS111);
- Distributions are non-cumulative (APS111);
- Distributions only payable out of this year's profits (APS111 via RG147); and
- Restrictions on distributions if capital buffer breached (APS110).

COBA's objective is to maximize flexibility for mutual ADIs to issue CET1 instruments to retail or wholesale investor markets in accordance with their own governance and strategic objectives.

2. Background on Mutual Equity Interests

March 2012	**APRA Response to Submissions on Basel III capital** APRA canvasses CET1 for mutual ADIs and caps on distributions
September 2012	**APRA Response Paper on Implementing Capital reforms in Australia** APRA notes that it is consulting separately with mutual ADIs on regulatory capital matters.
November 2012	**Senate Banking Inquiry Report Recommendation** Recommendation 3.3: That APRA addresses, without further delay, the unique issues Basel III may pose for mutual ADIs as a result of their corporate structure and that it publishes a document which sets out how these problems have been addressed.
October 2013	**Letter to mutually owned ADIs: *Mutual equity interests*** APRA proposes an arrangement to facilitate mutual ADIs issuing certain capital instruments.
November 2013	**COBA provided a submission on the Mutual Equity Interest instrument**
December 2013	**UK mutual building society issues CET1** A mutual building society in the United Kingdom (Nationwide) issues an equity-like CET1 capital instrument.
February 2014	**COBA Financial System Inquiry submission (FSI) calls for access to CET1 capital**
April 2014	**Letter to all mutual ADIs: *Mutual equity interests*** APRA revises the prudential framework to provide for mutual ADIs to issue AT1 & T2 capital instruments that provide for contingent conversion into CET1-eligible mutual equity interests.
August 2014	**COBA 2nd round FSI submission reiterates need for competitive neutrality with CET1 capital**
July 2015	**COBA submission to Senate Mutuals Inquiry**
November 2015	**APRA liaison with industry representatives** Following a number of discussions with APRA industry representatives undertook to provide a written submission to APRA on a possible equity-like capital instrument informed by developments in the United Kingdom.
February 2016	**APRA appearance before Senate Mutuals Inquiry** APRA states that some jurisdictions have found a way to accommodate the mutual in ways that Australia has not.
March 2016	**Senate Mutuals Inquiry Report recommendation** Recommendation 16: 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.

3. Benefits of CET1 issuance capacity

CET1 is the highest quality and most useful form of regulatory capital. CET1 can be used to meet all prudential capital requirements as well as all regulatory deductions. This contrasts with AT1/T2 capital instruments which can only meet a limited set of requirements. The inability to issue CET1 limits mutual ADIs in their capacity to manage capital and their businesses.

Currently, for mutual ADIs, CET1 effectively comprises retained earnings with a growth rate bound by their growth in net profit. Capital issuance allows mutual ADIs to take growth opportunities and to pre-emptively issue capital for expansion. It also allows mutual ADIs to better absorb CET1 capital deductions for investments that can comprise a significant amount of a smaller ADI's regulatory capital such as IT modernisation.

Activity	Explanation	Outcome
Meet specific CET1 capital buffers (countercyclical and capital conservation)	Buffers specifically require CET1 capital	Greater ability to meet prudential requirements
Grow assets for capital constrained ADIs	Allows increases in capital at a faster rate than profit growth	Increased competitive capacity and capacity to take diversification opportunities
Grow while maintaining the same capital buffer	ADIs who wish to hold higher capital buffers can grow without diluting their capital reserves	Retain a similar level of financial stability
Grow without having to manage multiple capital types	CET1 meets all capital requirements while there are restrictions on AT1 and T2 use. AT1 and T2 are more complex than CET1, due to conversion or write-off requirements	Simplifies capital management
Increase capital raising flexibility	MEI currently can only come into existence if converted from AT1/T2 in a non-viability scenario	Increased capital raising flexibility by demonstrating existence of conversion option for AT1 & T2
Modernise IT systems and software such core banking systems	Offsets the CET1 deduction	Reduced operational risk and more efficient operations
Acquire intangible assets	Offsets the CET1 deduction	Expands business opportunities and encourages innovation
Recover from adverse events	Issuance can replenish capital	Greater recovery ability and a 'safety net' for taking calculated risks
Undertake strategic business development initiatives	Offsets the CET 1 deduction	Better future prospects and increased competitive capacity
Reduce regulatory uncertainty	As the highest form of capital, CET1 instruments are unlikely to fall out of regulatory capital definitions	Greater certainty around capital management. Reduced need to undergo costly capital replacement processes

4. Mutual ADI past Regulatory Capital Issuance

Mutual ADIs have issued regulatory capital instruments under previous Basel accords, including Tier 1 equity capital under Basel II.

Most of these instruments are not Basel III-compliant due to the CET1 'ordinary shares' definition or their lack of conversion or write-off clauses to qualify as AT1 or T2.

Date	Institution		Dividend	Type
15-06-2016	IMB Ltd	T2	3M BBSW + 3.75%	Debt
24-06-2015	Heritage Bank	T2	3M BBSW + 3.50%	Debt
09-11-2012	Australian Mutual Investment Trust Series A[1]	T2	AUD BBSW + 593 bps	Debt
29-06-2012	IMB Ltd	T2	3M BBSW + 425 bps	Debt
16-09-2011	IMB Ltd	T2	3M BBSW + 400 bps	Debt
15-12-2009	The Capricornian Ltd	T2	90D BBSR + 2.25% pa	Debt
15-12-2009	The Capricornian Ltd	T2	90D BBSR + 3.50% pa	Debt
26-06-2006	Australian Mutual Capital Funding Trust No.1[2]	T1	AUD BBSW + 299 bps	Equity
31-05-2006	The Capricornian Ltd	T1	180D BBSR + 2.5% pa	Equity
29-06-2001	Holiday Coast Credit Union	T1	180D BBSW + max 2%	Equity

[1] 18 institutions: Australian Defence Credit Union (Australian Military Bank), B&E, Beyond Bank, Community Mutual, Circle Credit Co-Operative, ECU Australia, EECU, Ford Co-operative Credit Society, Hume Building Society (Hume Bank), IMB Ltd, Laboratories Credit Union, Maritime, Mining and Power Credit Union, SGE Credit Union (G&C Mutual), Summerland Credit Union, Sutherland Credit Union, Sydney Credit Union, Victoria Teachers Mutual Bank, Warwick Credit Union.

[2] 13 institutions: Bankstown City Credit Union, Community Mutual, ECU Australia, EECU, Ford Co-operative Credit Society, Queensland Police Credit Union (QBANK), Laboratories Credit Union, Maritime, Mining and Power Credit Union, SGE Credit Union (G&C Mutual), Sutherland Credit

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Our reference: PMR 2012/3792
6764/12

15 April 2014

Ms Louise Petschler
Chief Executive Officer
Customer Owned Banking Association

By email: **LPetschler@coba.asn.au**
Cc: **LLawler@coba.asn.au; MDegotardi@coba.asn.au**

Dear Ms Petschler,

Basel III – 'Mutual equity interest' (MEI) capital instrument

We are writing to you in relation to APRA's public release today of the amended Prudential Standard APS 111 *Capital Adequacy: Measurement of Capital*, which now includes an Attachment K (and consequential amendments) titled 'Mutual equity interests' (MEI) and a draft MEI capital instrument (the draft MEI capital instrument).

The purpose of this letter is to set out ASIC's views on the application of Part 5 of Schedule 4 of the Corporations Act (the demutualisation provisions) to the draft MEI capital instrument.

We ask that COBA distribute this letter to its ADI members.

Part 5 of Schedule 4 to the Corporations Act

ASIC understands that the demutualisation provisions will not necessarily be triggered by a proposal either to amend the constitution of a mutual ADI to allow the entity to issue MEI capital instruments, or by a proposal to issue MEI capital instruments themselves. This will need to be assessed by individual mutual ADIs on a case by case basis and will depend on the terms of the individual mutual ADI's constitution and the terms of the MEI capital instrument.

If a mutual ADI considers the demutualisation provisions are triggered in relation to an MEI capital instrument proposal, the mutual ADI may make an application to ASIC for relief from the demutualisation provisions. If ASIC receives such an application, ASIC is likely to exempt the mutual ADI from the demutualisation provisions if the proposed MEI is in the same terms as the draft MEI capital instrument. ASIC has assisted APRA in the formulation of the draft MEI capital instrument and considers that the proposed features and requirements of the draft MEI capital instrument align with the elements of the 'economic relationship' and 'governance relationship' tests in Regulatory Guide 147 *Mutuality – Financial institutions* (RG 147).

I note that it is possible that a particular MEI capital instrument proposal by individual mutual ADI might raise issues that have not been contemplated during the development of the draft MEI capital instrument and that in such a case, relief from the demutualisation provisions may not be appropriate. We expect that this would not be the usual case.

Mutual ADIs that intend to issue MEI capital instruments should also consider:

- The various disclosure and approval requirements, and any other relevant obligations, under the Corporations Act (including Part 5) and in the mutual ADI's individual constitution.
- If the mutual ADI's constitution contains 'demutualisation approval procedure rules' – Whether those rules are triggered and, if so, what is required to comply with those rules. ASIC details the circumstances in which it will move to 'disapply' the rules in a mutual ADI's constitution in REP 369 *Response to submissions on CP 210 Demutualisation approval procedure rules: Minimum member participation requirement.*

Any relief application should address the matters outlined in Regulatory Guide 51 *Applications for relief* and in RG 147 and should be sent to applications@asic.gov.au. If a mutual ADI has any concerns about how demutualisation provisions might apply in its circumstances we encourage the mutual ADI to speak with us as early as possible.

Contact

Please contact Jennifer Lyons or Boyd Honor (details below), if you have any questions about the content of this letter.

Yours sincerely,

Christopher Green
Acting Senior Executive Leader – Deposit Takers, Credit & Insurers

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