REFORMS FOR COOPERATIVES, MUTUALS AND MEMBER-OWNED FIRMS

HERITAGE BANK SUBMISSION TO GREG HAMMOND REVIEW

Heritage Bank

Heritage Bank ('Heritage') is Australia's largest customer-owned bank and one of the three largest mutual ADIs in the country. Heritage's history stretches back 142 years to its beginnings as a building society founded in Toowoomba in 1875, making it one of the oldest mutual financial institutions in the country. Heritage has grown to more than $9 billion in assets, 300,000 customers, 800 staff (including 470 in the Toowoomba region), and 61 branches across southern Queensland. Heritage is a national player in the mortgage market, with customers around Australia sourced via a network of mortgage broker partners.

Heritage is a leader in capital management within the mutual sector, having completed a number of innovative, industry first transactions. Notable accomplishments over the past decade include completion of the first ASX listed, Basel II compliant subordinated debt transaction by a mutual ADI in October 2009. More recently Heritage issued the first Basel III compliant subordinated debt issue, after having convinced APRA to change its view on the prudential treatment of Tier 2 capital instruments that satisfied the non-viability provisions via a 'write-down' only capability. Heritage's experience in completing these transactions gives the business a unique insight into proposed changes to the Corporations Act designed to facilitate capital issuance by mutual entities.

Action required to address competition inequities

Heritage Bank asserts that Australian banking customers are being denied the benefits of stronger competition because of the barriers to capital-raising that exist for mutual ADIs.

The Australian banking sector needs greater diversity as a prudent approach to diffusing systemic risk associated with the concentration of retail banking services into four dominant players. Banking consumers need broader choices to stimulate competition and innovation. At present, mutual organisations have the potential to provide meaningful competition to the dominance of listed banks, but their ability to compete is constrained by the barriers they face in cost-effectively funding innovation and growth. This need not, and should not, be the case. The regulatory and legislative changes needed to remove barriers accessing capital are clear, feasible and readily able to be enacted. Doing so will not only strengthen the corporate structures associated with mutual businesses, but support diversity within the Australian banking sector to the benefit of all Australians.

Heritage Bank has a proud 142 year history as a mutual organisation. Mutuality is not just a corporate structure, it is a business philosophy. As a mutual, Heritage has always prided itself on putting customers at the centre of its decision-making, made tangible via its commitment to offering highly competitive interest rates, low fees and charges, and support for community activities.

That commitment means delivering real financial benefits to Heritage customers. In fact, analysis by research company CANSTAR has shown our customers were more than $208 million better off over the last five years through banking with Heritage rather than the big four banks (based on the average pricing/fees across lending and deposit products).

Not only do our customers benefit financially, they also have a more satisfying banking experience. For example, at the end of last financial year, our Roy Morgan MFI customer satisfaction score was 94.3% - more than 13% higher than the average score of the four big banks in Queensland. Also at that time, our Roy Morgan net promoter score was 38.4, indicating a strong likelihood of customers recommending Heritage to others. The average score of the big four banks was just 6.6.

These statistics provide a compelling indication that the mutual sector offers banking customers distinct and tangible benefits, which should not only be protected but encouraged. However we now find ourselves at a tipping point where lack of access to capital is putting the capacity of mutuals to continue providing these benefits to customers under enormous pressure.

Regulatory and legislative barriers which impede Commonwealth-registered cooperatives and mutuals from accessing capital

For Heritage, providing customers with valued benefits is part of our DNA, and central to our mutual philosophy. However, the fact that retained earnings provides our only viable source of capital has severely hamstrung our ability to fund our growth and development. As an entity that operates in a heavily regulated industry Heritage is obliged to hold minimum levels of capital as determined by the Australian Prudential Regulation Authority (APRA). While mutual ADIs can currently issue a variety of debt and capital instruments, under APRA's prudential standards none of the instruments that Heritage is able to issue qualify as the highest quality capital, Common Equity Tier 1 (CET1). To source new CET1 Heritage's only option is to grow profits at a faster rate or demutualize, which conflicts with the underlying business philosophy. This places the business at a competitive disadvantage relative to listed banks, which have a significant number of capital management options available.

Lack of access to capital raises two key issues.

The first is the need for Heritage, and all ADIs, to meet minimum capital requirements specified by APRA. Since the GFC, APRA has been amending prudential rules with an objective of introducing more capital into the broader banking system. Changes have included tightening the definition of prudential capital and reforming alternative capital management options such as securitisation so as to reduce leverage in bank balance sheets. In effect, the revised operating environment has affected mutual ADIs to a greater extent than listed competitors because of the different regulatory approaches applied by APRA. The changes have acted as a handbrake on Heritage's ability to gain a greater foothold in core markets and provide improved competition for consumers. At a base level, Heritage has to provide larger buffers and hold a higher average quantum of capital against its loan portfolio than the major banks. To meet prudential requirements, but retain our pricing and service proposition, we have had to control the amount of lending provided. Not only is this a constraint on Heritage's business development, it is also a constraint on competition in the mortgage market. Improving Heritage's ability to access additional sources of capital would enable us, and other mutuals, to lend more and offer greater competition – which delivers a better outcome for customers.

The second issue is the lack of access to capital to fund investment in our business. The impact of digital technologies is having a major impact on the banking sector. Significant changes to service delivery and the potential for improved operational efficiencies are impacting every financial services provider. It is not overstating the situation to suggest that there is an urgent need for financial institutions to fund significant investments in technology. Without the ability to invest in technology needed to support business objectives, smaller institutions are not able to keep pace with larger banks. This process has the potential to reduce diversity within the banking sector and deliver even greater dominance to the big four banks. Transforming our business to meet the new demands of the digital age is now our highest strategic priority. As with most financial institutions, our business has historically been based around a physical network of branches, with often manual processes. As we have entered the digital age, we have overlaid an online presence on top of this branch-based model. However as the digital revolution has rapidly gathered speed and reach, changing customer demands mean we must now transform into a primarily digitally-based business, that also has a physical presence. This means not only delivering the customer-facing digital offerings such as apps and website capabilities that they now demand, but also totally overhauling our back-office operations such as loans processing, marketing and financial management.

The inability to issue capital is compounded by the current prudential rules relating to investments in technology. Under the APRA capital management regime all investments of an 'intangible' nature are a deduction from capital for prudential capital purposes. Therefore capitalized technology costs associated with investments in software licensing and consultancy are effectively funded entirely from core capital. Transforming into a digitally-led business requires significant investment. Funding that investment out of retained earnings alone is a massive challenge for mutual ADIs. The scale of investment required puts the sector at a huge disadvantage compared to the listed banks, which have already used their much more flexible access to capital to invest in technological transformations.

To provide some context, current digital investment projects underway within Heritage include the following: implementation of a new Financial Management System at a total cost in excess of $10 million; a Customer Engagement (Marketing Automation) project expected to cost a comparable amount; implementing the New Payments Platform initiative expected to cost more than $2 million; and digital upgrades at branches which involves a capital outlay of approximately $30 million across our network of 61 branches over a period of years. The cost of these investments need to be compared with Heritage's total Tier 1 capital amount of approximately $450 million, earned over 142 years of operation.

Adding to this program of work are a number of major 'pipeline' projects, including a new loan origination platform, a digital customer-facing banking platform; improved business intelligence capabilities; comprehensive credit reporting, internet and mobile banking upgrades; process efficiency projects; replacement HR information system. These projects all require significant investment. The current restrictions in relation to capital raising extend the timeframes associated with investment and delivery and act as a significant barrier to adopting technologies crucial to remain relevant to our customer base.

Access to cost effective capital management options that do not threaten our corporate structure, and by inference our underlying business philosophy, are urgently needed. This dilemma is common across the mutual sector. We are already seeing the mutual sector shrink. As smaller institutions realise that the scale of investment required is beyond their scope many have chosen merger and/or acquisition. It may also lead some firms to consider demutualising. In many instances these decisions are not driven solely by market forces, but because of capital and other barriers that do not exist for listed companies. That trend will continue without measures that facilitate broader access to investment capital and further exacerbate concerns over diminishing competition within financial services and the lack of viable and competitive alternatives to the major banks.

Proposals for legislative changes to improve access to capital – the pros and cons of inserting a definition of mutual enterprise into the Corporations Act

Defining a mutual enterprise

There is currently no separate national legislative framework for mutual enterprises within Australia. The lack of a fundamental reference point to legislatively define what a mutual is has resulted in a plethora of corporate structures emerging, all of which justifiably see themselves as 'mutual' in nature. Finding commonalities across these entities is not without challenges, but best served via changes to the Corporations Act using a principles based approach designed to encapsulate the diversity of the sector. Heritage would recommend including at least four categories within a definition of 'mutual enterprise', flexible enough to incorporate the structures used by mutual ADIs, other APRA regulated mutual institutions, non-prudentially regulated mutual enterprises and state based mutual entities seeking to operate across state jurisdictions.

Legislative change requires careful thought around what it means to be a mutual business so as to minimize unintended consequences. The defining characteristics for a co-operative as recognized in one section of the Senate Economics Reference Committee Report are that an entity is owned by members and acts in the best interests of those members. These attributes are a logical starting point. In Heritage's view the key considerations as to what satisfies a mutual enterprise should centre around:

1. A definition of mutual ownership structure, in particular formal recognition of how a mutual is governed i.e. one member = one vote; and
2. The need for a constitution to effectively capture the purpose underpinning a mutual operation, in particular recognizing cooperative pursuit of outcomes that align with the interests of the membership base. This part of a definition could also incorporate a control capping the quantum of investor share ownership stake e.g. 49% of the member base or balance sheet capital value.

Together these principles capture the member-based ethos that sets mutuals apart from listed counterparts without being overly prescriptive about the way in which these requirements are implemented in practice.

Objectives underpinning changes to the Corporations Act

In considering the pros and cons of changes to the Corporations Act, there are a number of issues to address. From Heritage's perspective the primary reason to change the Corporations Act is to provide legislative clarity that embeds the mutual corporate structure as a credible alternative to a listed corporate structure. This would achieve a number of flow on benefits for the sector and promote understanding and education about the role of mutuals across a broad range of stakeholder groups.

More specifically legislative changes must be designed to simplify the ability for mutual entities to directly issue capital. For the reasons highlighted above mutual entities are unable to compete on equal terms without simpler and effective access to new forms of capital. Accordingly Heritage consider the following objectives important for the future of the mutual sector within Australia:

(i) Define the key characteristics of a mutual capital instrument

Defining a mutual enterprise within the Corporations Act would provide a much needed reference point from which a marketable capital instrument can be constructed. Legislative changes should be drafted to provide as much flexibility as possible to accommodate access to capital across a diverse range of operating models. Mutual entities need the ability to issue different forms of a capital to achieve different outcomes. The specific characteristics for a transaction are best defined within the transaction documentation applicable for the relevant circumstances of the issuing entity.

In the context of mutual ADIs specifically the characteristics of a capital instrument should reflect, as much as possible, the characteristics of listed share capital so as to satisfy the prudential requirements for CET1 (as defined by APRA). This includes a perpetual term; an interest subordinated to all other creditors; ability to absorb losses on a 'going concern' basis; earning a discretionary, non-cumulative earnings stream.

A mutual capital instrument could be defined as a security, note or investor share. As noted flexibility is important and Heritage's preference would be that the only definitive requirement is that a newly defined instrument is consistently referenced across related legislation (e.g. Financial Sector Shareholders Act, Tax legislation etc.) to ensure it receives comparable governance and oversight treatments to listed share capital. Facilitating access to as broad a range of investors as possible is more likely to provide greater opportunities and therefore benefits. In the past Heritage has successfully issued to institutional investors, retail investors and existing members. All of these groups should be accommodated under the proposed changes to legislation.

Specific issues that need to be considered as a flow on from this request include the impact of regulatory changes in the future, whether an instrument conveys voting rights, buy back provisions to facilitate retirement or repurchase of capital, taxation treatments, member approval processes and the role of Directors in managing a mutual entity's defined purpose.

Heritage's thoughts in relation to these issues are briefly summarized below:

- Regulatory framework – Mutual entities that operate in a regulated environment, particularly ADIs and insurance companies, need flexibility within applicable legislation to accommodate the likelihood of future regulatory changes. The one constant within the financial services industry within Australia is that regulatory change will continue going forward. This should include provisions to retire or repurchase existing capital instruments when regulatory interpretations are altered.
- Voting rights – Excluding voting rights for purchasers of investment shares should not be automatically prohibited in legislation. Heritage believes it is more important for mutuality to retain one member = one vote, therefore treatment of voting rights is best managed via the constitution of a mutual entity, or in the appropriate transaction documentation.
- Buy back provisions – Making a market in capital securities should be allowed for mutual entities where that function aligns with the stated purpose of the business. Further to the point raised above provisions for the retirement or repurchase of capital are needed where there is an adverse outcome because of regulatory or legislative changes.
- Taxation treatments – There is a need to harmonize tax treatments for mutual entities to promote competitive neutrality. There are numerous examples of discrepancies in the way mutual and listed entities are treated for tax purposes, for example franking credits. Many retail investors in capital and hybrid capital instruments, particularly retirees, actively seek franking credits when making investment decisions. Mutual entities pay the same rate of tax as listed entities therefore should be entitled to the same treatments in relation to franking credits. This is not possible under the current legislation. *(Note: Providing mutual entities access to franking credits to pay franked dividends to investors is unlikely to result in a material reduction in Government tax receipts. At the time of writing Heritage has approximately $190 million in accumulated franking credits and pays approximately $15 million per annum in tax. Heritage would need to pay approximately $50 million in annual coupon payments to utilize franking credits earned in one year. Heritage currently has total retained earnings of approximately $450 million, meaning it is highly improbable that the business would be in a position to issue an amount large enough to require an annual dividend payment of $50 million.*
- Member approval processes – The role of members should ideally be defined within the relevant constitution of a mutual entity. Operational decisions relating to mutual ADIs are best left in under the control of Senior Management and the Board of Directors.
- Directors duties – The role of Directors should reflect, as much as possible, the duties for Directors of listed entities as defined within the Corporations Act.

(ii) Reduce barriers caused by regulatory uncertainty

Mutual ADIs operate in a heavily regulated environment with supervision provided in some form or another by APRA, ASIC, ATO and RBA. As a general observation Australian regulators have a limited understanding of the mutual sector. This is supported by the recommendations contained within the Senate Economics References Committee (recommendations 2, 7, 12, 13, 16).

Capital related transactions are subject to prudential rules imposed by APRA and the Corporations Act, which is supervised by ASIC. It is Heritage's view that the current objectives of APRA and ASIC in relation to mutual ADI capital are contradictory. As a result mutual ADIs are subject to significant uncertainty when seeking regulatory approval for capital transactions. This has resulted in increased costs and protracted delays (months/years) when progressing initiatives. The current approach is unsustainable and a major impediment to effective commercial decision-making within the mutual sector.

The only effective solution to the current impasse is for legislative change to remove subjectivity associated with current approval processes. Embedding a definition of mutual enterprise within the Corporations Act will provide greater certainty in relation to key interpretations impacting capital decision-making. Heritage would also recommend that self-certification be a core objective of any associated legislative framework.

Regulators have a role to play in the formulation of capital issuance principles and ongoing oversight, but their involvement should not extend to a requirement for mutual ADIs to seek pre-approval of transaction documentation. There are numerous examples across the mutual ADI sector where regulators have micro-managed commercial negotiations and unexpectedly reversed precedent advice and interpretations adversely impacting timely execution of capital related initiatives.

(iii) A 'one size fits all' solution is not required

As noted Heritage has a positive track record issuing ASX listed prudential capital instruments. The number of similar transactions that have been completed by other mutual entities are very few. Heritage's view is that there is an appetite amongst wholesale and retail investors for suitably structured capital transactions of this nature. This appetite will grow if the legislative framework was supportive and the volume of issuance by mutual entities increased. Currently regulatory and legislative impediments prevent this from occurring. The scale of many mutual entities is also a barrier.

Executing a transaction at a cost-effective level is easier when there is a broader investor base and transparency in relation to key considerations, including:

- Investors value simple structures in preference to overly complicated instruments;
- Upfront disclosure of risk/reward features to ensure effective pricing (risk/reward balance);
- Transparent and effective mechanisms that allow an investment to be traded;
- Continuous disclosure to assess ongoing performance of the issuing entity.

This list is not exhaustive, but highlights that mutual entities wishing to issue capital will face challenges it they are unable to address these considerations. It is important to note that these barriers are the same for both mutual and listed entities. For many smaller mutual entities using existing regulatory frameworks to facilitate deal execution, such as an ASX listing and adherence to the continuous disclosure regime, is too onerous or costly. This applies equally for smaller companies with share capital, which often do not have sufficient scale or a strong enough track record to raise capital via the ASX. This is a key point that Government needs to consider as part of the current discussion. It is also an issue that resonates with many stakeholders outside of the mutual sector, particularly regulators.

Heritage has formed a view that less informed observers tend to bundle all mutual entities together. This has fostered perceptions that the sector has limited commercial capacity and capability, and that it is not suited to issuing capital via established fulfillment channels such as the ASX. It also gives rise to the notion that the mutual sector is asking for a 'one size fits all' approach to facilitate access to capital markets. This view is incorrect. While the changes under discussion will generally benefit the mutual sector as a whole Heritage believes that many mutual entities already have the scale and capability to use established fulfillment channels to issue capital. It is the legislative and regulatory uncertainty that has prevented these types of transactions from being completed, not the underlying appetite of potential issuers or investors. In Heritage's view there is no need to defer proposed legislative changes so as to create a 'one size fits all' solution to some of the execution challenges listed above.

(iv) Ensure legislation continues to facilitate demutualization (and vice versa).

Heritage believes it is important to retain provisions within the Corporations Act that enable mutual entities to demutualize. However the current definition of mutual entities, drafted specifically for the banking sector, is captured within ASIC's Regulatory Guide 147 (RG 147). These rules have shaped ASICs influence on the industry for more than a decade. The core principles embedded within this Guide are considered outdated and represent a significant obstacle to the development of a marketable mutual capital instrument. This is an important consideration at this time because RG 147 currently provides the only legislative reference point for relevant stakeholders looking to define a mutual enterprise.

More specifically the 'economic relationship test' within RG 147 is used by ASIC as a proxy to define the underlying purpose of a mutual entity. The premise underpinning the test is that the rights created for an investor shareholder group should not dilute current member entitlements (undistributed surpluses and annual earnings) because this may threaten the cooperative purpose of the entity. The test effectively defines the assessment of value derived from a member interest in a purely economic context. In addition the definition limits this assessment to a point in time. Philosophically the assumptions underpinning this interpretation are flawed and too restrictive for application across a diverse range of mutual operating structures.

Heritage's retained earnings base represents the cumulative contributions of members dating back more than 140 years. The interests of past members receive no consideration in the 'economics relationship test' interpretation as it currently stands. In addition the interests of future generations of members are similarly ignored. This is at the heart of the problem faced by mutual ADIs seeking access to investment capital – the need to invest in core capabilities or take advantage of opportunities that will help secure the business' future without compromising the mutual structure that defines a mutual entity's identity.

The principles of a workable framework for mutual ADIs to issue capital require a move away from a test based on 'dilution' to a more holistic assessment of the value derived from a member interest. In addition the needs of potential investors willing to support the development and investment strategies of the businesses should not be devalued. This might mean this group of investors is not prevented from participating in undistributed profits on a wind up or subject to a cap on their earnings in any given year. As noted enhanced flexibility is required to accommodate a wider range of mutual structures. For most mutual ADIs the issue of acquiring investment capital to fund ongoing investment in member services is not contrary to their underlying purpose to provide retail financial banking services to their member base.

For mutual ADIs the basic requirement of CET1 instruments must satisfy the Basel Committee definition of loss absorption. By definition this requires pari passu treatment by all equity holders when a loss is incurred. In Heritage's view it would be logical for this definition to include those stakeholders that purchased equity and/or were converted into equity. In Heritage's view a contribution of investor shareholding capital for a mutual ADI would not change the purpose of the business or dilute existing member interests. There are numerous examples across the world of mutuals raising additional capital without compromising their mutual status. Australia can draw on these examples and adapt to local circumstances to achieve comparable results.

Conclusion

Heritage believes there is a compelling case for the Federal Government to take the regulatory and legislative changes necessary to achieve positive change for the mutual sector in Australia. Key issues that need to be addressed include:

- Amend the Corporations Act 2001 to provide a specific definition of an "Incorporated Mutual Company". Heritage believes that such a definition should be principles based so as to benefit all existing mutual businesses. In addition the drafting should not be overly prescriptive, but have regard to the key features of mutuals – one member/one vote and the cooperative purpose as defined within the constitution of each entity.
- Heritage is a member of the capital project group convened by BCCM, and supports its proposal for legislation to create a new Mutual Capital Instrument (MCI). This instrument should be sufficiently adaptable so that all types of mutual businesses are able to issue to institutional and retail investors, as well as investing members. In developing the MCI, it is important that it is structured in such a way as to possess the relevant features to qualify as core equity tier 1 capital for mutual ADIs. It must also possess the relevant features to qualify for the release of franking credits.

- Legislation will help provide a clear guide to Regulatory bodies by removing doubt and the potential for changes in regulatory interpretation. This will also make the instruments more attractive to the market.
- Heritage is also cognizant of the constructive efforts made by APRA and the mutual ADI sector to amend prudential standards to enable instruments issued by mutual ADIs to qualify as Common Equity Tier 1 (CET1). We request that this work remain unencumbered by broader deliberations however we emphasise that a positive outcome in relation to this initiative should not be seen as a solution for the Corporations Act issue under consideration

We support the proposed reforms for Co-operatives, Mutuals and Member Owned firms. As Australia's largest Mutual Bank, we would welcome the opportunity to discuss our submissions and concerns with you.

Yours sincerely,

Peter Lock

Peter Lock
Chief Executive Officer

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