CUSTOMER OWNED BANKING ASSOCIATION

10 April 2019

Mr Graeme Samuel AC
Chair
APRA Capability Review Panel
The Treasury
Langton Crescent
PARKES ACT 2600

via email: apracapabilityreview@treasury.gov.au

Dear Mr Samuel

Australian Prudential Regulation Authority (APRA) Capability Review

COBA welcomes the opportunity to provide a submission to the Review.

Periodic reviews of a regulator's capability to deliver against its mandate are critical given the important role that regulators play in markets and the impact of their decisions on regulated entities. COBA commends the Government on its swift response to the Royal Commission's recommendation for regular regulator capability reviews.

COBA also welcomes the Government's recent Budget 2019-20 announcement to fund the Financial Regulator Oversight Authority (FROA). The FROA will provide vital accountability for regulators against their mandates, including in how they consider competition in their decisions.

COBA has a good working relationship with APRA and we appreciate our ongoing access and dialogue. COBA recognises that there has been some improvement in recent years in APRA's engagement with our sector and its accommodation of smaller ADIs, including the development of a simplified capital framework, standardised capital documents and direct issue mutual equity capital instruments.

COBA believes that our suggestions will significantly improve APRA's capability as a regulator of mutual and smaller ADIs. This will improve mutual ADIs' ability to compete in the concentrated banking market and to continue to be a 'point of difference' in the financial services sector with our customer-owned model.

COBA urges the Review to recommend enhancements to APRA's capabilities to:

- **better balance competition with its other objectives**
- **communicate externally about the benefits of the Financial Claims Scheme for competition and stability**
- **accommodate regulated entities seeking to innovate and to participate in initiatives outside their "traditional business model"**
- **ensure regulatory capital approval processes are efficient**
- **coordinate effectively with ASIC**
- **consult about and plan for macroprudential measures, and**
- **understand and accommodate different business models and corporate diversity.**

The customer-owned banking sector

COBA represents Australia's mutual banks, credit unions and mutual building societies. Our sector has over $117 billion in assets and over $100 billion in deposits across 72 ADIs. Our members are all supervised by APRA's Specialised Institutions Division.

Customer-owned banking institutions have a different ownership structure to investor-owned financial services companies. Our primary ownership relationship is as a customer either through holding a non-tradeable member share or being a member by guarantee.

For customer-owned banking institutions, the contribution of a nominal amount of capital (akin to a membership fee) is based on the expectation of a return via good service and competitively priced products. For a listed bank, the contribution of capital is based on the expectation of a financial return via dividends and capital gains on the tradable share. This different structure leads to different behaviour expectations and incentives within the regulated entity.

However, this different expectation does not mean that customer-owned banking institutions do not need to make a profit. Customer-owned banking institutions must be profitable to be sustainable businesses, to continually invest in new technology and systems upgrades and to continue to provide the products and services expected by their members. This means that they need to be able to innovate and make business decisions that may be outside what APRA characterises as their "traditional business model". As ADIs, they require regulatory capital to underpin their lending operations. Earning profits is the primary way for customer-owned banking institutions to accumulate regulatory capital. Further, if they issue equity capital instruments, they need to make a profit to provide a return to investors holding those instruments.

Capability to balance competition

The Review should aim to ensure that APRA has the capability and processes to balance the competition aspect of its mandate. It must also consider how APRA's internal processes provide accountability against this aspect of its mandate. While APRA has multiple 'balancing' considerations, given the current post-Royal Commission environment, it is important that there is clear consideration of competition in APRA's policy and supervisory decision-making processes. If the banking sector were more competitive, it would likely have reduced the extent of the misconduct examined by the Royal Commission.

The APRA Act s8(2) outlines its mandate as:

> "In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia."

COBA accepts that financial stability is APRA's primary purpose as a prudential regulator. However, the mandate outlines several other objectives—efficiency, competition, contestability and competitive neutrality. The relative importance of these four criteria is unclear aside from being 'less important' than financial stability and financial system stability.

In our view, competition is the most important of these additional considerations.

COBA continues to advocate for greater APRA accountability and focus on competition through the introduction of a statutory 'secondary competition objective' in APRA's mandate. This would increase the relative importance of competition and enshrine its importance in APRA's ongoing processes and culture. Alternatively, this can be achieved through strengthened requirements in APRA's Statement of Expectations. However, COBA recognises that these changes are not within the review's scope.

COBA acknowledges that APRA has recently increased transparency around its mandate. Since January 2018, APRA has published annual Policy Priority documents.[1] This includes a short one-page outline around how APRA interprets its mandate's elements. Similarly, APRA's consultation papers now include a single page that very briefly outlines the potential impacts on each element.

Despite this transparency, there is little detail about how competition is incorporated into APRA's culture and internal supervisory & policy decision-making processes. It is not clear if this is done in a systematic fashion. Similarly, it is not clear as to what level of 'competition expertise' exists within APRA.

COBA believes it would valuable to look at international examples such as APRA's UK peer, the PRA, to see how it incorporates competition into its decision-making processes. Unlike APRA, the PRA has a 'secondary competition objective' (SCO) but like APRA it maintains a financial stability primary mandate.

The PRA Competition Report outlines a number of actions taken to implement the SCO:

> "Internal guidance has been updated to ensure that competition issues are identified at the earliest possible stages of policymaking. For example, 'trigger' questions have been developed and included in the PRA's updated internal policy guidance.
>
> "The revised policy guidance highlights the importance of considering the SCO where developing policy and engaging with the PRA's senior advisor on competition and the PRA's in-house experts in order to ensure that competition issues are given due attention. This process is facilitated by periodic horizon scanning exercises to identify emerging competition issues well in advance."

The Review should consider whether APRA undertakes the necessary actions that demonstrate consideration of competition. These should include analysis of the regulatory impacts on different-sized ADIs, mutual ADIs and between ADIs and non-ADIs.

The 2018 Productivity Commission (PC) inquiry into Competition in the Financial System[2] found that regulators largely have the tools to support a competitive marketplace but their focus is tilted towards the stability of the system, with regulatory regimes that are indifferent to, or actively discourage, innovation and competition.

The PC also found that:

- competition can support stability, for example, through preventing excessive concentration in the financial system that would otherwise lead to dependency on a very small number of providers,
- regulatory settings and the (actual or perceived) interventions of the Australian Government are having a significant impact on competition in the financial system,
- APRA's approach to risk weights has increased the cost disadvantage for smaller financial institutions and reduced the scope for price competition, potentially harming consumers, and
- creating a regulatory system that supports competitive outcomes will require an explicit recognition of the role regulators play in restricting competition and a cultural shift towards considering pro-competitive action.

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[1] See Information Paper: APRA's Policy Priorities, 28 February 2019

[2] PC 2018, Competition in the Australian Financial System: Final Report, 29 June 2018

Capability on external communication on deposit insurance and competition

APRA needs a stronger external communication capability, particularly to promote the Financial Claims Scheme (FCS) to consumers and communicate its competition approach and consideration to industry (i.e. the 'outputs' of its competition consideration).

It is critical for APRA to raise public awareness that retail deposits in all ADIs are subject to the same level of protection under the Financial Claims Scheme (FCS). There is a clear role for APRA to do this in line with its financial system stability and financial safety mandates and its role as the FCS administrator.

APRA should have the capability to more actively and effectively promote the existence of the FCS to encourage depositors to confidently look beyond the Big Four banks. COBA recognises that this is likely to expand APRA's traditional communication ability to include a more 'retail' focus.

It is important for both competition and financial stability that depositors understand that bigger does not mean safer when it comes to retail deposits. APRA acknowledges that a deposit guarantee system such as the FCS "is more likely to provide financial stability if the public is aware of it."[3]

While COBA agrees there is some role for industry, the primary responsibility should remain with the Government and more specifically with APRA. COBA notes that this capability may differ from APRA's current capability that is likely to focus on non-consumer stakeholders.

As noted above, COBA supports the clear consideration of competition within APRA's policy and supervisory processes. This is accompanied by increased accountability on competition. In line with this, there should also be greater external communication around how APRA balances this aspect of its mandate. This will ensure that stakeholders have the full confidence that APRA has considered competition, including where it has decided not to incorporate competition considerations.

COBA recognises that there appears to be an increased focus on competition within APRA over recent years. APRA has increased its references to competition in its consultation papers and other external communication. COBA believes there must be more transparency around how APRA considers competition, and this can be achieved through an evolution of APRA's communications approach.

In terms of how this capability appears, the Review should consider how the UK PRA has changed its external communications with the introduction of its SCO. While APRA does not currently have an SCO, nor the accountability of an SCO, this can provide further international experience on how a 'competition' communication capability evolves alongside the primary stability communications.

Capability to allow regulated entities to innovate beyond "traditional business models"

The financial services sector is currently undergoing significant disruption. The traditional business models of the past must evolve with new products and new lending areas. APRA must have the capability and enabling culture to deal with the additional complexity that comes with a more diverse and broader range of ADI business models. This includes the expansion of ADIs into new areas.

Without these capabilities, APRA could unfairly restrict ADI's ability to innovate in the name of conservatism and financial stability. This restricts ADIs' ability to compete with non-ADIs and the ability of smaller ADIs to complete with larger ADIs. Restricting smaller ADIs from expanding into new areas will limit the potential growth and future sustainability of these entities.

Some COBA members have provided feedback that they believe APRA is unreasonably preventing innovation by resisting ADIs participating in initiatives "outside their traditional business models".[4] For most mutual ADIs, the "traditional business model" is based around consumer banking rather than

[3] APRA letter to ADIs, Prudential Standard APS 910 Financial Claims Scheme (APS 910) Requirements and Operational Preparedness, 10 January 2019.

[4] APRA letter to ADIs, Exposure to third party lenders including Peer to Peer lenders, 25 March 2019.

business banking. Given APRA's financial safety mandate, COBA recognises that APRA is not going to take a 'carte blanche' approach to innovation. However, where ADIs have appropriately considered the risk impacts then the regulator should not stand in the way of innovation.

In order to make this assessment, APRA must have the capacity to assess and communicate these risks to ADIs. Some COBA members have noted that the responses provided by APRA have not been satisfactory. Potential causes could be an overly conservative attitude or an absence of particular types of expertise in the regulator.

Capability to ensure regulatory capital approval processes are efficient

COBA members have noted that in that past they have experienced unacceptable delays in obtaining decisions from regulators about proposals to issue regulatory capital instruments. The 2017 Hammond Review identified APRA processes as a barrier to capital issuance.[5] COBA acknowledges that APRA has responded very positively to COBA on these recommendations. However, COBA members have noted that they still hold concerns and want to ensure that a facilitative environment continues, including for new innovative instruments such as the 'mutual capital instrument' (MCI).

Inefficient approval processes are costly due to the ongoing legal and tax advice and the diversion of internal resources over unreasonably lengthy periods. These costs are most stark for smaller ADIs who are subject to higher fixed costs and with more limited resourcing envelopes.

APRA advised the 2015 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."[6]

APRA provided the 2015 Senate Mutuals Inquiry with an example of this process involving a non-CET1 instrument which took six months and 12 iterations.[7]

In the past, COBA has been advised by members that there are some cases where the approval 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.

The ability to deal with novel instruments is critical given the recent passing of the *Treasury Laws Amendment (Mutual Reforms) Bill 2019*. This bill creates a new and innovative share-like instrument known as the MCI. While mutual ADIs have issued shares in the past, the MCI is a new instrument and APRA must ensure that it is able to efficiently deal with potential MCI issuances. Given APRA's past track record, COBA members have already raised concerns about the potential time it will take to issue an MCI due to APRA processes.

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[5] The Hammond Review report recommended that: Government encourage APRA to facilitate the issue of capital instruments by prudentially regulated mutuals by (i) assisting industry to develop standard template forms for member equity interests (MEIs), other capital instruments and documentation, and (ii) developing minimum service standards (including an agreed process, framework and timetable) for the timely assessment of capital instruments proposed to be issued, and accountability mechanisms for the service standards.

[6] See Answers to Questions on Notice by the Australian Prudential Regulation Authority (APRA) at 2015 Senate Mutuals Inquiry hearing held in Canberra, ACT on 26 February 2016

[7] See 6

Capability to coordinate with ASIC and its requirements

Under the ‘twin peaks’ model, APRA and ASIC play key roles in Australia’s financial regulation system. APRA is the prudential regulator while ASIC focuses on consumer protection and conduct. It is critical that both regulators can work together in a coordinated manner in order to minimise the impost on ‘dual’ regulated entities while pursuing their respective mandates.

An inability to do so will unfairly burden these ‘dual’ regulated entities. While ideally, the regulators would have clear mandates with no overlap, COBA recognises in some cases this cannot be avoided. Given the regulators’ expanding roles and the increasing complexity of financial services, it is likely that there is going to be a greater need for coordination.

An example of this complexity is the intersection of ASIC’s approach to the responsible lending obligations of credit licensees and APRA’s approach to lending standards by ADIs.

ASIC’s regulatory guidance allows lenders, in making reasonable inquiries about a consumer’s financial situation, to include indirect income sources (such as income from a spouse) where that income is reasonably available to the consumer, taking into account the history of the relationship and the expressed willingness of the earning person to meet repayment obligations. This allows lenders, in assessing a borrower’s ability to service and ultimately to repay a loan, to determine whether the borrower’s household is operating as a single economic entity. This allows the lender, in determining serviceability, to look at economic substance rather than just legal form.

However, APRA has advised a COBA member that this approach is unacceptable. APRA’s view is that a spouse or partner who is not a co-borrower or party to the loan contract cannot be relied upon to repay the loan as the ADI has no legally enforceable claim over him/her. As such, income included in serviceability assessments should be restricted to borrowers who are legally bound by the terms and conditions of the loan contract.

In this case, APRA is prescribing a narrower approach than the ADI’s own risk management preference and narrower than that considered acceptable in ASIC Regulatory Guide 209 *Credit Licensing: Responsible lending conduct*. There is clearly a need for greater consistency across both regulators.

COBA notes that ASIC is currently consulting on revising RG209 while APRA is consulting on a related new standard on credit risk management. COBA members have already expressed some concern about the different language used in these documents.

While lending standards are one example, COBA notes that similar issues could arise given that the currently APRA-administered Banking Executive Accountability Regime will be extended to a dual-administered program in the near future (i.e. Both APRA and ASIC). Similarly, given that both regulators are increasing their data collections it is critical that they coordinate respective data requests to minimise the burden of ‘dual’ regulated entities.

APRA should also ensure that there is effective internal coordination between its policy supervisory and statistics areas.

Capability to proactively identify and respond to risks – macroprudential measures

APRA needs the capability to be able to proactively identify and put in place and consult on potential responses, particularly in the area of macroprudential measures.

APRA’s recent macroprudential measures have had a significant impact on competition. COBA accepts that macro-prudential measures play an important role in managing systemic risk, and such measures are likely to be used in future. In line with this, APRA should be more transparent around the potential macroprudential measures that could be used in future. APRA should also communicate and consult on these through public processes. This would ensure that there is adequate consideration of competition impacts and communication of policy objectives to regulated entities. This can also inform the ex-ante analysis of the measures.

The IMF's 2019 Financial Sector Assessment Program[8] review of Australia found that, with respect to macroprudential policy, it: "recommend[s] carrying out a 'readiness' assessment of potential options that would facilitate the introduction of new or expanded policy measures, if needed".

It is critical that ahead of any "new or expanded policy measures" there is broader public consultation. Consultation would help smooth the application of measures and provides the opportunity to reduce unintended consequences while clearly reinforcing the intended consequences.

The ACCC highlighted the clear impact on competition of APRA's previous macroprudential measures:

> "We consider that the lack of sensitivity to scale in the design of these regulatory measures has given a competitive advantage to the large banks. "
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> "For example, compliance with APRA's investor benchmark is likely to have been particularly challenging for the Other Banks as a direct result of the 'one-size-fits-all' cap on growth."[9]

The PC's Draft Competition Inquiry Report highlighted the 'different' approach taken by other regulators, noting:

> "The Reserve Bank of New Zealand, for example, released consultation papers and asked for submissions before it set restrictions around high LVR lending in 2013, and then prior to changing these restrictions in 2015 and 2016. A Regulatory Impact Statement was also published in 2013."[10]

A Memorandum of Understanding between the Minister of Finance and the Governor of the Reserve Bank of New Zealand[11] states that "[RBNZ] will consult with the registered banks prior to deployment of a macro-prudential policy instrument in the manner required under Section 74(3) of the Act."

Consultation can also inform the pre-implementation analysis and minimise unnecessary operational issues in implementing the measures. Consultation could have avoided disproportionate impacts on smaller ADIs. This would allow APRA and other regulators to "keep costs to the least necessary to achieve their objectives in all material future macro-prudential actions."

Consultation can also be used to build wider policy legitimacy across the public and the regulated community – something that would support individual interventions as well as the broader macro-prudential toolkit.

Similarly, such an approach could be extended to outlining a macro-prudential toolkit. For example, RBNZ consulted in July 2017 on adding Debt-to-Income restrictions to its macro-prudential toolkit. This would not limit the potential measures available to APRA but provide more certainty about the potential future 'rules of the game' and hence allow ADIs to plan for them.

As a result of APRA's macroprudential intervention, several COBA members had no choice but to take time 'out of the market' due to the risk of breaching caps. Customer-owned banks, due to their small size relative to the major banks, are subject to greater volatility in their lending flows. This made it much more difficult to manage a predictable growth path within the 10% limit.

Having to temporarily exit the investor lending market had significant impacts on customer and broker relationships. New and existing customers were turned away as institutions were unable to provide a product that is part of the standard offering of modern banking institutions. For example, an existing borrower with an owner-occupied loan may seek to move both their current loan and new investor loan

[8] IMF 2019, Australia: Financial Sector Assessment Program-Technical Note-Systemic Risk Oversight and Macroprudential Policy, 21 February 2019

[9] ACCC 2018, Residential mortgage price inquiry: Final Report, November 2019

[10] PC 2018, Competition in the Australian Financial System: Draft Report, 7 February 2018

[11] See Memorandum of Understanding between the Minister of Finance and the Governor of the Reserve Bank of New Zealand

to another ADI if the current ADI is unable to provide the investor loan. This creates reputation and trust issues.

Capability to understand mutuals and promote corporate diversity

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 members have consistently commented that APRA does not understand mutuals. This capability is critical given the Royal Commission's findings about how the investor-owned model has effectively put profit before people.

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 consider the customer-owned model. In the United Kingdom, ASIC's peer regulator the Financial Conduct Authority (FCA) and the PRA are required to apply several 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"[12]

This was modified in 2016 to explicitly include consideration of mutuals.[13]

The FCA and PRA are required under law to report on their performance in meeting the corporate diversity obligation in relation to mutuals.[14]

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. In many cases, our regulators consider 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 between 2012 and 2018 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:

> "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."[15]

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[12] Financial Services Act 2012, 3B Regulatory principles to be applied by both regulators

[13] Bank of England and Financial Services Act 2016, Part 2, section 20

[14] See Part 9A, section 138K of the Financial Services Act 2012

[15] APRA 2012, APRA discussion paper: Implementing Basel III capital reforms in Australia

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."[16]

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 mutuals in ways that APRA has not." APRA and COBA have since resolved this issue.

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.

COBA seeks to ensure that mutuals operate in a regulatory environment that does not disadvantage them based on their corporate model. More broadly, COBA believes that this should take the form of a corporate diversity clause which requires relevant regulators (including APRA) 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'. COBA notes that while this may be beyond the scope of the review, the underlying capability of considering the impacts on the mutual structure vs. investor-owned structure is not.

If you have any questions or comments in relation to our submission, please contact Mark Nguyen, Senior Policy Adviser on 02 8035 8443 or at mnguyen@coba.asn.au.

Yours sincerely

MICHAEL LAWRENCE
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[16] Senate Economics Committee Inquiry into Post-GFC Banking Sector