



BUSINESS COUNCIL
OF CO-OPERATIVES AND MUTUALS

Private Health Insurance Capital Standards Review

Submission to the Australian Prudential Regulation Authority

30 September 2020

General Manager
Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

Via email: PolicyDevelopment@apra.gov.au

To whom it may concern,

The Business Council of Co-operatives and Mutuals (BCCM) welcomes the opportunity to make a submission in response to the Private Health Insurance Capital Standards Review Discussion Paper.

The BCCM is the national peak body for co-operative and mutual enterprises (CMEs) in Australia. It is a member driven and funded organisation representing CMEs operating in all industries including insurance, agriculture, banking, mobility, housing, retail, wholesale, health and community services.

BCCM is generally supportive of APRA's proposal to align private health insurance capital requirements with those of general and life insurers. The focus of our submission is to provide comment on the proposal to make mutual equity interests (MEIs) allowable capital for private health insurers (PHIs) (consultation question 2(e)) as well as for mutual insurers more broadly.

1. BCCM supports APRA making MEIs allowable capital for mutual insurers and imposing an initial 25% limit on the proportion of capital eligible for CET1 capital

BCCM supports APRA making MEIs allowable capital for mutual PHIs, general insurers and life companies (friendly societies) as this would introduce greater flexibility for these insurers to access CET1 capital beyond retained earnings, consistent with the flexibility currently afforded to non-mutual companies and mutual ADIs under APRA's prudential standards.

In our submission, this would be in line with the recommendations in the Independent Facilitator Review Report on Reforms for Cooperatives, Mutuals and Member-owned Firms (**Hammond Review**), which inquired into the barriers that mutual entities face in being able to compete, and followed the earlier Senate Economics References Committee report on Cooperative, mutual and member-owned firms.¹

¹ As APRA is aware, Recommendation 2 of the Hammond Review recommended: 'Government support (i) the ability of mutual friendly societies and mutual private health insurers to directly issue CET1 instruments, and (ii) APRA considering the amendment of its prudential standards to permit them to do so'. While the Hammond Review did not consider the capital requirements of general insurers, we support APRA permitting MEIs as allowable capital for general insurers on the same basis, namely that this would provide greater flexibility for

The recommendations in the Hammond Review are aimed at improving access to capital, removing uncertainties faced by mutual entities, and removing or reducing other barriers to capital raising, in order to enable mutual entities to invest, innovate, grow and compete. A key challenge faced by mutual entities in raising capital, identified in the Hammond Review, was their lack of access to the sources of capital that non-mutual companies can access by issuing ordinary shares.

Allowing mutual insurers to raise CET1 through issuing MEIs also makes sense, given the recent reforms made to the *Corporations Act 2001* (Cth) (**Corporations Act**) for mutual entities and equity raising (outlined further below).² The flexibility to issue equity will be increasingly critical for mutual insurers, given the changing conditions they operate under.

BCCM supports the proposed 25% cap, in line with the current limit for mutual ADIs, as an initial limit on CET1 raised through MEI issuance. This should remain open for further discussion and review.

2. APRA's MEI requirements for mutual insurers will need to account for certain aspects of the structure of mutual insurers

We note that 'APRA proposes that the PHI capital standards incorporate provisions comparable with those in the ADI capital standards to allow mutually owned insurers to issue MEIs'.

While we are broadly in agreement with this approach, on the basis that consistency between prudentially-regulated mutual entities would be desirable, we wish to draw to APRA's attention some features of mutual insurers which should be taken into account in the development of MEI requirements for mutual insurers to facilitate the success of the MEI regime.

In summary, these are:

- the nature of many mutual insurers as not-for-profit entities;
- differences in group/corporate structure between mutual insurers and mutual ADIs; and
- bespoke provisions in the constitutions of mutual insurers.

Not-for-profit (NFP) tax exemption status

A key difference between mutual ADIs and mutual insurers is that many mutual insurers, including the majority of mutual PHIs, are tax exempt NFP organisations.³ The constitutions of

these insurers to access CET1 capital beyond retained earnings.

² In particular, provisions for the issuance of MCIs were introduced into the *Corporations Act 2001* (Cth) (**Corporations Act**) as part of the reforms made in the *Treasury Laws Amendment (Mutual Reforms) Act 2019* (Cth) (**Mutual Reforms Act**), which commenced on 6 April 2019.

³ For example, a PHI is tax exempt under section 50-30 of the *Income Tax Assessment Act 1997* (Cth) provided it is 'not carried on for profit or gain of its individual members'.

NFPs reflect this requirement by broadly restricting distributions of profits and gains to members. NFP status is central not only to the identity of a NFP mutual insurer as a member-owned organisation, but also to its capital management.

It will be critical that the MEI requirements published for mutual insurers, especially PHIs, are drafted in a way which is not inconsistent with the NFP structure and tax exemption status of these entities. This is likely to be an important factor in the overall success of the MEI regime.

We understand that certain aspects of the MEI requirements currently in force with respect to mutual ADIs⁴ may be regarded by the ATO as inconsistent with NFP status, including:

- the references to dividends and distributions paid by the issuer from distributable items, such as retained earnings (see paragraph 1(e) of Attachment K and the modified versions of paragraph 1(f) and (g) of Attachment B of APS 111); and
- the reference to a MEI holder's claim on the residual assets of the issuer. This is arguably inconsistent with the manner in which a NFP must manage its assets on a winding-up.

Any requirements that MEIs confer membership interests or be regarded as 'shares' may result in similar challenges.

BCCM recommends APRA provides sufficient flexibility in its MEI requirements for mutual insurers for the ATO to determine whether it is appropriate or not for NFPs to issue MEIs (rather than prudential requirements necessitating an outcome).

BCCM additionally recommends that APRA work closely with mutual insurers and the ATO in relation to what form of MEI could be consistent with income tax exempt status.

Group/corporate structures

Many mutual insurers, especially PHIs, are registered as companies limited by guarantee, rather than companies limited by shares (or limited by both shares and guarantee). Historically, this prevented these entities from issuing shares. However, following the recent reforms outlined below, it is now possible for certain mutual entities, including those structured as companies limited by guarantee, to issue shares in the form of mutual capital instruments (MCIs).

If MEIs must take the legal form of shares, we note that a company limited by guarantee would only be able to issue MEIs which are MCIs.⁵ In such a case, the instruments would need to meet the requirements for MCIs under the Corporations Act, which are, in summary:

⁴ See, in particular, Attachment K to Prudential Standard APS 111, *Capital Adequacy: Measurement of Capital*.

⁵ Companies limited by shares or limited by both shares and guarantee could elect whether or not the MEIs are to be issued in the form of MCIs.

- the issuer must meet the definition of ‘mutual entity’⁶ in section 51M of the Corporations Act;
- the issuer must be able to meet the requirements of the definition of ‘MCI mutual entity’⁷ on issuance of one or more MCIs;
- an MCI may only be issued as a fully paid share;
- dividends in respect of MCIs must be non-cumulative;
- the issuer’s constitution must set out the rights attached to the MCI with respect to participation in surplus assets and profits; and
- rights attached to an MCI may only be varied or cancelled by special resolution and either by special resolution passed at a meeting of the class of members holding shares in the same class or with the written consent of members with at least 75% of the votes in the class.

We consider that the requirements for MCIs are compatible with the MEI requirements currently in force with respect to mutual ADIs. We submit that the MEI requirements to be published in respect of mutual insurers should also be compatible with the requirements for MCIs and that this is likely to be an important factor in the overall success of the MEI regime.

Further, we note that many mutual insurers are either currently, or in future are likely to be, part of a broader group structure, which may be a combination of mutual/non-mutual entities, companies limited by guarantee or otherwise, and NFP/for-profit entities. In our submission, their capital requirements should, taking into account this context, permit issuance structures commonly used by non-mutual companies, including internal/external note arrangements and issuances by related entities, to the fullest extent possible.

Bespoke constitutional provisions

For completeness, we note that the constitutions of mutual insurers differ to those of mutual ADIs and some have been specifically designed around a bespoke structure. For example, some or all members may not have rights to distributions or surplus (whether or not the entity relies on NFP tax exemption status) or the constitution may include bespoke provisions with respect to capital shortfalls or a winding-up.

⁶ In summary, a company is a mutual entity if: (a) the company is registered as a company under the Corporations Act; and (b) the company’s constitution provides that a person has no more than one vote at a general meeting of the company for each capacity in which the person is a member of the company.

⁷ For example, it must be a public company which is not a registered entity within the meaning of the *Australian Charities and Not-for-profits Commission Act 2012* (Cth) and which does not have any voting shares, other than MCIs, quoted on a prescribed financial market. The mutual entity must also have made certain amendments to its constitution.

We submit that the constitutions of mutual PHIs, general insurers and friendly societies should be considered as part of APRA's process for the technical drafting of the MEI requirements for mutual PHIs, general insurers and friendly societies, respectively.

3. BCCM recommends APRA consults with mutual general insurers and life companies (friendly societies) on its proposal to recognise MEIs as allowable capital for life and general insurers through the LAGIC framework

BCCM notes APRA's comment in the PHI Capital Standards Review that it is considering recognising MEIs as allowable capital of life and general insurers through the LAGIC framework.

While our comments above with respect to PHIs apply in general terms in the case of other mutual insurers, we recommend that APRA consult with the mutual life and general insurance sectors specifically in relation to this suggestion. Each mutual industry has distinct structures and frameworks that need to be carefully considered in implementing regulatory capital requirements as well as regulatory reforms more generally.

4. BCCM notes the 'special procedure' for amending mutual entities' constitutions under the Corporations Act expires on 6 April 2022

There is a consideration as to timing which we especially wish to draw to APRA's attention. To be able to issue MCIs, mutual entities must amend their constitutions and the Mutual Reforms Act provides for a 'special procedure' by which mutual entities can do so.

The special procedure expires on 6 April 2022 and we expect most mutual entities intending to rely on the special procedure will amend their constitutions at the preceding AGM in 2021.

Our experience to date suggests these entities would require final draft MEI requirements for mutual insurers to be published in the first half of (calendar year) 2021 in order to allow sufficient time for internal approval processes and member engagement prior to the AGM, in light of the majority of mutual entity AGM dates tending to fall in the second half of the year.

Although it is not mandatory to rely on the special procedure, this special statutory procedure was introduced to provide greater legal certainty,⁸ and to facilitate constitutional amendments being made by mutual entities whose constitutions include demutualisation procedure provisions or other onerous amendment requirements in their constitutions.⁹ As APRA will be aware, a number of mutual entities (including mutual ADIs) have relied on the procedure, or intend to rely on the procedure at their AGM this or next year, to make the amendments.

This issue is particularly acute with respect to the requirement under the Mutual Reforms Act to set out in the constitution 'the rights attached to [MCIs] with respect to participation in

⁸ For example, section 167AJ of the Corporations Act provides that an MCI amendment resolution passed in compliance with the requirements of the special procedure 'has effect as a special resolution despite subsections 136(3) and (4) [of the Corporations Act] and anything in the mutual entity's constitution'.

⁹ By way of background, see, eg, the Explanatory Memorandum to the Bill which introduced the Mutual Reforms Act at [1.49].


surplus assets and profits'. Because of this requirement, at present, mutual insurers which intend for their MCIs (or instruments convertible to them) to be eligible as regulatory capital are awaiting the outcome of APRA's consultation before they amend their constitutions.

We would greatly appreciate APRA taking this timing into consideration if it intends to revise the timetable of the review and in planning timetables for consultation with mutual insurers.


We would be pleased to provide further information on any matters raised in this submission.

Yours sincerely,




Chief Executive Officer

Contact:


Policy Adviser
info@bccm.coop; 