CUSTOMER OWNED BANKING ASSOCIATION

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8 September 2017

Ms Heidi Richards
General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

Via email: ADIpolicy@apra.gov.au

Dear Heidi

Consultation on Common Equity Tier 1 Instruments for mutually owned ADIs

COBA welcomes the proposed amendments, and notes that they follow a constructive consultation process between COBA, APRA and COBA members over the last year.

COBA supports the changes to the prudential framework to allow the direct issue of Common Equity Tier 1 (CET1) instruments by mutually owned ADIs. This will allow customer owned banking institutions to grow and compete on a more level footing with their investor-owned peers. These changes are another step towards an efficient and effective capital issuance framework for mutual ADIs.

COBA supports APRA's changes to simplify the MEI framework. Removing references to regulatory requirements that sit outside of APRA's jurisdiction will reduce complexity. Relaxing the requirement about the subordination of MEI relative to members' interests will provide greatly flexibility and clarity. These changes should improve the operational efficiency for mutual ADIs seeking to issue capital, including in relation to APRA approvals, with the onus remaining on mutual ADIs to ensure compliance with the other requirements.

While we are generally supportive of APRA's proposed approach, COBA seeks the following changes to further improve the efficiency of the framework:

- removing the limit on MEIs inclusion in an ADI's CET1 capital base or, alternatively, increasing the initial limit to at least 35 per cent
- aligning APRA's approval requirement with the approach applying to other capital instruments, i.e. assessing eligibility within the prudential framework
- clarifying additional disclosures requirements for MEIs, and
- in allowing caps on distributions, the prudential standard should accommodate different ways to calculate caps but does not need to prescribe this in detail.

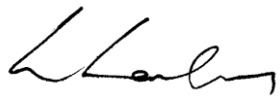
COBA notes that prior to the release of this July 2017 consultation package, the Government announced a review (the Hammond Review) into reforms to support cooperatives, mutuals and member-owned firms. This review focused on the access to capital for mutuals. As such, any recommendations could lead to changes in the legislative environment around mutual ADIs. We support an approach to the prudential framework that as far as possible will accommodate any future changes such as specific new provisions in the Corporations Act for mutual capital instruments, changes to Part 5 of Schedule 4 of the Corporations Act, and/or changes to *ASIC Regulatory Guide 147 Mutuality - Financial institutions.*

In terms of implementation, COBA agrees with the discussion paper that the amended framework should commence as soon as practicable.

COBA would welcome the opportunity to meet with APRA to discuss this submission.

If you have any questions about our submission, please do not hesitate to contact me on 02 8035 8448 or llawler@coba.asn.au or Mark Nguyen, Policy Adviser on 02 8035 8443 or mnguyen@coba.asn.au.

Yours sincerely



LUKE LAWLER
Director – Policy

Removing the limit on MEI inclusion in an ADI's CET1 capital base

COBA requests removal of the proposed 15 per cent limit.

This is COBA's preference but if APRA is committed to imposing an initial limit, it should be 35 per cent rather than 15 per cent and it should be expressed in a prudential practice guide or letter to ADIs rather than prescribed in the prudential standard.

In addition, APRA should include a review after a certain period (3 years) to examine whether any limit is still appropriate.

COBA members have noted that a 15 per cent limit is insufficient and would likely only cover a single issuance. This would not allow mutual ADIs that have successfully issued and have created an in-demand equity instrument to continue to issue. A higher initial limit of at least 35 per cent is appropriate as it would allow mutual ADIs to potentially do two or more issuances and provide additional capital management flexibility. An initial limit of at least 35 per cent remains consistent with APRA's position that MEIs should not constitute a 'predominant' part of a mutual ADI's CET1 capital.

COBA notes APRA's reasons for imposing the limit, including that:

1. MEIs involve some relaxation of APRA's required CET1 capital characteristics
2. the operation of MEIs is untested in a wind-up or resolution scenario
3. MEIs are likely to have a significant cost of capital, and an over-reliance on MEIs could place undue strain on the ongoing ability of the ADI to generate capital from retained earnings.

In relation to point 1, there is some departure from the ordinary share definition but MEIs are equivalent to ordinary shares in terms of their capital quality as regards loss absorption. We note APRA's comment on page 8 of the discussion paper that "the key elements for high quality capital are preserved".

In relation to point 2, this 'test' is unlikely to arise any time soon given the prudent and conservative approach of customer owned banking institutions. It seems contradictory to limit the proportion of high quality capital that mutual ADIs can raise, particularly tying this limit to the outcome of a remote scenario, i.e. until a mutual ADI goes through a wind-up or resolution scenario.

In relation to point 3, the mutuality tests set out in RG 147 include a requirement for a cap on distributions. The requirement to cap distributions is a natural barrier to over-reliance on MEIs.

As the market becomes increasingly familiar with MEIs, these initial concerns will diminish and hence the need for a prescribed limit.

Therefore, we ask that APRA agrees to examine the appropriateness and operation of the limit, after a certain period of time (i.e. 3 years after the first issuance).

COBA also seeks these following additional points of clarification:

Clarifying in APS 111 that MEI in excess of any limit is included in AT1

This could be achieved by an addition to APS 111 para 28 regarding AT1 capital "*(d) instruments issued by a mutually owned ADI that meet the criteria in paragraph 2 of Attachment K (mutual equity interests) and exceed the limit specified in paragraph 5 of Attachment K"*

The discussion paper notes that MEIs "in excess of this [15 per cent of CET1] limit could be included in the ADI's AT1 capital". This should be formalised in the prudential framework to ensure that mutual ADIs have certainty when issuing MEI that any excess would be included in their respective Tier 1 capital ratios.

While COBA notes that APS 111 para 13 allows APRA in writing to reallocate an instrument to a lower category of capital if it does not satisfy prudential standards (i.e. in this case being in excess of the limit), mutual ADIs need the certainty that MEI is included as Tier 1 given the costs involved.

COBA notes that APRA's previous position has been to allow excess capital to cascade down to lower tiers.

Clarifying the denominator of any CET1 limit

The discussion notes that the limit is a percentage of the "ADI's total Common Equity Tier 1 Capital". COBA seeks clarification that this figure is gross CET1 capital and does not include regulatory capital adjustments. COBA believes that it should be gross CET1 as otherwise there would be an extra CET1 'penalty' on MEI-issuing mutual ADIs.

Aligning the approval requirement in line with those for non-mutuals

COBA suggests that any approval be limited to the "eligibility of the capital instrument" as regulatory capital in line with the existing requirement under APS 111 para 15.

This would limit approval to meeting the prudential standards i.e. APS 111 Attachment K, part 2 and 3.

The discussion paper notes that APRA proposes to retain the requirement that an ADI must obtain APRA approval prior to directly issuing MEIs (para 4 of proposed APS 111 Attachment K).

COBA notes the proposed 'prior approval' requirement could be time consuming and lead to delays for mutual ADIs that are seeking to efficiently raise capital in a timely manner.

The proposed simplification of the MEI alongside COBA's proposal to narrow the assessment to objective criteria in Attachment K could reduce these approval times.

In our view, any approval should be limited to the eligibility of the capital instrument as regulatory capital in line with the existing requirement under APS 111 para 15. This will narrow the focus of the assessment onto whether the issue terms meet the relevant prudential standards i.e. APS 111 Attachment K, part 2 and 3.

APS 111 para 15 - COBA emphasis

> "Where the terms of an instrument depart from established precedent, an ADI must consult with APRA on the eligibility of the capital instrument for inclusion in the ADI's Regulatory Capital in advance of the issuance of the capital instrument, and provide APRA with all information it requires to assess the eligibility of the capital instrument."

With respect to APRA's approval power, COBA recognises that at present there is no established precedent for MEI so it is likely to require some form of APRA assessment.

However, it is critical that any approval is provided in a straightforward and efficient manner. Given that the MEI is currently a novel instrument, it should have the same

treatment as a novel instrument issued by a non-mutual to ensure there is competitive neutrality. This necessitates limiting approval to whether or not the MEI meets the prudential standard.

Establishing a precedent for MEI issuance and relaxing approval

The discussion paper notes that the approval requirement may be removed if "standardised documentation is developed for the issuance of MEIs by mutually owned ADIs." This roughly carries the same intent as in APS 111 para 15 (above) in that subsequent to an 'established precedent' (which in this case is standardised documentation) that approval may no longer be required.

However, the underlying trigger of 'standardised documentation' may not be appropriate given the diversity in the mutual ADI sector. For example, some members will require more detailed prospectuses targeting both retail and wholesale investors (especially if they pursue listings) while others could limit capital raisings to offer information statements aimed at retail investors. COBA believe that this should align with the concept of the 'established precedent' used in APS 111 para 15. This moves away from a 'one-size-fits-all' approach and aligns it with the expectations of other capital instruments.

Nevertheless, COBA welcomes APRA's intention in the discussion paper to potentially relax approval for MEI issuances if a common practice emerges. However, COBA believe APRA should formalise this intention in the prudential standard based on the creation of 'established precedent'. In line with this, and more broadly for capital issuances, APRA should also provide advice as what it considers to be an 'established precedent' in terms of APS 111.

Ensuring individual ADIs can undertake multiple issuances with existing documentation

COBA also seeks clarification to ensure that APRA would relax approval requirements for subsequent issuances by a mutual ADI that already has MEIs in the market.

For example, take the case of a mutual ADI that has already undertaken an MEI issuance with its own individual APRA-approved documentation. This documentation has been approved to meet APRA's prudential standards and has created a 'precedent' for the individual ADI. The mutual ADI should be able to use this documentation to undertake further MEI issuances without requiring a significant APRA reassessment of its issue terms. This makes sense from an efficiency perspective as the ADI has already undertaken the fixed costs of preparing an APRA-approved issue and should be able to benefit from this.

However, COBA notes that if there were to be material changes to the terms of the instrument then it would be prudent for the ADI to consult APRA.

Clarifying additional disclosures requirements for MEIs

COBA supports the underlying policy rationale for these additional disclosures.

It is important for the mutual ADI sector, potential MEI investors and APRA that MEIs operate 'as intended' and absorb losses in the same manner as the equivalent CET1 ordinary share instrument (while accounting for differences in the mutual structure). Given that MEI may be sold to retail investors, it is very important that it is clear that they are not 'regular' deposits or redeemable 'member' shares.

COBA seeks clarifications to the following disclosures to ensure that these disclosures do not impair the operation of the MEI as a 'normal' capital instrument for mutual ADIs.

Ensuring disclosures reflect that MEIs are repurchasable subject to APRA approval

With respect to disclosure 3(c), COBA agrees that it should be clear that the MEI is not redeemable as it exists as a 'perpetual' instrument. This is reflected in the first part of 3(c) noting that it "cannot be redeemed". However, COBA believes that the second part needs further clarification given that there are individual circumstances where the purchase price of the MEI could be repaid, for example, in liquidation or in a repurchase.

COBA notes that corresponding criteria to this disclosure is 1(c) in Attachment B (the MEI is subject to this criteria) which notes:

> "the principal amount of the instrument is perpetual (i.e. it has no maturity date) and is never repaid outside of liquidation (other than discretionary repurchases subject to APRA approval)"

COBA believes that APRA should amend disclosure 3(c) to ensure that it is clear that there are certain limited circumstances in which they may get the value of their MEI repaid. This would reduce any confusion about MEIs' status as a 'normal' capital instrument that is subject to repurchase subject to APRA approval under APS 110 35-38.

Explicitly allowing for repurchases, subject to APRA approval, provides important flexibility given the prospect of further changes to the Corporations Act framework flowing from the Hammond Review and the possibility of new capital options for mutual ADIs.

Ensuring disclosures note that the no set-off provisions are limited to MEI claims

COBA believes that disclosure 3(e) noting that "neither the issuer nor the holder of the mutual equity interest is allowed to exercise any contractual rights of set-off" requires greater clarification that the inability to exercise these rights is limited to the MEI.

As noted under Attachment K para 2, the MEI is subject to 1(h) in APS 111 Attachment B which notes that: "The instrument may not be subject to netting or offset claims on behalf of the holder or the issuer of the instrument".

The proposed disclosure 3(e) should be clarified to more clearly represent the intended criteria that reflect limits on 'set-off' for the instrument. This is important as some mutual ADIs may sell MEI to members and this may create some confusion relating to respective set-off rights in relation to member-held products and MEIs.

Allowing for reference to benchmark or a fixed percentage cap

Under RG 147, a mutual ADI is subject to a dividend cap on investor shares to ensure that it does not have a dominant purpose of generating shareholder returns.

The options for these caps are identified in RG 147.39 and must:

- 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
- 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%.

However, APRA's draft standard is not consistent with this approach and instead requires that distributions "on all MEIs, however determined, may still not exceed 50 per cent of the ADI's net profit after tax for that annual period".

COBA requests that the prudential standard should allow for both caps but not prescribe the caps in detail. APRA does not need to replicate the content of RG 147 other than to allow for caps to be applied to MEI dividends. We would prefer clause (e) of Attachment K to simply allow distributions to be capped, including by being calculated by reference to an external benchmark.

If it is considered desirable by APRA to explain the rationale for allowing caps on distributions, the standard could include words such as: "The level of distributions must not be tied or linked to the credit standing of the issuer, but may be capped to ensure the issuer does not become a company with the dominant purpose of yielding a return to shareholders. The cap may be calculated by reference to an external benchmark or by other means."

RG 147 may be amended or replaced in future so it is preferable that the prudential framework does not 'lock in' elements of a separate regulatory regime based on the Corporations Act and ASIC policy. For example, RG 147 currently requires that dividends can only be paid "out of that year's profits". In contrast, APRA's prudential framework does not explicitly prohibit ADIs from paying dividends from previous years' profits but rather requires ADIs to obtain APRA's written approval for such a planned reduction in capital (APS 110 paras 35 and 36(c)).

Clarification on potential "independent expert opinion" (IEO) requirements

COBA seeks clarification that the potential requirement for the independent expert opinion (APS 111 Attachment B para 2) is contingent on the instrument (a MEI) being subject to another jurisdiction. COBA notes that in other parts of APS 111 that the IEO is clearly only a potential requirement for multijurisdictional instruments in AT1 (Attachment E para 16) and T2 (Attachment H para 15).

APS 111 – Attachment B para 2

> "Where an instrument is subject to the laws of a jurisdiction other than Australia or its territories, the ADI must also ensure that the instrument satisfies all relevant qualifying criteria for Common Equity Tier 1 Capital under the laws of that jurisdiction. APRA may require the ADI to provide an independent expert opinion, addressed to APRA by a firm or practitioner of APRA's choice and at the expense of the ADI, confirming that the instrument meets all or any of the criteria applied to Common Equity Tier 1 Capital instruments in this Prudential Standard."

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