



# DISCUSSION PAPER

## Common Equity Tier 1 capital instruments for mutually owned ADIs

26 July 2017

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# Preamble

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This discussion paper outlines proposed revisions to the capital framework to facilitate issuance of Common Equity Tier 1 Capital instruments for mutually owned authorised deposit-taking institutions (ADIs). Concurrently with this paper, APRA is releasing for consultation draft revisions to *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111).

This discussion paper and the draft revised APS 111 are available on APRA's website at [www.apra.gov.au](http://www.apra.gov.au).

APRA invites written submissions on its proposals. Written submissions should be sent to [ADIpolicy@apra.gov.au](mailto:ADIpolicy@apra.gov.au) by 8 September 2017 and addressed to:

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

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Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOIA).

APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in the submission about any APRA-regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and will therefore be exempt from production under the FOIA.

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# Glossary

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<b>ADI</b>	Authorised deposit-taking institution
<b>AT1</b>	Additional Tier 1
<b>APRA</b>	Australian Prudential Regulation Authority
<b>APS 111</b>	<i>Prudential Standard APS 111 Capital Adequacy: Measurement of Capital</i>
<b>ASIC</b>	Australian Securities and Investments Commission
<b>Basel Committee</b>	Basel Committee on Banking Supervision
<b>Basel III</b>	Basel Committee on Banking Supervision, <i>Basel III: A global regulatory framework for more resilient banks and banking systems</i> , revised June 2011
<b>CET1</b>	Common Equity Tier 1
<b>Corporations Act</b>	<i>Corporations Act 2001</i>
<b>MEI</b>	Mutual equity interest
<b>Mutually owned ADI</b>	An ADI that is a credit union, building society or mutual bank
<b>RG 147</b>	Australian Securities and Investments Commission, <i>Regulatory Guide 147 Mutuality – Financial institutions</i>
<b>T2</b>	Tier 2

# Chapter 1 – Introduction

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## 1.1 Background

In 2013, APRA implemented its revised capital framework to improve the quantity and quality of regulatory capital, based on the internationally agreed measures known as Basel III.<sup>1</sup> A key element of the revised framework is greater focus on the highest quality component of capital, Common Equity Tier 1 (CET1), consisting primarily of ordinary shares and retained earnings. *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111) defines CET1 capital and, in Attachment B, sets out the criteria for classification as ordinary shares.

In effect, these criteria require ordinary shares, in order to be classified as CET1 capital, to:

- be perpetual;
- be the most subordinated claim in liquidation;
- be not redeemable without APRA's approval;
- be fully paid in;
- give shareholders an unlimited claim on residual assets that is proportional to their share of issued capital;
- have distributions that are not obligatory, cumulative or subject to a contractual cap that may suggest payment is obligatory; and
- be classified as equity under accounting standards.

For ADIs such as credit unions, building societies and mutual banks that are owned by members rather than shareholders (mutually owned ADIs), issuance of CET1 capital instruments that comply with these criteria may be inconsistent with mutuality principles, and may require enhanced disclosure to the mutually owned ADIs' members under the demutualisation provisions in the *Corporations Act 2001* (Corporations Act).<sup>2</sup> For example, the criterion for ordinary shareholders to have the most subordinated, and unlimited, claim in liquidation after payment of all senior claims conflicts with the rights of members of mutually owned ADIs to a subordinated claim on residual assets.

The Basel III framework acknowledged that the criteria may need to be adjusted for non-joint stock companies such as mutuals, taking account of their constitutions and legal structure, provided that the substantive quality of regulatory capital and loss absorption are preserved.<sup>3</sup> Since its implementation of the framework, APRA has been in discussions with the mutual ADI industry on how new capital instruments issued by mutually owned ADIs could be

<sup>1</sup> Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010 (revised June 2011) (Basel III) <http://www.bis.org/publ/bcbs189.htm>

<sup>2</sup> These provisions are set out in Part 5 of Schedule 4 to the Corporations Act, which is a separate regulatory regime applying to mutually owned ADIs.

<sup>3</sup> Basel III, footnote 12.

considered equivalent to ordinary shares in terms of quality of capital and loss absorption properties without compromising the issuing ADIs' mutual corporate status.<sup>4</sup>

The initial outcome of these discussions was APRA's 2014 introduction of the mutual equity interest (MEI) framework to facilitate mutually owned ADIs' ability to issue Additional Tier 1 (AT1) and Tier 2 (T2) capital instruments that complied with the revised capital framework. Such a framework was proposed because, under the Basel III reforms, AT1 and T2 instruments must be written off or converted to CET1 capital in particular circumstances.<sup>5</sup> However, because of the definition of CET1 capital, mutually owned ADIs were limited to writing off AT1 and T2 instruments. The MEI framework provides a mechanism under which AT1 and T2 instruments may convert to instruments (MEIs) that are deemed equivalent to CET1 capital so long as specified criteria are met.

The MEI criteria were modelled on the Basel III criteria for classification as ordinary shares in Attachment B of APS 111, adjusted to accommodate the different legal structures of mutually owned ADIs. The adjustments were to introduce a cap on MEI holders' rights to residual assets and on the level of distributions that may be paid. These criteria also incorporate provisions from *Regulatory Guide 147 Mutuality – Financial institutions* (RG 147), which sets out the Australian Securities and Investments Commission's (ASIC) approach to granting exemptions from the demutualisation requirements under the Corporations Act. The MEI criteria were incorporated in a new Attachment K to APS 111.

Further discussions were undertaken about extending the MEI framework to facilitate direct issuance of instruments that may be included in CET1 regulatory capital. These discussions were noted by the Senate Economics References Committee, which recommended in its report, *Cooperative, mutual and member-owned firms* (March 2016), that APRA bring these discussions to a timely conclusion.

This paper sets out APRA's proposed framework for the direct issuance of MEIs. Appendix A considers the net benefits of the two identified policy options. A draft of the revised MEI framework in APS 111 is being released concurrently with this discussion paper.

## 1.2 Timetable

APRA anticipates that, following consideration of submissions received, it will release the final revised APS 111 in late 2017 for commencement as soon as practicable thereafter. As issuance of MEIs is an additional option for mutually owned ADIs to raise capital and does not create any new prudential requirements, no transitional arrangements are proposed. Some minor amendments to reporting and disclosure requirements to refer explicitly to MEIs may be required, and these will be considered following finalisation of the revised APS 111.

<sup>4</sup> *Implementing Basel III capital reforms in Australia*, September 2012, p14  
<http://www.apra.gov.au/adi/PrudentialFramework/Pages/Basel-III-Capital-Reforms-September-2011.aspx>

<sup>5</sup> For AT1 instruments classified as liabilities, conversion or write-off is required if the issuing ADI's CET1 capital ratio falls below 5.125 per cent of risk-weighted assets (the loss absorption requirement). For AT1 and T2 instruments, conversion or write-off is required if APRA declares that, without conversion, write-off or a public sector injection of capital, the issuing ADI would become non-viable (the non-viability requirement).

### 1.3 Balancing financial safety and other considerations

In proposing these revisions to the capital framework for ADIs, APRA has sought to find an appropriate balance between the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, whilst promoting financial stability. On balance, APRA considers that the proposed revisions in this discussion paper will deliver improved prudential outcomes and provide efficiency and competitive benefits to mutually owned ADIs.

PRIMARY OBJECTIVES	
Financial safety 	Financial system stability 
<p>The proposed MEI framework reflects a relaxation of some of the prudential criteria applying to ordinary shares. However, the key elements for high quality capital are preserved and APRA therefore does not expect that there will be any material effect on prudential safety.</p> <p>The issuance of MEIs may result in more subordination to protect depositors. However, MEIs are untested in wind-up or resolution scenarios and are also likely to have a significant cost of capital.</p> <p>Limits on the aggregate amount included in CET1 capital and on distributions effectively mitigate financial safety considerations.</p>	<p>As the proposed MEI framework preserves the key elements for high quality capital and MEIs are expected to constitute a limited portion of total CET1 capital in the banking sector, there is not expected to be any material effect on financial system stability.</p>
OTHER CONSIDERATIONS	
Efficiency 	<p>Simplifying the existing MEI framework by removing references to ASIC's regulatory requirements may increase operational efficiency for ADIs in issuing MEIs.</p>
Competition 	<p>The ability to issue CET1-eligible instruments has the potential to provide mutually owned ADIs with additional capital management flexibility and thereby enhance their ability to compete effectively.</p>
Contestability 	<p>No material contestability considerations.</p>
Competitive Neutrality 	<p>The extension of the MEI framework to allow direct issuance of CET1-eligible instruments by mutually owned ADIs provides regulatory capital options similar to non-mutual ADIs.</p>

## 1.4 Request for cost-benefit analysis information

APRA asks that all stakeholders use this consultation opportunity to provide information on the compliance impact of the proposed changes to APS 111, and any other substantive costs associated with the changes. Compliance costs are defined as direct costs to businesses of performing activities associated with complying with government regulation. Specifically, information is sought on any changes to compliance costs incurred by businesses as a result of APRA's proposals.

Consistent with the Government's approach, APRA will use the methodology behind the Regulatory Burden Measurement Tool to assess compliance costs. This tool is designed to capture the relevant costs in a structured way, including a separate assessment of upfront costs and ongoing costs. It is available at <https://rbm.obpr.gov.au/>.

APRA requests that respondents use this methodology to estimate costs to ensure the data supplied to APRA can be aggregated and used in an industry-wide assessment. When submitting their costs assessment to APRA, respondents should include any assumptions made and, where relevant, any limitations inherent in their assessment. Feedback should address the additional costs incurred as a result of complying with APRA's requirements, not activities that institutions would undertake due to foreign regulatory requirements or in their ordinary course of business.

## Chapter 2 – Mutual equity interest requirements

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APRA proposes to amend the existing MEI framework to allow a mutually owned ADI (credit union, building society or mutual bank) to issue CET1-eligible instruments directly, in addition to issuing AT1 and T2 instruments that convert into MEIs.

### 2.1 A simplified framework

The existing MEI framework is set out in Attachment K to APS 111 and adopts by reference the relevant CET1 criteria for classification as ordinary shares set out in Attachment B to APS 111.

Attachment K to APS 111 also incorporates a number of requirements primarily designed to minimise the need for enhanced disclosure to the mutually owned ADI's members under the demutualisation provisions in the Corporations Act.

APRA's aim is to simplify the framework by removing provisions that essentially mirror requirements set out in the Corporations Act and RG 147. In APRA's view, it is unnecessary to reproduce in APS 111 regulatory requirements that do not fall within APRA's jurisdiction. Ultimately, it is the responsibility of mutually owned ADIs to ensure compliance with all regulatory requirements. APRA has consulted with ASIC on this approach.

### 2.2 Criteria for classification as an MEI

The following sections highlight the proposed revisions to the MEI criteria and associated requirements for ADIs issuing MEIs.

#### 2.2.1. Subordination and claim on residual assets

Under APRA's existing criteria for ordinary shares in Attachment B to APS 111, in a liquidation scenario shareholders are entitled to a claim on the residual assets of the ADI that is proportional to their share of issued capital after all senior claims have been repaid. This claim is unlimited and variable and is therefore not fixed or capped. The instrument must also be the most subordinated claim in liquidation.

The provision for an unlimited and variable claim on residual assets would conflict with the rights of members of a mutually owned ADI to a subordinated claim on residual assets. The existing MEI framework addresses this problem by imposing a cap on MEI holders' claims on residual assets. The existing MEI framework also includes a formula for apportioning residual assets between members and MEI holders in liquidation.

APRA has found that this approach presents a number of practical complexities, and has as a result proposed a simplified approach. MEI holders would continue to be subject to an overall cap on residual assets based on the amounts paid in; however, members would retain the right to any surplus once MEI holders had been paid out. Overall, APRA does not see that this

proposal would reduce the loss absorption quality of instruments or possess any features that would weaken the issuing ADI during periods of market stress.

Under Attachment B to APS 111, ordinary shares represent the most subordinated claim in liquidation of the issuer. APRA proposes to amend this provision to accommodate the rights of members in liquidation, clarifying that MEIs are subordinated to AT1 and T2 instruments.

## 2.2.2 Limit on distributions

Under APRA's capital framework, ordinary shares included in CET1 may not provide for a cap on distributions, in order to avoid any suggestion that payment up to the capped amount is guaranteed. Under ASIC's RG 147, however, dividends on investor shares should be capped, either by reference to an independent and objectively verifiable external benchmark (e.g. the Bank Bill Swap (BBSW) benchmark rate) or by being less than a fixed percentage (up to 50 per cent) of the ADI's annual net profit after tax. This is to avoid the dominant purpose of the ADI changing from being in the best interest of members to generating returns for shareholders. Under RG 147, an ADI with a dominant purpose being shareholder returns does not have a mutual corporate structure.

APRA included a provision in the existing MEI framework limiting distributions to 50 per cent of the issuing ADI's annual net profit after tax. APRA now proposes to also allow distributions to be determined by reference to a benchmark or index. 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. As applies under the existing MEI framework, there must be no circumstances under which distributions are obligatory and an ADI must retain full discretion to reduce or waive distributions where necessary. An ADI must not provide any indication that payment is guaranteed.

## 2.3 Limits on MEI inclusion in an ADI's capital base

While the ability to issue CET1 instruments would provide additional capital management flexibility for mutually owned ADIs, APRA is of the view that MEIs should not form the predominant part of a mutually owned ADI's CET1 capital or its capital base more broadly for the following reasons:

- MEIs involve some relaxation of APRA's required CET1 capital characteristics;
- the operation of MEIs is untested in a wind-up or resolution scenario; and
- 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.

APRA proposes to limit the aggregate amount of MEIs that may be included in an ADI's CET1 capital, whether these have been created through direct issuance or as a result of conversion of AT1 or T2 instruments. APRA is proposing a limit of 15 per cent of the issuing ADI's total CET1 capital. Any MEIs in excess of this limit could be included in the ADI's AT1 capital.

## 2.4 Disclosure

APRA's proposed revised MEIs would be a new form of CET1-eligible instruments which would be untested in the market. Historical experience, such as the failure of the Farrow group of companies in 1990, highlights the potential for investors to misunderstand, or be misled about, the nature of instruments similar to MEIs. It is important that investors understand that, as CET1 is the highest quality component of capital, an MEI is designed to absorb losses incurred by the issuer. Critically, MEIs are not deposits and are not guaranteed by the Commonwealth Government or covered by the Financial Claims Scheme.

To ensure that potential investors are appropriately informed of the nature of these instruments, APRA proposes requiring issuing ADIs to make specific disclosures to potential investors about MEIs. The issue documentation and marketing material must clearly indicate the subordinated nature of the instrument and that the MEI does not represent a deposit liability of the ADI, is not covered by the Financial Claims Scheme or guaranteed by the Australian Government and is not redeemable.

## 2.5 Approval requirements

Given their novelty, APRA proposes to retain the requirement that an ADI must obtain APRA approval prior to directly issuing MEIs or issuing AT1 or T2 instruments that convert into MEIs in loss absorption or non-viability scenarios. APRA may give consideration to removing this requirement if standardised documentation is developed for the issuance of MEIs by mutually owned ADIs.

## Appendix A – Policy options and estimated comparative net benefits

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APRA has considered two options for enhancing the MEI framework:

- retain the status quo and allow MEIs only on conversion of AT1 or T2 instruments; or
- extend the framework to facilitate direct issue of CET1-eligible instruments by mutually owned ADIs.

These options are discussed further below, together with a preliminary analysis of the costs and benefits of each. The analysis of costs associated with each option focuses on compliance costs, that is, the direct administrative, substantive (business) and financial costs incurred by ADIs in complying with government regulation. Indirect costs for ADIs and other stakeholders arising as a consequence of regulation (or not applying regulation) are also considered.

Any information provided in response to APRA's request for cost-benefit analysis information (see page 9) will be used by APRA to quantify the change in regulatory burden using the Regulatory Burden Measurement Tool, and inform calculations of the net benefits of the proposal.

<b>Option 1: Status quo</b>	Maintain APRA's existing capital framework for mutually owned ADIs, which could still issue AT1 and T2 instruments but remain unable to issue CET1-eligible instruments.
<b>Option 2: Extend the MEI framework</b>	Extend the MEI framework to allow mutually owned ADIs to directly issue MEIs while retaining their ability to issue AT1 and T2 instruments.

Under option 1, mutually owned ADIs could continue to issue non-CET1 instruments eligible for inclusion in regulatory capital (AT1 and T2 instruments) but would continue to be restricted from issuing CET1-eligible instruments. This does not meet the desire of mutually owned ADIs to improve their capital management flexibility. There would be no additional costs or benefits from this option.

Option 2 relaxes some of the current requirements in APRA's framework to facilitate mutually owned ADIs directly issuing CET1-eligible instruments. There would be some compliance costs incurred by mutually owned ADIs in ensuring compliance with the criteria governing MEIs, including seeking APRA's approval and, potentially, an ASIC exemption from the demutualisation provisions of the Corporations Act. Additional costs may also be incurred if enhanced disclosures, changes to the ADI's constitution, or the agreement of members, are required. APRA has sought to reduce these costs where possible by simplifying the framework and removing most references to ASIC's requirements from its prudential framework.

However, these costs are only incurred where a mutually owned ADI chooses to issue CET1-eligible instruments; an ADI with other sources of regulatory capital (retained earnings, AT1 or T2 instruments, for instance) would not incur these costs. As a result, there are no additional costs or requirements imposed by this option, and potential material benefits. The proposed limitation on the amount that can be included in CET1 is designed to ensure that there is no material impact on financial safety. The proposed disclosure requirements are intended to minimise any investor confusion about the nature of the new instruments.

The mutual sector has been actively seeking an amendment to facilitate the issue of CET1-eligible instruments and has been involved in the development of APRA's proposal.

For these reasons, APRA is of the view that option 2 provides the greatest net benefit.



 **APRA**