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General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
12/1 Martin Place
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Email: ADIpolicy@apra.gov.au

Dear Sir/Madam

Common Equity Tier 1 Capital Instruments for Mutually Owned ADIs

Thank you for the opportunity to provide Heritage Bank's submission on Common Equity Tier 1 Capital Instruments for Mutually Owned ADIs.

Please see our submission attached.

Yours sincerely

Peter Lock
Chief Executive Officer
Heritage Bank Limited

COMMON EQUITY TIER 1 CAPITAL INSTRUMENTS FOR MUTUALLY OWNED ADIs

HERITAGE BANK SUBMISSION TO APRA

Heritage welcomes APRA's discussion paper on CET1 capital instruments and proposed changes to APS 111 *Capital Adequacy: Measurement of Capital.* Heritage considers the proposed framework a genuine step forward for mutually owned ADIs within Australia. While Heritage is supportive of APRA's proposal, it offers the following observations:

- Heritage understands and accepts the need for APRA to be involved prior to an issue of mutual ADI CET1. Heritage recommends that an engagement process to support the issuance of CET1 by mutual ADIs be clearly defined in advance so as to ensure clarity, increase efficiency and safeguard the interests of all stakeholders.
- Heritage firmly believes that a self-assessment process is the most suitable approach to support positive outcomes in relation to CET1 issuance. If an ADI is complying with relevant prudential requirements, has the necessary approvals from internal stakeholders (e.g. Board and where applicable members) as well as any necessary legal, accounting and tax opinions then this should constitute sufficient due diligence to proceed. This would reduce the impact on APRA staff and avoid protracted delays.
- Heritage notes that while it is appealing to think that 'standardised' documentation may be developed to assist all parties, this is likely to be very difficult in practice. This is because of the inherent differences in corporate structures resulting from the distinct nature of mutual ADI constitutions as well as the inevitable changes to the prudential regime (and potentially the Corporations Act) that would need to be accommodated over time.
- Heritage understands APRA's view that the proposed CET1 product is untested but believes the suggested 15% cap on the size of a CET1 instrument is unnecessary and unworkable. There are multiple reasons supporting Heritage's positon:
  - ASIC Regulatory Guide 147 incorporates a cap on dividends paid for investment shares as well as various governance related criteria. This regime creates a significant number of prudential hurdles that impact the potential use of CET1 instruments. We also note the proposed application of a 50% cap on dividends. Heritage question the reasons why APRA need to add, duplicate or tighten the ASIC regulatory controls already in existence.
  - A cap like that proposed inherently discriminates against smaller ADIs. A cap limits the size of an individual transaction as well as the frequency of potential issuance that can be contemplated. It also reduces the cost-effectiveness of this channel as a potential capital management tool for ADIs and significantly increases execution risks for individual transactions. A cap was introduced as part of the covered bonds regime effectively restricting access to the larger banks. These types of regulatory imbalances undermine the competitive neutrality position of smaller ADIs.
  - Capping the use of a CET1 product severely restricts the ability of a mutual ADI to build sustainable access to investors. 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 regulatory framework was supportive and the volume of issuance by mutual entities increased.

- o A key barrier impacting competitive neutrality within the mutual ADI sector is the ability to access new capital. This is because advances in technology are changing the nature of retail banking service delivery and redefining operational efficiency for financial services providers. Under current prudential rules all 'intangible' investments, including capitalized technology costs associated with investments in software licensing and consultancy, are a deduction from capital for prudential capital purposes. Mutual ADIs cannot adequately fund investments to remain competitive if access to new forms of capital is capped or the existing rules relating to technology investments are not amended (listed ADIs are not subject to similar caps in relation to CET1 issuance).
- o Many market observers perceive mutual ADIs to have limited commercial capacity and capability. This fosters a view that the sector is not suited to issuing capital via established fulfilment channels such as the ASX. It also leads to higher levels of oversight and/or a greater focus on embedding operating constraints. This view should be challenged. While the proposed prudential changes will generally benefit the mutual sector as a whole Heritage believes that a limited number of mutual ADIs have the scale, appetite and capability to issue CET1, therefore the need for a 'one size fits all' restriction is inappropriate.
- o The cap appears to be a mechanism designed to reduce risks by restricting the amount of issuance completed. The need to limit access to this form of prudential capital because it is 'untested' does not eliminate risks to potential investors, just the extent of access. ADIs are subjected to effective scrutiny through existing levels of prudential oversight. Faith in established processes is needed to overcome this, and other imbalances in the current prudential settings.

- Heritage is supportive of the need to meet appropriate disclosure requirements. The market for CET1 instruments will only function correctly, and the sector considered more credible, if ADIs using this instrument are subject to appropriate disclosure obligations.
- Heritage recognises that an instrument must be perpetual in nature to qualify as CET1 under the Basel III regime. However the Bank has a strong view that ADIs must be allowed to redeem/repurchase these instruments under certain circumstances e.g. merger/acquisition, change of control event or if regulatory changes undermine the prudential treatment of the issued instrument. Heritage supports APRA's requirements that ADIs seek pre-approval for a redemption of a CET1 instrument.

Heritage is supportive of the proposed timeline to finalise the revised APS 111 in late 2017, for implementation as soon as practicable thereafter and would welcome the opportunity to discuss any aspects of our submission with you.

Yours sincerely,

Peter Lock
Chief Executive Officer

Heritage Bank
People first.