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Dear Neil

Implementing Basel III capital reforms in Australia

Thank you for the opportunity to comment on APRA's draft prudential standards to implement the Basel III capital reforms in Australia.

Abacus and our member ADIs are greatly appreciative of Dr Laker's public commitment that APRA will work closely with mutual ADIs on the particular challenges that the Basel III measures on the quality of capital pose for our sector.

We welcome APRA's acknowledgement of our sector's particular difficulties and APRA's undertaking to consult separately with mutual ADIs on the issues raised.

We look forward to continuing these consultations with the objective of accommodating mutual ADIs in a stronger capital framework for all ADIs.

The mutual model is the proven alternative to the listed model in the Australian retail banking market. Mutual ADIs have 4.5 million customers, a strong share of the household deposits and new home loan markets and are consistent market leaders in customer satisfaction and responsible lending.

The mutual model can be recognised and accommodated in the prudential regulatory framework without weakening capital standards or creating a two-tiered system. Recognition of the mutual model is critical to delivering the objectives of competitiveness, contestability and competitive neutrality, along with safety and stability, in the prudential framework.

The mutual ADI sector is strongly capitalised and the vast majority of this capital is in the form that is of the absolute highest quality – retained earnings. However, mutual ADIs must have access to capital in addition to retained earnings to increase market share and to take opportunities in future. We want to increase, rather than reduce, access by ADIs to different forms of high quality capital.

It is unacceptable to the mutual ADI sector to be required to demutualise to gain access to external capital.

Capacity to access external capital is a prudential benefit *per se*, but also enables mutual ADIs to more flexibly manage and grow their balance sheets to serve their members' interests.

The prudential regulatory framework already takes account of the differences between ADIs in terms of size, complexity and risk profile. Although the Basel III capital reforms are global minimum requirements for internationally active banks, Abacus does not seek exemption from the framework for Australian mutual ADIs. We seek application of the framework taking into account the mutual model, as is expressly permitted by the Basel Committee.

The outcome we seek is *equivalent* treatment for mutual ADIs and listed ADIs because *identical* treatment of the two models in a framework that blatantly prefers the listed model will harm competition, choice and diversity for no prudential benefit.

Abacus will continue to work with APRA as per the undertaking in the Response to Submissions paper and in the short term will seek APRA's response to mutual reform proposals on:

- CET1, claims on reserves and the operation of "caps" on dividend distributions for mutuals;
- Alternatives for mutuals to conversion or write-off of AT1 and T2 instruments at the point on non-viability.

Abacus and its members are also seeking a response to other issues raised in this submission, including:

- Clarification of the operation of the capital buffers;
- More definitive guidance on the requirements of the new ICAAP process for the mutual ADI sector.

CET1

The Basel Committee's *Basel III: A global regulatory framework for more resilient banks and banking systems* says:

"...the predominant form of Tier 1 capital must be common shares and retained earnings. This standard is reinforced through a set of principles that <u>also can be tailored to the context of non-joint stock companies</u> to ensure they hold comparable levels of high quality Tier 1 capital."

Non-joint stock companies in the Australian market are mutual ADIs – credit unions, building societies and mutual banks. APRA's 30 March 2012 Response to Submissions paper defines a mutual ADI as "an ADI operating under the mutual corporate structure in accordance with *Regulatory Guide 147 Mutuality – Financial institutions*, ASIC, September 2000.

This definition provides the opportunity for a clear distinction between mutual ADIs and listed ADIs in the prudential standards. Abacus recommends inclusion of the definition in the proposed new prudential standard APS 001 *Definitions*.

APRA's criteria for ordinary shares, as set out in Attachment B of draft APS 111 *Capital Adequacy: Measurement of Capital*, includes the following elements that may conflict with mutuality:

- the instrument holder is entitled to a claim on the residual assets that is proportional to its share of issued capital after all senior claims have been repaid in liquidation (i.e. there is <u>an unlimited and variable claim, not a fixed or capped claim</u>); and
- the level of distributions [on the instrument] <u>must not be tied or linked to the amount paid in at issuance</u>, or to the credit standing of the issuer, and <u>must not be subject to a contractual cap</u>.

ASIC's Regulatory Guide 147 says:

- [investor shareholders] must not participate in or otherwise accrue rights to surpluses in that capacity except by receiving dividends;
- The dividend that can be paid to holders of investor shares 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%.

Claim on reserves
It is a principle of mutuality that an investor shareholder's claim to a mutual's reserves is limited to the nominal value of the shareholder's investment.

APRA's criteria in relation to the claim on residual assets could be tailored for mutual ADIs to take into account their mutual structure and the requirements of RG 147.

One approach to achieving this outcome would be an addition to the criteria saying that for mutual ADI instrument holders, claims on residual assets will be limited to the nominal value of the instruments after all senior claims have been repaid in liquidation.

Cap on distributions
APRA said in its Response to Submissions that the purpose of the Basel III prohibition on a contractual cap on distributions is to ensure that banking institutions have full and unfettered discretion to restrict or cancel dividends where needed to maintain an appropriate level of capital.

"APRA understands that instruments providing for the payment of dividends by reference to an external benchmark or a fixed proportion of after-tax profits will not be inconsistent with the Basel III prohibition provided that:

- there is no linkage between dividend payments and the price paid at issuance;
- the amount is a maximum amount, does not operate as a de facto minimum and the ADI retains full discretion to reduce or waive distributions/payments where necessary; and
- there are no other features that could weaken the ADI as a going concern during periods of market stress.

"APRA believes that such an approach could alleviate the primary concern of mutual ADIs about constructing an instrument that may be deemed to be equivalent to ordinary shares under Basel III, and it invites further submissions on this issue."

Abacus welcomes APRA's statement on the 'cap' issue. The criteria in relation to distributions could be tailored with an addition to the relevant clause saying mutual ADIs may establish a ceiling on rights of distributions, to preserve their mutual structure.

Importantly, the cap would be a ceiling not a floor and it would be abundantly clear to investors that payment of distributions would be entirely discretionary and there would be no circumstances under which distributions were obligatory. Abacus is interested in discussing with APRA what may or may not be permitted to be disclosed in an indicative distributions policy.

APRA's Response to Submissions noted that one submission pointed to the approach taken by the European Commission in its draft *Capital Requirements Regulation* as a means to facilitate the issue of ordinary shares by mutuals. APRA noted that Article 25 of this draft allows mutually-owned banking institutions to include a cap on distributions where this is allowed under the relevant jurisdiction's legislative framework and the instrument does not possess features that could weaken the institution as a going concern during periods of market stress.

See Attachment A for an update on the status of Article 25.

The UK's largest building society, Nationwide[1], is reportedly close to finalising a new core Tier 1 instrument that is consistent with the society's mutual model and that is compliant with the proposed new European capital framework. Nationwide is reportedly in advanced discussions with the UK Financial Services Authority and the European Banking Authority on the new instrument.

AT1/T2

Abacus appreciates APRA's willingness to consider proposals for AT1 and T2 capital instruments issued by mutual ADIs that would meet the Basel Committee's goals of improving the quality and loss absorbency of regulatory capital.

We will continue to engage with APRA on the practical application of the non-viability principle to develop workable options for mutual ADIs.

Mutual ADIs do not have listed shares to provide a "conversion" option. Therefore, without some tailoring of the framework the only option facing mutual AT1/T2 instrument holders will be immediate and irrevocable write-off for the instrument at a trigger event. This would put mutual ADIs at a significant disadvantage to listed ADIs in raising AT1 and T2 capital.

Potential solutions for discussion with APRA to provide equivalence for mutuals include:

- conversion into mutual CET1 unlisted 'investor shares'; and/or
- alternatives to conversion, such as:
    - suspension of the instrument; or
    - immediate write-down and payment of, say, 20 per cent of the remaining principal.

As an illustration of the partial write-down approach, Dutch cooperative Rabobank issued a capital instrument in March 2010 that in the event of Rabobank's core capital falling below 7 per cent holders of the instrument face not conversion into equity but a write down of 75 per cent with the remaining 25 per cent paid out in cash.

Capital buffers

Draft APS 110 Capital Adequacy requires that from 1 January 2016 an ADI must hold a capital conservation buffer above the PCR for CET1 determined by APRA and the capital conservation buffer is 2.5 per cent, unless otherwise determined by APRA. The sum of the CET1 PCR plus the buffer determined by APRA will be no less than 7 per cent.

Abacus welcomes APRA's public acknowledgement in the Response paper "that mutual ADIs have less flexibility in capital management than listed ADIs and it will continue to work with mutual ADIs to address this issue."

We also welcome subsequent reassuring messages from APRA that the capital conservation buffer is largely already effectively built in to mutual ADI PCRs as those PCRs have CET1 ratios well above 7 per cent.

However, the requirement in the draft prudential standard is for the buffer – of whatever level up to 2.5 per cent – to apply above the PCR and there is therefore continuing concern in our sector about the uncertainty of future PCR requirements.

Abacus urges removal of this uncertainty at the earliest opportunity.

[1] Nationwide has total assets of £196 billion.

The capacity of mutual ADIs to meet any increase in their capital ratio will depend on the length of the transition period and the sources of capital that are available. The latter factor depends on the outcome of deliberations on capital instruments for mutual ADIs.

There is also uncertainty about the countercyclical buffer. Abacus supports allowing the countercyclical buffer to be met with capital other than CET1.

New ICAAP requirements
Abacus seeks detailed guidance from APRA and a practical implementation timeframe for the new requirements for an ADI's Internal Capital Adequacy Assessment Process.

A lack of clarity about the new requirements and APRA's expectations will lead to unnecessary and counter-productive compliance costs, particularly for smaller mutual ADIs. A Prudential Practice Guide for APS 110, focusing on the ICAAP requirements, would address this problem.

A key change is the formal new requirement to include stress testing and scenario analysis. While existing ICAAPs will generally include some stress testing and scenario analysis, there is uncertainty about the scope and extent expected by APRA under the new standard. Guidance is requested from APRA on factors and risks to cover in stress testing and scenario analysis.

Guidance is also requested about the definition and nature of "material risks" for the new section 14 (f).

Clarification is sought about the term "financial soundness" in new section 15(a) concerning the ICAAP summary statement.

Mutual ADIs will need to conduct a gap analysis of their existing ICAAPs to ensure they have adequate risk management 'policies, controls and personnel' in addition to the existing requirement for adequate risk management 'systems and procedures'.

As noted above in relation to buffers, meeting the ICAAP requirement to address the "means available for sourcing additional capital" depends on the outcome of deliberations on capital instruments for mutuals.

The obligation to review the ICAAP is strengthened to require review by "appropriately qualified persons who are operationally independent of the conduct of capital management." It is unclear whether this automatically means an external consultant, or whether the review be performed by the ADI's chief risk officer or internal auditor and our sector seeks clarification of this point.

As with all aspects of the Basel III reforms, mutual ADIs will need reasonable and adequate timeframes to assess, plan for, and comply with new Basel III regulatory requirements such as the revised and expanded ICAAP obligations.

Please do not hesitate to contact me on [redacted] or Luke Lawler on [redacted] to discuss any aspect of this submission.

Yours sincerely

MARK DEGOTARDI
Head of Public Affairs

ATTACHMENT A

European Commission: Article 25 *Capital Instruments of mutuals, cooperative societies or similar institutions on Common Equity Tier 1 items*

A new draft of Capital Requirements Directive (CRD) IV and the accompanying Capital Requirements Regulation (CRR) were published at the beginning of March 2012. There has been only one substantive change to Article 25 of CRR since it was first published on 20 July 2011, being that they have removed the requirement that a mutual CET1 instrument must "not possess features that could cause the condition of the institution to be weakened as a going concern during periods of market stress". Rather, Article 25 now states that all that is required is for the instrument to meet the requirements set out in Articles 26 (which sets out the key criteria for CET1 instruments) and 27 (which amends the key CET1 criteria for mutuals and similar institutions).

Article 27 sets out the following exceptions for mutuals, which have been included since the first draft:

Redemption – except where prohibited under national law, the institution shall be able to refuse the redemption of the instruments; where the refusal by the institution of the redemption of instruments is prohibited under applicable national law, the provisions governing the instruments shall give the institution the ability to limit their redemption; and refusal to redeem the instruments, or the limitation of the redemption of the instruments where applicable, may not constitute an event of default of the institution. The European Banking Authority (EBA) is tasked with drawing up further rules to specify the nature of the limitations on redemption necessary where the refusal by the institution of the redemption of instruments is prohibited under national law (such as, for example, where an instrument must be redeemed where the holder is no longer a member of the institution). There is no official timetable for the EBA to produce a draft of these further rules – however, it is widely anticipated by industry and media that a draft will be published within the next month.

Distribution caps – the instruments may include a cap or restriction on the maximum level of distributions only where that cap or restriction is set out under applicable national law or the statute of the institution.

Limited rights to reserves - where the capital instruments provide the owner with rights to the reserves of the institution in the event of insolvency or liquidation that are limited to the nominal value of the instruments, such a limitation shall apply to the same degree to the holders of all other CET1 instruments issued by that institution. This provision was tweaked at the beginning of the year to make it clear that it would not prevent mutuals from issuing non-voting CET1 instruments where the claims of the holders of those non-voting CET1 instruments in a winding-up is proportionate to the share of total CET1 instruments that those non-voting instruments represent.

Capped claims - where the capital instruments entitle their owners to a claim on the assets of the institution in the event of its insolvency or liquidation that is fixed or subject to a cap, such a limitation shall apply to the same degree to all holders of all CET1 instruments issued by the institution.

CRD IV and CRR are still being debated between the European Parliament and the European Commission. Following the release of the latest drafts, a number of comments have been made by MPs in relation to Articles 25-27 of the CRR. Importantly however, there have been no proposals to remove any of the exceptions for mutuals set out in Article 27. The official timing for final adoption of the CRD IV and CRR texts is now mid-June 2012.