



RESPONSE TO SUBMISSIONS

Common Equity Tier 1 capital instruments for mutually owned ADIs

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Glossary

ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
APS 110	<i>Prudential Standard APS 110 Capital Adequacy</i>
APS 111	<i>Prudential Standard APS 111 Capital Adequacy: Measurement of Capital</i>
ASIC	Australian Securities and Investments Commission
AT1 capital	Additional Tier 1 Capital, as defined in APS 111
CET1 capital	Common Equity Tier 1 Capital, as defined in APS 111
Corporations Act	<i>Corporations Act 2001</i>
ICAAP	Internal Capital Adequacy Assessment Process, as required under APS 110
MEI	Mutual equity interest
Mutually owned ADI	An ADI that is a credit union, building society or mutual bank
RG 147	<i>ASIC, Regulatory Guide 147 Mutuality—Financial Institutions</i>
T2 capital	Tier 2 Capital, as defined in APS 111
Total Capital	Total Capital, as defined in APS 111

Chapter 1—Introduction

1.1 Background

Common Equity Tier 1 (CET1) capital, consisting primarily of ordinary shares and retained earnings, is the highest quality component of capital and the cornerstone of the financial strength of an authorised deposit-taking institution (ADI).

ADIs such as credit unions, building societies and mutual banks that are owned by members rather than shareholders (mutually owned ADIs) have historically had limited access to CET1 capital beyond retained earnings. This is partly because instruments meeting APRA's criteria for classification as ordinary shares may be inconsistent with mutuality principles under the *Corporations Act 2001* (Corporations Act). As a result, mutually owned ADIs have largely depended on retained earnings to meet their CET1 capital requirements.

In July 2017, APRA consulted on proposals that would allow mutually owned ADIs to issue capital instruments that meet the definition of CET1 capital.¹ These proposals were to simplify and extend the current framework for mutual equity interests (MEIs) set out in Attachment K to *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111). This framework was introduced in 2014 and provides a mechanism for Additional Tier 1 (AT1) and Tier 2 (T2) capital instruments issued by mutually owned ADIs to convert into MEIs and be included in CET1 capital in a time of crisis.

The criteria for MEIs to be eligible for inclusion in CET1 capital were based on the criteria for ordinary shares set out in Attachment B to APS 111, amended to accommodate the corporate structure of mutually owned ADIs. The current framework also incorporates provisions from *Regulatory Guide 147 Mutuality—Financial institutions* (RG 147), which sets out the approach of the Australian Securities and Investments Commission (ASIC) to granting exemptions from the demutualisation provisions under the Corporations Act.²

APRA's proposals were to simplify the criteria for MEIs, including removing references to ASIC's guidance and requirements in the Corporations Act. APRA also proposed to introduce a limit on the amount of MEIs that may be included in CET1 capital and to require specified public disclosures to potential investors.

¹ See APRA's discussion paper, *Common Equity Tier 1 capital instruments for mutually owned ADIs*, 26 July 2017, available at: <http://apra.gov.au/adi/PrudentialFramework/Pages/Consultation-CET1-Instruments-for-mutually-owned-ADIs-July-2017.aspx> (the July 2017 discussion paper).

² ASIC's RG 147 is available at: <http://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-147-mutuality-financial-institutions/>

1.2 Submissions received

APRA received eight submissions on its proposals from industry associations and ADIs. All respondents supported amending the regulatory framework to facilitate direct issuance of capital instruments that mutually owned ADIs could include in CET1 capital. However, some sought clarification of, and raised concerns about, particular elements of the proposed framework. These relate to:

- limits on the amount of MEIs that may be included in an ADI's CET1 capital;
- limits on distributions on MEIs;
- disclosure requirements; and
- APRA's approval process.

APRA's response to these issues are set out in chapter 2.

Some submissions also sought advice about the application of tax and corporations laws to the MEI framework. APRA is not able to give advice about these laws and regulations, which are administrated by other government agencies. ADIs seeking to issue MEIs should make their own inquiries to ensure their proposals also comply with other relevant regulatory requirements.

1.3 Assessment of regulatory costs

As part of its public consultation, APRA specifically invited submissions on estimated regulatory costs that would be incurred as a result of the two options outlined in the July 2017 discussion paper: retain the current framework (under which MEIs arise only on conversion of AT1 or T2 capital instruments); and amend the current framework to facilitate direct issuance of MEIs. APRA suggested that the latter option would necessitate some additional compliance costs but noted that these would only be incurred voluntarily, where an ADI sought to meet minimum regulatory requirements through issuing MEIs that could be included in CET1 capital. Respondents were invited to use the Commonwealth Regulatory Burden Measure to assess regulatory costs. No respondents took up the invitation to use this tool.³

In the view of one respondent, the cost of issuing any capital instrument is treated as a business cost. APRA agrees with this assessment, noting that the framework is not mandatory and it remains open to an ADI to continue to meet minimum CET1 capital requirements through retained earnings. It is therefore arguable that the costs incurred to meet the eligibility criteria for directly issued MEIs to be included in regulatory capital are business rather than compliance costs. However categorised, the overall costs are insignificant, involving minor changes to calculating and reporting of regulatory capital and

³ This tool calculates the compliance costs of regulatory proposals on business, individuals and community organisations using an activity-based costing methodology. The 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/home.aspx>.

ensuring APRA's disclosure requirements are included in issue and marketing documentation. Against this cost is the benefit of providing an alternative means of raising CET1 capital. Overall, APRA concludes that the net benefit of allowing mutually owned ADIs to directly issue CET1-eligible capital instruments outweighs any costs of meeting additional requirements. Industry submissions support this assessment.

1.4 Changes to prudential and reporting standards

Accompanying this paper is a final version of APS 111 incorporating changes to the MEI framework in response to feedback received during consultation and to clarify its intended operation. For example, to remove any potential ambiguity APRA has amended paragraph 1(a) of Attachment K, which now states that holders of MEIs are subordinate to all claims other than members' rights to residual assets. Other minor amendments have been made to align with APRA's current drafting preferences. The revised APS 111 will commence from 1 January 2018.

In early 2018, APRA will make minor consequential changes to the following prudential and reporting standards to accommodate the revised MEI framework:

- *Prudential Standard APS 110 Capital Adequacy* (APS 110) to align with references to MEIs included in APS 111;
- *Prudential Standard APS 330 Public Disclosure* (APS 330) to ensure that MEIs included in CET1 capital and Tier 1 capital are clearly disclosed; and
- *Reporting Standard ARS 110.0 Capital Adequacy* (ARS 110) to capture the amount of MEIs included in CET1 capital and Tier 1 capital.

Chapter 2—Response to submissions

2.1 MEIs included in CET1 capital

APRA proposed to limit the aggregate amount of issued MEIs that could be included in an ADI's CET1 capital to 15 per cent of the issuing ADI's CET1 capital. All issued MEIs would be subject to the limit, regardless of whether they were directly issued or had been created on conversion of AT1 or T2 capital instruments. APRA further proposed that MEIs exceeding the limit could be included in AT1 capital.

Comments received

All respondents objected to the 15 per cent limit, concerned that it restricted ADIs to a single issue of MEIs or to multiple small issuances that would increase issue costs. Another respondent raised the concern that small issuances could indicate a shallow secondary market that might discourage institutional investors. It was submitted that, notwithstanding the relaxation of some of the criteria applying to ordinary shares, MEIs are equivalent to shares in terms of capital quality and loss absorption and should be treated accordingly.

Respondents further submitted that the limit on distributions proposed by APRA places an effective barrier on the issuance of MEIs, making a limit on the amount that may be issued unnecessary (this limit is discussed in section 2.2 below). Respondents asked that APRA remove or, alternatively, increase the 15 per cent limit to 25 or 35 per cent and to review it after two or three years. One respondent suggested that the value of the limit should not be included in APS 111 but through an external mechanism that would afford APRA greater flexibility to change it.

Some respondents also requested that APRA specify in APS 111 that MEIs issued above the limit may be included in AT1 capital.

APRA response

While MEIs can be a useful addition to a mutually owned ADI's capital structure, APRA remains of the view that MEIs should not constitute a material proportion of an ADI's CET1 capital. Not only are MEIs new and untested, but ADIs risk diluting future earnings and stunting long-term growth capacity if the cash distribution rate on an MEI exceeds the issuing ADI's return on equity. A specific limit included in APS 111 is a simple mechanism to address these concerns.

APRA has considered industry's concerns about the potential impact of this limit, including an increase in issuance costs. APRA has therefore decided to increase the limit to 25 per cent of CET1 capital. For the purposes of determining the limit, CET1 capital is the amount before regulatory adjustments.

This limit strikes an appropriate balance between enhancing capital management flexibility and preventing over-reliance on MEIs and will be kept under review. APRA also expects that the Internal Capital Adequacy Assessment Process (ICAAP) of an ADI seeking to issue MEIs would explore in some detail the potential investor base and potential impact on the issuing ADI's long-term growth based on a range of anticipated distribution rates.

In response to submissions about the treatment of MEIs on issue above the limit, APS 111 (paragraph 9, and paragraph 5 of Attachment K) has been amended to clarify that MEIs on issue that are in excess of the limit on eligibility for inclusion in CET1 capital may be counted towards meeting the issuing ADI's Tier 1 and Total capital requirements. To be eligible, they must meet the criteria set out in Attachment K to APS 111. There is no specific requirement to also meet the criteria for inclusion in AT1 capital set out in Attachment E to APS 111 but APRA expects that, as higher quality capital, the terms and conditions of MEIs would not contain any provisions that conflict with these criteria.

2.2 Limit on the level of distributions

One factor in ASIC's assessment as to whether an entity has a mutual structure for the purposes of exercising its powers under Part 5 of Schedule 4 to the Corporations Act is that dividends on any investor shares issued by the organisation must:

- be limited by reference to an independent and objectively verifiable benchmark or mechanism; or
- not be more than a fixed percentage of the ADI's net profit after tax (up to 50 per cent).

The current MEI framework incorporates the second criterion and provides that distributions are not to exceed 50 per cent of the issuing ADI's net profit after tax. In the July 2017 discussion paper, APRA proposed to also incorporate the first criterion by amending APS 111 to allow distributions on MEIs to be determined by reference to an external benchmark or index.

APRA also proposed to apply an overall limit on MEI distributions of 50 per cent of the issuer's net profit after tax, regardless of whether the maximum amount of distributions are calculated by reference to an external benchmark or index or as a fixed percentage of profits.

Comments received

One submission objected to APRA's proposal to apply an overall limit on distributions, preferring to leave the methodology for determining distributions to RG 147. Alternatively, it was suggested that APRA's limit on the issuance of MEIs (section 2.1) would effectively operate as a limit on distributions, making an explicit limit redundant. As distributions on AT1 and T2 capital instruments are likely to be linked to a benchmark but are not capped under RG 147, it was argued that it may be difficult for an ADI to meet a limit on distributions for MEIs that are converted from these instruments.

Another submission did not dispute APRA's extension of the limit but proposed that APS 111 need only specifically apply it to distributions calculated by reference to an external benchmark or index because RG 147 otherwise limits distributions calculated as a percentage of net profits.

APRA response

Consistent with APRA's preference to avoid duplicating regulatory requirements of other government agencies, APRA is removing from APS 111 the wording from RG 147 allowing distributions on MEIs to be calculated by reference to an external benchmark or index. This does not prevent issuing ADIs from using an external benchmark or index in calculating a

distribution, so long as issue documentation and marketing material do not indicate that the distribution rate will be a set amount, such as a specified margin above the bank bill swap rate applied to the face value of the instrument. That is, to appropriately reflect the equity nature of MEIs and the discretionary nature of all distributions, any reference to determining distributions by reference to a benchmark or index must be illustrative only.

APRA is retaining the overall limit on distributions of 50 per cent of an issuing ADI's net profit after tax (before distributions are paid) in the financial year to which the distributions relate. As stated previously, MEIs are new and untested, and APRA is concerned about the risk of compromising long-term growth by paying distributions at a rate that exceeds the issuing ADI's return on equity.

2.3 Trading in MEIs

One submission questioned how MEIs might be traded. Subject to ASIC and other regulatory requirements being met, APRA has no objection to mutually owned ADIs providing a mechanism or platform to facilitate transfers between willing buyers and sellers. However, APRA would not support ADIs that do not otherwise operate trading books making a market and trading in MEIs themselves. Such trading by ADIs could be used to provide a mechanism for redemption, as well as potentially giving rise to investor expectations that an ADI will support its own MEIs.

2.4 Disclosure requirements

To ensure that potential investors, particularly retail investors, understand the equity characteristics of MEIs, APRA proposed that issuing ADIs make specified public disclosures in issue documentation and marketing material. This included disclosing that an MEI cannot be redeemed and that the purchase price will not be repaid.

Comments received

Submissions broadly supported APRA's rationale for requiring specified disclosures, with one noting that, as MEIs may be sold to retail investors, it is important that it is clear that they are not deposits or redeemable member shares. Several respondents asked that APRA amend the disclosure about redemption to accommodate the provisions in paragraphs 35 to 38 of APS 110, which allow an ADI to voluntarily repurchase capital instruments with APRA's approval. One also asked that APRA amend the disclosure about contractual set-off to clarify that this relates only to MEIs and not to other rights relating to member-held products.

APRA response

APS 110 does provide a mechanism under which ADIs may seek APRA's approval to reduce capital through share buyback, redemption, repurchase or repayment of regulatory capital instruments. This mechanism is intended typically to apply to instances where an ADI's ICAAP clearly identifies a strategic need to reduce capital through these means as part of well-thought out capital management planning. It is not intended to apply to *ad hoc* requests on behalf of individual or groups of investors to redeem capital instruments. APRA has amended APS 111 to require ADIs to disclose that an ADI cannot repurchase or redeem an MEI, other than in exceptional circumstances and with APRA's approval.

It is important that MEIs are distinguished from deposit products and member shares, particularly for retail investors. To address this concern, APRA has added a further requirement in paragraph 2(f) of Attachment K under which an ADI must clearly and prominently state in issue documentation and marketing material that it has full discretion over the timing and amount of any distributions, including not paying a distribution.

APRA has also amended paragraph 2(e) of Attachment K to clarify that disclosure about the restriction on contractual rights of set-off relates to MEIs.

2.5 APRA's approval requirements

APRA proposed to require mutually owned ADIs to obtain APRA's approval prior to issuing MEIs as is currently the case with AT1 and T2 capital instruments that convert into MEIs.

Comments received

Several submissions asked that APRA remove the approval requirement for MEIs as there is no comparable pre-approval requirement for ADIs to issue ordinary shares. They also queried whether independent advice would always be necessary. One submission also sought confirmation that the approval process addressed only the eligibility of the MEI capital instrument as regulatory capital. Some respondents also requested clarification on whether APRA would relax any approval requirement for subsequent issuances of MEIs.

APRA response

Ordinary shares have standardised features that have developed over many years and are subject to ASIC and other regulatory requirements. As MEIs are new and untested, APRA remains of the view that they should be subject to prior approval. As stated in APRA's *APS 111 Frequently Asked Questions*, an ADI needs to submit an independent legal opinion on an instrument's eligibility under the prudential framework and other matters.⁴ APRA will continue to require advice of this nature.

However, APRA may consider removing the approval requirement if standardised documentation is developed. That said, APRA will need to be satisfied that an ADI's proposed issuance of MEIs is appropriately addressed in its ICAAP, including an analysis of the ADI's ability to pay expected distributions and the potential impact on long-term growth.

⁴ These frequently asked questions are available at: <http://www.apra.gov.au/CrossIndustry/Pages/Capital-Adequacy-FAQ.aspx>



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