SUBMISSION TO THE FINANCIAL SYSTEM INQUIRY

23 AUGUST 2014

Common Equity Tier 1 Capital
for Mutual ADIs

Neville Parsons – CEO Holiday Coast Credit Union

Dear Mr. Murray and Committee members

Overview of Holiday Coast Credit Union & Why this submission

Holiday Coast Credit Union is a mutual ADI servicing the NSW mid north coast and Maitland regions, with 32,000 members and total assets of $511m.

The credit union started at the local Dairy Cooperative in Wauchope in September 1967 as Hastings Rural Credit Union to serve the savings and lending needs of the suppliers to and the employees of the local Dairy Cooperative.

Holiday Coast Credit Union as the credit union has been known since 1996 has always known and continues to respect that it exists to provide affordable and caring financial services for its members who are its owners and customers.

Although the means of providing products and services has changed over the last 47 years the reason for the credit union's existence has not. Holiday Coast Credit Union exists to enhance the financial and social wellbeing of its members and their community.

As a business, we focus on providing our members, as customers, with quality products and services with a continuing emphasis on the education of members in the benefit of saving and the wise use of credit.

In addition to this, and in the true spirit of a mutual organisation, we also provide much needed funding to local community groups who, like us, work to make our communities a great place to live, work and play.

Our "giving back" to our community has been highlighted in the Customer Owned Banking Initial Submission to this Inquiry at section 3.6 Community Contribution. This support of and engagement with our local communities is part of our Strategic Focus and indeed a key part of our Holiday Coast Credit Union difference.

Our ability to continue to deliver on our community giving and engagement will be dependent on our having the ability to raise additional Capital through means other than retained earnings.

We, as an individual credit union with the assistance of Cuscal (the Association representing credit unions at that time) pioneered in 2000 the issuance of tier 1 capital for credit unions that maintained the Principles of Mutuality as prescribed by ASIC and met the requirements of APRA in terms of being the highest level of capital available for a mutual.

We issued irredeemable non-cumulative preference shares that had the approval of APRA, ASIC and the ATO as eligible Tier 1 capital at that time that enabled the release of franking credits on the dividends paid to the member holders of those shares. The reason for our treading this new ground in 2000 was to underpin the growth and development of the credit union and to strengthen our capital base.

We make this specific submission to ensure that under Basel III and its application by APRA to Australian mutual ADIs, that mutual ADIs can directly issue Common Equity Tier 1 (CET1) Capital.

The current situation I propose is inequitable and fails to provide mutual ADIs with the same capability for the issuance of CET1 as non-mutual ADIs.

Holiday Coast Credit Union has also a more urgent need for this capacity to directly issue CET1 as our initially endorsed Tier 1 Capital that we have on issue is now being amortised for capital treatment for APRA Regulatory purposes as a result of APRA not considering the irredeemable non-cumulative preference shares as CET1 and also not allowing the direct issuance of CET1by mutual ADIs.

Our Submission

Further to your Committee's Interim Report on the Financial System Inquiry I would like to address your attention to one of the specific issues identified in your report with respect to the Mutual ADIs (Approved Deposit Taking Institutions) in Australia.

As noted in the Inquiry's Interim Report at Section 2 (Competition) page 3:

The Inquiry has made the following observations about competition in the Australian financial system:

- *The banking sector is competitive, albeit concentrated. The application of capital requirements is not competitively neutral. Banks that use internal ratings-based (IRB) risk weights have lower risk weights for mortgage lending than smaller authorised deposit-taking institutions (ADIs) that use standardised risk weights, giving the IRB banks a cost advantage.*

The specific issue that I raise is the other aspect of the following statement from above - *The application of capital requirements is not competitively neutral.*

The aspect of issuance of capital is not competitively neutral as a result of the mutual structure of Mutual ADIs and specifically the drafting of the APRA Prudential Standard APS 111 Capital Adequacy: Measurement of Capital.

The crux of the Prudential Regulation drafting in APS 111 is that for any direct issuance of Common Equity Tier 1 (CET1) Capital the language used is "paid–up ordinary shares" which is in itself language that is relevant to a non-mutual corporation and contrary to the structural requirements of a mutual ADI as determined by the Principles of Mutuality as prescribed within ASIC Regulatory Guide 147.

It is considered important for the future growth and continued viability of Mutual ADIs in the Basel III world to have the ability to issue as a means of Capital Raising CET 1 Capital that maintains the Principles of Mutuality as prescribed within ASIC Regulatory Guide 147.

It is my proposition that the real area of lack of competitive neutrality in relation to capital is indeed this lack of ability for Mutual ADIs to directly issue CET 1 Capital.

The Inquiry's observation that there is a possible need to adjust the internal ratings (IRB's) for competitive neutrality is appreciated but it is the direct ability to raise CET1 Capital that is the real issue to be remedied for Mutual ADIs.

The following extract from the Committee's Interim Report at Section 2 page 10 highlights the need for mutual ADIs to have the ability to issue CET1 as a means to underpin future growth, viability and relevance. Especially given that at present there is no capacity for mutual ADIs to directly issue CET1 within the current APRA Prudential Standard.

> *The aggregate regulatory capital requirements of an ADI should reflect its overall risk profile. Although small ADIs may benefit from detailed knowledge of their customers, they also have relatively concentrated loan books and, in the case of credit unions and building societies, limited capacity to raise new equity. They also tend to have less sophisticated risk management systems, albeit with less complex risks. These factors suggest smaller ADIs may need higher regulatory capital buffers than their larger competitors.*

Such access would enable mutual ADIs to utilize the raising of additional CET1 capital through means other than retained earnings and therefore release some of the currently generated profits to become more competitive with product pricing to benefit members and or to invest in future technologies to better meet the needs of members and or invest further back in to their respective communities of interest.

I note that the Inquiry's objective … *is to assess, and make recommendations on, how the financial system can most effectively help the Australian economy be productive, grow and meet the financial needs of Australians.*

To meet this objective, the Inquiry considers that the financial system must satisfy three principles: efficiently allocate resources and risks, be stable and reliable, and be fair and accessible.

I consider that a financial system that does not at this stage provide the opportunity for mutual ADIs to issue CET1 as a means of underpinning future growth and investment is not fair and I believe that this can simply be addressed through the recognition of the specific requirements for a mutual ADI within the APRA Prudential Standard and specifically within the context of issuance of CET1 capital.

As identified in the Interim Report at Section 2 page 5

To facilitate competition, the Government should… ***Remove regulatory impediments to competition, such as barriers to entry and distortions to level playing fields…*** as per the attached extract:

> *The Inquiry's principles for competition policy*
>
> *To facilitate competition, the Government should:*
>
> - *Ensure market participants do not act anti-competitively or build up excessive market power through mergers and acquisitions*
> - *Remove regulatory impediments to competition, such as barriers to entry and distortions to level playing fields, subject to trade-offs with other policy objectives that the regulation seeks to achieve*

The industry body, for Mutual ADIs, Customer Owned Banking Association in their submission to the Financial Systems Inquiry, has outlined the characteristics of the mutual sector within the Australian Financial System of which I am sure you will be aware.

It is important that customer-owned ADIs have the ability to issue regulatory capital in the form of CET1 and are able to do so without compromising their mutuality.

Under Basel II, customer-owned ADIs were able to issue all forms of regulatory capital.

Indeed, we at Holiday Coast Credit Union issued what was classed under Basel II as Tier 1 Capital via an Offer Information Statement that was issued to members on 11 September 2000. We negotiated with APRA and ASIC, prior to the formal issuance of that Offer Information Statement, the requirements to create and issue to our members an eligible Tier 1 Capital instrument that met the APRA requirements at that time together with the ASIC requirements for Mutuality.

The Instrument that we created and issued to our members is an irredeemable non-cumulative preference share which from our research at the time was the highest form of capital instrument that we could issue and not breach our mutuality.

The share has been serviced since inception and has received a fully franked dividend, 6 monthly. This share has allowed us to release some of our franking credits that we have accumulated, but we still accrue more franking credits each year then we release through the imputation credits relating to the dividend payments.

We have on issue 3.815m of these shares (of $1 value each) and as a result of the new APRA Standard and interpretations we are now forced to amortise these at 10% per annum on and from 1 January 2013 for Capital purposes.

Thus, as a result of the APRA application of Basel III, a Capital instrument that we developed with the engagement of both APRA and ASIC in 2000 is now not counted as CET1 from an APRA perspective, but continues to be an irredeemable non-cumulative preference share that is subject to the terms and conditions as to dividend payment as per the original Offer documents.

Unfortunately, APRA's implementation of the Basel III capital framework does not allow issuance of mutual capital instruments that qualify as CET1 capital, which is the most important type of regulatory capital.

As a consequence, under Basel III, customer- owned ADIs can now only raise CET1 capital through retained earnings restricting their ability to raise capital more effectively, inhibiting their ability to diversify their capital base and constraining their ability to grow.

Whilst APRA has been working with our sector on supplementary capital instruments, more work is required to ensure that customer- owned ADIs have better access to a wider range of capital instruments and specifically CET1.

As referenced in the Customer Owned Banking Association (COBA) March 2014 Submission to this Inquiry the DAE report *Competition in Banking* found that denying mutuals access to Common Equity Tier 1 instruments could also have the following impacts:

- Customer-owned ADIs will not have the ability to manage and grow their balance sheets flexibly and in a manner that best serves their members' interests;
- Growth will be constrained to the uneven rate at which organic capital can be generated from retained earnings;
- Organic capital will not be able to be generated quickly to respond to sudden increases in capital requirements;
- Customer-owned ADIs will be less able to lend in a downturn and will be less able to provide effective competition to listed banks;
- The competitive disadvantage in relation to banks resulting from lack of access to Common Equity Tier 1 risks reducing supply, and increasing the cost, of credit to customers by the mutual sectors; and
- Ratings agencies may take a negative view of the customer-owned banking sector, given its restricted access to Common Equity Tier 1 capital and its increasing dependence on the economic cycle—this would have a knock-on effect on the ability of customer-owned ADIs to access senior funding.

Customer-owned ADIs have considerably less flexibility than they had prior to the Basel III reforms. In contrast, listed ADIs have been accommodated under the Basel III capital rules and are able to issue all forms of regulatory capital in Australia.

This outcome appears due to APRA taking a highly cautious approach to Basel III implementation, and concerns within the prudential regulator that accommodating the customer-owned mutual model may result in some departure "from its longstanding policy of applying a common set of prudential requirements across the ADI industry."

It is my proposition that providing APRA accommodate the mutual ADI difference in terms of the Principles of Mutuality within the Capital Standard then there is the ability to accommodate an eligible mutual CET1 capital share.

The Basel Committee on Banking Supervision (BCBS) prepared rules on capital primarily for listed, internationally-active banks, but incorporated an allowance for 'national discretion' in the hands of local regulators. This discretion allows a regulator to adapt certain rules to particular legal forms, such as customer-owned ADIs, due to the different characteristics inherent in their structure and focus.

The BCBS, when designing the new rules, recognised this by acknowledging that the constitutional and legal structure of mutuals needed to be considered in the context of 'common shares' under the CET1 definition.

The BCBS took the position of leaving it to each national regulator to make the necessary adjustments. While the BCBS makes reference to this requirement in relation to common shares only, the principle carries equal weight to all relevant aspects of new framework.

However, APRA instead applied the Basel III capital rules to all ADIs without utilising the 'national discretions' allowed by the Basel Committee.

By taking a less flexible approach than the Basel Committee would have envisaged, APRA has significantly reduced the capacity of customer-owned ADIs to issue regulatory capital.

COBA appreciates the importance of Basel III in enhancing the robustness of the international banking system. Our sector supports the objectives of raising the quality, quantity and consistency of capital in the international banking system. However, by applying the rules in such an inflexible manner, they effectively give preferential treatment to the listed ADI sector over the mutual ADI sector.

This is a perverse outcome, given that the Basel III capital framework was designed for large, listed, systemically important banks that have a substantial international focus, rather than for smaller, locally-focused mutuals that carry a much lower systemic risk and have limitations on the ways in which they raise capital.

In contrast to the Australian experience, other jurisdictions have successfully accommodated the mutual model into the Basel III capital framework:

- in the UK, Nationwide (a large UK Building Society), has recently launched a CET1 capital offering under Basel III – for further information see http://your.nationwide.co.uk/your-news/articles/Pages/ccds-issuance.aspx

- Canadian mutual (except in Saskatchewan) are allowed to count member shares and investment shares as the highest form of capital, provided certain conditions are met as highlighted by Dave Grace & Associates, *Competitive Dynamics in Retail Banking: An International Comparison,* March 2014, p. 14.; and

- European regulators have specifically allowed member shares in mutuals to be considered CET1 capital (Refer Dave Grace & Associates, *Competitive Dynamics in Retail Banking: An International Comparison,* March 2014, p. 20).

While APRA has acknowledged the need to provide customer-owned ADIs with the capacity to issue AT1 and T2 instruments, the Basel III capital standards took effect in Australia more than a year before APRA provided the sector with this flexibility.

Furthermore, mutual ADIs remain unable to directly issue CET1 capital. This is despite a Senate Committee recommending in November 2012 that:
"APRA addresses, without further delay, the unique issues Basel III may pose for mutual ADIs as a result of their corporate structure and that it publishes a document which sets out how these problems have been addressed"

It is essential that listed ADIs and mutual ADIs receive equivalent treatment under the Basel III capital rules. Failure to provide mutual ADIs with the capacity to issue the same forms of capital as listed ADIs will continue to harm competition, choice and diversity for no prudential benefit.

This capacity for mutual ADIs to issue capital of equivalent status in capital terms to retained earnings is not new as I have already highlighted in this submission.

We at Holiday Coast Credit Union negotiated with APRA and ASIC in 2000 to create an eligible Tier 1 Capital instrument that met the APRA requirements at that time together with the ASIC requirements for Mutuality.

We see the ability for mutual ADIs to directly issue CET1 as a critical matter to be urgently addressed as it is a regulatory impediment to competition and it is evident that the application of capital requirements is not competitively neutral.

We as a credit union also endorse the submissions of our Customer Owned Banking Association both the initial and the further submission to be lodged and also specifically the August 2014 submission from Jon Hutchins, Chairman of Victoria Teachers Mutual Bank.

Thank you for the opportunity to contribute to the Inquiry and I am available to discuss any of the above at nparsons@hccu.com.au or 02-65808226.

Yours Sincerely

Neville Parsons

Chief Executive Officer

For & on behalf of Holiday Coast Credit Union

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