

## REGULATION IMPACT ANALYSIS

---

### COMMON EQUITY TIER 1 CAPITAL INSTRUMENTS FOR MUTUALLY OWNED ADIS

#### ***Background***

APRA's development of its revised prudential framework for mutual equity interests involved an equivalent process and analysis to that required for a Regulation Impact Statement (RIS) as set out in *The Australian Government Guide to Regulation*.<sup>1</sup> Through this process, APRA answered the seven RIS questions, which are summarised below.

#### ***Questions 1 & 2—Assessing the policy problem and objectives of government action***

APRA's capital requirements for authorised deposit-taking institutions (ADIs) are based on the framework developed by the Basel Committee on Banking Supervision known as Basel III, which established criteria for capital instruments to qualify as regulatory capital. Under the framework, Common Equity Tier 1 (CET1) Capital consists primarily of retained earnings and ordinary shares.

As set out in APRA's July 2017 discussion paper, *Common Equity Tier 1 capital instruments for mutually owned ADIs*, ADIs such as credit unions, building societies and mutual banks that are owned by members rather than shareholders (mutually owned ADIs) are unable to issue ordinary shares meeting these Basel III criteria without compromising their mutual corporate status.<sup>2</sup> Accordingly, mutually owned ADIs were limited to meeting their CET1 Capital requirements with retained earnings. Further, eligibility criteria for other categories of capital (Additional Tier 1 and Tier 2) required these instruments to either be written off or convert to ordinary shares in specified circumstances. Mutually owned ADIs' inability to issue ordinary shares also affected their ability to issue Additional Tier 1 and Tier 2 instruments on the same terms as those issued by shareholder-owned ADIs.

APRA took steps to address these limitations by initially allowing Additional Tier 1 and Tier 2 capital instruments to convert to a new type of capital instrument—a mutual equity interest—that was comparable to an ordinary share. The mutual equity interest framework was introduced in 2014.

Since this framework was introduced, APRA has been in discussions with industry and the Australian Securities and Investments Commission (ASIC) about extending it to allow mutually owned ADIs to directly issue mutual equity interests that could qualify as CET1 Capital. These discussions formed the basis of the proposals set out in the July 2017 discussion paper and aimed to improve capital management flexibility for mutually owned

---

<sup>1</sup> *Australian Government Guide to Regulation*, March 2014

<sup>2</sup> Refer to [section 1.1. Background](#) of the discussion paper, which is available on the APRA website.

ADIs. Another objective was to simplify the current framework by removing duplication of ASIC requirements.

In 2016, the Senate Economic References Committee report, *Cooperative, Mutual and Member-owned Firms*, recommended that APRA set a target date for the outcome of these discussions and to bring them to a timely conclusion. This report was reviewed by an independent facilitator who recommended that APRA give priority to consideration of amendments to its prudential standards to permit mutually owned ADIs to directly issue CET1 capital instruments, a recommendation supported by the Government.<sup>3</sup> APRA's finalisation of the revised mutual equity framework addresses these recommendations.

### **Questions 3, 4 & 6—Options that may achieve the objectives, impact analysis and the best option**

In the July 2017 discussion paper, APRA consulted on the following two policy options:

1. Maintain the *status quo* under which no changes would be made to the current prudential framework for mutual equity interests; or
2. Extend the current prudential framework to allow mutually owned ADIs to directly issue mutual equity interests that qualify as CET1 Capital.<sup>4</sup>

APRA noted that there would be some additional compliance costs in ensuring compliance with additional eligibility criteria for mutual equity interests and with any ASIC requirements. However, these would only be incurred where a mutually owned ADI chooses to issue CET1-eligible instruments rather than using other sources of regulatory capital. APRA's preliminary assessment was that option 2 provided the greatest net benefit.

No respondents accepted the invitation to use the Commonwealth Regulatory Burden Measure to provide an indication of the regulatory costs involved. The one respondent that directly addressed the question of regulatory burden submitted that issuing any capital instrument incurs costs and that the incremental compliance costs of meeting the requirements of the revised framework are therefore considered to be business as usual expenses.

In its November 2017 response to submissions paper, APRA agreed with this approach, noting that the mutual equity interest framework is voluntary.<sup>5</sup> It is therefore arguable that the additional compliance costs outlined above are business, not regulatory costs. However categorised, the overall costs are insignificant, involving minor changes to calculating and reporting of regulatory capital and 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 concluded 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 supported this assessment.

---

<sup>3</sup> The [Senate Committee's report](#) is available on the APH website, the [report of the independent facilitator, Mr Greg Hammond](#), is available on the Department of the Treasury website as well as the [Government's response](#).

<sup>4</sup> Refer to *Chapter 2* and *Annexure: Policy options and comparative net benefits*

<sup>5</sup> The response to submissions paper [Common Equity Tier 1 capital instruments for mutually owned ADIs](#) is available on the APRA website.

### **Question 5—Consultation**

APRA consulted informally with industry and ASIC when forming its proposed amendments to the mutual equity interest framework. Formal consultation on its specific proposals commenced with the release of the July 2017 discussion paper and a draft revised *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111). APRA sought feedback on the proposals set out in this discussion paper and on the draft revised APS 111.

APRA received eight submissions from industry associations and individual ADIs that broadly supported the proposal to amend the mutual equity interest framework and also raised specific concerns and requests for clarifications. The November 2017 response to submissions paper outlined APRA's amendments to the mutual equity interest framework following consideration of these submissions and APS 111 was amended where relevant.

### **Question 7—Implementation and review**

APRA published its final revised APS 111 on 30 November 2017 and issued a media release that was also emailed to the prudential contacts of ADIs. The revised APS 111 takes effect from 1 January 2018 in response to industry submissions. It also meets the Government's recommendation that APRA give priority to its work on facilitating mutually owned ADIs to issue CET1-eligible capital.

The prudential framework for ADIs in Australia is based on the international framework developed by the Basel Committee. APRA keeps its prudential standards under regular review to ensure alignment with this framework. APRA also regularly reviews these standards to ensure they remain fit for purpose and will implement changes to address issues that arise through its supervisory activities.