

Banking (prudential standard) determination No. 4 of 2017

EXPLANATORY STATEMENT

Prepared by the Australian Prudential Regulation Authority (APRA)

Banking Act 1959, section 11AF

Under subsection 11AF(1) of the *Banking Act 1959* (the Act), APRA has the power to determine standards (prudential standards), in writing, in relation to prudential matters to be complied with by authorised deposit-taking institutions (ADIs) and authorised non-operating holding companies (authorised NOHCs). Under subsection 11AF(3) of the Act, APRA may, in writing, vary or revoke a prudential standard.

On 28 November 2017, APRA made Banking (prudential standard) determination No. 4 of 2017 (the instrument), which revokes *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* made under Banking (prudential standard) determination No. 1 of 2014 and determines a new *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111).

The instrument commences on 1 January 2018.

1. Background

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that they can meet their financial promises to depositors, policyholders and fund members within a stable, efficient and competitive financial system. A core element of APRA's prudential framework is measuring the capital adequacy of ADIs to ensure they hold adequate capital to cover the risks arising from their activities.

APS 111 sets out, among other things, the criteria that capital instruments must have to qualify as regulatory capital. This framework is largely based on the internationally agreed prudential capital framework developed by the Basel Committee on Banking Supervision, known as Basel III.¹ APRA implemented the Basel III framework in 2013.

One criterion is that, to qualify as regulatory capital, Additional Tier 1 (AT1) and Tier 2 (T2) capital instruments must be able to be written off or convert into ordinary shares in particular circumstances. However, because mutually owned ADIs are unable to issue ordinary shares because of their corporate structure, their AT1 and T2 capital instruments could only be written off. APRA addressed this issue by introducing a new type of instrument, a mutual equity interest that shared most of the characteristics of ordinary shares and into which AT1 and T2 capital instruments could convert. This framework was implemented in 2014.

¹ Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010 (revised June 2011) (Basel III) <http://www.bis.org/publ/bcbs189.htm>

APRA also discussed with industry its intention to expand the mutual equity interest framework to facilitate direct issuance by mutually owned ADIs. 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 Common Equity Tier 1 (CET1) Capital instruments, a recommendation supported by the Government.² APRA's finalisation of the revised mutual equity framework addresses these recommendations.

2. Purpose and operation of the instrument

The purpose of the instrument is to revoke APS 111 and replace it with a new version of APS 111 that allows mutually owned ADIs to directly issue mutual equity interests by establishing criteria that must be met for these instruments to be eligible for inclusion in CET1 Capital. These measures are intended to give mutually owned ADIs greater flexibility in their capital management without compromising their mutual corporate structure.

The criteria for mutual equity interests are based on the criteria for ordinary shares set out in Attachment B to APS 111, amended as appropriate for the issuance of a new type of capital instrument by a mutually owned ADI. Under these amendments:

- the amount of mutual equity interests that may be eligible for inclusion in an ADI's total CET1 Capital is limited to 25 per cent of CET1 Capital before applying regulatory adjustments. Any mutual equity interests on issue that exceed the limit for inclusion in CET1 Capital are eligible for inclusion in an ADI's Tier 1 Capital and Total Capital;
- distributions, in aggregate, on all mutual equity interests must not exceed 50 per cent of the issuing ADI's net profit after tax for the financial year to which the distributions relate; and
- an ADI must make specified disclosures in issue documentation and marketing material.

Other amendments to APS 111 are to:

- remove references to the demutualisation provisions in the *Corporations Act 2001* and related guidance issued by the Australian Securities and Investments Commission (ASIC), *Regulatory Guide 147 Mutuality—Financial institutions*³;

² The Senate Committee's report is available at: https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Cooperatives/Report, the report of the independent facilitator, Mr Greg Hammond, is available at: <https://treasury.gov.au/publication/p2017-t235882/> and the Government's response is available at: <https://treasury.gov.au/publication/p2017-t235692/>

³ ASIC's RG 147 is available at: <http://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-147-mutuality-financial-institutions/>

- make it clear that a reference to an Act, Regulation, prudential standard, Australian Accounting Standard issued by the Australian Accounting Standards Board or Australian Auditing and Assurance Standard issued by the Australian Auditing and Assurance Standards Board is a reference to the instrument as it exists from time to time. These instruments are available on the Federal Register of Legislation at www.legislation.gov.au;
- remove out-of-date provisions in Attachment L —Transitional arrangements for capital instruments;
- make minor wording changes; and
- update incorrect cross-references.

3. Consultation

APRA consulted informally with industry and ASIC on its proposed amendments to the mutual equity interest framework. In July 2017, APRA commenced formal consultation on specific proposals with the release of its discussion paper *Common Equity Tier 1 capital instruments for mutually owned ADIs* and a draft revised APS 111.⁴ APRA received eight submissions in response to this consultation from ADIs and industry associations.

Submissions were broadly supportive of the proposals to allow mutually owned ADIs to directly issue mutual equity interests. Respondents requested clarification or amendment regarding the limit on the amount of mutual equity interests that may be eligible for inclusion in an ADI's CET1 Capital, the limit on distributions, prior approval requirements and disclosure requirements in regards to repurchase and redemption.

In November 2017, APRA released its response to submissions paper clarifying and outlining changes to its proposals in a number of areas following consideration of the issues raised in submissions.⁵ The new version of APS 111 incorporates the policy changes made following consideration of the issues raised in submissions.

4. Regulation Impact Statement

In developing the revised mutual equity interest framework, APRA undertook a process and analysis equivalent to a Regulatory Impact Statement (RIS), which satisfies the Office of Best Practice Regulation's requirements. The document evidencing APRA's policy development process has been lodged as supporting material.

5. Statement of compatibility prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

⁴ The discussion paper is available at: <http://apra.gov.au/adi/PrudentialFramework/Pages/Consultation-CET1-Instruments-for-mutually-owned-ADIs-July-2017.aspx>

⁵ The response to submissions paper is available at: <http://apra.gov.au/adi/PrudentialFramework/Pages/Response-CET1-instruments-for-mutually-owned-ADIs-November-2017.aspx>

A Statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* is provided at Attachment A to this Explanatory Statement.

ATTACHMENT A

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

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The legislative instrument is compatible with the human rights and freedoms recognised or declared in the international instrument listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* (HRPS Act).

Overview of the Legislative Instrument

The purpose of the instrument is to revoke *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* determined by APRA in 2014 and replace it with a new *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (the new APS 111).

APS 111 sets out the characteristics that an instrument must have to qualify as regulatory capital for an authorised-deposit taking institution (ADI) and the various regulatory adjustments to be made to determine total regulatory capital for the ADI and its related companies. ADIs are body corporates that have been granted the authority, under the *Banking Act 1959*, to carry on banking business in Australia.

The new APS 111 introduces new provisions that allow ADIs with a mutual corporate structure (credit unions, building societies and mutual banks) to issue capital instruments (mutual equity interests) that qualify as Common Equity Tier 1 Capital (CET1), the highest form of regulatory capital. These measures are intended to give mutually owned ADIs greater flexibility in their capital management without compromising their mutual corporate structure.

Further minor changes have been made to clarify wording and update incorrect cross-references.

Human rights implications

APRA has assessed the instrument and is of the view that it does not engage any of the applicable rights or freedoms recognised or declared in the international instruments listed in section 3 of the HRPS Act. Accordingly, in APRA's assessment, the instrument is compatible with human rights.

Conclusion

The instrument is compatible with human rights as it does not raise any human rights issues.