CUSTOMER OWNED BANKING ASSOCIATION

8 November 2024

Mr James Douglas
General Manager Policy (acting)
Policy and Advice Division
Australian Prudential Regulation Authority

Via email: PolicyDevelopment@apra.gov.au

Dear Mr Douglas

Discussion Paper - A more effective capital framework for a crisis

COBA welcomes the opportunity to respond to APRA's discussion paper on changes to the capital framework.

COBA is the industry association for Australia's customer owned banks (mutual banks, credit unions and building societies). Collectively, our sector has over $179 billion in assets and is the fifth largest holder of household deposits. Our members range in size from less than $200 million in assets to around $25 billion in assets – all significantly smaller than our ASX-listed peers. Customer-owned banks (i.e. mutual banks) account for around two thirds of the total number of domestic Authorised Deposit-taking Institutions (ADIs) and deliver competition and market leading levels of customer satisfaction in the retail banking market.

APRA's proposal to fully replace Additional Tier 1 (AT1) capital with Tier 2 capital is expected to have a positive impact on the customer owned banking sector. Mutual ADIs have more limited pathways to managing their Tier 1 capital needs compared to their larger, listed peers and not all mutual ADIs have the size, scale and complexity to issue Tier 1 capital instruments, including AT1 and Mutual Equity Instruments (MEIs).

COBA generally supports the simplification of the capital framework in Australia, while recognising the need to maintain a strong, stable and well capitalised financial system which works to protect Australians' savings. Mutual ADIs have strong capital ratios and operate conservatively to ensure the safety and stability of their organisations.

APRA's approach to implementing the changes in a proportional way is welcome, as a simplified capital framework will be easier for mutual ADIs, which are smaller and less advanced than their larger, lister peers, to manage their capital needs. This submission highlights several issues which APRA should consider to ensure that the changes do not have unintended consequences on the customer owned banking sector.

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Key points

COBA generally supports the simplification of the capital framework in Australia, and APRA's proposal to fully replace Additional Tier 1 (AT1) capital with Tier 2 capital is expected to have a positive impact on the customer owned banking sector.

APRA's approach to implementing the changes in a proportional way is welcome, as mutual ADIs will see no changes to their minimum capital requirements.

The removal of AT1 will see a reduction in the diversity of capital raising options for mutual ADIs.

Although Tier 2 instruments are generally easier and cheaper to issue than AT1, mutual ADIs are still expected to incur costs in accessing this capital instrument, in particular smaller ADIs.

The removal of AT1 eliminates an effective pathway for mutual ADIs to distribute franking credits to investors.

APRA should consider transition arrangements for existing AT1 issuers across liquidity, accounting and large exposure limit requirements.

Diversity of capital

Mutual ADIs generally operate a simpler capital structure than larger listed banks, with COBA members largely relying on retained earnings as a primary tool for Tier 1 capital generation. Larger COBA members also access Tier 2 capital for a small portion of their capital needs, and a small proportion of members also utilise AT1 to increase their capital.

Although the removal of AT1 will reduce the diversity of options for mutual ADIs to raise capital, the cost and complexity of AT1 issuance has seen few mutual ADIs take this pathway to date. Those mutual ADIs which have invested significant resources in developing an AT1 program may be relatively disadvantaged under APRA's proposed change compared to those which did not do so.

Access to Tier 2 capital

Tier 2 instruments are generally cheaper and easier to issue relative to AT1, and COBA welcomes APRA's proposal to remove the Tier 1 requirements and allow standardised banks to issue Tier 2 capital as a replacement for AT1. This is expected to make it easier for COBA members to increase their capital buffers through the issuance of Tier 2 instruments.

Tier 2 instruments are generally easier and cheaper to issue than AT1 and this proposal will allow mutual ADIs to issue more Tier 2 capital to meet their needs. However, COBA members will still incur costs in setting up Tier 2 capital programs, in particular smaller members with significant resource constraints. More APRA support for small ADIs in setting up Tier 2 programs would be a good opportunity for APRA to further embed proportionality in the capital framework. This could potentially be achieved through the provision of standardised Tier 2 issuance documentation by APRA (vs what is currently provided by industry) which would make it easier for small ADIs to comply with APRA's requirements. We would welcome opportunities to reduce the administrative burden and cost of Tier 2 issuance by mutual ADIs.

Impacts on Tier 2 capital markets

While Tier 2 capital instruments are currently more cost-effective to issue than other forms of capital, the removal of AT1 and the resulting increased demand for Tier 2 issuance could shift market pricing dynamics, potentially leading to higher issuance costs for Tier 2 capital.

The removal of AT1 from the capital stack could also impact on the price of Tier 2 instruments as Tier 2 debt holders will face less subordination in the event of a bank crisis event. Without AT1 in the capital stack, Tier 2 debt would become the first to bear losses after CET1 capital holders, increasing its risk profile and potentially leading to a reassessment of its price by the market to compensate for this increased exposure.

Franking credits

Mutual ADIs have very limited pathways to distribute franking credits to investors, given their non-dividend paying nature. AT1 instruments offer mutual ADIs the ability to issue franked distributions to investors and the removal of this pathway will curtail mutual ADIs' ability to utilise franking credits.

Although MEIs offer a pathway to pay dividends, the cost and complexity of issuing such instruments does not generally represent a viable option for many mutual ADIs.

Transition considerations

APRA's proposed transitional arrangements sees existing AT1 instruments becoming eligible as Tier 2, until their first scheduled call date. APRA needs to clarify how this arrangement will impact mutual ADIs' liquidity requirements through changes to the adjusted liability base.

Prudential Standard APS 111 Measurement of Capital requires Tier 2 instruments to be amortised on a straight-line basis at a rate of 20 per cent per annum over the last four years to maturity.[1] APRA must clarify whether existing AT1 instruments, which are eligible to be included as Tier 2 from 1 January 2027, will be subject to these requirements from this date.

Transition arrangements should be considered for counterparty large exposure limits, which are based on Tier 1 capital. Banks with AT1 on issue should have their large exposure limits arrangements grandfathered until the first call date of the AT1 instrument.

Thank you for taking the time to consider our submission. We look forward to continuing our engagement with APRA on this important issue. If you wish to discuss any aspect of this submission, please contact Alexander Woloszyn, Policy Manager (awoloszyn@coba.asn.au).

Yours sincerely

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Chief Executive Officer

[1] APS 111 Attachment E, paragraph 21