CUSTOMER OWNED BANKING ASSOCIATION

7 May 2021

[redacted]
General Manager – Regulatory Affairs and Licensing
Policy and Advice Division
Australian Prudential Regulation Authority

Via email: Licensing@apra.gov.au

Dear [redacted],

Consultation on revisions to APRA's approach to licensing and supervising new ADIs

COBA is the industry association for Australia's customer owned banking institutions (mutual banks, credit unions and building societies). Collectively, our sector has $146 billion in assets and more than 4.5 million customers.

COBA approaches this consultation from the perspective of representing long-established ADIs, but also in the context that COBA occasionally receives queries regarding establishing new mutual ADIs. Uniquely, our members are owned by their customers rather than a separate set of shareholders. As a result, our model better aligns the interests of customers, staff and the institution compared to their investor-owned peers.

As simple retail banking businesses, our members take deposits from retail deposits and lend them to retail borrowers for home lending and other personal lending. Historically, this has involved a physical touchpoint such as a branch.

Customer-owned banks have a well-established business model that has existed for over hundreds of years in banking. Our members' long term approach has led to sound business, governance and risk management behaviours. While our model will continue to evolve to meet changing consumer needs, it starts from a position where there is confidence in its viability and long-term sustainability.

COBA supports proportionate regulation — i.e. regulation that is proportionate to the risks. New ADIs face additional risks as untested businesses. This compares to the lower risk and more predictable business models of customer-owned banks that have been proven to work for at least several decades. In line with this, COBA supports APRA's moves to adjust its frameworks to "focus on the areas demonstrated to be of higher risk to new entrant ADIs."

Ensuring sustainable neobanks that if unsuccessful can exit in an orderly manner

COBA supports APRA's revisions to its new banking entrant licensing expectations.

New entrants, alongside the growth of challenger institutions such as customer owned banks are critical to applying competitive pressure on incumbent lenders.

While many of these new entrants have a similar investor-owned ethos to the major banks, they can present a different value proposition to the market. However, their inclusion must be appropriately supervised and not create undue stability risks to established ADIs.

The UK Prudential Regulation Authority's Supervisory Statement outlines the concerns regarding newer ADIs:[1]

> *"The likelihood of failure is higher during the early years of a bank's development. Factors which may lead new and growing banks to fail include failure to obtain the required loss absorbing capacity or an inability to realise their business model. Many new and growing banks operate in highly competitive markets and many have novel and untested business plans; this facilitates innovation and competition but not all may prove to be viable. Coupled with this, new and growing banks may have fewer recovery options available to them than established banks, meaning it is crucial they have the ability to exit the market in an orderly way, if required."*

ADI licensing requirements should ensure the stability of the financial services industry through the economic cycle. This will ensure that there is sustainable competition rather than competition fuelled by a transfer of value from shareholders to customers. APRA's Discussion Paper adequately recognises this by stating that "Sustainable new entrants will provide more effective competition to incumbents than those which are perpetually reliant on additional capital raises simply to meet ongoing prudential capital requirements."

New entrants should be put in the best position to succeed, by becoming profitable institutions, without have an undue regulatory advantage on established and proven business models.[2] If these neobanks are not able to succeed, which recent evidence has shown happens, they need to be able to leave the industry in an orderly manner as to not impact other entities.

An orderly entrance as an ADI must be followed by an orderly exit. The need to exit in an orderly fashion means these ADIs must have sufficient recovery options that are tailored to the unique circumstances of new ADIs. APRA has outlined improving recovery and resolution capabilities as one of its key supervisory priorities[3] on APRA-regulated institutions. Given these requirements apply to established ADIs, this must also apply to those newer institutions.

COBA supports APRA's expectation that new and restricted ADIs include a credible return of deposits strategy as a resolution option (a primary option for restricted ADIs). COBA notes a newly licensed ADI recently executed a return of deposits and exited the industry.

Newer ADIs have limited resolution options given that they do not have a track record or saleable assets to sell or merge with another party. It is therefore critical that these ADIs have the ability and are perceived to have the ability to execute a timely and credible return of deposits. This will ensure that the market believes that depositors are able to be repaid. While the Financial Claims Scheme could be activated to cover deposit losses, this is a last resort as there are likely to be broader implications of FCS activation. Any unsustainable competitors that cannot exit in an orderly fashion will have consequences beyond just their immediate customers and institution.

Requiring the launch of income-generating products

COBA supports APRA's revisions that require new entrants ADIs to launch an income-generating asset product and a deposit product before receiving an ADI license.

Having both sides of the balance sheet is critical for sustainable competition and without both sides, there is a lack of revenue generation which must be subsidised from other means (i.e. eroding capital

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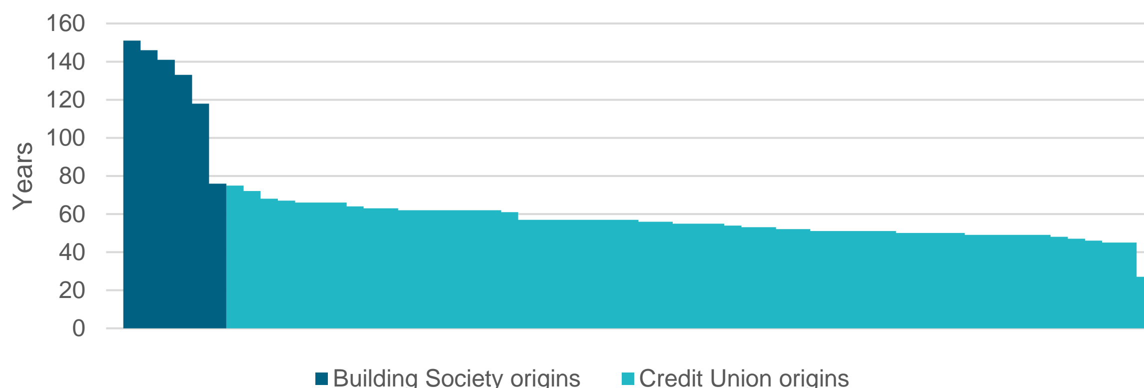
[1] Supervisory Statement - SS3/21 Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks April 2021

[2] i.e. regulatory arbitrage

[3] See information paper: APRA's supervision priorities

buffers, or additional equity issuances). Income-generating products are the first step to the organic capital generation required to build capital independent of equity issuances. Our sector has many years of organic capital generation behind it (see Graph 1 & Graph 2). COBA believes this requirement is reasonable, considering the Bank of England's requirements for a similar, but potentially tougher, expectation of profitability or a credible strategy for profitability within five years.[4]

Graph 1: Distribution of customer-owned banks' age profile[5]



Ensuring adequate capitalisation for new and emerging business models

COBA supports APRA's intent to set capital requirements for new ADIs that "[b]etter reflects the idiosyncratic and often fast changing risk profile of new ADIs, when compared with established ADIs".

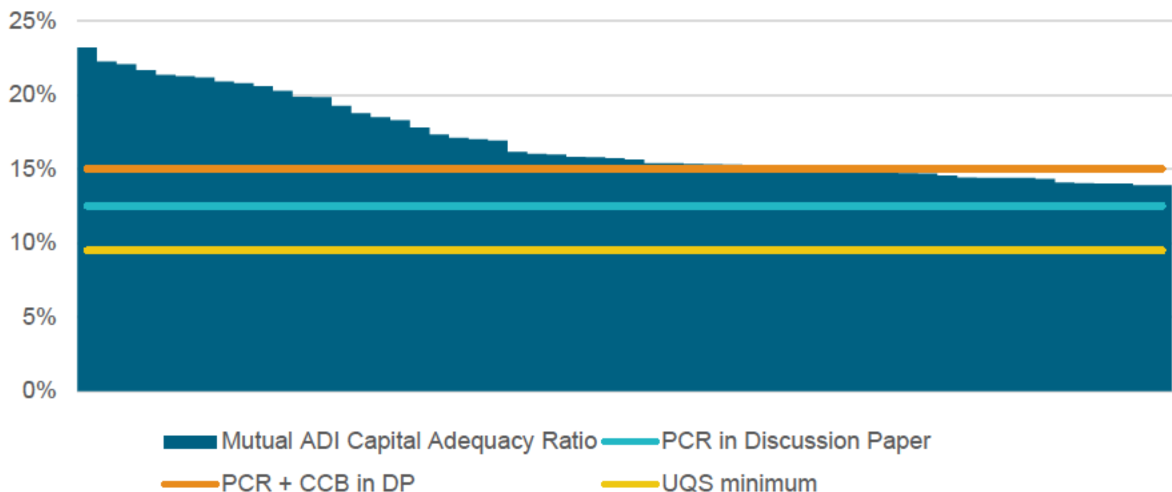
While established ADIs have more predictable risk-weighted asset and expense growth, this is not the case for newer ADIs who concurrently undertake significant investments and lending growth to get to an operational scale. While we recognise that APRA sets these capital requirements as a maximum of three different figures, COBA questions whether one of the figures currently being set at 6.5 months (PCR + CCB) provides enough time for an ADI to recapitalise given that it would be eating into its capital buffers during this period. COBA also notes that PRA sets its buffer based on 6 months, which is additional to other requirements.

Graph 2 shows that COBA members are well capitalised relative to the example benchmarks provided for new ADIs. This raises the question whether the capital requirements on mutual ADIs are too conservative, or whether the levels of capital targeted new ADIs is not conservative enough (or a combination of both) given the significant difference in risk profile of a new ADIs versus a long-established ADIs. As a general principle, APRA should ensure that newer businesses are not subject to lower capital requirements compared to long-established and proven entities.

[4] PS8/21 Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks

[5] Internal COBA data

Graph 2: Capitalisation of customer-owned banks[6]



Supporting capital flexibility for new mutual ADIs

COBA welcomes the retained flexibility in APRA's Information Paper that allows APRA to make exceptions for mutually owned ADIs to have a broader capital composition other than CET1 to meet their capital requirements. This flexibility recognises the unique capital structure of mutual ADIs. Mutual ADIs do not have access to the common 'ordinary share' CET1 capital instrument that would capitalise the overwhelming majority of restricted or new ADIs.

COBA acknowledges APRA's statement that these "revisions may discourage marginal applicants, resulting in fewer licence applications, and may be considered a slight raising of the barriers to entry." However, having more sustainable new entrants will be more beneficial to competition and sustainability in the long-run. Being an ADI is long-term proposition and new entrants should have to approach it that way.

Yours sincerely,

Senior Policy & Analytics Manager

[6] Based on ADI's APS 330 disclosures