CUSTOMER OWNED BANKING ASSOCIATION

17 November 2023

Mr [redacted]
General Manager Policy
Policy and Advice Division
Australian Prudential Regulation Authority

Via email: PolicyDevelopment@apra.gov.au

Dear [redacted]

Discussion paper - Enhancing bank resilience: Additional Tier 1 Capital in Australia

COBA welcomes the opportunity to respond to APRA's discussion paper on Additional Tier 1 (AT1) capital in Australia.

COBA is the industry association for Australia's customer owned banks (COBs) (mutual banks, credit unions and building societies). Collectively, our sector has over $165 billion in assets and is the fifth largest holder of household deposits. Customer owned banks (i.e. mutual ADIs) 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.

Although the major banks are the primary issuers of AT1 instruments in Australia, COBs are increasingly accessing this market for their capital needs. COBA encourages APRA to consider the perspective of mutual ADIs when making changes to the AT1 regime, recognising that changes may affect COBA members differently to other market participants and therefore could result in unintended consequences for our members.

In any future policy proposals, APRA needs to consider the importance of the AT1 market to mutual ADIs in its decision making process and encourages APRA to retain access to this valuable instrument for access to Tier 1 capital for the customer owned banking sector.

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Key points

Maintaining access to the AT1 market is particularly important for mutual ADIs, given that AT1 instruments present a viable and cost-effective method of increasing Tier 1 capital.

Any changes to the AT1 framework should ensure a level playing field for market participants, ensuring smaller players such as mutual ADIs can retain access to the AT1 market on similar terms to their larger peers.

A reduction in the role of AT1 in the capital framework is likely to result in detrimental outcomes for COBA members, given mutual ADIs' reliance on AT1 issuance as an important option to raise Tier 1 capital.

The costs of proposed changes to the AT1 framework should be extensively modelled to provide a better overview of the impacts of the proposals. Costs to issuers should be minimised, particularly non-major ADIs which have less scope to absorb them.

An increase to the trigger level of AT1 instruments could be a viable way of addressing identified shortfalls in the existing framework.

Restrictions on retail investor access to the AT1 market are likely to result in higher costs for AT1 issuance, which would have a disproportionate impact on smaller ADIs. The imposition of minimum parcel sizes may unintentionally capture wholesale investors which only seek small parcel sizes.

Existing AT1 programs should be grandfathered to ensure that issuers of existing AT1 securities are not subject to additional transition costs.

Maintaining mutual ADI access to the market for Tier 1 capital

Mutual ADIs have more limited pathways to managing Tier 1 capital needs compared to their listed peers and are increasingly utilising the AT1 capital market for this purpose.

Compared to their 'ordinary share' listed counterparts, mutual ADIs are constrained in their ability to increase Tier 1 capital outside of AT1 issuance. Although the mutual equity interest (MEI) pathway does exist, MEIs are significantly more costly to issue and maintain than AT1 instruments. Maintaining access to the AT1 market is particularly important for mutual ADIs, given that AT1 instruments present a viable and cost-effective method of increasing Tier 1 capital particularly in a world of increasing demand for capital.

Reducing the attractiveness of AT1 to investors including by altering the design of or access to the AT1 market will result in additional costs to issuers. Any changes to the AT1 framework should ensure a level playing field for market participants; given the scale and market presence of the major banks, changes should ensure that smaller players such as COBs can retain access to the AT1 market on similar terms to their larger peers.[1]

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[1] This would be consistent with the Australian Government's Statement of Expectations for APRA. In section 2.2 the Government expects APRA to "balance the objectives of financial safety, efficiency and competition, contestability and competitive neutrality". In section 4.3 the Government expects APRA to "minimise the costs and burdens of regulatory requirements for regulated entities, including by applying proportionate requirements, considering different businesses models, and taking a principles-based approach to regulation, ultimately to benefit consumers".

Changes to the structure of AT1 instruments should incorporate the differing business practices of ADIs, in particular references to conversion of AT1 to ordinary shares should also explicitly include references to the equivalent MEI pathway for mutually owned institutions.

Unintended consequences of changes to the capital stack

Any reduction in the role of AT1 capital in the capital framework is likely to result in detrimental outcomes for COBA members. A commensurate increase in CET1 capital requirements would see mutual ADIs disadvantaged relative to their listed peers given the challenges mutual ADIs face in raising CET1 capital, as discussed in the section above. COBA does not advocate for this pathway to increase the effectiveness of AT1.

A shift away from AT1 to an increased reliance on Tier 2 capital would not pose the same detrimental impacts to our members as a shift to CET1, as many mutual ADIs already issue Tier 2 capital instruments and are able to access the market with greater ease and at a lower cost relative to Tier 1, however we note that Tier 2 capital is designed to serve a different purpose to AT1 and therefore there may be impacts to capital ratios from such an approach. Any changes which increase reliance on Tier 2 capital could still have cost impacts for mutual ADIs, as an increased reliance on Tier 2 at the industry level may also result in a wider price, with mutuals already paying a premium relative to majors based on their (generally) lower credit ratings. Any increase in pricing is therefore likely to impact mutuals more than their larger peers.

COBA calls on APRA to maintain AT1 as a viable method of meeting Tier 1 capital requirements and believes that APRA’s focus should be on addressing possible shortcomings in the design of AT1 rather than reducing its role in the Tier 1 capital framework.

Articulating the costs of change

Once APRA has detailed proposed amendments to the AT1 regime, the costs of these changes and their impact on competitiveness and contestability should be extensively modelled and publicly presented to provide a better overview of the impacts of the proposals. If possible, these costs should be broken down by impacts to different participant sectors and sizes.

APRA should seek to minimise additional costs for participants to access the AT1 market, with a particular focus on small entities such as mutual ADIs, which do not have the scale or resourcing to absorb higher AT1 issuance costs compared to the major banks.

Trigger level for loss absorption

COBA recognises that the current trigger level for AT1 instruments is set low relative to the capital position of our members. Although an increase in the trigger level could see some impact on market pricing, the strong capital position of our members and the lower likelihood of a mutual ADI hitting this trigger means that this impact is likely to be small. Therefore, an increase to the trigger level is expected to be a relatively lower cost option to address some of the shortcomings to AT1 which APRA has identified in its discussion paper.

Restrictions on market access – retail vs wholesale

Restrictions on retail investor access to the AT1 market are likely to affect market pricing and general demand for new AT1 issues, given the existing significant retail investor presence in the marketplace. This would likely result in higher costs for AT1 issuance across the board which would have a disproportionate impact on smaller ADIs, including COBA members, as they are unable to easily absorb higher costs compared to other banks. Where listed banks have the option of reducing shareholder payouts in order to balance increasing costs, mutual ADIs must either raise prices, reduce investment in customer offerings or cut investment in core business needs – resulting in a detrimental impact to competition.

Furthermore, a reduction in demand for AT1 in the domestic market, due to restrictions on ownership, would likely see large banks seek AT1 funding from offshore markets that may then offer more competitive pricing and deeper liquidity. Due to their smaller size and less complex business models, mutual ADIs are unlikely to be able to easily access offshore markets for AT1 capital therefore putting them at a competitive disadvantage relative to their larger peers under a scenario of restricted domestic demand.

The imposition of minimum parcel sizes, such as $500,000, as a method of restricting retail ownership of AT1 securities can result in unintended consequences. Using such a blunt instrument to restrict ownership is likely to also encompass small wholesale investors which only purchase small parcels of securities. These investors are important to mutual ADIs and such a restriction would be anti-competitive and put small AT1 issuers at a disadvantage. Should APRA decide to restrict retail ownership of AT1 securities, COBA calls on APRA not to implement large minimum parcel sizes as the solution.

Grandfathering of existing programs

Existing AT1 programs should be grandfathered to ensure that issuers of existing AT1 securities are not subject to additional costs. Grandfathering arrangements should include extended time periods for redemption of issues to ensure that the transition remains orderly and the market has sufficient scope to absorb new issuance under any altered AT1 framework. Transition timeframes to any new regime should be sufficient to ensure that industry has the capacity to develop new processes, systems, investor relationships and business plans, as required.

As previously noted, mutual ADIs have a more limited capacity to absorb additional costs and consideration should be given to this constraint when determining transition arrangements.

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 [redacted], Senior Policy Adviser ([redacted]).

Yours sincerely

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Chief Executive Officer