
SUBMISSION TO THE FINANCIAL SYSTEM INQUIRY

AUGUST 2014

“Core” Capital for Mutual ADIs

Jonathan Hutchins – Victoria Teachers Mutual Bank

Dear Mr. Murray and Committee

Further to your committee's interim report on the Financial System Inquiry I would like to address your attention to specific issues identified in your report with respect to the **Mutual ADIs** (Approved Deposit Taking Institutions) in Australia. The industry body, for **Mutual ADIs**, Customer Owned Banking Association in their submission to the Financial Systems Inquiry, has outlined the characteristics of the mutual sector within the Australian Financial System of which I am sure you will be aware.

The focus of this submission is in regard to the themes and options of:

1. Growth and Consolidation –Capital Requirement,
2. Growth and Consolidation - Impact Investment, and
3. Post GFC Regulatory Response – Strong Prudential Framework

In focusing on these three aspects of the review a major structural weakness for **Mutual ADIs** must be addressed to ensure there remains an alternative-banking model for the 4 million Australians that benefit from a **Mutual ADI**. This weakness can be rectified easily and within the framework of the terms of reference of your inquiry by the introduction of a **Core Capital** instrument for **Mutual ADIs**.

1. Capital Requirements

The proposal to adjust the internal ratings (IRB's) for competitive neutrality will not directly assist **Mutual ADIs** as their current capital structure is based on retained earnings without dividends that effectively provide a "no-cost" capital base. Recognising the points made in terms of bias in the major banks allocating more capital to residential backed mortgage as opposed to commercial lending. The essence is not the cost of the capital but the inability of **Mutual ADIs** to raise capital that qualifies as Common Equity Tier 1.

2. Impact Investment

I would also like to highlight the relevance of **Mutual ADIs** to the reference in your interim report for Impact/Social Investment. **Mutual ADIs** by their very nature and construct have been a form of Social Investment since inception. The concept of providing returns to the constituents of a **Mutual ADI** whether they are a region, industry, religious, employee or social affiliation is the essence of their mutual interest. The contribution by **Mutual ADIs** to the community is well documented and precedes some of the current platitudes for a social investment model.

Mutual ADIs are differentiated by being customer owned and compete on the basis of providing a benefit to members. They are funded by the customer's membership and the operating surplus from providing services is retained for

future growth rather than distributed as a return on invested capital as a dividend. The distinctive nature of the value proposition arose from historical discrepancies in the value proposition of other ADI's and is demonstrated by

- the high proportion of assets secured against residential properties
- majority of funding from retail depositors.
- a low provision of bad debts and
- a high capital ratio under the current regulatory regime.

Capital is the intrinsic difference for a mutual organisation and the principle of "one member one vote" provides a democratic and stable capital environment. Following the issues of the Global Financial Crisis the mutual sector has managed to continue to deliver the value proposition to members despite

- reduced net interest margins,
- competition for retail deposits and
- high levels of loan repayments.

In addition, many of the larger ADI's post GFC, have followed the competitive high customer service models maintained by **Mutual ADIs** as they focus on retail deposits and residential lending.

Mutual ADIs have been limited by two factors that are peculiar to the mutual industry and it's capital structure.

1. The limitation on the mutual sector to raise capital other than from retained earnings, and
2. The impost of the taxation of mutual that has occurred since the Wallis Inquiry without the ability to benefit from the imputation credits, this arises as the mutual structure is not constructed for a dividend distribution based on contributed "ordinary share" capital.

There have been many attempts within the mutual sector to raise capital and while some have been successful some have been withdrawn due to the high regulatory cost both directly and on the weighting of these capital instruments in determining the **Mutual ADI's** capital adequacy.

3. Strong Prudential Framework

There is a lack of recognition of the mutual financial sector in the structure of governing legislation for financial services in Australia being the Corporations, Income Tax Assessment and Banking Act. The failure to recognise and adequately structure in the legislation for the concept of **Mutual Capital** has provided the respective regulators with different perspectives on how **Mutual Capital** should be treated.

Australian Prudential Regulatory Authority (APRA)

As the regulatory authority for Approved Deposit Taking institutions, APRA has provided the mutual sector with a strong framework of prudential standards that serves the mutual financial sector well in terms of security for deposit holders.

The post GFC focus by APRA on governance and risk management has enabled the mutual sector to survive and many of the **Mutual ADIs** to flourish particularly with a consumer rebound against the major banks post-GFC.

However, as a result of the divergence of performance and consolidation within the sector there appears to be an approach by APRA to regulate to the lowest level within the sector. Consequently the better performing **Mutual ADIs** who recognise the BASEL III direction of better governance, risk management and higher capital have been restricted from attaining greater security for deposit holders by raising **Mutual Capital**.

This approach is in contrast to the situation in the UK where Nationwide Building Society were able to construct a “core capital” instrument which provided this mutual with Common Equity Tier 1 (CET1) capital despite the same constraints incurred in being the Australian equivalent of a **Mutual ADI**.

APRA’s concern for the security of deposit holders is essentially supported by the raising of risk bearing capital for **Mutual ADIs** in the event of winding up or operational distress. Unfortunately the APRA Prudential Standard APS111 based on BASEL III refers to CET1 capital being the lowest form of ordinary capital. This is fundamentally misaligned for **Mutual ADIs** that do not have ordinary capital. The UK regulators have recognised this impediment and introduced the concept of **Core Capital** for Nationwide.

By providing a **Core Capital** type instrument for **Mutual ADIs** in Australia, with no voting rights or control of the **Mutual ADI** and that qualifies as CET1 will protect depositors and meet the direction of BASEL III. The **Core Capital** would stand alongside the member share in the situation of a winding up in a deficit situation but only to the par value of the instrument in a surplus.

Australian Securities and Investment Commission (ASIC)

ASIC’s approach to protecting the interest of shareholders and consumers in the corporate sector, is simplified for **Mutual ADIs** as these are both the same parties. Unfortunately, the interests of members of a **Mutual ADI** are again thwarted by the regulations concerning de-mutuality and restricting members from investing risk capital.

Core Capital provisions can be qualified to restrict voting rights and control of the **Mutual ADI** thereby protecting members/customers and depositors. The distribution of surplus capital in the event of winding up to the par value of the share allows the members to participate in the distribution of retained earnings surplus maintaining the elements of mutual/customer owned capital.

Australian Taxation Office (ATO)

Despite meeting the principles of mutuality that exempt other corporations that are member based for income tax liability, since the time of the Wallis inquiry,

Mutual ADIs have incurred the liability of corporate taxation without having the benefit of relief from dividend imputation.

(Note: An exemption does exist for small credit unions with income less than \$50,000 although this has not been adjusted since inception.)

This has effectively impacted **Mutual ADIs** with a current 30% impost (company tax rate) on profits that are the only form of common equity capital available from retained earnings. Such an inequity is not only non-competitive but also restricts a mutual ADI from protecting deposit holders by restricting capital accumulation from profits. It is estimated that the balance of the impost of failure to realise franking credits is in the vicinity of \$1.5 billion and are adding \$150-200 million per year.¹

This competitive imbalance occurs not just against other ADI's but to unregulated financial companies outside the jurisdiction of APRA that enjoy the competitive pricing benefits of operating at lower capital levels in the market place. This was clearly demonstrated by the demise and losses incurred from BANKSIA Financial Services.

CONSIDERATION FOR THE FINANCIAL SERVICE INQUIRY

Based on the above observations I would urge your inquiry to address the anomalies for **Mutual ADIs** in not providing for a **Core Capital** instrument that can be included in the **IRB ratings**. This capital would support the principles of mutuality and the concept of **Impact Investment** for **Mutual ADIs** with common purpose endeavours to better serve members with financial services and products. To facilitate a **Core Capital** facility requires the co-ordination and support from the regulatory authorities as demonstrated in the UK. Ultimately this will require a government policy that recognises the unique aspects of **Mutual ADIs** and their undeniable social and financial contribution to the nearly 4 million Australians and the competitive elements of the Australian Financial System.

SUMMARY ACTIONS FOR CORE CAPITAL for MUTUAL ADIs

1. To prescribe to the regulatory bodies above that they allow **Core Capital** (Common Equity Tier 1 Capital) to be raised by Mutual ADIs that have the capabilities and systems to manage the capital for the benefit of members. This capital will rank as the lowest form of capital as with ordinary capital under the APS111 standard. This will protect depositors and provide equity in the Australian Financial System for **Mutual ADIs** to compete with other ADI's and non-bank (shadow) corporations. The same benefits of dividend imputation would be available to investors in **Mutual ADIs** as exist for other participants in the financial system.

¹ Customer Owned Banking Association – Franking Credits and Customer Owned DI's – Discussion Paper October 2013

2. Allow those ADI's that are not in a position to provide **Core Capital** with an exemption from income tax that allows them to compete and further build retained earnings reserves for the security of depositors while still meeting the prudential standards required for an ADI.

In invoking these two relatively simple recommendations the Financial Systems Inquiry will address a major inequity within the financial system that effects around 4 million members of **Mutual ADIs**.

This will not only provide security to depositors but also address the competitive imbalance arising from the lack of franking credit imputation for **Mutual ADIs**.

In conclusion the Financial System in Australia would be greatly enhanced in providing funding to **Mutual ADIs** through a **Core Capital** instrument. This instrument would provide opportunities for

- new Impact Investment endeavours by groups with a common purpose under the **Mutual ADI** structure
- enhance the stability of the mutual sector by providing a loss absorbing mechanism to protect deposit holders
- encourage diversity in retail financial services as a counter balance to systemic risk
- introduce equity in the taxation treatment of **Mutual ADIs** and
- provide capital to **Mutual ADIs** for investment to meet the many new challenges from digital technology, competition, housing sector growth and reducing interest margins.

To further support and clarify the proposal for CET1 capital for **Mutual ADIs** three documents are attached:

1. Comparison of Victoria Teachers Mutual Bank (VTMB) 2013 Balance Sheet and Operating Statement with \$25 million in Core Capital CET1.
2. A statement from Prof Kevin Davis identifying the issue of equitable tax treatment for credit unions.
3. An extract from the Customer Owned Banking Association (COBA) submission to the Financial Systems Inquiry on access to regulatory capital CET1.

Yours sincerely



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Chair – Victoria Teachers Mutual Bank

VTMB 2013 BALANCE SHEET - Summary

	\$k	% of Assets
CASH	313,870	17.7%
LOANS	1,417,276	79.8%
OTHER	45,417	2.6%
TOTAL	1,776,563	100.0%
DEPOSITS	1,616,926	91.0%
OTHER	20,422	1.1%
TOTAL	1,637,348	92.2%
RESERVES	136,313	7.7%
RPS AT2 / SUB ORD DEBT	2,902	0.2%
CORE CAPITAL (CET1)	-	0.0%
TOTAL	139,215	7.8%
TOTAL	1,776,563	100.0%
INCOME	49,905	
EXPENSES	39,573	
PROFIT	10,332	
TAX	3,251	
NET PROFIT	7,081	
DIVS	-131	
Available for reserves	6,950	

WITH \$25M CET1

	\$k	Change	% of Assets
CASH	338,870	25,000	18.8%
LOANS	1,417,276		78.7%
OTHER	45,417		2.5%
TOTAL	1,801,563	25,000	100.0%
DEPOSITS	1,616,926		89.8%
OTHER	20,422		1.1%
TOTAL	1,637,348		90.9%
RESERVES	136,313		7.6%
RPS AT2 / SUB ORD DEBT	2,902		0.2%
CORE CAPITAL (CET1)	25,000	25,000	1.4%
TOTAL	164,215		9.1%
TOTAL	1,801,563	25,000	100.0%
INCOME	51,309	1,404	
EXPENSES	39,573	-	
PROFIT	11,736	1,404	
TAX	3,693	442	
NET PROFIT	8,043	962	
DIVS	-1,260	-1,129	
Available for reserves	6,784	-166	

Other Information:

Interest Income	97,226	5.6%	98,630	5.6%
Interest Expense	58,000	3.6%	58,000	3.6%
DIV		4.5%		4.5%
RoA		0.40%		0.45%
Rol		5.09%		4.90%
Risk Weighted Assets	920,970		945,970	25,000
Total Regulatory Capital	137,088		162,088	25,000
Capital Adequacy Ratio	14.89%		17.13%	

Franking credits absorbed	56	540	484
Member Investor Share return	Nominal	4.5%	
	Franking credit	1.9%	
	Total	6.4%	
Floating Rate Hybrids			
CBA Pearls	CBAPC	6.39%	
	CBAPA	5.99%	
ANZ CPS 2	ANZPA	5.69%	
NAB	NABPA	5.79%	
Westpac	WBCPC	5.85%	
Bendigo	BENPD	7.60%	
BOQ	BOGPD	7.70%	
			Balance

Are Tax Incentives needed for a viable Fifth Pillar?

Treasurer Wayne Swan has indicated his interest in creating a fifth pillar in the financial sector based around mutual credit unions and building societies to increase competition with banks. But the ability of that sector to grow is limited by its access to the capital required to meet APRA's minimum capital standards.

Credit Unions can, with minor exceptions, only generate capital in the form of shareholders funds by retaining earnings from their dealings with their member/owners. Prior to the early 1990s they were not taxed on this surplus (profit), and that remains the case in a number of overseas countries.

If nothing else, the application of corporate tax to credit unions reduces the after tax earnings available for retention and thus growth of the credit union's capital base and its lending ability. At first glance that looks fair – since banks are also subject to the same taxation.

However, the intricacies of the dividend imputation system make that simple comparison inappropriate. Banks can distribute franking tax credits arising from corporate taxation as franked dividends.

Use of these tax credits by bank shareholders means that corporate tax is essentially “washed out” and the profits of the bank ultimately taxed in total at the personal tax rate of the investor. To the extent that superannuation funds (with a tax rate of 15 per cent) are major bank shareholders, this suggests that the average total tax rate on bank profits is in the region of 15 per cent.

Mutual credit unions cannot, however, distribute franking credits to their owner/ member /shareholders who each hold one share of notional (eg \$1) value. Consequently, the company tax paid by the credit union at the current rate of 30 per cent is not offset by the usage of the tax credits locked inside the organization.

That apparent tax disadvantage could be removed if some financial instrument were created which allowed credit unions to distribute franking credits to member/owners. But, for several reasons, this is no simple matter.

First, distribution of franking credits also involves imputation of taxable income to the recipient. Without the distribution of the retained earnings on which tax has been paid (which would undermine the mutual structure) credit union members on high tax rates might find themselves being imputed with notional income (but no cash flow) on which tax is payable and which exceeds the tax credits they have received.

Second, with each credit union member having one share, any pro-rata beneficial distribution of franking credits would be unrelated to the level of the member's involvement with, and contribution to the generation of the earnings of the credit union. There would be inappropriate incentives created for joining credit unions – not to use

their services, but to receive some part of the franking credit distribution at the expense of other members.

Third, current credit union members are only partially responsible through their business dealings with the credit union for its accumulated shareholder equity. They largely “inherited” it as a form of financial and social capital from members past, and will cede it to future members when they leave. Thus, the issue is not so much about fairness to current members, but whether the tax system discriminates against this form of organizational structure, its ability to provide effective competition, and its ability to further grow the social capital involved.

The arguments outlined earlier suggest that this may indeed be the case, and that the tax treatment of credit unions is adverse and worth reviewing. Returning to a system of tax exemption is one possibility, but would probably tilt the playing field in the opposite direction.

It would, however, facilitate capital accumulation and growth by credit unions by removing the tax bite on retained earnings. And because Basel III is likely to reduce the ability of prudentially regulated institutions to use hybrid or debt type instruments as a funding source which also qualify as regulatory capital, other capital raising options for mutual credit unions may be even more restricted.

*This article is based on Australian Centre for Financial Studies FRDP 6-2010.
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One way to address this problem is to allow RMBS to be part of a diversified MLH portfolio (subject to an appropriate cap on these holdings).

Recommendation: Provide more consistent treatment of RMBS for regulatory liquidity purposes between MLH ADIs and LCR ADIs.

5.2.4.3 Access to regulatory capital

Listed ADIs regularly issue regulatory capital, and it is important that customer-owned ADIs also have the capacity to do so. Under Basel II, customer-owned ADIs were able to issue all forms of regulatory capital. Unfortunately, APRA's implementation of the Basel III capital framework does not allow issuance of mutual capital instruments that qualify as CET1 capital, which is the most important type of regulatory capital.

As a consequence, under Basel III, customer-owned ADIs could only raise capital through retained earnings restricting their ability to raise capital more effectively, inhibiting their ability to diversify their capital base and constraining their ability to grow. Whilst APRA has been working with our sector on alternative capital instruments, more work is required to ensure that customer-owned ADIs have better access to a wider range of capital instruments.

"...Customer-owned ADIs have considerably less flexibility than they had prior to the Basel III reforms. In contrast, listed ADIs have been accommodated ... and are able to issue all forms of regulatory capital..."

The DAE report *Competition in Banking* found that denying mutuals access to Common Equity Tier 1 instruments could also have the following impacts:

- Customer-owned ADIs will not have the ability to manage and grow their balance sheets flexibly and in a manner that best serves their members' interests;
- Growth will be constrained to the uneven rate at which organic capital can be generated from retained earnings;
- Organic capital will not be able to be generated quickly to respond to sudden increases in capital requirements;
- Customer-owned ADIs will be less able to lend in a downturn and will be less able to provide effective competition to listed banks;
- The competitive disadvantage in relation to banks resulting from lack of access to Common Equity Tier 1 risks reducing supply, and increasing the cost, of credit to customers by the mutual sectors; and
- Ratings agencies may take a negative view of the customer-owned banking sector, given its restricted access to Common Equity Tier 1 capital and its increasing dependence on the economic cycle—this would have a knock-on effect on the ability of customer-owned ADIs to access senior funding.

Customer-owned ADIs have considerably less flexibility than they had prior to the Basel III reforms. In contrast, listed ADIs have been accommodated under the Basel III capital rules and are able to issue all forms of regulatory capital in Australia.

This outcome appears due to APRA taking a highly cautious approach to Basel implementation, and concerns within the prudential regulator that accommodating the customer-owned model may result

in some departure “from its longstanding policy of applying a common set of prudential requirements across the ADI industry.”⁷⁶ APRA stated:

“Some other submissions argued that, since the Basel III reforms are global minimum capital requirements for internationally active banks, the reforms should not be applied to all ADIs in Australia. APRA does not accept this argument. Unlike other jurisdictions, banks, credit unions and building societies in Australia are supervised under the same legislative regime and APRA’s longstanding policy is to apply a common set of prudential requirements across the ADI sector. When appropriate, these requirements can take account of an individual ADI’s size, complexity and risk profile. In APRA’s view, the Basel III reforms will improve the regulatory capital framework for ADIs and, in so doing, strengthen the protection available for depositors and the resilience of the Australian banking system as a whole. There are, nonetheless, certain aspects of the Basel III reforms that are problematic for mutually owned ADIs (mutual ADIs).”⁷⁷

The Basel Committee on Banking Supervision (BCBS) prepared rules on capital primarily for listed, internationally focused banks, but incorporated an allowance for ‘national discretion’ in the hands of local regulators. This discretion allows a regulator to adapt certain rules to particular legal forms, such as customer-owned ADIs, due to the different characteristics inherent in their structure and focus.

“...by applying the rules in such an inflexible manner, they effectively give preferential treatment to the listed sector over the customer-owned sector.”

The BCBS, when designing the new rules, recognised this by acknowledging that the constitutional and legal structure of mutuals needed to be considered in the context of ‘common shares’ under the CET1 definition.⁷⁸ The BCBS took the position of leaving it to each national regulator to make the necessary adjustments. While the BCBS makes reference to this requirement in relation to common shares only, the principle carries equal weight to all relevant aspects of new framework.

However, APRA instead applied the Basel III capital rules to all ADIs without utilising the ‘national discretions’ allowed by the Basel Committee. By taking a less flexible approach than the Basel Committee would have envisaged, APRA has significantly reduced the capacity of customer-owned ADIs to issue regulatory capital.

COBA appreciates the importance of Basel III in enhancing the robustness of the international banking system. Our sector supports the objectives of raising the quality, quantity and consistency of capital in the international banking system. However, by applying the rules in such an inflexible manner, they effectively give preferential treatment to the listed sector over the customer-owned sector. This is a perverse outcome, given that the Basel III capital framework was designed for large, listed, systemically important banks that have a substantial international focus,⁷⁹ rather than for smaller, locally-focused mutuals that carry a much lower systemic risk and have limitations on the ways in which they raise capital.

In contrast to the Australian experience, other jurisdictions have successfully accommodated the mutual model into the Basel III capital framework:

⁷⁶ Response to Submissions: Implementing Basel III capital reforms in Australia. March 2012 APRA

⁷⁷ Response to Submissions: Implementing Basel III capital reforms in Australia. March 2012 APRA

⁷⁸ <http://www.bis.org/publ/bcbs189.pdf> page 14

⁷⁹ APRA Basel III capital paper, September 2011, page 10 and BIS Basel II publication, paragraph 9 <http://www.bis.org/publ/bcbs118.htm>

- in the UK, Nationwide (a large UK Building Society), has recently launched a CET1 capital offering under Basel III.⁸⁰
- Canadian mutuals⁸¹ are allowed to count member shares and investment shares as the highest form of capital, provided certain conditions are met;⁸² and
- European regulators have specifically allowed member shares in mutuals to be considered CET1 capital.⁸³

While APRA has acknowledged the need to provide customer-owned ADIs with the capacity to issue AT1 and T2 instruments, the Basel III capital standards took effect in Australia more than a year before APRA provided the sector with this flexibility. Furthermore, customer-owned ADIs remain unable to directly issue CET1 capital. This is despite a Senate Committee recommending in November 2012 that:

"Failure to provide customer-owned ADIs with the capacity to issue the same forms of capital as listed ADIs will continue to harm competition, choice and diversity for no prudential benefit."

"APRA addresses, without further delay, the unique issues Basel III may pose for mutual ADIs as a result of their corporate structure and that it publishes a document which sets out how these problems have been addressed."⁸⁴

It is essential that listed ADIs and customer-owned ADIs receive equivalent treatment under the Basel III capital rules. Failure to provide customer-owned ADIs with the capacity to issue the same forms of capital as listed ADIs will continue to harm competition, choice and diversity for no prudential benefit.

Recommendation: Accommodate the customer-owned model in the prudential regulatory framework by allowing customer-owned ADIs to issue a form of CET1 capital.

5.2.4.4 Use of terms "bank" & "banking"

Customer-owned banking institutions are subject to the same prudential regulatory regime as listed banks but face a number of restrictions around their use of the terms 'bank' and 'banking'.

Banks, credit unions and building societies are all Authorised Deposit-taking Institutions under the *Banking Act 1959* but not all ADIs can describe themselves as banks and APRA is proposing to further restrict use of the term 'banking' by some ADIs.

Prior to July 1998, building societies and credit unions looking to convert to banks were required to demutualise. Many of today's regional banks (Bendigo and Adelaide Bank, Suncorp) and major bank sub-brands (St George, Bank of Melbourne) were originally mutual building societies.

Customer-owned banking institutions wanting to rebrand as banks no longer have to demutualise but they must pass a substance

"Customer-owned banking institutions are subject to the same prudential regulatory regime as listed banks but face a number of restrictions around their use of the terms 'bank' and 'banking'."

⁸⁰ <http://your.nationwide.co.uk/your-news/articles/Pages/ccds-issuance.aspx>

⁸¹ Except in Saskatchewan

⁸² Dave Grace & Associates, *Competitive Dynamics in Retail Banking: An International Comparison*, March 2014, p. 14.

⁸³ Dave Grace & Associates, *Competitive Dynamics in Retail Banking: An International Comparison*, March 2014, p. 20.

⁸⁴ Senate Economics References Committee, *The post-GFC banking sector*, November 2012, p. xxv.