Australian Prudential Regulation Authority

400 George Street (Level 26)
Sydney NSW 2000

GPO Box 9836
Sydney NSW 2001

T 02 9210 3000
F 02 9210 3411
W www.apra.gov.au

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To: All locally incorporated Authorised Deposit-taking Institutions

INTERIM ARRANGEMENTS FOR ADDITIONAL TIER 1 CAPITAL INSTRUMENTS

In December 2010, the Basel Committee on Banking Supervision (BCBS) published its package of reforms, *Basel III: A global regulatory framework for more resilient banks and banking systems,* known as 'Basel III'[1]. APRA indicated in a letter to authorised deposit-taking institutions (ADIs) on 17 December 2010 that, as a member of the BCBS, it fully supports the Basel III framework and would commence consultation on Basel III implementation in Australia during 2011. The Basel III framework comes into effect from 1 January 2013, subject to various transition arrangements.

The Basel III framework introduces a number of changes affecting the eligibility of capital instruments, including stricter criteria for eligible Tier 1 capital instruments. APRA is currently preparing a discussion paper on how it intends to incorporate the eligibility criteria into its prudential standards on capital adequacy. This paper will be released in coming months, with the aim of issuing final prudential standards in mid-2012.

APRA has previously confirmed that capital instruments issued prior to the announcement of the Basel III framework will be eligible for transitional treatment beyond 2013. However, APRA also notes that some ADIs wish to issue new Tier 1 capital instruments before the Basel III framework is finalised in Australia and are seeking guidance as to the status these capital instruments would have from 1 January 2013.

APRA confirms that, until the end of 2012, eligible Tier 1 capital instruments must continue to satisfy all relevant criteria contained in *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (**APS 111**). In addition, APRA confirms that it is prepared, on an interim basis, to accept newly issued capital instruments as being eligible for transitional treatment as Additional Tier 1 capital under the Basel III framework, on the basis that they meet:

- the current eligibility requirements in APS 111; and
- the criteria set out in the Attachment.

Instruments issued under these transitional arrangements may be assessed against the prudential standards establishing the Basel III framework, when they are finalised. At that time, ADIs may apply to have any Tier 1 capital instruments that they consider meet the stricter eligibility criteria treated as a permanent addition to their Tier 1 capital.

[1] http://www.bis.org/bcbs/basel3.htm

The criteria set out in the Attachment are based on the existing criteria in Attachment A, paragraphs 1 to 3 of APS 111. The key differences from APS 111 are the:

- prohibition on the inclusion of step-ups, or other provisions which act as incentives to redeem, from all forms of eligible Additional Tier 1 capital (not just non-cumulative irredeemable preference shares);

- exclusion of stapled securities;

- provision that eligible Additional Tier 1 capital instruments cannot be called within five years unless for a tax or regulatory event. In addition, such instruments cannot be called unless they are replaced concurrently or beforehand with capital of the same or better quality, or the issuer can satisfy APRA at the time that its capital position is well above minimum capital requirements such that replacement is unnecessary;

- requirement that eligible Additional Tier 1 capital instruments recognised as liabilities under Australian Accounting Standards must include a provision under which they will convert to ordinary shares of the issuer if the Level 2 group's Common Equity Tier 1 ratio falls below 5.125 per cent;

- application of criteria governing conversion of all forms of eligible Additional Tier 1 capital instruments into ordinary shares (not only non-cumulative irredeemable preference shares); and

- exclusion of instruments, whether non-cumulative irredeemable preference shares or otherwise, issued through a special purpose vehicle.

For ease of reference, the key differences from APS 111 are italicised in the Attachment.

Further information on APRA's treatment of capital instruments prior to implementation of the Basel III framework is provided in the Frequently Asked Questions section on the APRA web-site (http://www.apra.gov.au/ADI/upload/FAQ-ADI-3.pdf).

Yours sincerely,

Charles Littrell
Executive General Manager
Policy, Research and Statistics
Tel: 02 9210 3160
charles.littrell@apra.gov.au

Attachment

1. To qualify as Additional Tier 1 capital at Level 1 and Level 2, an instrument must satisfy the following:

   (a) the instrument is unsecured and paid up:

      (i) any partly paid issue is eligible only to the extent that it has been paid up; and

      (ii) only the proceeds of the issue that have been received by the issuer are permitted to count as capital;

   (b) the instrument is perpetual (i.e. it does not have a maturity date):

      (i) the instrument is not redeemable at the option of the holder and has no provisions that require future redemption by the issuer; and

      (ii) the instrument contains no step-ups or other provisions that act as incentives to redeem;

   (c) redemption at the option of the issuer is permitted provided:

      (i) it may occur only five years or more after the date of issue, unless redemption is a result of regulatory or taxation events;

      (ii) the redemption or call option is subject to APRA's prior written approval at the time of exercise and it does not operate in conjunction with any other feature that creates or signals a *de facto* tenor of the instrument;

      (iii) *the issuer does not exercise a call unless the instrument is replaced concurrently or beforehand with capital of the same or better quality or the issuer*[2] *can satisfy APRA at the time that its capital position is well above its minimum capital requirement after the call option is exercised;* and

      (iv) issue documentation gives clear and prominent notice to prospective investors that the issuer's right to exercise any option to redeem or purchase the instrument is subject to APRA's prior written approval *and that investors should not expect that supervisory approval will be forthcoming;*

   (d) the instrument does not impose any fixed servicing costs on the issuer:

      (i) dividend or interest payments to holders are at the discretion of the issuer. The issuer is able to *cancel* or otherwise extinguish dividend or interest payments on the instrument and alter the timing of payments;

[2] Where an issuer is a member of a consolidated banking group for Level 2 purposes, applications to, or approvals by, APRA, required of such an issuer may be undertaken through the ADI or authorised NOHC which ultimately heads the consolidated banking group to which the issuer belongs.

(ii) *the issuer has full access to any undeclared or cancelled dividend or interest payments;*

(iii) any unpaid dividends or interest are non-cumulative (i.e. not required to be made up by the issuer at a later date). The instrument, both in form and substance, does not provide for cumulative dividend or interest payments. For example, the instrument does not provide for payment of a higher dividend or interest rate if dividend or interest payments are not made on time or a reduced dividend or interest rate if such payments are made on time. Any special or optional dividends or interest payments on the instrument outside of normal scheduled payments require APRA's prior written approval;

(iv) the non-payment of a dividend or interest on the instrument does not trigger any restrictions on the issuer other than its ability to pay dividends on ordinary shares, or purchase shares (outside normal trading operations) or retire other shares or pay dividends or interest on more junior capital instruments;

(v) the instrument does not provide for payment of any form of compensation to investors other than by way of a distribution of profits. Any such profit distribution is in the form of a cash dividend or interest payments. Payment in kind is not permitted;

(vi) dividend or interest payments on the instrument are not linked, in whole or in part, to the credit standing of the issuer. However, linking dividend or interest payments on the instrument to movements in general market indices is permitted; and

(vii) the rate of dividends or interest on the instrument, or the formulae for calculating dividend or interest payments on the instrument, is predetermined and set out in the issue documentation;

(e) the instrument is able to absorb losses incurred by the issuer on a going concern basis and in the winding-up of the issuer. This includes the following provisions:

(i) *any instrument recognised as a liability in accordance with Australian Accounting Standards must include a provision under which it will convert to ordinary shares of the issuer if the Level 2[3] group's Common Equity Tier 1 ratio falls to 5.125 per cent or below. (Prior to 1 January 2013, reference to Common Equity Tier 1 should be taken to mean Net Fundamental Tier 1 capital as defined in Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111)). For these purposes, the Common Equity Tier 1 ratio is defined as the ratio of Common Equity Tier 1 capital net of deductions, as specified in ADI prudential standards, to total risk-weighted assets as defined in ADI prudential standards;*

(ii) *should an issuer fail before conversion can be effected*, the instrument (both principal and any unpaid dividends or interest) is treated as a specific class of share capital or members' interest of

[3] *As defined in Prudential Standard APS 110: Capital Adequacy*

the issuer. The contractual rights of the holders of the instrument to receive and enforce any payments under the instrument are consistent with the intention that the instrument functions as if it constituted a specific class of share capital or members' interest of the issuer;

(iii) the issuer does not have any liability to make a dividend or interest payment on the instrument if making the payment would result in the issuer becoming, or being likely to become, insolvent for the purposes of the *Corporations Act 2001* (**Corporations Act**) or, where the issuer is incorporated in a foreign jurisdiction, for the purposes of equivalent corporate insolvency law of that jurisdiction;

(iv) the instrument cannot contribute to liabilities of the issuer exceeding assets of the issuer if such a balance sheet test forms part of any national insolvency law governing the issuer; and

(v) issue documentation makes explicit that:

A. payment of dividends or interest on the instrument is at the discretion of the issuer;

B. failure of the issuer to make a dividend or interest payment on the instrument does not constitute an event of default;

C. there are provisions for mandatory conversion into ordinary shares of the ADI;

D. holders have no right to apply for the winding-up or administration of the issuer, or cause a receiver, or receiver and manager, to be appointed in respect of the issuer on the grounds that the issuer fails to make, or is or may become unable to make, a dividend or interest payment under the instrument; and

E. holders of the instrument will have no offsetting rights or claims on the issuer in the event that the issuer cancels or suspends dividend or interest payments on the instrument;

(f) the instrument is subordinated in right of repayment of principal, interest and dividends to all depositors, *senior subordinated debt holders* and other creditors of the issuer and the issue documentation:

(i) clearly indicates the subordinated nature of the instrument to prospective holders, and precludes the exercise of any contractual rights of set-off between the instrument and any claims by the issuer on the holders of the instrument;

(ii) clearly indicates that the instrument does not represent a deposit liability of the issuer;

(iii) does not contain any clauses that could trigger early repayment of debt (e.g. cross-default clauses, negative pledges, restrictive covenants); and

(iv) states that the only form of default under the instrument is the winding-up of the issuer and that the occurrence of such an event does not prejudice the subordination of the instrument;

(g) *the instrument is neither secured nor covered or otherwise supported by any guarantee, put option or other facility involving the issuer or related entity, or any other arrangement that legally or economically enhances the seniority of the investors vis-à-vis all other creditors of the issuer*;

(h) the instrument, where drawn down in a series of tranches, meets the requirements of APS 111 as if each tranche is a capital issue in its own right;

(i) the instrument does not contain any terms, covenants or restrictions that could inhibit the issuer's ability to be managed in a sound and prudent manner, particularly in times of financial difficulty, *or hinder recapitalisation of the issuer (such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame),* or otherwise restrict APRA's ability to resolve any problems encountered by the issuer (e.g. clauses preventing further senior debt issues are prohibited);

(j) there are no cross-default clauses in the documentation of any debt or capital instruments of the issuer linking the issuer's obligations under the instrument to default by the issuer under any of its other obligations, or default by another party, related or otherwise;

(k) the instrument is marketed in line with its prudential treatment and does not include any "repackaging" arrangements that have the effect of compromising the permanency of capital raised. If the prospectus or other offering documentation or marketing of the instrument suggests to investors that the instrument has attributes of a lower level of capital than claimed for prudential treatment, APRA will treat the instrument as an instrument falling into that lower level of capital for prudential purposes; and

(l) the instrument has not been issued directly or indirectly through a special purpose vehicle.

2. Where an instrument is subject to the laws of a jurisdiction other than Australia or its territories, the ADI must also ensure that the instrument satisfies all relevant qualifying criteria under the laws of that jurisdiction. APRA may require the ADI to provide an independent legal opinion addressed to APRA by a firm or practitioner of APRA's choice, at the expense of the ADI, confirming that the instrument meets all or any of such criteria.

3. An ADI must seek APRA's written approval for any subsequent modification of the terms or conditions of the instrument that may affect its eligibility to continue qualifying as eligible capital. Failure to obtain such prior approval may render the instrument ineligible as Additional Tier 1 capital.

4. In addition to satisfying the criteria set out in paragraphs 1 to 3 above, converting instruments must also satisfy the following criteria:

(a) conversion of instruments into ordinary shares is permitted, subject to the following criteria:

   (i) conversion cannot occur at the option of the holder;

   (ii) conversion is into *shares* of the issuer only;

   (iii) the conversion formula for determining the number of ordinary shares received upon conversion of a converting instrument must be fixed in the issue documentation and must include a cap on the maximum number of ordinary shares that holders will receive upon conversion;

   (iv) for the purposes of the previous paragraph, the maximum number of ordinary shares received upon conversion of each converting instrument must not exceed the ratio of the price of the converting instrument at issue divided by 50 per cent of the price of the ordinary share at time of issue of the converting instrument. For these purposes, in calculating the ordinary share price at time of issue, adjustments may be made for subsequent ordinary share splits, bonus issues and similar transactions;

   (v) the conversion is not structured in a way that would effectively provide for a return of capital or compensation for unpaid dividends; and

   any exercise of the conversion option by the issuer is subject to APRA's prior written approval. Approval is not required for any mandatory conversions whose terms were agreed to by APRA prior to issuance of the converting instrument.