Australian Banking Association

# DISCUSSION PAPER – ENHANCING BANK RESILIENCE: ADDITIONAL TIER 1 CAPITAL IN AUSTRALIA

## APRA

15 November 2023

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## Key Considerations

- ABA believes that AT1 has an important role to play in Australia's capital framework. AT1 is critical to ensure flexibility is retained in times of stress. It is also consistent with Basel principles, provides flexibility to banks in their capital management and reflects a market that has been developed over an extended period.
- Nonetheless, ABA acknowledge the importance of ensuring that AT1 remains fit for purpose and available to be used in a crisis in a way that respects the hierarchy of capital in a timely manner.
- Changes to the design of AT1 securities could include a modest increase in the existing CET1 trigger for conversion (to no more than 7 per cent) to be in line with some other jurisdictions, or the introduction of a qualitative trigger which would provide APRA with the flexibility and discretion to compel the conversion of the securities at a 'point of re-capitalisation'.
- While the above suggestions both have costs, there appears more merit in investigating these rather than some of the other design options canvassed (such as increasing restrictions on AT1 distributions), where the costs would outweigh the benefits. In all cases, APRA should consider the effects of any changes through a proportionate lens, including the effects on market access and funding costs.
- The discussion paper raised the prospect of reducing the role of AT1 in the capital framework and shifting reliance to other forms of capital, but there has been an extensive work program undertaken on the capital stack for Australian banks, with the introduction of Basel III and Total Loss-absorbing Capacity (TLAC). It is the position of the ABA that the existing ratios have been thoroughly investigated and any action to ensure the effectiveness of AT1 securities is better focused on design of AT1.
- The introduction of Design and Distribution Obligations (DDOs) ensures investors who purchase AT1 are either verified as wholesale investors (as defined in the Corporations Act), or have received personal advice. It has also led to an increase in AT1 issuance to wholesale investors. A key benefit of DDO is that the distributors of the product can more precisely identify as to whether an investor is a wholesale account versus a retail investor using all ASIC's criteria and therefore do not need to solely rely on the minimum $500,000 test.
- Increasing the denomination size (minimum parcel size of an AT1 Capital instrument) to $500,000 in order to restrict its availability to retail investors would have significant consequences in terms of the liquidity of the market and potentially the ability of banks to continue listing AT1 securities on the ASX.
- Unless the recommendations of the Board of Taxation are implemented, offshore issuance will remain prohibitively expensive in part due to the inability to deduct AT1 distributions for tax purposes (changes to the tax treatment would also encourage greater domestic institutional participation as well).
- In the event of APRA pursuing any changes to AT1 securities, there would be a strong need for a comprehensive and transparent transition process to provide the clarity and certainty that would be required by the market. ABA recommend that there would be a transition period of at least 7 years, with existing AT1 instruments grandfathered. APRA should also consider their process and incorporate an additional step to allow for detailed analysis of the changes before moving to a standard change.

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**About the ABA**

The Australian Banking Association advocates for a strong, competitive and innovative banking industry that delivers excellent and equitable outcomes for customers. We promote and encourage policies that improve banking services for all Australians, through advocacy, research, policy expertise and thought leadership.

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## ABA submission to APRA

The ABA welcomes APRA's consultative approach to the topic of Additional Tier 1 Capital (AT1) in Australia. In particular, the decision to begin with a discussion paper to explore issues with industry in an open manner at the start of the process was appropriate and appreciated.

ABA believes that AT1 has an important role to play in Australia's capital framework. Maintaining AT1 in the Australian capital framework is critical to ensure flexibility is retained in times of stress. It is also consistent with Basel principles, provides flexibility to banks in their capital management and reflects a market that has been developed over an extended period.

Industry believe AT1 would operate as intended in a crisis, noting the context in Australia is different than it was in other recent examples, with clear, existing prudential standards and requirements. In particular, AT1 in Australia has very clear contractual provisions and the legal risk to its usage is comparatively low given the statutory support in the conversion and write off provisions within the Banking Act.

Further, the Australian regulatory environment provides clear guard rails for the usage of AT1, including:

- APRA's prudential standards provide for early-stage intervention on dividends and distributions via constraints on capital distributions.
- Recovery planning that takes place under CPS 190 includes objective targets for implementing capital raising and other actions.
- Resolution planning under CPS 900 includes recapitalisation plans following a declaration that an institution has reached the point of non-viability (PONV).

We would also note that the review by the FSB found that the recent Credit Suisse example does not suggest the existing resolution framework is not workable.[1] The write-off of AT1 achieved its objectives limiting the cost to the public purse, though was criticised due to the failure to respect the hierarchy of capital.

Nonetheless, ABA acknowledge the importance of ensuring that AT1 remains fit for purpose and available to be used in a crisis in a way that respects the hierarchy of capital, consistent with statements from regulators in other jurisdictions that state their intention to impose losses first and fully on equity before moving to subordinated creditors.

Appendix A will discuss various policy options raised in the discussion paper to achieve this and will consider their impact. Appendix B will consider the transitional arrangements that would be required should any changes be proposed, while Appendix C raises the important issue of the tax treatment of AT1 securities, which needs to be considered in the context of any changes to the participation in AT1 securities.

[1] Financial Stability Board, '2023 Bank Failures: Preliminary lessons learnt for resolution', 10 October 2023.

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## Appendix A: Review of Policy Options

The discussion paper outlines three broad policy approaches for options that APRA could consider towards enhancing the effectiveness of AT1 securities.

### Design of AT1 Securities

This section will outline the considerations that arise from various options of changing the design of AT1 securities to enable AT1 to be used earlier and ensure it will more effectively absorb losses.

Increase in the CET1 Trigger

One option that was flagged in the discussion paper was the level of the loss absorption trigger (which in Australia is a CET1 ratio of 5.125 per cent of risk weighted assets). As noted in the discussion paper, given the 'unquestionably strong' capital regime in Australia, a deterioration in CET1 ratios down to 5.125 per cent would imply a substantial decline in capital and would have already prompted discussion as to whether PONV had been reached.

Given the concerns raised by APRA in the discussion paper about ensuring AT1 can be used in a more timely way in a crisis, there is merit to consider whether a higher CET1 trigger point would be more effective.

Several international jurisdictions have a higher trigger point, often in the range of 7-8 per cent, with 7 per cent being the most common. Adoption of a higher trigger, such as 7 per cent, in Australia would go some way towards addressing the concerns raised by APRA in the discussion paper, by providing an earlier opportunity for AT1 to be used in a crisis. A 7 per cent trigger based on APRA ratios is significantly "closer" than international peers' AT1 triggers are calibrated (given that that Australian bank's internationally comparable CET1 ratios are ~6 percentage points higher than assessed under APRA prudential standards).

However, any revision to the CET1 trigger would need to appropriately consider the usability of CET1 capital buffers, which by design are intended to absorb the impact of losses during periods of stress while preserving the ability to continue lending.

Further, such a move would not be costless. As was noted by rating agency Standard & Poor's (S&P) in an update after the release of the discussion paper, an increase in the trigger from current levels would increase the risk of loss-absorption of the instrument.[2] The update noted that in some jurisdictions where the contractual terms of AT1 instruments indicate a trigger of 7 per cent, S&P have considered this to represent a going concern trigger for the issuing bank, resulting in downgrade of one or more additional notches in its rating on the AT1 instruments.

The impact of a one notch downgrade would move some AT1 securities to a below investment-grade rating, which could lead to a reduction in demand from institutional investors governed by mandates. While the actual pricing impact will differ by individual banks, it suggests an increase in issue costs of up to 25 basis points per annum.

Raising the trigger, particularly if there were consideration to raising it above 7 per cent, would also be a challenge for banks operating under the standardised approach to credit risk. In that case, the smaller distance between their existing individual CET1 targets under the 'unquestionably strong' capital framework and the trigger would limit the opportunity for banks to implement their existing recovery and capital raising plans.

[2] Standard & Poor's, 'Credit FAQ: Will Australia Increase The Likelihood Of Bank AT1 Loss Absorption?', 19 October 2023.

An additional challenge with increasing the likelihood of an automated conversion being triggered is that approaching such a point would compromise the ability of entities to successfully raise capital, given automated conversion will result in a significant dilution of existing shareholders. Maintaining the ability to exercise supervisory judgement (either for PONV or some other trigger point – see below – is critical).[3]

Introduction of a Qualitative Trigger

An alternate approach to ensuring that triggers for conversion for AT1 securities are available when it is deemed necessary by regulators (i.e., before PONV or for situations that have been driven by other events such as liquidity), would be to introduce into the terms of issue for each AT1 security the capability of AT1 being triggered by regulatory discretion.

Such a trigger could potentially be designed to be consistent with Section 13E of the Banking Act (Recapitalisation direction by APRA). This would allow the regulator to act sooner than PONV (at a 'point of re-capitalisation') if it were concerned about the ability to convert AT1 to maintain the entity as a going concern.

However, while such a change would certainly aid in addressing some of the challenges identified in the discussion paper, there would need to be considerable work to ensure that such a trigger is designed in a way that would limit investor uncertainty.

Too broad a discretionary power, unaccompanied by an indication of limits to the scope for its intended usage would either increase uncertainty such that accurate market pricing of securities with such a trigger would be challenging or, if the market thought that the trigger would be used too precipitously, undermine market pricing as to effectively make them non-desirable by investors without a burdensome increase in cost for issuers.

In addition, careful consideration would need to be given to potential continuous disclosure and litigation risks associated with the introduction of a 'point of recapitalisation' trigger. We also acknowledge that further work is needed to explore the viability of this option including investor appetite and rating agency implications. We are happy to engage further with APRA on this potential approach.

Usage of forward-looking or alternate triggers

In addition, we have also considered alternative triggers, although we do not recommend these options for the following reasons:

*Forward looking triggers*

One of the potential changes raised in the discussion paper would be through basing triggers on more forward-looking metrics. While this could help in the identification of issues at an earlier stage than the existing CET1 triggers, it is likely that the benefits of introducing such a trigger would be outweighed by the challenges and increasing complexity that would be introduced.

The use of forward-looking triggers is challenging given market disclosures are based upon reported actual (historical) balances. Introducing a forward-looking trigger based on internal assumptions is likely to be highly subjective, complex and difficult for investors to understand and very challenging from a disclosure perspective. Any forward-looking view will be based on a set of assumptions and achieving consistency across banks will be challenging. For example, this could lead to banks triggering AT1 instruments at different times given differing views and assumptions on the outlook.

[3] Consistent with the position outlined by the European Central Bank in 'ECB contribution to the European Commission's targeted consultation on the review of the crisis management and deposit insurance framework', page 8.

Identifying the metrics for such a trigger would take considerable time and research to ensure that it would not be triggered inappropriately. A broader problem would be the openness of such a trigger, especially if it were based upon a measure such as the share price, to market manipulation. In contrast, using a forward-looking trigger reliant on internal bank calculations would be unappealing to investors due to the difficulty of being able to accurately price such information.

Similarly, if one of the concerns identified by APRA in the discussion paper is reducing uncertainty and litigation risk, the inclusion of metrics that rely on forecasts or ratings does not seem to accomplish this.

*Non-capital triggers*

Relatedly, the discussion paper notes that "other drivers of stability and market confidence beyond capital, such as liquidity risk, may be important triggers". Industry would advise against the inclusion of any explicit liquidity target as a trigger for AT1, given the likelihood of the presence of such an explicit trigger, and the incentives for some market players to trigger it, would have on undermining the stability of a banks liquidity. We also note that the conversion of AT1 securities by itself would not deliver any additional cash flow liquidity following the conversion.

If such issues were of concern, we would note that a more effective approach to the above would be the 'point of recapitalisation' trigger, which could consider other factors such as a banks liquidity position and forward-looking considerations rather than having a direct trigger.

<u>Changes to AT1 distributions</u>

The discussion paper notes that "banks have been reluctant, in practice, to cancel AT1 distributions to conserve capital given the market signalling effects" and defines this a key challenge in using AT1 to absorb losses.

ABA would note the following key points in response:

- It is important that the principle of the hierarchy of capital is preserved. Non-payment of AT1 distributions is effectively a transfer of value from AT1 investors to equity investors. Cancelling AT1 distributions prematurely while dividends are still being paid (or restarted in a short period) to ordinary shareholders would breach this principle.
- Given the size of coupon payments, restrictions on AT1 coupon payments are unlikely to be sufficient to restore an ADIs capital position. Existing distribution restrictions, that would generally focus on restricting dividend payments first, are likely to be far more effective.
- These existing regulatory requirements are already operating effectively. APS 111 and the operation of the minimum capital conservation ratios provide early-stage intervention on dividends, with limits on the payment of dividends and distributions.[4]

## Role of AT1 Securities

The discussion paper raised the prospect of reducing the role of AT1 in the capital framework and shifting reliance to other forms of capital.

In response to those suggestions, ABA would note:

- The current form of AT1 capital was designed following the global financial crisis to serve as a mechanism to raise capital at a point prior to resolution, when it would be difficult or time-consuming to raise CET1 capital. At this point, existing shareholders may have little incentive to support capital raisings, which would likely be highly dilutive and uncertain.

[4] APS 110 Attachment B – Constraints on capital distributions.

- In recent times there has been an extensive work program undertaken on the capital stack for Australian banks, with the introduction of Basel III and TLAC. It is the position of ABA that the existing ratios have been thoroughly investigated and any action to ensure the effectiveness of AT1 securities is better focused on design of AT1. Further, the ABA does not agree that introducing a cap on eligibility for AT1, as raised in the discussion paper, is required.
- Internationally comparable CET1 measures show a high usage of CET1 capital in Australia compared to their international peers, with the Australian bank internationally comparable CET1 ratios ~6 percentage points higher than assessed under APRA standards.
- The existing level of AT1 in Australia provides significant support to Tier 2 capital instruments, which is critical given the high level of usage of Tier 2 capital in Australia to meet TLAC requirements.

## Participation in AT1 Securities

The discussion paper noted that the risks of converting AT1 securities are "amplified where there is a high proportion of domestic retail investors, such as in Australia". Some possible policy options explored by the paper include restricting access to retail investors and increasing denomination size.

<u>Restricting Retail Investors from Accessing AT1</u>

The paper raises the possibility of restricting or banning retail investors from access to AT1 issuance. An important point to consider with this would be what definitions of retail and wholesale investors is being contemplated, noting that the UK example cited by the discussion paper only banned "ordinary retail investors" and still allowed participation by "sophisticated" and "high net worth" investors – concepts analogous to the Sophisticated Investor Test in the Corporations Act.

The discussion paper appears to view the wholesale/retail distinction largely through the prism of parcel size (i.e., parcel size below $500,000 indicates a retail investor). Indeed, it seems to use this distinction to draw the conclusion outlined in Footnote 22 that "there has not been a material reduction in non-wholesale investor participation in new issues of AT1 instruments following the introduction of Design and Distribution Obligations (DDOs)".

This assertion does not match the experience of Members who have issued AT1 securities following the introduction of DDOs in October 2021. These issuers have seen increased shares of issuance to wholesale investors (including those that have been verified to meet the sophisticated investor test) such that the vast majority (over 80 per cent) are allocated to wholesale investors. We also note that with the implementation of DDO, it ensures investors who purchase AT1 are either verified as wholesale, or have received personal advice (and subject to the "best interests" requirements of the Corporations Act), which ensures they comprehend the possibility of and are able withstand a loss.

The benefit of DDO is that the distributors of the product can more precisely identify as to whether an investor is a wholesale account vs retail using all ASIC's criteria and therefore do not need to solely rely on the minimum $500,000 test.

A potential way forward could be to develop a staged approach to any changes in this area. In particular, if any initial restrictions are placed on retail participation, there should be time to consider their impact before other changes (such as those outlined below that would affect ASX-listing and the resulting liquidity and price discovery that it provides). If further changes were deemed desirable, ABA would be happy to work with regulators on a pathway ahead.

If any decision were to be made to restrict retail investor access, it would not be a fair description to suggest that this would lead to a diversification by expanding the investor base given the existing tax treatment of AT1 notes. While the topic is discussed in further detail in Appendix C, unless the tax treatment is changed there will be limited institutional participation, and offshore issuance will remain prohibitively expensive in part due to the inability to deduct AT1 distributions for tax purposes. Changes to the tax treatment would also encourage greater domestic institutional participation as well.

As such, the main outcome will be to reduce the size of the investor pool for AT1 capital, which will reduce overall market access to capital (and restoring capital) in times of stress.

Any such move would also need to consider the implications of reducing the domestic market demand for AT1 for mid-tier and smaller banks. If the investor pool is reduced, it is possible that the larger (and higher-rated) issuers will exhaust market appetite for AT1 such that there are challenge in the capacity for smaller issuers to find buyers. Again, changing the tax treatment would provide an offshore market for the larger issuers that would free up some of the domestic market demand. It would also increase domestic market demand by making it more attractive to domestic market institutional investors.

Increasing Denomination Size

The discussion paper raises the possibility of increasing the denomination size (minimum parcel size that the AT1 Capital instrument could be broken down to) to $500,000 in order to restrict its availability. ABA believe that such an action would have significant potential consequences and would not be the best way to achieve this.

Importantly, there is a need to consider ASX listing rule requirements around minimum denominations (Rule 2.5 Condition 6). Increasing the denomination size by this magnitude would effectively make ASX listing for the securities impractical, which would reduce systemic liquidity and reduce the ease of the securities being converted if needed (converting securities listed on the ASX is considerably more efficient than if the market were OTC).

Consideration could be given to increasing the minimum denomination size to a more reasonable figure (for example, $1,000) but the impact that would have on mid-tier and smaller banks' capacity to issue the securities able to be listed would need to be considered so they were not disadvantaged.

An alternative option could be to institute a minimum allocation size for primary distribution (of say $15,000 or $25,000), which would reduce the scope for retail participation.

The challenge with pursuing these interventions, including restrictions to retail investors, is that it is likely that it will potentially simply shift demand into managed funds that offer an exposure to AT1 securities but still serves a similar investor base (or alternatively it will shift demand into the riskier ordinary shares).

## Appendix B: Need for Transitional Arrangements

In the event of APRA pursuing any changes to AT1 securities, there would be a strong need for a comprehensive and transparent transition process to provide the clarity and certainty that would be required by the market.

ABA recommend that there would be a transition period of at least 7 years, though the exact time period would depend on the nature of any proposed changes. Such a time would also be required to allow new AT1 documents to be drafted and approved by APRA, including for new markets if required. APRA granted an extended transition period during the Basel II to Basel III changeover, which enabled banks and the broader market to assess new issuance structures, market capacity and pricing.

Similarly, Tier 1 capital feeds into several other prudential requirements. Changes to the usage of AT1 securities and the composition of the capital stack would have flow on impacts to other standards (for example, leverage ratio and limit setting for APS 221, APS 222 among others). Ensuring that there are no unintended consequences from these changes will require a comprehensive assessment.

Existing AT1 instruments and instruments issued prior to finalisation of prudential standards would need to be grandfathered to ensure an orderly transition and maintain the functioning of the AT1 market (including refinancing activities during consultation). To this end, an announcement similar to that made by APRA ahead of the transition from Basel II to Basel III would be helpful, to provide clarity to banks wishing to issue new AT1 instruments in any interim period, and to confirm that the existing instruments would be eligible for grandfathering.[5]

Should there be any restrictions on the participation in AT1 issuance, transitional arrangements will depend upon the issue being addressed, the effect on existing wholesale investor market and the need to develop a likely replacement investor market. Considerations include:

- Minimum allocation sizes at say $25,000 can be implemented relatively quickly. Larger minimum allocation sizes will require development of an institutional market which is dependent upon amendment to tax settings.
- Minimum denominations will need clearing and trading systems to be updated.
- Restrictions on secondary market trading are likely to reduce liquidity and be costly to implement, and unlikely to be effective. We recommend reviewing the outcome of other changes before determining the need for any restrictions in this area.

## Appendix C: Importance of Tax Treatment of AT1 Securities

If decisions are made to either the design or distribution channels of AT1 securities that either substantially reduce their attractiveness to investors or restrict the sale of them to a class of investor, it will be necessary to ensure that there is still a viable market for Australian AT1 securities.

One way of ensuring that would be to remove the barriers that are currently in place to offshore issuance of AT1 securities. Offshore issuance is currently prohibitively expensive in part due to the inability to deduct AT1 distributions for tax purposes.

To address this issue, ABA recommend that any changes be accompanied by the implementation of the recommendation of the 2016 Board of Taxation Report to treat AT1 as debt for tax purposes.[6] This will allow entities to access capital from both domestic and offshore institutional investors without distortions caused by tax considerations. More broadly, it would likely also benefit smaller entities that may not be able to issue overseas by increasing the available pool of domestic institutional investors.

This will require policy coordination with ASIC, the ATO and the Department of Treasury and again highlights the need for a sufficient transitional timeframe to allow these changes to be made.

[5] APRA's letter to ADIs entitled "Interim arrangements for Additional Tier 1 capital instruments" (27 May 2011).
[6] The Board of Taxation, 'Application of Hybrid Mismatch Rules to Regulatory Capital: A Report to the Treasurer'. December 2016.