15 November 2023

General Manager, Policy
Australian Prudential Regulation Authority
GPO Box 9836
Sydney NSW 2001

By email: PolicyDevelopment@apra.gov.au

Dear [redacted],

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

The Australian Financial Markets Association (**AFMA**) welcomes the opportunity to comment on the Australian Prudential Regulation Authority's (**APRA**) discussion paper, *Enhancing bank resilience: Additional Tier 1 Capital in Australia* (**discussion paper**). AFMA also welcomes APRA's early engagement with industry on this important issue.

AFMA is supportive of measures to enhance banks and system resilience. We also acknowledge the benefits of Australia's 'unquestionably strong framework for bank capital'. Notwithstanding these benefits, efforts to further enhance this framework must be carefully considered as they could materially impact markets and market participants. These impacts could include, intended and unintended, changes to risk, pricing, liquidity, volatility and market depth, in addition to changes to the composition and diversity of market participants, all of which potentially impact the functioning of debt instruments both in 'normal times' and in times of stress.

Globally, there is some uncertainty regarding various aspects of Additional Tier 1 capital (**AT1**) instruments. There is, however, no evidence that Australian AT1 capital instruments would not operate as intended in the lead up to, or during, stress events. As such, there is a need to ensure any policy adjustments to this over $40 billion market are based on detailed and accurate evidence and industry engagement. Thorough analysis and industry engagement is particularly required regarding how best to segment AT1 investors, the proportion of outstanding issuance held by these investors and their likely response to stress events, the potential impact of changes to AT1 on other instruments and how lessons learnt from global events could be incorporated into the Australian system.

Given the potentially material and uneven impacts that could result from modifications to AT1 instruments and the capital requirements of banks, AFMA recommends that further policy development only occur after a thorough analysis of the Australian AT1 market and further engagement with industry participants. Without such an analysis, to ensure a deep and accurate understanding of the current state of the AT1 market, it is impossible to accurately determine the impact of potential changes and it is premature

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to consider, for example, 'What are the best policy options for improving the effectiveness of AT1 to support resilience?'.

AFMA and its members are available to assist and contribute to this analysis.

In undertaking such an analysis, AFMA recommends APRA focus on two overarching themes:

1) Maintaining functioning financial markets

   Transparency over any potential and likely changes, as well as how any such changes are likely to be implemented will be a key component to avoiding market disruption. This transparency and engagement must extend beyond regulated entities to all relevant industry participants. APRA's engagement on the discussion paper is a positive step in this regard.

2) Balancing costs, benefits, knock-on effects and new risks in designing a new regime.

   Making changes to AT1 instruments, or banks' capital profiles more generally, may have a material impact on the holders and issuers of AT1 instruments, in addition to the attractiveness, pricing and liquidity of other instruments. These changes, and changes to the composition of investors, may also impact the overall effectiveness of capital and debt markets, including in times of stress.

Further detail on these and other observations are attached for APRA's consideration.

For more information or if you have questions in relation to this letter, please contact me on [redacted] or at [redacted]

Yours sincerely

[redacted]

[redacted]

Head of Banks and Prudential

About AFMA

AFMA is the leading financial markets industry association promoting efficiency, integrity and professionalism in Australia's financial markets, including the capital, credit, derivatives, foreign exchange, energy, carbon, and other specialist markets.

We have more than 120 members, from Australian and international banks, leading brokers, securities companies and state government treasury corporations to fund managers, energy traders and industry service providers. Our role is to provide a forum for industry leadership and to advance the interests of all these market participants.

Appendix A: Overarching industry observations

1. Analysing the Australian AT1 market

Robust policy development should be evidence based and built on rigorous analysis. Given the significance of the Australian AT1 market and its linkages to other markets, further analysis and evidence is required, upon which policy options can then be developed. As highlighted above, AFMA recommends that further policy development only occur after such an analysis has been completed.

<u>Distribution of AT1 holdings</u>

Determining the distribution of holdings of AT1 instruments is critical to policy considerations as it is a factor in both the analysis of the current risks and the potential benefits(, costs and risks) of any policy changes. This understanding is relevant to all three 'potential options' presented in the discussion paper:

- 'Potential option 1', *Design of AT1*: Discussions on AT1 effectiveness often include consideration of the implications of retail holdings;
- 'Potential option 2', *Role of AT1*: Any initiative to "shift reliance to other forms of capital that do not carry the same challenges as AT1" should be based on an informed and accurate view of the current "challenges of AT1", such as the degree of retail holdings; and,
- 'Potential option 3', *Participation in AT1*: The need to, and benefits from, adjusting the proportion of AT1 instruments held by retail investors can only be determined when there is an accurate understanding of current holdings.

APRA's discussion paper positions that 'small investors' hold 53% of outstanding AT1 instruments. This does not align with early industry estimates which put AT1 holdings by retail investors at a significantly lower level, potentially less than 20% (**Figure 1**).[1]

It appears that two key drivers for these different findings are:

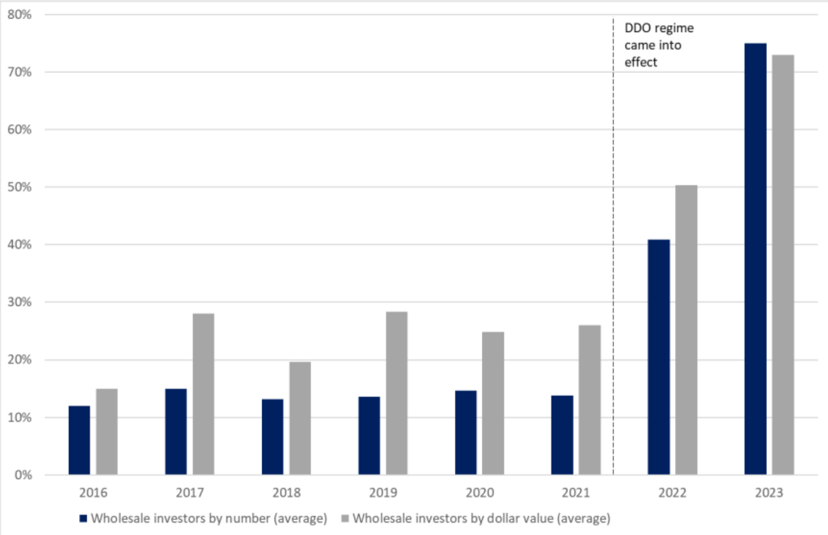
1) As discussed below, it should not be assumed that holders of individual AT1 instruments with parcel sizes less than $500,000 are all retail investors; and

2) The proportion of AT1 holdings by retails investors has fallen considerably following the implementation of Design and Distribution Obligations (**DDOs**); DDOs ensure that investors who purchase AT1 instruments are either wholesale in nature, or have personal advice, that is they understand, for example, that there is the potential for loss. Since the implementation of DDO, some market

[1] Industry is not aware of any significant change in the profile of investors between initial offers and secondary markets.

participants have gone so far as to exit the advice business and instead focus purely on targeting wholesale investors.

Figure 1: Wholesale Investor Holdings of AT1 Capital Instruments



Source: CHESS, AFMA member analysis

Note: Initial industry estimates. Data represents the current average (by number and value) of wholesale investors holding AT1 securities on issue by Australian financial institutions, issued in a given year.

Further, for many investors, their AT1 investments likely represents only a small fraction of their overall/equities portfolio, with many investors holding both equity and AT1 exposures to the same issuer(s). Given this, should an AT1 issuer experience a trigger event, it could be assumed that an investor's broader equity portfolio is likely to be experiencing significant losses, causing them significantly more concern than their AT1 holdings converting into equity.

Industry acknowledges that there are challenges in conducting such market analysis, such as determining how AT1 holders should be segmented. AFMA and its members continue to assess market data and would welcome the opportunity to collaborate with APRA on this undertaking. Insights from such an analysis will also assist industry to provide more accurate feedback to APRA regarding the impacts of any proposed changes.

<u>Broader and deeper analysis of AT1 market is required</u>

AFMA strongly recommends that APRA perform a broader and deeper analysis of Australia's AT1 market to establish a base against which policy suggestions can be assessed. This analysis should consider:

- Options to segment AT1 investors;
- The proportion of holdings of AT1 instruments across investor segments;
- The proportion of AT1 holdings to investors' overall portfolios;
- How Australia's regulatory and legal frameworks differs from foreign jurisdictions;

- The potential availability and depth of offshore investors in Australian AT1 instruments, for larger and smaller issuers;

- Implications of increased foreign holdings of Australian bank and insurer debt, on both larger and smaller issuers; and

- How the above could impact market liquidity and pricing, and investor behaviour in the lead up to and during stress events.

This analysis should build on a growing body of international literature, such as the Financial Stability Board's (**FSB**) recent publication, *2023 Bank Failures: Preliminary lessons learnt for resolution*, and the Basel Committee on Banking Supervision's *Report on the 2023 banking turmoil*.

AFMA and its members are available to assist APRA in this undertaking.

2. Maintaining functioning financial markets

In developing and communicating its policy thinking regarding AT1 instruments, particular care should be given by APRA to avoid market confusion or dislocation, or adverse impacts on the global perception of the Australian financial system. Early, frequent and transparent communication with all relevant stakeholders should minimise these risks and help maintain orderly markets.

APRA's release and engagement on the discussion paper is supported by AFMA as a positive step in enhanced industry engagement. AFMA remains available to assist APRA in its engagement with relevant stakeholders.

Particular points on which clarity will be required to support orderly markets include:

- How and by which means APRA intends to implement any changes, for example by amending the relevant provisions in APS 111 and GPS 112;

- APRA's expectations of both current and new issuances, both during policy development and any grandfathering period; and

- How APRA expects institutions to manage any transition, such as any need to 'call and replace' existing instruments.

Uncertainty regarding these matters could lead to market dislocation, like that seen in late 2022.

3. Balancing costs, benefits, knock-on effects and new risks

When modifying rules and incentives in one market, there are often uneven impacts on market participants and unavoidable knock-on effects to other markets. For example, reducing the domestic market for AT1 instruments may have a disproportional impact on small and mid-sized bank issuers. This is due to these issuers potentially not being able to as easily or cost effectively access offshore markets, due to scale, lack of publicity/reputation and investor relationships offshore, or due to instruments being non-investment grade. This uneven increase in funding costs across ADIs could be amplified if investors also substitute away from current debt holdings of small and mid-sized banks to AT1 instruments of larger banks. Additionally, any increase in the volume of Tier 2 to be issued may also impact the cost and execution of Tier 2 transactions as banks continue to build towards APRA's loss-absorbing capacity implementation in January 2024 and 2026.

For individual non-wholesale investors, implementing restrictions or disincentives to invest in AT1 instruments may encourage these investors to increase their equity holdings. The result of which would be increased risk to investors and, should a trigger event occur, it would likely put investors in a far worse outcome in resolution. It would do so without reducing systematic risk.

Impacts such as these should be thoroughly considered during the policy development process. AFMA recommends that APRA's cost-benefit analysis of potential changes consider these broader impacts, including to other debt markets and the broader costs to the economy, and how any changes may hinder the broader policy goals of further increasing banks capital levels and supporting the ability of small and mid-sized banks to effectively compete in the Australian market.

Further, AFMA recommends that the proposition that the presence of retail holdings increases contagion and litigation risks should be thoroughly tested in an Australian context. In this regard AFMA notes:

- Australian AT1 instruments generally provide for conversion rather than pure write-off;
- Legislation passed in 2018 provided statutory backing to the conversion and write-off provisions in regulatory capital instruments, despite any other laws[2], in a manner indifferent to whether the holders are small or large; and
- The risks of litigation may increase when the investors have ample resources to pursue litigation.

3.1 Implications of increased foreign holding of Australian bank and insurer debt

Increased foreign investor holdings of Australian bank debt may provide additional challenges, particularly in stress events and, as noted above, not all issuers will be able to (efficiently) access international markets. These additional challenges potentially include:

- Increased market volatility, with foreign investors more likely to quickly make substantial changes to their positions;

[2] With the exception of laws regarding maximum shareholdings in regulated entities, which would not impact smaller investors.

- Decreased market transparency and liquidity, if the proportion of exchange listed securities reduces;[3]
- Increased complexity when needing to consider the impact of foreign legal and regulatory regimes;
- Increased funding costs, particularly if adjustments to tax rules are not implemented; and
- Increased influence of foreign investors on Australian banks.

These challenges should be thoroughly considered in the policy development process.

3.2 Incentives, including tax, will greatly influence potential market participants

Domestic demand from wholesale investors may be insufficient to cover all AT1 issuance. As such, any reduction in domestic non-institutional holdings may necessitate an increase in foreign investor participation. However, current tax rules inhibit increased foreign investor participation.

Under the current tax rules, AT1 securities are treated as tax equity, with distributions frankable. The issuer is obliged to frank at the same rate as is applied to distributions on its ordinary shares. The availability of franking credits makes these instruments attractive to domestic investors, who derive value from the franking. This 'franked value' is not available to foreign investors.

Reflecting this offshore issuance is currently prohibitively expensive in part due to the inability to deduct AT1 distributions for tax purposes. Any offshore issuance would need to be 'netted up' by the value of the 'missing' franking plus additional margin for 'foreign premium' and, in some cases, small issuer inefficiencies. From a purely indicative price perspective excluding associated costs, offshore issuance would be at least ~1.3-1.8x higher for a major bank, assuming the major bank AT1 issuance remains investment grade. For smaller banks, the cost could be considerably higher, being non-investment grade.

If it is APRA's intent that foreign investors increase holding of Australian AT1 securities, AFMA recommends that APRA extend its interagency engagement beyond the Council of Financial Regulators, to include the Treasury and Australian Tax Office.

3.3 Practical challenges with increasing parcel size

There are various options to limit retail investor holdings of AT1 instruments. In considering these options, it is important that investor choice and their ability to diversity risks are not unduly inhibited. For example, AFMA members are aware of sophisticated

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[3] Benefits, such as transparency, from securities being traded on an exchange flow to issuers, investors and regulators.

investors who seek to diversify their AT1 exposure through multiple positions, with different issuers, with individual exposures below $500,000. For these investors, limiting parcel sizes to, for example, $500,000 would inhibit their ability to diversify. By extension, implementing such a minimum parcel size would likely reduce the pool of well-informed, sophisticated investors in AT1 instruments. It is worth nothing that the average bid size on 2023 major bank AT1 issuance has been less than $500,000 despite being sold to predominately wholesale investors.

Limiting parcel size could also shift demand into managed funds and ETFs. This could result in the same investors acquiring the same risks, though needing to pay an intermediary to gain that exposure. The result being no material change in individual or system risk but an increase in costs to investors.

In addition, enforcing a minimum parcel size by increasing minimum denominations may result in the inability of issuers to list AT1 instruments on the ASX. This is a result of the ASX setting a floor of at least 100,000 securities for equity securities, such as AT1[4]. Requiring a minimum denomination of $1,000 or $10,000 would result in a minimum $100 million or $1 billion issue size respectively. A minimum denomination of $500,000 would result in a minimum issue size of $50 billion which would effectively prevent the secondary listing of any AT1 instruments based on current ASX listing rules.

In addition to the above observations, feedback from AFMA members is that the decision to invest in AT1 instrument is more likely to be influenced by their taxation treatment rather than their denomination.

[4] ASX listing rule 2.5 condition 6