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General Manager, Policy
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Re: Discussion paper – Enhancing bank resilience: Additional Tier 1 Capital in Australia

Thank you for the opportunity to provide a response to the above discussion paper.

BA Asset Management is a firm specialising in research, custody, and asset management for wholesale clients with a predominant exposure to Australian prudential capital instruments. Our asset managers have extensive competence in assessing, structuring, and educating investors on the intricate aspects of hybrid Tier 1 and Tier 2 instruments and have been familiar with these markets since the effective commencement of listed capital issues in the late 1990's. Consequently, the following comments are brought in response to the discussion paper in the light of considerable experience.

It is appropriate that APRA should continually examine the applicability of the prudential capital regulations and by doing do, check all aspects of resiliency within bank and insurance companies in Australia.

We agree that all levels of the capital stack within banks and insurance companies should work as they are meant to in times of stress while acknowledging that the work done by APRA since 1998 to strengthen these entities has delivered industries that are comparatively conservatively managed with low-risk banking practices, highly regarded and highly rated by global credit rating agencies, and banks & insurance companies that hold to the application of appropriately stringent capital, liquidity and funding rules.

APRA notes that events in overseas jurisdictions during 2023 created a need to reassess the design of AT1 instruments to ensure they are fit for purpose. It is important to note in terms of context that the events referred to were predominantly the failure of a number of US banks as well as the high profile forced takeover of Credit Suisse by UBS under the direction of the Swiss authority, FINMA and each failure was due to specific management processes (or lack thereof) or comparatively lax prudential oversight.

As a general observation, we note that the style of regulation between jurisdictions across the world differs despite central direction on capitalisation from the Basel Committee. This difference in regulatory style is appropriate given the starkly different nature of banks in these jurisdictions – particularly when compared to banks in Australia and New Zealand. Credit Suisse conducted numerous broad investment-bank style businesses that created a materially higher risk from the regulatory perspective than if the bank had operated a predominantly loan and deposit banking business that is more prevalent here in Australia (Macquarie bank aside) and New Zealand.

Aside from Macquarie Bank, the banks in Australia are not investment banks and each balance sheet contains significantly lower risk than internationally operating conglomerates such as UBS, JPMorgan, and HSBC just to name a few from differing global jurisdictions. The US experiences numerous bank failures each year (usually not subject to public scrutiny here in Australia) with each either due to a failure of mismanagement, poor decisioning or small size. The US prudential regulators (and there are more than one body in the US which is a problem in itself) do not apply the same level of scrutiny and regulation as does APRA to Australia's banks. Australian prudential regulation is considerably more conservative and centralised versus the US, even when considering mutual financial entities in this country. We would stress to APRA that acknowledgment of this fact is important if comparing the events of 2023 to any potential

event that may influence the fate of Australian banks, regulated non-banks and insurers. Additionally, the fact that the major banks in Australia have managed to achieve the 'unquestionably strong' capability required by APRA is an important aspect when comparing Australia's banks to those offshore.

In its comments on 'early-stage intervention' APRA notes that capital triggers are currently set at a relatively low level. It is further noted that capital levels within Australian banks have lifted materially since the onset of Basel III in 2013 such that the volume of CET1 capital held by banks would on average have to fall by well over half the current level before the current trigger of 5.125% was hit.

We agree that there is a case for lifting the CET1 capital trigger to address this issue. We would suggest that lifting the trigger from 5.125% to 7% would be sufficient to deliver an outcome likely to ensure AT1 is utilised significantly earlier in the case of excess stress in the Australian banking industry.

Within Box 4 of the Discussion paper, APRA states that "the challenges of using AT1 to support resolution are likely to be more acute in Australia, given the investor base" with retail investors holding around half of the instruments on issue. We observe that it is erroneous to consider an investor trading or holding less than $500,000 as automatically a retail investor. Many wholesale investors trade securities in volumes lower than $500,000. Indeed, the average self-managed super fund currently holds a little over $1 million in balance. Under APRA's assumption here, SMSF's run by wholesale-qualified investors would hold only two securities in their portfolios. This is not a realistic scenario.

Our estimate of true retail involvement in listed AT1 markets, based on significant experience distributing these instruments since the late 1990's is much lower than that quoted by APRA under the above assumption. Further, we would assert that knowledge of an instrument and confidence in the banking industry more broadly is not determined by the size of a trade or investment, particularly when considering the need for diversity in any portfolio. We acknowledge that APRA notes that the Government is currently reviewing the definition of 'wholesale investor' but the above commentary would still apply under any amended regulation.

APRA mentions that the UK and some other jurisdictions have banned the distribution of contingent convertible and other AT1 instruments to retail investors. We argue that APRA should not see the same imperative owing to both the nature of the banking industry in Australia (as discussed above) including significantly better rated banks and the simpler structure of AT1 in the Australian market – unlike coco's, Australian AT1 is broadly convertible into equity and not write-off only. We note that the Credit Suisse note that was bailed in earlier in 2023, was a write-off only structure. Australian bank Capital Note issues in the Australian market are convertible into equity under both the capital trigger and non-viability triggers in the terms of the instruments. Consequently, their ranking is not compromised relative to equity.

Concerns with retail ownership of AT1 instruments becomes a redundant issue when it is understood that retail investors are much more significant owners of bank and insurance company equity. If the order of absorption works appropriately, these retail investors would experience a greater material penalty on any initial loss absorption of CET1. This fact cannot be simply waved away by a cursory opinion that investors understand their position in equity. The public expectation of loss from buying Australian bank shares is not perceived at all, and yet this would happen in advance of any loss of AT1 value.

APRA states that Australian banks have a greater reliance on AT1 relative to international peers and suggests that this may be driven by pricing levels and strong demand. Pricing and demand levels are generally related to each other and markets will tend to adjust based on both inputs. It would be more important to note here that the $ value difference between 14% AT1 (Australian major bank + Macquarie AT1 as a proportion of Total Tier 1) and 12% AT1 (other jurisdictions) would be A$3 billion, or A$600 million per bank. This is a decidedly non-material issue when considering the total asset base within these 5 Australian banks of currently A$4.1 trillion. Even total equity for the 4 majors and Macquarie bank stands in excess of A$300 billion.

In summary, it is appropriate that APRA continually observe and ensure that the application of capitalisation rules are resulting in resilient and workable banking and insurance industries. With this Discussion Paper focused on AT1, we see merit in lifting the capital trigger from its current level of 5.125% to a higher level and propose 7% as appropriate, noting that this would likely place it higher than the theoretical point of non-viability (PONV) (whereas the 5.125% level would likely be below PONV).

We would question APRA's concerns with non-wholesale investor participation in AT1 issues particularly when comparing to offshore jurisdictional investors on the basis of materially different business compositions versus Australian bank counterparts. The lack of a broad investment banking business model within the bulk of Australian

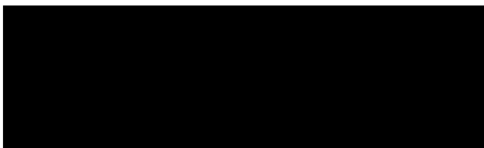
banks is an important factor when considering the risks inherent in Australia's banks and the likelihood of a need to include AT1 in absorbing losses. Concerns with the effectiveness of AT1 being absorbable are materially overplayed if the regulator chooses to ignore the fact that retail investors are overwhelmingly large holders of CET1 capital in the form of bank shares which must be utilised first to absorb risk of loss in Australian banks.

If APRA is ultimately considering a scenario where listed AT1 is not allowed such that this prevents retail participation, then the outcome of significantly higher costs for AT1 capital together with much lower volume capacity for this important Tier 1 alternative need also to be considered. If banks are left with the only practical solution to raising tier 1 capital in a crisis being CET1, then bank equity, which is the vital lifeblood for bank capitalisation may be over-utilised and, if bank shares begin underperforming more often as a result, they may not be available when really needed for capital issuance.

Additionally. any consideration of adjusting the proportion of AT1 in the total capitalisation stack needs to consider the comparative value of these adjustments versus the asset and total equity value of the Australian banks.

We trust that these comments provide assistance to APRA in its considerations on the effectiveness of AT1.

Yours Faithfully



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Lead Portfolio Manager
BA Financial Capital Income Fund
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