farrelly's

Enhancing bank resilience: Additional Tier 1 Capital in Australia

Summary

This submission begins by directly answering the questions posed in the discussion paper before going into some observations arising from our research into the cited failures of overseas banks and concludes with comments about the likely impacts of the policy options canvassed in the discussion paper.

Answers to APRA Questions

1. What are the best policy options for improving the effectiveness of AT1 to support resilience?
    - A. Redefine the calculation for CET1 to be '*the lower of the statutory calculation of CET1 and the directors' best assessment of economic CET1, taking into account factors that are not captured by the statutory definition.*'
    - B. Ensure APRA has all the powers it needs to insist banks take timely action in matters regarding capital adequacy.
    - C. Ensure that only advised investors are able to invest in AT1 securities directly and remind all licensed advisers of their need to fully disclose the risks of these types of securities to their clients.
    - D. Allow unadvised investors to invest via diversified vehicles (such as Super Funds, Managed Funds or Accounts)

2. What would be the impact of these options?

    - A. **Redefine CET1** : This recommendation would help mitigate against the sudden decline of capital such as occurred with Silicon Valley Bank. In that case the statutory definition of CET1 allowed for a much higher reported number than would have been the case for an economic CET1 which would have included a mark to market valuation of Treasury Securities. On this basis, it is likely that SVB would have raised capital some 12 months prior to their ultimate failure.
    This measure should also increase all participants confidence that all banks are truly solvent. In that environment, even in a crisis, a Government guarantee of deposits should come at zero cost or, at worst, very low cost to taxpayers.
    - B. **Ensure proactive regulatory action**: One of the issues in both the case of Silicon Valley Bank and Credit Suisse was the regulators reluctance or lack of power to ensure these banks had adequate capital. The US Federal Reserve identified that one of the four key drivers of the failure of SVB was that: "*When supervisors did identify vulnerabilities, they did not take sufficient steps to ensure that Silicon Valley Bank fixed those problems quickly enough.*[1]"
    - C. **Only advised investors**: In the event of a need to convert AT1 Securities to equity, APRA need have no hesitation whatsoever because advised investors

should have been advised of the risks inherent in these securities. Further, in the event that the risks inherent in AT1 securities had not been adequately explained, investors will be able to seek compensation from their adviser.

D. **No restriction on broad professionally managed portfolios**: Where these securities form part of a professionally managed portfolio such as a super fund, retail investors should still be able to enjoy the higher returns that are likely accrue to these securities. See Appendix 1(i) for more detail.

3. What transition arrangements could soften these impacts?
    A. **Redefine CET1** : A 12 month phase-in period for banks to consider how this would work in practice. SVB and Credit Suisse could be useful case studies.
    B. **Ensure proactive regulatory action** : None required - assuming the Banking Act already contains sufficient powers.
    C. **Only advised investors** : None.
    D. **No restriction on broad portfolios** : None.

4. Are there other considerations or options that APRA should take into account?

    In Appendix 1 we consider the following policy options
    i. Prohibit retail investors from investing in these securities
    ii. Increasing the bail in level
    iii. Reducing the reliance of Australian Banks on AT1 securities

In the Appendix we describe how, in Farrelly's view, all of these measures are sub-optimal from the perspective of improving bank resilience and from the perspective of achieving good outcomes for Australian investors and borrowers.

About Farrelly Research and Management Pty Ltd

Farrelly's is an asset consulting business established in 2003 to provide advice to Financial Planning businesses on asset allocation, risk management and the macro-economic environment. Farrelly's clients provide advice on over $15 billion in retail investors funds.

A particular focus of Farrelly's work has been the Australian banking system given its critical importance to Australian investors

- from a financial stability viewpoint
- from the perspective of the interaction between home lending, interest rates and residential property prices.
- from the perspective of Australian investors investments in bank equities, Term Deposits and, of particular relevance to this discussion, bank AT1 securities.

Tim Farrelly is the principal of the business. Prior to founding Farrelly's he was an Executive Director of the Investment Management Group of Macquarie Bank. His qualifications include MBA(Distinction) from the Harvard Business School and a BE (Hons) from Melbourne University.

Increasing resilience of the banking system – some observations

The stated main aims of AT1 securities are to provide an early source of support in time of stress and then as a loss absorber at the Point of Non-Viability. Recent events have cast doubt on whether AT1s will satisfactorily do either because they are not converted quickly enough or because retail investors may ultimately be bailed out reducing their absorbance of losses.

A quick review of the three cases cited, Silicon Valley Bank (SVB) Credit Suisse (CS) and the Italian Bank bailouts in 2017 can provide some useful observations.

Silicon Valley Bank and Credit Suisse

Both SVB and CS reported sound CET1 ratios as late as December 2022; 15.3% for SBV[2] and 14.0% in the case of CS[3]. As described in the APRA discussion paper, the failure of both entities was very swift so that there was no opportunity for any early bail in of AT1 securities and, as a result, they did not provide any early source of support. While this is factually correct, the reality is that, in both cases, there was no higher bail-in trigger that would have made any difference whatsoever. For sudden failures such as these, the level of the CET1 bail-in trigger is simply not a useful policy instrument.

Which is not to say that useful policy instruments do not exist. In the case of SVB a more useful policy instrument would be to consider the way that CET1 was calculated. In that case, US Treasury securities were valued at face value even though their market value was much lower than face value. On a liquidation basis, SVB was insolvent and had been in trouble for more than a year – a fact about which the Fed was well aware[1]. While the failure seemed to come quickly, this was, in fact, a slow-moving trainwreck that could and should have been addressed much earlier – which the Fed acknowledges.

One possible policy response would be to ensure that Government securities are marked to market for CET1 purposes. However, that would be a narrow response that solves just one problem in a potentially much broader set.

In the case of Credit Suisse, the anecdotal cause for depositors' loss of faith in the institution was the possibility that ever-increasing regulatory fines would consume the capital base. Was the directors best estimate of regulatory losses in the calculation of CET1? Or was it a best case estimate of future losses? Or simply one they thought they could get away with? Farrelly's has no insight into the answers to these questions but observes that the more directors are encouraged to provide a true estimate of a bank's financial strength, the more confidence all participants will have in the banking system.

Hence the Recommendation (A) that banks report the lower of statutory CET1 and economic CET1. This certainly would have made a difference in the SVB case and may have helped in the case of CS.

How that is enforced is a matter for APRA and Government. However, to state the obvious, the more meaningful the penalties suffered by directors and management the more likely it is that the stated CET1 will reflect the true position of a bank's capital.

The bail out of Popolare di Vicenza and Veneto Banca in 2017

When these two Italian banks failed in 2017, smaller investors in AT1 securities were bailed out. The circumstances are not completely clear but it would appear that there were a number of factors that contributed to that decision; the investors had been mis-sold these securities by unscrupulous sales people[4], these securities made up a substantial portion of the investors' portfolios, and the investors mainly came from a small geographical area that was suffering a deep economic downturn.

It is not clear which were the most important criteria in the bail-out but all seem to play a part.

The key observation from this event is that if the investors had been well advised, (that is informed of the risks and not over-concentrated in one or two banks' securities) no bailout would have been necessary. Further, as it is doubtful that the investors had the ability to be re-imbursed by their advisers, there was a concern that the small investors could seek redress from the government via the courts.

The position in Australia is very different. Where licensed, independent advice is involved, investors should be aware of the risks, appropriately diversified and, in the event they are not properly advised, investors have the ability to retrieve any losses via legal action. This is the essential logic behind Recommendation C.

The importance of strong proactive regulators

While should not need to be stated, it is very clear from the Feds report into the SVB failure what an important part it played in that event.

In the Feds report on the failure of SVB, it acknowledges, repeatedly, that it was aware of problems but failed to act in a timely manner[1].

"The (Federal Reserve) Board's tailoring approach …impeded effective supervision by reducing standards, increasing complexity, and promoting a less assertive supervisory approach."

"Over the same period, supervisory policy placed a greater emphasis on reducing burden on firms, increasing the burden of proof on supervisors, and ensuring that supervisory actions provided firms with appropriate due process. Although the stated intention of these policy changes was to improve the effectiveness of supervision, in some cases, the changes also led to slower action by supervisory staff and a reluctance to escalate issues."

"SVB's foundational problems were widespread and well-known, yet core issues were not resolved"

Similarly, following the demise of Credit Suisse, many, including the Swiss Financial Regulator, FINMA, highlighted the need for regulators to have the power to enforce their rules. Reuters reported on 5 April 2023…*"FINMA's Amstad called for more power to penalise and name and shame banks that break the rules. Her agency is largely powerless to call banks to account, as Switzerland pursues a hands-off approach to industry, giving it free rein"*.

“The agency also wants bankers to be held to account in a special regime that singles them out as responsible. "Imposing fines would be a step forward. But, as we have seen, Credit Suisse paid billions in fines and that didn't change its catastrophic business strategy," said Dominik Gross of the Swiss Alliance of Development Organisations. "There must be the power to pursue top managers of banks for criminal negligence."

Whether it is a matter of culture or powers (or both), bank regulators must be willing and able to enforce capital requirements in a responsible and timely manner. This is the underlying logic behind Recommendation B.

Appendix 1 on the following page describes why Farrelly’s believes the measures proposed in the discussion paper are sub-optimal.

Farrelly Research & Management Pty Ltd
November 2023

References

1. Review of the Federal Reserve’s Supervision and Regulation of Silicon Valley Bank: April 2023
2. SVB Basel III Standardised Approach Disclosure December 31, 2022
3. Fitch Ratings : Credit Suisse Losses Highlight Challenges to Restructuring. Feb 2023
4. “O Tell Me The Truth About Bail-In: Theory and Practice”; European Corporate Governance Institute March 2019

Appendix 1: Impacts and Transition requirements for alternative policy options

i. Prohibit retail investors from investing in these securities.
Impacts

- The first, and major impact will be to deny many small Australian investors access to what has been an important source of returns over the past decade. The Table shows how well these securities have performed. Cumulative rather than annualized, returns are shown to clearly demonstrate the major difference these assets have made to smaller investors' portfolios.

Value of $100,000 invested	5 years ago	10 years ago
Cash	105,350	116,382
Term Deposits	106,431	122,810
Vanguard Australian Fixed Interest fund	101,744	125,129
Dimensional Global Bond Trust	99,153	127,101
Janus Henderson Tactical Income Fund	109,570	130,609
Major bank Hybrids[1]	**126,582**	**166,518**
Bentham High Yield Fund	111,332	154,917

As at 30 June 2023

1. Solactive Australian Banking Preferred Shares Index

We show a range of commonly used investments, both active and passive. All have different levels of risk but nonetheless, other than the Bentham High Yield Fund, are all considered Investment Grade or better.

Clearly, the outcomes from investing in the AT1 securities has been outstanding compared to other investment grade options – and has even matched non-investment grade credit. We also note that small investors are free to invest in non-investment grade credit which the rating agencies assess as more risky than major bank AT1 securities.

- To the extent that small investors are excluded from investing in these securities and banks raise capital elsewhere, we can assume that it would be at a higher cost. That cost would be passed on as higher interest rates for domestic borrowers. Clearly an undesirable side effect.

- Unless exempted, Managed Accounts programs may be forced sellers. These programs now manage over $160 billion for small and medium Australian investors and many make meaningful investments in bank AT1 securities. One feature of these portfolios is that, in any one program, all portfolios must be alike. This means that if AT1 securities can no longer be bought in these accounts for new investors then, in many cases, all existing holdings must be sold. (If not, then any new investors will have a different portfolio to others in the program.)

- If direct retail investment in AT1 securities is banned, APRA will need to consider how to treat managed funds which predominantly invest in these types of securities such as the widely held Betashares Active Australian Hybrids Fund. In the UK the treatment of these type of funds is inconsistent. New retail funds are discouraged while existing funds appeared to have been grandfathered.

    - If investment via funds is allowed it potentially solves the problem of investors being over exposed in any one security and the potential for misunderstanding the risks of the nuances of any individual security. It also widens the responsibility of risk disclosure to both fund manager and adviser if advice is involved.
    - If funds are banned will small investors be allowed to remain in such funds or will they be forced sellers?
    - Note that the Managed Accounts who invest in such Funds may be forced sellers – even if grandfathered.

Possible transition arrangements

- Managed Accounts, being professionally managed portfolios, should be allowed to invest in these securities for the accounts of small investors as per the recommendations C and D.
- Existing small holders of direct securities should be allowed to hold until maturity. However, this is a very slow process. Of the major bank AT1 securities, approximately 65% will still be on issue in three years time; 40% will remain on issue in five years time. Banning retail investors is a very slow way to fix this potential problem. The Proposals A-D outlined provide a much faster solution.

ii. Increasing the bail in level

Impact.

- This is unlikely to be effective in many cases and, in particular, would not have been effective in the cases of SVB or Credit Suisse.
- In the event that an increase in the bail in trigger did result in an earlier conversion, it would most likely make matters worse. As we saw in the case of SVB, in a scare, large uninsured depositors would be likely to withdraw deposits and do so regardless of whether they held AT1 securities. In a bank run, the only rational course of action is to withdraw uninsured deposits as that action has substantial upside and no downside risk. A higher bail in trigger simply increases the chance of a run on the bank in question.
- Small retail investors may also join in the run as any such bail in would no doubt feature heavily on the nightly news – regardless of whether or not they owned AT1 securities.

iii. Reducing the reliance of Australian Banks on AT1 securities

Impact

- Higher borrowing costs for domestic borrowers as per above.