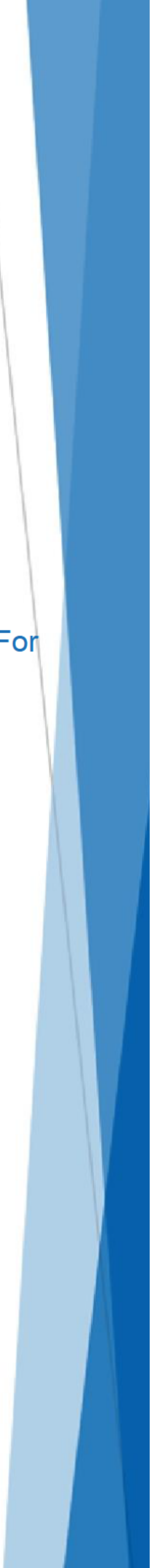
Australian Banking Association

APRA Discussion Paper – A More Effective Capital Framework For A Crisis

8 November 2024



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Key Recommendations

- The ABA notes APRA's concerns that existing AT1 instruments in Australia have design features and market characteristics which could create challenges for their effective use in a crisis. We agree that design features such as discretionary coupons and the 5.125 per cent CET1 trigger point may not be as effective as APRA requires in helping to stabilise a bank ahead of the declaration of the point of non-viability (PONV).
- We accept APRA's proposal and intention to increase CET1 for Advanced banks by 0.25 per cent and increase Tier 2 by 1.25 per cent in order to continue to meet the Basel III minimum total Tier 1 requirement. At the same time, the proposal to allow Standardised banks to replace the entirety with Tier 2 capital is an appropriate application of proportionality.
- The ABA believes that one way of promoting stability in global funding markets would be to maintain a tranche of subordination within "gone concern" capital, which could address the financial stability and contagion issues outlined with the current proposal, whilst still achieving APRA's key objective of simplicity.
- Given the significant amounts of Tier 2 capital proposed to be held, we outline further recommendations that focus on improving the efficiency of the capital framework. This includes recommendations relating to the usability and flexibility of CET1 buffers, as well as allowing Tier 2 capital instruments to have capital eligibility for up until 12 months prior to maturity.
- The ABA considers the transition timeframe to phase out AT1 instruments by 2032 is appropriate to enable the orderly transition for issuers and AT1 investors. However, there are some key technical aspects of the implementation that will need to be managed carefully, including ensuring that the outstanding AT1 securities effectively convert before Tier 2 securities at PONV.

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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 potential impacts of the proposed replacement of AT1 capital with higher amounts of CET1 and Tier 2 capital under APRA's prudential framework in Australia.

The decision to remove the AT1 layer in the capital stack is a significant one that will have substantial flow-on effects on how investors assess the risk of the Tier 2 asset class, international comparability, bank ratings, and financial stability, particularly in times of stress. In addition, the removal of AT1 will require a substantial reworking of the current capital adequacy framework. This includes amendments to a number of prudential standards and APRA requirements. As such, it is important that any proposed changes are carefully calibrated to ensure the desired outcomes are achieved in the most effective way.

The ABA notes APRA's concern that existing AT1 instruments in Australia have design features and market characteristics which could create challenges for their effective use in a crisis. We agree that design features such as discretionary coupons and the 5.125 per cent CET1 trigger point may not be as effective as APRA requires in helping to stabilise a bank ahead of the declaration of the point of non-viability (PONV).

Notwithstanding those limitations noted above, AT1 provides a substantive layer of protection to Tier 2 investors through the subordinated ranking it provides in a winding-up and through conversion providing an ability to absorb loss ahead of Tier 2 holders.

Insulation of Tier 2 investors from losses could be important to help mitigate the contagion risk that could arise in certain stress events and the potential weakening of financial system stability (as described in more detail below). Subordination also helps to support various bank credit ratings of Tier 2 instruments. Strong credit ratings are critical for banks to continue to attract funding and liquidity, particularly during times of stress and the ability to attract wholesale funds at competitive cost will ultimately benefit Australian consumers. Preserving some of the features of this subordination, albeit within the class of "gone concern" capital, could be helpful once AT1 are removed.

We accept APRA's proposal and intention to increase CET1 for Advanced banks by 0.25 per cent and increase Tier 2 by 1.25 per cent in order to continue to meet the Basel III minimum total Tier 1 requirement. At the same time, the proposal to allow Standardised banks to replace the entirety with Tier 2 capital is an appropriate application of proportionality.

The ABA would like to be as helpful as possible in the development and further consideration of APRA's proposal. The following sections will outline the ABA's further thoughts on the design, impact and implementation of APRA's proposed changes.

Design

The ABA acknowledges that APRA's approach of removing AT1 capital from the capital stack and replacing it with CET1 and Tier 2 is simple, is likely to work in a business-as-usual scenario and is clear in a bank resolution where all Tier 2 capital instruments would be required to be bailed in. The proposed approach does leave some risks to be managed in that a bank may move from business-as-usual to the point of non-viability more quickly, where a stress event would require some but not all bail-in of Tier 2 capital.

Loss of AT1 layer of subordination

The subordination of AT1 capital provides an important layer of protection to Tier 2 debt holders. It allows for the quarantining of losses in a stress scenario to a discrete class of AT1 investors who understand and are better placed to manage the risk of investing in the more deeply subordinated part of the capital structure, without the need to bail in Tier 2 investors. The removal of the AT1 layer will change the risk profile of Australian Tier 2 instruments as Tier 2 holders will now face a greater risk of

incurring losses (i.e. next in line after CET1 holders to absorb losses), noting Tier 2 investors would not be accustomed to being at the top of the loss hierarchy.

This impact may be more acute in times of stress where it could become harder to raise Tier 2 capital, forcing ADIs to rely on larger equity raisings at increasing discounts when the call on equity markets is already high.

Contagion risk

Australia is unique in that Loss Absorbing Capacity (LAC) for those subject to the requirements is being met with Tier 2 capital, whereas LAC in most offshore jurisdictions is in the form of Holdco debt or senior non-preferred instruments. Therefore, investors in LAC instruments are accustomed to having substantial volumes of more deeply subordinated tranches of AT1 and Tier 2 capital sitting between CET1 and LAC to absorb the first losses in a stress.

Most significant bank resolutions in Europe since 2016 (including Credit Suisse), have quarantined losses to CET1, AT1 and Tier 2 holders, without needing to bail-in senior or senior non-preferred investors. This approach allowed the resolution of the failing bank to occur without creating further contagion impacts in that jurisdiction.

In contrast, APRA's proposal to remove the tranche between CET1 and Tier 2 capital could introduce contagion risk within the expanded tranche of Tier 2 capital.

International equivalence and comparability

The ABA acknowledges the proposed minimum CET1 capital requirement of 6 per cent maintains international equivalence and meets the Basel minimum standards for internationally active banks.

As noted in the discussion paper, the removal of AT1 reduces international comparability of the capital framework for Australian banks. External stakeholders such as international regulators and ratings agencies have expressed that they continue to find value in the AT1 product. As such, Australia is likely to be unique in its approach to its removal, and Australian banks will be an outlier when compared to international peers. This may impact the market perception of investors regarding Australian banks and could impact capacity from international investors as further outlined in the next section.

Potential alternative way of providing subordination

The ABA believes that one way of promoting stability in global funding markets would be to maintain a tranche of subordination within the “gone concern” class of capital, which could address the financial stability and contagion issues outlined with the current proposal, whilst still achieving APRA’s key objective of simplicity.

While we note that the ability to issue Tier 2 instruments with different priority of conversion at the PONV already exists within the current prudential standards for Tier 2, we consider it to be a clearer approach to align the loss hierarchy on conversion with losses in a liquidation.[1] We therefore recommend amending APS 111 to allow for Tier 2 instruments with a more deeply subordinated claim in liquidation.

While the ABA is open to discussion on specific details, the ABA recommends that APRA allow a more subordinated tranche of Tier 2 capital while also maintaining flexibility in their prudential standards to accommodate other enhancements to the features of Tier 2 instruments to accommodate for evolving rating methodologies.

[1] APS 111, Attachment G, Paragraph 31 currently permits an order of conversion of instruments within the category of Tier 2 capital that would help to maintain the loss hierarchy for a more deeply subordinated tranche of Tier 2 capital.

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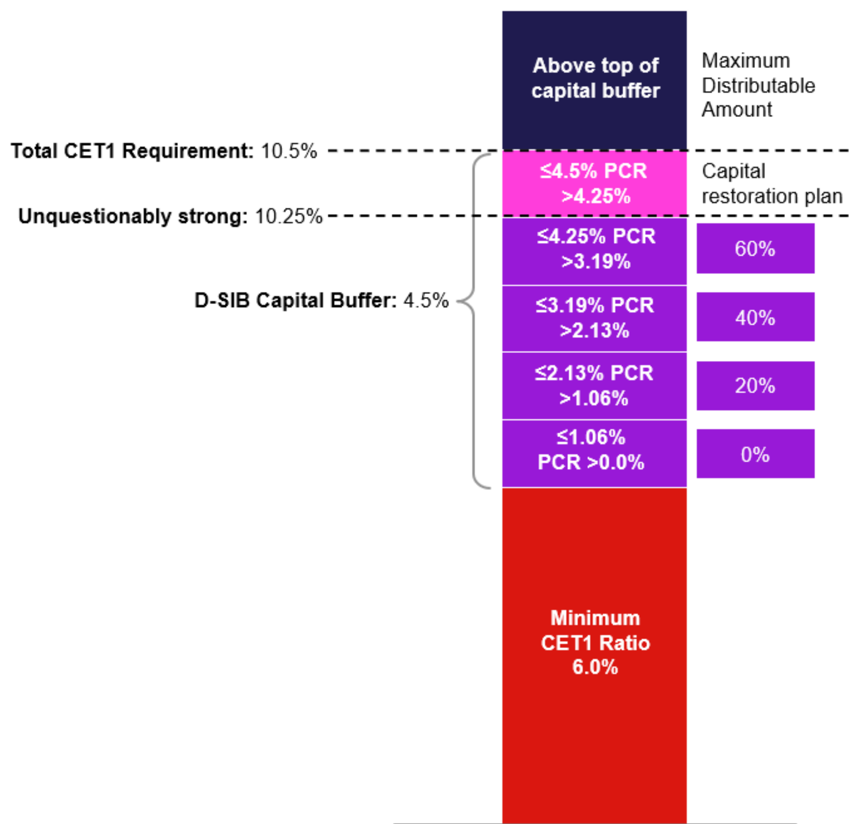
Other proposed enhancements

Increasing the usability and flexibility of CET1 buffers

Under the current framework, for certain banks constraints on capital distributions start applying at the point where the CET1 ratio falls below 10.25 per cent CET1 capital (the CET1 Prudential Capital Requirement (PCR) + capital buffers, or "CET1 Minimum").[2] With the proposal's addition of 0.25 per cent of CET1 capital and recalibration of the buffers, banks will be constrained on their distributions at an earlier point (i.e. 10.5 per cent CET1 capital) and have less flexibility and time to respond when operating within the capital buffers.

To provide greater flexibility and useability of the buffers, we propose amending the existing buffer quartiles to become five quintiles. The first quintile will be 0.25 per cent wide from the CET1 Minimum (i.e. 10.50 per cent-10.25 per cent under APRA's proposal), and the remaining four quintiles will be spilt equally as per the existing framework.

Should a bank be operating in the first 0.25 per cent quintile, banks would be required to submit a capital restoration plan to APRA. If the bank's CET1 capital ratio falls below this level, then automatic restrictions would apply in line with the existing framework (see below).



The benefits of such an approach are as follows:

- Major banks meet the Basel minimum requirement for Tier 1 capital.
- Reaffirms to the market that a CET1 ratio of 10.25 per cent remains unquestionably strong.
- Provides APRA with the confidence that a bank operating within this initial buffer has a credible plan to restore their CET1 ratio.
- Provides flexibility and minimises the penalty applied to banks for temporary dips below the CET1 Minimum but above the unquestionably strong level of 10.25 per cent CET1.

[2] Capital buffers includes the Capital Conservation Buffer and any applicable Countercyclical Buffer.

Tier 2 amortisation

Compared to international peers, Australian major banks are exposed to a greater degree to Tier 2 market accessibility due to the reliance on Tier 2 capital to meet LAC requirements. It should be noted that any material market dislocation during the implementation period may adversely impact the ability of Australian banks to meet the higher capital requirements. In addition, the expanded Tier 2 stack going forward would be exposed to a greater degree of refinancing risk.

For LAC purposes, international peers can recognise LAC eligible instruments, including Tier 2 capital, up until 12 months prior to maturity.[3] Under the Australian capital framework, Tier 2 capital loses eligibility progressively in the 4 years prior to maturity.[4] In periods of significant market dislocation, Australian banks would be under greater pressure to replace instruments approaching maturity in order to maintain capital levels.

We recommend APRA consider allowing capital eligibility for all Tier 2 capital instruments up until 12 months prior to maturity, in line with the international LAC principles.

The main advantages of allowing Tier 2 capital eligibility up to 12 months prior to the contractual maturity are:

- reducing/simplifying decisions on capital calls;
- closer alignment with international LAC standards;
- recognising the continued ability of Tier 2 capital as a resolution mechanism in the period leading up to contractual maturity in resolution;
- access to deeper and more diverse sources of Tier 2 capital available in 'bullet' format;
- greater flexibility in times of material market dislocation to delay calling existing Tier 2 instruments; and
- orderly implementation of the proposal through greater flexibility in managing near term maturities while weighted average maturities are lengthened to accommodate the higher Tier 2 requirement – the current amortisation rules add significant pressure to Australian banks with around $27 billion of Tier 2 maturities expected in 2029.

Impact

Credit ratings impacts

AT1 currently supports various bank credit ratings of both Tier 2 and senior instruments. Strong credit ratings are critical for banks to continue to attract funding and liquidity, particularly during times of stress. As the AT1 capital layer is removed, APRA's proposal increases the risk of Tier 2 holders incurring losses in a stress scenario. This may adversely affect credit ratings of Tier 2 instruments.

Current rating agency methodologies assign varying, but positive benefits to the AT1 layer in the capital stack, with both Standard and Poor's Global Ratings (S&P) and Moody's Ratings' (Moody's) giving explicit value for the subordination of AT1 in their rating frameworks.

Under a business-as-usual scenario we could see major bank Tier 2 ratings downgraded by one notch by S&P, and no initial changes from other rating agencies. We also expect bank senior ratings to also remain unchanged. S&P has outlined in their report dated 18 September 2024, "Phasing Out Bank AT1 -- An Australian Solution To An Australian Dilemma", that with the removal of AT1 from the capital stack, their Risk-Adjusted Capital (RAC) ratio for the major Australian banks are likely to fall below the 10 per cent threshold and thus the SACP ratings may be downgraded (without offsetting action). This may result in a major bank Tier 2 instrument downgrade by one notch, but no change to senior ratings as S&P's expectation for extraordinary Australian government support would increase. Moody's and Fitch

[3] Total Loss-Absorbing Capacity Principles and Term Sheet (9 November 2015).

[4] APS 111 Attachment G, Paragraph 21.

have also commented that under their respective methodologies, they do not expect any immediate ratings impacts. As such, we expect minimal impact to funding market appetite and capacity under business-as-usual conditions.

However, in a stress scenario, under this proposal there is a risk of both Tier 2 and senior ratings being adversely affected. This proposal would see buffers to key rating thresholds decline, such that in a crisis, banks would be more sensitive to rating changes and would make utilisation of the CET1 buffers such as the Counter-Cyclical Buffer (as intended during a stress) more difficult. In addition, lower buffers to rating thresholds means heightened risk of bank credit ratings being adversely impacted by other exogenous shocks, such as a downgrade in the Australian Sovereign rating. Currently under S&P's rating framework, the current layer of AT1 would support the senior rating in a systemic stress scenario, by allowing for a 2-notch downgrade of the Australian sovereign rating before the senior rating is downgraded. Without the AT1 layer, the senior rating would be downgraded following a downgrade of Australian sovereign debt. During a stress any rating downgrade would materially impact funding capacity at the very time banks are trying to recover, and the management of capital levels in that scenario will become driven by rating requirements.

Implementation

Transition and AT1 eligibility

The ABA considers the transition timeframe to phase out AT1 instruments by 2032 is appropriate to enable the orderly transition for issuers and AT1 investors.

We would like to distinguish between the removal of the Tier 1 requirement, and the removal of AT1 from the prudential standards, the latter of which may have adverse unintended consequences. We note that the proposal to count existing AT1 as eligible for inclusion as Tier 2 capital from 1 January 2027 until each outstanding instrument's first call date, has the potential to create significant investor uncertainty in the transition period.

The ranking and order of conversion provisions in the AT1 and Tier 2 terms of most issuers are linked to the regulatory capital treatment of the relevant AT1 instrument (which will change to Tier 2 under APRA's proposal). While the regulatory treatment of the instrument may change, the investor's contractual position under the terms would need to be determined, noting issuers have different formulations for ranking and order of conversion provisions.

As such, the ABA strongly believes that transitional AT1 instruments should continue to be recognised as AT1 capital which counts towards the total capital requirement, to support the intended contractual arrangements under the existing AT1 and Tier 2 instrument terms, including the current ranking position of AT1 holders in a winding-up and ensuring the outstanding AT1 securities are converted or written-off upon a CET1 or PONV trigger event before Tier 2 securities.

Maintaining the AT1 treatment of existing AT1 instruments will mitigate potential investor confusion and inadvertently creating an industry wide ranking issue between AT1 and Tier 2 instruments on conversion, which follow the current prudential capital hierarchy. In addition, we recommend that the revised prudential standards do not deem the outstanding AT1 as Tier 2 and do not refer to the AT1 as being replaced by Tier 2.

Leverage ratio

In line with the Basel Framework the leverage ratio is calculated as Tier 1 capital divided by exposures with a minimum of 3.0 per cent.[5] APRA's proposal would see a material deterioration in the leverage ratio from the removal of AT1 (if not recalibrated), making it weaker versus international peers. In addition, APRA's implementation of leverage ratio requirements result in lower reported leverage ratios

[5] Basel framework paragraphs 20.3 to 20.7

compared to the Basel framework due to the application of higher credit conversion factors (CCF) which incorporate additional conservatism into the leverage ratio calculation.[6]

APRA may decide to recalibrate the leverage ratio from the current APRA regulatory minimum requirement of 3.5 per cent, reducing it by 50 basis points to align to the Basel III minimum requirement of 3.0 per cent. Australian banks would then remain compliant with the Basel minimum, and it would go some way to alleviating the negative impact of this proposal on our buffer. However, we note that this would still result in a reduction in the ratio's buffer leaving banks relatively worse off, which could impact banks' competitive positioning for global funding.

As an alternative, APRA could consider allowing the "Tier 1 Capital" numerator to include up to 1.5 per cent of RWAs of supplementary capital (including AT1 and Tier 2), which will leave Australian banks unchanged versus international peers, and remain compliant with the Basel III minimum requirement of 3.0 per cent.

Association with related entities and Trans-Tasman requirements

Under APS 222 and Trans-Tasman funding arrangements, each of these requirements rely on percentage-based limits relative to an authorised deposit-taking institution's (ADI) Level 1 Tier 1 capital levels, which will be impacted by the removal of AT1.

The ABA requests that the requirements for APS 222 are recalibrated to offset the impact of the proposal. For the Trans-Tasmin limits, given it is not a prudential prescribed limit, the ABA recommends that APRA remove the current requirement.

As an alternative approach, APRA could consider allowing the inclusion of supplementary capital (including AT1 and Tier 2) to provide up to 1.5 per cent of RWAs under each requirement above.

Large exposures

Similar to APS 222 and Trans-Tasman, the calibration of large exposures (APS 221) thresholds and limits rely on percentage-based limits relative to an ADI Tier 1 capital levels. Some of these elements of the prudential framework are variations on the Basel large exposures framework (LEX) with APRA having used national regulator discretion when implementing prior revisions to APS221. The ABA recommends that APRA consider the recalibration of these thresholds and limits to offset the impact of the proposal, and to consider varying APS 221 to improve consistency with the Basel LEX and its implementation in other jurisdictions, for example, removing limits for sovereigns and aligning exposure measurements, particularly for structured vehicles.

Holdings of other bank AT1

ADI's with trading operations may hold other issuers AT1 instruments, including from foreign bank and insurance issuers. Currently these holdings are deducted using the "Corresponding Deduction Approach". With the removal of AT1, the ABA recommends that these are instead deducted from Tier 2 capital.

[6] APRA, Response to submissions: Leverage ratio requirement for authorised deposit-taking institutions (27 November 2018)