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General Manager, Policy
Policy and Advice Division,
Australian Prudential Regulation Authority

Re: Discussion paper - A more effective capital framework for a crisis

Acacia Partners appreciates the opportunity to provide a response to APRA's discussion paper.

Acacia Partners is a Melbourne based corporate advisory business that serves the needs of established and emerging public and private companies and their boards and management teams in contemplating and executing financial transactions, including listed and unlisted debt and hybrid issuance. Acacia team members have had substantial experience in the hybrid market over the last twenty years.

We set out our thoughts below:

- The Australian Additional Tier 1 ("AT1") market is unique in the context of international markets for regulatory capital instruments. Its most striking feature is its **resilience** as a source of funding when other markets are not functioning. We suggest this is a direct consequence of transparent public trading which encourages primary and secondary market participation by a more diverse range of buyers (including private investors) than other markets, making for efficient price discovery and investor confidence which enables the primary market to function under stress.

- While the leverage and related impacts of the proposal to phase out AT1 capital instruments are likely well understood - including reduced financial flexibility for banks, potentially higher leverage ratios, increased funding costs, and diminished international comparability of Australian banks' capital structures - it is the impact on **availability** of capital, when it is needed most, that concerns us about this proposal.

- Historically, the listed hybrid market comprised a broader range of issuers including the likes of Woolworths, AGL, and Orica, but in recent years has become far more concentrated around bank AT1. In that context, we believe there is a material possibility that once shut off, the listed market for regulatory capital instruments may not be able to be reopened as effectively in the future. We also hold a concern, perhaps outside APRA's remit, that closing off the dominant private investor syndication product in the country will ultimately weaken the ability to syndicate equity in Australia and reduce the competitiveness of Australian equity capital markets.

- Reflecting these concerns, our preference is for AT1 to survive in the listed form. One solution which we believe investors would have good tolerance to is an increase in the loss absorption trigger, potentially to 9%. To the extent that APRA determines to exclude retail from the market in some form, we suggest a hierarchy of alternatives that would still enable open and transparent participation of multiple investor groups:

1. A requirement akin to the ASX Warrant Client Agreement, tailored specifically for hybrid instruments covering risk, suitability ("ASX Hybrid Client Agreement") and supported by an "Understanding Hybrids" booklet, outlining how hybrids work, associated risks, and case studies including write-off of AT1 but also drawing on adverse experience from non-financial hybrid issuers on ASX; or

2. Denominations are increased, for instance to $5,000, which should limit participation of smaller retail investors. An issue has been noted in respect of the requirements of ASX Listing Rules. We assume these concerns relate to Condition 6 of Listing Rule 2.5, which (amongst other things) requires at least 100,000 securities to be issued. We are not aware of any substantive practical or policy reason that would prevent ASX from simply modifying this listing rule (either for hybrids or more generally); or

3. Primary market issuance is restricted to wholesale investors only. Retail investors are able to participate in the secondary market only, possibly subject to executing an ASX Hybrid Client Agreement; or

4. Primary and secondary market are restricted to wholesale investors only. Brokers, who generally operate wholesale registers already, would be required to hold wholesale certificates in order to authorise trades for AT1 instruments on ASX. This should be operationally feasible given existing requirements for other ASX listed products such as warrants.

- In the event that APRA determines to eliminate AT1, we advocate for the introduction of Lower and Upper Tier 2 instruments, with Lower Tier 2 effectively replacing some functions of AT1 and continuing to be issued in the listed format.

- Given our material concern that the likely impact of the proposal is to reduce the availability of capital to Australian banks under stress, to the extent reasonably possible, issuers should be encouraged to replace listed AT1 with AT2. Although the characteristics are different, supporting the listed market will help ensure access to capital under stress including for smaller ADIs who may be frozen out of the OTC markets when liquidity is poor.

- Should AT1 continue we believe the market would function better and be relatively more appealing to larger wholesale investors if the Board of Taxation's December 2016 recommendations to the Federal Treasurer to treat AT1 as debt for tax purposes were adopted.

For further information or any questions regarding this submission, please feel free to contact me on [redacted] or via email at [redacted]

Yours sincerely
Acacia Partners Pty Ltd

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Director