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General Manager Policy

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Dear Sir

Discussion Paper: A more effective capital framework for a crisis

1. This submission responds to APRA's request for stakeholder feedback on its proposal to streamline the capital framework of ADIs by replacing Additional Tier 1 (AT1) Capital with more robust forms, such as Tier 2 and Common Equity Tier 1 (CET1) Capital. The submission reflects on two perspectives: that of investor stakeholders and that of an accountable person within an Australian ADI, considering the implications of this significant change from both viewpoints.

Effectiveness of AT1 instruments

2. APRA has raised concerns about the effectiveness AT1 capital citing issues such as delayed loss absorbency, potential complexities in resolution, risks of contagion and litigation. Furthermore, a concern for APRA is the large proportion of issued AT1 capital held by retail investors. The proposal is to remove AT1 capital instruments from the Australian capital framework for ADIs. While simplifying capital requirements, this limits flexibility and increases funding costs, posing a question of whether these trade-offs are justified given Australia's regulatory environment.

3. A notable example of the stabilising effect that AT1 capital can bring in times of financial stress is the 2008 Goldman Sachs case.[1] *Following Goldman Sachs' transition to a bank holding company, Goldman Sachs issued preferred shares along with warrants, purchased by Berkshire Hathaway to bolster its capital base. This intervention not only provided capital but also reinforced market confidence—a key consideration in evaluating AT1's utility within Australian ADIs, where similar stability instruments might play a critical role during times of crisis in the future.*

4. To cater for an event of bank failure, Australia's regulators have taken proactive steps to ensure that Australia is prepared to respond to a crisis by having a comprehensive set of regulatory tools to apply. ADIs are governed by a single comprehensive framework under the Corporations Act 2001[2], there are clear

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[1] Goldman Sachs website: https://www.goldmansachs.com/our-firm/history/moments/2008-buffett-investment (accessed 8 November 2024.)

[2] On 1 July 1999 the registration and regulation of credit unions as financial institutions were transferred from the Financial Institutions Codes of each state and territory to Commonwealth regulation, in the Corporations Act 2001 (Corporations Act).

longstanding expectations on the priority of claims against ADIs[3]. Thus, Australia does not have to contend with hard-to-manage situations with different entities in different jurisdictions. The Banking Act was also amended in 2018 to enforce loss-absorbency provisions, aligning with Basel III requirements.[4]

5. Australia's framework is therefore a stark contrast to the international experience that APRA has highlighted in the discussion paper. Statutory provisions in Australia eliminate conflict in the law to ensure that capital instruments apply as designed. This is to ensure the effectiveness of loss absorbency provisions thus reducing potential litigation concerns. For example, while APRA references the challenges faced by Spanish authorities[5], these challenges arose primarily due to multiple jurisdictions and because the capital instruments were unlisted and there was misselling.

6. In contrast, in Australian there is one common statutory and regulatory framework that applies to all issuers of AT1 capital instruments. APRA has wide powers to activate the conditions that apply to such instruments notwithstanding any conflicting Australian or foreign law. The risks to the holders of such instruments have been highlighted in financial markets for over two decades. The financial markets regulator, the Australian Securities and Investment Commission ("ASIC") have carried out reviews of such instruments.[6] ASIC's oversight has also recently been bolstered with product intervention powers and issuers are subject to consumer-focused obligations to ensure these securities are appropriate to target markets. One can only take from this that Australian investor's interests have been properly considered and the risks of these instruments, and the likelihood of misselling and investor misunderstanding has been reduced to the extent possible.

Concentration of retail investors

7. AT1 capital instruments in Australia absorb losses, in the event of a non-viability or when a CET1 capital level event is triggered. It is the capital trigger event that is given most prominence, being less ambiguous than the non-viability event. The CET1 capital event threshold of 5.125% has been applied in Australia, being the Basel minimum level. Australian ADIs however maintain capital levels significantly above such minimum threshold. This creates a buffer above the trigger, providing reassurance to investors[7] of an apparent safety of these instruments. This low trigger level has signalled that AT1 securities are last-resort tools, and perhaps this has contributed to retail investors investing more in AT1 (hybrid securities) than they might otherwise have done, had a higher trigger applied.

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[3] Section 13A (3) of the Banking Act 1959

[4] Subdivision B—Conversion and write-off provisions of Division 1A of the Banking Act 1959. Under this provision the contractual loss absorption provisions required for Additional Tier 1 and Tier 2 capital instruments issued by ADIs operate as intended by the prudential standards and are not rendered ineffective by provisions of any Australian law or any law of a foreign country or the constitution of the entity that has issued the instrument.

[5] The 2008-14 banking crisis in Spain (FSI Crisis Management Series No. 4), paragraph 20 paraphrased. Spanish savings banks operated under a unique legal framework shaped by their welfare-focused origins. Legally ownerless, their profits were directed towards social causes. However, their governance left them vulnerable to political influence, leading to distortions in risk management. Lacking shareholders, they faced restrictions in raising high-quality capital, relying solely on profit retention. Despite issuing substantial debt, they were subject to limited market discipline. Furthermore, their legal status hindered sales to healthier banks, and regional governments had to approve cross-regional mergers.

[6] See, 2017–18 ASIC business plan summary by sector | Surveillance | Hybrids distribution | Examining the selling and distribution practices of market intermediaries in relation to hybrids and to improve investor understanding of the risks of trading hybrids.

[7] See, Submission - Roland Panich (Retail Investor) October 2023 to APRA's discussion paper Enhancing bank resilience: Additional Tier 1 Capital Australia 21 September 2023

8. Raising the minimum trigger (e.g. to 7% CET1), as suggested in the first round of consultation could result in a shift in the investor risk assessment, potentially making these securities more costly to issuers and perhaps less appealing to retail investors, given the reduced perceived margin of safety represented by a lower buffer. Thus, market forces may drive down the issuer appetite for issuing AT1 instruments by aligning their returns more closely with higher-risk CET1 capital returns.

9. Therefore, that retail investors in Australia show a significant demand for AT1 (hybrid instruments) is rational. It is a function of the following;

   — the perception of a large margin of safety over the Basel minimum before the trigger for write off or conversion,

   — a sound legal and regulatory framework,

   — the availability of franking credits that are seen as attractive, and

   — that these instruments are listed on the ASX, making them liquid and tradeable.

10. Australia's substantial private superannuation pool, itself being an outlier internationally, gives rise to significant levels of private investment and retail investors. This is also driven by a prevalence of self-managed superannuation funds and the sophistication of such investors.

Impact for accountable persons of eliminating AT1 capital

11. Eliminating AT1 capital instruments from the ADI capital framework will restrict accountable persons, who are charged with the management of capital from optimising capital structures effectively — Chief Financial Officers and Treasurers in particular.

12. The versatility of AT1 capital securities are; they can be called only at the issuer's discretion, bear conditional distributions and, they complement subordinated debt and common equity. Importantly, such capital is permanent. This capital tool provides flexibility to raise capital at an optimal cost while providing safeguards to depositors.[8] Those charged with capital management ought not to be hamstrung in good times from raising capital by reduced options available to them, especially when these have been successfully used in Australia and internationally.

13. The impact of APRA's proposal is that accountable persons at Australia's ADIs will be precluded from issuing the full suite of Basel III recognised securities, limiting options to raise capital and increasing costs.

14. All the deliberations for an accountable person in raising and managing ADI capital is not publicly known. However, by way of an example the considerations that go into this are succinctly documented in the case of Mills v Commissioner of Taxation[9]. This was a test case to determine whether franking credits arise in respect of payment of interest on the notes forming part of bank capital securities. There, the deliberations and the challenges presented by the supply and competition for capital were publicly unveiled.

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[8] Swiss National Bank, Financial Stability Report 2023 (June 2023) p30. In the case of Credit Suisse, AT1 "instruments absorbed losses only as the point of non-viability was imminent and state intervention became necessary. At this late stage in the crisis, AT1 played an important role in the package of measures."

[9] See Mills v Commissioner of Taxation [2011] FCAFC 158 paragraphs 57 to 69. This sets out the background and environment in which AT1 securities were issued and the competing deliberations leading up to the issue of AT 1 securities at that time.

15. The deliberations surrounding capital management decisions are influenced by a range of factors, including:

    — APRA's prudential standards and directions,

    — market perception of the adequacy of the Bank's capital levels,

    — a Bank's position in relation to other major banks,

    — prevailing market conditions,

    — competing demand for capital by other institutions,

    — the Bank's business strategy, and

    — the cost of the different types of capital.

16. In this example between September 2008 and August 2009, Commonwealth Bank's Tier 1 ratio targets were under pressure, there had been large capital raisings by the industry, the acquisition of BankWest was being considered and two other major banks entered the capital markets to raise funds, namely ANZ and NAB. These circumstances show that there are several variables influencing the raising of capital. Commonwealth Bank had to choose between capital instruments based on the access to capital market themselves and the competition in such markets for the limited capital in uncertain times.

17. Accordingly, just as APRA must have the tools at their disposal to manage regulated entities, especially in times of crisis, so too it's just as important for accountable management to have the various options to raise capital in good times and in times of stress.

Capital levels and triggers for conversion or write off

18. Capital levels are managed in good times to ensure they are sufficient to protect depositors. Access to capital markets and the capacity requires considerable planning and options across all tiers of capital. Management may also take action to raise capital during times of crisis. In the Goldman Sachs case, previously referred to, in preparation for the impact of the GFC, the CET 1 ratio was 10.6% in Q2 2008 and raised to 15.6% by year end 2008, bolstered by AT1 issuance. In the case of Credit Swisse, its CET1 ratio increased from 13.8%: Q1 2022, to 20.3%: Q1 2023, due to decreased risk-weighted assets, capital raising, and a write down of AT1 capital instruments. Firstly, these cases demonstrate the advantage or, perhaps even the necessity, for having the flexibility to raise capital using all capital instruments to their optimum.

19. Secondly, as highlighted above in the recent crises, capital levels were not the leading indicator of an emerging crisis. The emergence of losses and the recognition of asset write-downs are delayed. This results in a lag in the impact to capital ratios. Accordingly, the bright-line trigger of 7% CET1 for write off or conversion of AT1 capital was not applied in Switzerland (5.125% is the trigger in Australia), rather it was the non-viability determination by regulators, due to government support, that triggered the conversion of AT1 capital. Thus, the concern expressed over the trigger levels embedded in AT1 securities' conditions and the impact of the cancellation of discretionary distributions sending negative market signals is misplaced. Cancellation of such distributions would have applied to all ADIs, notwithstanding AT1 instruments, where they enter their capital conservation buffer range. Capital distribution constraints[10] become effective, well

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[10] Paragraph 30 APS 110 Prudential Standard APS 110 Capital Adequacy.

before the 5.125% CET1 trigger. While ADIs may be reluctant to use buffers that trigger restrictions on capital distributions, once these are used then there will be a progressive phasing in of constraints on earnings that can be distributed on all Tier 1 instruments.

20. Therefore, even without AT1 instruments on issue, the capital framework anticipates restrictions on distributions once buffers are used and this will lead to negative market sentiment for all Tier 1 instruments. Such negative market sentiment will also cause a reaction from depositors.

Conclusion

21. In conclusion, APRA's proposal, while aimed at simplification and safeguarding retail investors to eliminate the possibility of contagion, the flexibility to manage capital structures optimally will be reduced. Accountable persons in Australia will be hamstrung by this ban on a class of securities, limiting options to raise capital before and during a crisis.

22. It suggested that it is appropriate to retain AT1 as part of the capital framework. This will ensure that that ADI accountable persons retain a full suite of tools to raise and manage capital levels and ensure resilience for times of stress. Australia's product distribution oversight and open markets provide a sound environment for investors. There is a common legal and regulatory framework that allows capital to be dealt with primarily in the interests of depositors. It is recommended that the CET1 threshold, currently at the Basel minimum, is raised well above 5.125% for future issues. It is considered that this will increase the risk awareness in the mind of retail investors, who purchase these securities on the secondary market.

23. Alternatively, if in the interests of safeguarding retail investors and preventing possible contagion, APRA dispenses with the issuance of new AT1 securities there will be outstanding issues until 2032. To avoid any possible ambiguity regarding the risks of these securities and their treatment in times of crisis now needs clarification. Clarification by way of a notice could be issued, regarding the clear statutory order in which capital holders bear losses and the significant powers that APRA has to order the conversion or write-off of AT1 capital instruments.[11] This will go a long way to crystalise in the minds of such security holders any misunderstanding of the risks involved.

Yours faithfully

James Came

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[11] See Bank of England Statement: UK creditor hierarchy https://www.bankofengland.co.uk/news/2023/march/boe-statement-uk-creditor-hierarchy) (Accessed 1 November 2024)