Australian Banking Association

14 February 2020

Ms Katrina Squires
Acting General Manager
Policy Development
Policy and Advice Division
APRA
1 Martin Place
SYDNEY NSW 2000
By email: ADIpolicy@apra.gov.au
Delivery details

Dear Ms Squires

Revisions to APS 111 Capital Adequacy: Measurement of Capital

Thank you for the opportunity to make a submission on APRA's proposed revisions to Prudential Standard APS 111 Capital Adequacy: Measurement of Capital. With the active participation of its member banks in Australia, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and community. It strives to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

The ABA supports APRA's review of the capital framework and acknowledges APRA's intention to strengthen the capital position of parent authorised deposit-taking institution's **(ADI's)** to protect Australian depositors. The most significant impact from the proposal is in relation to the equity investment in New Zealand subsidiaries. While we are broadly supportive of the proposal for treatment of CET1 invested into banking and insurance subsidiaries, further consideration of the treatment of Supplementary Capital Instruments is needed.

Our key findings are that in its current form the proposal is likely to:

- Incentivise banks to issue Regulatory Capital Instruments from their NZ subsidiaries. This approach would increase complexity in resolution by exposing banks to a more complicated multiple point of entry (**MPE**) resolution model (depending on the resolution regime applied to banks operating in in New Zealand.
- Require double Supplementary Capital funding of New Zealand assets. As part of our analysis, we have had an Investment Bank estimate the cost of the double regulatory capital funding requirement across the four major banks to be $176 million per annum
- Provide an incentive to restructure to a non-operating holding company **(NOHC**) to eliminate the double Supplementary Capital funding requirement

The ABA believes that a more appropriate approach is to allow banks to issue Supplementary Capital instruments from a Level 2 entity. This will allow a bank to issue APRA complying securities to external investors and to downstream these funds to the NZ subsidiary in a RBNZ compliant manner. This will achieve the objective of Supplementary Capital Instruments by protecting the capital position of the ADI

(as the instrument is outside of Level 1) while also allowing banks to issue an instrument that is efficient and cost effective.

This is discussed further below. In addition, the submission also outlines the ABA's concerns and alternative policy proposals for the treatment of TLAC holdings and other technical suggestions.

Please do not hesitate to contact myself if you have any queries regarding this submission. The ABA would be happy to facilitate a workshop with members to further explain our positions put forward in this submission.

Yours faithfully

Karen O'Brien
Policy Director
Phone 02 8298 0421
Karen.obrien@ausbanking.org.au

Australian Banking Association

Investment in regulated subsidiaries

APRA has proposed to amend the existing Level 1 treatment of banking and insurance subsidiaries from a 400 per cent risk weight to an approach whereby capital exposures are risk weighted at 250 per cent up to a limit of 10 per cent of an ADI's Level 1 CET1. Any amount above the 10 per cent limit is deducted from CET1 capital. The ABA also understands from discussions with APRA that for the purpose of the calculation, capital investment includes all Regulatory Capital Instruments. Therefore, Supplementary Capital Instruments (Additional Tier 1 **(AT1)** and Tier 2) are also deducted from CET1 when total investment is above the 10 per cent threshold.

Reserve Bank of New Zealand (RBNZ) capital review decisions and New Zealand resolution changes

In addition to the APRA proposal, in December 2019, a number of changes to the New Zealand regulatory framework were announced:

- the RBNZ finalised its own Capital Review where one of the key changes is that RBNZ qualifying AT1 preference shares and Tier 2 instruments will not have APRA non-viability triggers and therefore will not be APRA eligible for group capital at level 2; and
- The New Zealand government announced a proposal to give the RBNZ the ability to restore to solvency or to recapitalise a failed deposit taker by writing down or converting to equity unsecured liabilities (statutory 'bail-in')

Key principles

The ABA consider the key principles for the capitalisation of banking and insurance subsidiaries for any proposal are:

1) **Promotes financial soundness of the group in addition to the ADI and individual subsidiaries.** Recognition of the importance of the Level 2 Group in the regulation of multinational institutions such as Australian banks.
2) **Effectiveness**. Certainty of loss absorption for all regulatory capital instruments within a group. An instrument must be effective in resolution and is a credible mechanism to recapitalise a bank.
3) **Minimises complexity**. Maintains a single point of entry model in resolution allowing the home regulator the option to control all aspects of resolution of a group.
4) **Efficiency.** An instrument that is efficient (i.e. by being eligible at both Level 2 and in NZ) and cost effective (so that capital funding costs are only incurred once for each asset).

Impacts

The impact of the proposed APS 111 likely to be:

- Double Regulatory Capital funding for NZ assets will lead to higher funding costs; and
- Resolution complexity will be increased.

Double Supplementary Capital resulting in higher funding costs

It is our understanding that the proposed NZ Supplementary Capital Instruments will not qualify to be recognised by APRA at Level 2. It is expected that new RBNZ capital regulations will not align to APRA's requirements as they will not have a non-viability trigger to convert to CET1 capital. Therefore, to support NZ assets, Australian ADIs will need to:

- issue Supplementary Capital Instruments that qualify as APRA Level 2 group capital: and
- issue Supplemental Capital Instruments from the NZ banking subsidiary that comply with RBNZ capital regulations.

As a result, Australian ADIs will incur capital funding costs twice in financing NZ assets. This will effectively double the amount of level 2 capital held for New Zealand assets (and the associated costs) to mitigate the same risk.

As part of our analysis, we had an Investment Bank estimate the cost of Supplementary Capital Level 2 instruments under the double regulatory capital funding requirement (refer to Table 1). They have estimated that the cost to the four major Australian banks is additional funding costs of $176m each year.

These increased funding costs are likely to be in the form of higher banking costs to customers and/or reduced returns to shareholders.

These costs are in addition to higher funding costs already borne by Australian ADIs as APRA loss absorbing capital (LAC) requirements are applied at the group level, which includes NZ assets.

Table 1 – Estimate of increase in funding costs

Risk weighted assets	
Group RWAs (A$)	1,724,372[1]
NZ RWAs (Current APRA requirements) (NZD)	278,061[1]
NZ RWAs (High level estimate of RBNZ requirements) (NZD)	333,673[2]
Incremental AT1/T2 requirement for Banking Groups due to non-eligibility of NZ instruments (A$m)	**Minimum requirement[3]**
AT1	4,004
Tier 2	10,411
Total Supplementary capital	14,415
Estimated cost (A$m per annum)	
AT1	82
Tier 2	94
Total inefficiency cost	**176**

Resolution complexity increased

Under the current proposal, banks will be incentivised to change their existing resolution and/or legal entity structure to a NOHC or a MPE resolution model. The proposed 10 per cent threshold incentivises ADIs with NZ subsidiaries to issue Supplementary Capital out of their NZ subsidiaries instead of the Australian ADI. Once an ADI reaches the 10 per cent threshold, the benefit from issuing Supplementary Capital from its Australian base diminishes, making issuing Supplementary Capital Instruments issued from NZ subsidiaries more cost effective

The impacts of moving to an MPE resolution model are:

- More complex than a Single Point of Entry **(SPE)** resolution model

[1] Represents risk weighted assets for the four major Australian banks per the latest pillar 3 as at February 2020 [to clarify that NAB's Q1 Pillar 3 released today would not have been used for this calculation] and NZ Disclosure Statements
[2] Assumes that risk weighted assets under the revised RBNZ framework are 1.2x from today
[3] Under the RBNZ framework, 2.5% of the Tier 1 capital requirement can comprise AT1, compared to the APRA requirement which allows 1.5%. The above calculation assumes that the additional 1.0% of AT1 is used to reduce the Group Tier 2 requirement.

- APRA will have less control in the resolution and/or recovery of a group headed by an APRA regulated ADI, as there may be other equity holders or classes of preferred equity which limit the options available to the resolution authority to direct the restructuring or sale of the business or parts of that business or limit the recapitalisation of the entity
- MPE requires much greater cross border coordination
- Does not recognise primacy/relevance of Level 2 in the regulation of multinational banking institutions

The Financial Stability Board Thematic Review on Bank Resolution Planning, Peer Review Report released in April 2019 noted that "In most cases a single point of entry (SPE) combined with a bail-in is preferred for G-SIBs and most D-SIBs, as this enables the resolution authority to stabilise the firm and provide for continuity of its critical functions by keeping operational subsidiaries open." It provides the lowest risk alternative for a resolution authority and is consistent with APRA's approach to regulating Australian banks including the focus on both level 1 and level 2 capital requirements that ensures sufficient loss absorbing capital for the entire banking group. APRA, in cooperation with RBNZ can then determine if alternative resolution strategies are required.

ABA proposal

The ABA recommends that APRA retain the flexibility for banks to issue supplementary capital instruments from a Level 2 entity. This would involve the Supplementary Capital Level 2 entity issuing APRA complying securities to external investors and down streaming these funds to the NZ subsidiary in RBNZ compliant manner. For example:

- Level 2: APRA eligible Regulatory Capital Instruments that are issued from a Level 2 entity including intermediate holding companies **(IHOC)** (including SPVs), contributing to Level 2 capital
- Level 1: No impact upon issue as the instrument is issued outside of Level 1. Upon CET1/PONV trigger the instrument converts into ordinary shares of the ADI
- NZ Subsidiary: Internal securities issued to the IHOC/SPV meeting the RBNZ requirements (being a similar security with differing legal form and resolution framework).

This may be achieved with some minor amendments to the proposed standard to allow recognition at Level 2. However, it may be clearer to maintain substantially the current special purpose vehicle (SPV) provisions (and stapled security provisions) in attachments G and I and amend to facilitate the down streaming to the NZ bank in a differing legal form to reflect local regulatory, legal and resolution requirements.

TLAC holdings

The Discussion Paper proposes a full deduction of holdings of third party issued Tier 2 and TLAC securities from an ADI's Tier 2 capital. While we acknowledge APRA's intention to limit potential contagion to the Australian banking sector by providing a disincentive to invest in "TLAC" and Tier 2 between banks, we recommend an appropriate exemption so that Australian banks can continue to participate in these markets and to allow for market making.

Holdings of TLAC instruments issued by third parties

TLAC instruments are becoming a larger component of the debt capital markets globally. Introducing a blanket deduction approach without applying a concessional limit, will place Australian banks at a significant disadvantage in facilitating capital flows compared to international peers[4].

The ABA recommends that APRA introduce a concessional threshold based on the ADI's CET1 capital for holdings of third-party issued TLAC instruments. Relevant holdings would be risk weighted up to the threshold, similar to the existing framework. Recognising the smaller scale of Australian banks' activity in, and holdings of, TLAC instruments, the ABA expects that the threshold for Australian banks would be substantially lower than that applied by the Basel committee (i.e. 5 per cent allowed for market facilitation of TLAC instruments). The ABA can assist APRA with refining the specific elements of this proposal and agree an appropriate risk-weight and/or the threshold to be used in the Australian context.

Trading book exemption for holdings of Tier 2 instruments issued by third parties

APRA's LAC framework relies on the existing capital framework. This will result in the Australian major banks becoming some of the largest Tier 2 issuers globally. APRA's current treatment of deducting all Tier 2 holdings will hinder the development of a sufficiently deep and liquid market, which is essential for the sustainability of Tier 2 issuance.

The ABA recommends that APRA introduce a 'market facilitation' exemption for holdings of Tier 2 instruments issued by third parties, where Tier 2 holdings in the ADI's trading book are subject to the same concessional threshold based on the ADI's CET1 capital as outlined above. Tier 2 holdings up to the threshold would be risk weighted at 250%. For the avoidance of doubt, the same threshold would apply for both holdings of TLAC instruments as well as trading book holdings of Tier 2 securities.

Definition of TLAC instruments

APRA's draft prudential standard defines TLAC instruments with reference to the November 2015 Financial Stability Board (**FSB**) TLAC Term Sheet. This is not desirable as it does not provide sufficient certainty for banks to identify TLAC exposures and will increase the prudential burden for APRA to enforce these requirements.

The ABA recommends that APRA include in the final prudential standard a clear definition of instruments intended to be captured by the TLAC provisions. For example, APRA could specifically carve-out liabilities which are not classified as regulatory capital (i.e. with explicit statutory or contractual recapitalisation features and recognised as TLAC in the relevant issuer's most recent Pillar 3 disclosures).

Amortisation of TLAC instruments issued by Australian major banks

The ABA acknowledges that APRA is not contemplating any change to the amortisation of capital instruments as part of the revisions to APS 111. However, the ABA wishes to reiterate its view that for LAC purposes, all capital instruments with a maturity of greater than one year should be allowed to meet the higher Total Capital requirements announced by APRA in July 2019 reflecting that these instruments continue to be loss absorbing.

The FSB framework recognises that loss absorption features remain intact for instruments subject to amortisation in the final five years to maturity. By not adopting this FSB concession, APRA has increased the super equivalence of the Australian LAC framework and thereby prejudicing domestic banks in meeting their LAC funding task. Estimating the size of this amortising Tier 2 requires an estimate of the volume and tenor of bullet issuance. Initial analysis indicates banks may have ~50bps of amortised Tier 2 capital.

[4] The ABA notes that the original Basel committee proposal in 2016 did not distinguish between 'market facilitation' purposes and cross-holdings in the financial system. Subsequently, based on feedback received from several financial institutions, the Basel committee revised the threshold from 10% to 15%, thereby recognising the important role financial institutions play in market facilitation.

The ABA recommends that APRA implement a separate LAC ratio, which recognises the full face value of regulatory capital instruments, including Tier 2, with a maturity date greater than one year.

Cross default clauses

The below sets out our view on the proposed changes to "cross defaults" within the Discussion Paper. We appreciate that this is a highly technical area and it would be useful to discuss these points further with APRA to ensure there are no unintended consequences to the changes proposed including to senior debt programmes.

APRA has proposed amendments to the existing cross default provisions within APS111, as a combination of two limbs covering (i) cross-default clauses within capital instruments themselves[5] ("Prohibition 1") and (ii) a prohibition on any other debt or capital instruments being subject to default as a result of non-payment on a capital instrument[6] ("Prohibition 2").

The ABA considers that Prohibition 1 is not necessary and recommends that it should be removed from APS 111 since:

- in order for an instrument to be eligible as Additional Tier 1 Capital, it must not contain any events of default[7]; and
- in order for an instrument to be eligible as Tier 2 Capital, in practical terms it can only provide for "events of default" on account of default under the terms of the instrument or winding-up of the issuer[8].

The ABA also envisages that in some circumstances, a link between a default event for senior creditors and capital actions could be beneficial in managing an ADI. For example, senior creditors may agree to abstain from action pending the successful completion of a rights issue. Another example could be contracts put in place as part of a take-over of an ADI, which may be dependent upon capital actions. Such actions would be prohibited under the proposed standard. As such we suggest that if APRA wish to retain the broad restriction of Prohibition 2, it should also retain the right to override such a restriction in limited circumstances.

Additionally, the ABA suggests:

a) it should be clarified that Prohibition 2 refers only to clauses in an issuer's other debt funding and capital instruments; and

b) the inclusion of the words "… and the time for the appeal of the decision has passed" in the exception to Prohibition 2 is not appropriate. Tier 2 holders are permitted to seek winding up under the standards. However, an appeal against such a winding up order is likely to involve and be relevant to senior creditors in some manner. As such, we suggest that it is not appropriate to delay the actions of senior creditors once a court action is actually granted for the Tier 2 holders.

Timelines and Transition

The ABA recommends that the implementation is aligned to coincide with the implementation of other components of the capital framework in 2022 which is consistent with international timelines. There are a number of other contiguous requirements in the capital framework which could impact on the proposed timeline for members for example proposed reforms to increase comparability, transparency and flexibility of the capital framework.

In addition, as RBNZ requirements will be implemented over a longer transition period than previously proposed it is unlikely that significant capital injections into New Zealand subsidiaries would be required

[5] Revised draft APS 111, Attachment E, Paragraph 1(u); Revised draft APS 111, Attachment G, Paragraph 1(u).
[6] Revised draft APS 111, Attachment E, Paragraphs 16 and 17; Revised draft APS 111, Attachment G, Paragraphs 16 and 17.
[7] Existing APS 111, Attachment E, Paragraph 1(h)(ii).
[8] Existing APS 111, Attachment H, Paragraphs 1(h) and 1(p).

in the near term necessitating the accelerated implementation of revised APS 111 requirements to mitigate concentration risk of Australian parent exposures to New Zealand subsidiaries.

Lastly, based on the significant complexity and cost impacts noted above in relation to Supplementary Capital instruments the ABA urges APRA to allow sufficient time to consider the merits of allowing issuance of Supplementary Capital instruments from a Level 2 entity. Further, the ABA would also suggest a transition of existing Supplementary Capital instruments to current call dates, particularly where the transactions are linked to public market transactions.