AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY
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TO: ALL AUTHORISED DEPOSIT TAKING INSTITUTIONS, GENERAL INSURERS AND LIFE COMPANIES

EXPECTATIONS ON CAPITAL CALLS

With global credit spreads widening significantly over the past 12 months, the prospect of new capital instruments being issued at higher credit spreads than equivalent outstanding instruments has become more pronounced, and APRA is seeing requests to make "uneconomic calls". In this context, APRA is writing to reinforce existing prudential requirements for Additional Tier 1 Capital or Tier 2 Capital instruments.

Set out below are expectations for all ADIs, general insurers and life companies (together 'Insurers') that are seeking APRA approval to call and replace an outstanding Additional Tier 1 Capital or Tier 2 Capital instrument with one that has a higher credit spread or that is otherwise more expensive. APRA expects the senior executive accountable for capital to follow the expectations outlined in this letter.

APRA's prudential requirements

It is critical that an APRA-regulated entity's capital base is high quality and has a high degree of permanence. To that end, an instrument issued by an ADI or Insurer must meet all applicable criteria specified in the relevant Prudential Standard relating to the measurement of capital.

These criteria require Additional Tier 1 Capital to provide a permanent and unrestricted commitment of funds. For Tier 2 Capital, the capital attributed to each instrument must be amortised in the 5 years to maturity. These criteria are reinforced by the requirement that the issuer must not create an expectation that a call will be exercised.

In line with the existing prudential standards, ADIs[1], general insurers[2] and life companies[3] generally should not call an Additional Tier 1 Capital or Tier 2 Capital instrument and replace it with an instrument with a higher credit spread or that is otherwise more expensive, as it may

[1] For Additional Tier 1 Capital instruments, please refer to paragraph 25 of *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111), Attachment E. For Tier 2 Capital instruments, please refer to paragraph 24 of APS 111, Attachment G.

[2] For Additional Tier 1 Capital instruments, please refer to paragraph 6 of *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital* (GPS 112), Attachment C. For Tier 2 Capital instruments, please refer to paragraph 6 of GPS 112, Attachment E.

[3] For Additional Tier 1 Capital instruments, please refer to paragraph 6 of *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* (LPS 112), Attachment C. For Tier 2 Capital instruments, please refer to paragraph 6 of LPS 112, Attachment E.

create the expectation that the issuer will exercise a call option on other outstanding Additional Tier 1 Capital and Tier 2 Capital instruments with call options.

An exception would be where the issuer can (i) satisfy APRA as to the economic and prudential rationale of the call; and (ii) satisfy APRA that such action will not create an expectation that other instruments will be called in similar circumstances.

Satisfying the prudential requirements

In satisfying themselves and APRA as to the economic and prudential rationale of the call, the ADI or Insurer should, at a minimum, provide analysis that demonstrates:

- the cost of issuing the replacement instrument is equal to or less than the cost of keeping the existing instrument outstanding. This analysis should consider various scenarios including, but not necessarily limited to, comparative spread levels and issuance volume. Where relevant, it should also factor in any loss of Tier 2 capital benefit due to amortisation, offset by the benefit that instrument provides as debt funding; and

- the credit spread at which the ADI or Insurer would consider the cost of the replacement instrument to be uneconomic.

Separately, the ADI or Insurer will be required to satisfy APRA that replacing an Additional Tier 1 Capital or Tier 2 Capital instrument with one that has a higher credit spread or that is otherwise more expensive, will not create an expectation that other instruments will be called in similar circumstances.

A rationale solely based on exercising calls to maintain access to capital markets (or limit reputational damage) would undermine the permanence and quality of capital that the Prudential Standards seek to maintain.

Assurance in public announcements

Where the ADI or Insurer has satisfied APRA and replaces an instrument with one that has a higher credit spread or is otherwise more expensive, the regulated entity is to ensure that a public announcement relating to the call clearly indicates that this action does not imply that other outstanding instruments with call dates will be called in the future.

Yours sincerely,

John Lonsdale
Chair