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Submission to Consultation on Enhancing bank resilience: Additional Tier 1 Capital in Australia

Additional Tier 1 (AT1) Capital Instruments represent a theoretically innovative idea introduced as part of the Basel 3 regulatory framework by the Basel Committee as a means of improving protection against disruptive bank failures. The theory is, unfortunately flawed, and in practice the role of AT1 instruments has been shown to ineffective.

My recommendation is for APRA to remove AT1 instruments as a component of allowable regulatory capital, meaning that the whole of the 6 per cent Tier 1 capital requirement would need to be met by “core” CET1 capital. Since this would be a “tougher” requirement than the Basel 3 standard, there is no problem with consistency with Basel requirements in adopting such an approach. Australian banks would no doubt object since they have used AT1 instruments to economise on common equity – as is reflected in their ability to pay franked distributions on such instruments. While that reflects a commonly held view that AT1 is a cheaper form of capital funding than common equity, there is little, or no evidence to support that view.

1. Theoretical Shortcomings

The theory behind use of “bail-in” instruments such as AT1 is that risk of disruptive bank failure due to a decline in common equity to a “point of non-viability” can be overcome by conversion of AT1 into common equity (or by writing off such instruments). The CET1/Risk Weighted Assets ratio is increased.¹ The concerns over a shortfall of bank equity from that desired, leading to non-viability and potential runs will be dissipated. The bank will be able to continue its operations, although perhaps temporarily while a merger with another institution is planned.

¹ In the “write-off” situation this arises from total liabilities (which include AT1) decreasing and the accounting calculation of equity (being total liabilities minus total assets) thus increasing.

The theoretical deficiency in the argument is that it ignores the rational response of financial markets and creditors (including depositors) to announcement of the bail-in. Via the regulator signalling (through a bail-in) that a bank is at risk of non-viability, market expectations are hardly unlikely to be unaffected. Uninsured depositors (and possibly insured depositors²) are likely to shift deposits elsewhere. Creditors of the bank are likely to demand higher returns, and be unlikely to provide funding for new issues of AT1 securities – which are required to replace the AT1 securities converted (or written off). Equity markets are also likely to react adversely. Expectations that the bank is no longer strong and well managed (otherwise why would a bail-in be required?) will be enhanced.

Moreover, because of an inability to distinguish between specific (to the bank) and general (industry wide) issues which have led to the bail-in, there is the potential for contagion to occur.

As the recent Swiss experience has demonstrated, a bail-in is likely to sound the death-knell for a bank, rather than providing it with breathing space to continue operations and seek non-disruptive resolution of the problems which have led to the bail-in.

2. Design Issues

While I believe that AT1 instruments should be dropped as eligible regulatory capital, I make the following comments regarding problems with their current design (which should be rectified if AT1 instruments continue to be used as regulatory capital).

Uncertainty regarding bail-in trigger and consequences.

While there is a formal trigger event (a 5.125 per cent CET1 ratio) the regulator (APRA) has the power (and is likely) to apply a bail-in at its discretion at CET1 ratios above that. Moreover, which AT1 instruments and how many might be bailed-in is not prespecified. Also the resulting outcome in terms of the market value of common equity received is also uncertain since it will depend on the equity market reaction to the bail-in announcement (about which there is no historical evidence to determine the likely magnitude). Rather than bail-in being a calculable risk amenable to valuation techniques used to assess the risk premium required on financial instruments, it is an example of unknowable uncertainty. Consequently, it is impossible for investors to assess the “fair” risk premium involved in the pricing of such instruments. *For regulators to encourage the issuance of such complicated securities by banks seems, at best, inconsistent with good regulatory practice.*

² Although there is, in principle, no reason for insured depositors to “run”, a lack of knowledge about the Financial Claims Scheme can prompt such reactions. This has been reflected several times in the last decade by groups protesting against the possibility of “bail-in” of depositors by the regulator.

While it might be argued that “the market” is able to assess an appropriate price (or distribution rate as a margin above the indicator rate used) there is no evidence that I am aware of that the prices are based on solid fundamentals – but rather on what the general consensus believes appropriate.³ Were the market prices based on sound foundations, the regulator might be able to use movements in those prices as an indicator of a bank’s condition to assist in its regulatory oversight. In some preliminary research I undertook several years ago, there was no evidence that the market prices of AT1 instruments reflected usual measures of bank risk, and I am not aware of any recent such research. Rather the market prices may be subject to fads and fashion.

In that regard, it may well be that, if in some way they are under-priced, AT1 instruments are a cheaper form of regulatory capital for banks than is common equity. If so, such that AT1 investors are not receiving sufficiently high yields, regulators should ask why they are allowing such complex securities which are transferring wealth from AT1 investors to common equity-holders.

Alternatively, if in some way, “correctly priced”, it is not clear why AT1 should be regarded as cheaper funding than common equity. An AT1 instrument can be linked to common equity in the following way:
AT1 = Bank Share + Swap + uncertain bail-in event

Here the swap involves the AT1 investor giving up dividends and capital gains on the share in exchange for the distributions and principal repayment on the AT1.⁴ Unless either the swap or bail-in event are wrongly priced by investors (relative to the bank’s valuation, such that it sees the resulting terms as adding value for the bank) it is not clear why AT1 would provide cheaper financing than common equity.

The recent spate of share buybacks by Australian banks indicates that bank management believes that AT1 provides cheaper funding, indicating that they are exploiting an arbitrage opportunity created by regulatory requirements and inability of market participants to correctly assess the uncertainty involved.⁵
Why regulators aiming for banks to be “unquestionably strong” would wish to allow such substitution of core equity by lesser quality AT1 is unclear.

³ Some practitioners justify pricing of one bank’s AT1 instrument by “relative” pricing – ie relative to pricing of other bank AT1 instruments in the market. That, of course, cannot explain the “absolute” level of pricing.

⁴ For ease of exposition (without loss of generality) this assumes that the AT1 issue price is the same as the current share price, and that the bank exercises the option to redeem the AT1 after a specified time (as in practice they have done). The bank would issue an AT1 instrument rather than a share if the swap (which reflects the distribution rate demanded by investors) and the investor valuation of the bail-in event had a positive value to the bank.

⁵ The calculation of relative costs is complicated by a need to allow for inflation expectations. While nominal distributions on AT1 issues have increased in line with the bank bill rate used as a benchmark, expected real distributions need to be compared with the required real return demanded on equity.

Target Investor Market

Initially Australian bank AT1 issues were largely targeted at Australian retail investors with such investors attracted by franked distributions which were also high relative to low interest rates available on fixed term securities (such as bank term deposits). It is implausible that retail investors (or their advisers) are able to correctly assess and value the “bail-in” component in the security. (However, they may believe the possibility of bail-in is so close to zero as to be ignored, either because of belief in bank strength or that political considerations mean a bail-in will not occur).

While the introduction of Design and Distribution Obligations (DDOs) has meant that many retail investors are now precluded from subscribing to initial issues of AT1 securities, they are still able to purchase them on the listed ASX market. Also many “retail” investors (including SMSF’s) are able to obtain certification as “sophisticated” investors and participate in initial issues.

Because AT1 securities generally pay franked dividends, they have been attractive to Australian retail investors, and unattractive to foreign (institutional) investors who do not value the franking credits. The foreigners prefer the Tier 2 securities which pay unfranked distributions.

It is difficult (impossible) to imagine APRA not consulting the Australian Treasurer before doing a bail-in of a bank’s AT1 securities. And it is even more difficult to imagine the Treasurer being willing to have Australian retail investor holders of AT1 securities being bailed-in while foreign investors holding Tier 2 hybrids are not bailed in. The politics would prevent the bail-in regime from operating in the way it is designed to.

Political considerations mean that it is not credible to believe the bail-in arrangements would be able to operate as envisaged in theory and legislation. If nothing else, legislation to prevent AT1 securities from paying franked distributions could be expected to diminish retail investor interest (and marginally reduce this problem). While it might be argued that the possibility of bail-in and of a bank electing to convert AT1 into equity give the securities sufficient “equity-like” features to justify tax treatment as a form of equity and thus allow franking of distributions, that contention warrants challenge.

Behavioural Consequences of AT1 Securities

It can be argued that the existence of bail-in securities (used to keep capital ratios above APRA-minimum required levels) help to reduce risk of depositor (or other creditor) runs by the psychological effect of them providing a larger buffer to absorb losses. It could also be argued that AT1 investors may provide another source of market discipline on bank management (although there is not, to my knowledge, evidence indicating that market pricing of AT1 securities operates in that way).

But such behavioural effects could also be achieved by simply requiring higher levels of equity, and avoiding the question of whether bail-in will work when it is implemented.

Unsuitability for Mutual Banks

Any form of bail-in security is unsuited to mutual banks which are a small but important component of the Australian banking sector. Such banks have no tradeable equity into which AT1 securities could convert.

Mutuals can issue financial instruments which qualify as Mutual Equity Interests (MEIs) or which may convert to MEIs.⁶⁶ It is worth noting that APRA's APS 111 specifies that "issue documentation and marketing material do not indicate that the distribution rate will be a set amount, such as a specified margin above the bank bill swap rate applied to the face value of the instrument. That is, to appropriately reflect the equity nature of MEIs and the discretionary nature of all distributions, any reference to determining distributions by reference to a benchmark or index should be illustrative only." While distributions on AT1s issued by banks are discretionary, it would be interesting to know what proportion of AT1 investors are aware of, or understand, or believe it credible that distributions are discretionary and would differ from the specified margin over the reference rate.

While, in principle, mutual banks can issue tradeable instruments which can be counted as regulatory capital (provided they convert to MEIs if a point of non-viability is reached) few mutuals are able to issue financial instruments at a scale required by capital markets. To the extent that issue of AT1 instruments enables listed banks to economise on use of core (CET1) equity they may provide some competitive advantage over mutual banks (although currently different regulatory arrangements for large D-SIBs etc may counterbalance that).

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⁶⁶ Such MEIs will be regarded as a claim against the assets of the mutual should it become insolvent.