23 March 2016

Mr Pat Brennan
General Manager Policy Development
Australian Prudential Regulation Authority
Level 26
400 George Street
Sydney NSW 2000
By email adi.policy@apra.gov.au

Dear Pat

Amendments to Prudential Standard APS 110 Capital Adequacy and draft Prudential Practice Guide APG 110 Capital Buffers

The Australian Bankers’ Association (ABA) welcomes the opportunity to provide feedback on the draft Prudential Practice Guide APG 110 Capital Buffers (APG 110).

With the active participation of its members, 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 to ensure Australia’s banking customers continue to benefit from a stable, competitive and accessible banking industry.

In October 2015, the ABA provided feedback on the draft version of Prudential Standard APS 110 Capital Adequacy (APS 110), in particular the proposed amendment to the countercyclical capital buffer (CCyb) requirements which commenced on 1 January 2016. For completeness, the comments below should be read in conjunction with that previous submission1.

The ABA provides the following feedback in response to APRA’s proposed changes to APG 110.

Operation of constraints on capital distributions

While the primary focus of the revised APG 110 is to define the operation of the Capital Conservation Buffer (CCB), paragraph 41 Period of earnings introduces a revised definition of the period of earnings to be employed in the calculation of the Capital Conservation Ratio (CCR).

Currently, the period of earnings definition is based on footnote 5 to paragraph 36(c) Reductions in capital of APS 110 which states in part that a “Financial year means a period of 12 consecutive months covered by one or more sets of publicly available operating results preceding the date of the proposed payment of dividend or interest”. Paragraph 41 Period of earnings in APG 110 proposes instead that earnings be determined on a rolling 12-month basis “as close as practically possible, for the 12-month period immediately preceding the announcement of any distribution”.

The proposals as they stand give rise to three concerns:

1) Given the backward looking nature of the test there is limited flexibility with a >60 per cent payout ratio to prioritise an AT1 distribution once within the CCB creating the potential for undesirable market uncertainty regarding CCB-based distribution restrictions, as witnessed in Europe most recently.

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1 http://www.bankers.asn.au/Submissions/Prudential
2) Basing the test on a 12-month rolling period will further distort the CCR outcome under APRA’s backward testing of ‘capital distributions’. At a technical level, the problem is that ordinary dividends are paid in the half year after the period in which the earnings were generated. As an ADI’s earnings decline and the ADI then cuts ordinary dividends per share to maintain the same dividend payout ratio (DPOR), the effective DPOR for CCR purposes will increase due to this lag effect (see worked example later); and

3) Disclosure concerns.

The worked example below illustrates these concerns. An ADI with a DPOR of 60 per cent, faced with an earnings decline, cuts its dividend per ordinary share to maintain the 60 per cent target DPOR. However, APRA’s rolling 12-month earnings and payment test, result in the DPOR effectively increasing to 62.7 per cent when the dividend is paid 1 December 2015, and the ADI is prima facie ‘stopped’ on AT1 coupon payments. ADIs obviously stand ready to adjust their ordinary dividend payment as needed to satisfy the CCR requirements of the relevant CCB quartile, but the existing and proposed approaches to satisfying the CCR requirements are unnecessarily complex and make it difficult to do this in practice. Investors understand the risk on the ordinary dividends, but expect that AT1 distributions will be prioritised over ordinary dividends.

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The ABA welcomes APRA’s indication of a pragmatic approach in the exercise of CCB-based dividend-stopping provisions, but the recent volatility impacting Deutsche Bank illustrates that there is a high risk that investors will act upon market rumour and supposition rather than assuming supervisors will adopt a pragmatic outcome. Any concerns within financial markets can quickly escalate into declining market confidence and hence, appetite for the issuer’s capital and debt securities.

This is a risk that the Bank of England highlighted in a recent announcement when it drew attention to “uncertainty that distribution restrictions may create about … financial strength to the outside world”2. This is a risk that would be heightened for Australian banks given their lower numerical capital ratios than their international peers, due to APRA’s more stringent capital and risk-weighted asset requirements.

The ABA is concerned that the proposed approach to the calculation of the CCR is unduly complex and prone to unintended impacts that may impede the ability of banks to quickly rebuild capital buffers via the issue of new capital. The complexity of the operation of the CCR and CCB also appears to be at odds with the focus of the Basel Committee on Banking Supervision (BCBS) on simplicity and transparency.

The ABA therefore recommends that, at a minimum, ‘earnings’ for CCR purposes is aligned to the definition of ‘financial year’ as per Footnote 5 of paragraph 36(c) Reductions in capital in APS 110.

The ABA also recommends that APRA adopt a simpler, more intuitive profits test, consistent with the objectives of the BCBS framework, and also aligned with the test already adopted by comparable jurisdictions. In particular, the ABA recommends that the calculation of the CCR be based on distributions paid from the financial year to which they relate. This would mean that ordinary dividends, which are typically determined and paid after the close of the financial period on which they are based,

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would be backdated for the purposes of the CCR to align with the last day of that financial period. This would then be consistent with the existing paragraph 36 (c) in APS 110 for reductions in capital, which requires that a “Planned reduction in an ADI’s capital includes … the aggregate amount of dividend payments on ordinary shares that exceeds an ADI’s after-tax earnings after taking account of any payments on more senior capital instruments, in the financial year to which they relate”.

This will better align earnings and capital distribution payments, which principally are ordinary dividends.

**Disclosure concerns**

Additionally, ABA members have raised concerns that the requirement to determine earnings on a rolling 12-month basis would mean using an earnings period for capital constraints that is inconsistent with public disclosures, with the potential for non-disclosed P&L information to be ‘inferred’ from any CCB announcement should any constraints apply. This inconsistency also makes the calculation unnecessarily complex for ADIs to undertake and for investors to understand, when compared with an approach that is based on a full year or half year period (which is also subject to external audits, reviews and sign-off). It would be an unnecessary cost and regulatory burden for ADIs should such external audits/reviews be required for monthly P&L information or non-reporting full year or half year periods, for the sole purpose of accommodating the requirements that accompany any CCB announcement.

**Consistency of capital distributions**

Paragraph 3 in Attachment B *Constraints on capital distributions* of APS 110 states that ‘earnings’ are restated to be prior to the ‘capital distributions’ charges restricted by paragraph 28 *Capital conservation buffer* of APS 110. Such proposed treatment effectively results in an effective CCR pay-out ratio on these capital instruments being 100 per cent which further reduces the DPOR available for ordinary dividends. This gives rise to two questions of consistency of treatment as to capital distributions:

1) AT1 coupons for ‘debt’ classified AT1 are accrued to P&L and hence deducted from CET1 but ‘equity’ classified AT1 coupons are charged to CET1 only when paid. This treatment is inconsistent. The ABA considers these to be the same instrument under prudential standards and therefore considers that coupons should be treated consistently.

2) The adding back to earnings of capital distributions is presumably on the basis that the payments are discretionary and hence can be avoided. Paragraph 42 *Period of constraints* of APG 110 requires the ADI to calculate the CET1 ratio at each payment date.

The ABA requests that APRA, when finalising APG 110, clarifies that capital distributions accrued through the P&L but unpaid, should be added back to ‘earnings’ and hence the CET1 capital ratio before assessing the CCB triggers and treatment.

**Bonus payments**

Paragraph 28 *Capital Conservation buffer* in APS110 requires ‘distributions’ that affect CET1 only be considered for CCB purposes, and sub-paragraph 28(c) refers to discretionary bonus payments. Share-base payments only affect CET1 if the shares are purchased on market to settle the obligation. Whilst share-base payments create CET1/P&L charges for accrued share-based expense, there is an offsetting credit to CET1 via paragraph 25(b) of APS 111 *Capital Adequacy: Measurement of Capital*. There is a net CET1 charge only if the shares are purchased on market.
The ABA requests that APRA expand the final APG 110 to confirm, for CCB purposes:

1) Share-based P&L accruals should be reversed for CCB for the purpose of quantifying 'earnings'; and

2) ‘Capital distribution’ payments to purchase the ADI’s equity to settle share-based payments falling due, need only relate to the P&L write back to earnings (see above) given the value of the shares purchased may represent several years of P&L accrual charges.

Application of a materiality threshold for detailed disclosure of CCyB

The ABA accepts the need for each ADI to monitor their exposures and CCyB in offshore jurisdictions. The ABA requests that APRA give consideration to the application of a materiality threshold to the detailed disclosure of the CCyB.

ABA members seek this materiality threshold for offshore CCyB announcements applying to an Australian ADI’s Level 1 or Level 2 CCyB calculation to avoid a costly regulatory burden given the resourcing needed to calculate immaterial CCyB requirements to meet external disclosure standards.

Internal assessments by ABA members of their exposure to CCyB jurisdictions reveals that the ADI specific buffer for some jurisdictions (i.e. the jurisdictional CCyB multiplied by the jurisdictional weight) is so small that the percentage buffer needs to be displayed to 6 decimal places (1 ten thousandth of a basis point) to show any value in some of the cells.

ADIs will monitor exposures and CCyB in offshore jurisdictions. However, the ABA proposes that in the final APG 110 a materiality threshold be defined. This definition, when applied, would have the effect that the quantitative disclosure specified in paragraph 2 of Attachment A, Capital disclosure template, in APS 330 is not required when the aggregate CCyB is below the materiality threshold.

Alternatively, the draft APG 110 could be updated to include explicit confirmation that the materiality provisions of paragraph 55 Materiality in APS 330 be utilised by ADIs in assessing whether the quantitative disclosure should be included.

The ABA notes that there is a precedent in the application of materiality thresholds. The European Banking Authority’s materiality threshold for foreign credit exposures is 2 per cent of group RWA3 before the offshore CCyB had to be incorporated in European banks’ calculations.

Jurisdictional reciprocity

The ABA would welcome guidance from APRA on how ADIs should treat the CCyB requirements of foreign jurisdictions where they differ to the ‘standard’ Basel requirements. For example, Part A, paragraph 15 of the Draft APG 110 states that it is not mandatory to apply CCyB to a sub-set of private exposures with an example of a buffer applying only to housing loans. However, we believe that this guidance could be expanded.

Using the Swedish jurisdiction to illustrate the issue:

The current Swedish CCyB jurisdictional buffer is set at 1 per cent with 1.5 per cent to be applied from 27 June 2015. This is higher than the Basel transitional arrangement of 0.625 per cent in January 2016 (increasing by 0.625 per cent each subsequent January up to 2.5 per cent). In the Basel FAQs on CCyB4, it is stated that the mandatory reciprocity arrangements will not apply should the host jurisdiction accelerate the phase-in unless the home authority is of the view that this should be followed.

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3 European Banking Authority Guideline:

4 Basel Committee on Banking Supervision: Frequently asked questions on the Basel III Countercyclical Capital Buffer
http://www.bis.org/bcbs/publ/d339.pdf
The ABA is unsure if APRA is of the view that the higher Swedish jurisdictional buffer percentage for CCyB (if in scope) is to be followed, as the draft APG 110 is silent on this. The ABA’s understanding is that the definition of relevant exposures under Swedish regulations is corporate and household exposures. Although this should form the majority of private exposures per the APRA/BCBS definition, the ABA is unsure if the definitions are exactly the same and would welcome further clarification.

The ABA is concerned that there is no mention in the Swedish regulations on those trading book specific elements that form private exposure (specific risk, incremental risk, securitisation etc.).

Given the above example, the ABA is unsure if the definition of exposures under the Swedish regulations should fall under the exemption in Part A, paragraph 15 of APG 110. Further, APRA’s guidance will ensure all ADI’s have a consistent interpretation to the operation of CCyB in other jurisdictions, therefore avoiding inconsistency in the application of the reciprocity provisions.

As such, and reiterating the comment from our October 2015 submission on modifications to APS 110, the ABA recommends that APRA should inform ADIs:

1) Whether or not to implement the CCyB requirements of offshore jurisdictions, and

2) Should there be accelerated phase-in by offshore regulators, whether APRA requires ADIs to adopt the accelerated phase-in or follow the Basel transitional path.

Given that the Pillar III disclosures date of 31 March approaches, industry would appreciate an early decision on the CCyB issues raised in this section.

Minor clarifications

Paragraphs 15 and 21 in APG 110 make reference to certain determinations in respect to offshore CCyB not being relevant to the Level 2 consolidated ADI calculation. The ABA seeks to understand why the same determinations should not also apply at Level 1 where the ADI operates in those jurisdictions via branch operations.

Conclusion

Given the complexity surrounding the operations of the CCB constraints, the ABA and members would welcome a meeting with APRA at the earliest opportunity to discuss the above comments and for members to demonstrate the operation of CCB regulations using a number of other potential payment and capital scenarios in response to different types of fast moving economic events impacting earnings and the likely market consequences.

Thank you for taking our comments into consideration, the ABA is happy to facilitate the above meeting at APRA’s earliest convenience.

Yours sincerely

Aidan O'Shaughnessy
Policy Director - Industry Policy
Aidan.O'Shaughnessy@bankers.asn.au

5 Decision regarding the countercyclical buffer rate