AUSTRALIAN BANKERS' ASSOCIATION INC.

Tony Burke
Policy Director

AUSTRALIAN BANKERS' ASSOCIATION INC.
Level 3, 56 Pitt Street, Sydney NSW 2000
p. +61 (0)2 8298 Ext **f.** +61 (0)2 8298 0402

www.bankers.asn.au

31 May 2012

Mr Neil Grummitt
General Manager, Policy Development
Policy, Research and Statistics
Australian Prudential Regulation Authority
GPO Box 9836
Sydney NSW 2001

Dear Neil,

Basel III Capital Reforms: response paper and draft prudential standards

Please find attached the ABA submission on APRA's on *Basel III Capital Reforms: response paper and draft prudential standards*.

Yours sincerely,

Tony Burke

Submission on Basel III Capital Reforms: response paper and draft prudential standards

Tony Burke

Policy Director

31 May 2012

Contents

1. Introduction

The Australian Bankers' Association (ABA) appreciates the opportunity to comment on APRA's response paper and draft prudential standards. The ABA and its member banks also appreciate APRA's ongoing willingness to engage with industry on these matters. Continued open engagement between APRA and industry is important to ensure an optimal outcome is reached, especially as the new Basel III standards are proposed to be implemented on an accelerated basis in Australia. The ABA provides the following comments for consideration by APRA.

2. Integrated Approach

The ABA's submission dated 9 December 2011 to APRA's September 2011 Discussion Paper titled "Implementing the Basel III capital reforms in Australia" highlighted that the ABA believes that APRA should adopt the Basel Committee's reforms as drafted, fully aligning the calculation of capital ratios both with respect to the numerator and denominator.

While the ABA continues to stand by this belief, we understand that APRA is unlikely to adopt international harmonisation. APRA has stated the use of the proposed Basel Committee disclosure template will resolve comparability issues.

However, the ABA has a number of concerns about the disclosure template, as well as the timing for implementing the various pieces of the Basel III changes and other regulatory reforms APRA is currently undertaking.

2.1. Disclosure template to address harmonisation concerns

In its Response to Submissions dated 30 March 2012, APRA states that the disclosure template proposed by the Basel Committee in December 2011 will address industry's concerns about international comparability and creating a level playing field, particularly in relation to raising funding. The ABA does not believe this to be the case. While the proposed Basel Committee disclosure template attempts to enable market participants to compare the capital adequacy of banks across jurisdictions, it focuses on a detailed reconciliation of capital calculations (based on national regulatory capital rules) with the financial statements of the relevant bank and does not require comparable capital ratios to be calculated on an internationally harmonised basis.

In industry meetings, APRA has suggested that the Basel Committee template will enable analysts to do further work to calculate comparable ratios. Based on the experience of ABA members, it is unlikely that analysts and investors will either have the detailed understanding of the respective regulatory standards or the time and resources commitment to do so. As a result, they will most likely make their investment decisions based upon the bank's locally reported numbers, which will disadvantage Australian ADIs.

This point is well exemplified in the following extract from an international report by RBS dated 24 May 2012[1], commenting on the Australian banks and making the following comment on capital (with no further analysis):

> *"**Australian banks are less capitalised relative to peers.** All four of the major commercial Australian banks fall below the 9% Core Tier 1 threshold, as required of European banks. The Australian regulator, APRA, is more stringent on capital ratios, making direct comparisons with overseas banks difficult. However, capital ratios appear to be lower than banks in northern Europe or the US. We believe that in order to be competitive in international funding markets, all four commercial banks will likely need to keep capital ratios at similar levels to these banks."*

It would be helpful if APRA could assist Australian ADIs in achieving a disclosure outcome which requires the calculation and disclosure of capital ratios based upon a global standard, thereby creating transparency of capitalisation and a level playing field.

2.2. Timing of implementation

APRA is currently undertaking an ambitious set of regulatory reforms that impact ADIs and conglomerate groups. In addition to the Basel III capital reforms to which the draft standards released on 30 March 2012 relate, APRA is also undertaking the following regulatory reforms:

---

[1] The Revolver, RBS Macro Credit Research, 24 May 2012, page 7.

- Counterparty Credit Risk reforms under Basel III;
- Basel III disclosure requirements;
- Liquidity reforms under Basel III;
- Review of Operational Risk Capital;
- Introduction of Recovery and Resolution Plans ("Living Wills") for Australian ADIs;
- Global framework for Systematic Important Financial Institutions (SIFIs) and interconnected risk;
- Domestic-SIFI (D-SIFI) requirements;
- Changes to APS 221 and APS 222 limits;
- Insurance capital reforms (LAGIC);
- Superannuation reforms; and
- Level 3 ("Conglomerates") supervision.

At the ADI level, most of these reforms involve the same Treasury, Risk, Finance and IT professionals, who also have business as usual roles. The impact of having a similar implementation timetable for many of the reforms is significant, particularly where there are delays in the release of draft and final standards. It is the ABA's view that APRA needs to ensure it takes a coordinated and realistic approach to implementing these reforms to ensure both APRA and the industry are able to properly implement each reform without significant implications on the day-to-day operation of the affected entities and APRA.

Counterparty credit risk

In particular, while the changes to counterparty credit risk are scheduled for implementation on 1 January 2013, APRA is yet to provide draft regulations in relation to these changes. The ABA understands that APRA is waiting for further clarity from the Basel Committee on this component of the reforms. However, given the systems changes that will be required to implement these changes and the significant impact they could also have on the levels of capital required to be held, details of the changes to counterparty credit risk are required as a matter of urgency.

The industry is currently proceeding on the assumption that the final requirements are in line with the Basel Committee's current published approach. If the final requirements are materially different, the implementation date for this component of the reforms will need to be deferred.

APS 221 and APS 222 limits

APRA has previously flagged to the industry that it is considering changes to existing related party exposure limits contained within APS 221 and APS 222. The ABA understands that APRA is waiting on further guidance from the Basel Committee on large exposures and will not be reviewing these limits until 2013.

APRA should recognise the impact any changes to these limits will have on Australian ADIs and their subsidiaries, and the inter-connection of these limits with the capital standards that are proposed for Level 1 capital. The ABA encourages APRA to discuss its proposals with the individual ADIs impacted. If material changes are made to the existing limits, or limits are effectively reduced through higher Level 1 capital deductions, then significant transition periods may be required to allow sufficient time for the orderly restructuring of existing subsidiaries.

D-SIFIs

While no Australian ADIs have presently been designated as Globally Systemically Important Financial Institutions (G-SIFIs), a number of Australian ADIs will possibly qualify as D-SIFIs.

The ABA notes that Australian ADIs that are "more systemic" are already subject to significant additional supervision than less systemic institutions, through APRA's SOARS and PAIRS systems which provides APRA with the flexibility to increase minimum capital levels through the PCR framework.

To date APRA has not proposed to apply additional capital requirements on D-SIFIs outside the existing framework, however the ABA notes the recent report from the Financial Stability Board (FSB)[2], which indicates the

[2] Progress Report to G-20 Ministers and Governors, Extending the G-SIFI Framework to domestic systemically important banks, 16 April 2012.

Basel Committee and FSB will be developing a D-SIFI framework for submission to the G-20 Ministers and Governors Meeting in November 2012.

The ABA would be concerned if this resulted in a change to APRA's current approach to addressing D-SIFI risk and resulted in additional capital requirements on D-SIFIs, especially given APRA's already conservative approach to capital deductions and risk setting in various areas compared to 'vanilla' Basel regulations that are expected to be adopted by other jurisdictions.

3. Securities

Background:

APRA has proposed the following conservative overlays to the Basel Committee's proposed Basel III requirements as to the terms and conditions required for an Additional Tier 1 or Tier 2 securities:

1. **Profits Test (APS 110 "Capital Adequacy", Paragraph 34):** APRA's proposed annual current year profits test for the payment on all Additional Tier 1 and Tier 2 securities' coupons – the Basel Committee has no such requirement as it relies solely on the Capital Conservation Buffer restrictions based upon capital ratio triggers. Rating agency Standard and Poor's (S&P) has indicated APRA's profit test will result in the securities being 'notched' an additional credit rating level, which will ultimately adversely affect investors' appetite and pricing for the securities against like securities issued by international peers.
2. **Banking Act Restrictions as to Preference Shares (Banking Act Sec 14(aa):** The Banking Act currently allows an APRA appointed administrator to change the terms and conditions of any preference share issued by the ADI including to cancel, sell or vary the terms. APRA's new non-viability provisions and loss absorbency requirements basically pre-empt and, to a degree, duplicate these requirements and make them obsolete. By retaining these requirements APRA creates the perception of a further risk for investors that may adversely affect their appetite and pricing of the security. The provision also creates an arbitrary inconsistency in the requirements and risk of an Additional Tier 1 instrument constructed as a preference share to that constructed as a legal form debenture or note.
3. **Dilution Floor of 20% (APS 111, Attachment E ("Loss Absorbance") Paragraph 8(e) and Attachment I ("Non-viability") Paragraph 16(c)):** APRA has proposed a dilution floor, for any Additional Tier 1 or Tier 2 security that converts to ordinary shares, based upon a minimum conversion price set at 20% of the ADI's ordinary share price at the date of issue of the Additional Tier 1 or Tier 2 security, whereas Basel does not prescribe any dilution floor.

   Further, APRA has proposed that the conversion price floor will only be adjusted for "ordinary share splits and bonus issues". This diverges from standard capital markets precedents, which allow for various capital structure adjustments such as adjustments for discounted rights issues (refer Credit Suisse security) recognising that Additional Tier 1 and Tier 2 investors should not be exposed to equity risk created by the ADI's actions in normal circumstances, rather they should only be exposed to those that arise from the non-viability of the ADI.
4. **Two Year Cash Call Moratorium (APS 111, Attachment D ("Additional Tier 1") Paragraph 5 and Attachment G ("Tier 2") Paragraph 1(f))):** The Basel Committee prescribes that Additional Tier 1 and Tier 2 securities not include an incentive to redeem. Guidance from Basel indicates that an issuer call right concurrent with a conversion date will be deemed to be an incentive to redeem, but that multiple call dates do not create an incentive to redeem given that risk of an issuer calling on a specific date is lessened by the availability of multiple call dates.

   Further, APRA is proposing to extend the limitation on call dates to a two year period either side of the conversion date. The cash call moratorium period will adversely affect the ADI's ability to manage its capital in normal circumstances given the potential ordinary share overhang and potential dilution risk from the conversion of the Additional Tier 1 or Tier 2 security (at a discount to market value), adversely affecting any ordinary share raising during the two year moratorium period. It also creates a greater focus by the market on the last cash date. There is a risk that traditional fixed income investors exit after the passing of the last call date due to the increased risk of them receiving equities, thereby potentially causing some disruption to the orderly trading in the ADI's Additional Tier 1 and Tier 2 securities.

5. **Permanent Write Down (APS 111, Attachment E ("Loss Absorbance") Paragraph 1(b) and Attachment I ("Non-viability") Paragraph 1(b)):** While APRA's proposal is consistent with the Basel III requirements, other global regulators, particularly the European Commission in CRD IV, are discussing the option to have Additional Tier 1 and Tier 2 securities written up upon recovery of the stressed financial institution. ABA member discussions with Additional Tier 1 and Tier 2 investors to date have indicated a strong preference for a write down/write up structure, with significant differences in price and volume achievable. Should this structure be permitted by overseas regulators, Australian issuers would be materially disadvantaged when competing in the global and domestic financial markets for access to these capital resources.
6. **Combined Effect of APRA Superequivalence when related to the Liability Loss Absorption Requirements***:* The combined effect of APRA's conservative approach to implementing Basel III requirements in Australia for most Australian ADIs has been to reduce Common Equity Tier 1 ratio by the order of 2%. However, the requirements of APS111 Attachment E, consistent with the Basel Committee standards, place a floor at 5.125% of Common Equity Tier 1 for conversion or write down. In this regard, APRA's conservatism creates a clear penalty on Australian issuers when compared to international counterparts due to the reduced Common Equity Tier 1 buffer. This impact is also recognised in S&P's rating methodology for hybrids, likely leading to an additional rating notch deduction for an Australian hybrid, when compared to an international peer that is similarly capitalised.

Issues:

The ABA is concerned that while the conservative overlays proposed by APRA to the Basel Committees' regulations (announced in December 2010) may not be material when considered individually, collectively they may have a material impact on the ability of Australian ADIs to raise capital in the global financial markets or to effectively manage the capital structure.

The difficulty in assessing the potential impact on Australian ADIs of APRA's conservative overlays is that there has been limited issuance of Basel III compliant Additional Tier 1 and Tier 2 given that very few of the major regulators globally have issued draft Basel III capital securities regulations. However, comparing APRA regulations to draft regulations issued by European and Canadian regulators, the ABA notes the following divergences:

- Canadian regulations
  - No Profits Test
  - A limit on the number of shares that maybe issued, but the dilution floor is not specified. It is however noted that caps of ~4% have been observed in OSFI approved transactions.
  - No restriction on timing of cash call other than it cannot be concurrent with the conversion date
- European (CRD IV) regulations
  - No Profits Test
  - Conversion to ordinary shares is permitted but no cap is specified. It is however noted that a 50% floor was included in the Credit Suisse security, which the ABA understands was a Swiss Securities Law issue and not a prudential requirement. The ABA also notes that the floor price was adjusted for other adjustments to the capital structure including discounted rights issues.
  - No restriction on timing of cash call other than it cannot be concurrent with the conversion date
  - Write down and write up structures are permitted

However, the ABA does note that the profits test will result in Australian ADI securities receiving an additional credit notch downgrade and a hybrid issued as a liability would receive a further notch downgrade (compared to a similarly capitalised international peer), which will impact on pricing and volume. The exact impact will vary from ADI to ADI depending upon their credit grading but, based upon the four major trading banks Additional Tier 1 securities will be rated BBB- and not BBB+, which would be expected to have a modest impact on liquidity and pricing. The effect is more substantial for smaller issuers, where these impacts imply that Additional Tier 1 securities will be unable to gain investment grade ratings. If the current strong level of credit ratings within the Australian banking system were not maintained this larger impact would also apply to the major trading banks.

Further, the restriction around the no cash calls within two years either side of a conversion date will potentially adversely affect the ability of an ADI to effectively manage its capital base over that period. Should the ADI require additional Common Equity Tier1 Capital during that period, global equity investors will be concerned about the uncertainty caused by the ordinary share overhang and the potential dilution impact (where the Additional Tier 1 security is converted at a discount to market price) on existing shareholders at the date the Additional Tier 1 security converts. A cash call on the Additional Tier 1 security would permit the ADI to remove this uncertainty and raise the required Common Equity Tier 1 capital in a transparent and effective manner.

Action:

The ABA suggests, for APRA's consideration, the following changes to improve market access and capital management flexibility for Australian ADIs:

1. Market price used for the 20% dilution floor pricing should be adjusted to reflect other capital structure adjustments such as discounted rights issues, in a similar manner to other capital markets instruments;
2. Remove the explicit profit test requirement for Additional Tier 1 and Tier 2;
3. Multiple cash call dates for the ADI up to within six months of the conversion date (both pre and post the conversion date);
4. Consider write up structures should they be permitted by major overseas regulators; and
5. Confirm that the assessment of a security's qualifying as Additional Tier 1 is made at the point of issue only, and that subsequent changes to accounting standards or regulatory interpretation (absent specific changes to APRA standards) would not impact eligibility of an issued instrument.

4. Securities tax haircuts

The inclusion of the requirement to account for potential taxation liabilities at the time of issuance will make the instruments uneconomical. The regulatory capital benefit of utilising an Additional Tier 1 and Tier 2 capital instrument will be significantly reduced as a result of this requirement, to address what is a remote event that an ADI is 'non-viable', but is not stressed enough that it could not be recovered through the conversion of its Additional Tier 1 and Tier 2 securities and other capital initiatives.

4.1. Potential tax haircut

Potential deferred tax liability should be interpreted in accordance with the recognition rules of accounting standards on deferred tax "AAS 112". This standard states that there is no potential tax liability unless a trigger event has occurred, that is, there is no potential tax liability recognised on a going concern basis.

On this basis, and assuming no trigger event has occurred at the time, there would be no requirement for up front recognition of a potential deferred tax liability, allowing instruments to be counted at 100% of their face value.

Despite whether or not conventional accounting standards can be used, APRA should permit an ADI to:

- Take into account the net tax payable position, after considering highly likely offsets that would be occurring at the time of converting the Additional Tier 1 and/or Tier 2 security due to either a non-viability or the ADI breaching Common Equity Tier 1 capital ratio of 5.125%, in forming an assessment of any 'tax discounting' required up front:
    - The likelihood of significant tax offsets at the time of an ADI being deemed non viable is extremely high, given that the ADI would have had to suffer significant operating losses to be 'capital stressed' to the point of non-viability. As an example, for the four major ADIs, each with RWA of ~$300 billion:
        - A circa 300bps decline in Common Equity Tier 1 ratio is ~$9 billion of Common Equity Tier 1 capital, which would imply an operating loss of $6 billion to $7 billion, allowing for some RWA increase due to credit migration.
        - Additional Tier 1 conversion unlikely to give rise to any tax liabilities, through either:
            - the Additional Tier 1 terms providing for conversion to ordinary shares and hence there being no or limited 'debt forgiveness'; or,

        - the Additional Tier 1 instrument being considered an equity instrument of the ADI and hence any 'debt forgiveness' would not be taxable.
      - Assume the ADI is operating Tier 2 volumes broadly in line with Basel's capital minimums, that is 200bps being the difference in Total Capital of 8% and Tier 1 of 6%, the operating losses would broadly shelter from tax any taxable gain on write down of the Tier 2 portfolio.
    - In relation to the loss absorbency trigger, it should be noted that the ADI is only required to convert sufficient Additional Tier 1 or Tier 2 securities for the ADI to restore the Common Equity Tier 1 ratio to 5.125% (APS 111, Attachment E, Paragraph 4), so the conversion rate is likely to be lower under this breach than the non-viability breach discussed above.
    - Further, it is noted that the APS requirements are not static, and require periodic review of the potential tax effect (APS 111 Attachment I Paragraph 2, and Attachment E Paragraph 3), which would allow for adjustments to the ADI's capitalisation and Additional Tier 1/Tier 2 portfolio to be considered.
- Also, the ABA submits that the ADI should not have to consider the tax consequences of the fail-safe embedded write off provisions for convertible securities given the fail-safe provision is included to cover unforeseen circumstances (APS 111, Attachment E Paragraph 6, Attachment I Paragraph 14).

As stated above, the impact of up-front recognition will be costly. The amount that would be 'haircut' from the value applied to the capital instrument would represent very expensive funding. This would effectively add approximately 50 bps per annum to the cost of issuance[3]. Assuming a transaction size of $1.0 billion over a minimum period of 5 years, this would create an addition cost of approx $25 million for this instrument.

As a result of the increased cost, offshore banks may have a significant competitive advantage over Australian banks, depending on their tax treatment. The ABA believes that there should not be a reliance on Australian legislators to make the necessary changes in a timely fashion. The ABA therefore proposes that the issue relating to potential deferred tax liability be resolved within the APRA standards.

4.2. Multiple 'haircuts' for subsidiary issued Additional Tier 1 and Tier 2

Background:

Tier 1 and Tier 2 securities outstanding at 1 January 2013 issued by banking subsidiaries of an ADI, that may count at Level 2, are subject to the following reductions:

1. APS 160 "Basel III Transitional Arrangements" Paragraph 12, will be amortised at 20% per annum, commencing at 80% on 1 January 2014 for both Tier 1 and Tier 2 securities; and,
2. APS 111 "Measurement of Capital", Attachment C ("Minority Interest") Paragraph 6 (Tier 1) and Paragraph 7 (Tier 2) respectively, which reduce the amount of eligible Tier 1 and Tier 2 capital at Level 2 where the banking subsidiary is capitalised in excess of the aggregate of the Level 2 PCR and Capital Conservation Buffer of the parent ADI.

Further, APS 110 "Capital Adequacy" Paragraph 24 establishes that at Level 2, the Capital Conservation Buffer (and similar capital buffers) will only formally be applied to Common Equity Tier 1 capital. However, APS 111 Paragraph 26 indirectly applies the Capital Conservation Buffer to Tier 1 and Total Capital by disallowing Common Equity Tier 1 used to meet Tier 1 and Total Capital PCRs, from being eligible to count towards the Capital Conservation Buffer.

Issues:

1. Multiple 'reductions' in Tier 1 and Tier 2 securities issued by subsidiaries

APRA's March 2012 draft Prudential Standards do not prescribe how these two restrictions interact with each other. Set out in Appendix A is a simple example to illustrate the issue, where a banking subsidiary that is capitalised at 11.67% for Total Capital, having issued $400 million of external Tier 2 securities, and the ADI has

[3] Capital instruments price at around 150 to 200bps wider than normal senior funding. Assuming a 30% haircut to the capital instrument, this equates to an increased margin of approx 50bps pa.

Level 2 'minimum' prudential requirement of 10.5% (PCR 8.0% plus 2.5% Capital Conservation Buffer), than at 1 January 2014, having:

1. An APS 160 reduction of $80 million (being 20% of $400 million); and,
2. An APS 111 reduction of $40 million (calculated in accordance with Paragraph 7(a) of Attachment C).

The ABA submits that the APS 160 and APS 111 reductions should not be additive (i.e. $120 million) rather the reduction should be the higher of the APS 160 and APS 111 calculations, i.e. $80 million, on the basis that an additive reduction approach is excessive.

2. Inconsistency between APS 110 and APS 111 as to Capital Conservation Buffer

APS 111 Attachment C ("Minority Interest") calculation is based upon the excess capital over the capital required to meet the PCR and Capital Conservation Buffer, based upon Level 2 settings. However, APS 110, Paragraph 24, only formally applies the Capital Conservation Buffer to Common Equity Tier 1. This is also inconsistent with Attachment C Paragraph 6 and Paragraph 7 which clearly contemplates a Capital Conservation Buffer would be included in the calculations.

3. The ABA notes the following anomaly in the wording contained in Attachment C for APRA's review and clarification:

- Footnotes 31, 32 and 33 should refer to APS 110 Paragraph 22(a)(b)(c) and not 21(a)(b)(c).

Action:

1. The ABA recommends that APRA amend APS 160 Paragraph 12 to identify that a reduction under Table 2 is only required where that calculation exceeds the calculation under APS 111 Attachment C for the corresponding class of capital.

2. The ABA also recommends that APRA reviews the interaction of APS 110 Paragraph 24 and 26, and APS 111 Attachment C Paragraph 6 and 7 as to the application of the Capital Conservation Buffer at Level 2 as to Tier 1 and Total Capital.

5. ADI margin lending

In its Response to Submissions APRA states "The Basel III criteria for Common Equity Tier 1 Capital exclude shares that have been directly or indirectly funded by the ADI. This includes holdings of the ADI's shares by retail margin loan customers and other borrowers from the ADI involved in share market investing. APRA is adopting this exclusion" (page 16).

Neither Draft APS 111 nor the Basel Committee[4] explicitly mentions shares held by retail margin lending customers.

The ABA does not believe it is appropriate for shares held by retail margin lending customers to be excluded from Common Equity.

Margin lending involves customers borrowing money from an ADI and posting shares and/or managed funds as collateral. The amount that can be borrowed depends on the type and diversification of the collateral provided by the customer, but is typically between 40% and 75% of the value of the collateral. Customers are incentivised to provide diversified portfolios of stocks as collateral to improve their LVR limit.

As a result, margin lending customers typically have a diversified portfolio of stocks held as collateral under their margin lending account. In most cases customers margin loan accounts will also be over collateralised.

In addition to these safe guards for margin lending providers, Australian bankruptcy laws permit the outstanding borrowings to be recovered from the general resources of the borrowers and not just the pledged collateral.

APRA has also proposed to require indirect holdings in ADI securities outside of an ADI's margin lending business to be deducted from capital. This requirement is of concern to the ABA as the practicalities of capturing this level of information questions the cost to implement these changes and whether there is expected to be a material benefit from making such changes. Industry is not yet in a position to satisfy current requirements. If APRA were to proceed with this requirement (an approach which the ABA believes the benefits will be immaterial and exceed the

[4] Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010 (rev June 2011).

costs of compliance) industry would need time to make the necessary changes to capture the specific information required.

As a result, the ABA believes consideration should be given to delaying implementation of this requirement until the Basel Committee has provided further guidance on its intent in this area. The ABA believes there are a number of alternatives that require consideration; one example could be to set the value of the ADI's shares to zero in determining collateralisation and requiring any resulting amount of under-collateralisation to be treated as unsecured for the purpose of determining risk weighted assets. Industry recommends further consultation to agree a more appropriate approach.

Should APRA maintain that a CET1 deduction is required, the ABA requests that APRA engage with the ABA as to how that CET1 deduction is to be calculated given the lending arrangements include over-collateralisation requirements and diversified portfolios that most customers provide as collateral.

6. Non-viability guidance

The ABA requests APRA's assistance in developing guidance for investors in relation to non-viability (either an APRA statement or standard disclosure) which can be used in prospectuses.

The ABA suggests an approach that balances an element of guidance and clarity for investors without being overly prescriptive. This can be achieved through a similar level of guidance provided from the Office of Financial Institutions ("OSFI") in Canada. In August 2011, the OSFI released a notice "Non-viability Contingent Capital" which outlined (in section 4) criteria to be considered in triggering conversion of capital instruments. A similar list could be determined by APRA that outlines, in its view, a list of potential situations where it would regard an ADI as non-viable.

In addition, Section 1 of the notice (Principle 3) outlines trigger events that must be included in all contractual terms of all Additional Tier 1 and Additional Tier 2 capital instruments. This clarity would also be of benefit to Australian issuers of Additional Tier 1 and Additional Tier 2.

The ABA has included with this submission an example of the guidance and presentations that OSFI has provided to the market. Additionally, industry provides the attached suggested disclosure (below) for consideration by APRA.

110816 advisory (non-viability trigger)	110816 letter from OFSI (non-viability tri	110914 OFSI presentation (non-via	111028 OFSI presentation (non-via	ABA-#110341-v6-Non-viability_disclosure.

7. Capital management (in)efficiencies

The ABA suggests that standards should not be overly prescriptive as this may lead to restrictive practices, for example:

- Consistency of "Earnings" definition
  For the Capital Conservation Buffer, APS 110 Attachment B-14, Paragraph 3 defines earnings as "distributable profits" net of tax and before "distributable items" (i.e. dividends and share buybacks, discretionary payments on Additional Tier 1 and discretionary bonus payments to staff).
  For the Payments Test, APS 110-10 Paragraph 34 (d) defines earnings as "after-tax earnings after taking into account any payments made on more senior capital instruments, calculated before any such payments are applied in the financial year to which they relate".
  It is the ABA's view that these definitions should be aligned to avoid complexity and the potential for conflicting signals on Additional Tier 1 and Tier 2 coupon payments.
- Non-viability requirements and the impact on other APRA standards such as APS 222
  The ABA recommends APRA consider the downstream impacts of these reforms and makes the necessary adjustments to existing policies to ensure they work together to avoid creating constraints. The Basel Committee's non-viability requirements may result in Australian parent ADIs being more inclined to issue Additional Tier 1 and Tier 2 securities themselves rather than through offshore subsidiaries, and subsequently down streaming this capital to subsidiaries as internal Additional Tier 1 and Tier 2 securities. This would conflict with APRAs current thinking on APS 222 limits which are likely to reduce. The ABA

recommends that APRA consider these secondary impacts and consider engaging with industry around APS 222 changes once the full impacts of Basel III are clearly understood.

Additionally, to allow for the efficient management of existing securities, the ABA suggests that the drafting in APS 111, Attachment D: Criteria for inclusion in Additional Tier 1 Capital, Paragraph 6, “Calling an instrument and replacing it with an instrument with a higher credit spread or that is otherwise more expensive will constitute an incentive to redeem on other outstanding Additional Tier 1 instruments with call options...”, be aligned with the Basel Committee’s rules. It remains unclear to industry under what circumstances APRA would not consider an increase in the spread or cost of a new Tier 1 capital instrument to be an incentive to redeem on other outstanding instruments. Industry maintains that there are legitimate circumstances under which an ADI may want to call an instrument. An example of this could be replacing 10 year instrument with a 20 years instrument which, although more expensive in the short-term, is expected to be cheaper in the long-term and/or forms part of an ADI’s wider liquidity/funding management.

Please find attached:

Appendix A: Other issues

Appendix B: Items confirming APRA’s positions

Appendix C: Calculation of multiple reductions to Subsidiary Transitional Tier 1 and Tier 2

Appendix D: Base Amount of foreign currency denominated capital instruments accounted for as equity

Appendix A – Other issues

1. Securities

1.1. Subsidiary non-equity capital (Additional Tier 1 and Tier 2)

While recognising that the RBNZ is not bound to follow APRA's lead, there would be significant process efficiencies if the two authorities were able to agree on a consistent approach to the issuance of non-equity capital by subsidiaries. As a general rule, the ABA believes that two entities should be able to issue the same mix of Common Equity Tier 1, Additional Tier 1 and Tier 2, irrespective of whether they are or are not a subsidiary of an ADI. The Basel Committee appears to have accepted this principle via the introduction of a "corresponding deduction approach" to investments in wealth and insurance subsidiaries. To facilitate the application of the principle more broadly, the ABA recommends that APRA's proposals be drafted in a way which supports subsidiaries being able to raise non-equity capital in their own name.

Furthermore, there is a market for New Zealand bank Additional Tier 1 and Tier 2 capital. Accessing this market would allow diversification of sources of capital both for those businesses and for the ADI groups.

1.2. Non-viability for securities issued by subsidiaries

Background:

APS 111 "Measurement of Capital" Attachment I ("Loss Absorbency") Paragraph 4 (non-banking subsidiary) and Paragraph 5 (banking subsidiary) specify that non-viability will trigger at the subsidiary level upon the occurrence of the events specified in the respective paragraphs.

Issue:

1. The ABA submits that the non-viability triggers referred to in Paragraphs 4 and 5 should be left to the local regulator to establish for the respective subsidiary. There is a risk that a local regulator may include additional triggers to those specified in Attachment I, or describe the triggers in different wording to those in Attachment I, thereby potentially creating a conflict or inconsistency with the requirements to Attachment I of those required at the local subsidiary level. This would create difficulties for the ADI in both framing the terms of the security and describing the risk of the security in any offering memorandum.

2. The ABA queries how an ADI can comply with the requirements of Paragraph 4 where the local subsidiary does not have a prescribed "host regulator", given the subsidiary does not have to be a regulated bank or insurance entity to be subject to these requirements.

3. The ABA notes, for APRA's review and clarification, the following anomalies in the wording contained in Attachment I:

- Paragraph 1 refers to a non-viability trigger event such as defined in Paragraph 3 and 4. The ABA queries why Paragraph 5 (a banking subsidiary) is not referenced in Paragraph 1.
- Paragraphs 3, 4 and 5 reference a non-viability trigger event occurring in the ADI, a subsidiary of the ADI, or a banking subsidiary of the ADI, so the Attachment does not appear to contemplate a Level 2 non-viability trigger event, although Paragraph 9 does contemplate a Level 2 breach of a non-viability trigger point. The ABA queries whether APRA considers a Level 2 breach would have to be preceded by a breach at an individual company level.
- Paragraph 9 refers to an "ADI's Level 1" capital ratio in the first line, but in the fifth line refers to capital ratio of "the ADI". The ABA queries whether there is any significance in the different terminology.

Action:

The ABA submits that APS 111, Attachment I, Paragraphs 4 and 5 should be simplified, and that APRA should, in Attachment I, just refer to that a non-viability event would occur at the point the local regulator (as defined by in its local regulations) deems it to have occurred.

2. Underwriting positions

APRA's draft standards require a deduction from Common Equity for underwriting positions in equity holdings in financial institutions (across both the banking and trading book) and commercial entities (banking book only) held for more than five working days. While the ABA understands this is a Basel Committee requirement, the ABA does have a number of concerns with the reduction in the allowed holding period from 90 days in the current standards to 5 working days.

In Australia, the following types of underwriting arrangements are used:

- Full underwriting – the arranger underwrites the distribution of a fixed amount of securities from a certain point in time, for example, from the time the arranger is mandated or from the time pricing is set. The arranger assists the issuer to market the transaction. If the underwritten amount of securities is not sold, then the arranger must purchase the shortfall on the date the transaction is settled
- Settlement underwriting – the arranger assists the issuer to market the transaction. After pricing is set and the issuer allocates securities to various institutional investors and retail broker firms, the arranger undertakes that the amount of securities allocated to those institutional investors and retail broker firms will be settled. On the settlement date, if one of those institutional investors or retail broker firms fails to pay, then the arranger must purchase the shortfall

A further type of arrangement is a best endeavours transaction. The arranger undertakes to distribute the securities using its best endeavours but there is no commitment to purchase securities at any time.

Full underwritings are not common in Australia but to the extent they are, and there is a bank underwriter who is exposed to a potential medium-term position in relation to securities, we agree that this should be a deduction from capital. For this reason, the ABA believes that the current 90 day period is an appropriate period.

Settlement underwritings are more common and, where retail investors are involved, the period between the date of pricing and settlement is usually 28 days or slightly longer. In such situations, a bank underwriter has little risk because the retail broking firms are the ones who are bearing the risk against the end investors and the bank has a back-to-back agreement with the retail broking firm which allows it to pursue the retail broking firm if a shortfall occurs.

In the ABA's view, the banking sector should not have to recognise a risk where the risk is born by another sector. Doing so also has the potential of putting ADIs at a competitive disadvantage to non-ADIs. In addition, where another bank owns one of the retail broking firms, there would be a potential double-counting of risk. Such settlement underwritings are more like an administrative arrangement to ensure that the correct amount of money is received on the settlement date. The ABA believes that the bank should only have to recognise a risk when it is exposed to a potential medium-term position in relation to securities. Again, for this reason, the ABA believes that the current 90 day period is a more appropriate period than the proposed 5 days.

Best endeavours transactions should not be viewed as an underwriting as there is no commitment to purchase securities.

3. Capital Conservation Buffer

The ABA seeks further guidance from APRA on the mechanics of the Capital Conservation Buffer ("CCB"), in particular that APRA confirm:

1. The CCB will apply to all capital ratios, and as such, will result in the same restrictions apply should the capital ratio move in the CCB range; and
2. The same sized CCB is applied to all capital ratios.

Additionally, the ABA requests further explanatory guidance on the CCB, which could possibly be best provided as part of the FAQ process, by providing illustrative examples around APS 110-8 paragraph 26 "Any amount of Common Equity Tier 1 Capital required to meet an ADI's PCRs for Tier 1 Capital or Total Capital, above the amount required to meet the PCR for Common Equity Tier 1 Capital, is not eligible to be included in the capital conservation buffer" and extending the examples when the Countercyclical Capital Buffer becomes active as per APS 110-9, paragraph 32.

4. Share payments

4.1. Dividend Re-investment Plan

Background:

ADIs offer to ordinary shareholders the option to take ordinary dividends via:

(a) cash payment;

(b) Dividend Reinvestment Plan ("DRP") where shareholders elect to have their cash dividends reinvested into ordinary shares of the ADI. The election is irrevocable at the 'books close' date for the dividend a date that is usually around a week after the dividend is declared; and

(c) Bonus Option Plan ("BOP") where shareholders elect to forego a dividend payment in consideration for receiving bonus ordinary shares. As with the DRP, the election is irrevocable at the 'books close' date for the dividend.

APS111, Paragraph 18 to 20 sets out requirements as to Common Equity Tier 1 capital.

APS111, Attachment B sets out the requirements for ordinary shares.

APS110, Paragraph 34 sets out requirements as to current years' profits test.

APS110, Attachment B sets out requirements as to constraints on capital distributions.

Issues/Action:

(a) Attachment B requirements:

The ABA requests that APRA confirm that the following issues will not be technical contravention of the following provisions:

- Paragraph 1(e) states that distributions must be "paid out of distributable items" and the instrument cannot provide for payments "other than in the form of a cash payment". APRA is requested to confirm that neither the DRP nor the BOP arrangements will breach these arrangements, noting that DRP/BOP arrangements appear to be sanctioned by Basel – refer December 2011 FAQ page 20, point 2.
- Paragraph 1(c) requires that issue documentation must give notice that "an issuer's right to buyback an instrument is subject to the prior approval of APRA". This type of disclosure would not be normal practice for an ordinary share raising, and the ABA requests that APRA delete this requirement.

(b) APS111 – Common Equity Tier 1 Capital:

The regulations propose that a dividend is deducted from the ADI's capital base at the date it is declared (Paragraph 20(d)) but the ordinary shares issued under DRP would only be recognised as Common Equity Tier 1 capital when the dividend is paid and the shares recognised in the financial statements (Paragraph 19(a), Attachment B Paragraph 1(i) & (j)). There may be a gap of six to eight weeks between the dividend declaration and payment date, with the ADI's capital ratios showing increased volatility during that period (this would particularly be the case at the June quarter reporting period) which is not reflective of the ADI's capital position, as shareholders have an irrevocable funded contract to subscribe for the ordinary shares under DRP/BOP arrangements at the books close date. The timing delay may also cause technical breaches of APS 110 as to current year payments test or constraints on capital distributions.

The ABA proposes that the capital expected to be raised under the DRP be reflected on the DRP 'announcement' date. The ABA believes this approach is appropriate since at this time ADIs outline their DRP settings (for example, share price discount, cap on take-up) to shareholders. The ABA proposes that the regulatory treatment be changed to allow ADIs to reflect expected DRP take-up in the capital base at this time. Management to this approach aligns more closely to the capital impacts of the dividend and dividend reinvestment period; as

- It recognises that banks can make a decision on dividend policy up until the announcement of the dividend – for example, banks have the option of retaining all earnings until the dividend is declared;
- It recognises that banks position their dividend reinvestment plan settings to recover the dividend through new shares being offered;

- Banks are able to accurately predict DRP participation through past settings.

Alternatively, APRA is requested to either:

- Extend the current practice of permitting dividends payments to be considered net of expected DRP/BOP participation via amending APS111 Paragraph 20(d) wording and associated changes to APS 110 Paragraph 34 and Attachment B as to 'capital distributions'; or,
- Amend APS111 Attachment B, paragraph 1(i) and (j) to permit DRP shares to be recognised at books close date – refer also Basel FAQ December 2011, page 2, point 5 for support for this position

(c) The ABA notes the following anomaly in the wording of the draft standards for APRA's review and clarification:

APS110, Paragraph 34(d) with the current year Payments Test having been extended to cover all Tier 2 coupon payments

4.2. Dividend stoppers and ranking

The ABA requests that APRA review the following technical issues with the draft capital standards

- APS110, Attachment D, Paragraph 1(h)(iv) provides that 'dividend stoppers' on Additional Tier 1 securities must not extend beyond 'distributions on CET1 capital instruments'. This should be reworded to include "Common Equity Tier 1 and Additional Tier 1 Capital instruments" which would be consistent with Basel FAQ December 2011, page 3, point 3 that outlines that stoppers on Additional Tier 1 coupon payments are permitted.
- APS110, Attachment D, Paragraph 2(c) provides that 'dividend stoppers' may not extend beyond when "the Additional Tier 1 Capital instruments are resumed". ABA queries the reference to the plural, as the ABA believes the reference should solely be to the AT1 being issued.

5. APS 160 Transitional Arrangements

5.1. Transitional Arrangements for Perpetual Instruments with No-Step Ups or Other Incentives to Redeem

Further clarification is required to confirm how the phase out arrangements in Paragraph 10 of APS 160 would apply to capital instruments with the following features:

- Issued prior to December 2009;
- The instrument is perpetual;
- The issuer has a call right on every interest payment date and the call right has been in existence since before December 2009; and
- There is no step-up in interest rate if the call is not exercised and there are no other incentives for the issuer to redeem the instrument.

Examples of such instruments include:

- Perpetual floating rate notes issued on or around 1986 by the major ADIs and currently recognised as Upper Tier 2 capital; and
- The National Income Securities issued by NAB in June 1999 and currently recognised as Residual Tier 1 capital.

5.2. Capital Instruments Issued by Consolidated Subsidiaries

It would appear from the construction of APS160 that transition treatment for Additional Tier 1 and Tier 2 securities issued by the ADI (refer Table 1) and those issued by a subsidiary (refer Table 2) are separate and independent portfolios and calculations. APRA is asked to confirm that:

(a) ABA's understanding is correct; and

(b) Whether the portfolios will be required to be reported separately in regulatory capital.

5.3. Capital Instruments issued by an SPV

Clarification is required that the transitional arrangements in Table 1 apply to capital instruments issued by an ADI through an SPV vehicle. Clarification is required for the following example: a wholly owned SPV issues a capital instrument to external investors, the SPV has in turn invested the proceeds in an instrument issued directly by the ADI. While an SPV has issued the external instrument to investors, the combined arrangement represents a directly issued capital instrument by an ADI and should be subject to the transitional arrangements in Table 1 of APS 160.

5.4. Notification and approval of transitional amounts

5.4.1 Base Amount of foreign currency denominated capital instruments accounted for as equity

APS 160 Attachment A Paragraph 5 provides that in calculating the base amount, an ADI must use the AUD value of the foreign currency denominated Additional Tier 1 Capital instruments and Tier 2 capital instruments, respectively, as at 1 January 2013.

Certain foreign currency denominated hybrids are accounted for as equity and recorded at historical cost. Australian accounting standards do not require any subsequent adjustment to the recorded value in equity for foreign currency movements. Instead, foreign currency movements relating to the foreign currency denominated hybrid instruments issued through a branch are taken directly to equity via changes in reserves, typically the foreign currency translation reserve (FCTR) - this is true whether or not the issuer has swapped the proceeds into another currency like AUD.

By extension, the impact of any currency movement is also reflected in regulatory capital (per new draft standard APS 111, foreign currency movements of this kind are picked up in Common Equity Tier 1 via paragraph 24(c)).

Therefore, by requiring the base amount of any foreign currency denominated, equity classified, hybrid Tier 1 instrument to be determined by reference to exchange rates at 1 January 2013, it is highly likely (based on current foreign exchange rates) to cause an artificially low base amount to be calculated at that date relative to liability classified instruments - the difference will broadly equal the FCTR impact already reflected in regulatory capital, resulting in a double counting of the foreign currency impact and artificially penalising issuers of equity classified hybrid Tier 1 instruments.

The base amount for equity accounted foreign currency hybrids should be reflected at the value as presented in the ADI's Balance Sheet as at 1 January 2013 (and not the foreign exchange spot rate as at 1 January 2013).

See Appendix D for examples.

5.4.2 APRA Approval of ADI Base Amounts

APS 160 paragraph 13(c) requires that the base amounts of capital instruments must be provided to APRA for approval prior to 1 January 2013. APS 160 Attachment A Paragraph 4 however requires that the base amount must determined using the AUD value of foreign currency denominated instruments as at 1 January 2013. As it will not be possible to provide the value of foreign currency denominated instruments to be included in the base amount prior to 1 January 2013, the ABA recommends that APRA should approve in-principle the instruments that are eligible for inclusion in the base amount prior to 1 January 2013. ADIs should then be allowed to confirm the base amounts shortly after 1 January 2013, once the value of foreign currency denominated instruments are determined. It is also important that APRA approve the capital instruments that will be eligible for transitional arrangements well in advance of 1 January 2013 to allow ADIs sufficient time to seek approvals and prepare for the redemption of ineligible capital instruments.

6. Interest rate reset

Background:

APS 111 “Measurement of Capital”, Attachment D (Additional Tier 1 Capital), Paragraph 4 states that “an incentive or expectation to call includes, but is not limited to:

(b) a call option combined with a change in reference rate where the credit spread over the second reference rate is greater than *the initial reference rate* less the swap rate (i.e. the fixed rate paid to the call date to receive the second reference rate).

Further, APS 111 Measurement of Capital", Attachment G (Tier 2 Capital), Paragraph 1(e) in Footnote 43 states that:

Conversion from fixed rate to floating rate (or vice versa) in combination with a call option without any increase in the credit spread is not considered an incentive to redeem.

Issue:

1. It is not clear in APS 111, and attachments thereto, that a change in reference rate, without an increase in credit spread, is permitted for Additional Tier 1 and Tier 2 securities as the issue is not presented consistently across the respective Attachments
2. As to Attachment D as currently drafted, the ABA believe that:

2.1. The format deals incorrectly with the basis risk premium paid on the first coupon period. The current construction infers that the basis risk premium between the reference rate (i.e. the Government rate) and the swap rate has to be effectively deducted from the credit margin that would have otherwise been paid on the reset. Example, ADI issues a Tier 2 in 10NC5, fixed/fixed setting off the Government curve. At issue date the coupon is 7.0%, with a 500bps credit margin over 5 year Government rate 2.0%, noting that the 5 year Swap rate is 2.5% i.e. 50bps basis risk between Government and Swap rate. Despite setting off the 5 year Government rate at the reset date, the formulae would require the credit margin to be decreased to 450bps (initial coupon 7.0% less Swap rate 2.5%). ABA acknowledges that the example may not strictly be caught by Paragraph 4 as there has been no change in index (5 year Government), but presentation in this fashion clearly identifies the anomaly in the proposed calculation methodology.

2.2. In the current draft, the "initial reference rate" should be the "initial coupon rate" as typically fixed rate securities are set off the Government interest rate curve (being the 'initial reference rate') which is below the 'swap rate' i.e. as worded the calculation would be a negative credit spread.

Action:

1. ABA recommends that APS 111 Attachment D wording be conformed to the wording in Attachment G Footnote 43 to increase clarity and consistent application across the security types. Clarity around what constitutes an increase in 'credit spread' can be addressed through the more informal FAQ process that will allow APRA and the ABA to consider commonly used changes in interest rate indices.
2. Should Attachment D Paragraph 4(b) in its current format be retained, then the "initial reference rate" should be changed to "initial coupon rate".

7. Fair Value Accounting – Level 3 Assets

In its September 2011 Discussion Paper APRA proposed, in relation to fair value practices, a requirement for "additional reporting from that required by IFRS 13 disclosures. Reporting will be required quarterly for financial assets and liabilities. The proposed reports will capture cumulative, gross unrealised gains and losses recognised on the Statement of Financial Position for fair values that are valued using 'Level 3' (i.e. unobservable) inputs, and detailed information about Level 3 inputs".[5]

In its submission dated 9 December 2011, the ABA stated that quarterly reporting of Level 3 asset and liability information over and above the requirements of IFRS 13 would be unreasonably burdensome.

APRA's Response to Submissions indicates that APRA now intends to extend this quarterly reporting requirement beyond Level 3 to cover Level 2 assets and liabilities as well.

The ABA remains concerned about the additional reporting burden this will generate and believes any reporting requirements should be aligned with accounting requirements both in terms of content required and timing of

[5] Discussion Paper, page 39

implementation. It is important to note that requiring more detailed disclosure does not necessarily lead to better disclosure outcomes, as it can sometimes result in market participants missing the key disclosures.

The ABA awaits further details of APRA's proposals when draft reporting standards are released later this year.

Appendix B - Items confirming APRA's positions

1. Deferred Tax Liabilities

There is inconsistency within the standards on whether or not APRA allows the deferred tax asset deduction to be net of deferred tax liabilities that relate to the same tax authority. Attachment J clearly sets out rules for netting, i.e. right of set-off, which are akin to those adopted for the financial accounting, so industry is not sure why this is an issue.

APRA appears to have deliberately removed the reference in the attachment that excluded amounts associated with defined benefit super funds.

A capital deduction is required in respect of deferred tax assets (DTA) net of deferred tax liabilities (DTL). The footnote to APS 111, Paragraphs 26(d) states that DTL exclude those netted elsewhere whereas this is not referred to in Attachment J, Paragraph 1. The ABA proposes that APRA align Attachment J to Paragraph 26(d) is to avoid double counting.

2. Equity exposures in subsidiaries

APRA has proposed that at Level 1, ADIs are not required to deduct equity exposures held in other ADIs, or overseas deposit-taking institutions, their subsidiaries, and insurance companies that are subsidiaries of the ADI. Exposures, after deduction of intangibles, are risk-weighted at 300% or 400%. It is unclear whether this concession applies only to ADIs and insurance companies that are direct subsidiaries, or whether it also extends subsidiaries held through a holding company structure.

The ABA suggests that:

- The risk weighting treatment should apply to all regulated financial institutions where distinct capital requirements applies including funds managers; and
- The calculation of this exposure should look through holding companies and apply to the equity exposure to such institutions held within a holding company structure. For example, if an ADI had a $100 equity investment into a holding company, which in turn held $50 equity in an insurance company and $50 investment in other commercial entities, then at Level 1, the parent ADI would risk weight the $50 relating to the insurance subsidiary at 400% (as appropriate for an unlisted insurance company) and deduct the remaining $50 from Common Equity Tier 1 (for the exposure to the commercial entities).

3. ICAAP

In addition to the existing formal capital adequacy reporting, Australian ADIs routinely share with APRA the ICAAP reports they present to their Boards. Paragraph 17 of draft APS 110 however introduces a formal requirement to submit an annual "ICAAP Report" and paragraph 18 goes on to prescribe the detail required to be included in this report. The prescriptive detail required in the draft APS does not appear to be consistent with the feedback APRA provided to the ABA at the 10 May 2012 meeting that it did not plan to define how the report should be structured and that the reporting requirement could be satisfied using existing ICAAP material presented to the board.

APRA has repeatedly emphasised the importance of the Board being accountable for setting risk appetite. Prescribing the detail of this new ICAAP Report has the potential to lead to ICAAP becoming a compliance requirement, ticking all the boxes defined by the APS, at the expense of allowing the Board to focus on the detail that it believes is relevant to setting its capital adequacy risk appetite.

Rather than prescribing the exact level of detail in an entirely new reporting requirement (that would presumably lead to a similar additional report for the ILAAP) industry believes that it would be better for the ICAAP report to APRA to take the form of the ICAAP document submitted to, and approved by, the ADI Board accompanied by a cover letter containing the CEO declaration set out in Paragraph 19 of APS 110.

To the extent that APRA believed the ICAAP material presented to the Board was inadequate it would be more useful to focus on those perceived gaps rather than creating a whole new reporting requirement that will place additional demands on the time of the bank personnel charged with managing the ICAAP. APRA have specifically requested feedback on the costs and benefits of their proposals. This is an example of additional reporting where the costs to the ADI of production would appear to outweigh any marginal benefit that APRA would derive over simply accepting a copy of the ADI's ICAAP submission to its board accompanied by the CEO declaration.

4. SPVs

APS 111 Attachment H Paragraph 1(g) requires that where a loss absorption trigger or non-viability trigger event occurs, the instruments issued to the SPV, and by the SPV to investors, must be subject to a write-off or conversion into listed ordinary shares.

If the loss absorption mechanism is conversion, the requirement to convert both the instrument issued to the SPV and the instrument issued to the external investors will become unnecessarily complicated and will involve greater legal and operational risk, which may reduce the effectiveness of the conversion.

Can APRA clarify that only one instrument should be subject to conversion (being the instrument issued by the ADI to the SPV), with the effect that the shares issued by the ADI following a conversion of the ADI instrument are passed to the external investors in satisfaction of the extinguishment of the capital instrument held by the external investors? An ADI could provide an independent legal opinion confirming the effectiveness of this conversion mechanism.

5. Regulatory and tax events calls allowed within first five years

In the first five years of a capital instrument the use of tax and regulatory event calls are permitted. Greater clarity is required as to when and how APRA would form a view that a tax or regulatory call should have been anticipated at issuance, and hence the requested call would not be approved.

Given the complexity and gestation period of taxation and regulatory matters, it may transpire that a taxation and/or regulatory matter may have been tabled publicly before issuing. Despite the matter being tabled, the outcome would be uncertain and tax experts can only form a view as to the likely outcome. In reality, the final outcome can take a significant amount of time to be determined (i.e. months or even years). The final outcome (determined some time after issuance) may be totally unexpected (and unfavourable). However, based on the information known to the ADI at the time of issuance, it would have been deemed appropriate to proceed. However, given the taxation/regulatory matter had been publicly tabled before the issuance, the ADI runs the risk that APRA determines that the ADI should not have issued in the first instance.

Therefore in the instances where the determination of whether the ADI should or should not have known is less clear, we recommend that APRA adopts an additional process that allows for an opinion to be provided by independent expert opining on the appropriateness of the view taken by the ADI at the time of issue. The firm or practitioner can be of APRA's choice and at the ADI's cost. This is in line with processes adopted elsewhere in prudential standards.

Recent discussions with APRA have indicated that a change in accounting standards is not currently considered acceptable as a trigger for a regulatory or tax event. The ABA submits that a change to the accounting standards is outside the control of an issuing ADI, subject to regulatory oversight and potentially have a material impact in either the tax treatment of an instrument or the regulatory capital recognised from an issued instrument. As such, it is appropriate that a change in accounting standards should be an acceptable trigger for a tax or regulatory event. The ABA requests that APRA give some guidance on this issue and explain the prudential rationale for any limitation of an acceptable tax or regulatory events.

In addition to tax and regulatory events, we request that APRA revisits previous requests so as to also include change of control. A change of control event has similar characteristics of being outside of the Issuer's control and should be allowed within the first five years. If APRA is not open to allowing an early call for Change of Control, can APRA confirm whether it is acceptable for Change of Control to be a conversion event?

6. Deferred tax assets relating to GRCL

APRA's draft standards have changed the treatment of deferred tax relating to the general reserve for credit losses (GRCL). Previously the GRCL, net of related deferred tax assets, has qualified as Tier 2 capital, subject to a limit of 1.25% of total risk weighted assets. Under the new standards the deferred tax assets relating to the GRCL will be deducted from Common Equity, with the gross GRCL eligible as Tier 2 capital, subject to a limit of 1.25% of credit risk weighted assets.

The ABA believes the change to the treatment of the deferred tax assets relating to the GRCL is an unnecessary burden that will adversely impact the capital position of ADIs with standardised credit portfolios, especially when combined with the change in the 1.25% limit to reference credit risk weighted assets rather than total risk weighted assets.

Appendix C – Calculation of multiple reductions to Subsidiary Transitional Tier 1 and Tier 2

Referred to in Section 4.2

	Calculation	Reference	Subsidiary	APS111 Attach C	APS160	Adjusted Subsidiary
Date of Calculation	Jan-14					
Fundamental Capital						
External Securities i.e Ordinary shares		A				-
Internal Securities i.e. Ordinary shares		B	1,000			1,000
Retained Profits		C	200			200
Internal		D				-
Minority deduction		E				-
Core Tier-1 Deductions		F	- 200			- 200
Common Equity			1,000	-	-	1,000
Tier-1 hybrids						-
External		G				-
Internal		H				-
Disallowed (transitional)		I				-
Minority deduction		J				-
Tier-1			1,000			1,000
Tier-2						
External		K	400			400
Internal		L				
Disallowed (transitional)		M				
Minority deduction		N		- 40	- 80	- 120
Total Capital			1,400	- 40	- 80	1,280
RWA		O	12,000			12,000
Ratio						
Common Equity		P	8.33%			8.33%
Tier-1		Q	8.33%			8.33%
Total Capital		R	11.67%	-0.33%	-0.67%	10.67%
Level 2 Minimum Capital (PCR + Capital conservation)						
Common Equity		S	7.0%			
Tier-1		T	8.5%			
Total Capital		U	10.5%			
Excess						
Total Capital (Attachment C, Para 7)						
Total Capital issued by Sub	Para 7(a)(i)	TC net of deduction	1,400			
Total Capital issued by Sub to third parties	Para 7(a)(i)	A,G,K	400			
Percentage of Total Capital attributed to 3rd parties	Para 7(a)(i)		28.6%			
RWA	Para 7(a)(ii)	O	12,000			
Total Capital Minimum Capital required	Para 7(a)(ii)	U	10.5%			
Total Capital required by Subsidiary	Para 7(a)(ii)		1,260			
Total Capital atttributed to 3rd Parties that maybe included	Para 7(a)		360			
Total Capital issued by Sub to third parties			- 400			
Total Capital excluded			- 40	- 40		
Tier-2 on issue			400			
Amortisation rate	APS 60 Para 12		20%			
Ineligible Tier-2			- 80		- 80	

Appendix D – Base Amount of foreign currency denominated capital instruments accounted for as equity

Examples referred to in Appendix A, Section 5.4.1

USD Trust Preferred Securities (TPS)

Issue date:	2003
Issue volume (USD m):	750
AUD issue volume equivalent (m):	1000
AUD/USD FX rate at issue:	0.750
AUD/USD FX rate at 1 January 2013	1.040
AUD Base Amount as at 1 Jan 2013	721

Capital Impact of TPS being Equity Classified

Incremental Balance Sheet impact at 1 January 2013

Assets	721		
Equity (TPS)		1,000	
Foreign Currency Translation Reserve (FCTR)		(279)	
Net increment to Equity		721	

Prudential capital impact at 1 January 2013

Common equity (being FCTR)		**(279)**
Additional Tier 1 "Base Amount" *	721	
Less amortisation (10%)	(72)	
Additional Tier 1 eligible for transition	649	**649**
Net contribution to Tier 1 capital		**370**

* Per Attachment A of draft APS160, equals USD750m / 1.04

Prudential capital impact at 1 January 2013
if "Base Amount" set off recorded value of TPS in balance sheet of $1,000m

Common equity (being FCTR)		**(279)**
Additional Tier 1 "Base Amount"	1,000	
Less amortisation	(100)	
Additional Tier 1 eligible for transition	900	**900**
Net contribution to Tier 1 capital		**621**

Capital Impact of TPS if Debt Classified

Incremental Balance Sheet impact at 1 January 2013

Assets	721	
Liability (TPS)		721

Prudential capital impact at 1 January 2013

Common equity (being FCTR)		**0**
Additional Tier 1 "Base Amount" *	721	
Less amortisation (10%)	(72)	
Additional Tier 1 eligible for transition	649	**649**
Net contribution to Tier 1 capital		**649**

* Per Attachment A of draft APS160, equals USD750m / 1.04