



Australian Government

Providing Certainty for Contractual Loss Absorption Provisions in Regulatory Capital

Consultation Paper
June 2014

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CONSULTATION PROCESS

REQUEST FOR FEEDBACK AND COMMENTS

The purpose of this paper is to assist in the preparation of advice to Government on the need for legislative amendments to facilitate the effective operation of prudential requirements on the loss absorbency of regulatory capital. These requirements have been adopted in order to strengthen Australia's financial system by ensuring capital instruments can absorb losses when institutions are in financial distress as opposed to relying on public sector funds.

The amendments discussed in this consultation paper are intended to ensure that contractual loss absorption provisions contained in Additional Tier 1 and Tier 2 capital instruments issued by authorised deposit-taking institutions (ADIs), general insurers (GIs) and life insurers (LIs) operate as intended and are not rendered ineffective by provisions in the *Corporations Act 2001* that may restrict the ability of companies to issue, vary, convert or cancel shares. This will ensure that these instruments can fulfil their role as regulatory capital by absorbing losses in line with their contractual terms.

The consultation paper seeks feedback on the proposed approach to removing limitations on triggering contractual loss absorption provisions including information on whether the proposal would generate any additional compliance costs (or savings). It also seeks comment on the capacity of investors to comply with Commonwealth laws and policies that prohibit or impose notification requirements or other tests in relation to the acquisition of shares in ADIs, GIs and LIs (including Australia's Foreign Investment Policy and the *Foreign Acquisitions and Takeovers Act 1975*, the *Financial Sector (Shareholdings) Act 1998* and the *Insurance Acquisitions and Takeovers Act 1991*).

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

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Legal requirements, such as those imposed by the *Freedom of Information Act 1982*, may affect the confidentiality of your submission.

Closing date for submissions: 30 June 2014

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1. INTRODUCTION

This consultation paper seeks feedback on the need for legislative amendments to facilitate the effective operation of prudential requirements for the loss absorbency of capital instruments of ADIs, GIs and LIs.

2. BACKGROUND

2.1 OVERVIEW OF REGULATORY CAPITAL REQUIREMENTS FOR ADIs

The prudential framework applicable to ADIs is set out in prudential standards made by the Australian Prudential Regulation Authority (APRA) under the *Banking Act 1959*. A core component of this prudential framework is the capital adequacy requirements applicable to ADIs, which aim to ensure that ADIs maintain adequate capital, on both an individual and group basis, to act as a buffer against the risks associated with their activities.

APRA's ADI prudential standards largely follow the framework set for internationally active banks by the Basel Committee on Banking Supervision and are applied in a way which is appropriate for Australia's financial system.

In December 2010, the Basel Committee published a new set of reforms designed to raise the level and quality of regulatory capital in the global banking system (the Basel III capital reforms).¹ The Basel III capital reforms represent the response to deficiencies in the international regulatory capital framework identified during the global financial crisis. APRA, as a member of the Basel Committee, played an active role in formulating the Basel III reforms. The reforms are also endorsed by the G20, of which Australia is a member.

APRA commenced consultation on its proposed implementation of the Basel III capital reforms in September 2011 and finalised the relevant capital prudential standards in September 2012. The new standards came into force on 1 January 2013.² However, some components of the new framework are subject to transitional arrangements. For instance, approved existing capital instruments that did not meet the loss absorption requirements on 1 January 2013 continued to be included in regulatory capital and are being phased out over time.

2.2 OVERVIEW OF REGULATORY CAPITAL REQUIREMENTS FOR GIs AND LIs

The prudential framework applicable to GIs and LIs is set out in prudential standards made by APRA under the *Insurance Act 1973* and the *Life Insurance Act 1995* respectively. In May 2010, APRA commenced a review of capital requirements for insurers. The purpose of the review was to improve the risk-sensitivity and appropriateness of these capital standards and, where appropriate, improve

1 See Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems — revised version June 2011* (Basel III Framework), accessible at www.bis.org/publ/bcbs189.htm.

2 The final prudential standards are accessible at: www.apra.gov.au/adi/PrudentialFramework/Pages/Implementing-Basel-III-capital-reforms-in-Australia-September-2012.aspx.

the alignment of capital requirements across the ADI and insurance industries. In October 2012, APRA released final prudential standards resulting from this review.³

APRA's revised capital framework for insurers also took effect on 1 January 2013. Again, some components of the revised framework are subject to transitional arrangements. For example, for GIs, approved existing capital instruments that did not meet the loss absorption requirements on 1 January 2013 continued to be included in regulatory capital and are being phased out over time. For LIs, individual transitional arrangements were made available to the LIs with existing capital instruments that did not meet the revised criteria.

2.3 IMPLEMENTATION OF LOSS ABSORBENCY REQUIREMENTS IN AUSTRALIA

The global financial crisis highlighted a significant weakness of the Basel capital framework as certain non-common equity capital instruments failed to absorb losses. It became apparent that the level of protection afforded by a given level of regulatory capital was actually much lower than had been assumed before the crisis. As a result, it meant that the amount of public sector funds extended to financially distressed institutions was larger than would have otherwise been required. This outcome is inconsistent with the intended role of non-common equity capital instruments in the prudential framework.

In response, the Basel III capital framework introduced new loss absorbency criteria for Additional Tier 1 and Tier 2 capital instruments.⁴ In broad terms, the effect of the new requirements is that, in order to qualify as a component of Additional Tier 1 or Tier 2 Capital, instruments must contain contractual provisions which allow them to absorb losses without the issuer necessarily entering liquidation. In effect, this means either conversion to ordinary shares or write-off.

The Basel III capital framework also recognises that, in applying capital requirements, supervisory authorities may take into account the specific constitution and legal structure of non-joint stock companies, such as mutuals, provided the substantive quality of regulatory capital is preserved. APRA allows mutual ADIs to issue Additional Tier 1 or Tier 2 capital instruments that could, if relevant conversion provisions in *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* are triggered, convert to 'mutual equity interests'.⁵ On conversion, mutual equity interests would be included as Common Equity Tier 1 (CET1) capital for APS 111 purposes provided they comply with certain criteria.

Application of loss absorbency requirements to ADIs

The key requirements for a capital instrument issued by an ADI to be recognised as a component of regulatory capital that came into effect on 1 January 2013 are summarised in the table below.

3 The final prudential standards are available at: www.apra.gov.au/CrossIndustry/Pages/Life-and-General-Insurance-Capital-Review-October-2012.aspx.

4 See Basel III Framework, p 17. See also Basel Committee on Banking Supervision, Final elements of the reforms to raise the quality of regulatory capital issued by the Basel Committee, 13 January 2011, accessible at: www.bis.org/press/p110113.htm.

5 APS 111, which provides for the issuance of Additional Tier 1 and Tier 2 capital instruments by mutual ADIs is available at: <http://www.apra.gov.au/adi/PrudentialFramework/Pages/prudential-standards-and-guidance-notes-for-adis.aspx>.

Additional Tier 1 Capital	An Additional Tier 1 Capital instrument classified as a liability under Australian Accounting Standards must include a contractual provision whereby it will be immediately and irrevocably: a) converted⁶ into ordinary shares of the ADI or its parent entity, which must be listed at the time the instrument is issued; or b) written off,⁷ where the ADI's Level 1 or Level 2⁸ Common Equity Tier 1 capital ratio falls to or below 5.125 per cent of total risk-weighted assets.
Additional Tier 1 Capital and Tier 2 Capital	An Additional Tier 1 or Tier 2 capital instrument must include a provision whereby, on the occurrence of a non-viability trigger event, it will be immediately and irrevocably: a) converted into ordinary shares of the ADI or its parent entity, which must be listed at the time the instrument is issued; or b) written off. A non-viability trigger event is the earlier of: a) the issuance of a notice in writing by APRA to the ADI that conversion or write-off of capital instruments is necessary because, without it, APRA considers the ADI would become non-viable; or b) a determination by APRA, notified to the ADI in writing, that without a public sector injection of capital, or equivalent support, the ADI would become non-viable.

In addition:

- corresponding requirements apply to capital instruments issued by wholly-owned subsidiaries of an ADI forming a component of the regulatory capital of the Level 2 group;
- capital instruments involving cross-border banking groups must provide for additional non-viability trigger events:
 - where a capital instrument is issued by an overseas wholly-owned subsidiary, the making of a non-viability determination by the overseas host regulator in relation to the subsidiary must constitute a trigger event; and
 - where an ADI is a locally incorporated subsidiary of a foreign bank, the making of a non-viability determination by the overseas home regulator in relation to the foreign bank or the subsidiary ADI must constitute a trigger event;
- where the capital instrument provides for conversion, the ADI must ensure, at the time of issuance and on an ongoing basis, that there are no legal or other impediments to issuing the

⁶ In the context of APRA's prudential standards, the term 'conversion' is used in a wide sense. Conversion includes exchange and also other transactions having the economic effect of conversion.

⁷ In the context of APRA's prudential standards, the term 'write-off' is intended to mean that the capital instrument is wholly extinguished.

⁸ In general terms, 'Level 1' comprises the ADI as an individual entity or the extended licensed entity, whereas 'Level 2' comprises the banking group of which the ADI is a member.

relevant number of shares and all necessary authorisations have been obtained to effect conversion;

- where a capital instrument provides for conversion, that capital instrument must provide that, in the event that conversion is not capable of being undertaken, the capital instrument must instead be immediately and irrevocably written off; and
- as indicated above, in recognition of the distinct ownership structures of mutually owned ADIs, APRA allows mutual ADIs to issue Additional Tier 1 or Tier 2 capital instruments that could, if the relevant conversion triggers in APS 111 are triggered, convert to 'mutual equity interests' in the issuing ADI.

Partial application of the ADI loss absorbency requirements to GIs and LIs

As part of its review of the capital requirements for GIs and LIs, APRA concluded that the regulatory capital of insurers suffered from the same deficiencies in respect of loss absorption that were identified in the ADI industry. It has therefore applied, in part, the new loss absorption requirements to GIs and LIs. Consequently, Additional Tier 1 and Tier 2 capital instruments forming a component of the regulatory capital of a GI or LI will be required to meet the requirements concerning loss absorbency at the point of non-viability. However, Additional Tier 1 capital instruments recognised as liabilities for accounting purposes will not be required to provide for loss absorbency in the event that the GI's or LI's CET1 ratio falls below a set level.

3. ISSUES

3.1 LIMITATIONS ON TRIGGERING CONTRACTUAL LOSS ABSORPTION PROVISIONS

There is some uncertainty around the potential application of contractual loss absorption provisions in Additional Tier 1 and Tier 2 capital instruments. The effect of other parts of Australia's corporate law framework means that the provisions may not be able to be triggered under all conceivable circumstances. In particular:

- it is likely that giving effect to contractual loss absorption provisions would be prohibited by the *Corporations Act 2001* in circumstances where an administrator has been appointed to the issuer of the capital instrument (or, if relevant, its parent entity), in so far as this requires the variation, conversion or issue of shares or mutual equity interests;⁹

⁹ Subsection 437F(8) of the Corporations Act provides that, subject to limited exceptions, any alteration in the status of members during administration is void. The administrator and the Court are each empowered to consent to an alteration in the status of members. However, it is unlikely this exception would be satisfied in relation to loss absorption provisions. The appointment by APRA of a statutory manager to an ADI, or the appointment by the Court of a judicial manager to a GI or LI displaces an administrator appointed under the Corporations Act: Banking Act, section 15A, Insurance Act, section 62U, Life Insurance Act, section 165A. However, the appointment of a judicial manager is a matter of judicial discretion, and accordingly it cannot be assumed that a judicial manager will be appointed at a point at which loss absorption provisions would otherwise come into effect. In addition, APRA's prudential standards permit capital instruments to be issued by wholly-owned subsidiaries of ADIs, GIs or LIs, but the statutory management/judicial management regime does not presently apply to wholly-owned subsidiaries of ADIs, GIs and LIs.

- it is arguable that the write-off of capital instruments in the nature of preference shares may be challenged as an unauthorised reduction of capital under section 256D of the Corporations Act;¹⁰ and
- it is arguable that the write-off of capital instruments in the nature of preference shares would be contrary to certain provisions of the ASX Listing Rules (for example, ASX LR 6.1, 6.10 and 6.12).¹¹

A further area of concern with contractual loss absorption provisions is that they do not have an established track record, and have not been the subject of judicial consideration in Australia. Historically, conversion features have been a common feature of capital instruments issued in Australia. However, loss absorption provisions differ from established conversion features in three important respects. Firstly, the purpose of loss absorption provisions is to impose losses on investors, potentially up to the full value of their investment, without the necessity of the issuer proceeding to liquidation. Secondly, loss absorption provisions are intended to take effect immediately. Finally, loss absorption provisions are intended to operate in circumstances where, while the issuer has not proceeded to liquidation, it may be subject to significant financial distress.

Uncertainty about the operation of contractual loss absorption provisions creates two risks:

- it may not always be possible for issuers to give effect to loss absorption provisions, with the consequence that holders of Additional Tier 1 and Tier 2 capital instruments may not fully absorb losses as contractually agreed. In an extreme case, this could significantly increase the amount of any private or public capital injection required to recapitalise a financially distressed ADI, GI or LI; and
- in the event that an ADI, GI or LI becomes non-viable, any potential rehabilitation of such an entity could be delayed at a critical point (for example, if the loss absorption provisions in a capital instrument forming a component of the regulatory capital became the subject of protracted litigation).

3.2 POTENTIAL IMPLICATIONS OF TRIGGERING CONTRACTUAL LOSS ABSORPTION PROVISIONS

Several Australian statutory regimes impose restrictions on the acquisition of shares issued by ADIs, GIs and LIs. Some of these contain thresholds that trigger requirements for particular action on the part of investors. Two examples from the Corporations Act are the takeovers provisions and the requirements governing disclosure of substantial shareholdings. There also are prior approval requirements under Australia's Foreign Investment Policy and the *Foreign Acquisitions and Takeovers Act 1975*, and other restrictions imposed by the *Insurance Acquisitions and Takeovers Act 1991* and the *Financial Sector (Shareholdings) Act 1998*. The *Competition and Consumer Act 2010* also restricts share acquisitions that would have the effect or likely effect of substantially lessening competition in any market. There is no numerical share ownership or equity threshold regarding such an assessment.

10 The possibility of loss absorption being characterised as an unauthorised reduction of capital is based on a literal reading of subsection 256B(1) of the Corporations Act. Given that loss absorption does not involve any depletion of the assets of the issuer in any way, it would not represent a reduction of capital from a commercial perspective.

11 In addition, in so far as loss absorbency provisions involve the issue of ordinary shares by an ASX listed entity, ASX LR 7.1 is potentially relevant. ASX LR 7.1 provides that a listed entity is generally prohibited from issuing, or agreeing to issue, equity securities representing 15 per cent or more of the ordinary shares on issue in any 12 month period. However, listed entities are currently able to take steps to ensure compliance with ASX LR 7.1 under existing exceptions to that rule.

It is conceivable that an investor who holds Additional Tier 1 or Tier 2 capital instruments issued by an ADI, GI or LI could cross these thresholds if these capital instruments were converted into ordinary shares. In some cases, such as the provisions governing the disclosure of substantial shareholdings, this may not be a problem. The investor would simply be required to complete the relevant notice. However, in other cases, there is a risk that the investor may be found to have contravened an offence provision by failing to take certain steps prior to acquiring the shares (such as seeking prior approval from the Treasurer under Australia's Foreign Investment Policy and the Foreign Acquisitions and Takeovers Act or the Financial Sector (Shareholdings) Act).

In some cases, restrictions apply not just to the acquisition of shares but to the acquisition of interests in shares. One example is the Foreign Acquisitions and Takeovers Act. Under this Act, interests in shares include instruments such as convertible notes or bonds and prior approval is required even if the conversion right has not yet been exercised (that is, even if the conversion is dependent on the fulfilment of a particular condition). It may therefore be expected that foreign persons acquiring Additional Tier 1 or Tier 2 capital instruments would provide advance notification of this proposed investment. However, it may be unclear in advance whether the triggering of these instruments would cross the relevant statutory threshold, as this could depend on factors not known at the time of the initial investment.

4. POSSIBLE APPROACH AND REQUEST FOR FEEDBACK

4.1 POSSIBLE APPROACH TO REMOVING LIMITATIONS ON TRIGGERING CONTRACTUAL LOSS ABSORPTION PROVISIONS

One approach to addressing the limitations would be to amend relevant legislation to explicitly state that an ADI, GI or LI may give effect to contractual loss absorption provisions in complying securities despite any provision in the Corporations Act or any applicable listing rules. Contractual loss absorption provisions would also be given priority over any provision in the constitution of the issuer or its parent and any contract or arrangement to which the issuer and, where relevant, its parent or non-operating holding company, is a party.

Contractual loss absorption provisions could include provisions that allow securities to be replaced with ordinary shares, converted into ordinary shares, cancelled or written-down in value when the CET1 ratio of an issuer falls below 5.125 per cent of risk weighted assets (in the case of ADIs) or when a non-viability event occurs (in the case of ADIs, GIs and LIs). These provisions could also provide for capital issued by mutually owned ADIs to convert to mutual equity interests.

This approach would be consistent with existing provisions in the Banking Act, the General Insurance Act and the Life Insurance Act relating to the recapitalisation or restructure of the capital of an ADI, GI or LI.¹² The principal benefit of this approach is that it would provide certainty to market participants and APRA regarding the effectiveness of contractual loss absorption provisions.

In considering the potential impact of the proposed approach, it is important to note the following:

- it only seeks to ensure that effect may be given to loss absorption provisions contractually agreed between the parties; and

¹² For example, Banking Act, ss 13G(3) and 14AA(4).

- it would have effect only if an ADI or the Level 2 group, GI or its Level 2 group or LI were to become the subject of a non-viability determination (and, in relation to ADIs, where an extreme degree of financial distress exists such that the CET1 ratio were to fall to or below 5.125 per cent of risk weighted assets).

Discussion questions

- Are there any provisions contained in the Corporations Act, listing rules or otherwise not identified in this paper that may be inconsistent with giving effect to loss absorption provisions in capital instruments? If so, should any of these provisions have priority in the particular circumstances in which loss absorption provisions are intended to operate?
- Is the scope of the proposal appropriate? If not, what changes may be required? Are there any other options that should be considered?

4.2 REQUEST FOR FEEDBACK ON THE POTENTIAL IMPLICATIONS OF TRIGGERING CONTRACTUAL LOSS ABSORPTION PROVISIONS

In addition to seeking feedback on the possible approach set out in Section 4.1, this consultation paper seeks comment on the need for further amendments to address the potential impact on investors of triggering contractual loss absorption provisions.

Discussion questions

- Do you think there is a need for amendments to address potential breaches of statutory shareholder limits resulting from loss absorption provisions taking effect?
- How might these amendments be drafted, given the significance and sensitivity of some of these restrictions?

4.3 REQUEST FOR IDENTIFICATION OF COMPLIANCE COSTS

To improve the quality of regulation, the Government requires all regulations to undergo a Regulatory Impact Assessment to establish the impact of regulation on businesses, not-for-profit organisations and individuals. This assessment includes the quantification of compliance costs associated with regulation. To inform this analysis, the Government welcomes information from interested parties.

Compliance cost questions

Where possible, please identify whether the proposed amendments would generate any additional compliance costs (or savings) compared to the situation where the proposal is not adopted. To assist in doing so please consider:

- Is the current uncertainty imposing a cost, and if so how?
- Would the proposed approach to remove limitations on triggering contractual loss absorption provisions increase or decrease the regulatory burden, and if so how?
- Do you have any suggestions on how to overcome the limitations on triggering contractual loss absorption provisions that would result in a similar outcome but at a lower regulatory cost?

Cost information, along with the assumptions used to determine the costs, would be welcome in any form. However, where possible please use the Business Cost Calculator (BCC) to estimate costs. The Government would appreciate being provided with the input parameters to the BCC as well as the final result. The BCC can be accessed at: <https://bcc.obpr.gov.au/>.

Note costs are categorised as follows:

- Administrative costs — costs incurred primarily to demonstrate compliance with the regulation or to allow government to administer the regulation (for example, keeping records, filling in forms, conducting internal audits and inspections, making an application or conducting tests).
- Substantive compliance costs — costs that directly lead to the regulated outcome (for example, training, providing information to third parties, inputs to comply with a plan or test, operations, purchase and maintenance of plant and equipment and installing safety devices).
- Delay costs — expenses and loss of income incurred through having to complete an application requirement or wait for an application approval (for example, waiting for approval of a building permit).

As part of the Government's deregulation agenda, the Government also welcomes information from parties on any other impacts that should be taken into account when considering the proposed regulation. For instance, does the proposed regulation impose broader regulatory costs, such as opportunity costs and impacts on competition that should be considered? If applicable, respondents are requested to provide an estimate of these regulatory costs noting that the BCC only focuses on compliance costs.