Insurance Council of Australia

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Australian Prudential Regulation Authority

By email: policydevelopment@apra.gov.au

Dear Mr Holland

Discussion paper - Enhancing bank resilience: Additional Tier 1 Capital in Australia

The Insurance Council of Australia (Insurance Council) welcomes the opportunity to provide a submission in response to the Discussion Paper, Enhancing bank resilience: Additional Tier 1 Capital in Australia (Discussion Paper). We thank APRA for the opportunity to provide insights specific to insurance on the Discussion Paper at the roundtable session held 4 October. The Insurance Council makes the following comments which we trust are of assistance. These comments are supplemented with observations on the discussion questions from Chapter 4 of the Discussion Paper at Appendix One.

Overview comments

Following the roundtable held between APRA and the Insurance Council in October, we understand the primary focus of the Discussion Paper is to review the effectiveness of Additional Tier 1 (AT1) capital in Australia as a critical part of a bank's: (i) financial resilience through absorbing losses in stress; and (ii) providing capital to support bank resolution at the point of failure. While the Discussion Paper is focussed on banks, it does indicate that changes to bank prudential standards would also be made, where relevant, to the corresponding standards for insurance.

The Insurance Council's comments on the Discussion Paper fall under four main headings:

- **Differences between banking and insurance and the appropriateness of the AT1 design policy options for insurance**: The way in which a crisis or stress emerges and unfolds is very different between the banking and insurance industries. In particular, an insurer is not exposed to the same risk of non-viability arising from a sudden loss of market confidence as a bank. For this reason, insurance AT1 instruments are mindful of these differences and currently do not have the loss absorption features outside of non-viability that exist in bank instruments. The Insurance Council is of the view this should continue to be the case and the majority of the proposed policy options outlined in the Discussion Paper are not necessary or appropriate for insurance.
- **The importance of AT1 capital in the capital structure for insurers**: AT1 plays a valuable role in the capital structure of insurers. Its key features (fully discretionary distributions, deeper subordination and being first in line to be converted or written-off in the event of non-viability) make it distinct from Tier 2. Having a mix of instruments with different levels of subordination and risk/return characteristics can enhance the resilience of the insurer whilst enabling the business to support policy holders with pricing outcomes that are reflective of a supportive cost of capital.

In addition, AT1 is a committed source of contingent Common Equity Tier 1 (CET1) capital available after other recovery actions have been exhausted.
- **The distribution of AT1 capital**: We understand regulatory concerns with high levels of retail investment in AT1 securities. However, the implementation of Design and Distribution Obligations in 2021 has significantly changed the marketing of bank and insurance AT1 transactions, reducing retail participation and distribution opportunities in addition to strengthening disclosures and appropriateness of investment for the participant at the time of issue. We see value to insurers, investors and regulators in the maintenance of an exchange-traded market in AT1 capital that provides transparent pricing. We do not believe that the potential for smaller investors to acquire securities on an exchange compromises the loss absorbency of AT1.
- **Timing, transition, grandfathering arrangements, and a holistic approach**: Ensuring an orderly transition in the event of any changes to the design or distribution of AT1 capital is critical and enables the AT1 market to continue to function smoothly during the consultation process. This includes for new issues up to the finalisation of new standards and existing instruments. The Insurance Council recommends a holistic approach that includes multi-dimensions of the product features, such as the role the Tax treatment has in the products' design and distribution, and ASIC/ASX with respect to distribution and listing requirements.

Differences between banking and insurance and the appropriateness of the AT1 design policy options for insurance

The Discussion Paper is focussed on banking, and it is unclear the extent to which APRA expects the proposals would apply to insurance.

There are fundamental differences between banking and insurance businesses that mean the way in which they each transition through a severe stress event and from recovery (going concern) to resolution (gone concern) are different. In particular, insurers do not provide a maturity transformation role for the economy with materially less leverage and so are not exposed to the same liquidity risks that can result from a sudden loss of market confidence leading to non-viability. The insurance industry is also not exposed to the same level of contagion risk as banks and generally will have more time to respond to and manage their way out of a crisis compared to banks. A distressed insurer that is unable to be appropriately recapitalised is usually managed by a run-off over time.

This fundamental difference has been recognised by other regulators including the Prudential Regulation Authority in the UK, stating: "Insurers do not, however, present the same risks for financial stability as banks. For instance, they do not typically undertake maturity transformation and so are less vulnerable to sudden losses of confidence, unanticipated withdrawals, and contagion than banks."[1]

As a result, it is preferrable to take a more measured approach to recovery and resolution with the insurance industry.

APRA already recognises this within the existing prudential standards through:
- Insurance AT1 capital criteria having an appropriate and distinct early absorbency trigger relative to banks, whose AT1 includes a 5.125% CET1 ratio trigger aligned to Basel Standards to ensure enhanced AT1 loss absorbency.
- The bank capital framework includes a combined buffer requirement that incorporates a capital conservation buffer, systemic buffers and/or macroprudential buffers such as the countercyclical

[1] The Prudential Regulation Authority's approach to insurance supervision (bankofengland.co.uk)

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buffer that are above minimum regulatory capital requirements and designed to progressively limit discretionary payments, including AT1 distributions, if banks operate within this buffer. There is no similar buffer framework for insurance.

Insurance-specific differences relative to banks have been in place since the introduction of Basel III and LAGIC requirements more than a decade ago. The Insurance Council is not aware of any changes in circumstances that would suggest the need for a change to the existing approach and believes the AT1 design policy options outlined within the Discussion Paper are not necessary or appropriate for the insurance industry.

The importance of AT1 capital in the capital structure for insurers

By having a mix of instruments with different levels of subordination and risk/return characteristics, an institution can derive a cost of capital that is supportive of equitable pricing outcomes provided to policy holders whilst enabling investors to choose how much risk of loss absorption they are comfortable taking. AT1 capital remains available as a source of CET1 capital if required to ensure the insurer remains viable or to facilitate resolution. Reducing the amount of AT1 capital within the regulatory capital requirements would reduce these benefits.

The total amount of AT1 capital issued by insurers relative to benchmark transaction sizes results in insurers having a smaller number of transactions than banks. Since insurer AT1 issuance is normally infrequent, the amount of an issue will often exceed the current AT1 requirements as the insurer needs to factor future business requirements and contingencies to ensure it prudently maintains sufficient AT1 capital until its next expected market issuance.

Insurance AT1 capital is also eligible as ratings agency capital. As a result, insurers may choose to operate within more AT1 capital than implied by APRA regulatory requirements in order to support the insurer’s target ratings to ensure market access and derive cost of capital that can best support pricing outcomes provided to policy holders.

Placing a limit on the amount of AT1 capital an insurer can issue could impact on an insurers ability to plan for future capital needs and contingencies and reduce flexibility in the mix of capital securities to support its desired credit ratings.

The distribution of AT1 capital

We understand regulatory concerns with the challenges in using AT1 as a means of loss absorption where there is a high proportion of retail investors, hampering the ability for authorities to shore up confidence and prevent a systemic crisis from worsening. However, in the Insurance Council’s view, in assessing overseas experience it is important to understand the differences that exist between Australia and those jurisdictions. Each jurisdiction in which AT1 securities are offered has different design and distribution features and legal framework.

The legal framework in Australia is robust with respect to loss absorption. Legislation reinforces the conversion (or write-off) of instruments in accordance with their terms and generally recognises creditor hierarchy. Furthermore, the law does not distinguish between retail and wholesale or institutional holders. All holders are equally bound by the terms of the instrument. However, a number

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of non-prudential regulations do affect who is likely to hold AT1, in particular securities laws, listing rules and taxation laws.

Design and distribution considerations

As APRA would be aware, the Design and Distribution Obligations (DDO), implemented in 2021 are intended to help consumers obtain appropriate financial products by requiring issuers and distributors to have a consumer-centric approach to designing and distributing products. The implementation of DDO has significantly changed the marketing of bank and insurance AT1 transactions. This has resulted in a reduction in retail participation, with the small amount of remaining retail participation being accessed through financial advisers to build on the extensive disclosure enhancements in recent years and ensure investors understand the risks associated with AT1 securities, including the loss absorbing features. This change in retail participation has resulted in an increase in notes issued to wholesale investors as defined under the *Corporations Act 2001*.

Wholesale investors

There is a wide range of "wholesale investors" from wealthy individuals and their controlled entities (e.g. SMSFs) through to institutional investors in Australia. In contrast, institutional investors (both Australian and overseas) are predominant in participating in unlisted Tier 2 securities. As we discuss below, the profile of investors is heavily affected by the peculiar Australian taxation treatment of the instrument.

There is no basis for suspecting that the persons who participate in an offer of AT1 in Australia are unaware of the risks of the instrument. In Australia the securities are offered under a prospectus with emphatic disclosure of the loss absorption provisions and the investors are clients of major brokerages who, if they are retail persons, should have received personal advice about the investment. The disclosure and DDO regimes are actively enforced by ASIC.

To the extent there are risks from a broader category of retail investors acquiring AT1 securities on market, these should be weighed against the benefits of the securities being listed for trading on an exchange such as ASX. The Insurance Council believes these benefits are significant.

Benefits of ASX Listing

ASX listing requires detailed disclosure documentation (prospectus), provides the highest level of price transparency and liquidity in the market supporting a theoretical lower cost of capital. Exchange trading, clearance and settlement is of benefit to investors and issuers. Transparent, real-time pricing should also be useful to regulators.

In addition, listing supports the loss absorption features within AT1 securities by providing an efficient conversion process. The same registry provider normally manages the registers for an issuer's AT1 securities and ordinary shares, enabling the registry to facilitate the conversion of the registered AT1 holdings quickly and easily to registered ordinary shares.

Higher denominations

Changes to increase denominations or other restrictions to 'retail' investors could impact liquidity and potentially make the securities ineligible for listing. Listing Rule 2.5 Condition 6 requires a minimum of 100,000 securities for listing. For example, an increase in denomination to $10,000 would imply a minimum issuance of $1 billion, which would be impractical for Australian insurer issuers.

In addition, such measures may not in practice succeed in changing the current profile of end investors in secondary markets. For example, where the AT1 securities are acquired on market or over the counter by professional investors whose business is to create interests in their holdings for a broader category of investors (e.g. exchange-traded funds).

The relevance of taxation

One change that could be made to support increased institutional and offshore participation in AT1 is the implementation of the Board of Taxation's previous recommendations to the Federal Treasurer in December 2016[2] to treat AT1 as debt for tax purposes. This would result in AT1 distributions being deductible rather than franked. While we recognise this is outside APRA's direct mandate, such a change would make AT1 securities more attractive to domestic institutional investors. This is due to their performance being typically measured on a pre-tax basis and does not include the value franking credits, and offshore investors, who do not receive the benefit of the franking credits.

Other Market considerations

If APRA does apply additional restrictions on the distribution of AT1 capital, over and above the DDO requirements, the recommended change in tax treatment is necessary to ensure sufficient market capacity for the required level of AT1 issuance across both banks and insurers.

If AT1 issuance were to be restricted to the wholesale over the counter (OTC) market, AT1 issuance would be competing for the same domestic investors as Tier 2 issuance. This means there would be insufficient domestic capacity to meet the AT1 requirements of all banks and insurers at an economic price, in particular if the securities continue to be treated as equity for tax purposes. Insurers and lower rated regional banks would be unlikely to be able to raise sufficient Australian dollar AT1 capital in this market.

Timing, transition, grandfathering arrangements and holistic approach

The BCBS Report indicated "there may be merit in further assessing the complexity, transparency and understanding of AT1 instruments in a holistic manner". To ensure consistency with international requirements, APRA should consider deferring the finalisation of its review of AT1 capital until any changes from the BCBS become clear and include all relevant product features and regulations in the review. This includes the role that the tax treatment has on the product and investor base. Any changes to the product's investor base should also include the tax treatment as mentioned above, in addition, to whether changes may be required to ensure a listed market continues.

It is noteworthy that in July 2020, Canada's Office of the Superintendent of Financial Institutions (OFSI) took a constructive and 'substance over form' approach to permit the issue of Limited Recourse Capital Notes (LRCNs) and recognise these as AT1. The issue of LRCNs provided for a tax deductible

[2] Application of hybrid mismatch rules to regulatory capital (taxboard.gov.au)

AT1 security that is only marketable to institutional investors and addressed certain concerns around the primarily retail AT1 preference share market, including liquidity.

To the extent APRA does make changes to the design or distribution of AT1 capital, it is important that the AT1 market can continue to function smoothly during the consultation and implementation process. This includes clear transition and grandfathering arrangements for existing AT1 securities as part of the next round of consultation. The Insurance Council recommends existing AT1 securities continue to receive full AT1 credit for the life of the instruments.

There are seven banks and insurers with AT1 securities that have an optional call date in 2024. It is important that new AT1 issuance can be considered throughout the consultation process so these issuers' ability to issue new AT1 securities is not disrupted. The Insurance Council recommends APRA confirms, as part of the next round of consultation, that new AT1 securities can continue to be issued under the existing standards (and will be eligible for transition and grandfathering arrangements in the same way as existing securities) until such time as any updated standards are finalised.

We trust that our initial observations on the Discussion Paper are of assistance and look further to further engagement with APRA on this topic. If you have any questions or comments in relation to our submission, please contact Mr Luke Whitcher, Senior Policy Advisor, Regulatory & Consumer Policy, at lwhitcher@insurancecouncil.com.au or 0481 008 730.

Kind regards

Andrew Hall
Executive Director and CEO

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Appendix One

APRA Discussion Questions

1. What are the best policy options for improving the effectiveness of AT1 to support resilience?

With the exception of the distribution concerns, the Insurance Council is of the view that the concerns APRA has outlined within the Discussion Paper are not applicable to the insurance industry, given the different nature of the insurance and banking industries. Therefore, the Insurance Council does not believe the policy options outlined in the Discussion Paper are necessary for the insurance industry and it would not be appropriate for the Insurance Council to comment on changes to banking instruments.

The Insurance Council also believes the implementation of DDO in 2021 has largely addressed APRA's concerns around retail investor participation in AT1 transactions. Changes to the tax treatment of AT1 (see response to question 4 below) could support increased institutional and offshore participation in AT1 issuance.

2. What would be the impacts of these options?

As highlighted above, given the differences between the insurance and banking industries, the Insurance Council does not believe the design policy options outlined in the Discussion Paper are necessary or appropriate for the insurance industry. The potential impacts of the policy options outlined in the Discussion Paper are:

- Reducing the amount of AT1 capital in bank/insurer capital structures or capping the maximum amount of eligible AT1. AT1 plays a valuable role for insurers as a source of contingent capital to help avoid non-viability and resolution once other recovery options have been exhausted. Reducing and/or limiting AT1 capital would reduce this final backstop recovery action available to help avoid failure.
- Restricting, over and above the restrictions arising from the implementation of Design and Distribution Obligations in 2021, the distribution of AT1 capital could limit the investor capacity for AT1. Changes to the tax treatment of AT1 (see response to question 4 below) could support the viability of institutional and offshore AT1 issuance.

3. What transition arrangements could soften these impacts?

To the extent APRA makes changes to AT1 capital design or distribution, the Insurance Council recommends the following transition and grandfathering arrangements:

- Existing AT1 securities continue to receive full AT1 credit.
- New AT1 securities issued during the consultation process, until such time as updated standards are finalised, continue to be issued under the existing standards and eligible for the same transition and grandfathering arrangements as existing AT1 securities.

4. Are there other considerations APRA should take into account?

The Insurance Council believes APRA should consider engaging with Federal Treasury and the ATO on implementing previous recommendations from the Board of Taxation to treat AT1 as debt for tax purposes. This would support increased institutional and offshore participation in AT1 issuance.