AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY
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13 July 2023

Mr D McCracken-Hewson
General Manager
Merger Authorisations — ACCC
By email: ANZ-Suncorp-Merger@accc.gov.au

Dear Mr McCracken-Hewson,

ANZ's proposed acquisition of Suncorp Bank

The Australian Prudential Regulation Authority (**APRA**) provides this letter to assist the Australian Competition and Consumer Commission (**ACCC**) in its consideration of the merger authorisation application regarding the proposed acquisition of SBGH Limited (which owns Suncorp Bank) by Australia and New Zealand Banking Group Limited (**ANZ**).

In doing so, this letter addresses the questions put to APRA by the ACCC in its letter as extracted below.

APRA notes that, separately from the ACCC's assessment process, the proposed acquisition would require approval under the *Financial Sector (Shareholdings) Act 1998*.

About APRA

APRA is an independent statutory authority that authorises, regulates and supervises institutions across the banking, insurance and superannuation sectors.

Under APRA's enabling legislation, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.

Background: APRA's capital requirements

To protect depositors, APRA requires authorised deposit-taking institutions (**ADIs**) to hold a minimum amount of capital. This is done to ensure ADIs have a financial cushion to absorb unexpected losses.

APRA's *APS 110 Capital Adequacy* (**APS 110**) sets out the minimum prudential capital requirement (**PCR**) that ADIs must maintain at all times. APS 110 also specifies that APRA can determine a higher PCR for an ADI. Minimum capital requirements are set relative to risk-weighted assets (**RWA**)[1].

[1] Put simply, risk-weighted assets are for credit risk the loans and other assets of a bank, weighted (that is, multiplied by a percentage factor) to reflect their respective level of risk of loss to the bank. Risk-weighted assets are calculated under the applicable prudential standards, to account for: credit risk, market risk, operational risk, interest rate risk in the banking book and securitisation, as applicable.

ADIs can use one of two approaches for calculating RWA for their loan books: the Standardised approach or the Internal Ratings-based Approach (**IRB**) approach. Table 1 provides a brief overview of the two approaches.

Table 1: Overview of Standardised and IRB approaches

Standardised	IRB
• Designed to be a simpler approach than IRB. • ADIs must use a common set of risk-weights prescribed by APRA, in accordance with *APS 112 Capital Adequacy: Standardised Approach to Credit Risk*.	• Subject to APRA approval, ADIs are permitted to use internal risk models as an input to calculate risk weights, in accordance with *APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*. • Associated with more stringent requirements including for risk measurement and modelling capabilities.
Note: There are many key differences between these two approaches.[2] For example, standardised ADIs are not required to hold capital for interest rate risk in the banking book (IRRBB).	

Minimum capital requirements are set with reference to three tiers of capital. The three tiers are Common Equity Tier 1 (**CET1**), Additional Tier 1 (**AT1**) and Tier 2 (**T2**) capital, as set out in *APS 111 Capital Adequacy: Measurement of Capital* (**APS 111**).

CET1 is the highest quality form of capital. This means that it has the greatest capacity to absorb losses, due to factors including permanency and ranking. The simplest examples of CET1 capital are shareholders' equity associated with ordinary shares and retained earnings. After CET1, the next tier is AT1 which is a high quality form of capital.

Finally, T2 capital also contributes to the overall strength of an ADI although not to the same degree as AT1 and CET1. Key reasons for this include that T2 capital is preferred in a liquidation to other forms of capital and T2 also has fixed interest payments and repayment dates. T2 capital must be converted into CET1 capital or written down in the event the ADI becomes non-viable. See APS 111 for further details.

Responses to questions

ACCC Question 1 *- How have the capital reforms that came into effect in January 2023, as well as the resolution reforms for domestic systemically important banks (D-SIBs) changed the amount of regulatory capital required to be held by each of Suncorp Bank and ANZ? How will those reforms change the capital required to be held by those banks in the future?*

In November 2021, after four years of design and consultation, APRA finalised the changes to the capital framework, as set out in APRA's Information paper - An Unquestionably Strong Framework for Bank Capital. The foundational objectives of the changes were to embed unquestionably strong capital (as recommended by the *Financial System Inquiry*[3]) and align to the internationally agreed Basel III framework.

An important improvement to the capital framework was enhanced risk sensitivity. Other improvements included increased flexibility, support for competition, improved transparency,

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[2] See, for example, APRA, *Insight Article: Is the capital benefit of being an advanced modelling bank justified?* (May 2023).

[3] Murray, D., Davis, K., Dunn, C., Hewson, C. and McNamee, *Financial System Inquiry - Final Report*, 2014.

and increased proportionality. The changes to the capital framework came into effect from 1 January 2023.

Another key change was the strengthening of capital requirements, mainly through expanded use of buffers. The two buffers are the capital conservation buffer (**CCB**) and the countercyclical capital buffer (**CCyB**)[4].

Regarding the CCB:

- The purpose of the CCB is to ensure ADIs have an additional layer of usable capital that can be drawn down when losses are incurred.
- The CCB is set at 2.50% - 4.75% CET1 capital (of RWA), depending on the category of the ADI (refer Table 2 below).

Regarding the CCyB:

- The purpose of the CCyB is for ADIs to strengthen resilience as systemic risks are building, which can be flexibly drawn upon during periods of market stress, including to enable ADIs to continue to supply credit to support economic activity.
- The CCyB is set within a range of 0% - 3.50% CET1 capital (of RWA). APRA publishes its CCyB decision at least annually, although changes may be made by APRA at any time. The CCyB is currently set at 1.00%.

Table 2: Settings in the capital framework — as at May 2023

Capital components for CET1 (% RWA)	Standardised	Advanced	Majors (D-SIBs)
Minimum Prudential Capital Ratio (PCR)	4.50%	4.50%	4.50%
Capital Conservation Buffer (CCB)	2.50%	3.75%	3.75%
Additional CCB for major banks as D-SIBs			1.00%
Countercyclical Capital Buffer (CCyB)	1.00%	1.00%	1.00%
Total	**8.00%**	**9.25%**	**10.25%**

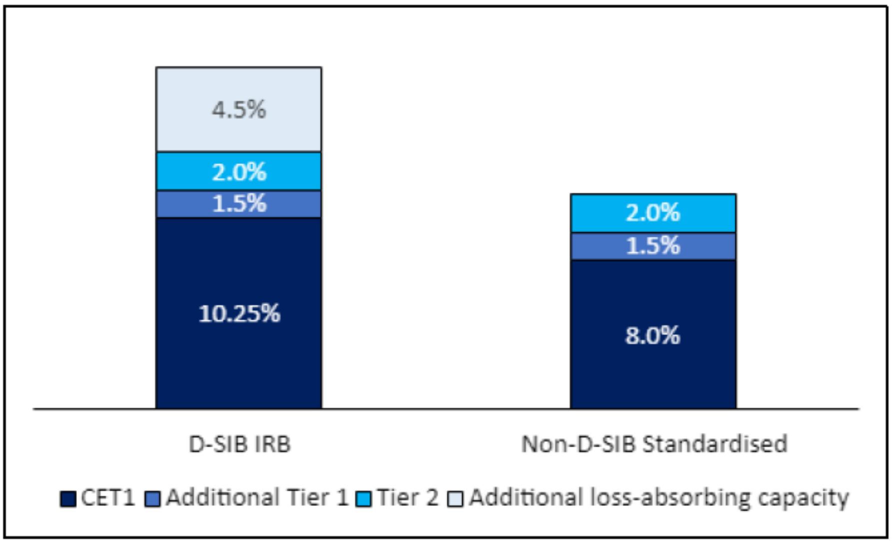
Loss absorbing capacity

APRA has also set loss absorbing capacity (**LAC**) requirements which provide additional capital to support resolution. APRA's final LAC requirement, which must be fully met by January 2026, is to increase minimum Total Capital for D-SIBs by 4.5% (of RWA) (Figure 1).[5]

[4] The CCyB is one of the macroprudential tools APRA can use to address risks to financial stability. Further information on macroprudential policy is set out in APRA's Macroprudential Policy Framework paper, released in November 2021.

[5] APRA set LAC requirements in two stages. In July 2019, APRA set an interim LAC requirement to increase the minimum Total Capital for D-SIBs by 3% (of RWA), to be met by January 2024. As at December 2021, D-SIBs had already met that requirement. In December 2021, APRA set the final LAC requirement of 4.5% (of RWA).

Figure 1 Indicative capital stacks: D-SIB IRB and non-D-SIB Standardised (from 2026)



LAC requirements may be met wholly or substantially with T2 capital. As set out in the background section above, CET1 is the highest quality form of capital in terms of capacity to absorb losses, followed by AT1 and then T2 capital.

Current and future effect of the capital reforms on the CET1 capital requirement of ANZ and Suncorp Bank

Table 3 shows how ANZ and Suncorp Bank were affected by the capital reforms in terms of their minimum CET1 capital requirements.

Table 3: CET1 capital requirements for ANZ and Suncorp Bank (Dec 2022 and Jan 2023)[1]

	ANZ		Suncorp Bank	
	31 December 2022	**1 January 2023**	**31 December 2022**	**1 January 2023**
Minimum PCR	4.50%	4.50%	4.50%	4.50%
CCB	2.50%	3.75%	2.50%	2.50%
CCB for D-SIBs	1.00%	1.00%	N/A	N/A
CCyB	N/A	c.1.00%[2]	N/A	1.00%
Total	8.00%	c.10.25%	7.00%	8.00%

[1] This does not include any PCR adjustments that APRA may apply but are not publicly disclosed.

[2] ANZ's CCyB may vary over time and differ from 1.00% which applies to Australian assets, due to its international exposures which will attract the applicable CCyB in their jurisdictions.

In terms of the future effects of APRA's capital reforms as set out above, the only element not yet fully in force is the final LAC requirement applicable to D-SIBs. ANZ (as a D-SIB) will be required to hold 4.50% Total Capital as loss absorbing capacity from January 2026.

Other factors relevant to the capital of ANZ and Suncorp Bank in the future

Separately, there are several factors which could impact the capital of ANZ and Suncorp Bank in the future. For example:

- APRA can adjust capital settings for an individual ADI by exercising supervisory discretion to set a higher PCR. For example, this may be done to address risks outside those addressed by the quantitative capital requirements set out in the prudential standards;
- should the proposed merger of ANZ and Suncorp Bank proceed following relevant approvals, the combined bank would be a D-SIB; and
- should the proposed merger of ANZ and Suncorp Bank proceed, the Suncorp Bank loan book would remain on the Standardised approach subject to ANZ applying for and obtaining approval to apply the IRB approach to the Suncorp Bank loan book.

Reported capital ratios

The capital reforms also had an impact on actual CET1 ratios due to changes in methodology used to calculate RWA. The public reporting of each bank provides some further insight into the effects of the capital reforms:

- ANZ's CET1 ratio increased by c.1.00 percentage points,[6] and
- Suncorp Bank's CET1 ratio increased by c.1.20 percentage points.[7]

ACCC Question 2 *- Why are D-SIBs required to hold additional regulatory capital, including loss absorbing capacity, compared to banks that are not D-SIBs?*

The global financial crisis over the period from mid 2007 through early 2009 was a period of extreme stress in global financial markets and banking systems.

In response, the Basel Committee on Banking Supervision (BCBS) introduced new capital and supervisory requirements applicable to global systemically important banks (G-SIBs). G-SIBs are required to hold further CET1 capital between 1.0% and 3.5% of RWA.

The purpose of the G-SIB framework is to address negative externalities associated with institutions that are perceived as not being allowed to fail due to their size, interconnectedness, complexity, lack of substitutability or global scope. This includes moral hazard costs associated with perceived implicit government guarantees as well as the risk of entity-failure costs being borne by taxpayers.[8]

While there are no G-SIBs in Australia, the BCBS and APRA have previously noted that there are many banks internationally that are not significant at the global level but could, if they were to come under stress, have an important impact on their domestic financial system and economy.[9] Accordingly APRA in 2013 commenced consultation to implement the D-SIB framework to address the potential adverse effects posed by systemically important banks in

[6] ANZ, *Consolidated Financial Report — Half Year 31 March 2023,* 4 May 2023.
ANZ, *2023 Half year results — results presentation and investor discussion pack*, 5 May 2023.

[7] Suncorp Group Limited, *Suncorp Bank APS 330: Quarter ended 31 December 2022,* 8 February 2023.
Suncorp Group Limited, *Suncorp Bank APS 330: Quarter ended 31 March 2023,* 10 May 2023.

[8] See, BCBS, *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement*, July 2013.

[9] APRA, *Information Paper: Domestic systemically important banks in Australia,* December 2013; APRA, *Finalising loss-absorbing capacity requirements for domestic systemically important banks,* December 2021.

Australia. In 2014 the Financial System Inquiry final report also recommended that APRA should develop a framework for loss absorbing and recapitalisation capacity to facilitate orderly resolution and minimise any need for taxpayer support.

In the Australian context, D-SIBs are those ADIs whose distress or failure would cause significant dislocation in the Australian financial system and adverse economic consequences. The four factors APRA uses to identify D-SIBs are size, interconnectedness, substitutability and complexity. Currently there are four D-SIBs in Australia.

ACCC Question 3 *- To what extent, if at all, does the requirement for D-SIBs to hold additional regulatory capital, including loss absorbing capacity, represent a calculation or estimate by APRA of the risk to financial system stability caused by the possibility that a D-SIB might fail?*

LAC is additional capital to support resolvability. The purposes of LAC are that:

- in the remote situation of D-SIB failure, the D-SIB could be resolved with minimal impact to the critical functions it provides to the economy and the community (such as deposit-taking and payments); and
- to reduce the risk of taxpayer funds being used for resolution purposes (as has occurred internationally).

The calibration of APRA's LAC requirement for D-SIBs was based on international benchmarking, including taking into account the historical losses experienced in past systemic banking crisis. APRA also took into account the impact of increased issuance of T2 capital instruments on market capacity, before determining final requirements.

ACCC Question 4 *- Does the additional regulatory capital, including loss absorbing capacity, D-SIBs are required to hold exceed or outweigh, as opposed to match or equal, the additional risk D-SIBs pose to financial system instability?*

Financial stability is a broad concept. A stable financial system is one in which there is trust and confidence that ADIs and other financial institutions can continue to perform their core economic functions for the benefit of the Australian community, including in the face of unexpected shocks howsoever arising.

Key components that contribute to a strong financial system include:

- financial resilience, extending to matters such as capital, liquidity and funding, as well as recoverability and resolvability;
- governance and risk management, extending to matters such as risk management frameworks and practices (e.g. sound credit portfolios and lending practices), governance, culture, remuneration and accountability practices, and resilience to operational and other risks (e.g. cyber); and
- broader factors, such as firm strategy and business model, as well as the economic and broader environment.

The nature and relative significance of these factors is dynamic and evolves over time. In addition, these factors apply at an individual ADI level and at a system level. Linkages across ADIs and other financial institutions are also relevant, as are linkages to the international financial system.

APRA interprets this question as being predicated on an assumption that it is possible to precisely quantify financial system stability and then derive ADI capital requirements. While APRA capital requirements are designed to reflect certain risks, the calibration of capital requirements involves a high degree of judgment.

In making such judgment, APRA has regard to a broad range of evidence and analysis. This includes international standards, domestic market conditions and industry structure, historical bank failures internationally, prior economic downturn experiences, regulatory approaches of peer jurisdictions, capital levels of internationally active banks, scenario analysis and stress testing, quantitative analysis and modelling, industry and broader stakeholder feedback, among other matters.

Bearing all of the above in mind, APRA's intent and best judgment is that the new capital framework which commenced January 2023, as well as the LAC requirements, are appropriately calibrated for the risks they are intended to capture. This entails both the probability of ADI failure, as well as the direct and indirect impacts of such failure.

Yours sincerely,

Renée Roberts
Executive Director