

# RatingsDirect®

---

## Australia's Developing Crisis-Management Framework For Banks Could Moderate The Government Support Factored Into Ratings

**Primary Credit Analyst:**

Peter Sikora, Melbourne (61) 3-9631-2094; peter.sikora@standardandpoors.com

**Secondary Contacts:**

Gavin J Gunning, Melbourne (61) 3-9631-2092; gavin.gunning@standardandpoors.com

Nico N DeLange, Sydney (61) 2-9255-9887; nico.delange@standardandpoors.com

Sharad Jain, Melbourne (61) 3-9631-2077; sharad.jain@standardandpoors.com

Ryan Tsang, CFA, Hong Kong (852) 2533-3532; ryan.tsang@standardandpoors.com

### Table Of Contents

---

APRA's Resolution Power Could Increase

Any Changes In Bail-In Powers To Be Closely Assessed

Depositor Protection Scheme Helpful To Financial System Stability But Falls Short For Some Creditors

Contingency Recovery Plans (Living Wills) Should Help Reduce But Not Eliminate Government Support Requirements

Hypothetical Scenario: Ratings On Major Banks And Macquarie Potentially At Risk From Any Change In Our Assessment Of The Australian Government's Willingness To Support Systemically Important Banks

Related Research

# Australia's Developing Crisis-Management Framework For Banks Could Moderate The Government Support Factored Into Ratings

The Australian government, like many governments in developed banking markets around the world, has been proactively contemplating a number of regulatory changes to strengthen its financial system safety net and improve its framework to manage financial crisis that may emerge in the future. Much of the changes being contemplated by governments around the world have been aimed at strengthening the resolution powers of their bank regulators. The urgency of this process has been boosted by a general interest globally by governments to improve banking system stability through crises and to reduce the prospect of taxpayer funds being needed to bail out financial institutions in difficulty, as was the case for some governments during the most recent dislocation of global financial markets in the years 2008-2009. Although some of these initiatives could potentially prove to be useful tools for aiding financial system stability in times of financial crisis, and might help reduce the government backing ultimately required to support systemically important banks if preemptive measures proved to be insufficient, some of the changes that might be considered or progressed in Australia could moderate the argument for factoring in government support to ratings at the level currently afforded.

## APRA's Resolution Power Could Increase

Standard & Poor's does not believe current developments around the potential establishment of greater resolution powers for the Australian Prudential Regulation Authority (APRA) have sufficiently weakened the rationale for our "highly supportive" assessment of the Australian federal government's tendency to support private-sector banks deemed to be systemically important under our bank rating methodology. That said, government support factored into bank ratings in Australia could be negatively affected if Standard & Poor's believed the Australian government or APRA were likely to establish powers within a resolution process that could see the repayment of creditor principal or interest delayed, or if creditors were likely to take a financial loss as part of the execution of bail-in resolution powers. Any strengthening of Australia's crisis-management framework will also need to be assessed for its impact on bank stand-alone credit profiles (SACPs).

In our view, APRA's general attitude to crisis management is aimed at building the suite of tools and options available to it and the government to support their abilities to deal with any emerging financial crisis. Furthermore, we believe the ultimate action taken by the government and regulator would continue to be heavily tied to what is the best solution for the circumstances at a given time.

Last year the Australian government released a consultation paper titled "Strengthening APRA's Crisis Management Powers", seeking market comment on a range of options to enhance Australia's financial sector, particularly around prudential regulation. The consultation paper specifically highlights that options canvassed include bringing Australia's regulatory framework in line with the Financial Stability Board's (FSB) paper "Key Attributes of Effective Resolution Regimes for Financial Institutions" (released in October 2011). Summarized simply, the FSB's paper called for G20

jurisdictions (which includes Australia) to put in place resolution regimes that give the resolution authority effective administrative power to resolve financial institutions in an orderly manner without exposing taxpayers to losses from solvency support, and without initiating insolvency proceedings. Importantly, these powers would need to be able to be exercised without the approval of creditors or the courts.

## **Any Changes In Bail-In Powers To Be Closely Assessed**

The FSB's key attributes paper specifically spells out 12 essential features that should be part of effective resolution regimes. A key one of those features centres on "resolution powers". The paper suggests that resolution authorities should have at their disposal a range of powers that include the ability to carry out "bail-in" within a resolution, meaning the regulator is empowered to write down creditor claims--including claims of senior creditors--to the extent necessary for absorbing losses. Based on that paper (or the resolution regimes in some other countries), we believe that the manner of loss-absorption powers could potentially include: explicit haircuts in the principal owed, a forced exchange of senior debt for common equity, or the restructuring of creditor terms. APRA does not currently have the express power to bail-in senior creditors, although it does have the power to order that no payment be made on a bond without APRA approval, and can, under the Banking Act, instruct a bank to raise additional capital.

From a ratings perspective, the development of a more comprehensive resolution regime in Australia if pursued--particularly one that confers bail-in powers to the regulator, thereby reducing the chances of government support being needed--could raise the question of whether the creation of such a framework and power will have an overall weakening impact on our assessment of a government's tendency to support private-sector banks. This is so particularly if the bail-in power allowed for a write-down in claims of senior creditors; that is, not only Basel 3 compliant capital instruments, where loss absorption is permitted within the terms of issue. Standard & Poor's would carefully review the detail of any changes that might be progressed as part of the Australian government's current deliberations around regulatory powers. Creation of bail-in powers would likely change our current "highly supportive" assessment of the Australian government in relation to systemically important banks. Our position recognizes that:

- Standard & Poor's rating focus with respect to support remains closely tied to what we think a government or regulator would do to support its systemically important banks, rather than only on what it could do within an established regulatory and legal crisis-management framework.
- Establishment of strong resolution powers for all banks in a banking system, including those deemed to be domestically systemically important financial institutions, can help manage moral hazard in a banking system and could be aimed at political posturing, as it may be perceived as a government's hesitance to use tax-payer funds to support private-sector banks.
- Resolution regimes provide effective powers for resolving problems that might emerge in smaller, less systemically important financial institutions should normal regulatory oversight or preemptive regulatory measures not be sufficient to sort out problems that might emerge at a bank.
- Establishment of a wide-reaching resolution framework could provide a fall back for resolving problems that might emerge at larger systemically important financial institutions if the government's currently "highly supportive" attitude or capacity to support systemically important financial institutions were to change.
- Bail-in on one or more debt issues of an approved Australian deposit-taking institution (ADI) by itself is unlikely to cause a cross-default on other debt obligations. This is because under the current regulation, for an ADI's additional

Tier 1 or Tier 2 capital instruments to be recognized as regulatory capital there must be no cross-default clauses in the documentation of any debt or other capital instrument of the issuer linking the issuer's obligations under the instrument to default by the issuer under any of its other obligations, or default by another party, related or otherwise.

## **Depositor Protection Scheme Helpful To Financial System Stability But Falls Short For Some Creditors**

Although the existence of government guarantees in a banking system is usually considered a characteristic of a "highly supportive" government, and initiatives such as depositor-protection schemes can effectively support system stability in times of financial system stress, they typically do not go far enough themselves to support factoring government support into ratings. The terms of Australia's current depositor-protection scheme (the Financial Claims Scheme, or FCS), were created in February 2012. The scheme covers deposits of up to A\$250,000 in value, which leaves a portion of system deposits not covered, and support might not be timely. In addition to this, the Banking Act prescribes depositor preference over other creditors in a winding up.

There has been some public discussion recently around the merit of establishing an ex ante-funded deposit-insurance scheme in Australia, a model adopted by many other banking jurisdictions around the world. The International Monetary Fund (IMF) prepared a technical note in November 2012 as part of its "Financial Sector Assessment Program", titled "Financial Safety Net and Crisis Management Framework", which recommends that Australia change its FCS to an ex ante-funded scheme, collecting premiums from ADIs periodically to build up a reserve fund against future ADI failures. Similar to the FCS, establishment of an ex ante depositor-protection scheme might not sufficiently cover all deposits, and would not in itself provide any repayment protection for other creditors, which would limit the direct benefit of such an initiative to our assessment of government support.

## **Contingency Recovery Plans (Living Wills) Should Help Reduce But Not Eliminate Government Support Requirements**

Contingency recovery plans being developed for banks in Australia have the potential to support financial system stability if problems were to emerge at a system level or in a large bank. However, the initiative does not support the argument for factoring government support into bank ratings, particularly as the plans exclude any scenarios that require the provision of public financial support. In our view, the establishment of credible recovery plans for banks may help moderate the financial losses that might emerge at a bank experiencing financial stress, but might not eliminate the prospect that government support could be required for averting repayment delay or loss for some creditors.

Starting with a pilot program in 2011, APRA has made some progress in developing contingency plans for its domestic systemically important financial institutions. Six of Australia's largest ADIs had their recovery plans approved by APRA in mid-2012, and the program has been extended to establishing recovery plans for midsize ADIs and large insurers.

The recovery plans consider a range of stress conditions and a menu of recovery actions that can be used in both idiosyncratic and/or market risk stress situations. APRA expects ADIs in a stressed event recover to prudential

minimums within six months. While this sets the minimum expectation, target recovery levels and timeframes are expected to change as the framework continues to evolve.

## Hypothetical Scenario: Ratings On Major Banks And Macquarie Potentially At Risk From Any Change In Our Assessment Of The Australian Government's Willingness To Support Systemically Important Banks

Standard & Poor's criteria for rating banks provide scope for lifting ratings from an ADI's stand-alone credit profile assessment to account for extraordinary government support. To qualify for rating uplift from government support under our bank rating methodology the government's tendency to support private sector commercial banks must be assessed as at least "supportive" or "highly supportive", and the bank's systemic importance (as described in Standard & Poor's methodology) must be assessed as at least "moderate" or "high".

An "uncertain" assessment on the government's tendency to support private-sector banks, or a "low" systemically important assessment on a bank would not support the factoring in of extraordinary government support from being factored into a bank's rating unless rating uplift were supported by our assessment under our criteria for Government Related Entities.

We classify the Australian government as being "highly supportive" of the country's banking system, reflecting our expectation of the government's timely financial support to ensure the stability of the financial system, if needed. This assessment factors in a well-developed administrative and institutional framework that should facilitate a timely and coordinated response, and a track record of proactive and prompt support for the banking system through measures such as guarantees for funding during the global financial crisis at a time when bank asset quality in Australia remained in good shape by international standards. We believe that the government's existing legislation, policy, and relationships with supranational agencies do not hinder it from assisting the banking system.

Although the Australian government has a long history of taking steps to support ADIs during times of market stress, there are currently only six domestically incorporated issuers in Australia that enjoy rating uplift from extraordinary government support (see table 1). The main reason for the remaining ADIs being assessed as of "low" systemic importance and hence their ratings not directly benefitting from government support relates to two key elements within Standard & Poor's methodology. These are:

- Under our criteria, the majority of banks in a banking industry are likely to be of "low" systemic importance to their country's banking system.
- The ADIs assessed as being of "low" systemic importance generally are smaller financial institutions whose failures are not likely to have a material impact on the financial system and real economy, in our opinion.

**Table 1**

Summary of Current Government Support in Australian Financial Institution Ratings				
	Systemic Importance	Stand-Alone Credit Profile	Rating Uplift from Government Support	Long-term Issuer Credit Rating
Commonwealth Bank of Australia	High	a	2	AA-
Westpac Banking Corp.	High	a	2	AA-
National Australia Bank Ltd.	High	a	2	AA-

**Table 1**

Summary of Current Government Support in Australian Financial Institution Ratings (cont.)				
Australia and New Zealand Banking Group Ltd.	High	a	2	AA-
Macquarie Bank Ltd.	Moderate	bbb+	2	A
Cuscal Ltd.	Moderate	a	1	A+

**Table 2**

Hypothetical Summary Of Government Support In Australian Financial Institution Ratings If The Government's Willingness To Support Banks Were Lowered To "Supportive" From "Highly Supportive"					
	Systemic Importance	Stand- Alone Credit Profile	Rating Uplift from Government Support	Long-term Issuer Credit Rating	Hypothetical Rating Impact
Commonwealth Bank of Australia	High	a	1	A+	1 notch downgrade
Westpac Banking Corp.	High	a	1	A+	1 notch downgrade
National Australia Bank Ltd.	High	a	1	A+	1 notch downgrade
Australia and New Zealand Banking Group Ltd.	High	a	1	A+	1 notch downgrade
Macquarie Bank Ltd.	Moderate	bbb+	1	A-	1 notch downgrade
Cuscal Ltd.	Moderate	a	1	A+	No rating change

So, when it comes to credit ratings, some of the changes being considered for Australia's banking regulation related to crisis management could diminish the case for factoring in government support to banks' ratings at the level currently assessed. Table 2 outlines the potential effect on financial institutions' ratings of a hypothetical diminution of government support that caused us to revise our opinion of the Australian government's willingness to provide extraordinary support to "supportive" rather than "highly supportive". Under such a hypothetical scenario, our opinion is that the ratings on the four Australian major banks and Macquarie Bank Ltd. might be lowered by one notch. Our analysis assumes that all other factors that could influence the hypothetical scenario are equal and unchanged, including no change to the AAA/Stable/A-1+ local currency issuer credit ratings assigned to Australia (i.e. that the government's capacity to provide extraordinary support was unchanged) and no change to our assessment of stand-alone credit profile factors.

Many of the crisis-management initiatives being considered by Australian authorities could help with financial system stability in times of financial crisis. They also might help reduce the amount of government support ultimately required to back up systemically important banks should those banks' own enterprise risk management measures prove to be insufficient. But the development and implementation of a more comprehensive resolution regime in Australia, particularly if it infers wide bail-in powers for the regulator, does give cause for musing on whether the creation of such a framework would weaken the impact on our assessment of a government's tendency to support private-sector banks.

## Related Research

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010

- Banking Industry Country Risk Assessment Update, Nov. 7, 2013
- How Government Support Is Factored Into Our Ratings On Australia's Banks, Nov. 13, 2013

Standard & Poor's (Australia) Pty. Ltd. holds Australian financial services licence number 337565 under the Corporations Act 2001. Standard & Poor's credit ratings and related research are not intended for and must not be distributed to any person in Australia other than a wholesale client (as defined in Chapter 7 of the Corporations Act).

Copyright © 2014 Standard & Poor's Financial Services LLC, a part of McGraw Hill Financial. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgement as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, [www.standardandpoors.com](http://www.standardandpoors.com) (free of charge), and [www.ratingsdirect.com](http://www.ratingsdirect.com) and [www.globalcreditportal.com](http://www.globalcreditportal.com) (subscription) and [www.spcapitaliq.com](http://www.spcapitaliq.com) (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at [www.standardandpoors.com/usratingsfees](http://www.standardandpoors.com/usratingsfees).