Aussie regulator junks ‘bail-in’ bonds as strategies fall apart

On 10 September, the Australian Prudential Regulation Authority (APRA) announced it would start phasing out hybrid (bail-in) bonds over five years, beginning from 2027. The decision, which was prepared in a consultation with banks commencing a year ago, was impacted by the failure of banking giant Credit Suisse in March 2023, which saw hybrid investments wiped out.

Hybrid bonds are risky securities that bear a high interest rate, but if the bank’s capital ratio falls below 5.125 per cent they are written off or converted into shares in a “bail-in” to help recapitalise the bank—a bank rescue using creditors’ funds. After the 2008 Global Financial Crisis bail-in was promoted as the only solution to averting another chain-reaction banking crash, because the now seemingly limitless reach of Quantitative Easing to keep the collapsing system afloat was then untested.

Jonathan Shapiro reported in the *Australian Financial Review* the day of APRA’s announcement that the Credit Suisse collapse made APRA “appreciate that hybrid capital [in Australia’s case] was owned largely by retail investors and if things got so bad it would be too uncomfortable to impose losses on them. And, by acting on hybrids’ sacrificial purpose, it would amplify a loss of faith in Australian banks rather than solidifying the system as intended.”

In other words, the purpose of hybrid bonds—to help “resolve” a collapsing bank—would be undermined. As APRA warned in 2023: “Converting their investments into equity or writing them off could undermine confidence in the financial system and impact the stability of other institutions—a complication that risks impeding the speed of decision-making in a crisis.”

The Australian banking system has issued some $43 billion worth of hybrids, which earn an interest rate of around 3-4 per cent more than the regular bank rate. According to APRA some 53 per cent are owned by small investors, which is “unusual by global standards”.

The then Chairman of the Australian Securities and Investments Commission (ASIC), Greg Medcraft, warned in 2017 that hybrid bonds were a “ticking time bomb”, which is why the UK had banned their sale to retail investors. In 2016 then-APRA head Wayne Byres had counselled against viewing hybrids “as simply higher-yielding substitutes for vanilla fixed-interest investments, let alone deposits” when they are actually the “first lines of defence … to aid an orderly resolution”.

On 10 September, APRA released the framework of its proposal to phase out the bonds for stakeholder feedback. Its statement noted: “The proposed changes draw on the lessons of last year’s global banking turmoil where several US and European banks either failed or needed to be resolved in short succession, with a number of governments having to intervene to minimise the risk of contagion and financial system instability.”

APRA acknowledged the role of hybrids in bail-in, using Bank for International Settlements (BIS) terminology, namely bank “resolution”: “The purpose of AT1 [Additional Tier 1 capital, a.k.a. hybrid bonds] is to stabilise a bank so that it can continue to operate as a going concern during a period of stress, and support resolution with the capital that is needed to prevent a disorderly failure.

“Unfortunately, international experience has shown that AT1 does not fulfil this function in a crisis situation due to the complexity of using it, the potential for legal challenges and the risk of causing contagion. These risks are heightened in the Australian context due to the unusually high proportion of AT1 held by retail investors.”

APRA Chair John Lonsdale claimed that replacing hybrid bonds with “more reliable forms of capital will enable banks to more quickly and confidently use their capital buffers in a crisis scenario”. The hybrid strata of regulatory capital will be replaced by increasing existing equity capital and Tier 2 bonds, largely held by wholesale rather than retail investors and described by APRA as “more reliable”. The total amount of regulatory capital required to be held by banks will remain the same, but AFR notes it could lead to higher costs for banks to obtain funding.

Figure 1. Crisis policy reforms

Crisis powers! A timeline of Crisis policy reforms including bail-in “crisis powers” provided in APRA’s paper, “A more effective capital framework for a crisis”, released 10 September.

In its framework paper, APRA referred to its effort over the last decade to reinforce the banking regulation framework in preparation for a crisis, including its “crisis management powers, developing a policy framework for resolutions planning, and requiring certain banks to increase their loss-absorbing capacity”—all of which refers to the BIS bail-in regime, the latter (loss-absorbing capacity) encompassing hybrids. Hybrid bonds were coopted in 2013 as a type of “regulatory capital” that banks must keep on their books, said the APRA paper, “as part of reforms to the international banking regulatory framework in response to the Global Financial Crisis.” (Timeline graphic, Fig. 1)

However, the confiscation of Credit Suisse bail-in bonds in 2023, noted APRA, revealed that the resolution process “is hampered where there is uncertainty around investor reactions, contagion risks, and broader systemic impacts”.

The beginning of the end?

The extensive and well-defined global bail-in regime is in fact a bare skeleton with no meat on the bones. While central bank technocrats have spent nearly two decades inducing parliamentarians to construct a new framework to rescue banks in the post-2008 crash era, since its initial use in 2013 in Cyprus—which itself was scaled back—it has rarely been successfully deployed.

In almost all instances of its use, it has been accompanied by bailouts, which it was meant to replace; in many cases exemptions to the bail-in regime were granted; the terms of bail-ins have been made up or changed by central banks during the process; new rules have been added to force the system to work, such as a European Union pre-resolution moratorium tool to prevent deposit withdrawals ahead of an anticipated bail-in; and nations from India, to New Zealand and Australia, have taken backward steps or refused to advance their bail-in regimes. *AAS* has thoroughly documented this at every step; relevant articles are posted at citizensparty.org.au/stop-bail-in/bail-in-overseas-horror-stories.

By exposing the BIS agenda, in 2013-14 the Citizens Party delivered a global setback for bail-in plans. Head of the BIS-run Financial Stability Board, Mark Carney, had declared that the global bail-in regime must be finalised by the November 2014 G20 Leaders’ Summit in Brisbane. But Carney beat a tactical retreat after it became clear that developing nations would not accede to the bail-in demands. His new plan? The hybrid bonds that have now been undermined, also from Australia thanks, at least in part, to the ACP.

By Elisa Barwick, Australian Alert Service, 18 September 2024

From the Archives:

Implementing bail-in requires rolling back democracy: JPMorgan

In March 2013 the European Troika—IMF, European Central Bank and EU—demanded Cyprus confiscate money from depositor accounts to save collapsing banks. It also ruled that its new “bail-in” scheme to save the banks—invented post-GFC by derivatives speculators—become the template for all future crises.

Not surprisingly the proposal met with much opposition, not only across Europe, but across the world. In Europe, however, it became a matter of upholding hard-won constitutional protections that resulted from the World War II fight against Fascism.

A European protest over bank bail-ins and bailouts. Photo: Revolution LA

The issue, for the bankers pushing bail-in, thus became one of removing those post-War political obstacles in order to provide central banking and regulatory authorities expanded powers to dictate policies that would save the banks.

In a revealing 2013 report, JPMorgan blasted European Southern Rim nations boasting anti-fascist constitutions for holding up plans for a fully-fledged European financial dictatorship.

The Wall Street behemoth revealed the plan in a 28 May 2013 report entitled " The Euro Area Adjustment: About Halfway There", which argued that the major obstacle to centralised financial control of Europe was the anti-fascist measures adopted in the constitutions of Southern European nations such as Italy following World War II. "The constitutions and political settlements in the southern periphery, put in place in the aftermath of the fall of fascism, have a number of features which appear to be unsuited to further integration in the region", JPMorgan complained.

"The political systems in the periphery were established in the aftermath of dictatorship, and were defined by that experience. Constitutions tend to show a strong socialist influence, reflecting the political strength that left wing parties gained after the defeat of fascism. Political systems around the periphery typically display several of the following features: weak executives; weak central states relative to regions; constitutional protection of labour rights; consensus building systems which foster political clientalism; and the right to protest if unwelcome changes are made to the political status quo. The shortcomings of this political legacy have been revealed by the crisis. Countries around the periphery have only been partially successful in producing fiscal and economic reform agendas, with governments constrained by constitutions (Portugal), powerful regions (Spain), and the rise of populist parties (Italy and Greece)."

The banking giant complained that, constrained by such constitutions, these nations were hamstrung from producing adequate fiscal and economic reform agendas—namely that of crushing austerity and more liberalisation, deregulation and privatisation. And, of course, stealing people's money to save failing banks.

The report stated that despite the existing austerity measures, which were harsh, the Eurozone was only about halfway through its period of adjustment, so austerity was likely to be a feature of the landscape "for a very extended period". The report claimed that the problem with imposing austerity was not just fiscal discipline, but that there is too much democracy in some European countries. This was blocking imposition of a top-down Euro wide bail-in regime, the report stated:

"In the early days of the [current] crisis, it was thought that these national legacy problems were largely economic: overleveraged sovereigns, banks, and households, internal real exchange rate misalignments, and structural rigidities. But, over time, it has become clear that there are also national legacy problems of a political nature. The constitutions and political settlements in the southern periphery, put in place in the aftermath of the fall of fascism, have a number of features which appear to be unsuited to further integration in the region."