EXPERT WITNESS REPORT

In relation to ANZ's Authorisation Application For proposed acquisition of Suncorp Bank

Dr. Jeffrey Carmichael AO
25 November 2022

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Acknowledgement
I acknowledge that I have read the Harmonised Expert Witness Code of Conduct and that I agree to be bound by it.

My Qualifications as an Expert Witness
Over a 50-year career I have specialised in financial regulation. Relevant roles (from oldest to most recent, with some roles overlapping) include:

- Twenty years in senior roles with the Reserve Bank of Australia (1969-1989)
- Eight years as Professor of Finance at Bond University (1989-1997)
- Four years as Chairman of the Australian Financial Institutions Commission (AFIC) (1992-1996)
- Two years as Chairman of the Queensland Office of Financial Supervision (QOFS) (1994-1996)
- One year as a Member of the Commonwealth Government's Inquiry into the Australian Financial System (Wallis Committee) (1996-1997)
- Five years as Chairman of the Australian Prudential Regulation Authority (APRA) (1998-2003)
- Fifteen years as CEO and Practice Leader of Promontory Financial Group Australasia (2006-2022)

I have Honours degrees from the University of NSW (BComm and MComm) and an MA and PhD from Princeton University.

I have served on a number of government inquiries and government and private sector boards. I am currently a member of the Board of the Qatar Financial Centre Regulatory Authority.

I have published two books and over 40 articles in professional journals on economics, finance, and financial sector regulation.

In 1995, I was awarded an Officer of the Order of Australia (AO) for service to finance, education and the community.

In 2009 I was invited to address the US Senate on the strengths of the Australian banking regulatory architecture.

Assumptions and material facts relevant to the opinions expressed in this Report
See Attachment 1: Letter of Instruction from Ashurst Australia

Other matters required by the Harmonised Expert Witness Code of Conduct
Covered in the Report below

Declaration
I have made all inquiries that I believe are desirable and appropriate for addressing the questions posed. It is my opinion that no matters of significance relevant to these questions have been withheld from this Report.

Jeffrey Carmichael 25 November 2022

EXPERT WITNESS REPORT
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for Proposed Transaction to acquire Suncorp Bank

1. Background

The Letter of Instruction for this engagement (see Attachment 1 to this Report) requests that I, in my role as independent expert witness, address the following questions based on my training, study or experience and having regard to the factual assumptions set out in Annexure A to the Letter of Instruction:

(a) *In your opinion, would the Proposed Transaction result, or be likely to result, in any public benefit/s relating to the prudential safety and stability of financial institutions and/or the broader Australian financial system?*

(b) *In your opinion, would the Proposed Transaction result, or be likely to result, in any public detriment/s relating to the prudential safety and stability of financial institutions and/or the broader Australian financial system?*

(c) *If your opinion identifies both public benefits and detriments in response to the questions above, would the benefit/s outweigh the detriment/s to the public?*

The factual assumptions set out in Annexure A can be summarised as follows:

- The Proposed Transaction will involve ANZ Bank (ANZ) acquiring 100% of the immediate non-operating holding company of Suncorp Bank from Suncorp Group.
- ANZ estimates that the Proposed Transaction will result in an increase in the Total Capital held by the merged entity with respect to Suncorp Bank's Risk Weighted Assets (RWA) of $1.914 billion.
- The Proposed Transaction will otherwise have no impact on the capital held by the merged entity.

2. Public Benefits and Detriments

This Report addresses the public benefits and detriments arising from the impact of the Proposed Transaction on the safety and soundness (i.e., on the riskiness) of Suncorp Bank and the consequent implications for the safety of Suncorp Bank's deposits and for the systemic stability of the financial system as a whole.

I understand there may be other sources of public benefit and detriment arising from the Proposed Transaction and that others may be commenting on these.

2.1 Measuring Bank Risk

In regulatory circles, a bank that is safe and sound is one that has a low risk of failing. Consistent with international practice, the Australian Prudential Regulation Authority (APRA) identifies inherent banking risk as arising from the following five main characteristics of banking business[1]:

[1] In the Australian context, APRA categorises banks as part of the broader group of Authorised Deposit-taking Institutions (ADIs). In this Report I will simply refer to all APRA requirements applying to ADIs as applying to banks.

- credit risk (the risk of loss arising from customer defaults on borrowing commitments);
- market risk (the risk of loss on a bank's trading assets and liabilities arising from changes in the general level of market prices or interest rates);
- operational risk (the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events);
- interest rate risk in a bank's banking book (the risk of losses in earnings or in the economic value of banking book items as a consequence of movements in interest rates); and
- liquidity risk (the risk that a bank will not have sufficient liquid funds to meet its payment obligations as they fall due).

Each of these five risk types is seen as central to the safety and soundness of a bank. Consequently, APRA has specified detailed processes for quantifying these risks. The key metric in quantifying the first, second and fourth of these risks is RWA, which provide a measure of the inherent riskiness of different asset classes on a bank's balance sheet. APRA is also prescriptive about how banks should manage liquidity risk and operational risk although, unlike the other main risk types, measurement of risk in these cases is not linked to RWA.

In addition to the five core risk types, APRA also identifies a range of other risks, such as outsourcing risk and information security risk, that could diminish the safety and soundness of a bank. APRA provides guidance on how such risk should be managed but provides no guidance or prescription about how such risks should be measured.[2]

While the failure of an individual bank poses an immediate risk to its depositors, it can also pose a systemic risk to the stability of the financial system more broadly. Systemic risk is the risk that there is a material disruption to the ability of financial institutions to perform their functions of providing financial products and financial services to the community.

Systemic instability is an overarching weakness of financial systems, in which a loss of confidence in one institution (most typically a highly leveraged bank) can lead to a loss of confidence in other similar institutions. In this way, systemic instability can undermine a system, even when it comprises otherwise sound institutions.

There is little agreement among experts about how systemic risk should be measured. An IMF study based on US banks following the global financial crisis of 2008 found that large banks were riskier, and created more systemic risk, when they have lower capital and less-stable funding.[3] These large banks were found to create more systemic risk when they engage more in market-based activities or are more organisationally complex. While this study suggests that bank size is a driver of systemic risk, the findings were as much a reflection of the characteristics of large US banks in the pre-crisis period (e.g., lower capital, less-stable funding, higher engagement in market-based activities, and greater organisational complexity than smaller banks), as they were of the inherent risk in large banks.

Size was nevertheless, and predictably, the focus of the regulatory response to the global systemic disruption experienced in 2008.

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[2] While these other risks are viewed by some as components of operational risk, the regulatory measure of operational risk is independent of variations in these particular risks.
[3] See L. Laeven, L. Ratnovski and H. Tong, Bank Size and Systemic Risk, *IMF Staff Discussion Note*, May 2014.

2.2 Mitigating Bank Risk

Consistent with international practice, APRA has established a Prudential Framework for regulating banks that requires them to mitigate their inherent risks by implementing risk management practices and holding capital sufficient to cover most, if not all potential losses.[4]

While APRA requires bank boards to take responsibility for determining the appropriate level of capital to hold at any point in time, it also sets strict minimum capital levels for various definitions of capital in terms of ratios relative to the bank's RWA to address credit, market and IRRBB risks.[5]

In Australia, as in other countries, the measurement of capital and the minimum levels of capital required to mitigate risks has undergone a steady evolution since their initial introduction in the 1970s.

Following the global financial crisis in 2008, banking regulators worldwide recognised not only the need to strengthen the minimum capital adequacy standards required to mitigate the risk to depositors, but also the need to strengthen capital adequacy standards further, in order to reduce the risk to systemic stability posed by systemically important banks.

Measures proposed by the Basel Committee on Banking Supervision in 2010 for global implementation over a period of years[6] included introducing a regulatory capital requirement for interest rate risk in the banking book (IRRBB) for systemically important banks, raising the minimum ratio of Common Equity Tier 1 Capital (CET 1) and establishing three capital "buffers":

- a capital conservation buffer (CCB);
- an additional CCB applicable to banks identified as domestic systemically important banks (D-SIBs); and
- a countercyclical capital buffer (CCyB) relevant to the specific jurisdiction.

APRA introduced the capital charge for IRRBB to apply to D-SIBs in January 2013, and the other changes in 2016.[7] Prior to that, in December 2013, APRA determined that the four Australian major banks were D-SIBs. APRA initially set the CCB at 2.5% of RWA (to be held in CET 1), the additional CCB for D-SIBs at 1% of RWA (to be held in CET 1), and the CCyB at zero.

In December 2020 APRA released a consultation package outlining proposed revisions to the capital framework for Australian banks.[8] The significant changes proposed reflected continued implementation of both international thinking about the capital adequacy framework being coordinated by the Basel Committee on Banking Supervision as well as the recommendation of the

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[4] In the same way that measurement of a bank's liquidity risk is not linked to RWA, mitigation of liquidity risk is not linked to its capital.

[5] In addition to the RWA-based capital requirements for credit, market and IRRBB risks, APRA imposes a capital requirement on banks for operational risk that is based on specified business indicators.

[6] These measures were proposed as part of Basel Committee's Basel III reforms to address shortcomings exposed by the 2008 global financial crisis. Basel III, which was published in November 2010, was originally scheduled to be introduced from 2013 until 2015, although implementation was extended several times.

[7] While APRA formally linked the capital charge for IRRBB to a bank's designation as a D-SIB in 2013, it had already required those banks that had been approved to use the internal ratings-based approach to calculating credit risk to also meet the IRRBB requirement. Thus, for example, ANZ had been meeting the IRRBB requirement since mid 2008.

[8] APRA, *Discussion Paper - A more flexible and resilient capital framework for ADIs*, December 2020.

2014 Financial System Inquiry to establish an 'unquestionably strong' capital framework for Australian banks[9].

The new framework, the bulk of which is scheduled to be implemented in January 2023, incorporates material changes to the way in which some RWA are calculated, an increase in the additional CCB applicable to D-SIBs from 2.5% to 3.75%, and a jurisdictional CCyB for Australia of 1%.

The imposition of additional CET 1 capital requirements for D-SIBs (1% in 2013 and a further 1.25% in 2023) reflected the internationally agreed position that, because of their threat to systemic stability, such institutions were regarded by the community as 'too-big-to-fail'.[10] The perception that an institution is too-big-to-fail leads to the expectation that, should failure become likely, public authorities will have no option other than to bail out the institution using public funds to avoid financial instability and economic damage. Provided the probability of failure is material, the cost of the moral hazard that can be associated with such a perception is borne by taxpayers, representing a large and unacceptable implicit public subsidy of private enterprise.

To offset this cost, global banking regulators, including APRA, imposed additional capital requirements on D-SIBs.[11] The objective of the additional capital was to reduce the probability of failure of D-SIBs to a negligible level, thereby minimising the likelihood that taxpayers might be called on to resolve the bank.

Following the additional capital impost on D-SIBs under the CCB framework, APRA also developed a resolution framework for D-SIBs, based on the principle that D-SIBs should have additional 'loss-absorbing capacity' (LAC). The combined additional CCB and LAC elements of the systemic stability framework sought to ensure that, in the event a large or complex bank failed, it could be resolved with minimal impact to its critical functions and with minimal probability of needing to call on taxpayer funds.

Unlike other banking regulators around the world APRA chose to integrate LAC into the existing capital framework, rather than introducing new instruments. An interim setting, introduced in mid 2019, increased the minimum Total Capital requirement for D-SIBs by 3%, to be met by January 2024.[12]

In December 2021 APRA released a Letter to D-SIBs finalising the systemic stability framework.[13] In its final release, APRA increased the LAC ratio from 3% to 4.5%, effective January 2026.[14]

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[9] See *Australian Financial System Inquiry Final Report*, Australian Treasury, December 2014.

[10] The challenges posed by banks that are 'too big to fail' were discussed extensively in the wake of the 2008 global financial crisis. These discussions led to the introduction of the concepts of G-SIBs and D-SIBs. See, for example, Basel Committee on Banking Supervision, *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement*, updated in July 2013, at http://www.bis.org/publ/ bcbs255.htm, and Financial Stability Board, *Progress and Next Steps Towards Ending "Too-Big- To-Fail"* (TBTF), Report of the Financial Stability Board to the G20, 2 September 2013.

[11] While global regulators also imposed additional capital requirements on global systemically important banks (G-SIBs), no Australia banks are classified as G-SIBs.

[12] Imposing the increase on Total Capital permits the additional capital to be held in the form of Tier 2 capital.

[13] APRA - Letter to D SIBs re Finalising Loss-absorbing Capacity Requirements for Domestically Important Banks This can be found at: https://www.apra.gov.au/search?query=Letter+to+D-SIBs+2021.

[14] In the Letter, APRA noted that *"The final requirement will be set at the lower end of the range previously announced by APRA, in dollar terms. Given changes to RWA from the ADI capital reforms, the lower end of the range in dollar terms broadly equates to a requirement of 4.5 percentage points of RWA under the new capital framework, in place from 2023".*

By the start of 2026 D-SIBs will face a Total Capital requirement of 18.25% of RWA. The comparable requirement for Standardised banks will be 11.5% of RWA (6.25 percentage points lower than for D-SIBs).

2.3 Assessing the impact of the Proposed Transaction on safety and soundness

The starting point for assessing the impact of the Proposed Transaction on safety and soundness is its impact on the change in regulatory capital that the merged bank will be required to hold against the assets currently on the balance sheet of Suncorp Bank (Incremental Capital).

Starting with capital is consistent with the regulatory focus on capital. As APRA put it recently:

> *"Capital is the cornerstone of financial safety and system stability."*[15]

However, as should be clear from the analysis above, estimating the impact of the Proposed Transaction on the Incremental Capital required of the merged entity is reasonably complex.

The factual assumptions set out in Annexure A of Attachment 1 to this Report estimate the Incremental Capital to be $1.914 billion. This is the additional Total Capital that the merged entity will be required to hold against Suncorp Bank' assets. Of this total, ANZ estimates that $348 million will need to be held in additional CET 1 capital and $1.566 billion in Tier 2 capital. ANZ makes a number of key assumptions that simplify the calculation and notes that some of these are conservative, to avoid the risk of over-estimating the Incremental Capital.

While the Incremental Capital estimate is provided in Annexure A as an assumption for this Report, given the centrality of capital to any assessment of benefits and detriments there is a need to test the reasonableness of ANZ's estimate. In particular, it is useful to test whether ANZ's simplifying assumptions are indeed conservative.

In testing the reasonableness of ANZ's calculation of the Incremental Capital required by the Proposed Transaction I note that ANZ has access to considerably more detailed information about both Suncorp Bank and ANZ than I do. Thus, my intent is simply to test, on the basis of publicly available information, whether ANZ's calculation appears to be reasonable.

Annexure A sets out the basis of ANZ's calculation of the Incremental Capital associated with the Proposed Transaction. There are two main parts to that calculation: the impact of the Proposed Transaction on the calculated RWA of the assets in Suncorp Bank's book; and the impact of the Proposed Transaction on the minimum capital ratios imposed on the assets in Suncorp Bank's book.

Impact of the Proposed Transaction on Suncorp Bank's RWA

ANZ's calculation of Incremental Capital is based on Suncorp Bank's reported RWA at June 2022 of $34.797 billion. It is important to note that Suncorp Bank's RWA are likely to evolve in the natural course of business between June 2022 and the date at which the Proposed Transaction is likely to take place. There is no way of predicting accurately how this evolution might occur over that period and so, in the absence of any better information, ANZ's assumption to base its capital calculation on the composition of assets at June 2022, is a reasonable starting point.

[15] APRA, *Information Paper – An Unquestionably Strong Framework for Bank Capital*, Nov 2019.

There are three main potential factors[16] that could impact this starting point under the Proposed Transaction:

- The first is that APRA's Capital Adequacy changes scheduled for January 2023 are, *prima facie*, likely to reduce the level of RWA in the Suncorp Bank book.

- The second is that, while Suncorp Bank uses the Standardised Approach for calculating RWA, ANZ has approval from APRA to use its own internal ratings-based (IRB) approach. Following the Proposed Transaction, ANZ intends to use its IRB approach in calculating Suncorp Bank's RWA (subject to APRA's approval), which will tend to reduce measured RWA.

- The third is that the Proposed Transaction will lead to Suncorp Bank's assets becoming subject to a regulatory capital charge for IRRBB as a result of becoming part of a D-SIB, which will increase Suncorp Bank's measured RWA.

ANZ acknowledges these factors but notes that its due diligence indicates that the combined impacts would not result in any material change to Suncorp Bank's RWA.[17]

My observations about this assumption are as follows:

- With respect to APRA's Capital Adequacy changes scheduled for January 2023, based on its own modelling, APRA has estimated that RWA will, on average across D-SIBs reduce by 5% and, on average across standardised banks reduce by 6%.[18] While such a 6% reduction would be in the order of $2 billion on Suncorp Bank's RWA, the actual reduction is heavily dependent on the structure of Suncorp Bank's book, to which I was not privy.

- The impact on measured RWA of the move from the Standardised Approach to the IRB Approach is equally difficult to estimate accurately from publicly available information. An approximation to the impact can nevertheless be obtained by focusing on the single largest asset class in Suncorp Bank's book, namely 'Claims secured against eligible residential mortgages'. In Suncorp Bank's APS 330 Report for June 2022 these claims are reported as having a gross Credit exposure of $50.87 billion, and a RWA value of $17.88 billion. This reflects the credit risk weight on this class of loans of 35%. ANZ's APS 330 Report for the same period implies a risk weight for these assets of 27% (based on ANZ's IRB model). Applying ANZ's risk weight to Suncorp Bank's gross exposure for this lending category suggests that Suncorp Bank's RWA would decrease by a little over $4 billion.

- The impact of the requirement to hold capital against IRRBB is to increase Suncorp Bank's RWA. Again, a precise computation of the additional IRRBB charge is beyond the scope of this opinion. It is nevertheless possible to approximate this capital charge using the numbers provided in Suncorp Bank's and ANZ's APS 330 Reports for June 2022.[19] ANZ reports that its IRRBB RWA at that time was $38.4 billion or 10.7% of its reported Total Credit RWA of

[16] There is a potential fourth factor that could affect Suncorp Bank's measured RWA under the Proposed Transaction. Under Pillar 2 of its regulatory framework, APRA can impose an additional capital buffer on any bank. If this Pillar 2 buffer were materially different between ANZ and Suncorp Bank, the Proposed Transaction could have an additional impact on Suncorp Bank's RWA. As these Pillar 2 buffers are not made public, it is not possible to determine whether there is a differential Pillar 2 requirement for Suncorp Bank and ANZ. However, it is my understanding that, as APRA has introduced additional capital through the capital buffers and LAC, it has reduced its reliance on Pillar 2 buffers. Thus, the Pillar 2 factor can reasonably be ignored.

[17] See section 2.4(a) of Annexure A.

[18] APRA, *Information Paper – An Unquestionably Strong Framework for Bank Capital*, Nov 2019, p. 9.

[19] See https://www.anz.com/content/dam/anzcom/shareholder/2022-anz-june-pillar-3-disclosure.pdf and https://www.suncorpgroup.com.au/announcements-pdf/1693583.

$357.0 billion. Applying this same percentage to Suncorp Bank's reported Total Credit RWA of $30.9 billion suggests an estimate of the RWA increase due to IRRBB in the order of $3.33 billion.

My high-level estimates suggest a net reduction in Suncorp Bank's RWA of around $2.8 billion. While this is arguably material, my estimates are subject to the caveat that they are not based on the same level of detail that would have been available to ANZ in the course of its due diligence on Suncorp Bank.

Thus, while my high-level estimates are for a reduction, on balance, I find ANZ's estimate of 'no material impact' from the Proposed Transaction on Suncorp Bank's RWA to be reasonable.

Impact of the Proposed Transaction on Suncorp Bank's Minimum Capital Ratios

In the absence of a material impact on Suncorp Bank's RWA, the impact of the Proposed Transaction on Incremental Capital will be entirely in response to the additional requirements that will apply to Suncorp Bank's assets as part of a D-SIB, rather than as a Standardised bank.

ANZ's calculation of this impact is based on an increase in CET 1 of 1% of RWA and an increase in Tier 2 Capital of 4.5% of RWA. As should be clear from the analysis in Section 2.2, ANZ's calculation is a simplification to reflect the 'end state' of APRA's LAC transition by January 2026. ANZ acknowledges this simplification and the fact that its calculation does not include all aspects of APRA's evolving capital adequacy framework. ANZ notes that this simplification is conservative, to avoid the risk of over-estimating the Incremental Capital.

The table below summarises the differential in minimum capital requirements for D-SIBs and Standardised banks as they currently stand, as they will be under the changes that will be effective in January 2023, and when the LAC framework is fully implemented in January 2026.

Incremental Minimum Capital Adequacy Ratios (D-SIB vs Standardised)

	2022	**2023**	**2026**
CET 1:			
CCB	1%	1%	1%
Additional CCB for D-SIBs		1.25%	1.25%
Tier 2:			
LAC for D-SIBs*	3%	3%	4.5%
RWA (Suncorp Bank):	$34.797 b	$34.797 b	$34.797 b
Incremental Total Capital	**$1.39 b**	**$1.83 b**	**$2.25 b**

* The 3% LAC requirement for D-SIBs is to be met by January 2024. APRA has noted that D-SIBs are currently in compliance with this requirement and so it is assumed to be applicable in full. ANZ notes that it will likely meet the new 4.5% Tier 2 requirement well in advance of 1 January 2026 to minimise the risk of non-compliance with APRA's deadline.

The table also shows the additional Total Capital that will be required of the merged entity under the Proposed Transaction.

Allowing for the regulatory changes due to be implemented over the next few years I estimate that the Incremental Capital to be held by the merged entity against Suncorp Bank's RWA is likely to be in the order of $1.8 billion in 2023, and that this amount will increase to over $2.2 billion once the new LAC requirement for D-SIBs becomes fully effective in 2026. These estimates suggest that ANZ's assumption of Incremental Capital of $1.9 billion is not only reasonable (as an estimate of the impact within a few years of the Proposed Transaction), it is arguably conservative.

With reference to the earlier discussion of the impact of the Proposed Transaction on Suncorp Bank's RWA I note that, even if Suncorp Bank's RWA were to reduce by my high-level approximation of $2.8 billion, the impact of the Proposed Transaction on Incremental Capital would not be materially different from the estimates in the table above. With such a reduction in RWA the Incremental Total Capital requirements would be $1.36 billion in 2022, $1.68 billion in 2023 and $2.16 billion in 2026.

> **Based on my high-level calculations, I find ANZ's estimate of the impact of the Proposed Transaction on Incremental Capital to be reasonable.**

The impact of Incremental Capital on Suncorp Bank's overall safety and soundness

While capital is unarguably the central pillar of APRA's approach to safety and soundness, from a purely technical perspective, the dollar amount of Incremental Capital is not necessarily the best proxy for the change in safety and soundness associated with the Proposed Transaction. Incremental Capital only provides a public benefit in terms of safety and soundness if it reduces the probability that the bank managing the assets will fail. It is reasonably widely accepted within regulatory circles that higher levels of capital relative to risk-weighted assets reduce the probability of failure of a bank. Therefore, the change in the risk-weighted capital ratio, rather than the actual dollar level of capital, is arguably a more relevant metric for assessing the public benefit of the Proposed Transaction from the increase in safety and soundness. While the two measures are almost interchangeable at any point in time, the risk-weighted capital ratio is a more robust indicator of the probability of failure as a bank's size changes.

In the case of the Proposed Transaction, the risk-weighted capital ratio for Suncorp Bank's assets will increase (relative to the alternative of no Proposed Transaction) in 2023 from 11.5% to 16.25%. In 2026 the ratio will increase further to 18.25%. In percentage terms, the ratio will be higher relative to the alternative by 46% in 2023 and by 59% in 2026.

These are material increases in Capital Adequacy. If we follow APRA's logic in implementing its capital framework for D-SIBs, the additional capital required of D-SIBs should be sufficient to reduce the probability of failure from a finite level in the case of a Standardised bank to a negligible level in the case of a D-SIB. While it may not be possible to map the increase in the risk-weighted capital ratio required under the Proposed Transaction into a specific change in the probability of failure, in my opinion there is little doubt that the size of the increases is such that there would be a material public benefit to the depositors involved, in terms of the increased safety and soundness of their deposits.

2.4 The impact of Incremental Capital on systemic stability

Whereas the benefits of strengthening the safety and soundness of an individual bank accrue directly to the depositors of that bank, the benefits of strengthening the systemic stability of the financial system accrue to the community more generally. Similarly, any detriment to systemic stability is felt by the community more generally.

While the Incremental Capital that APRA will require the merged entity to hold against Suncorp Bank's assets under the Proposed Transaction may not be related to any change in the inherent riskiness of those assets from a safety and soundness perspective, the same cannot necessarily be said of systemic risk. The benefits to safety and soundness could be duplicated in terms of systemic stability, or they could be offset.

In terms of public benefit it is important to recognise that global regulators, including APRA, view safety and soundness of individual banks as the foundation of systemic stability. Thus, anything that increases the safety and soundness of a bank (as I believe will be the case with the Proposed Transaction) also provides a benefit in terms of systemic stability.

With the exception of the additional capital that the merged entity will be required to hold for IRRBB in Suncorp Bank's book, all other increases in capital are linked to the fact that ANZ is classified as a D-SIB. That is, ANZ is regarded by APRA as posing a material risk to the stability of the Australian financial system in the event that it fails, whereas Suncorp Bank (as a stand-alone entity) is not.

Thus, it could be argued that the additional capital required of the merged entity is primarily a response to an increase in systemic risk associated with Suncorp Bank's assets due to their inclusion, under the Proposed Transaction, within a systemically important bank. If that were the case, the extra systemic risk would offset the public benefit of the additional capital under the Proposed Transaction.

For this argument to stand it would be necessary to establish that the systemic risk posed by the merged entity is greater than that of ANZ and Suncorp Bank as stand-alone entities and, indeed, that it is greater by the amount of Incremental Capital that APRA requires the merged entity to hold.

I am not persuaded by this argument, at least not by the argument that the increase in systemic risk fully negates the systemic benefit of the Incremental Capital and its impact on the safety and soundness of Suncorp Bank's assets. Unlike APRA's approach to core risks such as credit risk and market risk, its approach to systemic risk is not based on measurement. There is no established metric that can be used to measure the change in systemic risk that would be incurred by the Proposed Transaction.

While there is no objective basis on which to quantify the increase in systemic risk associated with the Proposed Transaction, it is noteworthy that APRA has separated the capital increase into two distinct components. The first, an increase in CET 1 equal to 2.25% of RWA (included in the CCB), is consistent with international practice for D-SIBs. The second, an increase in Tier 2 Capital of 4.5% of RWA, is not applied globally.

APRA's rationale for applying the LAC charge in terms of the existing capital framework is to provide a buffer to help absorb losses in the event a D-SIB were to experience difficulties and to minimise the likelihood that taxpayer funds will be required to assist with resolution of a D-SIB. Arguably, this makes LAC a tool for resolution, rather than a tool for preventing failure. While this is possibly applying more science than was intended by APRA, it suggests that a rough back-of-the-envelope estimate of the increase in systemic risk associated with a D-SIB is the 2.25% incorporated into the CCB. [20] If this interpretation were correct, the increase in systemic risk would offset roughly one third of the benefit ascribed to the improved safety and soundness of Suncorp Bank's assets.

> **On balance, it is my opinion that the Proposed Transaction will have a positive impact on the systemic stability of the Australian financial system as a result of the Incremental Capital adequacy required by the Proposed Transaction. That impact will be the net of the positive reduction in systemic risk due to the improved safety and soundness of the**

[20] Technically, 1.25% of the 2.25% increase in CCB is a calibration outcome due to the impact of APRA capital reforms on IRB banks and therefore not D-SIB specific. Thus, this component could also be considered as non-systemic.

Suncorp Bank assets, and the negative increase in systemic risk due to their inclusion under the Proposed Transaction within a systemically important bank. I believe the impact will provide a positive net benefit, although the precise extent of the net benefit is impossible to estimate with any degree of precision.

Note: This is a qualified opinion based on the assumption that, while the systemic risk associated with the merged entity will be greater than that of ANZ and Suncorp Bank as stand-alone entities, the increase in systemic risk under the Proposed Transaction is smaller than the risk mitigation provided by the Incremental Capital required of the merged entity. In the absence of any objective data or methodology for calculating the contribution of a bank to systemic risk I have relied on the fact that APRA has set the capital adequacy requirements for a D-SIB at a level almost 60% higher than that for a Standardised bank. This suggests that APRA has increased the capital requirement for D-SIBs by more than is needed to compensate for its perception of the actual systemic risk associated with D-SIBs.

2.5 Other factors arising from the Proposed Transaction that could impact safety and stability

While capital is central to assessing the impact of the Proposed Transaction on safety and soundness and systemic stability, other factors may also play a role. In considering other potential sources of benefit and detriment I will focus on their impact on safety and soundness, since any impact on safety and soundness will have a similar directional impact on systemic stability.

In my opinion the safety and soundness benefits to Suncorp Bank's depositors extend beyond the impact of the Proposed Transaction on capital and capital adequacy. As outlined above, APRA's prudential framework for banks encompasses the measurement of risk and risk mitigation through risk management practices and capital. While APRA acknowledges that capital is the cornerstone of financial safety and soundness, it is only a part of the story.

In a perfect world, risk management practices would be the primary mitigant of risk, with capital very much a backstop. Thus, a bank that employs more sophisticated and robust risk management practices should, in a perfect world, be required to hold proportionately less capital than a bank with less expert risk management systems.

The reality is that larger banks, in general, invest more heavily in risk management than do smaller banks. They typically employ more sophisticated systems and have greater expertise in risk management than smaller banks do. In part this reflects the high cost of risk management systems and in part it reflects the ability of bigger banks (with greater flexibility to pay the market price for expertise and more opportunities for career advancement) to attract expert staff. This disparity is evident in the sophistication of risk management in the areas of fraud detection, anti-money laundering, and cybersecurity. It is also evident in more conventional banking areas such as the measurement and management of credit risk. It is for this reason that APRA accredits very few banks to use the IRB approach to credit.

The quicker Suncorp Bank and its risk management and operating systems are integrated into the merged entity, the quicker these benefits are likely to be realised.

There is a second argument as to why the Proposed Transaction is likely to provide public benefits to the safety and soundness of Suncorp Bank's assets. It is a fundamental tenet of measuring risk that overall risk is reduced by diversification. Thus, a book of loans will have a lower overall risk level if it has greater diversification of borrowers across loan types, industries and geographies. It is not surprising that, in the US, which experiences more bank failures than any other jurisdiction, the vast majority of failures are small, local banks that have concentrated risk exposures to particular geographies and industries.[21] For example, in the three years following the full impact of the 2008 global financial crisis, of the nearly 400 US banks that failed, not one was as large as Suncorp Bank, let alone as large as ANZ.

While Suncorp Bank has a reasonable diversification of assets across loan types, industries and geographies, its historical concentration of lending in Queensland and to Queensland industries suggests that some risk reduction should be experienced from the additional diversification that Suncorp Bank's loans would have from being integrated into ANZ's broader portfolio of loans.

It is noteworthy that APRA makes no allowance in its Capital Adequacy Framework for diversification benefits in lending. It similarly makes little allowance for differences in risk expertise and systems. While approval to use models to calculate certain risk weights provides some recognition of these skills, many other areas are treated as skill neutral. It is not that APRA does not recognise the value of factors such as diversification, and better systems and skills in risk management. The reality is that agreeing how these advantages should be quantified is still a work-in-progress for global regulators.

> **While it is not possible to quantify the impact of these non-capital factors on the safety and soundness of Suncorp Bank's assets under the Proposed Transaction, it is my opinion that these would complement the reduction in the probability of failure linked to the increase in capital adequacy under the Transaction.**

Note: This is a qualified opinion based on the assumption that ANZ's credit portfolio is more diversified, and their risk management systems more sophisticated, than those at Suncorp Bank. I have not had the opportunity to examine and test these assumptions although, based on my experience as a regulator and a regulatory consultant, I believe these are highly likely to be supported by the evidence.

2.6 Public Benefits and Detriments – Summary

Assessing the public benefits and detriments of the Proposed Transaction is a complex exercise. While the directions of the benefits and detriments are relatively easy to predict, the sizes of the impacts are much more difficult to quantify.

At centre stage of any assessment of the direction of benefits and detriments is the Incremental Capital and higher capital adequacy ratios that would apply to Suncorp Bank's assets under the Proposed Transaction.

In this opinion I have tested the reasonableness of ANZ's calculation of Incremental Capital, as well as the relevance of other considerations for assessing public benefits and detriments on the safety and soundness of Suncorp Bank's assets and on systemic stability.

My conclusions are the following:

- ANZ's calculation of $1.914 billion in Incremental Capital is not only reasonable, it appears to be conservative, once the full impact of APRA's regulatory changes have been fully implemented.

[21] For US bank failures since 2008, see https://en.wikipedia.org/wiki/List_of_bank_failures_in_the_United_States_(2008–present)#2021.

- While Incremental Capital is the building block of assessing the impact of the Proposed Transaction on safety and soundness, a better measure of the impact is the change in capital adequacy that will be applied to Suncorp Bank's assets. The increase in the risk-weighted capital ratio for Total Capital under the Proposed Transaction, from 11.5% in 2023 to 18.25% in 2026, will, in my opinion, provide a materially lower risk of default for Suncorp Bank's assets under the merged entity (arguably bringing it close to zero). It will therefore provide a material public benefit to Suncorp Bank's depositors.

- In my opinion the reduction in risk for depositors from the Incremental Capital under the Proposed Transaction is likely to be increased further: a) as a result of these assets being integrated into ANZ's stronger risk management framework; and b) from the additional diversification benefits that would accrue from the assets being integrated into ANZ's larger and more diversified portfolio. While I believe these two additional sources of public benefit to be material, it is not possible at this time to quantify their scale with any precision.

- The public benefit or detriment of the Proposed Transaction on systemic stability is more difficult to quantify. Internationally there is no agreed methodology for estimating the contribution of any individual bank to systemic risk. I believe that systemic stability is likely to be increased by the Proposed Transaction to the extent that the additional capital required of the merged entity exceeds the likely increase in systemic risk from the integration of Suncorp Bank's assets into the Merged entity. It is not possible to quantify the scale of the net reduction in systemic risk with any precision.

3. Opinion

It is my opinion that the Proposed Transaction will yield a positive net public benefit to Suncorp Bank's depositors by materially improving the safety and soundness of Suncorp Bank's assets which, in turn, will reduce the probability of failure of the entity supporting those deposits. This improvement in safety and soundness will be driven primarily by a material increase (beginning at 46% in 2023 and rising to 59% in 2026) in the capital adequacy requirement applied to Suncorp Bank's assets under the Proposed Transaction.

It is my opinion that a further reduction in actual risk will follow from the Proposed Transaction by the application of ANZ's stronger risk management techniques and systems to Suncorp Bank's assets and from diversification benefits associated with integrating Suncorp Bank's assets into the merged entity's more diversified portfolio of loans. In the absence of a detailed analysis of ANZ's and Suncorp Bank's loan portfolios and risk management systems, this is a qualified opinion based on my experience as both a regulator and a consultant in this field.

It is also my opinion that the Proposed Transaction will yield a net positive public benefit by reducing the net systemic risk of the Australian financial system. The benefit in this case takes the form of a reduction in the risk of systemic disruption and a reduction in the probability that taxpayers will be called on to resolve the bank. The net benefit is driven by a reduction in systemic risk associated with the increase in safety and soundness of Suncorp Bank's assets, which is likely to be only partially offset by an increase in systemic risk related to the inclusion of Suncorp Bank's assets into the merged entity. In the absence of any objective data or methodology for calculating the contribution of an individual bank to systemic risk, this is also a qualified opinion based on my experience as both a regulator and a consultant in this field.

Attachment 1

Letter of Instruction from Ashurst Australia

Our ref: 1000-122-202
Partner: Tihana Zuk
Direct line: [redacted]
Email: [redacted]
Contact: Nathan Lindsay

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9 November 2022

BY EMAIL: [redacted]

Dr Jeffrey Carmichael
68 Riverlea Waters Dr
Nerang, QLD 4211

Dear Dr Carmichael

We refer to our letter of engagement to you dated 28 August 2022. Terms defined in that letter have the same meaning in this letter.

We have been instructed to seek your independent expert opinion, in the form of a written report, in connection with the Authorisation Application.

This letter sets out the instructions for the preparation of your expert report.

1. **QUESTIONS TO ADDRESS**

1.1 Please address the following questions, based on your training, study or experience and having regard to the factual assumptions set out in **Annexure A**:

(a) *In your opinion, would the Proposed Transaction result, or be likely to result, in any public benefit/s relating to the prudential safety and stability of financial institutions and/or the broader Australian financial system?*

(b) *In your opinion, would the Proposed Transaction result, or be likely to result, in any public detriment/s relating to the prudential safety and stability of financial institutions and/or the broader Australian financial system?*

(c) *If your opinion identifies both public benefits and detriments in response to the questions above, would the benefit/s outweigh the detriment/s to the public?*

2. **OTHER INSTRUCTIONS**

2.1 In addressing the questions above in your report, you are instructed to:

(a) give the terms "public benefit" and "public detriment" their widest possible meaning. A public benefit includes "*anything of value to the community generally, any contribution to the aims pursued by the society including as one of its principal elements ... the achievement of the economic goals of efficiency and progress*".

(b) for any public benefits or detriments you identify, please also address (to the extent possible):

(i) the materiality of the benefit or detriment;

(ii) where relevant, the sections of the public to whom the benefit or detriment will accrue (for example, but without limitation, the merged entity, customers, shareholders, taxpayers, or the public generally); and

(iii) when, or in what circumstances, the benefit or detriment will accrue.

2.2 You are instructed to prepare your expert report in accordance with the requirements of the Practice Note and the Code, which were provided to you with your engagement letter. You are expected to be objective, professional and to form an independent view regarding matters relevant to your analysis. It is important that you carefully read and comply with the Code. We note that under the Code, your report must clearly state the following:

(a) your name and address;

(b) an acknowledgement that you have read the Code and agree to be bound by it;

(c) your qualifications as an expert to prepare the report;

(d) the assumptions and material facts on which each opinion expressed in the report is based (this letter of instructions may be annexed);

(e) the reasons for and any literature or other material utilised in support of each such opinion;

(f) (if applicable) that a particular question, issue or matter falls outside your field of expertise;

(g) any examinations, tests or other investigations on which you have relied, identifying the person who carried them out and that person's qualifications;

(h) the extent to which any opinion which you have expressed involves the acceptance of another person's opinion, the identification of that other person and the opinion expressed by that other person;

(i) a declaration that you have made all the inquiries which you believe are desirable and appropriate (save for any matter identified explicitly in the report), and that no matters of significance which you regard as relevant have, to your knowledge, been withheld from the court;

(j) any qualifications on an opinion expressed in the report without which the report is or may be incomplete or inaccurate;

(k) whether any opinion expressed in the report is not a concluded opinion because of insufficient research or insufficient data or for any other reason; and

(l) where the report is lengthy or complex, a brief summary of the report at the beginning of the report.

Please contact Tihana Zuk if you require any further information at this stage.

Yours sincerely

Ashurst

ANNEXURE A – FACTUAL BACKGROUND AND ASSUMPTIONS

1. THE PROPOSED TRANSACTION

1.1 If the Proposed Transaction proceeds, ANZ would acquire:

(a) 100% of the shares in SBGH Limited, the immediate non-operating holding company of Suncorp Bank; and

(b) certain real estate and intellectual and other property rights held by Suncorp Group entities to facilitate the operation of Suncorp Bank.

1.2 ANZ is an ASX-listed financial services group and one of Australia's four largest banks. It provides a range of banking products and services to retail and commercial customers in Australia and New Zealand, and to institutional customers globally.

1.3 Suncorp Bank is currently part of the Suncorp Group. Suncorp Group is an ASX-listed provider of insurance and banking products and services. Suncorp Group operates in Australia and New Zealand only. Suncorp Group offers its banking products through Suncorp Bank. If the Proposed Transaction proceeds, ANZ would only acquire the banking business from Suncorp Group.

2. INCREMENTAL CAPITAL ARISING FROM PROPOSED TRANSACTION

2.1 ANZ is classified by APRA as a domestic systemically important bank (**D-SIB**). Suncorp Bank is not a D-SIB.

2.2 If the Proposed Transaction proceeds, ANZ's status as a D-SIB will require that the merged entity holds additional loss absorbing capital (**LAC**) in respect of Suncorp Bank's risk weighted assets (**RWA**), compared to the LAC which would be held by Suncorp Bank in the absence of the Proposed Acquisition.

2.3 Item C of Table 1 below sets out the additional LAC that will be held by the merged entity as a result of the Proposed Transaction.

Table 1: Incremental capital to be held by merged entity as a result of Proposed Transaction

ITEM	AMOUNT ($ MILLION)
Suncorp Bank RWA (as at June 2022)	34,797
A. Additional CET-1 capital (1% of RWA)	348
B. Additional Tier 2 capital (4.5% of RWA)	1,566
C. Total Incremental capital (Sum of A and B)	1,914

2.4 The following key assumptions were used to quantify the additional LAC in Table 1:

(a) **RWA:** The latest externally reported RWA for Suncorp Bank (as at June 2022) is an appropriate estimation of the additional RWA that will be subjected to the additional LAC requirement as a result of the Proposed Transaction. ANZ's due diligence in respect of Suncorp Bank indicates that the combined impacts from APRA's capital reforms (effective January 2023) and APRA's accreditation to use the internal ratings-based (**IRB**) approach for calculating RWA (refer to details in 2.5 below) would not result in any material change to Suncorp Bank's RWA.

(b) **CET1:** Table 1 does not include the additional 1.25% increase in the Capital Conservation Buffer (**CCB**) for major banks arising from APRA's capital reforms. This increase in CCB is a calibration outcome as part of the capital reforms to ensure capital levels (measured in dollar terms) for major banks are not reduced as a result of the expected reduction in RWA following APRA's reforms. Prima facie, while it would be applicable to the analysis in Table 1, the CCB increase has been conservatively excluded to avoid the risk of over-estimating the additional LAC requirements in the event that there is a material reduction in Suncorp's RWA (contrary to ANZ's expectations) following implementation of the APRA capital reforms in 2023.

(c) **Tier 2:** The incremental Tier 2 LAC of 4.5% of RWA reflects APRA's fully transitioned additional LAC requirements for major banks, which would take effect by January 2026. APRA has adopted a phased approach to its implementation of higher LAC requirements with 3% of RWA (~$1 billion) required by January 2024 (which would be the requirement in-force at completion of the Proposed Transition) and the remaining 1.5% (~$0.5 billion) increment to take effect by January 2026. However, in practical terms, and subject to market conditions, ANZ will likely meet the new Tier 2 requirement well in advance of 1 January 2026 to minimise the risk of non-compliance with ARPA's deadline.

2.5 In relation to RWA impacts arising from the adoption of the IRB approach, you should assume that the Proposed Transaction will otherwise have no impact on the capital that will be held by any institution as a result of the Proposed Transaction. For completeness:

(a) Suncorp Bank and ANZ use different approaches to calculate RWAs. Suncorp Bank currently uses the standardised approach, under which it uses a set of prescribed risk-weights to calculate RWAs. ANZ has approval from APRA to use the internal IRB approach, under which it uses its own ratings system to calculate RWAs.

(b) ANZ and other banks that use the IRB approach are also required to hold regulatory capital against interest rate risk in the banking book (**IRRBB**).

(c) Subject to APRA's approval, if the Proposed Transaction proceeds, ANZ intends to use the IRB approach to calculate Suncorp Bank's RWA. The net effect of this change will be minimal, having regard to:

(i) On the one hand, the RWA calculations under IRB modelling generally require ANZ to hold less capital in respect of RWA than if the calculations had been performed using the standardised approach; and

(ii) On the other hand, the IRRBB regulations require ANZ to hold additional capital against IRRBB.