Australian Shareholders' Association

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ASA SUBMISSION – APRA – IMPROVING THE EFFECTIVENESS OF ADDITIONAL TIER 1 CAPITAL INSTRUMENTS – NOVEMBER 2024

Dear Sir/Madam

As the peak member organisation representing individual investors and shareholders, the Australian Shareholders' Association (ASA) appreciates the opportunity to provide feedback on the consultation paper *Improving the effectiveness of Additional tier 1 capital instruments* and by extension *A more effective capital framework for a crisis.*

APRA's Role

We acknowledge APRA is responsible for protecting the interests of beneficiaries (depositors, policy holders and superannuation fund members) and promoting financial system stability in Australia and with the highest priority to maintain confidence and certainty in the banking sector in the event of a crisis.

This consultation proposes potential amendments to APRA's prudential framework to replace Additional Tier 1 (AT1) capital with more reliable and effective forms of capital. AT1 Capital is comprised of hybrid securities listed on the ASX (hybrids). These hybrids used to be I the form of preference shares and are now more likely to be in the form of capital notes. They combine elements of debt and equity and are unsecured and in any winding up of an entity they are subordinated to all but the shares (as in all other debts get repaid before the capital notes). Subsequent to prudential responses to the Global Financial Crisis (GFC), the hybrids have included a loss absorbing clause which if a bank is in extreme difficulty they can be written off.

We see the issue driving APRA to replace AT1 securities is the ownership is predominantly by retail investors either directly or through their superannuation. The proposal is an acknowledgement that it would be very difficult to enact the loss absorbing clause in an extreme crisis because of the consequent effects on these individuals and ultimately financial markets and the economy.

Broad implications due to interconnected nature of Australian financial markets

As we have flagged in many of our publications and communications, that the Australian financial market is entwined with the wellbeing of its citizens through our superannuation system which funds eventual retirement, the listing of securities which provides capital to fund growth and business endeavours and the nature of our listed markets. Large oligopolies dominate superannuation investments, employment opportunities and the provision of goods and services because of the size and distribution of our population and land mass. In short, banks dominate investment opportunities with weightings in excess of 25% of the ASX200 Index, and 5 banks (the big 4 plus Macquarie Group) being amongst the largest 7 listed companies, as well as employing large numbers of personal. The big 4 banks are so systemically important they should not be allowed to fail.

ASA concerned with reduced range of investment opportunities

We see the crux of the paper for ASA's members is the removal of securities which provide quarterly cash flow and, for many, an annual refund of franking credits above the investors marginal tax rate from accessible investments. We also note that for taxpayers at the marginal tax rate of 30% or below, the franking credits assist in managing any tax payments.

In Australia, investors have limited direct investment in the fixed interest asset class, and have appeared to substitute hybrids, which are a combination of fixed interest and equity, via market exchanges. While the existence of the loss absorbing triggers is known, it is considered to be a very low risk because of their systemic importance, the prudential oversight and banks attention to managing the risk.

Importance of orderly adjustment

We support an intent to ensure the impact on investors is limited by ensuring an orderly adjustment with no impact on existing AT1 tranches, and early advice of any changes is welcomed. Maintaing the existing AT1 tranches will mitigate the reinvestment risk by spreading it over the maturity dates of the retiring tranches.

Benefit of hybrid securities to current holders and superannuation funds

While APRA's focus is the banking system, ASA will focus on the impact on investors especially retail investors (those not designated professional or credentialled as sophisticated investors) and self-managed super funds (SMSFs). For some investors, buying and selling hybrid securities is purely a value-based decision, in both adding diversity to an equity portfolio and trading when the returns are seen to reflect the risk. For other investors, bank hybrid securities provide liquidity to their retirement incomes, funding ongoing living expenses through their fully franked distributions which are paid quarterly, and, if held in a superannuation account, any refund of tax paid by the company that is in excess of the holder's marginal tax rate.

Bank hybrid securities have offered higher returns compared to government bonds and other fixed-income instruments, while also being easier to access with varying sized parcels available to be bought on the ASX.

The practice of the banks in replacing maturing tranches of hybrids with a new issue of capital notes made reinvesting the funds an easier transaction in an administrative sense for retail investors. We have received complaints from some ASA members who have been impacted by the introduction of the Product Design and Distribution Obligations (DDO). The DDO has resulted in restricted participation in these new issues before they list to sophisticated and syndicate broker advised investors, either excluding investors or requiring them to pay an advice fee for access.

Bank Hybrid Securities in periods of low interest rates

Bank hybrid securities have played a significant role in the investment plans of Australian superannuation investors, particularly during periods of low interest rates, such as the GFC. These securities have been attractive to investors seeking higher returns than traditional fixed-income investments which were unattractive due to their lower yields and no capital upside if held to maturity or in a rising interest rate environment.

In the protracted recovery period after the GFC, some investors may have reduced the diversification of their portfolios, by favouring bank hybrids over other investments, while others lifted their allocation to pure equity securities. Engagement with ASA members indicates our constituents who invest in hybrids are comfortable with equity risk and trading on the ASX.

Impact on the Superannuation Industry if Hybrid Securities are removed from investible options

If hybrid securities are to be removed from the list of investible options, funds will be forced to seek alternative investments, which may not offer the same balance of risk and return. This could lead to lower overall portfolio performance and increased volatility.

Replacing AT1 capital with tier 2 capital

While corporate bonds can be traded on the ASX, current offerings of subordinated notes are limited. The market would need to develop to be a viable alternative for reinvestment of expiring hybrids investment. For many years there has been intent to improve the ability of retail investors to the debt markets, with limited improvement. Alternatives for investment will be via ETFs or managed funds.

Implications for Listed Hybrids Issued by Insurance Companies with Trigger Clauses

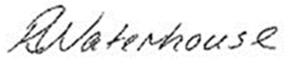
While appreciating APRA's concerns for AT1 are less acute for insurers, and noting the suggestion simplifying the capital framework involves different trade-offs, given the different nature of how financial or operating pressures may impact the insurance industry, we expect APRA to address the issue promptly before the end period for bank hybrids when funds from maturing hybrids will be seeking new investment options.

Summary

ASA agrees that the exposure of retail investors to AT1 capital could impede the use of the loss absorbing trigger in extreme crisis in the unlikely event of that failure. We consider that removing bank hybrids from the market will likely see reinvestment predominantly into equities, due to the ease of access and greater returns as well as the nature of the investors who are comfortable with equity investment.

If you have any questions about these comments, please do not hesitate to contact me, or Fiona Balzer, Policy & Advocacy Manager on (02) 9252 4244.

Yours sincerely



Rachel Waterhouse
Chief Executive Officer
Australian Shareholders' Association

Australian Shareholders' Association (ASA) is an independent not-for-profit organisation funded by and operating in the interests of its members. It represents primarily individual and retail investors, self-managed superannuation fund (SMSF) trustees, and investors, promoting good public policy and safeguarding their interests and financial wellbeing.