APRA review of AT1 hybrid securities – Lonsec submission

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Executive Summary

Lonsec would like to thank APRA for providing us with the opportunity to comment on the "Enhancing bank resilience: Additional Tier 1 Capital in Australia" discussion paper released in September 2023.

This submission is from the perspective of Lonsec Investment Solutions and Implemented Portfolios, which are the Lonsec Group's investment managers, focused on providing financial advisers and dealer groups with managed portfolios for retail clients. Because of this, we will defer to the banking sector on APRA's questions around resilience in the banking system and focus our own response on retail investment into AT1 hybrid securities.

Specifically, we wish to draw to APRA's attention the significant component of retail ownership of AT1 hybrids which is professionally managed at an aggregate level via Separately Managed Account (SMA) and Individually Managed Account (IMA) structures. We request that APRA considers the contrast of these two ownership structures, which have professional stewardship and embedded diversification, against the direct investment into specific AT1 hybrid securities by retail investors acting independently. We hope that consideration of the differences here would help APRA to ensure that any efforts to make AT1 hybrids more effective do not unreasonably disadvantage some retail investors.

Please feel free to contact the following Lonsec team members, should you have any questions or require further information:

- [redacted] – Portfolio Manager, Implemented Portfolios [redacted])
- [redacted] – Chief Operating Officer, Lonsec ([redacted])
- [redacted] – Head of Risk & Compliance, Lonsec ([redacted])

About Lonsec

The Lonsec Group

The Lonsec Group is Australia's leading financial research house, providing financial advisers, fund managers and superannuation funds with practical, actionable insights and investment solutions that add real value for their operations and clients.

Across our multiple brands, we research and rate over 2,000 managed investments and listed securities, and over 600 superannuation funds. We also provide managed portfolio solutions for financial advisers and their retail clients, as well as broader investment consulting services, data and analytics.

Lonsec Investment Solutions and Implemented Portfolios are our investment management brands and provide managed accounts, tailored portfolios and investment consulting to financial advisers and dealer groups.

Lonsec Investment Solutions

Lonsec Investment Solutions (LIS) is one of Australia's fastest-growing managed account providers, building high quality portfolios for financial advisers and dealer groups to meet the diverse needs of their retail clients. LIS's best ideas are represented in a suite of Separately Managed Account portfolios which are available on the major superannuation and wrap platforms.

Implemented Portfolios

Implemented Portfolios (IPL) is Lonsec's specialist Managed Discretionary Account (MDA) provider, currently servicing over 4,500 retail and wholesale clients of independent financial advisers. IPL's Individually Managed Account (IMA) service customises the individual investment experience at scale to help financial advisers provide a tailored investment solution for each client's specific circumstances.

Lonsec Research

Lonsec Research reviews and rates over 2,000 managed investments and listed securities. Its research is provided to over 4,000 financial professionals through the iRate® platform, and a Lonsec rating can give advisers the confidence that a product meets its objectives and may be suitable for their clients.

Lonsec Research's team of over 50 analysts has extensive access to the investment managers behind every product which it rates. The breadth and depth of the research helps advisers and fund managers achieve better investment outcomes.

SuperRatings

SuperRatings is Australia's longest-established superannuation research firm, focused on market-leading data, tools and insights. SuperRatings works with superannuation funds, regulators and financial advisers to drive better outcomes for members.

Responses to Consultation Questions

1. **What are the best policy options for improving the effectiveness of AT1?**
   We believe other firms are better placed to respond to this question.

2. **What would be the impact of these options?**
   As above.

3. **What transition arrangements could soften these impacts?**
   As above.

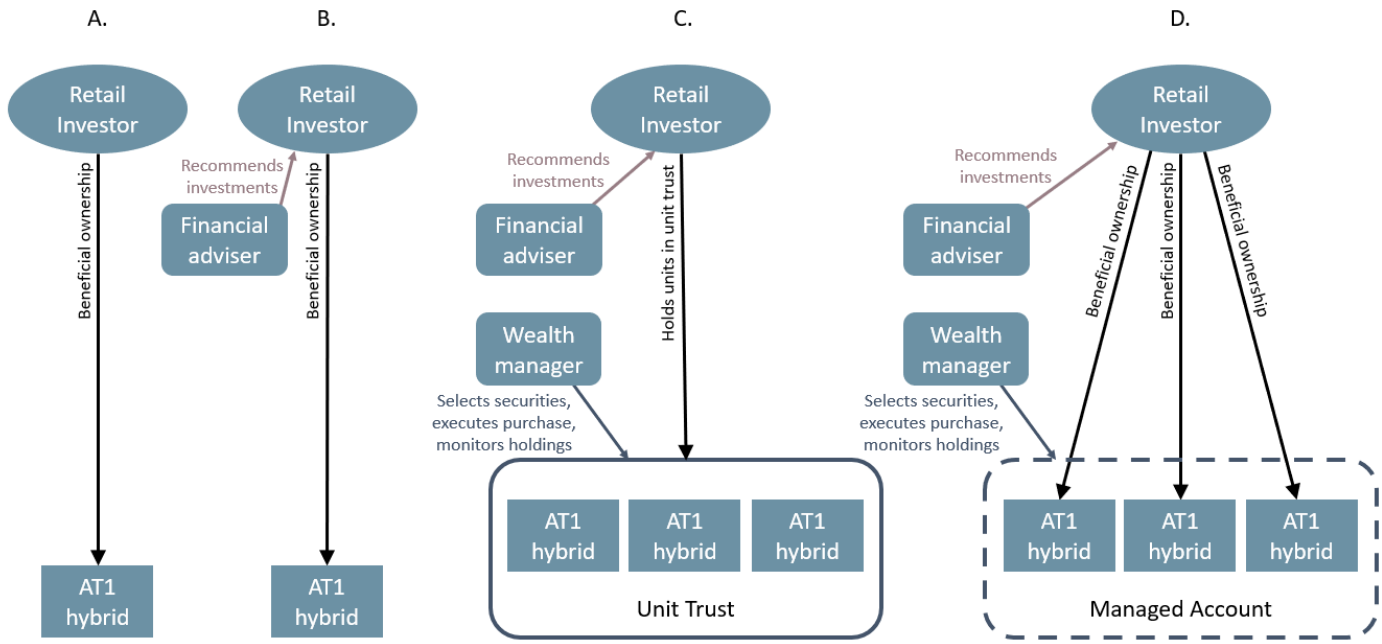
4. **Are there other considerations or options that APRA should take into account?**

We believe there is an important further consideration, related to APRA's concerns about the high retail ownership of AT1 hybrids. APRA's discussion paper notes on pages 14-16 that 53% of the current hybrid security value on issue is held in parcels smaller than $500,000, representing "retail" rather than "wholesale" investors. We would ask APRA to consider that these small parcels include the fragmented individual ownership of securities held through a managed account structure, which has professional wealth manager oversight at an aggregate level across many retail clients. As explained on the following pages, we would contend that this ownership structure bears some similarities to a managed fund unit trust, even though the latter would be classified as a "wholesale" owner. Most importantly, we believe that ownership of AT1 hybrids through a managed account structure is significantly different to an individual retail investor independently buying hybrids, and the difference merits consideration in APRA's efforts to mitigate risk to retail investors.

By way of background, retail investors can gain exposure to AT1 hybrid securities through various ownership structures, the 4 most common being represented in the list below and Figure 1:

A. Independent direct ownership of specific hybrids without a financial adviser,
B. Direct ownership of specific hybrids under guidance from a financial adviser,
C. Indirect exposure to a collection of hybrids by owning units in a managed fund unit trust, and
D. Direct beneficial ownership of a collection of hybrids within a managed account structure.

Figure 1: Retail ownership structures for AT1 hybrid securities



It is structure D from the previous page which we believe may require additional consideration within APRA's review. In that case, a retail investor has direct beneficial ownership of hybrid securities as part of a portfolio set up as a Separately Managed Account (SMA) or Individually Managed Account (IMA), supported by the major superannuation and wrap investment platforms. The SMA and IMA product categories have experienced significant growth in assets over the last decade as financial advisers migrate their clients out of pooled fund structures (such as traditional unit trusts) for better transparency and tax efficiency. According to the Institute of Managed Account Professionals (IMAP), managed accounts represented over $160 billion in total funds under management as at June 2023. Such managed accounts can include a wide variety of listed and unlisted assets, and some of them hold AT1 hybrid securities at the fund manager's discretion. For example, within IMA portfolios offered by Implemented Portfolios (part of the Lonsec Group), a retail investor client may own AT1 hybrid securities, selected by IPL's portfolio managers, alongside other listed investments such as equities and exchange traded funds (ETFs).

When using an SMA or IMA, a retail investor's effective portfolio exposure may be very similar to that achieved through structure C, where a professionally-managed pooled unit trust owns the hybrids. In both cases, the securities would be assessed by investment specialists, and the portfolio holdings subject to regular review to ensure that they offer appropriate levels of return and risk to the end investor. However, because the unit trust consolidates ownership of each hybrid into large parcels under a single beneficial owner (the trust itself), this would be recorded as wholesale ownership. By contrast, an identical combination of hybrid securities within an SMA or IMA portfolio would instead be recorded as "retail" because the beneficial ownership is fragmented across many individual investors. This is summarised in Table 1 below:

Table 1: Comparison of AT1 hybrid ownership under unit trust or managed account structures

	Unit trust	SMA or IMA
End investor client	Retail	Retail & wholesale
Professional selection of securities, trade execution, ongoing monitoring of holdings?	Yes	Yes
Hybrids exposure for the retail investor	Diversified across issuers and/or other asset classes	Diversified across issuers and/or other asset classes
Aggregate portfolio scale	Large (>$50m)	Large (>$50m)
Assets held by custodian on behalf of client	Yes	Yes
Exposure to the underlying investments	Indirect (investor owns units in the trust)	Direct (investor owns the underlying securities)
Beneficial owner of individual hybrids	A single unit trust	Many individual investors
Parcel size for each hybrid issue held	Few large parcels	Many small parcels
Resulting technical classification	Wholesale ownership	Retail ownership

Through its extensive manager research coverage, Lonsec has visibility of SMA and IMA portfolios from 3rd party investment managers. Based on our assessment of these, in combination with the portfolios offered by the Lonsec Group itself, we estimate that AT1 hybrid ownership through managed accounts comprises at least 10% of the small parcel holdings of AT1 hybrids over which APRA has expressed concern. For these holdings, the small parcel size is actually the result of portfolio diversification, at least across different issuers of hybrids, and in some cases across other asset classes such as equities, bonds and real estate. The 53% of AT1 hybrids owned in small parcels is therefore not uniform: it comprises several subsegments with significantly different levels of professional expertise and portfolio diversification. We would ask that APRA take these nuances into account in any course of action. Specifically, if APRA wishes to initiate changes or restrictions to reduce the risk from AT1 hybrids to retail investors in general, we request that it takes care not to disadvantage one set of investors against another.

For example, if APRA were to raise the dollar threshold for minimum parcel sizes to limit retail investor access to AT1 hybrids, this might force a managed account portfolio to own larger parcels of fewer securities than before to meet that minimum for each client account, resulting in *less* diversification across the portfolio. For the retail investors concerned, such forced consolidation might be counterproductive to an intention to reduce the overall investment risk.

Alternatively, if APRA were to restrict retail investors from directly owning AT1 hybrid securities at all, then this would prevent multi-asset-class managed account portfolios from including such hybrids, while multi-asset-class portfolios in a unit trust would be unaffected. Retail investors using a managed account would therefore be disadvantaged against retail investors using a unit trust.

Lonsec supports APRA's intention to improve the effectiveness of AT1 hybrid securities to promote resilience in the banking system and protect depositors. We are encouraged that APRA has taken note of the high retail ownership of these securities and the incremental challenges of protecting the interests of these investors. Since APRA is considering a range of possible actions, we request that it assess the implications of any approach to the different categories of ownership highlighted in this submission to ensure that any changes do not result in greater risk, or disadvantage, to some retail investors. We would like to thank APRA for the opportunity to provide feedback on its review, and we hope that this and other submissions from the industry will assist it in finding an optimal solution.