27th October 2023

[redacted]

General Manager

Policy (Policy and Advice Division, APRA)

RE: Feedback on improving effectiveness of AT1 (hybrid capital bonds)

I would like to discuss changes that have been made (Design and Distribution Obligations-DDO) and those proposed by APRA and their effects from the perspective of Trustees navigating investments for Self-Managed Superannuation Funds. The emphasis here is on SELF-managed. Trustees wish to have control over the mix of investments they hold and the risk profile of those investments.

APRA have stated that the DDO legislation has not dampened demand for AT1 from retail investors. This is not surprising. A retail investor has two options:

1. Enlist a Financial Planner to prepare an SOA, explain the risks but still recommend an investment in hybrids as part of the investment mix and charge for the privilege. We are going back to the days when investing incurred an entry fee payable to a planning firm and ongoing trailing commissions without providing any value-add services.
2. Purchase the hybrids on the ASX. This is a boon for wholesale/institutional investors because they are able to purchase units at issue price and then on-sell to retail investors. Historically, the market price for hybrids has always been higher than the issue price so this margin provides money for jam to the wholesale investor.

So why are hybrids so attractive in an SMSF investment mix?

- Quarterly distributions at a fixed margin to the BBSW
- Margin provides some income even when interest rates are near zero
- Income increases automatically within an inflationary environment as interest rates increase to curb the effects
- Major Banks and insurance companies maintain Tier 1 and Tier 2 capital ratios well above the minimum recommended by APRA as additional security against a trigger event occurring

APRA have stated that disclosure of risk via a PDS is too difficult for even a sophisticated investor to understand. I would strongly recommend that APRA look at hybrids in the light of these other alterative investments and ask if setting restrictions and driving investment into other more opaque and risky products is the outcome it really wants to achieve. APRA could show how the risk profile for hybrids fits in with the universe of other investments available to investors as a comparison rather than as a stand-alone investment.

Turning now to the specific policy questions:

1. What are the best policy options for improving the effectiveness of AT1 to support resilience and what would be the impact of these options?

APRA have suggested 3 alternatives

- *Design of the AT1*- raise the trigger point to 7%. For the reasons outlined in item 4, have 2 trigger points. One related to common equity capital, and if necessary, a second related to **conversion** of AT1 capital to equity.
- Reduce reliance on AT1 capital- reduce mix in Tier 1 capital to below 1.5%
  This will increase cost of funding to issuers and cause investors to seek alternative risky investments. **My concern is that APRA is concerned more about eliminating criticism from the fallout of a potential capital loss from retail investors rather than the potential for loss itself**. By diverting investments elsewhere, APRA can wash its hands of responsibility for any future capital losses incurred by those funds.
- *Diversify participation in AT1 away from retail investors-*
  Having retail or institutional investors in AT1 is not the problem. AT1 as a retail investment has a place in an investment portfolio and excluding retail investors only drives them into other risky investments that do not provide similar features as noted above. Treat SMSF's the same as other institutional investors with type of investment.

2. *What would be the impact of these options?*
   As an SMSF trustee (and retail investor), I am totally dismayed by the impact the DDO regulation has had on the AT1 purchase process. If APRA wishes to further restrict access to hybrids, then a safer option with the same features as hybrids should be made available.

3. *What transition arrangements could soften these impacts?*
   Rather than restrict access to retail investors, future hybrid PDS's should explicitly state the AT1 trigger conditions as outlined in section 4 below.

4. *Are there other considerations or options that APRA should take into account?*
   Common equity is subordinate to AT1 as Tier 1 capital and as such should be the "first line of defence' in a capital trigger event. **APRA must ensure that the rights of ordinary equity have to be extinguished before AT1 holders are subject to loss absorption. This is implied in every PDS accompanying a hybrid issue by major banks and insurance companies which have been under the oversight of the regulator**. **Cessation of distributions and a suspension of trading on the ASX for a period is a lower level of concern to investors than capital loss. Issuers need the time to convert AT1 to equity, not force a write-off of AT1 as a kneejerk reaction.**