8 November 2024

General Manager Policy
Policy and Advice Division
Australian Prudential Regulation Authority
Level 12, 1 Martin Place
SYDNEY NSW 2000

By email: policydevelopment@apra.gov.au

Dear Sir/Madam,

Discussion Paper: A more effective capital framework for a crisis – Submission from Morgans Financial Limited

We welcome the opportunity to provide further feedback in relation to APRA's Consultation process regarding the appropriate capital framework for Australian banks. Additionally, we appreciated the opportunity to meet with APRA representatives during the consultation period[1].

About Morgans

Morgans is Australia's largest full-service stockbroking and wealth management network with over 240,000 client accounts, 500 authorised representatives and circa 1,000 employees operating from offices in all states and territories. We have been helping Australian investors with stockbroking and investment services since 1982.

Executive Summary

- Morgans acknowledges the shortcomings of AT1 instruments as identified by APRA.
- We recommend APRA:
    - introduces explicit terms of conversion/bail-in;
    - removes the ambiguity of a PONV trigger;
    - codify and clarify terms removing the need for a non-exchange write-off; and
    - enact changes to deliver a simplified going-concern bank resolution process
- We believe there is risk of significant financial and societal costs to simply removing AT1 and relying on T2 as a gone-concern source of capital.
- Listing of capital instruments on a public exchange brings significant benefits and does not impede APRA's objectives.

[1] "Roundtable meeting held at APRA office, Sydney on 16 October 2024 and attended by industry participants".

Response to matters raised in the Discussion Paper

We acknowledge APRA's concerns regarding the likely effectiveness of currently issued AT1 securities in terms of supporting its efforts to undertake a going-concern restructure of an Australian bank.

Notwithstanding, we do not believe that the simple removal of AT1 and primary reliance on T2 in its current form, solves this problem. In fact, we believe the sole reliance on T2 will introduce additional and perhaps unforeseen complications and consequences.

We outline our views in the sections below.

1. Design:

How could APRA improve the design of the proposed approach, in line with the core design principles?

Terms

It is our view that it is not AT1 instruments per se, that are the issue, rather it is the specific terms of existing securities currently on issue.

Based on our understanding of the matters raised at the Roundtable, APRA's primary concerns are two-fold.

1. Currently issued AT1 securities would not convert to equity or bail-in sufficiently early in a resolution process to give confidence that a bank could be restructured as a going-concern.
2. There remains considerable ambiguity as to the possible catalysts for a PONV bail-in and the potential for such definitional ambiguity to impede APRA taking swift and effective action. Further, the announcement effect could have unforeseen and unintended consequences.

We believe that rather than removing AT1 from the capital stack, the simplest and most effective response would be to redefine the terms of newly issued AT1 securities such that they reflect the specific outcomes APRA believes it requires to give going-concern resolution the best chance of being achieved.

Alternatively, given the staged approach APRA has taken in this Consultation, an alternative approach would be to introduce a new class of T2, which for simplicity, we refer to as *Exchangeable T2*[2]. This new instrument (ET2) would over time replace AT1 as junior subordinated capital and reflect the specific terms that give APRA the flexibility and confidence it seeks in a going-concern bank resolution.

The introduction of an ET2 layer, retains T2 as additional gone-concern capital.

[2] For convenience, we will refer to a modified AT1 or Exchangeable T2 as "ET2" in this paper.

Specific amendments to terms could include:

1. Replacing discretionary security terms with specific codified triggers & processes while maintaining APRA's broader regulatory discretions.

2. Changing the bail-in trigger from its current level of 5.125% to a level sufficiently high such that it introduces new common equity at a much earlier point. Introduction of common equity at a much higher capital level, would likely avoid further deterioration to the point where a formal resolution process is required. This trigger level could be set at say 9%, providing significantly more confidence that the additional capital would allow the bank to reset its operations and financial metrics, thus remaining a going-concern.

3. Automatic conversion of ET2 instruments to common equity could be codified in the security terms. For example, conversion could be automatically triggered in a circumstance where the ordinary share price falls significantly from the level at the time the ET2 was issued. This could be set at say 75% or some other level as determined appropriate by APRA. This should serve to bolster a bank's capital position at a point where the market is indicating stress but well before a point of likely failure.

Introducing explicit terms of conversion/bail-in removes all uncertainty as to when and in what circumstances, bail-in occurs. This would also remove the ambiguity of and reliance on, a PONV trigger, which cannot be clearly defined and therefore introduces considerable uncertainty. Such codification and clarification should also remove the need for a non-exchange write-off.

We believe the above approach remedies the short comings of existing AT1 as identified by APRA, as it clarifies the exact points at which ET2 investors can expect to be exposed to pure equity risk and potential loss; there can be no confusion or ambiguity.

<u>Investor base</u>

As identified in our November 2023 submission and acknowledged in the 10 September APRA release[3], our data highlighted that wholesale investors already dominate the registers of bank issued AT1 securities and this level has continued to increase post the introduction of PDDO legislation.

Further, we highlighted the very high proportion of both wholesale and retail investors who own bank ordinary equity, relative to the much lower proportion who own AT1 instruments. This supports the proposition that investors are highly attuned to the risks of bank equity, having experienced significant drawdowns in value through previous cycles. Explicit and simplified terms will further enhance understanding of the risks associated with regulatory capital instrument ownership including the circumstances and timing of exchange/bail-in.

This strengthens our view that wholesale and personal advice investors remain an appropriate investor cohort. These reforms support investors in making an informed assessment as to the risk and return profile of these instruments.

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[3] https://www.apra.gov.au/news-and-publications/apra-proposes-update-to-bank-capital-framework-to-strengthen-crisis (Footnote 12).

We also highlight the significant strengthening of advice processes under ASIC's FOFA reforms including the best interest obligations of advice providers ensuring appropriateness of advice which has regard to an investor's specific circumstances and portfolio composition.

A further guardrail could be the introduction of an industry standard investor assessment so as to assess the knowledge and suitability of these securities for a specific investor cohort. Morgans already employs such an approach for clients seeking to use exchange traded options. This has seen the number of clients using options fall dramatically and delivered better financial outcomes for those approved to use the product.

We have noted APRA's previously held view that in the event of it having to take action as part of a bank recapitalisation or other support, it fears the potential for unintended adverse consequences e.g. withdrawal of deposits. In such a circumstance, we would contend that it would be institutional investors that are more likely to withdraw deposits rather than retail investors. It is generally acknowledged that retail and retail-like accounts are more "sticky" than institutional "hot" money deposits. Further, we have separately presented data to APRA highlighting the stickiness of holdings in bank equity and AT1 during the COVID period where bank share prices were under pressure and dividends were withheld.

We believe that codification of bail-in features in AT1 or ET2 and removal of non-exchange write-off, should provide APRA with a higher level of confidence that adverse consequences are significantly reduced.

2. Impact:

What is the likely impact (benefits and costs) of the proposed approach?

<u>Financial</u>

We can expect numerous impacts from the proposed replacement of AT1 with T2 as the only form of non-equity regulatory capital for Australian banks.

At face value, the suggested approach delivers a simplified bank capital stack, which may be seen as a benefit. However, it does not solve for APRA's primary concern which is the ineffectiveness of AT1 in a going-concern recapitalisation.

Having not solved the problem identified by APRA, it then must be assessed in the context of the potential financial and societal costs of such a change.

We note that one of the points in support of removing AT1, was potential concern that adjusting the loss absorption trigger level would result in higher costs. We do not believe this can be considered in isolation as any increase in cost, will be on a smaller proportion of capital stack, i.e. AT1 only.

The removal of junior subordinated AT1 instruments necessarily increases the risk profile of T2 securities. Standard & Poor's notes that "an implementation of the proposed changes could weaken going-concern bank capital under S&P Global Ratings framework, and, without offsetting action, may lead to lower ratings on the tier 2 (T2) instruments issued by the major

Australian banks".[4] Consequently, we should expect to see credit spreads on T2 widen significantly.

With major bank T2 issuance at circa 3 times outstanding AT1, the increase in credit spreads and increased T2 reliance will lead to higher funding costs; this should be of concern.

Any increased cost of funding for Australian banks can be expected to feed through to borrowers. As public companies with an obligation (among other things) to maximise shareholder returns, any increase in the cost of funding will be passed onto consumers. We should necessarily expect that banks will seek to at least maintain their NIM and therefore profitability. This could also have broader macro-economic and societal consequences.

We note also that under the proposed changes, regional banks will be forced to replace AT1 funding solely with T2. It is rational to expect this will have a disproportionate impact on their funding costs and may lead to a further decrease in their ability to compete with major banks.

S&P also notes that "APRA's proposal is unlikely to be widely replicated. We think that AT1 instruments can play a role in absorbing losses and conserving cash on a going-concern basis, and recapitalizing or resolving a bank that is no longer viable."[5]

There is a possibility that Australian banks could find funding options reduced if international (and some domestic) investors sought to avoid or demand too high a premium on higher risk Australian T2 instruments, as overseas banks with AT1 instruments would have a stronger capital stack and could be seen as a safer investment for T2 investors. We think this becomes especially problematic for regional banks if they are forced to rely solely on higher risk T2 issuance.

The removal of AT1 as a funding source could prove to be counterproductive. Any reduction in the available sources of funding could actually see the risk profile of the Australian banking sector increase, despite APRA's objective to reduce the sector's risk profile.

We have seen on multiple occasions how ineffective wholesale OTC funding markets can be in times of economic and/or financial stress. As noted in our meeting, it has been ASX listed markets that have tended to be more resilient and reliable channels for funding for both the bank and industrial sectors when OTC markets freeze. We see significant risks if this avenue were lost to Australian banks.

In summary, it is very likely that the cost of funding for all banks will rise and there will be a reduction in diversification of funding options, with these concerns potentially amplified for regional banks.

[4] https://www.spglobal.com/ratings/en/research/articles/240919-phasing-out-bank-at1-an-australian-solution-to-an-australian-dilemma-13253859

[5] https://www.spglobal.com/ratings/en/research/articles/240919-phasing-out-bank-at1-an-australian-solution-to-an-australian-dilemma-13253859

Investors

While not directly a concern of APRA, the loss of the listed AT1 market or a replacement listed offering, will have material implications for the allocation of investor capital. While AT1 instruments have identifiable flaws in their design, they have provided a significant and quality investment alternative for institutional, wholesale and select retail investors. Further, the listing of these instruments on ASX has ensured that investors have had the benefit of a transparent market and full disclosure of material information.

In the absence of a comparable exchange traded security, we could see many investors move to sectors where there is little or no disclosure of material information or a transparent market. This is a poor and retrograde outcome for investors and one that ASIC should be alert to. This is of particular concern where investors are drawn to unlisted managed investment schemes offered by poorly resourced and/or opportunistic operators.

If T2 (or ET2) is not listed, investors will be forced to invest via managed investment schemes. This will superimpose an additional layer of fees for no economic benefit.

3. Implementation:

Are there other relevant implementation (and transition) considerations for the proposed approach?

At this time, both issuers and investors are uncertain as to the specifics of the transition period.

The market would benefit from guidance as to whether APRA would permit re-finance transactions for existing AT1 securities with first call dates in the transition period (subject to APRA's normal approval processes) and new issue call profiles being consistent with the stated transition timeline.

Allowing issuers to offer replacement securities during this transition period, subject to the above factors, would assist in ensuring an orderly market transition while APRA resets the prudential capital framework. We highlight the market's reaction since the release of the September 2024 Paper as an example of the consequences of a poorly informed market. We would contend that investor uncertainty has seen the market subsequently mis-price AT1 risk, reflected in a material contraction in spreads. The introduction of a new (going-concern) loss-absorbing exchangeable security would, we expect, correct this anomaly. One would expect it to trade at a spread premium to AT1 and T2.

Potential compliance impact of the proposals, and any other substantive costs including business costs.

The benefits of listing and trading a security on an exchange are numerous while the costs of moving it to an OTC environment are not insignificant.

Economic loss & transparency

As already noted, price transparency is assured on ASX; this promotes market efficiency. This is particularly important for smaller transaction parcels. We estimate AT1 trading activity at ~$7.8bn over the last 12 months[6]. If we assumed this level of trading activity were moved to an OTC market where there is no price transparency, there will be a significant economic transfer from investors to intermediaries. OTC intermediaries will widen spreads so as to profit from investor trading activity with no guarantee of an efficient or effective market. Whereas, on a listed exchange, the market is visible to all parties, transaction costs are known and disclosed; there is no such transparency or disclosure in OTC trading.

If managed investment schemes are the only investment option, there will be substantial management fees payable by investors for no economic benefit. We can expect to see an increase in managed investment schemes seeking to list on exchanges. Morgans has already been approached by a number of operators expressing their interest in creating more managed investment schemes to take advantage of a potential removal of AT1 instruments from the listed market. This would be a retrograde development.

Compliance & custody

There is limited ability to regulate OTC trading activity in the same manner as listed markets. The transfer of substantial trading activity from an easily monitorable listed platform to OTC would require substantial additional compliance resources & costs and still be inferior to the oversight applied to listed markets.

The CHESS platform provides a complete custodial service with auditable and transferable ownership records. Movement to an OTC environment would require substantial investment in new systems with no economic benefit to investors or issuers.

Only Austraclear members have ready access to custodial services. There would be substantial costs imposed on investors to service custody and manage security ownership. It would also require intermediaries e.g. brokers, to invest in sub-scale (uneconomic) systems and platforms to manage investor trading activity and records.

Corporate access to capital markets

A significant and ancillary benefit of the AT1 market, during a period of relatively low equity capital raising, has been the substantial origination and trading activity of AT1 securities. The maintenance of a viable capital raising ecosystem is imperative for corporate Australia; the loss of which would be extremely harmful to the economy.

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[6] Source: Iress

Summary

We acknowledge APRA's views on the shortcomings of AT1 instruments. However, we believe that its objectives would be better served by either modifying the terms of AT1 or replacing AT1 with a new form of capital instrument as outlined in this paper.

As a consequence, we believe these modifications would also remove the need to restrict ownership and allow continued listing on ASX.

For clarification on any of the matters raised in this submission, please contact either of the undersigned.

Yours sincerely,

MORGANS FINANCIAL LIMITED

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Executive Director

[redacted]

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CEO & Managing Director