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Response to APRA Discussion Paper - A More Effective Capital Framework for a Crisis

Executive Summary

Shaw and Partners is a leading Australian wealth management firm, with over 220 advisers and holdings of bank hybrids of ~$1.8bn, equating to over 5% of ASX listed major bank hybrids as part of an overall FUA base of $35 billion. Shaw and Partners is a leader in the secondary ASX listed bank hybrid market and as a lead manager on all major bank new issuance. AT1 bank hybrids are used to diversify client portfolios, particularly for clients seeking income via direct investment in financially sound issuers.

While Shaw and Partners is cognisant of APRA's concerns about a banking crisis which may result in retail AT1 investors suffering financial losses, it has preference for clients to invest in AT1 securities in "Unquestionably Strong" banks. APRA's track record as the world's leading banking regulator is highlighted by it successfully navigating the banking system through crisis events such as the GFC and COVID.

Any investment has risk, where investors in ASX AT1 bank hybrids price in an appropriate margin uplift via bookbuild process as compensation for being lower in the banks' capital structure in the event of a wind up, plus the complexities of Trigger Events, multiple Optional Call Dates, and Mandatory Conversion Conditions.

Conclusion:

Shaw and Partners strongly supports maintenance of the status quo, as we see no compelling reason to materially change the highly effective and efficient $36bn market for ASX bank hybrids, which has operated for 25+ years, where Australia would become the only developed market with AT1 hybrids removed from bank capital structures.

Shaw and Partners does see some merit in potentially increasing the current CET1 Trigger Event from 5.125%.

Banking Crisis policy responses

Liquidity: The biggest issue in a banking crisis is a loss of confidence which results in a run on bank. APRA's prudential supervision incorporating a Net Stable Funding Ratio of at least 100%. The GFC saw the Federal Government successfully implement Government Guarantee on Deposits and Wholesale Funding "to promote financial system stability in Australia, by supporting confidence and assisting eligible ADIs to continue to access funding at a time of considerable financial turbulence."

Capital: The rapid erosion of regulatory capital appears as a more remote scenario, particularly with all of the major banks having Capital Adequacy Ratios above 20%. Bank Treasury departments monitor Regulatory Capital levels daily, where dips have typically resulted in banks promptly undertaking equity raisings, such as BOQ in March 2012.

APRA Policy Pathways

Maintain Status Quo

- The effectiveness of the capital framework during a crisis is most likely going to see banks promptly raise equity to replace any capital eroded, plus a buffer if the stress situation persists.
- AT1 hybrids have the ability to Convert into Ordinary Equity under Capital and Non Viability Trigger Events.
- ASX market functioned well and provided healthy levels of liquidity during COVID and GFC, and was not impacted by WBC not paying an ordinary dividend in 2020. The ability to see market depth provides more transparency to investors than an opaque OTC market.
- Regular research by Shaw and Partners will continue to identify red flags / concerns on AT1 bank hybrid issuers whose financial metrics have deteriorating to an unacceptable level, prompting a strong recommendation for Shaw and Partners clients to exit exposure, to avoid potential significant investment losses.
- **Status Quo is Shaw and Partners preferred outcome.**

Redesign AT1

- Shaw and Partners sees merit in a proposal to redesign AT1, with an enhancement such as a higher trigger level. We may also support a discretionary trigger, depending on design.
- This would address APRA's concern that the current 5.125% Trigger Event is too low, where a higher loss absorption trigger would "provide timely and meaningful support to a bank during stress".
- Shaw and Partners does see merit in further restrictions on the investor base.

Simplify the Framework

- Shaw and Partners does not support the logic behind replacing AT1 with other more reliable forms of capital.
- Australian AT1 is one of the most stickiest forms of funding for bank regulatory capital, where we struggle to see the benefits of eliminating a highly effective $36bn market with a 25+ year operating history.
- During a banking crisis, it is beneficial to have an additional form of equity to strengthen a bank's balance sheet, instead of being forced to conduct a highly dilutive CET1 issue. AT1 also provides flexibility with discretionary non-cumulative distributions, subject to an ordinary dividend stopper. Payment of Tier 2 interest is subject to the Solvency Condition.
- Over reliance on offshore funding markets is a major risk for banks if funding markets freeze. Australian banks changed their funding profiles post the GFC to increase domestic funding sources. This proposal appears inconsistent with the policy to achieve "Unquestionably Strong" banks.

Benefits from a more effective capital framework

Improving Capital Effectiveness in Crises

- AT1 provides an option to resolve crises, as a form of capital to strengthen banks.

Reducing compliance costs for banks

- Banks have been issuing ASX hybrids for 25+ years, with no apparent issues complying with the "regulatory burden around design, marketing and issuing of AT1"

Enhanced proportionality

- APRA has prudently implemented a D-SIB overlay for the major banks. A banking crisis for a smaller regional bank is easier to resolve, which historically has involved a merger with a major bank, such as the CBA acquisition of BankWest and the State Bank of Victoria.
- The proposal increases the risk profile of T2 without AT1 layer, and results in lower Tier 1 ratios and equity on bank balance sheets.

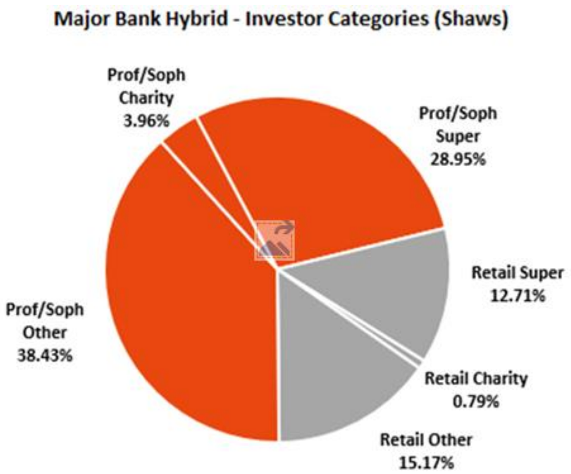
Shaw and Partners Analysis / Considerations

Investor Profile

- Shaw and Partners clients hold 5.3% of the 21 major bank ASX listed hybrids ($1.8bn of $33bn)
- 71% held by Professional / Sophisticated
- 42% held by Super Funds
- 5% held by Charities
- Investors who predominately hold hybrids are via DDO obligations with risks communicated, where Shaw and Partners does not object to investors requiring advice as a further safeguard mechanism.

Investors typically underweight direct fixed income

- SMSF data indicates the fixed income asset allocation is primarily done via bank deposits (18% weight), and only 1% allocated to debt securities



Asset Allocation	SMSF	Superannuation Industry
Cash / Term Deposits	18%	9%
Fixed Income / Debt Securities	1%	20%
Other	81%	71%
Total	100%	100%

Sources: ATO SMSF Statistical Overview 2021-22 -Table 28
APRA Quarterly Superannuation Performance June 2024 - Table 1d Superannuation Industry Asset Allocation

Shaw and Partners Analysis / Considerations

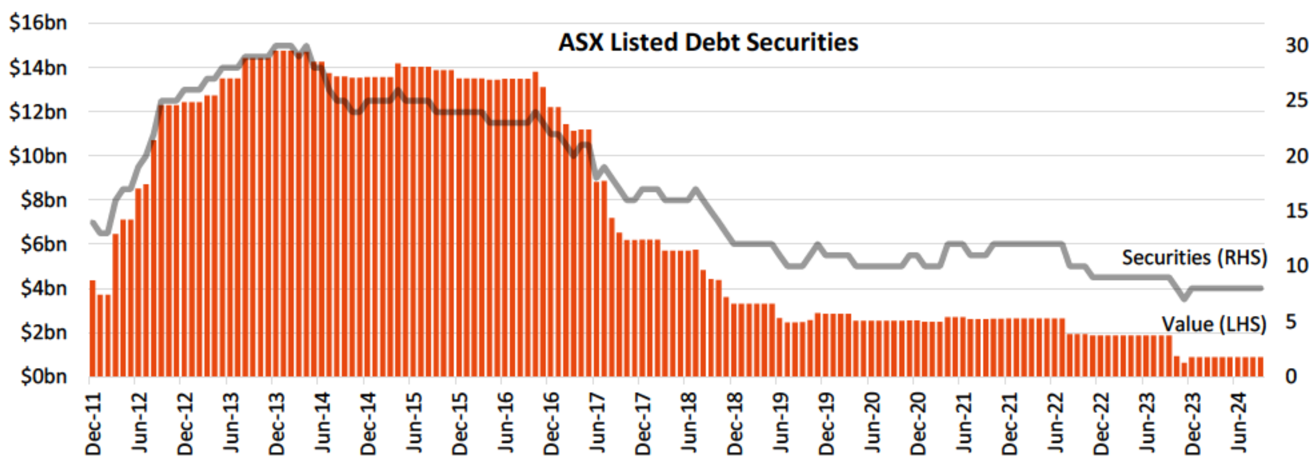
Investors forced to move to riskier investments, which have not been immune to financial distress

- The change in bank lending profiles to focus on prime mortgages and investment grade corporates has led to an explosion in non-bank lenders seeking investors to fund opaque private credit loan books.

Listed	ASX Code	Issue	Issue Size	Outcome	Comments
Jul-2007	ABSG	ABC Notes	$600m	Administration Nov 2008	Last trade $85 in 2008
Aug-2004	AHUG	Allco HIT	$130m	Administration Nov 2008	Last trade $10 in 2008
Jan-2005	AHUGA	Allco HIT	$250m	Administration Nov 2008	Last trade $27 in 2008
Jul-2018	AXLHA	Axsesstoday Bonds	$55m	Administration Apr 2019	Last trade $100 in 2018
Dec-2005	BNBG	Babcock & Brown Notes	$416m	Administration Mar 2009	Last trade $4.99 in 2009
Oct-2005	GNSPA	Gunns FORESTS	$120m	Administration Sep 2012	Last trade $45 in 2012
Oct-2004	GTPGA	Great Southern TREES 2	$75m	Administration May 2009	Last trade $6.495 in 2009
Nov-2005	GTPGB	Great Southern TREES 3	$125m	Administration May 2009	Last trade $6.30 in 2009
Apr-2007	PXUPA	PaperlinX Step-Up Pref	$285m	Restructure 2017	Last trade $15.50 in 2017
Sep-2006	TIMG	Timbercorp Notes	$83m	Administration Nov 2008	Last trade $3.02 in 2009
Jan-2006	TIMHB	Timbercorp 8.9% Bonds	$50m	Administration Apr 2009	Received $56 in 2011
Oct-2004	TIMPB	Timbercorp Reset Pref	$69m	Administration Apr 2009	Last trade $0.06 in 2009 ($2 issue)
Nov-2019	VAHHA	Virgin Australia Notes	$325m	Administration Apr 2020	Last trade $39 in 2020
		Total	**$2,583m**		

Quality ASX listed debt / hybrid investment alternatives limited

- ASX listed debt surged post GFC / Euro Sovereign crisis to a peak of $14.8bn / 30 securities in December 2013
- Issuers tapped the ASX market which was open for capital raising, where there were periods when wholesale funding markets were effectively closed.
- The process of issuers refinancing maturing securities in wholesale funding markets has seen ASX issuance shrink to $870m.



Shaw and Partners Analysis / Considerations

Measures to promote a liquid direct ASX fixed income market have not been successful

- Simple Corporate Bond regime has only seen $1.5bn of issuance since 2010.
- Only 3 banks have issued ASX listed senior debt
- ASX listed Commonwealth Bonds have limited liquidity, with YTD average daily turnover of 28 Exchange-traded Treasury Bonds (eTBs) only $0.1m versus $1.0m for 19 major bank hybrids, where 12 eTBs have had over 100 days of zero trading volume this year. Trading is typically subject to an average market maker bid-ask spread of 51bp, typically ranging 14-32bp for eTBs up to 4 years, widening to 80-140bp for eTBs over 10 years.

ASX Code	ASX Simple Corporate Bonds Issues	Issue Size $m	Issue Margin*	Launch
PRYHA	Primary Bonds Series A	152.3	4.00%	24 Aug 2010
TTSHA	Tatts Bonds	194.7	3.10%	29 May 2012
IMFHA	Bentham IMF Bonds	50.0	4.20%	7 Apr 2014
AYUHB	Australian Unity Bonds Series B – Tranche 1	250.0	2.80%	17 Nov 2015
PPCHA	Peet Bonds – Series 1, Tranche 1	100.0	Fixed 7.50%	3 May 2016
VLWHA	Villa World Bonds - Series A, Tranche 1	50.0	4.75%	22 Mar 2017
PPCHB	Peet Bonds – Series 2, Tranche 1	50.0	4.65%	20 Jun 2017
AXLHA	Axsesstoday Bonds - Series A, Tranche 1	55.0	4.90%	26 Jun 2018
AYUHC	Australian Unity Bonds - Series C, Tranche 1	115.0	2.00%	9 Sep 2019
AYUHD	Australian Unity Bonds - Series D, Tranche 1	207.0	2.15%	9 Sep 2019
AYUHE	Australian Unity Bonds - Series E, Tranche 1	255.8	2.50%	30 Oct 2023
	Total	1,479.8		

NOTE: PRYHA, TTSHA, IMFHA ISSUED UNDER MAR 2010 ASIC CLASS ORDER 10/321 OFFERS OF VANILLA BONDS
SUBSEQUENT BONDS ISSUED UNDER SIMPLE CORPORATE BONDS BILL WHICH BECAME LAW ON 11 SEP 2014.

ASX Code	ASX Bank Senior Debt Issues	Issue Size $m	Issue Margin*	Launch
CBAHA	CommBank Retail Bonds	570.0	1.05%	18 Nov 2010
BENHA	Bendigo & Adelaide Bank Retail Bonds Series 1	90.5	1.40%	22 Feb 2011
HBSHB	Heritage Bank Retail Bonds	227.5	Fixed 7.25%	17 May 2012
	Total	888.0		

* FLOATING RATE ISSUE MARGIN IS ABOVE 3 MONTH BANK BILL. SOURCE: COMPANY DATA

Shaw and Partners Analysis / Considerations

ASX hybrids provide a sticky investor base with strong reinvestment participation

Security	Issue Margin	Maturity/ Call Date	Issue Size $m	Reinvestment $m	**Reinvestment Participation**	Replacement Issue	Issue Margin	Listing Date	Issue Size $m
AQNHA	4.75%	15 May 14	202.2	30.1	**14.9%**	AMPHA	2.65%	19 Dec 13	325
ANZPB	2.50%	16 Jun 14	1,081.2	626.9	**58.0%**	ANZPE	3.25%	1 Apr 14	1610
WBCPB	3.80%	30 Sep 14	908.3	528.9	**58.2%**	WBCPE	3.05%	24 Jun 14	1311
CBAPA	3.40%	31 Oct 14	2,000.0	1328.1	**66.4%**	CBAPD	2.80%	2 Oct 14	3000
AYUHA	3.55%	14 Apr 16	120.0	62.6	**52.2%**	AYUHB	2.80%	16 Dec 15	250
PCAPA	1.05%	6 Apr 16	1,166.5	260.0	**22.3%**	CBAPE	5.20%	31 Mar 16	1450
ANZPA	3.10%	15 Dec 16	1,968.7	900.4	**45.7%**	ANZPG	4.70%	28 Sep 16	1622
IAGPC	4.00%	1 May 17	377.4	224.4	**59.5%**	IAGPD	4.70%	23 Dec 16	404
NABHB	2.75%	20 Sep 23	1,172.5	538.8	**46.0%**	NABPE	2.20%	21 Mar 17	943
ANZPC	3.10%	1 Sep 17	1,340.0	682.0	**50.9%**	ANZPH	3.80%	29 Sep 17	931
BENPD	5.00%	13 Dec 17	268.9	124.0	**46.1%**	BENPG	3.75%	14 Dec 17	322
SUNPC	4.65%	18 Dec 17	560.0	315.3	**56.3%**	SUNPG	3.65%	27 Nov 17	375
BOQPD	5.10%	16 Apr 18	300.0	158.7	**52.9%**	BOQPE	3.75%	29 Dec 17	350
WBCPC	3.25%	31 Mar 18	1,189.4	623.4	**52.4%**	WBCPH	3.20%	14 Mar 18	1690
MQGPA*	4.00%	7 Jun 18	600.0	445.7	**74.3%**	MQGPC	4.00%	8 Jun 18	1000
CBAPC	3.80%	15 Dec 18	2,000.0	870.0	**43.5%**	CBAPH	3.70%	18 Dec 19	1590
WBCPD	3.20%	8 Mar 19	1,383.6	721.6	**52.2%**	WBCPI	3.70%	19 Dec 18	1423
AYUHB	2.80%	15 Dec 20	250.0	178.7	**71.5%**	AYUHC-HD	2.00%-2.15%	18 Oct 19	322
CGFPA	3.40%	25 May 20#	345.0	297.5	**86.2%**	CGFPC	4.60%	26 Nov 20	385
WBCPF	4.00%	22 Mar 21	1,324.4	866.0	**65.4%**	WBCPJ	3.40%	7 Dec 20	1723
ANZPD	3.40%	1 Sep 21	1,120.0	749.7	**66.9%**	ANZPI	3.00%	9 Jul 21	1500
WBCPG	4.90%	20 Dec 21	1,702.1	1152.4	**67.7%**	WBCPK	2.90%	16 Sep 21	1750
ANZPE	3.25%	24 Mar 22	1,610.0	860.0	**53.4%**	ANZPJ	2.70%	25 Mar 22	1310
CBAPD	2.80%	15 Dec 22	3,000.0	1576.6	**52.6%**	CBAPL	2.85%	16 Nov 22	1777
WBCPE	3.05%	23 Sep 22	1,310.6	689.1	**52.6%**	WBCPL	3.40%	21 Jul 22	1509
IAGPD	4.70%	15 Jun 23	404.1	183.9	**45.5%**	IAGPE	3.50%	23 Dec 22	500
ANZPF	3.60%	24 Mar 23	970.2	502.0	**51.7%**	ANZPK	2.75%	27 Mar 23	1500
AYUHC	2.00%	15 Dec 24	115.0	82.9	**72.1%**	AYUHE	2.50%	15 Dec 23	256
WBCPI	3.70%	31 Jul 24	1,423.1	802.2	**56.4%**	WBCPM	3.10%	19 Dec 23	1750
BENPG	3.75%	13 Jun 24	321.6	183.7	**57.1%**	BENPI	3.20%	26 Mar 24	300
MQGPC	4.00%	16 Dec 24	1,000.0	577.0	**57.7%**	MQGPG	2.65%	17 Sep 24	1500
				Average	55.1%				

* 75% SCALING, FINAL REINVESTMENT $334.3m

SOURCES: COMPANY DATA, IRESS, SHAWS

6 MONTH DELAY IN REFINANCING OFFER DUE TO MARKET VOLATILITY.

Shaw and Partners Analysis / Considerations

ASX listed debt / hybrids issuance $100bn since 2010, an integral part of capital markets, exceeds IPOs

- Hybrid issuance volumes more consistent. Equity IPO market substantially more volatile
- Fixed income market is undeveloped for non institutional investors, no viable alternative for bank hybrids.

Issuance ($bn)	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024YTD	Cumulative
ASX Debt / Hybrid Issuance	0.92	3.42	13.16	8.66	7.46	5.60	7.03	5.44	7.16	5.74	6.03	6.79	10.30	6.73	5.33	99.79
ASX Equity IPOs	7.98	1.56	1.27	9.69	18.65	7.00	8.32	5.74	7.82	6.76	1.25	12.04	1.40	1.11	0.74	91.34

Wholesale AT1 has not been successful, BOQ and NAB promptly reverted back to ASX issuance

- BOQ wholesale issue of $150m in 2015. Subsequent ASX issues of $350m for BOQPE in 2017, $260m for BOQPF is 2020, and $400m for BOQPG in 2022.
- NAB wholesale issue of $600m in mid 2020. Subsequent ASX issues of $2,386m for NABPH in late 2020, $2,000m for NABPI in July 2022, $1,250m for NABPJ in 2023, and $1,000m for NABPK in 2024.
- Minimum wholesale parcel sizes of $0.5m impact liquidity.

Banks Promptly Raise Equity in Times of Stress: BOQ $450m Equity Raising 26 March 2012

- Market update disclosed 1H12 Statutory Net Loss of $91m on spike in impairments, representing the first loss reported by a key Australian bank in 2 decades. Capital raising provided a cushion for further impairments emerging.
- $450m equity raising to increase CET1 from 6.4% to 8.6%.
- BOQ declared 1H12 dividend of 26 cents approved by APRA

APRA common sense support of AT1 hybrids during COVID

- **NAB 12 March 2020:** allows cash redemption of $1,343m NABPC, combined with the withdrawal of the $1,950m NABPG refinancing offer.
- **MQG 13 March 2020:** allows cash redemption of $429m MBLPA and $400m MBLHB, combined with the withdrawal of the $425m MBLPB refinancing offer
- **CGF 30 March 2020:** allows CGF to extend cash redemption of CGPPA to future quarterly distribution dates post the 20 May 2020 Optional Exchange Date, with redemption funded by a refinancing offer once the hybrid market stabilises
- **BOQ 7 April 2020:** approval for BOQ to redeem its $150m wholesale AT1 hybrid at its 26 May 2020 call date, conditional upon BOQ conducting an AT1 refinancing issue at the first available opportunity.

APRA proposal to restrict banks efficiently distributing franking credits

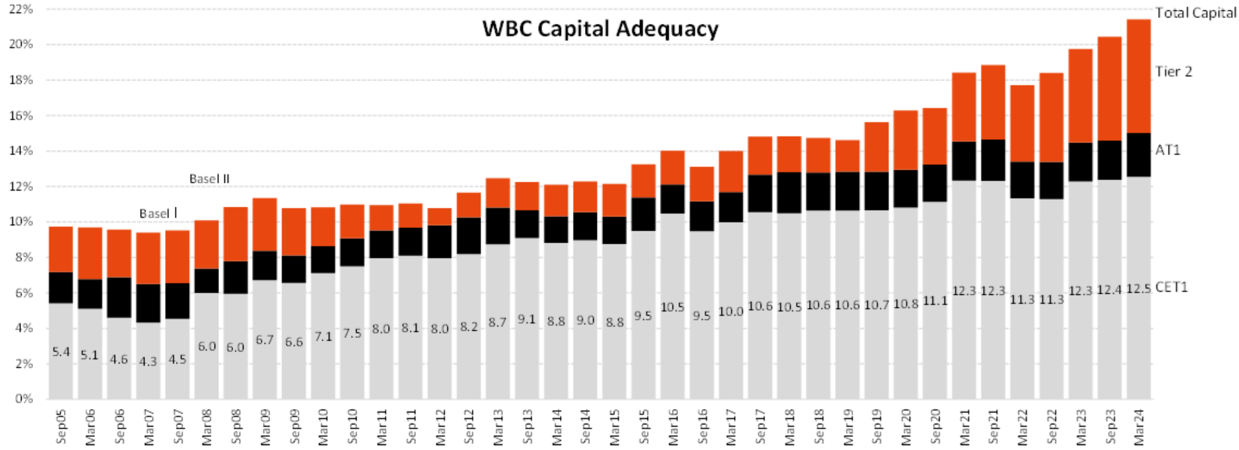
- Investors such as Charities and Not-For-Profits who can maximise franking benefits of hybrids will need to bear greater risks to achieve income goals.

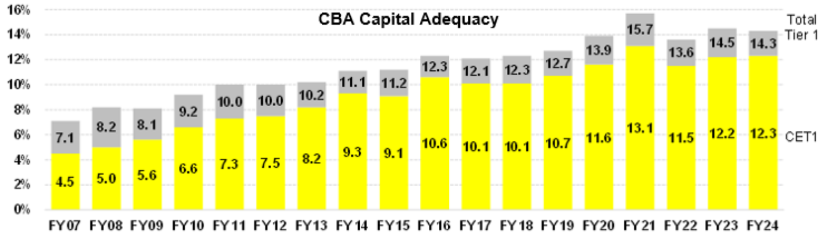
Australian banks exposed to mortgages significantly lower risk than Credit Suisse

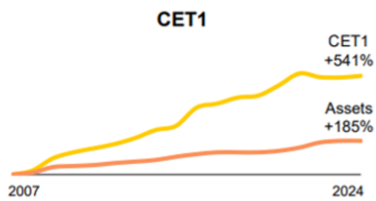
- It appears the Discussion Paper to eliminate the $36bn ASX hybrid market is based on the expectation APRA has a Credit Suisse scenario develop under its watch in Australia. This is at odds with measures implemented by APRA to create “Unquestionably Strong” banks.

Shaw and Partners Analysis / Considerations

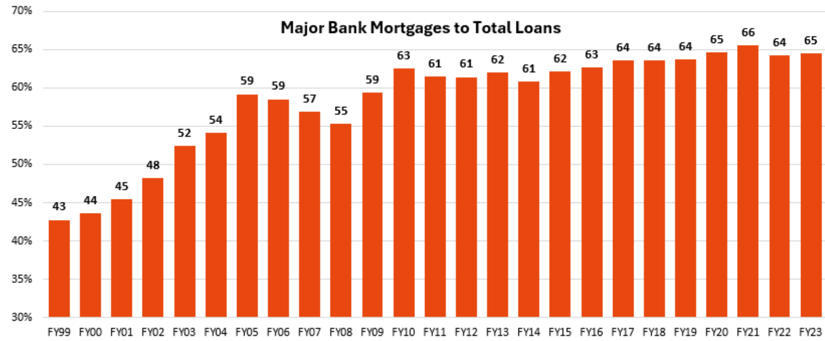
Unquestionably Strong Banks - substantial increase in regulatory capital since GFC, Capital Adequacy >20%

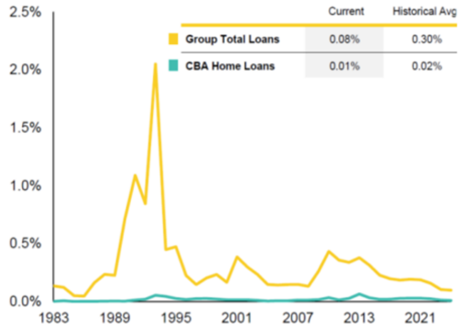






Major Bank Lending Shifting to Mortgages, 2bp historical average loss rate for CBA since 1983





Yours faithfully

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Head of Income Strategies
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