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HYBRID FUND (EHF1)

APRA TAKES OUT ITS TRASH

- APRA has been talking to journos again before updating the market this month.
- It looks like there has been a lot of pushback (probably from the big 4 banks) about their proposal to abolish bank hybrid capital.
- We're not sure why they are doing this article, but we think it is unlikely they will change their mind on the merits of retail owning bank capital and hybrids.
- Even if they do change their mind and allow hybrids to exist, hybrids are still cheap relative to other forms of traded debt.

RECAP: WHAT HAS GONE ON

It's been a long *minute* since APRA first started talking about AT1/hybrid changes, so a quick refresh of the saga might be helpful.

- September 2023; APRA releases a discussion paper about the efficacy of hybrids. The primary discussion point is the unsuitability of retail investors in bank capital, and how to change the investor base to non-retail investors by changing eligibility or security design. APRA requests response by mid-November and promises to issue a formal response on proposed amendments in 2024.

- September 2024; Rather than a formal response, APRA issues another discussion paper; this time proposing to abolish new AT1 and roll-off the existing issues, rather than changing the design. This option was never mentioned in the September 2023 paper, and it is our understanding that the abolition of AT1 was a surprise to all stakeholders, including banks. It seems that the proposed "*wholesaleisation*" of securities was not feasible (we thought that was reasonably obvious back in 2023), so the only way to rid retail from bank capital was to abolish AT1's. APRA requested responses to this discussion paper by mid-November, with consultation on specific changes to Standards in the first half of 2025.

- December 2024; APRA uses the AFR to take out the garbage and briefed a journalist on events since the September paper.

Our speculation is that the September 2024 proposal to abolish AT1's was a surprise to the banks. Capital structure, access to and cost of capital are big issue for banks, and we imagine they were unimpressed by shoddy and surprise nature of the proposal. In hindsight, this has not been APRA's best regulation work. We imagine banks have been in frank and forthright discussions with APRA pointing out the potential issues with APRA's proposed course of action.

SO, WHAT DID WE LEARN FROM THE ARTICLE?

TLDR: we thought that APRA burying hybrids was fait accompli. Maybe this is not the case.

The most important snippets from the article are:

> The speed at which APRA has consulted, and reached a decision, has led the fixed-income broking industry to conclude that banning hybrids is a fait accompli.
>
> Sources inside the prudential regulator say that is not the case. APRA is

That is news to us as well and we're not even a broker. We had assumed that there was 100% probability that hybrids would be banned. This may not be the case.

> APRA considered changing the rules so that hybrids are bailed in sooner, bringing the instruments closer into line with other jurisdictions.
>
> There is another idea that may be more logical: the reintroduction of upper tier-two bonds.

The first sentence is a reference to raising the equity capital level at which hybrids are converted to equity from 5.125% to a much higher level (i.e.) 9%. Current bank equity levels are >11.5%, well above the 10.5% minimum. As the AFR mentions in its article, banks can already issue Upper Tier 2 bonds which are long dated subordinated bonds, but they don't; either because there is no market, or they are too expensive. Maybe this isn't the solution that APRA envisages.

The rest of the article discusses whether APRA has indulged in inappropriate mandate expansion to regulate investor choice and whether they are too conservative.

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DOES THIS CHANGE OUR VIEWS?

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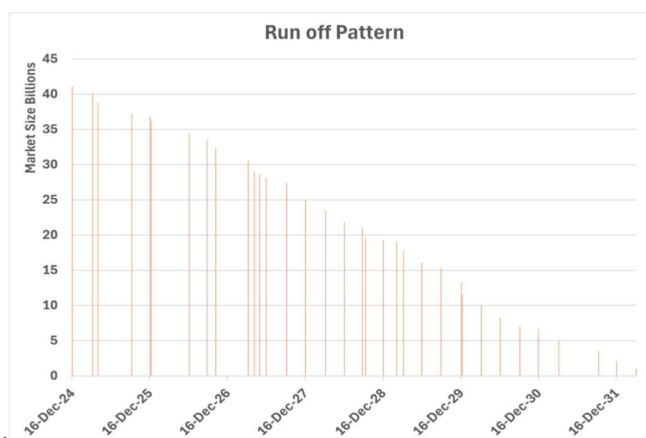
TLDR: not really. We think there is only a small chance that APRA changes its mind and even if they do, the sector will shrink by 25%. There is enough underlying demand out there that should result in margins continuing to contract.

Unfortunately, APRA has dug itself in pretty deep with this one and despite getting an earful from the banks (and all the submissions they received for their 2023 proposal were against it), it's hard to see them backing down from their core dislike of retail investors. In any case, one of the comments from the 2023 paper was that APRA saw little need for bank issuers to have as many hybrids on issue as they have. The Basel minimum is 1.5% of risk weighted assets (RWA) but for various reasons, all the majors had c2% levels. If APRA gets outmanoeuvred on the hybrids, they will probably only allow 1.5% as eligible capital. That means the market will shrink by c$10b over time. Our simple view is that there is still a lot of demand for hybrids from happy investors who have enjoyed a combination of low volatility, well above cash returns and liquidity for most of the past 15 years. The table below shows our primitive attempt at segmenting the market and what they would do if hybrids slowly disappeared. The largest unknown unknown is the extent to which there are advisers, who are partly/wholly invested in hybrids for the commission they receive. To date it has been a win-win for both the adviser and their clients; returns and risk have been great for the clients and the commissions have been pretty chunky. We don't know what happens when new issues (and the commissions that are attached) disappear.

Segment	$ billion	Action
Coolabah	$ 1.5	Let holdings roll off
Rich People	$ 3.0	Buy in secondary/Buy Fund
BHYB	$ 0.5	Continues to buy
Other Institutional	$ 4.0	Let holdings roll off
Unadvised	$ 6.8	Continues to buy
Advised-Commision sensitive	$ 7.3	?
Advised-comission insenstive	$ 21.5	Continues to buy

The chart below details the run-off which shows that by 2028 around $20b would have matured. Typically, each issue has a 50% rollover rate which means that by then there is around $10b of investors that like hybrids and would have gone back into the market via new issue. What do they do?



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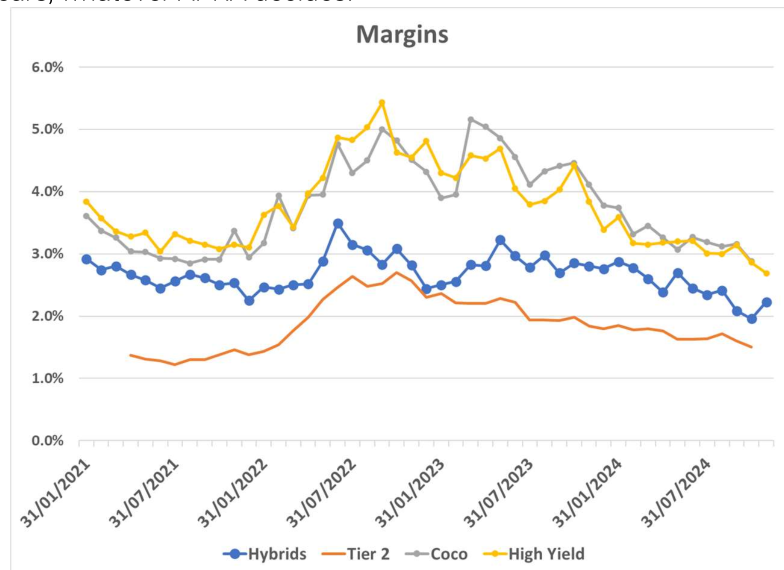
IT'S CHEAP NOW, WHATEVER HAPPENS

TLDR: hybrids are cheap on a tactical view. The fund will continue to do what we do and take advantage of an always interesting market.

Maybe it's a bout of pre-Christmas madness, and we are out on our own here, but movements in global credit markets make us think that hybrids are cheap on a tactical short-term level. Even if APRA changed its mind, we wouldn't expect much weakness and given the opportunity cost of staying out of the market, it's probably a good decision to buy on a 1 or 2year view. The chart below shows margins since 2021, but if you look at the far, far right-hand side, there are 3 things which stand out.

Since August 2024, which was a month before the APRA induced collapse in margins, hybrid margins had fallen by around 20bp. High Yield, BBB and CoCo all fell by more. For whatever reason, global credit margins continue to contract and in the absence of a broad and significant equity market drawdown, we can't see reasons why they will expand. There is far too much retail end demand for stuff with yields higher than cash and with limited volatility. So, hybrids have become marginally more expensive since midyear and now are around 0.25% higher than the post APRA announcement and we are looking at a material excess of demand over supply over the next few years, whatever APRA decides.



We've said before that whatever APRA does, we don't see a change to the Funds operations or risk and return profile before 2027. We think that still holds.

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