

September 2024

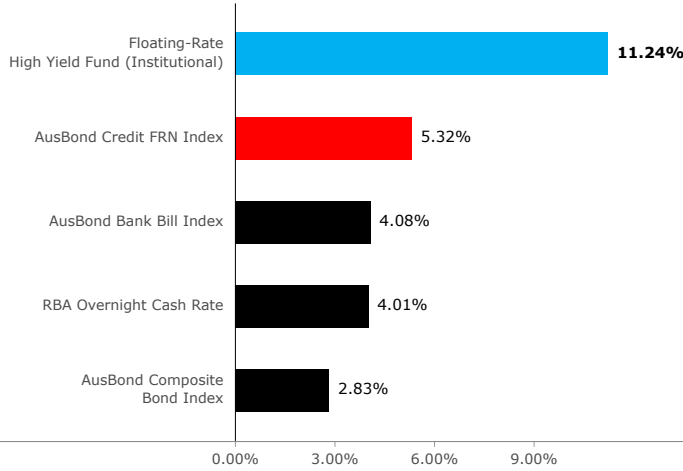
Objective: The Coolabah Floating-Rate High Yield Fund (Managed Fund) (YLDX) aims to provide investors with higher income than other traditional fixed income investments by investing in a portfolio of investment-grade Australian Floating-Rate Notes (FRNs) with enhanced yields.

Strategy: The Fund predominantly invests in a portfolio of cash securities and investment grade floating-rate, Australian bank-issued senior and tier 2 bonds. It also has the capacity to invest in government bonds and corporate bonds. In contrast to fixed-rate bonds, FRNs pay a variable-rate of interest that resets monthly or quarterly and moves up and down with changes in a recognised reference interest rate. In Australia, FRNs generally track the returns of the Reserve Bank of Australia's (RBA's) cash rate via a benchmark proxy called the quarterly Bank Bill Swap Rate (BBSW) plus an additional credit spread, or interest rate margin above BBSW. Unlike a fixed-rate bond, an FRN has very low interest rate risk given the interest paid by an FRN will be highly correlated with moves in the RBA cash rate. The Fund will borrow or use leverage to provide additional exposure to these assets. Leverage can amplify gains and also amplify losses. It cannot invest in hybrid securities, equities or property.

Period Ending 2024-09-30	Gross Return	Net Return	Bloomberg AusBond Credit FRN 0+ Yr Index
1 month	0.53%	0.46%	0.43%
3 months	2.02%	1.82%	1.39%
6 months	5.26%	4.83%	2.80%
1 year	10.96%	10.07%	5.73%
Inception pa Dec. 2022	12.13%	11.24%	5.32%

Floating-Rate High Yield Fund Returns (Net) vs Comparisons

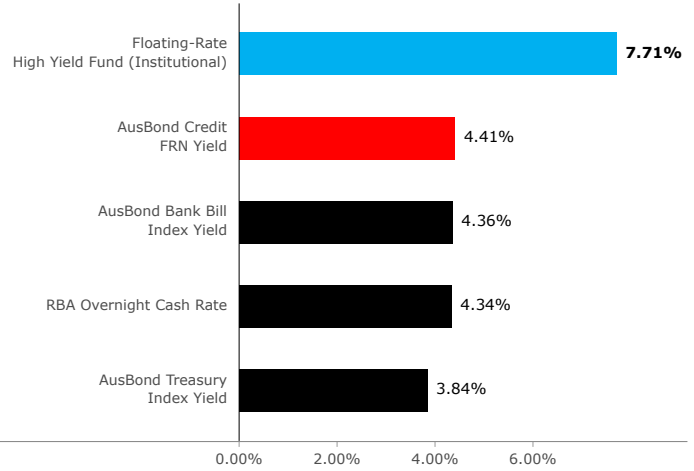
Annualized Total Returns Since Inception in December 2022 to September 2024



Data Source: RBA, Bloomberg, Mainstream, Coolabah Capital Investments

Annual Running Yield

30 September 2024



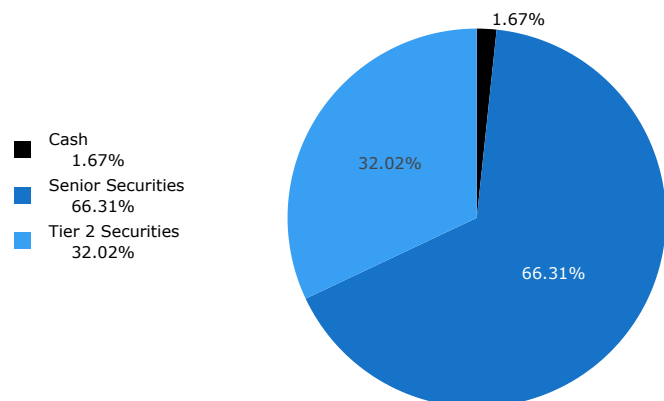
Data Source: RBA, Bloomberg, Coolabah Capital Investments

Disclaimer: The yield displayed for Coolabah's Floating-Rate High Yield Fund (Managed Fund) is the annual yield to maturity target before management costs at the date shown. The yields shown are as of the date displayed and assumes the Fund holds the bonds to maturity or call which may or may not occur. If the Fund does sell its bonds prior to maturity, it is expected it will reinvest in similar issues. This yield to maturity changes daily and may be different on the day you invest. All investments carry risks, including that the value of investments may vary, future returns may differ from past returns, and that your capital is not guaranteed. Past performance does not assure future returns. The Fund has a different risk profile to the other comparisons, including, amongst other things, that it invests in bonds, not hybrids or equities, and that it uses leverage, which means that both gains and losses may be amplified. Returns are shown net of all Management and Performance fees unless otherwise stated. To understand the Fund's risks better, please refer to the Product Disclosure Statement available at Coolabah Capital Investments' [website](#).

Note: all portfolio statistics other than yields and duration are reported on gross asset value

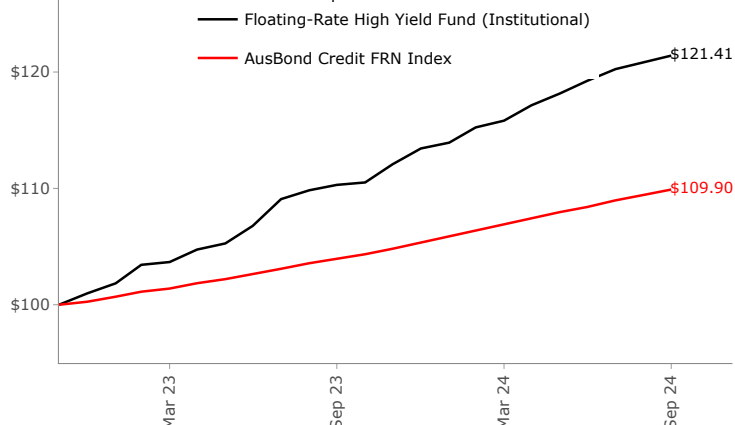
Av. Portfolio Credit Rating	A+	Av. Interest Rate (Gross Running Yield)	7.71%
Portfolio MSCI ESG Rating	A	Modified Interest Rate Duration	0.42 years
No. Cash Accounts	12	Gearing Permitted?	Yes
No. Notes and Bonds	84	Net Annual Volatility (since incep.)	1.47%
		Ratings: Superior - Complex (Foresight Analytics)	

Floating-Rate High Yield Fund Portfolio Composition (GAV)
30 September 2024



Data Source: Coolabah Capital Investments

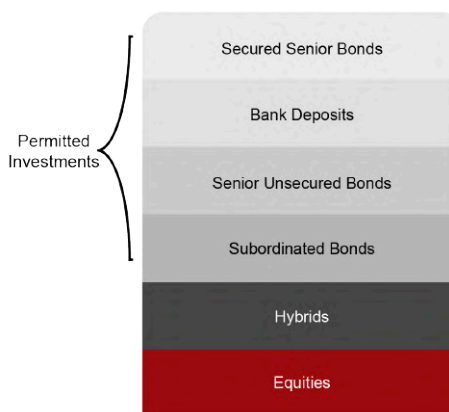
Value of \$100 Invested since Inception
30 September 2024



Data Source: Bloomberg, Coolabah Capital Investments



Investing Across The Capital Structure
A Bank's Capital Structure



Portfolio Managers Christopher Joye, Ashley Kabel, Roger Douglas, Fionn O'Leary (Coolabah Capital Investments)

APIR Code	ETL6855AU	Fund Inception	05-Dec-2022
ISIN	AU60ETL68557	Distributions	Quarterly
Morningstar Ticker	45878	Unit Pricing	Daily (earnings accrue daily)
Asset-Class	High yield/Floating rate note	Min. Investment	AUD\$1,000
Target Objective	Yield focused	Withdrawals	Daily requests (funds normally in 3 days)
Investment Manager	Coolabah Capital Investments (Retail)	Buy/Sell Spread	0.00%/0.05%
Responsible Entity	Equity Trustees	Mgt. & Admin Fee	0.80% pa
Custodian	Citigroup	Perf. Fee	Not Applicable

Portfolio commentary: In September, the zero-duration daily liquidity Coolabah Floating-Rate High Yield Fund (YLD) returned 0.53% gross (0.46% net), outperforming the AusBond Bank Bill Index (0.36%), the RBA Overnight Cash Rate (0.36%), and the AusBond Credit FRN Index (0.43%). Over the previous 12 months, YLD returned 10.96% gross (10.07% net), outperforming the RBA Overnight Cash Rate (4.32%), the AusBond Bank Bill Index (4.41%), and the AusBond Credit FRN Index (5.73%). YLD ended September with a running yield of 7.71% pa, a weighted-average credit rating of A+, and a portfolio weighted average MSCI ESG rating of A.

Since the inception of YLD in December 2022, it has returned 12.13% pa gross (11.24% pa net), outperforming the RBA Overnight Cash Rate (4.01% pa), the AusBond Bank Bill Index (4.08% pa), and the AusBond Credit FRN Index (5.32% pa). Since inception, YLD's Sharpe Ratio, which measures risk-adjusted returns, has been 5.51x gross (4.92x net). While YLD's return volatility since inception has been low at around 1.47% pa (measured using daily returns), as a daily liquidity product with assets that are marked-to-market using executable prices, volatility does exist. This contrasts with illiquid credit (eg, loans and high yield bonds) wherein assets that have very high risk can appear to have remarkably low volatility, which is, in fact, just a mirage explained by the inability to properly value these assets using executable prices.

Strategy commentary: In September, the US Federal Reserve kicked-off its widely anticipated monetary policy easing program with a jumbo, 50 basis point rate cut. Alongside more benign inflation data and a sharp decline in the price of oil, this helped trigger a reduction in long-term global bond yields, which fueled a rally in fixed-rate bond prices (aka "duration") and equities. Over the month, 10-year government bond yields declined in Italy (32bps), Germany (18bps), the US (12bps), France (11bps), NZ (3bps) and the UK (1bps).

One exception was Australia, where 10-year bond yields climbed 1bps in September in sympathy with expectations that the central bank will lag peers and not lower interest rates until around April 2025. The "wonder down under" is grappling with stickier demand-side inflation pressures as a result of the RBA deciding to run looser monetary policy, which is an approach that notably conflicts with many near-peers like the RBNZ.

Global fixed-rate bonds consequently performed well with the benchmark Bloomberg Global Aggregate Corporate Index leaping 1.57% (USD hedged) in September. Coolabah's global long duration strategy, the Pacific Coolabah Global Active Credit Fund (PCGA), outperformed by 11bps, returning 1.68% gross in September. (This solution is not available in Australia.)

Since inception, PCGA has returned 16.4% before fees relative to the Bloomberg Global Aggregate Corporate Index's 13.5% return, furnishing alpha of 2.85% before fees (USD hedged). The volatility of the PCGA strategy has been almost identical to the index.

In Australia, the AusBond Composite Bond Index only delivered a 0.31% return given the absence of a duration-led tailwind (long-term bond yields were largely unchanged). By way of comparison, Coolabah's Active Composite Bond Fund (ETF: FIXD) returned 0.49% net, outperforming its benchmark by 0.18% in September net of fees. Over the year to September, Coolabah's FIXD strategy has returned 10.81% net relative to the index's 7.11%, generating material alpha of 3.70% net. FIXD has historically had similar volatility to the index.

The decline in risk-free rates boosted equities in the US (S&P500 up 2.02% and Nasdaq up 2.48%) and Europe (Eurostoxx 50 up 0.86%), although UK stocks declined (FTSE 100 down 1.67%). Surprisingly, Aussie equities rallied 2.2% despite the fact that there is no interest rate cut looming (the NZX50 was flat). Over the month, gold climbed another 5.24% while Bitcoin surged 8.03%.

Globally, credit spreads were mixed: they were flat in the UK and Europe; tighter by 4bps in the US; and wider in Australia (major bank senior bond spreads drifted 1bps higher while major bank Tier 2 bond spreads moved 5bps wider).

One exception was the ASX hybrid market where 5-year major bank hybrid spreads gapped an enormous 32bps tighter on news that the regulator, APRA, was proposing to eliminate this equity buffer altogether off bank balance-sheets and replace it with debt (remarkably boosting leverage such that all "standardised" banks in Australia would suddenly become non-complaint with Basel 3). You can read more about our analysis of this surprising development, which has no global precedent, later.

Strategy commentary cont'd: Coolabah runs the full capital structure active ETF called HBRD for BetaShares, which invests across cash, senior bank bonds, Tier 2 bonds and hybrids. Given Aussie bank hybrid spreads are at their tightest levels since 2007, and only pay 20-30bps above Tier 2 bond spreads, HBRD's allocation to hybrids is at a since inception low around 30% (it is circa 50% allocated to Tier 2 bonds and 20% invested in senior and cash). Over the 12 months to 30 September, HBRD outperformed both the broader ASX hybrid and major bank hybrid markets on a post-fee basis, before franking credits. On a franked basis, HBRD returned 7.56% after fees, also beating SUBD's 7.06% return and its Tier 2 bond benchmark return of 7.29%. Over the last 24 months, HBRD has also outperformed SUBD after all fees (and since inception).

In the floating-rate (rather than fixed-rate) space, the AusBond Credit Floating-Rate Note (FRN) Index returned 0.43% in September. Coolabah's near-zero duration strategies outperformed, including: the Long Short Opportunities Fund (0.79% to 0.81% net); the Long Short Credit Fund (0.75% to 0.76%); the Smarter Money Fund (0.52%); and the Short Term Income Fund (0.47% net), amongst others.

This is general information only, not personal advice. Please also note that past performance is no guide to future returns and investors should read the product PDS to better understand its risks and consult an adviser before making any decisions.

Australians continue to run down their COVID-era savings

The latest data on cash flows show that Australian households continue to marginally dissave, which means that they are running down their financial assets and/or incurring more debt.(1)

Using the figures to estimate what has happened to the excess savings built up during COVID, they continue to decline, falling to 7% of annual GDP in Q2 (or 5% of GDP assuming households do not run down the higher offset/redraw balances built up early in the pandemic).

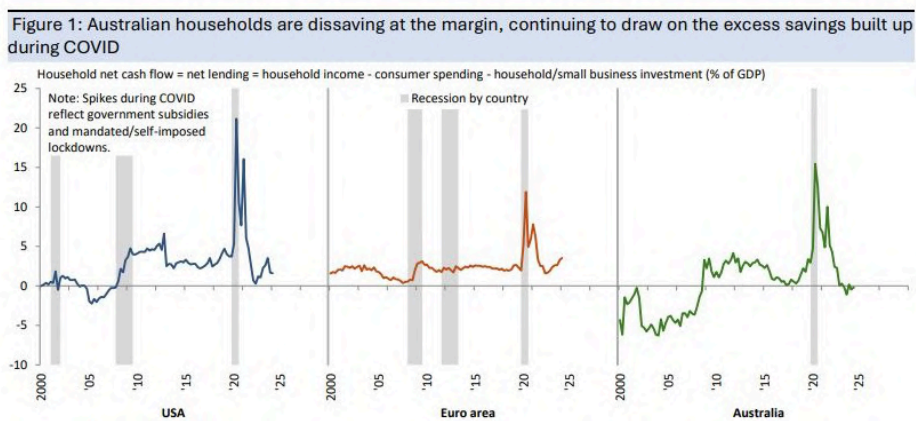
These calculations are sensitive to the underlying assumptions, but suggest that Australian households continue to hew to the American experience, where households have effectively exhausted their excess savings (Q2 US data are yet to be published).

In contrast, the decline in excess savings in the euro area has stalled, with cash flow data showing households saving at a faster rate recently.

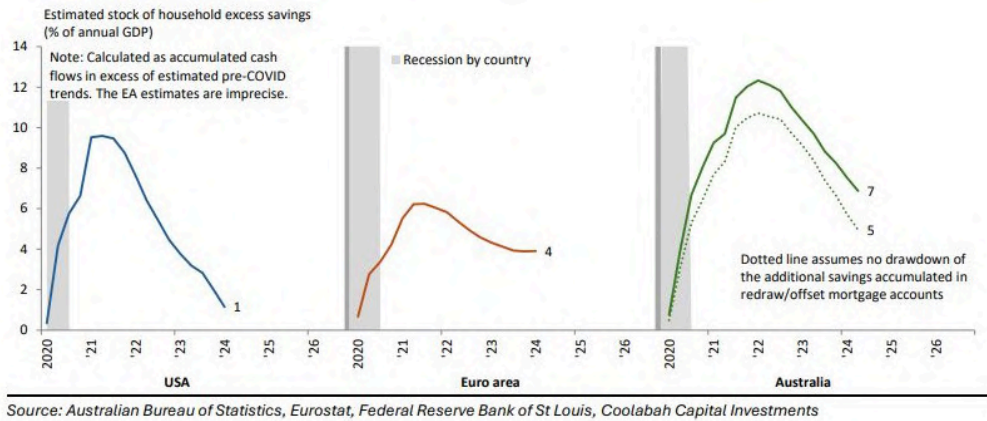
This difference in trends could reflect the fact that household wealth remains depressed in Europe in real terms, whereas wealth in the US and Australia has recovered strongly, buoyed by house prices reaching record highs.

Note:

(1) Household cash flow – aka "net lending" – is defined as household income less consumer spending less investment in physical assets (i.e., building new homes, renovating existing homes, and small business investment).



Strategy commentary cont'd:



Risks around Fed policy in a soft landing

Chair Powell recently argued that the Fed's 50bps rate cut represented the FOMC "recalibrating policy down over time to a more neutral level", where "the neutral rate is probably significantly higher than it was [before COVID]".

Consistent with the Fed still aiming for a soft economic landing, the updated median FOMC forecasts have the policy rate falling to 2.9% by end-2026 and holding at that level in 2027, matching the median policy-maker long-run neutral estimate of 2.9%.

The FOMC has been nudging the median estimate of neutral higher all this year, with the 2.9% estimate the highest since 2018 and with the median neutral forecast previously steady at about 2.5% from 2019 to 2023.

However, the range of policy-maker estimates around the median forecast of a 2.9% neutral rate is still the widest it has been since the FOMC started publishing its forecasts in 2012.

This is seen in the 1pp range for the "central tendency" of individual policy-maker forecasts of the neutral rate from 2.5% to 3.5%, where the central tendency excludes the three lowest and three highest individual projections.

Looking at the distribution of policy-maker forecasts within this wide central tendency, it wouldn't be surprising if the FOMC median forecast of neutral keeps edging higher, closing the gap with the roughly 3½% average estimate derived from market pricing and Fed staff models.

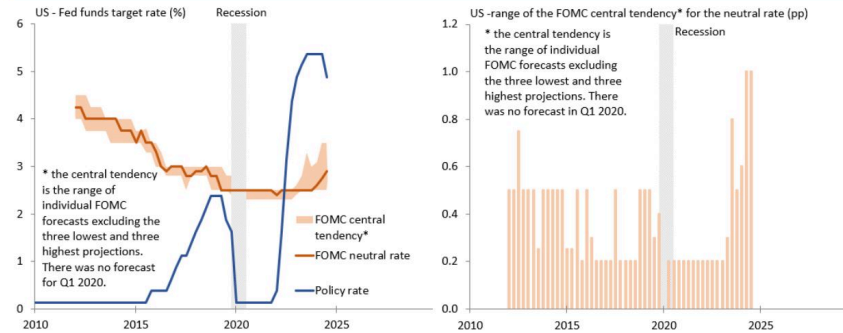
However, history shows that the long-term FOMC forecasts are usually wrong and if the US economy ends up in recession, the Fed will likely take the funds rate below the neutral rate into the 2s.

In such a scenario, government policy could limit the ultimate easing in monetary policy, or perhaps shorten the duration of the low in rates.

This is because both sides of politics already plan to spend more money regardless of the state of the economy and the republicans would additionally boost inflation through tariffs, planned large-scale deportations, and pressure on the Fed.

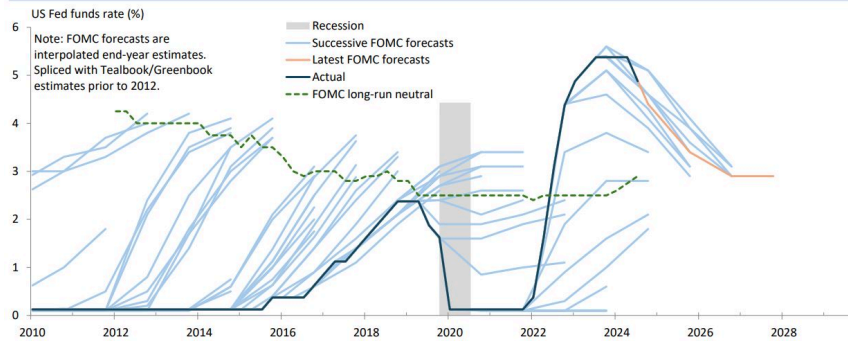
Strategy commentary cont'd:

Figure 1: The Fed has been nudging up its median estimate of the neutral rate all year, where the wide range of policy-maker forecasts suggests that the FOMC could close the gap with market/model estimates of a 3½% rate



Source: Board of Governors of the Federal Reserve System, Federal Reserve Bank of St Louis, Coolabah Capital Investments

Figure 2: History shows FOMC forecasts of the funds rate are broadly anchored by the Fed's view on the neutral rate, but that the long-term forecasts often end up wrong



Source: Board of Governors of the Federal Reserve System, Federal Reserve Bank of St Louis, Coolabah Capital Investments

Did APRA just make banks riskier to reduce its own reputational risks?

Years ago we argued that APRA would be better off getting rid of bank hybrids and replacing them with pure equity (ie, ordinary shares). Why? Primarily because ordinary shares are the highest quality form of first loss, or so-called "Tier 1", capital (also known as "going concern" capital). Why have an inferior form of equity capital via the use of Additional Tier 1 (AT1) bank hybrids, which only act as equity in certain extreme circumstances, when there is already an enormous sharemarket out there? Why not simplify the capital stack with just pure equity and debt? The counter-arguments were plentiful and include:

- All global banking regimes allow banks to draw-on a combination of pure equity and hybrid capital to meet their Tier 1 capital requirements;
- Hybrids are cheaper for banks to issue than ordinary equity – they are, therefore, return on equity accretive and shareholder friendly;
- The Basel 3 hybrids established in 2013 are forced to automatically convert into true equity in all extreme scenarios, most notably when a bank's equity capital ratio falls to very low levels (they do, consequently, act as equity when you need them);
- The Aussie and global hybrid markets are massive with \$41 billion of ASX listed hybrids alone, and in Australia have proven to be an exceptionally reliable, cheap and flexible source of Tier 1 capital funding during shocks (eg, in 2008, 2020, and post the 2023 Credit Suisse collapse); and
- We saw that in the case of Credit Suisse, hybrids served their intended purpose of recapitalising a failing bank very quickly – in fact, over a weekend.

Strategy commentary cont'd: Given the arguments above, it made sense to allow Aussie banks the freedom and flexibility to source their Tier 1 capital through a combination of ordinary shares and via listed and unlisted hybrids in Aussie dollars and foreign currencies, which they have done on APRA's instruction for the best part of 25 years. It also puts Aussie banks on the same playing field as all other global banks.

APRA's latest proposal to simply eliminate hybrids altogether from the Aussie banks' capital structure seemed superficially simple and sensible, which was [my original reaction \(see here\)](#).

But the more we drilled into the detail, the more serious questions emerged about why APRA was really doing this and the risks it would be imposing on the bank deposit holders that APRA is legislated to protect. In particular:

- **APRA never canvassed the complete elimination of the hybrid market in its [original discussion paper](#).** Outside of the banks, industry participants, including depositors, stockbrokers, advisers, bondholders, and investors appear not to have been consulted about this radical shift.
- **APRA is very directly increasing bank risks**, as represented by a substantial increase in leverage, and hence depositor risks, by removing a key component of the banks' Tier 1 capital buffers.
- **It is directly undermining the banks' credit ratings** on both their Tier 2 bonds and senior bonds, and hence their deposits, as highlighted by a deterioration in their S&P RAC ratios, although we are not expecting any formal rating changes at this juncture.
- **It is breaching the Basel 3 minimum Tier 1 capital targets for all the smaller standardised banks, which it previously complied with.** These minimums will fall very substantially to 4.5% compared to the Basel 3 minimum of 6% that APRA historically adhered to. Given this breach, APRA has proposed junking the Tier 1 minimums for all standardised banks, which seems reckless.
- **It is significantly reducing the equity funding flexibility that banks have relied upon** as demonstrated during the GFC, the pandemic, and after the Credit Suisse collapse.
- **And it appears to be doing all of this simply because it is worried about the reputational and management risks that APRA faces** when it is supposed to be doing its job of protecting deposit-takers by allowing hybrids to automatically convert into equity during a serious banking crisis (or using real equity in its place).
- **The primary motivation for these changes appears to be the fear of a backlash from individual investors**, even though banks and the industry have spent 25 years educating them on what are inherently low probability risks.

One especially spurious argument APRA makes is that retail investors understand bank equities, but don't understand hybrids, which they imply are riskier securities. This is wrong on all fronts. Since before the GFC, Aussie bank hybrids have displayed about 25% of the volatility of bank stocks, and have had 25-50% lower losses. All hybrid equity-conversion risks in a stress scenario in turn dilute-down shareholders, which mean that bank equities actually face the same risks as hybrids – and then a vast array of additional hazards. Mathematically, hybrids are easier to value than equities because they have a predetermined running yield.

While we run an ETF that can invest in hybrids, called HBRD, it is a full capital structure solution that allocates across cash, senior bonds, subordinated bonds, and hybrids, including AUD and foreign currency securities. Given hybrids are trading on the tightest credit spreads since 2007, it has only a modest, circa 30% allocation to the sector.

Whether hybrids continue to exist or not does not change that product's capacity to roam up and down the capital structure, locally and globally. While my initial reaction to the APRA proposal was that the simplification of the capital structure might be sensible, questions have since emerged about the risks of this process...

Strategy commentary cont'd: What triggered the APRA review in the first place?

The review was precipitated by the collapse of Credit Suisse March 2023 and the write-off of the Credit Suisse hybrids and recapitalisation of the bank at that time, which, ironically, was exactly what the hybrids were designed to achieve. The Credit Suisse hybrids were written-off with extraordinary speed, over a weekend, hammering the Aussie credit funds that held them.

APRA claimed in its original discussion paper that the Credit Suisse experience suggested hybrids could be illiquid, that hybrid funding markets could close, and that they did not work as quickly as they should. All these arguments were grossly incorrect, as I explained at the time:

"No less than \$890 million of Aussie listed hybrids traded in March 2023 at the time Credit Suisse collapsed. Aussie hybrid credit spreads widened, but only modestly. One month later in April 2023, more than \$500 million of Aussie hybrids traded in orderly conditions.

By May 2023, CBA had launched a huge \$1.55 billion hybrid issue at a cheap 3 per cent spread above bank bills. To say that Credit Suisse's write-down of its hybrids shut down the market is totally wrong.

The worst blow-out in hybrid spreads in history was in March 2020, when the pandemic forced them to 8.5 per cent above bank bills – even higher than the levels reached during the global financial crisis.

In an astonishing affirmation of the liquidity of the listed hybrid market, an extraordinary \$1.22 billion of hybrids traded on the ASX in March 2020 alone. That was more than the entire OTC corporate bond market, which was closed.

Much of this trading was done by institutional investors, who have increasingly come to dominate Aussie hybrid flows during times of stress."

The real driver of the APRA review of the \$41 billion ASX hybrid market seems to have been the bureaucrats' unease with the idea of Aussie bank hybrids being converted into equities, and possibly imposing losses on retail investors, during a time of stress. APRA appears to be extremely keen to reduce its reputational risks, so much so that it is now apparently prepared to shut-down the entire market – throwing the baby out with the bathwater. What is most perverse is that APRA is making banks riskier in the process...

Did APRA consult on this change?

At no point in its consultation paper published in September 2023 did APRA canvass the possibility of getting rid of hybrid capital. We further don't know anyone outside of the banks who had thought this was possible. In its [paper](#), APRA simply referred to "reducing reliance on AT1 by changes to the level or mix of regulatory capital requirements" and "reducing the level of AT1 capital, offset by a commensurate increase in other capital requirements". If eliminating hybrids was really an option, APRA would have said so explicitly.

In discussions with industry (outside of the banks), APRA was primarily focussed on improving the ability of hybrids to convert into equity (option 1) and reducing retail investors' holdings of hybrids (option 3). This was the thrust of all the initial consultations with APRA.

The banks were clearly consulted by APRA on this idea of eliminating hybrids later in the process, but this seems to have been because APRA concluded it would have been hard to completely ban individual investors from holding hybrids. APRA's original vision was to shift hybrid issuance into the unlisted wholesale market and/or ban retail investors from accessing them on the ASX. When this appeared to difficult to achieve, APRA seems to have resorted to simply eliminating hybrids altogether.

Strategy commentary cont'd: Is APRA making banks riskier to reduce its own reputational risks?

The Aussie major banks hold hybrids worth 2.15% of their risk-weighted assets. This counts as equity or Tier 1 capital. Bizarrely, APRA is getting rid of this 2.15% of Tier 1 capital and only replacing it with 0.25% of common equity Tier 1 capital, known as CET1. This means all Aussie bank Tier 1 capital ratios will drop very substantially. S&P reports an equity ratio that captures CET1 plus AT1 hybrids. This is called a risk-adjusted capital ratio or RAC ratio. S&P's RAC ratios for ANZ, CBA, NAB and Westpac will all drop by about 15-20% because of this move.

APRA is explicitly increasing bank leverage by reducing bank Tier 1 capital. This means APRA is increasing the risks that bank depositors and bondholders face. It would be perfectly logical if APRA was saying, "We are going to eliminate the 2.15% of hybrid Tier 1 capital and replace it with 2.15% of new CET1". This would leave Aussie bank Tier 1 ratios unchanged. In fact, it would make banks less risky, because the quality of Tier 1 capital would have improved due to the fact that you are replacing AT1 hybrids with better quality CET1 (ie, ordinary shareholder capital).

It doesn't matter whether you look at S&P's RAC ratios for Aussie banks or Moody's loss given default models, the equity capital protecting depositors and bondholders declines. The credit ratings on Tier 2 bonds and senior bonds might not change on our analysis, but those ratings definitely have less equity support than they did previously.

APRA is increasing the amount of Tier 2 subordinated bonds by 1.25% of risk-weighted assets. But as APRA explains carefully, this is not Tier 1 or equity capital. Tier 2 capital is "gone concern" capital that can only be used when a bank is declared by APRA to be "non-viable". That is basically an insolvency event. It is not first-loss equity, or going concern, capital that is used to act as a buffer when a bank is still alive.

APRA has further loaded up the major banks with the biggest Tier 2 capital ratios in the world – they will end up being about 8% of their risk-weighted assets. This makes declaring a bank non-viable even tougher because you would be converting such a massive sleeve of globally held bank bonds into equity at that time, which would be practically impossible.

Is APRA violating the global best-practice banking rules (Basel 3) to reduce its own risks?

Under the global banking rules that APRA seeks to abide by, known as Basel 3, banks have to hold minimum Tier 1 capital, which is CET1 plus AT1 hybrids, worth 6% of their risk-weighted assets. Because APRA is proposing to eliminate its current minimum target for AT1 hybrids of 1.5%, the smaller Aussie banks, known as "standardised" banks, will not have a minimum Tier 1 requirement of 6% under APRA's rules. This minimum would fall to just 4.5%, which is way below the official Basel 3 requirements. APRA acknowledges this, and is proposing to simply remove the minimum Tier 1 capital requirement for normal banks because it is reducing their equity capital and boosting their leverage or debt. The screenshot below highlights this.

Strategy commentary cont'd:

Standardised banks

The design for banks using the Standardised Approach to credit risk capital requirements (Standardised banks) would mirror the Advanced changes, with further simplification:

- fully replace AT1 with Tier 2 capital; and
- **remove the minimum Tier 1 Capital ratio.**

Table 4. Minimum prudential capital requirements under the proposed approach

Minimum capital requirements	Advanced		Standardised	
	Current	Proposed	Current	Proposed
CET1 Capital requirement	4.5%	6.0%	4.5%	4.5%
Tier 1 Capital requirement	6.0%	-	6.0%	-
Total Capital requirement	8.0%	9.25%	8.0%	8.0%
Total Capital requirement + CET1 buffers ¹⁶	13.75%	13.75%	11.5%	11.5%

This raises the concern that APRA is removing an important layer of going concern first loss equity capital (ie, hybrids) and only replacing it with debt capital (ie, Tier 2). In the case of standardised banks, this increases bank leverage and the risks faced by depositors.

As noted above, the advanced banks are also allowed to switch their hybrid equity capital for debt, materially increasing leverage. They do have to boost their CET1 capital by a tiny 0.25% margin under the proposal, which means that the total reduction in Tier 1 capital is about 1.9 percentage points (or the 2.15% hybrid capital less the new 0.25% of CET1).

At no point does APRA address the heightened leverage risks for depositors or the reduced credit quality of bank borrowings, which is extremely surprising given these are meant to be its primary prudential focus. It looks like these changes are solely motivated to make APRA's life easier...

Is APRA reducing bank funding flexibility during crises?

The \$41 billion ASX hybrid market has been a consistent source of flexible and shareholder-friendly funding for banks during shocks, as demonstrated during the GFC, in 2020 after the pandemic shock, and following the collapse of Credit Suisse in March 2023.

In May 2008, in the midst of the GFC, Macquarie averted a crisis by raising \$600m via a hybrid issue, boosting its Tier 1 capital buffers in a way that could not be done via pure equity. In June 2020, Macquarie again raised \$641m on the ASX via hybrids in the middle of the pandemic. And in May 2023, just after Credit Suisse's collapse, CBA raised \$1.55 billion via a hybrid issue. Aussie banks have also raised billions via hybrid issues in the unlisted USD and AUD markets, which they will no longer be able to do.

It is surprising that APRA would want to destroy all this cheap and liquid funding flexibility in the AUD and USD markets, especially in the case of the highly dependable ASX domain that has built-up a very reliable individual investor base that greatly value the franking credits that bank hybrids carry.

Strategy commentary cont'd: Is APRA taking an inconsistent approach to banks and insurers?

Another puzzle is why APRA has suddenly decided to eliminate the entire bank hybrid market but at the same time keep it in place for insurers. This seems, once again, completely inconsistent. Both banks and insurers have very similar equity, hybrid, and Tier 2 bond needs. APRA really ties itself up in knots in trying to explain why it is going to treat banks and insurers very differently when it comes to capital instruments:

For insurers, APRA is not proposing any changes to capital instruments at this time. APRA's concerns for AT1 are less acute for insurers, and simplifying the capital framework involves different trade-offs, given the different nature of how stress may impact the insurance industry. APRA will monitor developments in the AT1 market for insurers and may review the approach to insurance capital instruments in due course.

Are there politics at play here?

With a federal election looming in the next 6-12 months, APRA is proposing to destroy a \$40 billion franked investor market dominated by retirees and SMSF investors who prize the tax effective franking credits that hybrids offer. Franking credits were a key battleground between Scott Morrison and Bill Shorten at the 2019 election. APRA is increasing bank credit risks, and the hazards that deposit-takers face, apparently in the name of reducing the reputational risks it has to run when overseeing the conversion of hybrids into ordinary equity. All extremely odd stuff.

If APRA had said, we are removing the circa 2% hybrid capital buffer from the banks' equity ratios and replacing it with 2% of normal equity, we would all be cheering. But it is not doing that, presumably because the banks would start moaning about the impact on shareholder returns from replacing cheaper hybrids with higher cost ordinary equity...

So it is instead simply leveraging up the banking system, and transferring wealth from deposit-holders to shareholders, while myopically trying to protect its own hide in the process.

Watch the debate: Private Debt vs Fixed Income

In September, two Australian investment heavyweights took to the stage in front of a packed room to debate the merits of private debt versus fixed income.

Publicly traded fixed income has been a portfolio staple for asset allocators; however, in recent years, we've seen the rapid growth and rise of private credit.

Click on the image below to watch the debate and cast your vote.





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