

# Investor Education

## Understanding fixed interest securities

- Fixed interest securities offer investors investment income and portfolio diversification and come in many forms.
- ASX listed Corporate and Bank issued securities offer investors the benefit of higher returns than investments such as Government bonds or bank deposits, however they also carry a higher level of risk.
- Investors should understand the three primary sources of risk which are the credit quality of the issuer, interest rate exposure and the specific structural features of a security such as interest deferral, equity conversion or write-off conditions.

### The main characteristics of fixed interest securities

- **Face Value** – is the price at which the Security is issued and the amount repayable to the investor at Maturity/Redemption by the Issuer;
- **Distribution / Dividend / Coupon** – the income stream payable to investors either monthly, quarterly or semi-annually;
- **Maturity/Redemption** – the date at which holders must be repaid the Face Value of the security in cash;
- **Call** – the date at which the Issuer may (at its option) repay investors the Face Value of the security; and
- **Conversion** – the date when a preference share or other convertible security will convert into Ordinary Shares in the Issuer (assuming the required conversion conditions are met or enforced).

### Why invest in fixed interest securities?

Fixed interest securities are generally suited to Investors seeking income; however where a security trades at a discount to face value, some capital growth over time can also be expected as the security moves back to its face value at maturity. Conversely, where a security is purchased at a price above its face value, only the face value will be repaid at redemption; this will be reflected in the yield.

Investors seeking portfolio diversification should also consider Australian Securities Exchange (ASX) listed Exchange-traded Government Bonds or bank deposits which, while generally paying lower levels of income than bank and corporate securities, carry a lower level of credit risk. This is because all interest payments and the repayment of the bond's face value are guaranteed by the Government. Deposits are also protected from loss through regulation and legislation\*.

Government bonds also provide significant portfolio diversification benefits. This is because in times of economic stress where shares and other higher risk asset classes might be expected to fall in price, Government bond prices generally rise as investors seek the safe-haven status of bonds. For more detail please review [Morgans' Government bond publications](#).

Investors may also consider Listed Investment Trusts (LITs) for portfolio diversification. LITs provide retail investors with access to domestic and global credit and debt markets managed by experienced and specialist teams. LITs are discussed further below.

It is very important to read and clearly understand the security terms and risks as these can vary greatly across different types of securities. To assist your understanding, Morgans provides a detailed Offer Summary for all new investment opportunities. Some general features and risks associated with investing in various fixed interest securities are outlined in Appendix A.

\* Deposits of up to \$250,000 per depositor per ADI (see glossary) are subject to the Financial Claims Scheme (commonly referred to as the Government Guarantee).

## General features of ASX Listed Fixed Interest Securities:

- Known return profile with Distributions / Dividends / Coupons being either fixed or floating in nature;
- Returns are more predictable than ordinary share dividends, and in the event that they are not paid on these instruments, companies are generally unable to make payments on lower ranking securities including ordinary shares;
- Franking is often a component of investor returns for Preference Shares and Capital Notes;
- Issuers are generally known and trusted names;
- ASX listing provides transparency and liquidity;
- Price volatility is generally lower the higher ranking the security in the capital structure.

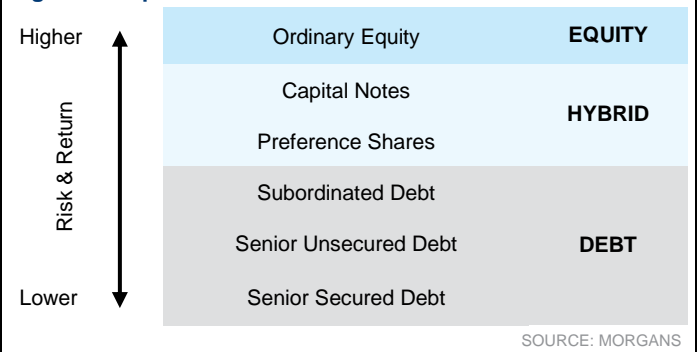
## General risks:

- Preference Share/Capital Note Distributions are subject to specific payment conditions, such as the issuer having sufficient distributable profits to make the payment and in many cases are discretionary;
- Subordinated Note coupon payments may only be deferred in certain circumstances;
- Investors are exposed to interest rate and market price risk;
- Returns to the investor upon conversion or preceding conversion may be affected by movements in the underlying ordinary share price;
- In the event that the issuer is wound up, investors may receive less than the security's face value if there are insufficient funds following the repayment of higher ranking creditors; and
- Securities issued by the APRA regulated entities i.e. banks & insurers, may in certain extreme circumstances be converted to equity or written-off resulting in financial loss.

## Capital Structure

The size and depth of the listed security market has grown over the past few years, from one which consisted largely of domestic hybrid securities (preference shares) to one now which provides investors with access to a range of fixed income instruments with domestic and international exposure across the capital structure. The table below illustrates the capital structure of a typical corporate or bank issuer and draws the distinction between debt and equity securities as well as hybrid securities which contain features of both. Below we outline the key features of these various securities and their respective positions in the capital structure.

Figure 1: Capital Structure



### Senior Secured Debt

If a company is declared bankrupt or enters liquidation, senior secured debt holders have first claim over specific assets of the Issuer<sup>1</sup>. This is because this class of investor or lender has direct and definable security or legal charge over specific assets of the company e.g. mortgage/lien over real property or other assets.

### Senior Unsecured Debt

As we move down the capital structure the probability of receiving all of the money invested decreases in the event of a company's failure. The expected level of recovery will vary depending on the initial financial strength of the company with senior unsecured creditors having first access to the proceeds in the event of liquidation (behind any secured lenders). Most corporate debt is issued on an unsecured basis.

### Subordinated Debt

This is another notch down in the capital structure and while still debt with a defined maturity date and interest payment obligations, in the event of wind up, the interests of the subordinated-debt holders will rank behind the senior debt holders (both secured and unsecured). Companies often issue subordinated debt (depending on the terms of the security) as it will support the corporate credit rating assigned by ratings agencies. This effectively provides them with what is referred to as "equity credit" (discussed in more detail further on in this document).

### Capital Notes / Preference Shares

Capital Notes and Preference Shares, often referred to as Hybrids, pay distributions which rank ahead of the payment to ordinary shareholders. These securities follow the sequential nature of risk, just as subordinated debt is subordinate to other forms of debt; hybrids are subordinate to all forms of debt, but generally rank ahead of ordinary equity in the event of a wind-up (unless conversion has taken place or the securities have been written-off).

<sup>1</sup> Certain statutory obligations will rank ahead of other creditors.

## Ordinary Equity

Finally, ordinary equity sits at the bottom of the capital structure. If the financial position of the company deteriorates, equity investors rank behind all other investors. This arises from the fact that there is no obligation to repay equity or pay dividends; companies are not breaching security terms or breaking any laws by losing shareholder value or not paying dividends.

Simply put, there are risks associated with moving down the capital structure from senior secured debt to ordinary equity which include:

- A reduction in the security of cashflows;
- No recourse against an issuer should payments not be made or capital is put at risk;
- Liquidity in the instrument may decrease particularly in times of financial stress; and
- Ranking or priority of claim in the event of the issuer being wound up.

## Types of Listed Fixed Interest Securities

While the major details of fixed interest securities have been outlined above including, the features and risks of investing in this asset class, it is important to understand the differences between the various types of securities on issue.

**Figure 2: Security types**

Debt securities  
Convertible notes  
Preference Shares / Capital Notes  
Reset preference shares  
Step-up preference shares  
Income securities

SOURCE: MORGANS

## Debt Securities

In terms of listed Debt Securities there are two major forms, senior debt and subordinated debt. Senior debt, as the name suggests, ranks senior to most other forms of capital, while subordinated debt ranks below senior debt, but ahead of hybrid capital and equity. Subordinated securities are an interest liability of the issuer, and if not paid, generally accrue penalty interest until the outstanding amount has been repaid. However, if interest is not paid on senior debt, the Issuer is in default, and the trustee can call for all funds to become due and payable by the issuer. Senior debt securities have a fixed term resulting in the security maturing for cash (i.e. there is no extension risk or equity conversion). Subordinated debt securities also have a fixed term when the issuer must repay investors the face value of the security; in addition they generally have a call date when the issuer may (at its option and with regulatory approval) repay the principal earlier than the scheduled maturity date.

We have seen subordinated securities issued in the unlisted wholesale bond market as companies look to raise additional capital, as well as extending and diversifying funding sources (there has been limited listed issuances). These securities generally provide regulatory or rating agency relief and consequently are attractive sources of funding for companies. They also pay higher returns than senior debt securities which makes them more attractive to investors.

## Subordinated Debt and Regulatory Capital – Financial Issuers

As part of a bank's funding profile they issue subordinated debt in addition to senior ranking debt. It is referred to as Tier 2 Capital. To qualify as Tier 2 Capital, the security must have a term of at least 10 years at which time it will be redeemed by the Issuer. The security will generally have a call date 5 years prior to maturity at which time the issuer may redeem the security if it has the prior consent of APRA. In the event that the security is not redeemed at the call date, the issue will progressively lose the regulatory benefit being ascribed to it by APRA, meaning it is less cost effective to the Issuer.

In addition to the above, Basel III compliant Tier 2 instruments also contain Non-Viability conditions (see page 5 for details) which may require in certain extreme circumstances and at APRA's direction, conversion of the securities to ordinary shares.

## Subordinated Debt and Equity Credit – Industrial Issuers

Non-bank (corporate) borrowers will often raise subordinated debt to diversify their funding as well as support their senior debt profile and corporate credit rating. Because this debt ranks behind senior obligations, rating agencies will treat a portion of the subordinated debt as if it were equity for the purposes of assigning a credit rating.

Rating agencies consider a range of quantitative and qualitative factors when evaluating an issuer's corporate credit rating. Quantitative factors include the issuer's earnings, profit, equity and debt levels, and the financial ratios calculated from them. Qualitative factors include the issuer's scale, competitive position, funding sources and the industry in which it operates.

The equity credit classification of an instrument provides an indication of the extent to which a rating agency treats an instrument as if it were equity rather than as debt when evaluating the quantitative aspects of an issuer's corporate credit rating. An equity credit classification is not a credit rating of the instrument itself nor is it an accounting treatment of the instrument.

The benefit to the company in issuing this form of instrument is that a portion of it can be treated as equity by the ratings agencies for the purpose of assigning their senior corporate credit rating but does not result in the issuance of ordinary shares which are dilutionary to existing shareholders.

### Specific features:

- Interest payments are cumulative if not paid; and
- Ranks above all forms of hybrid securities and equity.

### Specific risks:

- In the event of default, they rank as an unsecured loan;
- Company must have adequate resources to refinance/redeem at the call date or final maturity date; and
- Interest payments may be deferred in certain circumstances.

Investors can currently access subordinated debt exposure via certain ASX-listed Exchange Traded Funds (ETFs) and managed funds. Please contact your Morgans adviser for further information on which fixed income ETFs and managed funds are available.

## **Capital Notes (Additional Tier 1) – Financial Issuers**

Capital Notes are issued by financial institutions and count as Additional Tier 1 regulatory capital for APRA regulatory purposes; this results in an improved capital position. In order for these securities to count as regulatory capital they are required to be perpetual in nature (i.e. no fixed maturity date) and dividends must be non-cumulative. Notwithstanding, the security is structured with a mandatory conversion date and an early call date or multiple call dates which provide multiple specific exit points for holders (assuming there is not a severe decline in the ordinary share price of the Issuer). Under Basel III, APRA requires that two “bail-in” features are incorporated into Tier 1 securities; Capital Trigger and Non-viability conditions (see below).

### **Mandatory Conversion Date**

In the normal course of events, holders of Tier 1 instruments would look to exit a security via Mandatory Conversion if the security has not been called earlier (which is generally the case). On the Mandatory Conversion Date the following can occur:

- If the Issuer's Ordinary Share price is above the required levels, the securities will automatically convert into Ordinary Shares (generally at a discount); or
- If the Issuer's Ordinary Share price is below the required levels and the Issuer has the prior approval of APRA, the securities can be redeemed for their Face Value (at the Issuer's discretion).
- However, in the event that the conversion tests are not met and the security is not redeemed on the Mandatory Conversion Date, the term of the security will extend to the next Dividend Payment Date. On this date the underlying Share Price Conversion Tests will be conducted again, and if passed the Security will Convert. If not passed, the Security will

continue in this manner until those Conversion Tests are satisfied.

### **Basel III bail-in features**

Post January 2013, all new Additional Tier 1 capital instruments must be structured such that in certain circumstances they can either be written off or mandatorily converted into ordinary shares, this is referred to as “bail-in”. These securities must also have a minimum term of five years and have discretionary, non-cumulative distributions. Furthermore, they are only callable at the option of the Issuer (subject to prior regulatory approval).

### **What is a Capital Trigger Event?**

A Capital Trigger Event will occur when a bank's Core Tier 1 Ratio as reported in its most recent relevant disclosure is equal to or less than 5.125% on a Level 2 basis. If this occurs, the issuer must convert some or all of the securities into ordinary shares. Such conversion is not subject to the Conversion Tests (noted above) being satisfied. Following a Capital Trigger event the number of ordinary shares that holders will receive for each security will be limited to the maximum conversion number. If this were to occur an investor will very likely suffer a capital loss; generally though this would require a greater than 80% fall in the ordinary share price from the point at which the securities were issued.

See Appendix B for an example of Basel III CET1 Capital and Capital Conservation Buffers that act to protect against a Capital Trigger Event.

### **Non-Viability Conversion**

Under this scenario, the securities will convert at any time APRA has determined that without Conversion or a public sector injection of capital (or equivalent capital support) the issuer would become, in APRA's opinion, non-viable. Any such conversion would not be subject to the mandatory Conversion Tests (noted above) being satisfied and the number of Ordinary Shares a CPS/Note Holder will receive is capped at the maximum conversion number. If this were to occur an investor will very likely suffer a capital loss; generally this would require a greater than 80% fall in the ordinary share price from the point at which the securities were issued.

While the outcome of the exercise of Conversion under a Capital Trigger or Non-Viability Event is extreme (i.e. holders could lose capital), it is important to consider these issues in the context of the likelihood of such a circumstance eventuating and the operating environment in which such a circumstance could eventuate or is likely to exist. Consideration should be given to matters such as reputation, financial market stability and the systemic impact of such an event, were it allowed to develop. Importantly, one might also look to the Regulators' duties to oversee and promote a stable banking sector and the impact of allowing such a circumstance to develop. One would expect that the Board of the Issuer and the Regulators will have considered all possible actions (and have taken them) so as to prevent Conversion under such circumstances. Consideration should also be given to the impact on the value of the Issuer's ordinary shares, access to capital markets and historical precedents in

terms of Australian banks' willingness and ability to support their capital positions by other means in the context of evidenced conservative capital management.

### Write Off

Holders should be aware that in extreme circumstances, if the Issuer is prevented from Converting the Notes within five Business Days after the Trigger Event Conversion Date, the Capital Notes will be Written Off. If the Notes are Written Off, all rights (including to Distributions) in respect of those Notes Written-off will be terminated. The security will lose all of its value and capital will not be repaid.

While the outcome of such a circumstance is extreme, again it is important to consider the issue in the context of the likelihood of such a circumstance eventuating and the operating environment in which such a circumstance could eventuate or is likely to exist. Considerations such as reputation, financial market stability and the systemic impact of such an event were it allowed to develop and particularly the context of the regulators' obligation and desire to oversee and promote a stable banking sector.

### Specific features:

- Typically pay quarterly floating rate distributions set at a margin above the Bank Bill Swap rate;
- Franking often features as an integral part of the investor's return;
- Securities are perpetual in nature, however generally have a 5-8 year call profile (assuming the security is called); and
- Convertible into ordinary shares at a discount, if not previously called.

### Specific risks:

- Payment of distributions is subject to specific tests and is discretionary;
- If Conversion tests are not met, the Issuer may be unable to Redeem on the Mandatory Conversion Date;
- If either a Capital Trigger or Non-viability Event occurs, holders may suffer a capital loss; and
- If the Notes are Written-off, they will be worthless.

There are numerous Capital Notes available on ASX by each major bank and several regional bank issuers. To find out more please contact your Morgans adviser.

## Convertible Notes

Convertible Notes convert to ordinary shares at a set strike price at the investor's option. These securities generally pay a fixed rate of interest until conversion or maturity. If Convertible Notes are not converted, the holder will generally receive the face value back at maturity. Convertible Notes are considered debt within a company's capital structure and interest is tax deductible to the company. Usually, interest payments are

subject to the issuer having sufficient free cashflow after meeting senior debt obligations. There are numerous types of Convertible Notes with the distinguishing feature being the process upon conversion. For some Notes it is mandatory that they convert into a set number of shares, for others they may either convert the Note or redeem them at maturity. The Notes can often be converted on a number of dates, prior to or at maturity.

### Specific features:

- An opportunity to participate in the future growth of a company via conversion into ordinary shares while earning a known interest rate prior to conversion; and
- Convertible Note holders normally participate in ordinary share rights issues and are entitled to bonus issues for the purpose of conversion.

### Specific risks:

- In the event of default, they rank as an unsecured loan;
- Interest payments are subject to the issuer having sufficient free cashflow; and
- The Issuer must have adequate resources to repay the noteholder at maturity if this option is chosen by investors.

The following classes of securities are older forms of hybrids, however some still remain on issue and trade on ASX.

## Reset Preference Shares

Reset Preference Shares (RPS) provide the investor with the ability to request redemption or conversion on the reset date. On this date, the issuer must decide whether it will re-market with amended terms, redeem it, or convert it into ordinary shares. Even if the issuer decides to re-market the security with amended terms, if a holder requests redemption or conversion they will be provided with an exit from the investment by the issuer.

### At the Reset Date the Issuer can:

- Reset the Terms of Issue - Distribution rate, timing of payments, the next Reset Date etc;
- Repay the investor the Face Value of the security; or
- Convert (often at a discount) the security into the underlying Ordinary Shares of the Issuer.

### Specific features:

- Franking often features as an integral part of the investor's return; and
- Investors may participate in the growth of the underlying ordinary share, if converted to shares.



#### Specific risks:

- Returns to the investor upon conversion or preceding conversion may be affected by movements in the underlying ordinary share price; and
- Dividends are discretionary.

There are some convertible notes and preference shares available on ASX. To find out more please contact your Morgans adviser.

### **Income Securities**

Income Securities have floating rates and no maturity date, meaning that they are perpetual in nature and do not return the face value back to investors at any time. Each income security is different in terms of specific features however they rank in priority to ordinary shares for the payment of interest but behind all other debt obligations in the event of the issuer being wound up.

#### Specific features:

- Unfranked cash distributions

#### Specific risks:

- As these securities are Perpetual, the only exit mechanism is via selling on ASX, unless the Issuer redeems the security (at its option)

### **Step-up Preference Shares**

Step-up Preference Shares were generally issued by corporate borrowers to take advantage of relatively tight credit spreads pre-GFC. The Terms provided the Issuer with the option of increasing the Distribution Rate, rather than Remarketing or Redeeming the Security. The Terms of these Securities are generally weighted heavily in the Issuer's favour.

#### At the Step-up Date the following can occur:

- The Issuer Redeems the Security for the Face Value;
- The Issuer Converts the Security into Ordinary Shares (generally at a discount); or
- The Issuer increases the Distribution Rate on the Security by the Step-up amount. Following this occurrence, the Security becomes Perpetual and can only be Redeemed by the Issuer (at its option).

#### Specific features:

- A higher Distribution Rate if the Issuer Steps-up the distribution margin; and
- Attractive rates compared to the bank issuers given these securities are generally issued by corporates.

#### Specific risks:

- The Issuer decides to Step-up the margin, making the Security Perpetual;
- No ability for Investors to request Redemption at the Step-up Date; and
- Dividends are discretionary.

### **Mutual Capital Instruments (MCIs)**

MCIs were developed to provide member owned organisations, otherwise known as Mutuals and Cooperatives, with a means to raise permanent capital without giving up their status as a mutual entity. Like ordinary shares, MCIs are perpetual securities but unlike ordinary shares they have a defined dividend profile.

The development of MCIs reflects the recognition by the Australian Government that mutual entities make significant contributions across almost every area of the Australian economy and address the difficulties that mutual entities face in raising new capital to invest, innovate, grow and compete.

This innovation has also created an opportunity for investors seeking higher levels of income by incorporating MCIs into a diversified income portfolio. Australian Unity MCIs are currently the only MCIs listed on ASX (ASX.AYUPA) and provide investors with semi-annual fully franked dividends.

### **Listed Investment Trusts (LITs)**

A LIT is a type of investment that is incorporated as a trust and listed on ASX. LITs provide retail investors with access to a broad range of assets within the one investment structure, similar to unlisted managed funds. When an investor purchases a unit in a LIT, this provides them with access to a range of domestic or global investments across diversified sectors and asset classes such as corporate bonds, private debt, asset backed securities (ABS) and residential mortgage-backed securities (RMBS).

LITs provide an alternative investment vehicle that retail investors can utilise to diversify their portfolio and receive a regular income from their investment.

Each LIT has an experienced manager with a specialist team that actively manages the assets held within the Trust structure.

The main characteristics of a LIT are as follows:

- Closed End Fund
- ASX Liquidity
- Basket of Assets
- Regular Monthly and Direct Income
- Experience of a Specialist Manager

The following is a list of current LITs listed on ASX and their sector exposures:

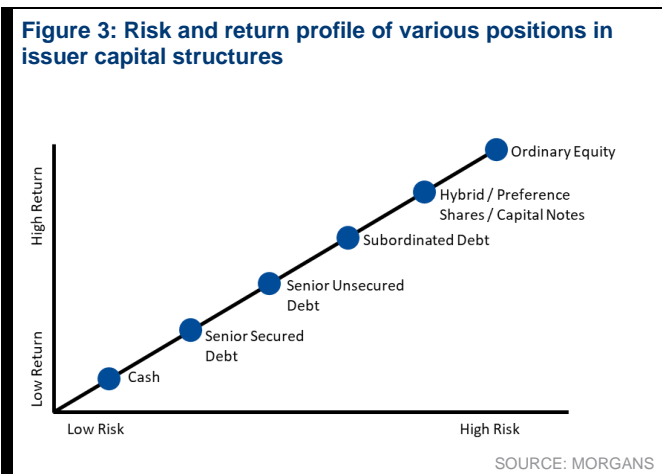
- GCI – RMBS and ABS
- MXT – Domestic Corporate Loans
- PCI – Diversified mix of RMBS, ABS, Domestic and Global Corporate Bonds and Private Debt
- NBI – Global Corporate Bonds
- KKC – Global Corporate Bonds and Private Debt

For more detail, please review Morgans' Understanding Listed Investment Trusts publication.

## Risk vs Return

Returns are generally related to risk i.e. the position of an investment within the capital structure of an Issuer (refer to the Chart below). The lowest returns will be provided for the most secure investments (Senior secured debt), but as investors move down the capital structure they should expect to be paid a higher return for assuming an increased level of risk. This should result in investors in hybrid/preference shares receiving higher distributions/margins than investors in senior debt.

Importantly, all the securities described that rank ahead of Ordinary Equity provide investors with income as opposed to capital growth. Naturally, the highest potential returns can be generated by equity investments as these investments benefit directly from the growth in earnings of the Issuer and consequently carry a higher level of risk.



## Risks and factors impacting fixed interest securities

There are numerous risks and factors that will affect the price of fixed interest securities, however they can be summarised as follows:

### Direction of interest rates

- **Fixed Rate** - In an environment where interest rates are rising, and given the inverse relationship between price and yield, the price of a security will fall if the yield moves up in line with general interest rate movements. Therefore fixed rate securities are more attractive in a falling interest rate environment as the price will rise as yields fall.
- **Floating Rate** - Floating rate investments are more attractive in an environment where interest rates are rising. Distributions are generally referenced to the 90 Day Bank Bill Swap Rate (90d BBSW) or the 180d BBSW. These securities have the distribution rate adjusted quarterly or semi-annually and consequently returns will be impacted by the direction of interest rate movements. Floating rate investments also provide an effective hedge against inflation, as interest rates can be expected to rise if inflation rises.

## Underlying Ordinary Share price

As hybrid securities may convert into the underlying equity, the price of the hybrid may, in certain circumstances, be influenced by the underlying share price. The conversion value will be impacted where there is a minimum / maximum conversion price in the security terms.

## Competing product pricing

New issues at higher interest margins may see prices adjust down on existing securities to reflect changed market conditions and higher returns on new issues.

## Credit quality / Default risk

The credit worthiness of an issuer and risk associated with a particular security will be factors in the pricing of a company's debt capital. Borrowers need to consider their ability to repay principal or pay interest/dividends/distributions when due;

Comparisons can be made based on industry, peers, and the ability to cope with changed economic or financial circumstances;

The credit rating of a company is an assessment of its ability to meet its financial obligations. It is a relative ranking of the credit worthiness of a company. The higher the credit quality of the issuer, the lower the perceived risk, and therefore the lower the issuer's funding costs;

The credit rating defines how likely it is that principal and interest will be paid as and when due; and

Changes in credit ratings can occur through the life of a security:

- Company or security ratings will change if the financial strength of the company changes either positively or negatively - as the financial strength of the company improves its rating will improve and vice versa.
- A change in credit quality will usually have an impact on the security's price - as the financial strength of the company improves, its risk of default decreases therefore the spread at which it borrows relative to the swap curve will decrease. A decrease in the security's yield or credit spread will lead to an increase in its price. The opposite applies as financial strength weakens.
- Since late 2010, no new listed securities have been assigned a public credit rating due to Standard & Poor's, Moody's and Fitch no longer providing credit ratings on retail investment products in Australia. This is due to ASIC's requirement that ratings agencies hold an Australian Financial Services License (AFSL). At the time of printing Australia Ratings is the only ratings agency to rate any publicly issued retail security.
- Investors should monitor an Issuer's credit metrics so as to track its financial performance. This can be done by reviewing publicly released information.



## Appendices

### Appendix A: Characteristics of Fixed Interest Securities Matrix

Common Features	Deposit	Government Bond	Senior Secured Debt	Senior Unsecured Debt	Subordinated Debt (Bank)	Subordinated Debt (Corporate)	Capital Notes/Preference Shares (Hybrids)
Government Guarantee <sup>1</sup>	Yes	Yes	No	No	No	No	No
Corporate Guarantee	N/A	No	Yes	Yes	Yes <sup>2</sup>	Yes <sup>3</sup>	No
Ranking	Deposits rank ahead of all unsecured financial obligations	N/A	Senior debt ranks ahead of other forms of capital.	Senior unsecured creditors have first access to the proceeds in the event of liquidation (behind any secured lenders).	Subordinated debt ranks below senior debt, but ahead of hybrid capital and equity.		Hybrids are subordinated to all forms of debt, but generally rank ahead of ordinary equity in the event of a wind-up.
Interest/Distribution Deferrable	No	No	No <sup>4</sup>	No <sup>4</sup>	No	In certain circumstances	Yes
Fixed Maturity Date	Yes	Yes	Yes	Yes	Yes	Yes	No, perpetual in nature
Call Date <sup>5</sup>	No	No	No	No	Yes	Yes	Yes
Conversion to Shares (Holder Election)	No	No	No	No	Yes, potentially	No	No
Conversion to Shares (Issuer Election)	No	No	No	No	Yes	No	Yes
Potential Write-off by Regulator	No	No	No	No	Yes	No	Yes
Common Equity Trigger	No	No	No	No	No	No	Yes
Non-Viability Trigger	No	No	No	No	Yes	No	Yes
Fixed/Floating Rate	Predominately Fixed	Fixed	Fixed/Floating	Fixed/Floating	Fixed/Floating	Fixed/Floating	Fixed/Floating

1. Government Guarantee for bank deposits is up to \$250k per client, per institution; this is effected via the Financial Claims Scheme.

2. To the extent that the Issuer is solvent it must repay funds at maturity.

3. Generally yes, subject to the terms of subordination.

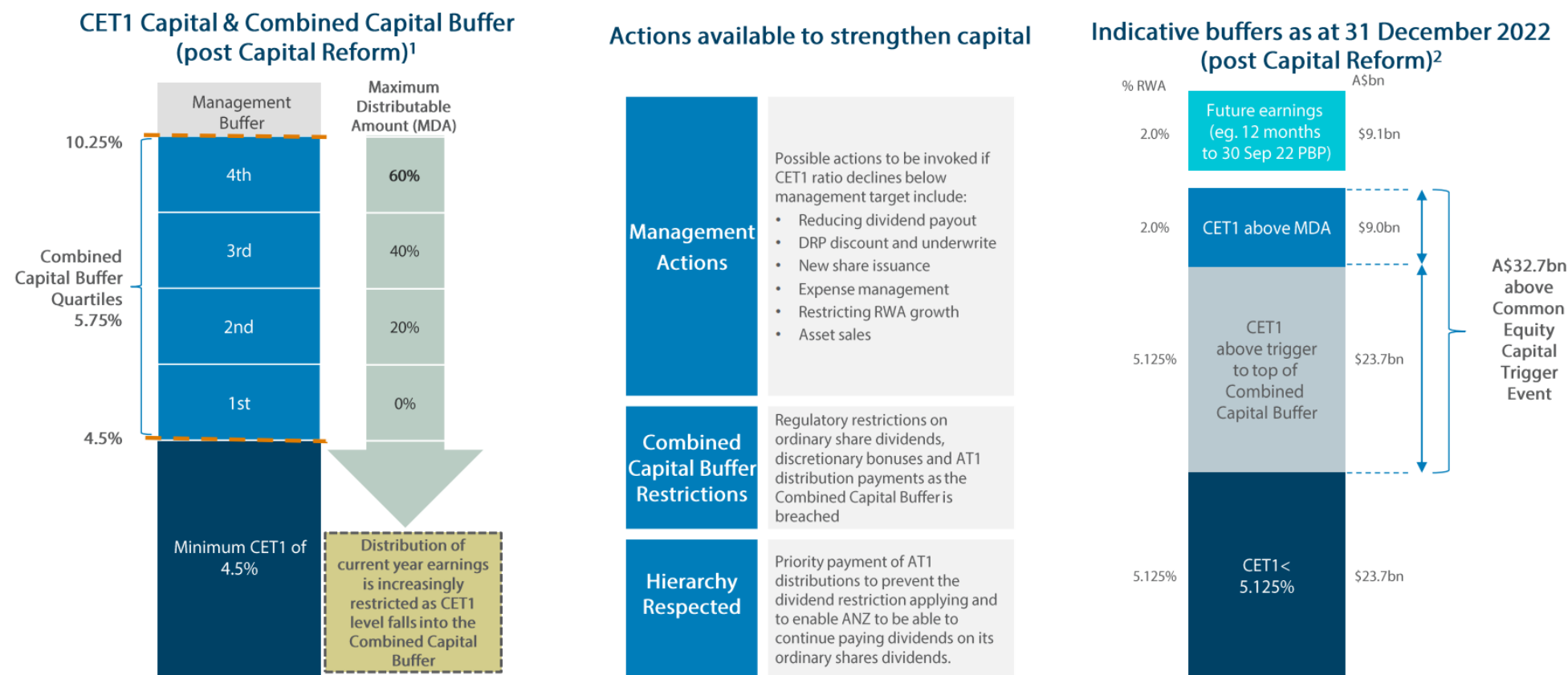
4. If interest is not paid on senior debt, the Issuer is in default, and the trustee can call for all funds to become due and payable by the issuer.

5. The issuer may repay the principal earlier than the scheduled maturity date.

## Appendix B: AT1 Distributions and Conversion Trigger Protection

This is an example of Basel III CET1 Capital and Capital Conservation Buffers that act to protect against a Capital Trigger Event. The example is sourced from ANZ's Capital Notes 8 Investor Presentation. The Common Equity Capital Ratio is the ratio of Common Equity Tier 1 Capital (including Ordinary Shares, retained earnings and certain reserves but net of Common Equity Tier 1 Capital Deductions) to the risk weighted assets of the Issuer, as prescribed by APRA.

There is a risk that the Issuer's Common Equity Capital Ratio falls to 5.125% or below and that as a result, Notes convert into Ordinary Shares before the Scheduled Mandatory Conversion Date. As outlined below, issuers have a number of options available to strengthen their capital position in order to prevent a Common Equity Capital Trigger Event from occurring.



1. On 1 January 2023, the Minimum Capital Ratio increased to approximately 10.25% (mainly reflecting the increased regulatory capital buffers), although the final outcome is uncertain and subject to finalisation of the APRA capital reform requirements. This includes a default 1% counter-cyclical capital buffer which may increase or decrease in the future. APRA has indicated that the capital reforms will likely result in a decrease in RWA. APRA may set higher minimum capital requirements for individual ADIs.

2. Future earnings are not forecast. Profit before provisions for the 12 months to 30 September 2022 was \$9.1bn (excluding Large / Notable items). All figures shown are on a Level 2 basis per APRA prudential standards.

## Key terms and their meanings

There are a number of terms used in the fixed interest market which may be unfamiliar to some investors. These are explained below:

Accrued Distribution: The income accrued to date in the current dividend or distribution period.

ADI: Authorised Deposit-taking Institution

APRA: The Australian Prudential Regulation Authority (APRA) is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, private health insurance, friendly societies, and most of the superannuation industry.

ASIC: Australian Securities & Investments Commission (ASIC) is Australia's corporate, markets and financial services regulator.

AT1: Additional Tier 1 Capital (bank issued Hybrids).

Bank Bill Swap rate (BBSW): This is a benchmark yield that is determined on a daily basis by a panel of banks across a range of terms and provides a benchmark from which a range of financial instruments and transactions are priced.

Basel III: Is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk of the banking sector. APRA, as a member of the Basel Committee, played an active role in formulating the Basel III measures.

Cash running yield: Is calculated as the cash distribution payable to holders (based on the security's issue margin plus the one year swap rate) divided by the last traded price of the security. We use the one year swap rate to give an indication of the expected return over the next 12 months.

CET1: Common Equity Tier 1 is a component of Tier 1 capital that consists primarily of ordinary shares and retained earnings held by a bank or other financial institution. It is a capital measure that was introduced in 2014 as a precautionary measure to protect against a financial crisis.

Current price: Most recent security price as at the date of this publication.

Gross running yield: Is calculated as the cash distribution payable to holders (based on the security's issue margin plus the one year swap rate) plus franking credits (if applicable) divided by the last traded price of the security.

Price target: May be set at a discount or premium to the Morgans assessed fair value depending on a variety of factors.

Trading margin: The YTM/YTC minus the relevant swap rate and shows the return premium required by investors to purchase the security rather than investing in bank bills. The relevant swap rate is determined by looking at the maturity/conversion date of the security and matching that to a comparable level along the interest rate swap curve. i.e. if a security has a YTM/YTC of 7.00% and four years to maturity, this would be benchmarked to the four year swap rate (e.g. 4.00%); subtracting this from the YTM/YTC gives a trading margin of 3.00%.

Yield to Maturity/Call (YTM/YTC): Investor's expected return having paid the published current price and assuming all distribution payments are made through to conversion. In addition, the calculation assumes investors realise the face value of the security and fully utilise any franking benefits. Income forecast for the calculation of the YTM/YTC is calculated using the interest rate swap curve.

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Springfield-Ipswich	+61 7 3202	Newcastle	+61 2 4926	Stockbroking, Corporate Advice, Wealth Management	
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