Elstree

DDO: Bank Treasurers' expensive nightmare?

A recap of DDO

DDO stands for Design and Distribution Obligations, and it means that PDS financial products can only be sold by initial public offering or IPO to appropriate consumers. For bank hybrid IPO's, this means wholesale investors or retail investors who receive the appropriate level of financial advice. We assume there will be material negative consequences for issuers who breach the rules by issuing to inappropriate investors.

So how does this affect Banks and Hybrids?

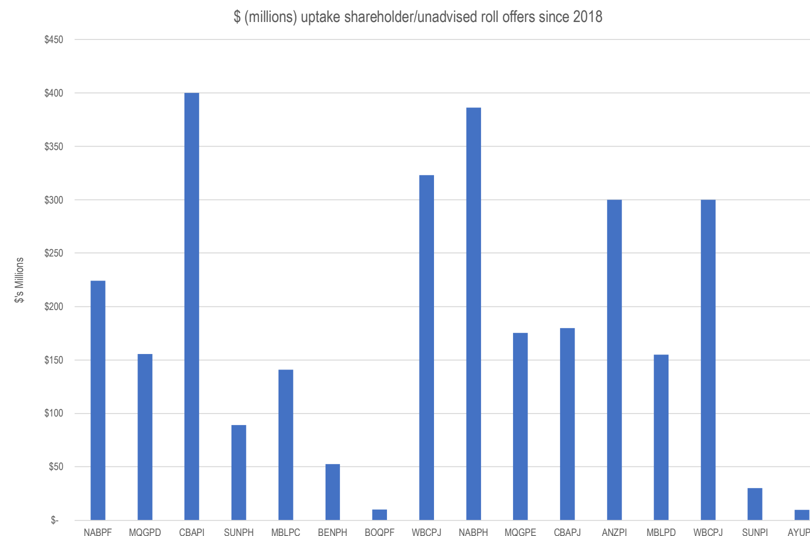
From ASIC's perspective, investors in hybrid IPOs have traditionally fallen into 5 categories. The 5 categories are;

1. Wholesale investors.
2. Investors who receive a high level of financial advice.
3. Investors who receive a lower level of financial advice.
4. Investors who receive no financial advice/are unadvised.
5. Investors who apply after receiving a shareholder offer.

The last 3 categories will most likely be deemed inappropriate under DDO guidelines.

Offers to Shareholder/Hybrid Security/Unadvised Investors who elect to roll.

The typical bank hybrid issuance process is usually a bookbuild conducted by brokers. The investor cohort includes potential new investors and existing hybrid security holders that use an adviser and wish to roll their investment. Then there is a post bookbuild process which includes shareholders and unadvised security holders who did not participate in the bookbuild. This cohort is not immaterial. The chart below shows the level of uptake in Shareholder/Unadvised security holder offers since 2018.



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For the average major bank issue, the Shareholder/Unadvised roll cohort constituted just over $300m or typically 18% of the total issue size. Bank Treasurers loved this method of raising money because they don't have to pay stamping fees.

It looks like this category of offer type is dead. There is no way that the issuer can determine if the hybrid is appropriate for the investor. ANZ recently announced a new issue. We understand there will be no unadvised existing security holder offer.

Advised Investors with inappropriate levels of financial advice.

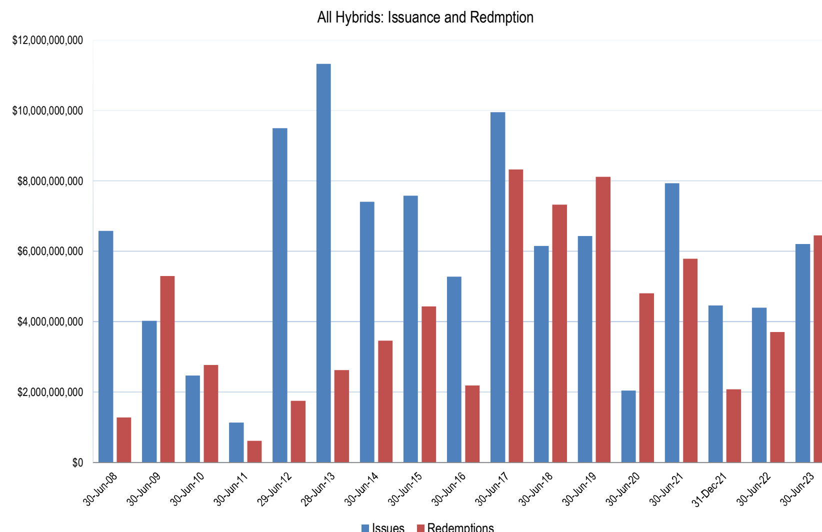
This category is trickier to analyse. Different advisers and issuers will have different thresholds as to what is required to provide a recommendation. We understand that up to 30% of demand for hybrid issues for some advisers originate from investors who will be deemed to be not appropriate (because they were not receiving the necessary level of financial advice). We estimate that the "roll" portion of bookbuilds is around 30% - 50% of the new issue and unless these investors are receiving personal advice, they won't be able to take part in the new issue.

20% shortfall + up to 30% shortfall. Maybe 50% of investors are cut out of IPOs ?

No one actually knows: this is new ground for everybody. But there will certainly be a smaller pool of investors who can buy new issues.

What's the demand/supply outlook like?

The chart below shows issuance and maturities for the market in aggregate (which we calculate by considering the banks current and targeted AT1/Hybrid ratios and issuance/redemptions). We've also assumed in our 2022 and 2023 forecasts growth in risk weighted assets or RWA which will result increased AT1 issuance (last year RWA grew by $100b resulting in a pro forma $2b of additional AT1 issuance).



Prima facie its not a big year of net demand for either the remainder of this year or next year, but it's still a chunky gross amount to issue given, that up to 50% of the market may have disappeared.

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Why this mightn't be as bad as the back of the envelope numbers suggest?

As we mentioned before, this is all new, but there are some potential mitigating factors. Those factors are;

- Maybe some of the investors who do not receive personal advice or are an investor in the shareholder/non advised roll categories are classified as wholesale investors (it's relatively easy nowadays to be a wholesale investor) in which case they can carry on as normal.
- Typically, all issues are heavily oversubscribed. That might be enough to fill any shortfalls. We're sceptical about that and think that most of the oversubscription is an attempt to gain higher allocations.
- All Investors (including those locked out of the IPO process) can buy the same hybrid in the secondary market on the first day of trading. This may encourage "wholesalers" who buy at IPO (if the yield is sufficiently good enough) and sell on the secondary market for a profit on day 1.

So, what happens now?

Our first thoughts are that banks are going to have to issue at a higher margin than they would have prior to DDO, either to ensure sufficient demand from qualified investors or to encourage "wholesalers."

It's going to be an interesting month or so. ANZ and CBA both have c$1.6b issues to refinance in March and both don't have a lot of slack in terms of their capital positions. Neither bank is in a position to abandon the issues should there be insufficient demand.

What does this mean for our Funds?

Probably good. We think hybrids at IPO will be cheaper. Overall, spread margin levels and return outcomes will be determined by long run supply and demand, but there may be spikes when there is issuance (*banks also might start being civil to fund managers and answer questions when they hold investor briefings).*

What does this mean for investors?

For some, nothing at all. They can still bid in IPOs and elect to roll existing issues. For others it's a big deal. They won't be able to roll existing investments or buy new issues. There are alternatives. They can buy on the secondary market or (*sales plug following*) invest in a managed fund which provides them with a diversified and managed exposure to hybrids. Or they can wait for the redemption amount and invest in cash or other investments.

What does this mean for Advisers?

They will have the same issues as their investors. Back in the bad old days, a sure fire way of increasing demand used to be to increase fees/brokerage/whatever it is called. We're not sure if that turkey will fly these days.

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