

## November 2020 Review – Listed Hybrid Sector

### *Fund and market performance*

The Elstree Enhanced Income Fund's total investment return for the month of November 2020 was 0.03%. This compares with the Elstree Hybrid Index return of 0.14%. In other markets the All Ordinaries Accumulation Index returned 10.16% while the All Maturities Bond Index returned (0.11%).

### *Loan deferrals. Is there much to worry about?*

There has been much commentary lately about loan deferrals and what the end of the moratorium in 2021 might mean for bank capital positions. While extending the moratorium was a sensible and logical thing to do what happens when it ends is creating some uncertainty. Clearly, there will be an increase in home and business loan default activity, we know that with absolute certainty. But will the impact on bank balance sheets be all that bad? We think the effect will be minimal due to a number of mitigating factors including, the extremely strong capital position of the banks, the low loss given default (LGD) associated with residential property and a more buoyant outlook for property values underpinned by record low interest rates.

### *Australian bank capital levels among the highest in the world*

Clearly, bank capital levels are sacrosanct. Under the guidance of APRA, the Australian banks are now among some of the most highly capitalised banks in the world. Common equity or CET1 levels of the major Australian banks as at 30 June 2020 presented at c11.4% of risk weighted assets (RWA). This is well above the minimum of 10.5% prescribed by APRA. The addition of 'loss absorbing' tier 1 and tier 2 instruments takes the average across the majors to more than 16.5% of RWA with CBA presenting with the highest ratio at 17.5% (refer chart below sourced from KPMG of the big 4 banks). We know the banks are well capitalised. In response to the pandemic APRA encouraged the banks to opportunistically raise capital and where possible preserve it (i.e by reducing their dividend payout ratios). While the banks are actively doing these things, they are not writing lots of new capital intensive risk weighted loans as evidenced by slowing rates of credit growth.

	ANZ		CBA		NAB		WBC	
	FY20	FY19	FY20	FY19	FY20	FY19	FY20	FY19
<b>Common Equity Tier 1 (%)</b>	11.3	11.4	11.6	10.7	11.5	10.4	11.1	10.7
Tier 1 Capital (%)	13.2	13.2	13.9	12.7	13.2	12.4	13.2	12.8
Tier 2 Capital (%)	3.2	2.1	3.6	2.8	3.4	2.3	3.2	2.8
<b>Total Regulatory Capital ratio (%)</b>	<b>16.4</b>	<b>15.3</b>	<b>17.5</b>	<b>15.5</b>	<b>16.6</b>	<b>14.7</b>	<b>16.4</b>	<b>15.6</b>

### *Loan deferrals are declining rapidly.*

While loan deferrals are large, both in number and volume, they are declining and declining at a rapid rate. According to APRA data as at 31 October ADI loans subject to repayment deferral total approximately \$88 billion being 3.3% of total loans outstanding. This compares with 10% at the deferral peak in May and June. While housing loans make up the majority of total loans granted repayment deferrals, SME loans have a higher incidence of repayment deferral with 4.5% of SME

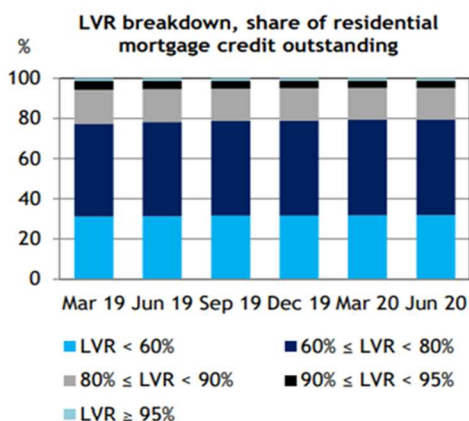
loans subject to repayment deferral. This compares with 3.9% of housing loans. The data, sourced from APRA, is presented in the chart below.

**Share of total loans**



*There will be defaults but because the LGD associated with residential property is low, loss rates will be low.*

While there will be defaults the losses incurred by the banks will not be all that large. This is because a large percentage of the loans are secured against property assets and what the banks' recover, should there be a default event, after incurring costs associated with selling the asset, will typically be sufficient to cover most, if not all of the loan. This also means, by definition (because 'loss given default' or LGD is integral in determining loss rates), that loss rates will also be low. Where it may become problematic is when loan to valuation ratios or LVR's are sufficiently high that the banks do not recover all of the loan and losses are incurred. While this is intuitively obvious the potential loss rates likely incurred by Australia's banks by residential property defaults is very low due to the low level (broadly) of LVR's across their residential lending book. The chart below, sourced from APRA details aggregated Australia's Approved Deposit taking Institution (ADI) property loan LVR data over the 15month period ending 30 June. The takeaway from the chart is that just under 80% of all residential property loans outstanding have an LVR of less than 80% while 30% of loans have an LVR of less than 60%. We note that loans with an LVR's of 90% or greater than 90%, which is where the greatest risk lies, constitute less than 5% of all ADI loans.

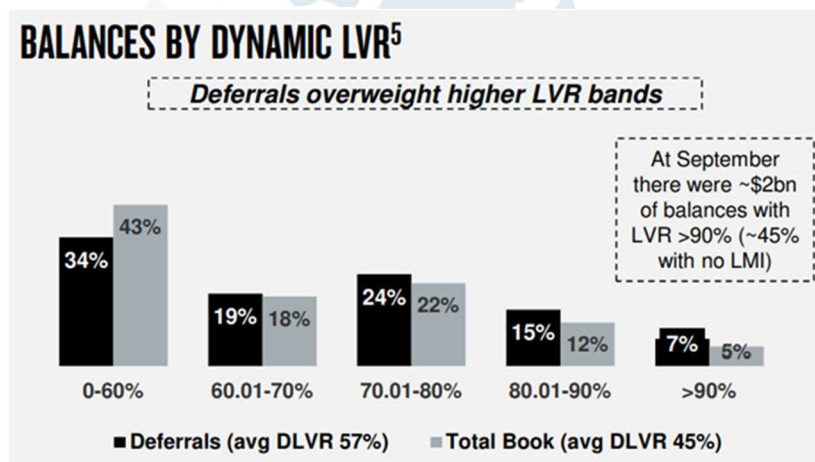


*The losses given*

While we understand the concern around loan deferrals, should property prices remain steady or decline only minimally the impact of default on the bank is almost immaterial. If there is a risk it lies in the most recently written loans where LVR's are likely highest. By way of example, we reference

*default are very modest.*

the NAB's investor presentation of 5 November of its full year results. The chart below details the dynamic LVR across the NAB's lending book @45% and the dynamic LVR of the pool of loans in deferral @57%. If we just focus on the cohort of loans where the bank is most at risk, being those loans with an LVR of 90% or >90% with a value of approximately \$2billion we can easily demonstrate that the loss incurred by the bank is minimal. We make the not unrealistic assumption that the average LVR of those loans in the cohort is (say) 95% (i.e between 90% and 100%). The NAB states that 45% of these loans have no mortgage insurance. Let's assume that all of the loans in this bucket default (say) because government assistance monies run out such as job keeper and the bank loan moratorium ceases (while this is a realistic scenario it is unrealistic to assume that all the loans in this cohort of loans will default, because they won't, but for the sake of the argument we will assume that they do). In this situation the NAB sells the properties in default with a value of \$2billion at 90% LVR, 45% of which are not covered by mortgage insurance. The actual \$ loss to the bank is calculated as follows: 5% (being the loss calculated as the difference between the average LVR of 95% less the LVR of 90% being the LVR at which property sales are realised) X \$2billion (being the \$ amount the loss is incurred on) X 45% (being those properties not covered by mortgage insurance). The actual dollar loss to the bank is \$45 million which pales compared with the NAB's net profit after tax in FY 2020 of \$2,608 million.



*While a lot depends on property values the worst, for all intense and purpose, looks to be behind us.*

Clearly should property prices decline sharply in value then the loss rate accelerates. A 15% decline in value for example would expose the NAB to a much larger loss of c\$135million on that cohort of loans (i.e the >90% cohort) alone. It would also expose the bank to losses in the 80% - 90% LVR bucket. Property values across Australia however have not declined to levels initially forecast at the pandemic's beginning. Now in fact property prices appear to be rising according to monthly data sourced from Corelogic. Corelogic's Home Value Index data released on 1 December 2020 showed that prices increased 0.8% Nationally over November. Indeed, the CEO's of the big 4 banks confirmed this trend when they declared as a collective at the AFR Banking and Wealth Management Summit in November, that a recovery in property prices was imminent. The common thread among the CEO's was that the driver of higher values was simply record low borrowing rates and changed confidence levels. We are sanguine about what loan deferrals and an increase in default activity might do to bank capital levels particularly in view of a likely recovery in property values. As an investor in bank capital preferred instruments we are extremely comfortable with this outlook.

## Fund characteristics as at (close of business) 30 November 2020

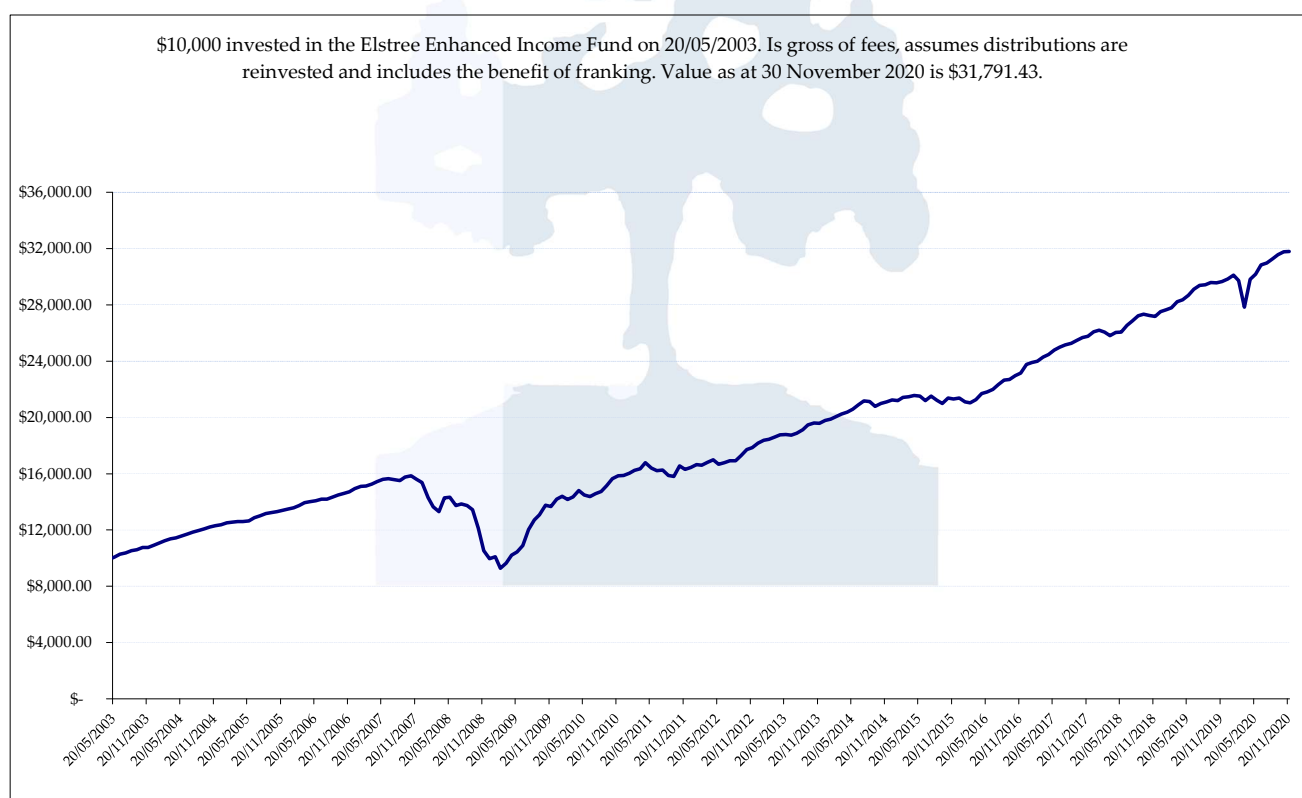
Yield to Maturity	4.00%
Cash yield to maturity	2.30%
Interest rate duration (years)	0.08
Credit term duration (years)	3.74
Investment grade issuer (% holding)	91.0%
Bank tier 1 exposure (% holding)	49.2%
Value at Risk (VaR)	3.40%

Performance Table	1 month	3 months	12 months	2 years p.a.	5 Years p.a.
Elstree Enhanced Income Fund *	0.03%	1.70%	7.21%	8.12%	8.33%
UBS Australia Bank Bill Index	0.01%	0.03%	0.44%	1.01%	1.56%
Betashares Hybrid Fund (HBRD)#	Refer Betashares	1.07% (est)	3.09% (est)	5.21% (est)	n/a

\*Returns are gross of fees and include the benefit of franking credits. Past performance is not necessarily a guide to future performance. "()" denotes negative return outcome.

# Source: Betashares. Return is net of fees and includes the value of franking credits. "est" – estimated.

## Value of \$10,000 Invested on 20/05/2003



### Disclaimer

The information and opinions contained in this report have been obtained from sources of Elstree Investment Management Limited (ABN 20 079 036 810) believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate or complete and it should not be relied upon as such. Information and opinions contained in the report are published for the assistance of recipients, but are not relied upon as authoritative and may be subject to change without notice. Except to the extent that liability cannot be excluded, Elstree Investment Management Limited does not accept liability for any direct or consequential loss arising from any use of material contained in this report.