Aussie Hybrids

More adventures for the red headed stepchild of bank capital

- **It's tough being a regulator: you can have a high degree of safety or a commercially effective banking system, but these goals conflict.**
- **Whatever changes occur, we don't expect any losses for hybrid owners.**
- **It's difficult to find evidence for some of the arguments that APRA uses in its proposal.**
- **We don't expect any major change. The equity levels at which AT1 is converted to bank equity will probably be increased but the wholesale changes to tax and securities legislation which APRA need to encourage institutions won't be achievable by mid 2024.**

Safety v viability

Banking regulators have a real dilemma; there is a choice between safety versus effectiveness. As the ancient Romans said: *reductio ad absurdum* (an extreme example will illustrate the issue). APRA could make the system completely safe for depositors, 25% equity levels and dividends are only payable when profits reach a certain level. However, if they did that, they wouldn't have a banking sector to regulate as the cost of banking products would be prohibitive and/or no investor would give banks capital because there would be no prospect of decent returns. Banking type activities would migrate to the non-bank sector with all the potential issues that come from non-regulated finance sectors blowing up. If they went to the other extreme and let banks operate with very little capital and limited regulation, you get lots of profitable banks and regular banking crisis (see GFC experience). So, a banking regulator must try and walk that tightrope They tend to safety because there is enough evidence that a systemic banking crisis results in GDP falls of 25%. But a risk-free banking system has the same economic result: bad stuff just happens in a different way. This is where we think APRA is with their call for comment in September regarding AT1. It is a largely subjective trade off, so we think it's worth discussing.

No loss for existing hybrid holders

APRA's call for comment has finished on November 15, and they will release the results in early/mid 2024. Whatever their decision, there should be no loss for existing hybrids. The table below shows a summary of potential APRA decisions and our view of what it might mean for existing hybrids.

APRA decides they hate retail ownership of hybrids and makes banks redeem them immediately	Banks repay hybrids at $100. Banks may issue hybrids to wholesale investors which include Funds/ETFs.
APRA decides they hate retail ownership but allow banks a grace period to restructure their capital	Existing hybrids continue to trade for the grace period. New hybrid issues to wholesale investors. Hybrid liquidity should remain unchanged and maybe prices increase marginally due to no new issues.
APRA decides they hate retail ownership but allow existing hybrids to mature	The existing c$42b of bank/insurer hybrids continue to trade until final maturity (2030). Liquidity should remain unchanged, and prices would probably increase due to scarcity.

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APRA decides that retail ownership of hybrids is OK, or it is too hard to materially change structures	No change
APRA changes the CET1 level at which AT1/hybrids convert to equity	Existing hybrids will continue to be subject to conversion if CET1 levels reach 5.125%. New hybrids have a higher (c7.5%) trigger. New hybrids may potentially be cheaper than the pre change securities. Existing hybrids may be subject to a transition period before call.
APRA convinces the ATO to change its views on franking of equity instruments to allow banks to issue unfranked hybrids	Some increased institutional ownership. Prices may move marginally higher due to increased demand. We can't see this happening by mid 2024.

So why does APRA object to hybrids

Both APRA and ASIC have been wary of retail investor exposure to hybrids for the last decade. We don't think many of the arguments stand up to evidence or discussion, but because they get repeated so often, some of them have gained the status of semi truth. There seems to be a range of arguments from both the discussion paper and the AFR articles in the week after. In no particular order.

This year was about liquidity crisis not solvency events

- **(from APRA) AT1 was only used when recent international banks (SVB?CreditSuisse?) had collapsed rather than providing capital support earlier in the crisis.**

  We disagree with APRA's interpretation of these events.

  SVB was clearly a liquidity event rather than a solvency event. It went broke in the space of less than a month after concerns become apparent. The final liquidity run was just 2 days. Converting an AT1 in that month would not have changed the click induced bank run. Arguably, one of the catalysts for the liquidity event was the recognition that SVB had enormous unrealised losses on securities (due to higher interest rates). If SVB was subject to Basel 3 regulation (or Australian Basel 3 regulation), those unrealised losses would have been deducted from equity levels, and SVB would have been in breach of its capital levels. It would have been required to convert hybrids to equity or raise new equity. If that was the case AT1 would have done its job,but we will never know.

  Credit Suisse. For the past 10 years Credit Suisse has been a really bad, but still solvent bank. It was solvent in February 2023, one month before collapse. Its average RoE for the last decade is around 3% and there were continual stupid events. Despite that, it has been operating with 13% CET1 levels over that period, which is above Australian bank levels. Prior to February 2023, it had been able to raise debt and AT1 and Tier 2 capital relatively easily and it had an investment grade rating. This all changed in February/March when deposits disappeared and the Swiss authorities acted. Bagehot, who wrote the bible on central banking believed "to avert panic, central banks should lend early and freely (without limit) to solvent firms against good collateral and at high rates". The Swiss forgot that (or never learned), and they shotgunned a marriage to UBS which involved the wiping out of CS AT1's. As it turns out UBS paid not much for $57B USD

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of net assets and the only legitimate post acquisition write offs were about $2.3B of asset/goodwill write downs and $4.5B of regulatory costs. The assets were OK. This was a solvent (bad) bank finished off by a liquidity run. Converting AT1 in 2022 or earlier would not have altered the situation. Basel 3 is constructed on the basis that banks fail primarily by credit losses, which is why solvency is determined by equity. Clearly, Basel didn't cope with liquidity events very well in 2023, but that is not an AT1 issue.

Too much retail involvement?

- **(from APRA) Australia is an international outlier due to the level of AT1 held by retail investors**

And? Australia is also an international outlier in the extent to which retail owns the ordinary equity of its financial system. Direct retail and SMSF probably own more than 40% of bank equity. The major banks have a capitalisation of $400b. Hybrids have a market capitalisation of $42b. If APRA is worried about the effect of retail ownership of bank capital instruments, bank equity will fall further and faster than hybrids and should create more problems of that kind. It's hard for us to comprehend APRAs view that it is worried about "unsophisticated" or "unaware" investors investing in hybrids. Since 2021, only "wholesale" investors can purchase hybrids at new issues. These investors almost all use financial advisers, who themselves are licenced and are required to select appropriate investments. Most financial advisers have approved product lists and probably have access to expert/independent advice.We can't see where the concept of this "knowledge vacuum" comes from.

Clearly, non wholesale/non advised investors can buy hybrids on the secondary market. If we look at the 3 largest non advice broking platforms (Commsec, CMC, Open Markets), they account for around 10% of turnover of all hybrids. All the other turnover is via brokers that offer advice. We think that given the warnings about hybrids,the experience of hybrids going to $0 (Axess, Virgin, Allco, Babcock and Brown etc), and the small number of investors who havent received advice, the problems of retail unadvised ownership are not material. We're not sure that wholesale changes to protect 10% of a $42b segment is an example of good policy.

- **(from APRA/Media) Problems of banks having to compensate retail investors who own hybrids**

In their paper APRA cites examples of Spain and Italy where banks that defaulted/reconstructed had to compensate investors. In at least some of these cases, the banks had offered hybrid type securities to customers alongside deposits. Customers walked into the bank and were offered a deposit or a higher yielding hybrid, without the risks being explained. Unsuprisingly, some opted for the hybrid. When the bank was restructured the hybrid holders suffered losses. The banks had to compensate the investors due to the banks explicit or implicit mis-selling. It's a little disingenous for APRA to cite these events as a comparison to Australia. Here banks have no role in investors buying hybrids. There have been no shareholder offers since 2021 and any investment in hybrids is via a financial adviser or via a broking platform. It is difficult to see how the banks would be required to compensate investors as they did in Spain and Italy. Their's and APRA's response would be ; "go and sue your advisor". There were also concerns about litigation from upset investors and some speculation that it would be worse from retail investors. Its not obvious these concens are valid. Apparently there were 1000 lawsuits regarding the bail

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in/reconstruction of the Spanish Bank Popular which was shuttered in 2017. None have succeeded.

Banks won't stop dividends

- **(from APRA) Banks are reluctant to stop AT1 distributions and hybrids haven't been converted early enough**

  APRA notes that Credit Suisse didn't cancel AT1 payments despite incurring losses and facing "uncertain profitability outlook" (we're not sure when any profitability outlook is "certain"). Let's start with the observation that hybrid distributions must be paid if the bank pays dividends on the ordinary shares (fair enough). Let's also note that Australian banks have consistently been viable enough to pay dividends (Westpac has paid an annual dividend since 1817). As per APS 111, banks can pay dividends provided they have an adequate process around capital and are above the required capital buffers. There is a specific waterfall about how much capital they can distribute depending on their equity levels. APRA's issues about banks paying AT1 distributions are entirely their own making. If APRA is sufficiently concerned about banks making hybrid capital distributions, they can simply instruct banks to stop them. Dividend payment or not does not relate to the structure of AT1 instruments or their ownership. But this is not a consequence free exercise. ANZ lost a lot of money in 1992 (but still paid a dividend). Should APRA have kvetched about banking system capital and exercised it's discretion to halt dividends (and hybrid distributions)? As it turns out the directors were right to continue paying divdends. Two years later the RoE hit 18%. If APRA exercised it's discretion (and was wrong), investors would have added an APRA risk premium to capital which would have resulted in more costly and less access to capital.

Trigger levels increasing

Under current regulations, hybrids are automatically converted to equity if CET1 levels reach 5.125%. We think that APRA's view that this is too low for "going concern" capital is valid. If a bank reaches 5.125%, it is a "gone concen". APRA's last stress test had the usual dire scenarios (10% unemployment, house prices falling 33%, no equity raisings), but apparently no bank breached the 5.125% trigger level. If those stress test conditions did occur, banks should be raising equity or converting hybrids. If (when!) APRA makes that change, new hybrids will be issued with a c7% conversion trigger. Existing hybrids will retain the 5.125% trigger. We think that pricing of new hybrids will be relatively unaffected in those circumstances. Under current documentation, investors receive $100 worth of shares provided that the share price at the time of conversion is greater than 20% of the issue price VWAP. We find it hard to see bank share prices falling by 80% for a bank which has a mild capital shortage and is reasonably profitable. It's a different story for equity, which gets diluted pretty heavily if this happens.

Why APRA shouldn't make wholesale changes

We noted before that regulatory policy is a trade off between safety and effectiveness. By any standards, APRA is one of the most conservative regulators in the world. The US regulator is reluctant to implement standard Basel 3 because it is anti economic. Australia's version of Basel 3 is even more restrictive. Is APRA too conservative? If you ask a new business owner who can't get bank finance and has to use non banks or a credit card, APRA probably is too conservative. More concretely, locking retail out of providing bank capital will lead to higher cost of capital and less access to capital.

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- There is limited demand for subordinated bank capital by institutional fund managers. The new 7% trigger level hybrids will have a sub investment grade rating. The institutional market for sub investment grade is very small.

- Currently institutions can't include franking credits in their performance calculations. They are only buy hybrids if the coupon is an appropriate level (ie c7%). Unless ATO rules change, banks will need to frank the distributions and if this occurs, banks won't issue hybrids. It would be more expensive than issuing equity, so banks would issue equity. The c2% increase which would lead to a c20% drop in EPS.

- During the post GFC era, it was impossible to issue bank capital instruments to wholesale markets. Australian banks funded their Tier 1 and Tier 2 needs via issues to the ASX market, with $6b of well received Tier 2 bonds, as well as c$40b of Tier 1 issues. The Australian bank equity and bank capital market was the envy of other banking regulators.

What eventually happens?

Our inkling is that there will be little change, due partly to the enormous changes that are needed to creat a viable institutional market. We can't see any banks being able to issue to institutions until the ATO allows banks to issue unfranked bank capital instruments. Unless APRA is able to convince the ATO to change its long held rules on franking of equity instruments within the next few months, their early/mid 2024 response will have to be no material changes to the status quo. In addition, there has been a lack of precautionary bank hybrid issuance in the 2 months since the paper was published. Conflict of interest statement; we manage hybrid funds. Changes to market structure will effect us, but if retail is locked out of direct ownership of hybrids, an unkown portion of investments will transfer to managed funds such as EHF1. Arguably we would end up managing more funds.

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