NARROW ROAD CAPITAL

Bank Hybrids are a Screaming Sell

Yield chasing has spilled over into nearly every asset class, with Australian listed bank hybrids no exception. The current average margin of bank bills + 2.40% is close to the lowest level it has been in the last seven years. For institutional investors there are some obvious alternatives that are both lower risk and higher returning. For the predominantly retail buyer base, the direct alternatives are fewer but nonetheless there are ways to get a better return whilst taking the same or less risk.

What is a Bank Hybrid?

For the uninitiated, a quick description of the security types is necessary so that fair comparisons can be made. The two types of securities captured by the moniker of bank hybrids are subordinated debt and preference shares. Subordinated debt (technically tier 2 capital) is the security type that ranks directly below senior debt and has interest payments that are compulsory unless the bank is insolvent. NABPE is the only listed security of this type from the major banks but this is highly likely to change in the near future.

Capital Type	Examples
Secured debt	Covered bonds
Senior debt	Term deposits, senior unsecured bonds
Tier 2	Subordinated debt
Additional tier 1	Preference shares
Equity	Ordinary shares

Preference shares (technically additional tier 1 capital) rank below subordinated debt. The major banks currently have nineteen of these securities listed on the ASX with the largest for each major bank being ANZPG, CBAPD, NABPF and WBCPG. Preference shares are not debt securities, they receive discretionary dividend payments which the directors or the regulator (APRA) can stop even when the bank remains solvent.

The Structural Flaws of Bank Hybrids

Bank hybrids include a range of issuer friendly terms such as:

- The ability to delay (subordinated debt) or perpetually defer (preference shares) the repayment of the securities if the bank is in financial difficulty or if the share price falls below a threshold (preference shares)
- The potential to be converted into equity that has little or no value
- The lack of equity control rights, for instance being able to vote at shareholder meetings
- Limited covenants that protect the investor's position
- Higher drawdowns than standard senior ranking bonds in times of market turbulence
- Limited liquidity in times of financial stress and for larger amounts

Some financial advisors have been known to tell their clients that bank hybrids won't ever suffer a capital loss as the Australian Government will never let a major bank fail. This is a complete misunderstanding of the reason these securities exist. Bank hybrids exist as a protection mechanism to ensure that the Australian Government doesn't have to use taxpayers funds to bail out a bank. It's like the safety features in a car – the crumple zones and airbags exist to protect the people in the car, not to ensure that the car isn't damaged. If a major bank was in financial difficulty, APRA has the power to convert hybrids to equity or to completely wipe out their value.

Recent Changes that Impact Bank Hybrids

Earlier this month APRA released its determination on how much additional hybrid capital the major banks would be required to hold. Whilst this was a little less than APRA had initially flagged, it still points to the major banks (as a group) needing to raise roughly $20 billion of subordinated debt each year for the next four years. This additional debt will predominantly be sold to institutional investors, but it is likely that some of this will be issued as ASX listed securities. The initial response to the announcement has been muted, both in institutional and ASX listed securities. Westpac and ANZ have both since issued institutional subordinated debt into very strong demand.

Relative Value between Subordinated Debt and Preference Shares

The most recent subordinated debt issue was by ANZ on July 19th and it priced at bank bills + 2.00%. This isn't far away from the average margin of listed major bank preference shares at bank bills +2.43%. This is scant additional return for the major step-up in risk, particularly the risk of dividends being stopped whilst the bank is still solvent. Whilst this comparison is between an institutional security and the more retail orientated listed hybrids, those with the capacity to trade in parcel sizes of $500,000 or more do have both options available to them.

Alternatives to Bank Hybrids

Whilst some might argue the toss in the relative value between subordinated debt and preference shares, the value available elsewhere makes both options look miserly. Institutional investors can look to securitisation, syndicated loans and marketplace lending opportunities for a much better risk/return outlook. Retail investors can take advantage of online savings accounts, investing in marketplace lending directly or various other debt sectors accessed via listed and unlisted managed funds.

Securitisation

The most relevant debt type that demonstrates the poor value in bank hybrids is non-conforming securitisation. Investors in the subordinated AAA tranches are often getting margins that are equal to or exceed the margins on BBB rated major bank subordinated debt. As well as a much higher credit rating, these securities also come with a shorter tenor and a history of much lower drawdowns in market downturns. For an equivalent BBB rating, securitisation tranches have been issued at around bank bills + 4.30% this year, more than double the margin on the recent ANZ subordinated debt issue.

Comparing securitisation to preference shares isn't an apples and apples comparison. The predominantly equity features of preferences shares, notably the ability for the directors or APRA to turn off dividends, means they can't be fairly compared with a debt instrument that has non-discretionary repayments. Whilst ratings agencies do rate some of these securities (e.g. Standard and Poor's rates the CBA preference shares at BB+) these ratings ignore most of the risks created by the non-debt features of preference shares. Once these features are included, preference shares arguably have a risk profile more in line with a B rating for a standard debt instrument. Either way, bank bills +2.43% for preference shares compares poorly to bank bills + 6.30%/7.75% (BB/B rating) for securitisation issuance this year.

Marketplace Lending

Institutional and retail investors can both access marketplace lending (also known as peer to peer lending) via a growing number of online platforms. There's a mixture of residential and commercial property secured loans available, as well as unsecured business and personal loans. For more conservative investors, loans backed by residential property with an LVR of 60% or less typically yield 5-7%. Commercial property loans, business loans and personal loans usually come with yields higher than this. Investors in racier loans should be expecting to lose a portion of their total return when some of the borrowers default and should set their return expectations accordingly.

Online Savings Accounts

Retail investors have a profound advantage over institutional investors when it comes to getting the best rates for online savings accounts. NAB's online subsidiary Ubank (2.41%) has the best, easy to access ongoing rate requiring only a $200 monthly deposit. There are other options with higher rates, but these have restrictions on withdrawals, spending requirements or are only introductory rates. Whilst this rate doesn't seem that high, note that two major bank preference shares, NABPC and WBCPF, are both trading with a forecast yield to maturity of less than 3%.

Managed Funds

Retail investors that cannot access securitisation, syndicated loans and various forms of private debt directly have a growing number of listed and unlisted fund options. As these types of securities are typically illiquid, care should be taken to (a) choose managers with a long track record of managing these assets well and (b) invest in a fund with a suitable liquidity profile for the asset type. Funds that offer daily liquidity whilst investing in illiquid securities have a history of blocking redemptions in substantial market downturns, as occurred in 2008/9. Listed vehicles are a better way to access these securities as liquidity demands are met via a sale of the units rather than selling fund assets at prices that may be below their long term fair value. Listed debt funds include GCI, MOT, MXT, NBI and QRI with these funds having various debt types, risk profiles and fee levels.

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Disclosure