Elstree

More Capital, more debt, more equity.
What APRA's latest announcement means for ASX Listed Hybrids.

- APRA released a discussion paper on adding more capital to bank balance sheets in order to reduce the possibility of systemic bank failures.
- We don't think it has any effect on hybrid prices in the short term and minimal effect in the medium term.

Bank capital in 4 dot points

1. After the GFC, bank regulators decided that they weren't going back to 2008 ever again. They (the regulators) decided that the best way to do that was to dramatically increase the amount of capital banks have to hold. In 2007, a "good" bank held around 9% of capital made up of 5% equity, 2% Tier 1/Hybrid and 2% Tier 2/Subordinated debt. The first decade was about increasing equity and the new "good" bank holds 10%+ equity, 2% hybrids and 2% Tier 2.
2. However, to make absolutely sure that we don't have another systemic crash (which results in 10% falls in GDP and governments having to nationalise banks), the final brick in the capital wall is for systemically important banks to have c20% loss absorbing instruments (i.e) equity, hybrids, Tier 2/subordinated debt and Tier3/senior subordinated debt. The theory is that if there is a small event, equity takes the loss, in a GFC type event, equity and maybe Tier 1 get wiped out and if there is a super GFC event, the Equity and Tier 1 are gone and Tier 2 and Tier 3 get converted to capital and the bank has enough capital to operate.
3. In overseas jurisdictions, this is called Total Loss Absorbing Capital or TLAC and they have invented a class of debt called TLAC aka Tier 3 which lies between bank deposits and Tier 2 subordinated debt. It's still subordinate to deposits and senior debt, but senior to Tier 2 and Tier 1.
4. The discussion paper APRA just released aims to get Australia's systemically important banks (the 4 majors) to issue another 4% of capital within 4 years. This takes the 4 majors to 18% total capital, which they claim is the equivalent to the 20% plus ratios that overseas banks aspire. The APRA paper talks about the additional capital being provided by Tier 2 capital.

How does that affect hybrids?

There has been some shouty-ness that this will be bad for hybrids as the additional supply of Tier 2 will push out the margins, resulting in wider hybrid margins and lower prices. We can't see that happening in the short term for 2 major reasons;

- We think the additional supply is pretty easily absorbed and
- There is not a high correlation between what happens in wholesale/OTC markets and ASX Listed markets.

How much extra supply?

The table below shows the supply mechanics of the additional capital requirements. The discussion paper talks solely about the banks issuing additional Tier 2 debt, but we think the banks would like the flexibility to issue Tier 3 debt as well. It's not only cheaper to issue, but it's also less risky (further away from equity) which means there will be a larger investor base. It's just plain common sense that both APRA and the banks need a diversified funding base and that includes diversification across

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level 10, 30 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348
Email: info@eiml.com.au

geographies but also investor type. If banks issue any Tier 3, the funding requirement for Tier 2 is reduced.

Current Risk Weighted Assets (4 major banks)	$1,670b	
Extra Tier 2 capital required @4%	$66b	
Offshore borrowing component	-$33b	Note 1
Domestic ASX Listed market borrowing component	-$10b	
Domestic wholesale borrowing component	-$23b	Note 2

Mechanics explained

The 4 major banks need to issue another 4% of capital, which equates to$66b of new capital.

(Note 1) Currently the 4 major banks issue 50% or more of their Tier 2 debt offshore. We assume that ratio continues. Whenever they do a Tier 2 issue overseas, there are big scale backs because there is a wall of money looking for higher yielding assets from Australian banks (which are still amongst the best rated in the world).

(Note 2) That leaves a domestic funding task of $33b. We expect that the banks will use the ASX Listed market for diversification reasons and we've assumed they issue c$10b, leaving $23b to be issued in the domestic wholesale market. Currently the major banks borrow around $105b from the domestic market (about $95b senior and $10b subordinated/Tier 2).

Does that affect margins?

We don't think it materially affects spread margins in the domestic wholesale market because;
- While $20b is big it is by no means material,
- We think the higher yields and plentiful supply will actually induce demand,
- We expect that if the ALP proposal to remove franking credit refunds from zero tax paying superannuants is implemented there will be flows of money from franked instruments such as hybrids and equities to an instrument that is not very volatile and offering margins of 1.5% to 2.5% higher than cash rates/TD,
- Current Tier 2 margins are cheap given the huge structural reductions in bank risk over the past decade,
- Similarly, we don't think an extra $10b of issuance in the ASX market is much of an issue and
- We suspect the listed market has been undersupplied to the tune of c$10b over the past 3 years.

No short term impact on hybrids

In the short term there is almost zero correlation between what is happening in the ASX hybrid market and wholesale debt markets. This simply occurs because almost all of the buyers and sellers in the ASX market cannot access the wholesale market, so the opportunity to do relative value trades between the markets is extremely limited. Over the longer term, there is a relationship which is driven by the supply side, rather then the demand side. If the pricing of the ASX market is out of synch with wholesale markets, new supply will flow to the cheapest market to issue in. If that is the ASX market there will be greater than expected supply and vice versa.

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level 10, 30 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348
Email: info@eiml.com.au

What would make us change our minds?	The biggest driver of hybrid margins in the short term is bank share prices, but if we have overestimated market demand for Tier 2, we would expect marginally lower hybrid prices as there would be increased supply into the ASX market and some leakage from ASX hybrid holders to the wholesale market. That said, it is a 4 year runway for the banks to issue additional capital and there will a significant number of big events between now and then that will have a greater effect on bank share prices, Tier 2 borrowing margins and hybrid security prices.

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level 10, 30 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348
Email: info@eiml.com.au