# ASX LISTED FIXED INCOME MARKET

## Navigating the Hybrid Highway

**Barry Ziegler**
**Head of Retail Fixed Income**

**August 2014**

BELL POTTER

# Navigating along the hybrid highway

Navigating along the hybrid highway is not a smooth drive in the country as there are certainly many signs and countless roadblocks and speed humps that need to be avoided.

This presentation is aimed at making the journey as smooth and rewarding as possible without engaging the airbags.

The topic of coverage will include:

- A brief history of the market
- Who issues these securities and why
- Analysing the new regulatory changes including Basel III compliant issues
- The main risks associated with this style of fixed income investment
- Future developments and wish list

# ASX LISTED FIXED INCOME

## Developments since we last met in 2012

- Exchange-traded Treasury Bonds-Australian Government Bonds

- Bank subordinated debt  Tier 2 Capital with “non-viability” triggers

- New style Bank issued Mandatory Convertible Preference Shares Tier 1
  - Trigger Events- “non-viability”
  - Basel III
  - Loss Absorption
  - D-SIB  (domestic systematically important bank)

- Risks associated with investing in this market have increased

## What are Treasury Bonds?

Treasury Bonds are medium to long-term debt securities issued by the Australian Government

Features include:

- Carry an annual rate of interest fixed over the life of the security, known as the Coupon Interest Rate.
- Coupon Interest Payments are made every six months.
- On the Maturity Date, the last Coupon Interest Payment and the Face Value amount of the Treasury Bond are paid to the bond holder.
- *The Australian Government is liable to make these payments.*

# Investing in Australian Government Bonds via eTB

Fixed Income securities provide:

- Security: The payment of coupon interest and repayment of principal at maturity is made by the Australian Government.
- Regular and stable income: You earn interest at a fixed rate for the life of the investment, payable six monthly.
- Liquid investment: *eTBs* can be sold any time the ASX market is open. This means your money is not locked away like it might be in some other interest earning investments.
- Diversification: *eTBs* may provide you with an opportunity to diversify your investment portfolio.
- Choice of maturities: There is a wide range of *eTBs* available extending out to around 15 years.
- Inflation linked: Bonds that offer a return above the inflation rate

# Key terms

## Coupon Interest Rate

The coupon rate on a Treasury Bond is set when the bond is first issued by the Australian Government, and remains fixed for the life of the bond.

i.e. Treasury Bond with a 4% Coupon Interest Rate will pay investors $4 a year per $100 Face Value amount in instalments of $2.00 every six months. These instalments are called Coupon Interest Payments.

## What is the Yield To Maturity?

**Yield to Maturity** is the rate of return on a bond (expressed as an annual rate) if purchased at the current market price and held until the Maturity Date. The calculation of the yield assumes all Coupon Interest Payments are reinvested at the same rate.

## What is the difference between Coupon Interest Rate and Yield To Maturity?

**Yield To Maturity** will vary through time with changes in the price and remaining term to maturity of the bond.

**Running yield** is simply the coupon rate divided by the purchase price

## Running yield vs. Yield to Maturity

Let's assume that we have a Government bond with a 10%p.a. coupon paid semi-annually, maturing in 2 years trading at a market price of $110.00

### Calculations:

**Running yield:** = income divided by outlay

= $10/$110

= 9.10% p.a.

**Yield to maturity** calculation using the standard bond formula.

= 4.703% p.a.

The difference is due to the running yield not assuming redemption in 2 years time and the bond formula takes into account the premium paid to receive the higher coupon and that there is a final redemption date at which holders will receive face value of $100.

*Yield to maturity calculation is a more accurate method of calculating the total return or yield for a fixed income security.*

# ASX LISTED FIXED INCOME MARKET

## Debt and Hybrid Securities

**The highway is safe if you observe the traffic signs**

# THE SEARCH FOR A HIGHER OCTANE YIELD

In order to achieve a higher yield, you need to take additional risk,

However:

- Will I be rewarded for taking additional risk
- How well protected am I seeking added risk
- Am I comfortable accepting additional risk

*Looking down the capital structure of the issuer*

ASX listed debt & hybrid market-new bank issued under Basel III

- Additional Tier 1 or 2 Capital
- Trigger Events: Common Equity and Non Viability

# Australian Basel 3 Tier 2- Structure

Key features:

- Subordinated debt ranks above equity for distributions
- Initial interest rate BBSW90+ margin.
- Yield to first call Interest payments, not dividends therefore no franking
- Defined maturity date in 10.0 years
- Early redemption or call option in 5.0 years
- Loss absorbing at the point of non-viability
- Potential for loss is conversion below 20% of the issue date VWAP of the issuer

# Loss Absorption and Non-viability Trigger

## What is a Non-viability Event

Non Viability Trigger Event would occur if APRA notifies the issuer in writing that it believes that issuer would become non-viable without:

- Conversion / write off of capital instruments: or
- A public sector injection of capital or equivalent support

## Loss Absorption

- Conversion to ordinary equity once regulator APRA deems the issuer "non-viable"
- Variable conversion price, subject to 20% floor of share price at issue. (i.e. If share price is $33, investors receive face value in shares down to $6.60)
- If an investor is unable to receive shares, a mechanism to sell the shares and deliver cash is included in the program
- If conversion within 5 business days is prevented by applicable law or unable to occur, the Notes will be permanently written off
- Conversion of Additional Tier 1 listed Capital Notes is required ahead of Tier 2 issues

# Australian Basel 3 Tier 2- Key Considerations

## Should we be concerned about the Australian major banks

- Australian banks are profitable and well capitalised by international standards
- Management have a range of alternative actions available to strengthen capital if required
- Contractual framework provides more certainty than US or European statutory arrangements
  - – • the applicable loss absorbency mechanics are known and contractually agreed upfront
    - Statutory frameworks in US and Europe provide significant flexibility to resolution authorities, including permanent write off

- Conversion to a variable number of ordinary shares, subject to a 20% floor price, provides some protection relative to current and historic share price

# The Bank Hybrids

**Basel III, new regulations relating to the issuance of Tier 1 Capital**

# New Basel 3 Tier 1 Structures

## premium octane fuel...

**"When debt becomes equity"**

# SECURITY RANKING- ANZ Bank

| | | | |
|---|---|---|---|
| **Higher ranking/ earlier priority** | Senior obligations | Liabilities preferred by law and secured debt | Liabilities in Australia in relation to protected accounts under the Banking Act (generally, savings accounts and term deposits) and other liabilities preferred by law including employee entitlements and secured creditors |
| | | Unsubordinated unsecured debt | Bonds and notes, trade and general creditors. This includes covered bonds which are an unsecured claim on ANZ, though they are secured over assets that form part of the Group |
| | | Term subordinated unsecured debt | ANZ Subordinated Notes and other equal ranking dated subordinated unsecured debt obligations |
| | | Perpetual subordinated unsecured debt | Perpetual Capital Floating Rate Notes issued in 1986 |
| | Equal ranking obligations | Preference shares and other equally ranked instruments | **ANZ Capital Notes 2**, ANZ Capital Notes, CPS3, CPS2, CPS1, and the preference shares comprised in the 2004 Trust Securities. |
| **Lower ranking/ later priority** | Lower ranking obligations | Ordinary shares | Ordinary Shares |

# NEW STYLE - MANDATORY CONVERTIBLE PREFERENCE SHARES

## *looks like a bond in good times and an equity in bad*

Key features:

- Distributions are paid quarterly/semi-annually
- Issuer has an exchange option after 7 or 8 years-*not redemption*
- Dividend payments are discretionary-*equity like*
- Dividend restriction-non payment will prevent payment to ordinary shareholders
- Automatic conversion under a Trigger Event – Common Equity and or Trigger
- Non-viability trigger
- D-SIB “domestic systematically important bank” 1.0% extra capital big 4

# BASEL 111- INTERNATIONAL BANKING RULES HAVE CHANGED

**Basel 3 reforms are designed for banks to strengthen their equity base in order to prevent some of the issues caused by the GFC.**

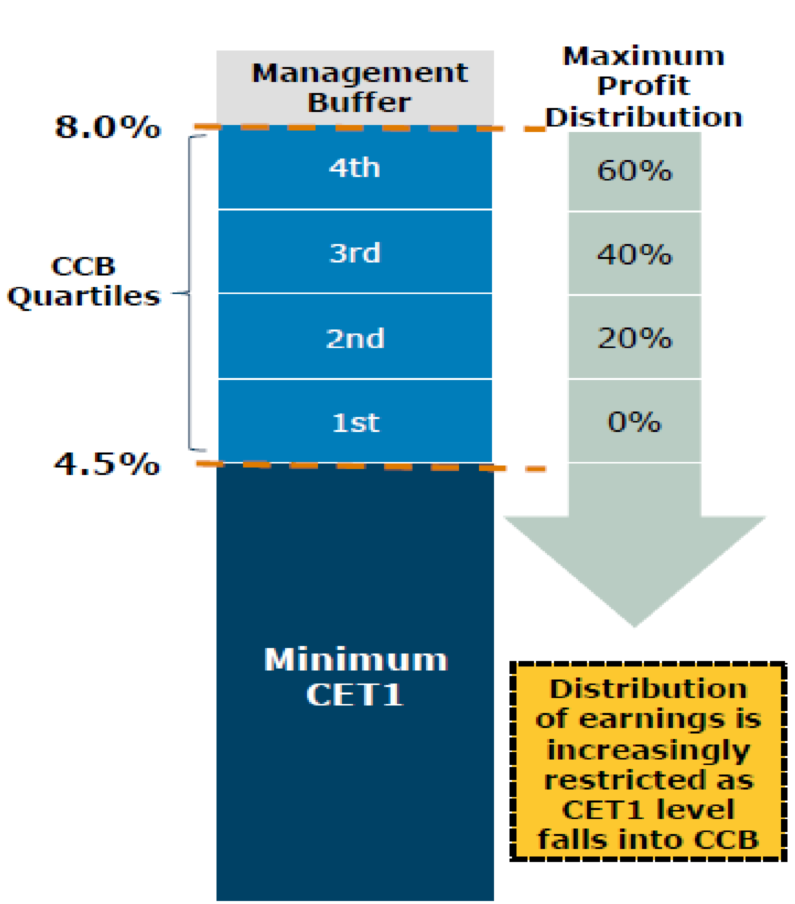
- New bank hybrid issues to include an automatic conversion clause under a Common Equity Capital Trigger Event (CET1), with conversion of the hybrid securities (Residual Equity) providing an immediate boost to the **Common Equity Capital Ratio** if this ratio falls below 5.125%.
- Under Basel III, APRA requires Australian banks to hold a minimum Common Equity Tier 1 Capital Ratio of 4.5% on 1 Jan 2013, increasing by the 2.5% capital conservation buffer to 7.0% on 1 Jan 2016.
- D-SIB "domestic systematically important bank" 1.0% extra capital for the Big4

Non-Viability Trigger

- APRA's Basel III requirements for the issue of Tier 1 securities include a Capital Trigger Event and a Non-Viability Trigger Event, where securities such as ANZPE must be converted into ordinary equity if the financial position of ANZ requires an immediate injection of capital.

# Basel 3 Common Equity Tier 1 & Capital Conservation

## Basel 3 CET1 Capital & Capital Conservation



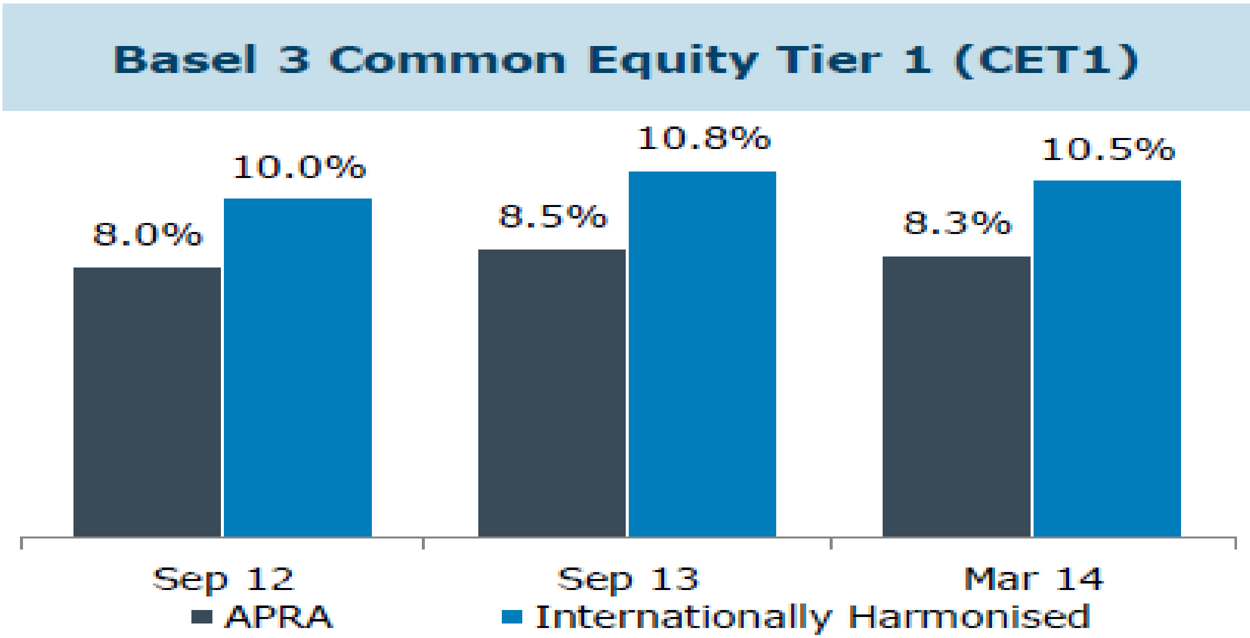

## Actions Available to Strengthen Capital

| | |
|---|---|
| **Management Actions** | Possible actions to be invoked as CET1 ratio declines below management target include:<br>• Reducing dividend payout<br>• DRP discount and underwrite<br>• New share issuance<br>• Expense management<br>• Restricting RWA growth<br>• Asset sales |
| **CCB Restrictions** | Regulatory restrictions on ordinary share dividends, discretionary bonuses and AT1 coupon payments as CCB buffer is breached. |
| **AT1 Conversion Trigger** | Mandatory conversion to equity or write-off of AT1 instruments once CET1 ratio declines to 5.125%, providing additional buffer for loss absorption. |

Source: ANZ Bank

## Capital Trigger Event

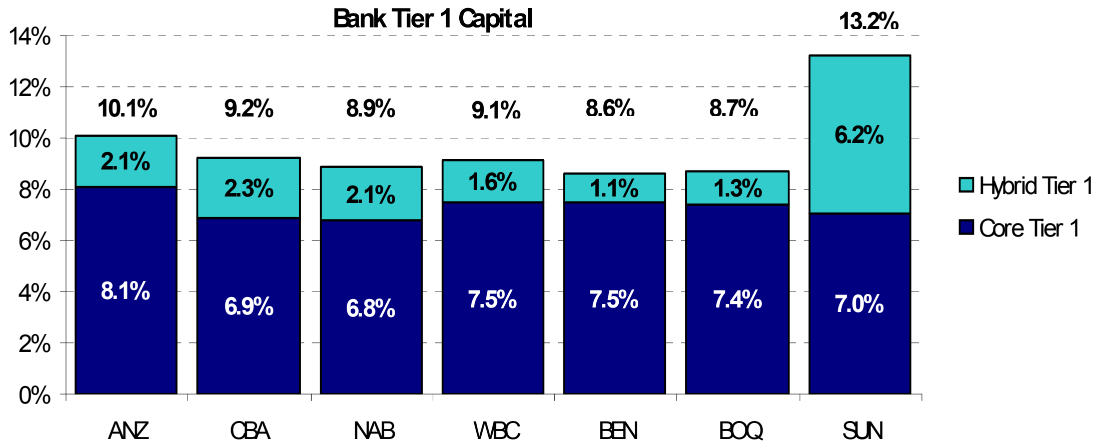
A Capital Trigger Event occurs when either ANZ determines, or when APRA notifies ANZ that it believes ANZ's Common Equity Tier 1 Capital Ratio has is equal to or less than 5.125%. Under this Trigger, ANZ must immediately Exchange enough ANZPD securities to boost the Common Equity Tier 1 Capital Ratio above 5.125%.




Source: ANZ Bank

# BASEL III IMPACT ON HYBRIDS

- In a coordinated effort to prevent another major financial crisis, central banks have determined more conservative global capital standards under the Basel III requirements:
    - Banks core tier 1 ratio to be 4.5% by January 2015
    - Additional 2.5% of core tier 1 to be held as a 'capital conservation buffer', with a transition period between January 2016 – January 2019
- Core tier 1 capital includes ordinary shareholders equity and retained earnings, however, excludes financial instruments such as hybrids
- Over time, we expect Australian banks will increase their core tier 1 ratios through increased retained earnings and conversion of preference shares
- Likely conversion for step-up preference shares (BENPB, PCAPA, WCTPA)



# Mandatory Exchange Conditions

**Using ANZ Capital Notes for illustrative purposes:**

First: VWAP of ordinary shares on the 25th business day before a possible Mandatory Exchange Date (1-Sep-23) must be above 56% of the Issue Date VWAP.

The ANZ price on 28-July-23 = **$16.33**

Second: VWAP of ordinary shares during the 20 business days immediately preceding a possible Mandatory Exchange Date must be greater than 50.51%

The ANZ price on 28-July-23 = **$14.88**

Non-viability or Common Equity Trigger Maximum conversion 17.56 or **$6.41**

If Mandatory Exchange Conditions are not satisfied, mandatory conversion will not occur. ANZ does, however, have the option of applying to APRA for cash redemption.

Two factors APRA will consider in allowing redemption are:

- ANZ issues a replacement capital instrument of at least the same quality as ANZPD
- APRA is satisfied ANZ's capital position is sound and does not have to issue a replacement capital instrument for ANZPD.

# Risks under the new Basel 111 rules in holding MCPS

- **ANZPD will lose its value and investors will not receive any compensation if ANZ is not able to issue ordinary shares within five business days from Exchange under a Capital Trigger Event or Non-Viability Trigger.** Scenarios under which this may occur include ANZ being prevented from issuing ordinary shares by circumstances outside of its control, including an applicable law or order of any court, or action of any Government authority from issuing shares.

- **Adverse change in ANZ's and financial performance which combined with a major bad debt event could lead to the Common Equity Tier 1 Capital Ratio falling below 5.125%, resulting in automatic conversion under the Capital Trigger Event.** Automatic conversion may also be required under a Non-Viability Trigger Event.

- **ANZ has an option Exchange Date of 1-September-2021, when at the Bank's discretion, they will redeem the issue for $100**

- **Exchange of ANZPD at the 1-September-2023 Mandatory Exchange Date requires ANZ's share price at the time of Mandatory Exchange to be above certain thresholds.** If these thresholds are not met in September-2023 or at future quarterly dividend payment dates, ANZPD may remain on issue indefinitely.

# The General Risks of the ASX debt markets

- Debt issues are not covered by the Government protected deposit liability
- Subordinated debt ranks behind all deposits and senior debt obligations
- New issues may offer more attractive issue terms and margins, placing downward pressure on the security price
- A dislocation of credit markets may result in an increase in credit spreads, placing downward pressure on the security price
- A material deterioration in global capital markets and the Australian economy could result in an adverse change in issuers operating and financial performance. This in turn could potentially lead to weakening of its capital adequacy and issuers ability to redeem the securities
- Adverse regulatory changes / Government policy
- Equity credit changes to treatment by the ratings agency
- Interest may be deferred and could cumulate for up to 5 years
- Failure of the issuer

# The General Risks of the ASX hybrid markets

## ASX Hybrids

- Hybrids are not Term Deposits and are not protected by the Government guarantee scheme
- Hybrids are preferred equity of the issuer and rank behind deposits, senior debt and subordinated debt
- Dividends are discretionary and non-cumulative
- Dividends are subject to several payments conditions including solvency
- Adverse credit markets- credit spreads widening
- New issues offering a higher margin
- Non-viability Trigger Event and Common Equity Trigger provisions
- Risk of conversion into equity

# WHAT'S NEXT FOR ASX LISTED DEBT & HYBRIDS

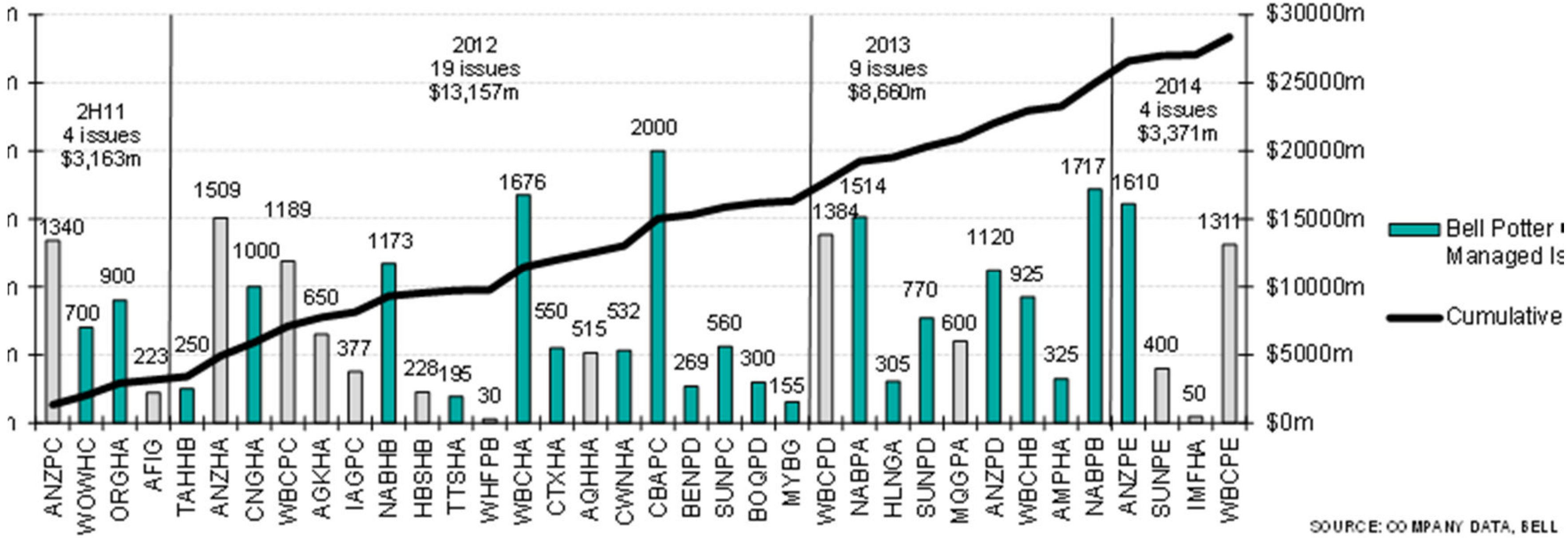
The pipeline:

- Listing of “Simple Corporate debt
- Bank Basel III compliant preference share template now settled
  - Replacing old style preference share issues with Basel III compliant structures
- Rollover of maturing issues

- Larger lines over $500k:
- Investment bank market makers are beginning to get involved
- Larger institutions will operate in these markets
- Market becoming larger: over $50bn

# A FLOOD OF NEW ISSUANCE

- $28.4bn of issuance across 36 new securities since August 2011
- Bell Potter has been the only broker to participate in the Book-build of all 36 issues
- Research reports on all issues
- Bell Potter Co-Manager to 22 issues (dark green columns)
- Potential to reduce portfolio risk and enhance income in volatile markets

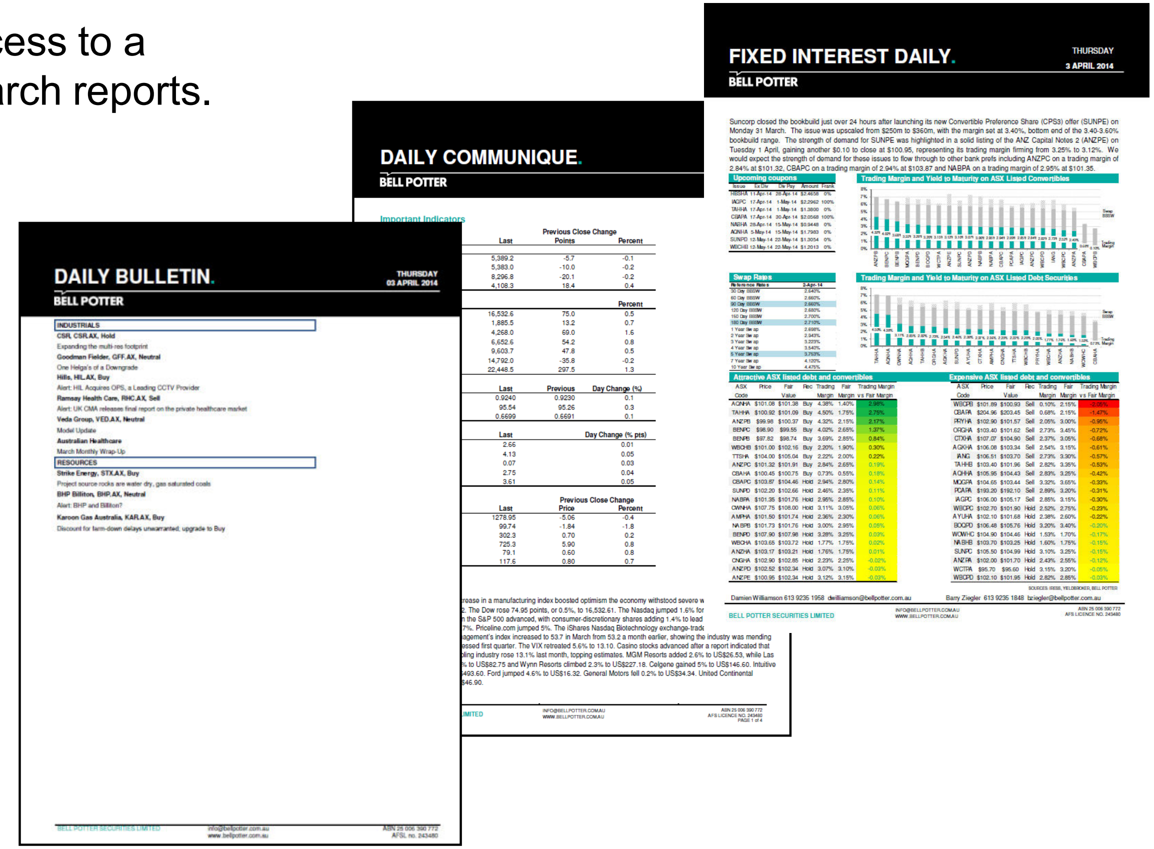



SOURCE: COMPANY DATA, BELL

# Conclusion

Our research is a cornerstone of our business, a truly broad and outstanding independent research offering.

As a client, you have access to a unique selection of research reports.



# DISCLAIMER

**The information presented in this seminar is general advice only and is not intended for any particular individual. No consideration has been given to the individual investment objectives, financial situation and particular needs of any person and Investors should independently assess whether the advice is appropriate to their own circumstances. Although the information in this presentation is taken from sources considered to be reliable, Bell Potter Securities Limited, its directors, employees and consultants do not represent, warrant or guarantee, expressly or impliedly, that the information is complete or accurate. Further we do not accept any responsibility to inform you of any matter that subsequently comes to our notice, that may affect the information disseminated in this presentation.**

**Bell Potter Securities Limited holds an Australian Financial Services Licence and earns brokerage and other fees from advising and dealing in securities.**