Cranky Bankies Misread APRA

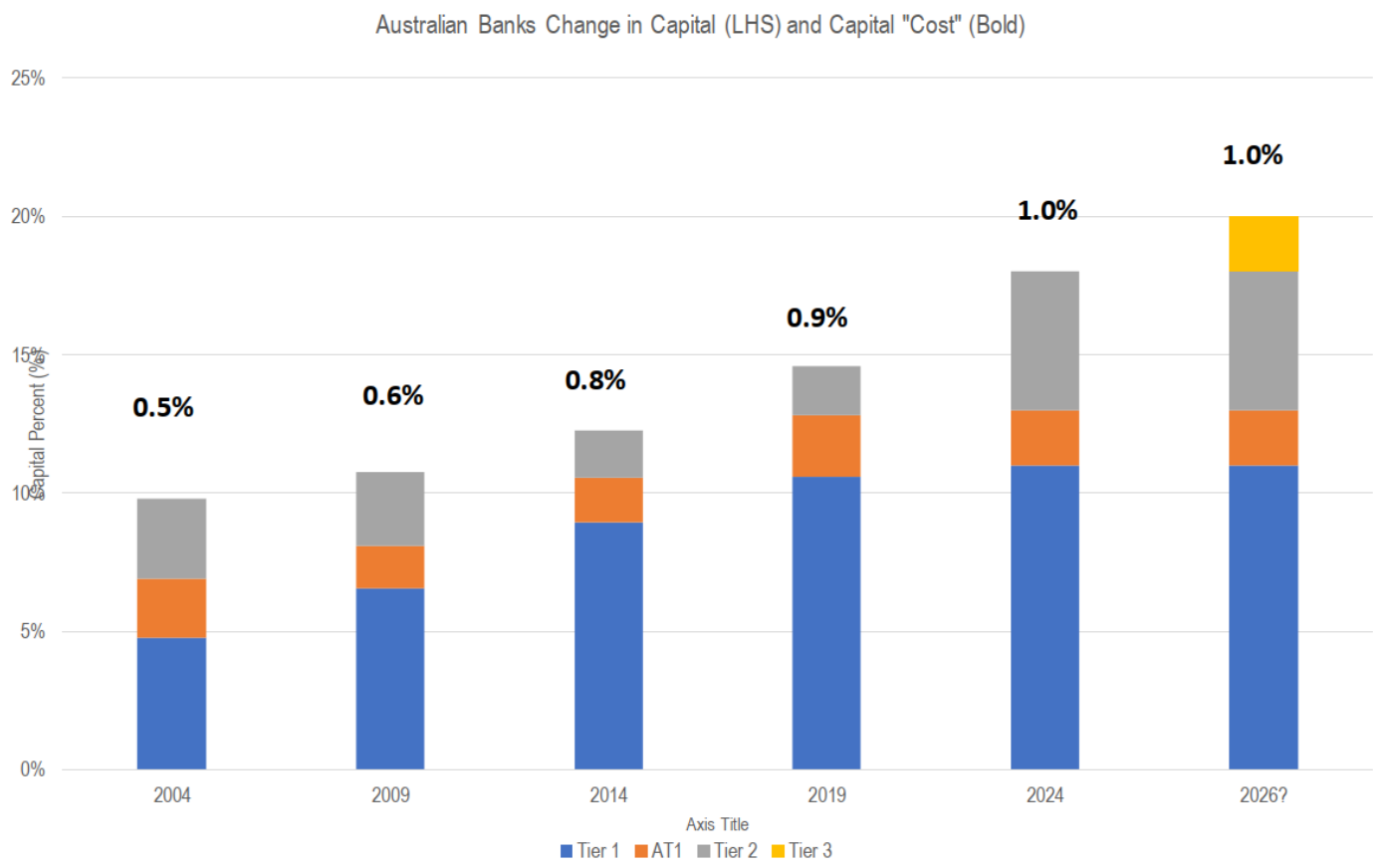
16 July 2019 | *Elstree Investment Management*

- Last year, APRA issued a discussion paper on how it intended to add a further 5% of additional capital to protect depositors and governments (who are effectively deposit guarantors) in the case of bank insolvencies.
- Last week, they announced their decision and the banks aren't happy.
- We don't think it's as big a deal as some of the commentators.
- It's a non-event over the next few years.
- We'll see some of the extra supply find its way to the domestic ASX Listed market.

Next to final deathroll of post GFC re-regulation

The abiding memory of regulators and governments of the GFC is that they had to pump billions into the banking systems to protect the banks and depositors (i.e) in the UK during the GFC, the banks needed GBP 500b, around 30% of UK GDP, and 10 years later the equity holdings are still underwater. We're imagining the scene when all the regulators met up in Basel at world central bank headquarters, exchanged pin pricks with their banking blood brothers and solemnly swore "never again". So, over the past decade we have seen investment banking regulated out of existence, bank capital levels more than doubled and short term funding by banks eliminated. In Australia we have seen equity levels more than double from 5% to more than 10% and the most recent (and probably penultimate GFC related) measure was to require banks to issue another 3% of deposit protecting instruments. It brings the total capital that needs to be dusted before governments or depositors are harmed (in theory anyway) to 18% of risk weighted assets cf 8 - 9% pre 2007. That's a lot safer. We think there is probably another 2% to be added by 2026. The chart below shows the gradual increase in capital from 2004 to the 2024 (and speculated 2026 levels). We've also shown the "capital" cost for lending for a 100% risk weighted asset. For example, in 2004, if the margin was 0.5% in excess of funding, expenses and default costs, banks made their cost of capital. By 2024 this will double to 1%. Housing loans are generally 25% risk weighted, so 0.25% of the margin between funding and what they charge borrowers covers their cost of capital.

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So, more capital is a good thing?

From the government's perspective it is, but from the banks' perspective it isn't, because, as the chart above shows, bank capital is expensive and the more there is of it, the lower profit and RoE. And this is the basis of the argument that is currently being put, and why noses are out of joint in Darling Park and Barangaroo and Docklands. It's logical that the closer bank capital is to equity, the more expensive it is, as there is a greater chance of it being utilised. At the de facto industry conference this year the issue was discussed by both the bank treasurers and APRA and there was more peace and love than Woodstock. The bank treasurers were particularly happy as they had made the argument to APRA that they should be allowed to raise the additional capital in the form of Tier 3 notes rather than Tier 2. To try and make it simpler for the 95% of the world who don't care about bank capital, Tier 3 is senior and safer than Tier 2, and therefore cheaper to issue (i.e) Tier 3 costs around cash plus 1.5% compared to cash plus 2.25% for Tier 2. This is a not an insignificant amount; 0.75% cheaper funding on the additional capital works out to around $100m p.a. for each of the majors. Bank Treasuries only make c$400m p.a. from their treasury activities. The argument they were putting to APRA was that there was not a big enough market for Tier 2

and there was a large global market for Tier 3, so why not afford the same protection for governments and depositors (there's still 20% of capital to wipe out before depositors get hit). And at the conference the treasurers looked like the cat that stole the cream and it looked like they'd won. That would have been the easiest $100m p.a. that the treasurers would make. The APRA guy made soothing noises as well.

Got that wrong (partially)

While the announcement last week was worse than expected, in reality, it's better than the banks could have got, so we're not sure why they are complaining. Compared to APRA's original proposal of 5% Tier 2 by 2023, they got 3% by 2023. However, they were expecting 3% of Tier 3 by 2023. Consequently, the banks are still at least $50m p.a. worse off than the budgets they would have been finalising after talking to APRA since last year.

Why we think it's almost a non-event (especially for now)

- You'll read arguments (by banks and others) that no-one will buy Tier 2 debt. We're not so sure about that. Apparently at a global level, there has been around $50b of Tier 2 debt issued this year, which is quite small in comparison to the c$40b that the Australian banks will have to issue. The major reason for the lack of issuance is not the lack of demand, but the lack of supply. Most global banks are awash with equity capital, and they are getting to their total capital requirements by issuing the cheaper Tier 3 rather than the more expensive Tier 2. For example, RBS needs to get to c26% capital levels (hint to Australian banks; don't whinge about 18%), but they can issue c12% of that as Tier 3. They have equity capital levels of 16%, so they don't actually need any AT1/hybrids or Tier 2 until they can get their equity capital levels down. So even though they have AT1 and Tier 2 securities on issue, they are not doing any issuance at all. Hence no global issuance.

- The market finds a price for everything. There are actually going to be upper and lower limits on cost. With Tier 3 at a cost of cash +1.5% and Tier 1 at 3.5%, you can really only argue that massive increases in supply will push the price up 1/4% - 1/2%. That's less than a 1 standard deviation event (i.e) those kinds of moves are seen 3 times every 2 years.

- The Tier 2 bonds will replace senior lending and that will create a scarcity of bank bonds. Each major borrows c$25b p.a. in senior bonds from local and overseas investment markets. This will almost halve when they borrow $10b p.a. of Tier 2. While not all of the senior bond buyers will transfer to Tier 2, some of them will.

- At this stage, we think some of the supply will find its way to the ASX Listed market. In 2012, each of the major banks issued Tier 2 bonds on the ASX and raised between $1b and $1.5b each. All were heavily oversubscribed. This is easily repeatable. The only reason they were not refinanced on the ASX is that it was cheaper to refinance them offshore. So, there is $8 - $10b of the $40b issuance problem solved.

- More importantly, not much will happen in the next 2 years. In Australia, the classic form of Tier 2 debt was 10 years, with a provision that allowed the bank to call them back at 5 years (the so called "10/non call 5"). The banks would always call the security at 5 years as the amount they could attribute to bank capital amortised over those final 5 years. So, if a bank treasurer now issued a standard 10/non call 5, they would be calling them back in mid 2024, 6 months after the capital regulations started. They would have been paying out the c2.25% margin for 4 years for no reason.

- In offshore markets, banks have been able to issue longer term Tier 2 (i.e) 15/non call 10. This makes more sense, but you are not going to find treasurers willing to pay the 2%+ margins for large amounts of Tier 2 for the next 3 years, when they can do it in a few years' time. They might show higher capital levels between now and 2024, but who cares? APRA doesn't, markets don't and ratings agencies don't, and it's not good for P&L. So, we see commentary that prices have dropped because of a possible increase in supply and we put our "bank treasurer hat on" and predict that we will only see replacement issues over the next 18 months (unless investors all of a sudden have a desire for 15/non call 10 debt). We can't see too many scenarios when there is much new net issuance before FY 2022. At the time of writing Westpac announced a 15/non call 10 in Euro markets, which is an indication that there is demand, but at the same time, they have a few $b that are coming up for maturity.

- 2024 is a long way away. Over the last 5 years AT1/Hybrid margins have moved from 2.8% to 5.4% and back to 2.9% and equity markets have been 35% lower than their current 10 year highs. Those are the kind of issues that investors should be concentrating on, not whether obscure bank capital instruments are 0.25% higher or lower than they otherwise should be.

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