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OPINION: The retail buffer

Andrew Papageorgiou from Realm Investment House warns that retail investors who buy hybrid issues, expecting safe high-yielding securities, may not be fully aware of the risks involved.

Most of the recent non-bank ASX-listed hybrid issues have managed to achieve an equity credit designation by the major ratings agencies. Equity credit essentially buffers the rest of the capital structure, preserving or improving the firm's credit rating.

Right now, the credit rating of a corporate is as important as it has ever been. This is driven by banking regulations that require higher amounts of capital to be held against lower rated assets. This is occurring at a time when total capital requirements are rising as well, not to mention harsher terms around what qualifies as said capital.

The Basel regulations hit at the heart of the banking sector by enforcing capital controls which will make the attainment of higher return on equity targets a lot more difficult from now on. This is not helped either by external factors that are making sourcing European capital extremely difficult and cost in-effective.

As such, the banking sector acts as it always will, to protect itself and its shareholders first. The increasing reliance on term funding has come at a significant cost as the process of increasing the funding share of deposits has directly impacted net interest margins. This trend, coupled with the Basel Capital reform introduction, has had the effect of increasing the lending margin over bills to compensate while also leading to risk being accounted for under tougher standards.

In short, depending on the credit rating of a corporate, a bank will need to assign a risk weighting of between 20 to 150 per cent against the loan. This risk weighting needs to be supported by the required amount of tier 1 and total capital.

The capital requirement of 8 per cent will require a bank to hold between 1.6 per cent and 12 per cent in regulatory capital depending on the corporate credit rating. The introduction of the 'non-viability' clause post-Basel III implementation, coupled with what could generally be described as uglier prospectuses for investors, mean that this capital will cost more than it has historically.

This is bad news for the corporate who will ultimately pay for this fact in their funding margin.

As you would expect, non-bank corporates have reacted by tranching their risk. The process of matching the appropriate liability to the appropriate investor allows for a more cost efficient outcome across the total capital structure.

For recent hybrid issuers, the injection of equity risk capital has been a key component of this. The retail demand for the right names has remained strong overall, providing broking houses and equity capital markets divisions some respite.

The question, however, for regulators and the market is whether having retail investors buffering our

national financial system is a good outcome from the perspective of the economy as a whole?

There would be no apologies from APRA. This is all about protecting the taxpayer from the moral hazard that was created by 'too big to fail'. That said, ASIC does realise the inherent risks associated with this rising trend, and its warnings to investors and the advisors who are charged with their stewardship is clear. However, there are a lot of reasons for clients and advisors not to listen. Solid yields, selling fees and a lack of confidence in the equity markets ability to deliver outcomes are clear contributors and create a great deal of noise for everyone.

The result is that retail investors have gone overweight equity risk capital, overweight in duration and massively overweight on tail risk insurance to the system. However, it is unfair to only blame issuers and their advisers. Rather, investors also need to take some responsibility, given their appetite for yield and what one can only assume is a degree of comfort in looking past the risks for the right names.

The question for the RBA, APRA and ASIC is what scenario testing looks like for these investors in the event of a significant slowdown? By the end of this year, the market will have soaked up close to twice the amount of previous peak issuance in 2009. More to the point, how effective will the buffer actually be if the holders are ultimately mums and dads (especially for bank tier one capital)?

Have a look at the Spanish example around how difficult it is to make the sub debt accountable when those holders are retail investors (and voters). In addition, the sheer size of issuance will only exacerbate the pain in a market-wide shake out.

The existence of these assets is not the issue, rather the key is that they are understood and bought with the full knowledge what they are. They are not enhanced term deposits or fixed income in its truest sense. Investors need to understand the consequences of the market moving against a name where an extremely long duration position is held.

Investors also need to look past the virtues of the equity and instead take a more cynical view of what could go wrong. After all, in any capped equity type scenario, while the vast majority of the best case is priced in at issue in the form of the coupon, this cannot be said for the downside.

These assets do not need the corporate to become insolvent for a significant loss to be suffered by the investor. Rather they are there to provide meaningful cover to the corporate, to assist them in navigating through tough times and to protect the interests of the banking syndicate.

Looking at the history of non-bank issuers in the hybrid market tells us that at least one of the recent batch of issues will be tested over the next five to seven years. However, equally it teaches us that a recognisable name, coupled with an attractive coupon, can continue to find support in the retail market in the current environment. The key is that investors learn to distinguish between hybrid structures and understand their role from an issuer's perspective as this will provide context around the real risk and probability of economic loss.

CAPITAL MARKETS | **Tags:** Andrew Papageorgiou, hybrid securities, Realm Investment House
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