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Bank hybrids hit hard by $4b deal rush

by Jonathan Shapiro

Investors in bank hybrids are nursing unexpected losses that experts say were triggered by Commonwealth Bank 's mega-hybrid issue in October, which has proved too large for the market to digest. At $3 billion, CBA's PERLS VII Tier One issue was the largest ever hybrid to list on the Australian Securities Exchange.

But the notes have traded underwater since listing on October 1 and closed on Friday at $99.56 – 4.34 per cent lower than the issue price. This has dragged down the price of hybrids across the board.

The poor outcome for investors could impact future sales of bank hybrids at a time when the major banks are being ordered to bolster their capital levels amid local and international calls to make the financial system safer.

"All fingers point to CBA," Realm Investments portfolio manager Andrew Papageorgiou said. "What they have done is create technical pressures in a market that already had liquidity issues. The free float has been surprisingly large and there was a lot of selling before the hybrid went ex-dividend. That's coming from somewhere," he said.

CBA's $3 billion offer was followed in quick succession by a further $1.2 billion of deals by Challenger, Bendigo and Adelaide Bank and Macquarie, which are all trading below par. CBA had taken advantage of a relatively quiet year for issuance to price the large deal.

Mr Papageorgiou said investors' experience could make it harder for banks to sell hybrids in future. "

"They've gone and knocked Pavlov's dog over the head. The retail market had been conditioned to positive outcomes and that's been disrupted.

"It will impact the demand dynamic for the next 12 months."

Evans and Partners head of income products Michael Saba said the rush of securities had weighed on the hybrid market. "All markets are subject to supply and demand issues, and there was oversupply. That, and a negative sentiment towards banks, led buyers to hold out and sellers to bail out," he said.

Some sources said much of the weakness was the result of two brokers that have changed the classification of hybrids in their model portfolios, which resulted in forced selling among clients to re-balance their asset allocations.

Mix of debt and equity

Hybrid securities are a mix of debt and equity and are predominantly issued by the banks to form part of their capital buffers. They have proved to be popular with retail investors and self-managed superannuation funds who want to earn high yields by investing in institutions they perceive to be safe.

The fall in bank hybrid prices comes as the David Murray-led Financial System Inquiry has recommended banks hold more capital to add stability to the financial system.

"The Murray inquiry, once it's in place, will de-risk the banks, which is positive for bond and hybrid holders," Mr Saba said.

Mr Papageorgiou said his fund used the selloff as an opportunity to increase its allocation to hybrids and has gone to the maximum setting. Investors in the CBA hybrid can now earn 3.48 per cent above over the bank rate or 6.24 per cent yield as a result of the lower price, compared to the issued margin of 2.80 per cent over the bank rate, or 5.54 per cent.

While hybrids have fallen sharply in value some investors remain cautious on the securities, which they say are difficult to fully price because of the "tail-risk" associated with securities linked to the viability of issuing banks.

“As a Tier One investor there is no getting around that you are providing insurance to the financial system. There are times when we are paid well for this and times when the insurance is expensive, and we should be happy to sell," Mr Papageorgiou said.

The selloff in bank hybrids is out of sync with the broader credit markets that are becoming more comfortable that systemic risk within local and international banks is reducing. The cost of insuring against the default of a major Australian bank over five years, currently 55 basis points, is as low as it’s been since January 2008.

“The professional credit market will move ahead of the retail market on signs of credit deterioration, and so far there is no evidence of concern [among the banks]," said Mr Saba. Comparably, we do not have a deterioration of bank’s credit quality if anything balance sheets are improving," Mr Saba said.

The impact of weaker energy prices was felt on the listed market. Yields on Origin Energy’s $900 million has spiked from 5.26 per cent in mid- November to over 7 per cent.

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