Realm Investment House Update – APRA & The AT1 Market 19 April 2017

We have reduced our total AT1 exposure to somewhere near 8%.

Our decision to reduce AT1 is primarily motivated by the potential for supply side factors to provide price pressure.

Wayne Byers (APRA Head) spoke at the AFR Bank and Finance conference on the 5th of April 2017, link here http://www.apra.gov.au/Speeches/Pages/Fortis-fortuna-adiuvat-fortune-favours-the-strong.aspx.

Our key take aways:

On the regulatory front:

- The inertia created by certain European central banks (mainly German Bundesbank) and Trumps America have seen progress around global bank regulation stall.
- The fallout from this is that we will likely see multipolarity in term of how regions progress along regulating their banking systems.
- At the same time, global banks have replenished capital meaning that the relative strength of Australian banks isn't what it used to be.
- When considering how much capital we import here in Australia we have little choice but to adhere to, if not exceed, global standards.
- This becomes more difficult when standards start to become more disparate.
- This means that we need to focus on adhering to universal measures of systemic health.
- We believe the emphasis on total leverage ratios and ratings based measures such as RAC (S&P) will find increasing prominence.
- This is to be distinguished to the Risk Weighted Approach which is driven by internal ratings based models and is more open to conjecture.
- The definition of "Total Capital" under S&P RAC and the Leverage ratio incorporates a banks AT1 balance.
- **Long story short, the impact will be that more capital is required. In addition we expect that total leverage ratios will be preferred or given greater prominence versus risk weighted assets.**

What is the likely impact on the AT1 market?

This may mean that Banks can use the AT1 market to help bolster Total Capital (TC) to meet a portion of any increase in capital requirements.

While there is an ongoing debate around whether AT1's are debt or equity from an investment perspective, the reality is that under the Leverage and RAC ratio's they are essentially treated the same as equity for regulatory purposes.

For large Australian Banks it is a lot more cost effective to issue AT1 paper than it is to issue equity.

While we are not suggesting that APRA would be fine with banks making up the whole of any capital shortfall out of AT1 or, for that matter, that the market could accommodate a significant increase in size, we would expect that a portion of any new capital requirement would include an increase in the AT1 allocation.

Ultimately we believe banks will increase core equity through retained earnings and their DRP programs and perhaps some smaller rights issues to make up the lion share of any new capital requirement, however if leverage ratios and ratings based approaches are adopted as an additional standard we can expect that the AT1 market will need to do some of the lifting.

Issuers will need to take extreme care through this period and restrain themselves from a grab for capacity (a la CBAPD), however investors need to be equally aware that there is a good chance more is coming and that could see as many as a couple of benchmark issues added to each of the Big 4 over a 2 to 3 year period.

The recent rate of over-subscription would give issuers some comfort that the demand is there, however we would be pretty comfortable asserting that advisers have increased padding as scale backs have risen.

Advisers and issuers will need to be careful here, not to create an idiosyncratic supply side event that hurts the market.

For our part we believe that more size and more issues are a positive for the market over the long term, however banks will need to pay up to accommodate for a supply increase.

If the banks can get the volume away and investors can be properly compensated for this adjustment it could be a win/win. In the short to medium term though the threat of supply side pressure could see secondary stock widen to reflect the potential of new issuance.

The one wildcard for this market is being held by the ATO. The banks have been lobbying for ages to gain the benefit of deductibility on their AT1 issuance (currently it is treated as equity by the ATO and as such the coupons are not tax deductible). If this changes the banks will find a large amount of new willing buyers very quickly. Indeed the impact of the ATO allowing deductibility of tier 1 coupons would be far greater than the negative impact of higher domestic issuance, however the question remains, why would the ATO allow it?

This isn't to be confused with why *should* they? In which case one could say that creating a system where the least sophisticated investors are forced to buy the most complex instruments in any domestic corporate capital structure (a problem for ASIC) is absolutely ridiculous and almost ensures that when the time comes, there is a very low likelihood that you will actually be able to bail these investors in (A problem for APRA). However neither problem seems to make much difference at the Australian Tax Office.

Our concern for the sector is that the weakness could be idiosyncratic, e.g. will create weakness aside from actual market volatility, this kind of volatility can't be hedged, as such we have taken the view to reduce our weighting further and maintain excess capacity in the sector.

Portfolio Positioning:

Portfolio targeted VaR is as low as it has been in the life of the fund, we have also reduced risk concentration in AT1 and RMBS. With over 30% in cash and short term liquidity the portfolio is clearly maintaining a very defensive posture.

We believe that regulation will see both the AT1 markets and RMBS widen from current levels and will provide us with ample opportunity to replenish our weighting to these sectors.