REALM investment house

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Outlook for TLAC - Implications for Australian Tier 2

We have reviewed recent commentary out of APRA and added some of our own thoughts around the current debate. This informs our outlook and positioning around the Australian Tier 2 market.

Reviewing recent regulatory commentary

Speeches reviewed:

- Pat Brennan, Executive General Manager, Policy and Advice Division - 2019 Kanga News Debt Capital Markets Summit, Sydney 25 March 2019
- Wayne Byres, Chairman – Australian Financial Review Banking and Wealth Summit, Sydney 27 March 2019

"**APRA intentionally proposed a simple approach** of using existing, well-understood capital instruments, given they have been proven to work for their intended purpose – **that is they recapitalise a bank when needed**."

Realm View - Speaks to the importance of intended purpose and a clear preference for going concern vs gone concern capital.

"We have been given clear feedback in a number of submissions that the quantum of Tier 2 targeted, particularly at the higher end of the calibration range consulted on, will test the likely bounds of investor capacity. **Submissions therefore challenged whether that calibration is sustainable over time** given debt markets will continue to experience occasional periods of difficult issuance conditions."

Realm View - Clearly the market has concern around the practicalities here and fairly-so. The funding task being proposed is significant, especially in the form originally proposed. If APRA are not willing to compromise on substance or structure, they may need to consider giving issuers more time to meet the funding task. This wouldn't be inconsistent with prior rhetoric, where they are on the record as saying they are happy to run behind the global timetable on implementation.

"Some submissions also questioned whether there are lower cost options to achieve the same level of recapitalisation capacity, **accepting these options are more complex.** On the other hand, we have also received feedback from some parties that using existing, proven capital instruments is a very good idea."

Realm View - Put simply: Those looking for alternative approaches to raising LAC are "**accepting these options are more complex**" and, we need to remember that "**APRA intentionally proposed a simple approach**". Our view is that these factors have already been considered by APRA, that said they may have underestimated the strength in the response.

"Submissions offered informative perspectives on the relative merits of differing forms of LAC from a capacity and efficiency perspective. **Few, however, reflected on the differing objectives and structures that have influenced the divergence of international approaches**."

Realm View - Clearly intent is very important here, in our opinion they are saying that those looking for other versions of LAC have missed the point that APRA may have "**differing objectives"** to regulators that have approved other forms of LAC more explicitly.

"**In some jurisdictions** this has led to a stated policy approach with the express, **singular objective to never again require taxpayers to fund a bank bail-out**. On the other hand**, in other jurisdictions**, **including Australia**, the objective is **to protect the community from the potentially devastating broader impacts of financial crises**. This is done firstly by reducing the probability of failure; and **secondly by establishing sufficient recapitalisation capacity such that, should a failure or near-failure occur, the overall cost is minimised**."

Realm View - Focus clearly on meeting Australian objectives.

What are APRA's Options?

Taking a step back, let's look at the three ways you can meet TLAC.

- **Contractual subordination:** The subordination of TLAC-eligible debt instruments that are excluded is determined by the debt contract, as is the case for subordinated bonds. Explicitly expressed in the contract documentation. In the case of LAC, it is senior subordinated, or Tier-3, debt which is bail-in-able but ranks above Tier-2 debt.
- **Statutory subordination:** The subordination of debt is determined in the insolvency hierarchy as stipulated by national law. The issued debt is subordinated to excluded liabilities by the Statute and stipulated by national law.
- **Structural subordination:** The subordination of debt is established by the structure of a bank, i.e. the debt is issued by a holding company (HoldCo), while excluded bonds are issued by an operating entity (OpCo). Debt issued through a bank holding company (HoldCo) is subordinated to debt issued by the operating company (OpCo).

A lot has been made of what they do off-shore, so let's look for a second at what the dominant approaches have been.

Holdco Senior: This is structural subordination, you basically get issued bonds out of a company that is subordinated to the operating bank, and as a consequence you are subordinated. This is the approach taken by the UK, Switzerland and the US. I would say this structure is what Pat Brennan alludes to when he says "**In some jurisdictions** this has led to a stated policy approach with the express, **singular objective to never again require taxpayers to fund a bank bail-out**." These are point of resolution rather than point of non-viability instruments. They do not seem to be fit for Australian purposes.

Non-Preferred Senior: This is the approach taken by the French, the Spanish and the Dutch. It is important to note that the treatment of these securities is legislated, i.e. the subordination is stipulated by law. This is a new class of security that is loss absorbing capital, however, it does not maintain the same contractual language as subordinated debt. Once again it is arguably better suited to meet the purpose of saving taxpayers from needing to pick up the bill. You could argue that this falls into the bucket of "approach with the express, **singular objective to never again require taxpayers to fund a bank bail-out**." Once again, its not fit for APRA's purposes.

Bail in senior: Ultimately the Germans took an approach of bailing in all senior bonds. Again, in no way consistent with APRA's intent, we can reject this as a destination off the bat. If anything APRA are focussed on protecting the credit rating of Bank senior debt, not reducing it.

Contractual Instruments (Tier 2/ or Tier 3): These instruments are designed to be bailed in while the bank remains a going concern, this is the fundamental difference between these securities vs the other alternatives. No major jurisdiction is taking this approach to fund TLAC. That said it is the only kind of instrument that will lock in the higher credit rating for banks senior unsecured spreads. So even though T2/T3 is an unconventional approach in a global context it is really the only solution which matches APRA's stated intent.

Fat Tier 2 vs The Introduction of Tier 3

Creating clear and definitive lines of structural subordination in this part of a bank's capital structure is extremely complicated. Ultimately these instruments will share the same trigger point and almost identical conversion conditions ,as such creating structural subordination will not be without challenges. Ultimately T3 would need to meet the current definition of Tier 2 to be acceptable to rating agencies, so the question is what's the difference?

Given that APRA have clearly noted their preference to keep things simple its hard to see how Tier 3 will fit the bill.

The other point is that a contractual bail in instrument sitting between Tier2 and senior is not a prominent global asset class. As such arguing for tier 3 over tier 2 on the grounds that it is more sensible from a global perspective is incorrect. These securities will not be confused or rolled in with non-preferred or hold-co senior markets.

Essentially Tier 3 is an exercise of muddying the waters. The banks will look to impact the narrative to have securities framed a certain way, even though they serve the same purpose as Tier 2 and as such should arguably pay the same weighted spread as a much fatter Tier 2.

By comparison a fatter or bigger tier 2 security meets simplicity and is fit for purpose. Also fundamentally speaking a fatter tier 2 tranche should model at a tighter margin than a thinner tier 2 that is heavily subordinated to Tier 3. Our assessment is that fair value of a thicker tier 2 is only likely to sit 30 basis points wider than a hypothetical tier 3 (assuming structural subordination could in some way be prescribed – which is no simple exercise).

That said APRA might need to address the question around the potential challenges on how to fund it. Our sense is that the concerns are being overstated. No doubt the banks will need to pay the market well to deal with the requirement to increase funding, however the demand is there and global markets will be very receptive.

The size is likely to increase the relevance of the product class globally and will likely increase greater global investor engagement.

A compromise might just be that some extra time to raise the money is required to placate banks and existing holders.

Australian AT1 is an ineffective buffer

It's hard to argue that forcing the banks to hold a higher quality of capital isn't good for all of us.

Let's also consider an additional fact that in our opinion increases the importance of maintaining a higher quality of TLAC versus our global peers –

Our AT1 market is retail. Right now we have the least sophisticated clients holding the most complicated instruments in the bank capital structure, having very often been sold these instruments by the banks themselves.

Putting it even simpler, it is very likely that if push came to shove that the regulator would find it easier to bail in wholesale contractual instruments versus retail contractual instruments.

Why? Well for one, these instruments do not actually comply as capital instruments if the sellers (in this case being the banks, or the various JLM's and their brokers) give an impression that these securities are anything other than deeply subordinated regulatory capital instruments.

Put another way, how many retail investors could articulate a reasonable understanding of the what non-viability is and how these mechanisms work?

Its important to note that Tier 2 instruments do not maintain cross default provisions, nor is subordination strictly prescribed. As such investors in Australian Tier 2 or for that matter a potential T3 with contractual conditions could find themselves on the frontline just behind CET1 in a shoot out.

On that basis and given APRA's stated "purpose" of being able to protect prevailing credit ratings and stabilise the system in the event of volatility (rather than minimising impost on tax payers), how does anything other than more tier 2 make sense.

Conclusion -

In our opinion the right outcome is more tier 2 for the following reasons:

1. **APRA's focus on preserving the ratings of senior unsecured means** these notes will need to be contractual, which automatically cancels using an Internationally comparable approach like Senior non-preferred or holdco structures.

2. **APRA's focus is on simplicity.** This makes T3 problematic. Given the absence of cross-default provisions and APRA's desire to maintain flexibility, how can you create clean sequential separation, where triggers are effectively the same.

3. **APRA need to consider** how effective AT1 will be given who holds it. In other jurisdictions bailing in retail investors has been difficult. Why will Australia be any different? APRA need to focus on the quality of capital, e.g. it must be contractual.

4. **There is no meaningful contractual tier 3 market anywhere**. There is no plausible argument for Tier 3 over Tier 2 on the grounds that it will help banks fund themselves more easily. Global investors will not confuse contractual tier 3 with non-preferred senior.

5. **Fat Tier 2 won't be that much more expensive than Tier 3** and the cost will probably be neutral when one looks at tier 2 impact anyway.

6. **A bigger market will attract new interest**, size isn't necessarily a bad thing. A big tier 2 market which is consistently issuing will attract broader market support, improve liquidity and ultimately see the product perform reasonably well.

The scare mongering around Tier 2 vs Tier 3 vs Senior Non-Pref has been totally over done by banks and existing investors concerned about the fall out.

While we expect that the eventual announcement of TLAC will deliver headwinds for performance for Tier 2, we think this impact will not be as dire as is prognosticated by the bank lobby and their friends.

On our fair value and assuming for technical disruption we would see a benchmark 5 year floating fair issuance spread for a thicker major bank tier 2 sitting somewhere between 2.5 to 2.75% over 90 day bills, before eventually settling back to a level slightly above the current market.

Meanwhile our modelling around a Tier 3 instrument would see a reasonable margin (considering technical considerations) sitting between 2.1% to 2.4% over 90 day bills. Interestingly we would see fair for tier 2 where tier 3 has been issued (and allowing for technical disruption) to sit closer to 300 over.

All of this assumes that AT1 acts as an effective buffer to tier 2 or tier 3, (this cant actually be guaranteed). Where no AT1 support can be assumed fair market spreads increase materially.

If you would like to discuss any of the content feel free to contact the team.

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