



# Hybrids

Delve deeper into the  
asset class

April 2015



Changes to hybrids and evolution of the market 01

Market overview 05

What drives hybrid issuance? 08

Types of hybrid securities 10

Key structural features of hybrids 13

Conclusion 16

Case studies 18

Hybrid glossary 23

# Foreword

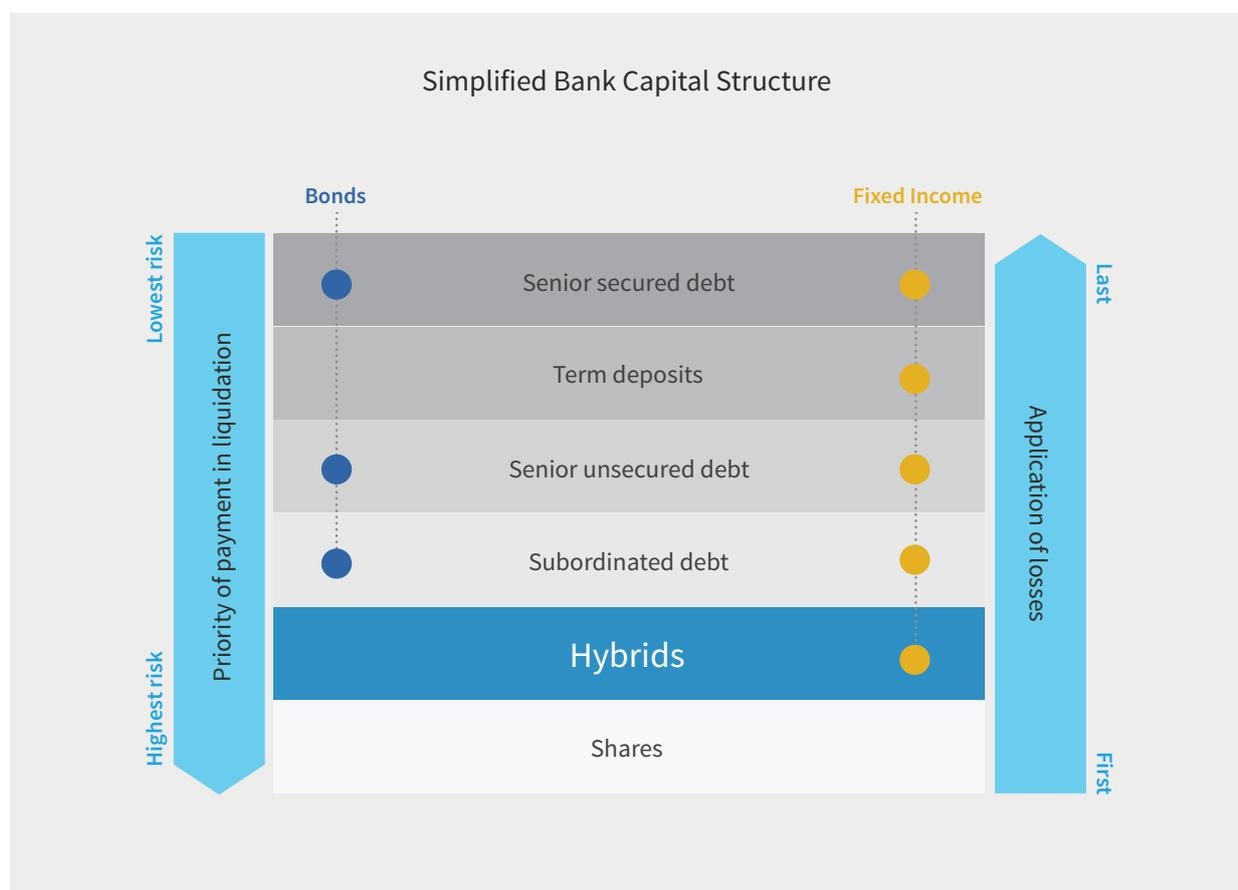
The term hybrid is a broad classification for a group of securities used by Australian companies to raise money, referred to as capital, that combine both debt and equity characteristics.

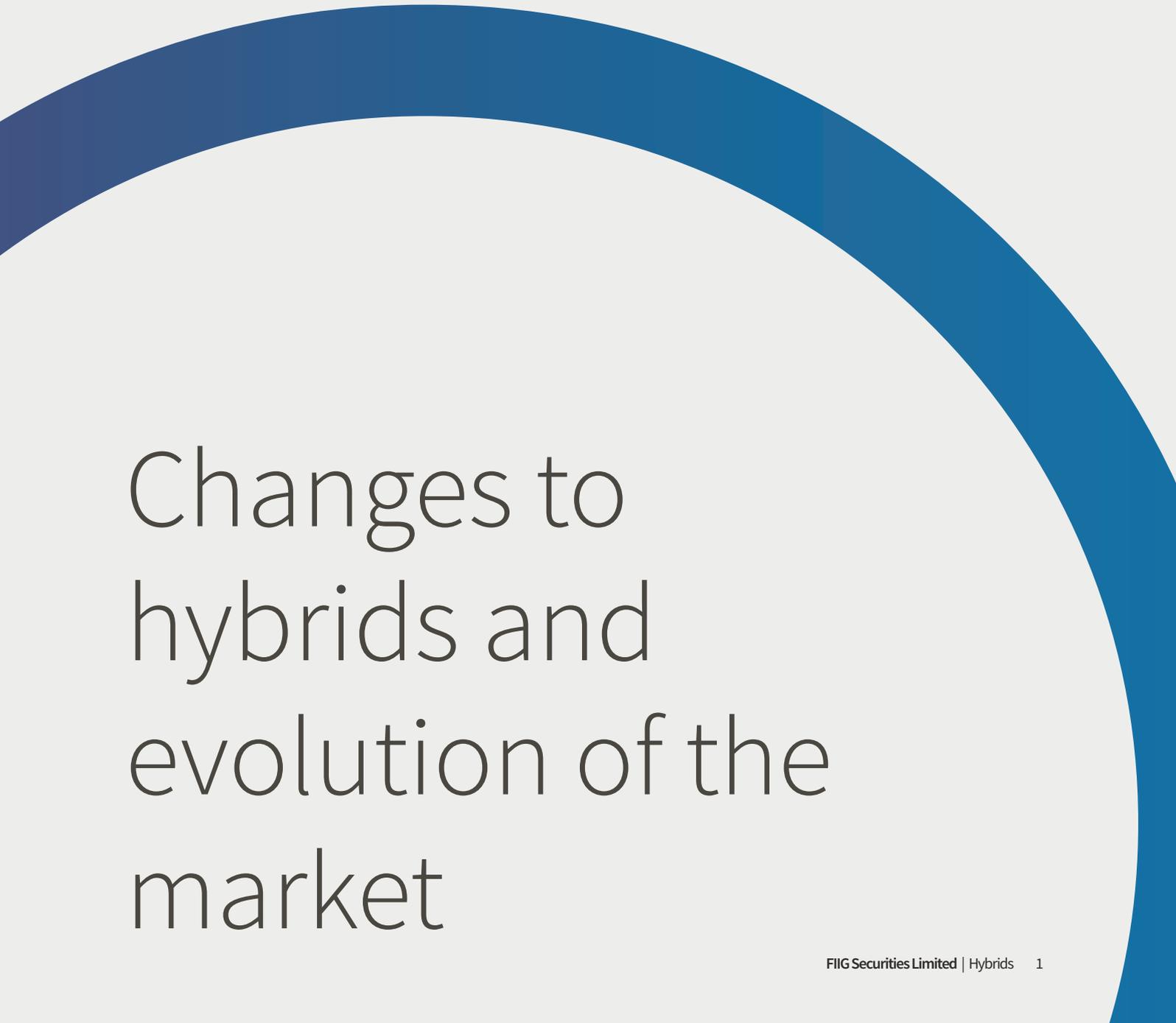
These securities sit below senior debt and above shares in the capital structure. They pay a predetermined (fixed or floating) rate of return or distribution until a certain date. Some hybrids are “non cumulative” which means that the issuer can miss distribution payments, while others are deemed “cumulative” where distributions may be deferred but must be made up at a later date. Many securities have call dates; these are a date/s prior to maturity where the issuer may have a number of options including:

- converting the hybrids into the underlying ordinary shares of the issuer
- redeeming the hybrids for cash
- leaving the hybrids outstanding

As the hybrid market has evolved in Australia, the options now sit entirely with the issuer who determines what happens to the hybrid securities in accordance with the terms and conditions set out in the initial prospectus. Therefore, unlike a share, the holder has a ‘known’ cashflow assuming no deferral and, unlike a fixed income security, the timing of final maturity and method of repayment is uncertain.

No two hybrids are the same and some are very complex. It is important to assess each security individually to weigh the risks against the return being offered.





# Changes to hybrids and evolution of the market

## Changes to hybrids

The global Basel III regulations introduced on the 1 January 2013 for banks combined with the credit rating agencies equity attribution for hybrids has resulted in new terms and conditions that increase the risk of:

- not receiving distributions
- temporary or permanent delay in the return of capital
- loss of capital in times of distress
- conversion into equity, when the company is under duress

- greater volatility in the price of the hybrid

Accordingly, new hybrids are more equity like than their predecessors.

## Evolution of the market

The evolution of the hybrid market has seen the terms and conditions of hybrid securities change with characteristics moving from debt like to equity like. While a few of the early hybrids provided investors with equity participation on the upside, recent hybrids generally only offer equity downside. This has been driven by companies trying to meet increasingly stringent and complex rules from the regulators (APRA for the banks and insurers) and the credit rating agencies (S&P, Moody's and Fitch).

Post GFC, both the regulator and credit rating agencies require companies to have more flexibility in times of distress and, to achieve this, new hybrid securities are required to have specific loss absorbing terms and conditions in their prospectuses.

This has significantly increased the complexity for investors. This means if a company is in distress, hybrid securities may absorb losses, so lose value or convert to equity at a point where the price of the equity is likely to be declining rapidly. There is a very broad range of outcomes for investors. In the worst case scenario, you could lose all of your capital and in the best case, you would receive all your distributions and face value at first call but are likely to experience increased price volatility on the way.

The newest form of regulatory capital are mandatory converting securities (MCS), also known as "bail-in" hybrids or contingent convertible securities (CoCos),

and they represent over 50% of the total ASX listed market and are likely to dominate the ASX new issues for the foreseeable future.

Since 2012 corporate issuers have stayed away from the ASX listed market as the credit ratings agencies changed their methodology and hybrids became less attractive.

The only exception is casino operator, Crown, who returned to the market in March 2015 with a \$600m floating rate note issue.

Prior to 2012, hybrids were assigned 100% equity credit, so did not contribute to the debt of the company, preserving their capital ratios and credit ratings. Under the revised method, the hybrids were given 50% equity credit and 50% debt, making them less attractive to corporate issuers. This treatment affected existing Origin, AGL and Tabcorp hybrids.

### Changes to hybrids and evolution of the market

The changes to hybrid securities provide companies with flexible loss absorbing capital. The hybrids can convert into equity or be written off in the case of another financial crisis. Australian retail investors' search for yield to fund retirement has made the ASX listed market the cheapest place to issue the new equity

like hybrids for financial institutions. This shift to equity like hybrids can be viewed in Figure 1 which shows the current composition of the ASX listed hybrid market. Note that debt like securities are shown in blue (25%) and equity like hybrids in orange (75%).

Types of ASX listed hybrids (as at the 31 March 2015)

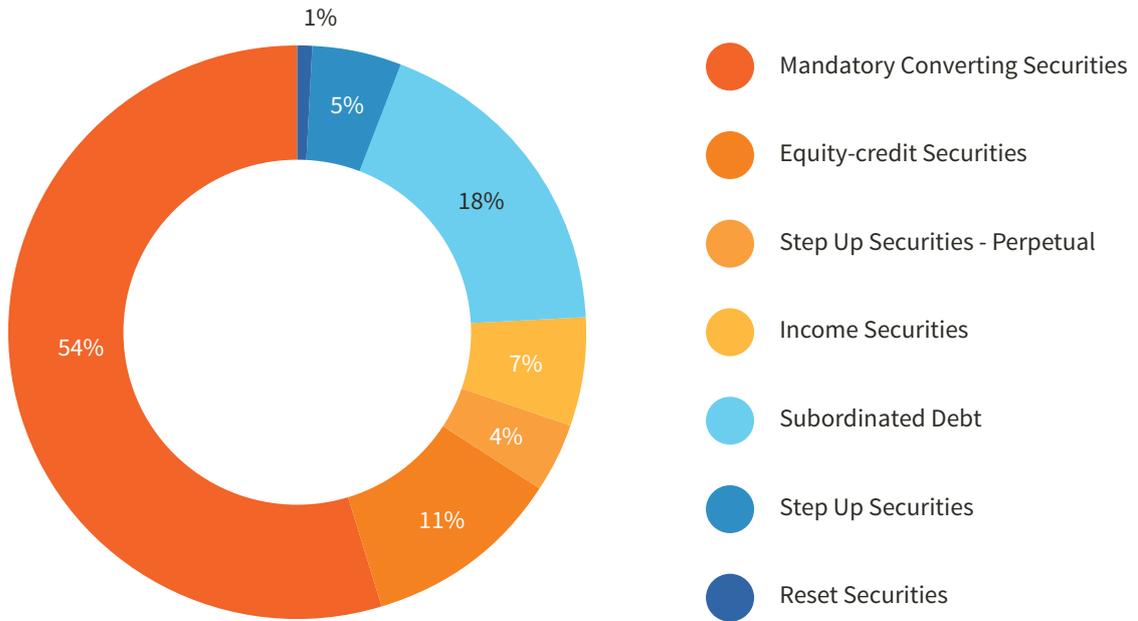


Figure 1

The ability to purchase ASX listed hybrids in small parcels, the strength of the big 4 bank brand names and the search for yield resulted in issuance of \$9.7bn for the year to 31 March 2015. In response to the increased complexity and the volumes of hybrids being purchased by retail investors, ASIC issued the following on its website:

 **Warning**

Hybrid securities are complex products. Even experienced investors will struggle to understand the risks involved in trading them. If you don't fully understand how they work, you should not invest.

Source: [www.moneysmart.gov.au/investing/complex-investments/hybrid-securities-and-notes](http://www.moneysmart.gov.au/investing/complex-investments/hybrid-securities-and-notes)

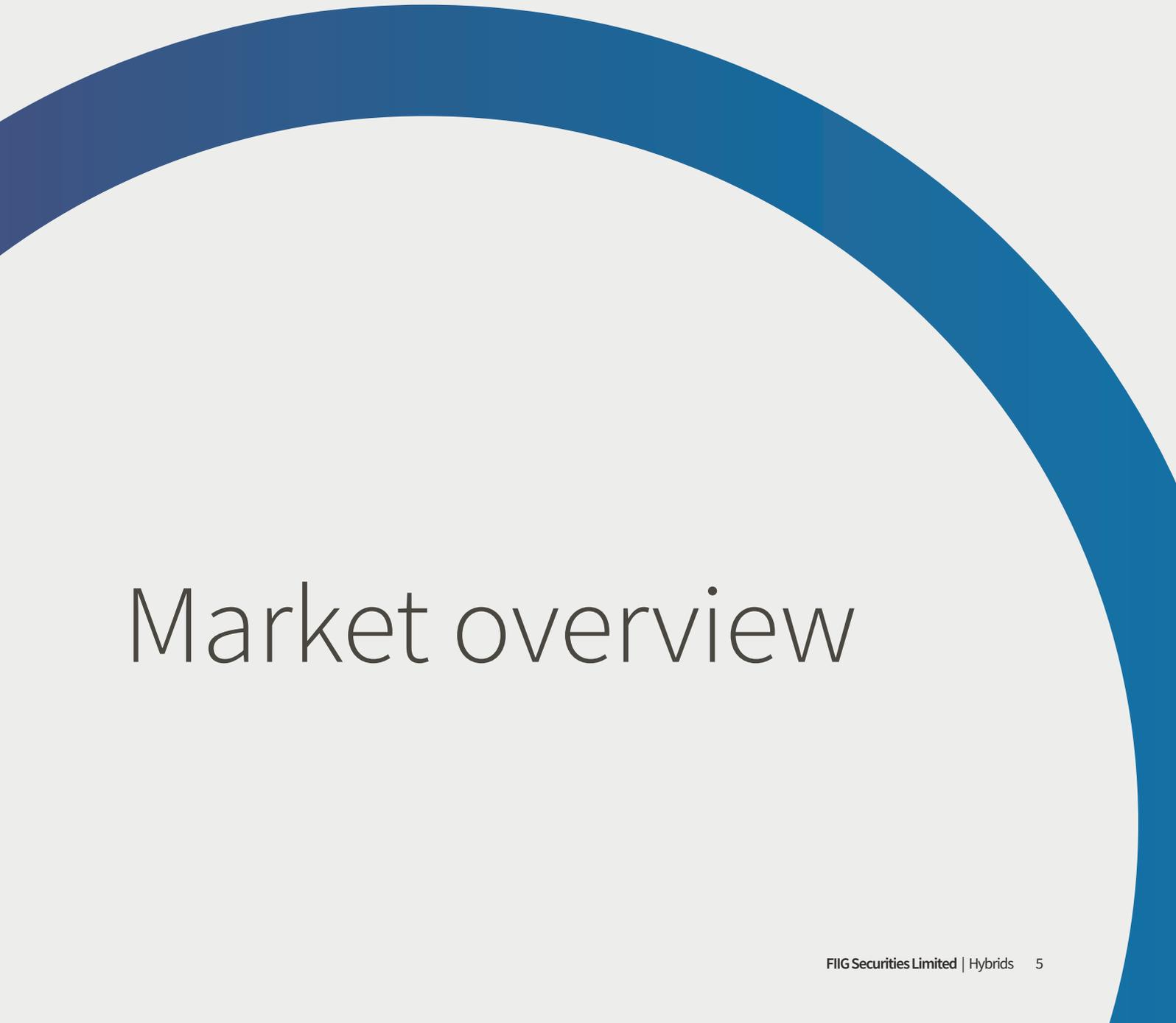
Further warnings have been issued by international regulators. The UK regulator, the Financial Conduct Authority, took a step further than ASIC, banning the sale of the new Basel III compliant hybrids, to retail investors for 12 months from 1 October 2014. The mandatory converting securities issued by Australian banks are CoCos and the FCA made the following comment about this security structure and the risk associated:

 CoCos are highly complex and the FCA believes they are unlikely to be appropriate for the mass retail market... CoCos (can be written off (in part or entirely) or converted into equity when the issuer's capital position falls, while issuers can have unusually broad discretion in relation to coupon payments making it extremely difficult for investors to assess, understand and price CoCos. At present there is little experience of how CoCos operate in practice”

Source: [www.fca.org.uk/news/fca-restricts-distribution-of-cocos-to-retail-investors](http://www.fca.org.uk/news/fca-restricts-distribution-of-cocos-to-retail-investors)

In September 2014, Standard & Poor's completed a review of Basel III hybrids that included the mandatory convertibles issued by the Australian banks and insurers. The result was a one to two notch credit rating downgrade to over 80% of hybrids globally. This reflected the ratings agency's view that these hybrids are more equity like than they previously assessed. The ratings agency's key concerns were the increased bail-in risk and non-payment of distributions on hybrid securities:

 Frameworks are generally favouring a “bail-in” approach that increases the possibility of regulatory intervention before a bank's non-viability ... to enforce loss absorption on hybrid capital instruments. This increases the likelihood of non payment via coupon deferral or loss of principal that we would consider to be defaults on these instruments. We believe that regulators expect hybrid capital instruments to absorb losses at an earlier stage in the deterioration of a bank than previously, and that the timing of regulatory intervention is now less predictable”.



# Market overview

## Market overview

The major issuers of hybrids in Australia are banks and insurers. Issuers can elect to issue hybrid securities via a listing (on the ASX), or in the over the counter (OTC) market. When choosing which market to issue hybrids, issuers will analyse the total cost of issuing in the ASX listed market versus the OTC market. They will choose the market where they can achieve the cheapest funding. This is similar to the decision to issue senior debt in the domestic AUD market versus the international bond markets in GBP, EUR or USD.

### Issuance by sector of hybrids and subordinated debt (as at 31 March 2015)

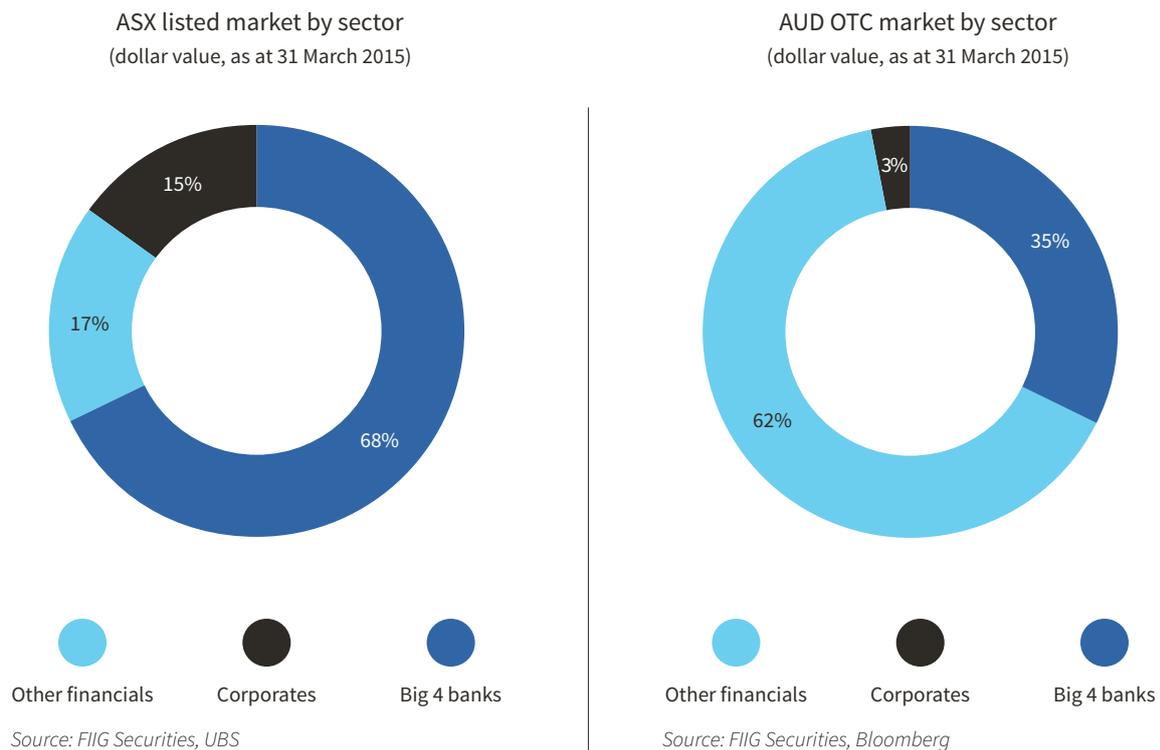


Figure 2

Figure 2 demonstrates that 85% of hybrids listed on the ASX as at 31 March 2015 were issued by financial institutions with the remaining 15% by Australian corporations. The big 4 banks dominate issuance in the ASX listed market with 68% of all hybrids. Financial institutions also dominate the OTC Australian dollar (AUD) market, however, there is a broader range of issuers including international insurers and banks.

Historically, issuers have accessed both the ASX and OTC markets, but in the last two years this trend has changed with almost all hybrid issuers choosing the ASX listed market.

The one exception to this was AMP, which issued a \$275m fixed rate hybrid at 6 month BBSW +400 basis points in March 2015.

Debt by capital structure in the ASX and OTC markets (as at 31 March 2015)

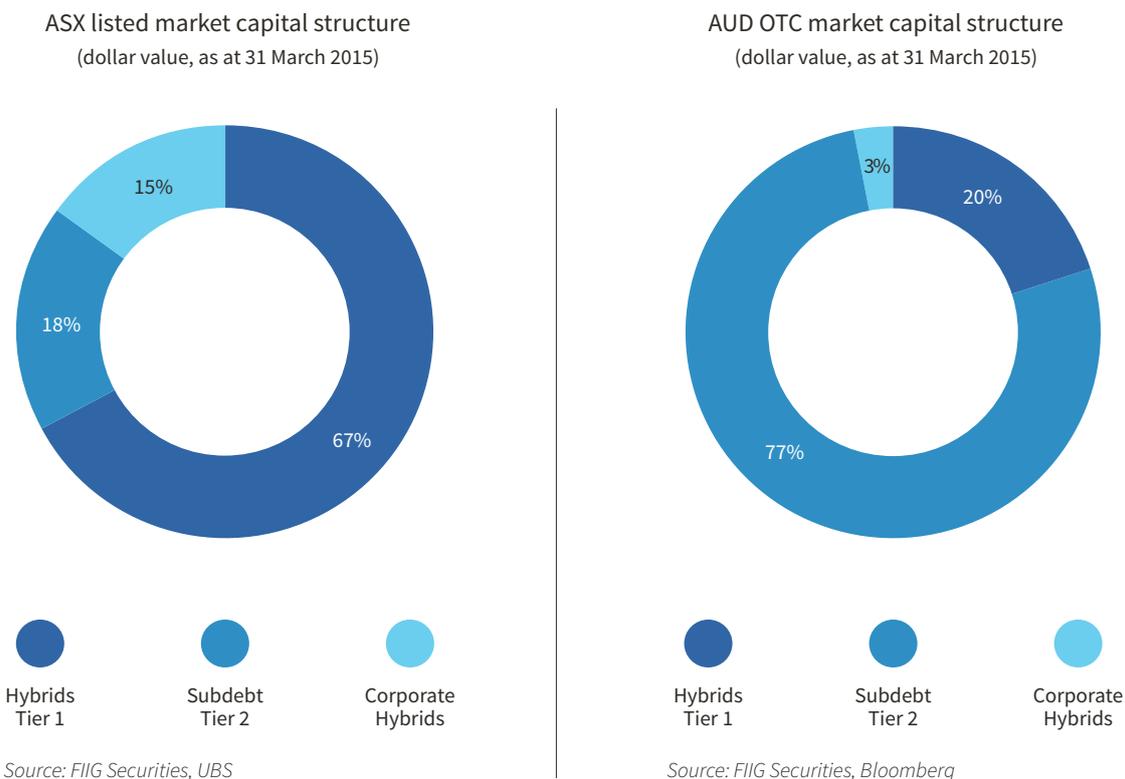


Figure 3

The polarisation of the two markets has been driven by the different investor types’ tolerance and pricing of risk:

**ASX listed market**

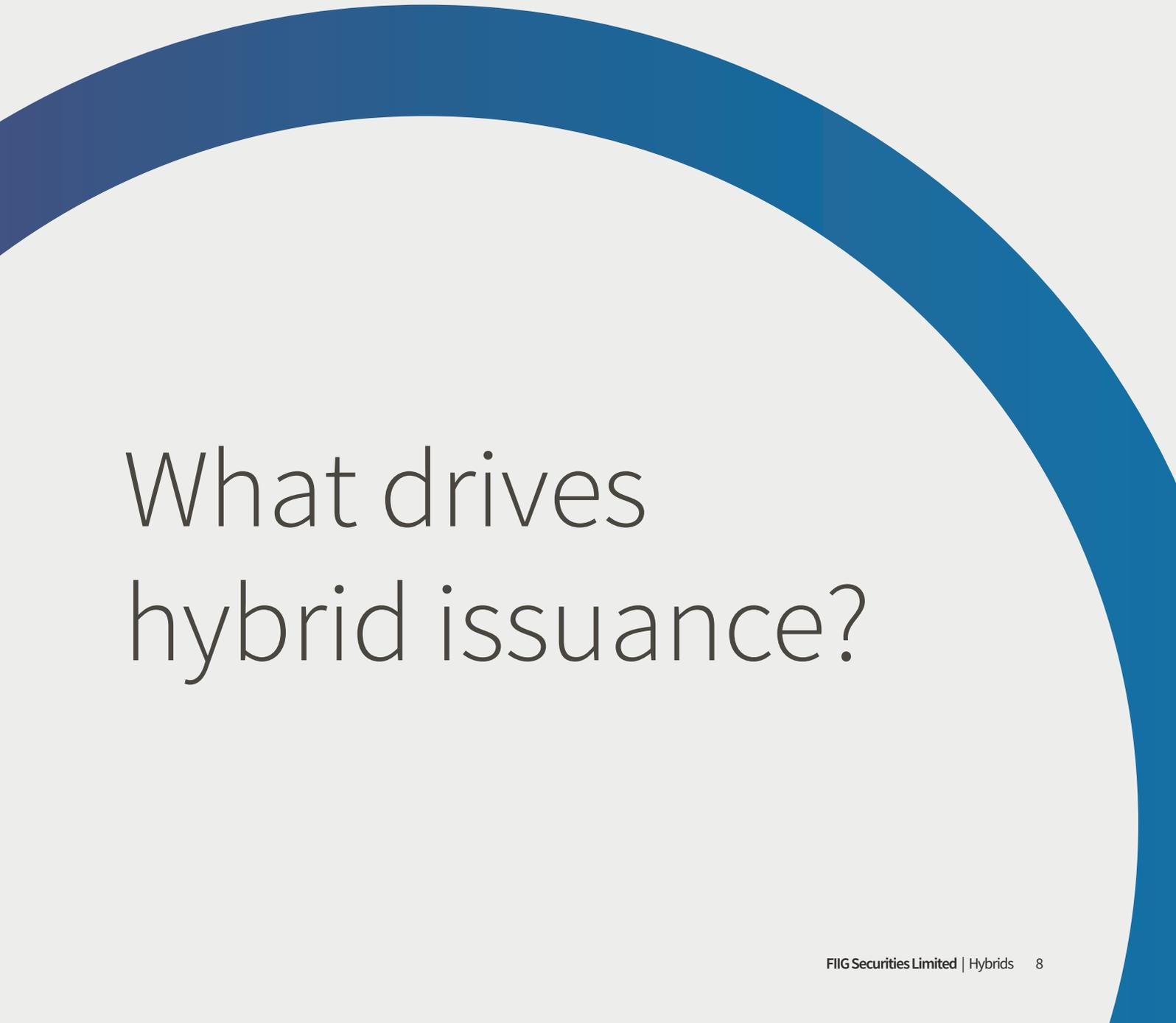
The ASX is a predominately retail investor market and this group has been seeking yield to fund retirement. Investors do not have the insight into the broader OTC market and are less sure about pricing of risk, taking comfort in the fact the issuers are well known banks. In most cases demand has been strong and the banks have increased the size of the issue to fulfil demand. For example the CBA PERLS VII was upsized from A\$2bn to A\$3bn (see the case study).

More recent evidence suggests investors are becoming more aware of the risks they are taking with the CBAPD hybrids trading below par for long periods.

**OTC market**

The OTC market is an institutional market. Institutional investors in Australia have not been willing to buy the new equity style hybrids due to the higher risk of the hybrids and the low returns. However, this changed with the recent AMP issue. Generally, these investors prefer the lower risk subordinated debt issues with a known maturity and greater income certainty and have been active in both the listed and OTC markets. Subordinated debt sits above hybrids in the capital structure.

The total size of the hybrid and subordinated debt markets at 31 March 2015 was \$41.4bn in the ASX market versus \$11.1bn in the OTC AUD market, although the global OTC hybrid and subordinated debt market is significantly larger.



# What drives hybrid issuance?

### 01 Loss absorption and diversification of funding

Hybrids provide regulatory capital for banks and insurers to meet the minimum capital required by the regulator (APRA) to support the institutions in times of financial distress. The purpose of hybrids is to act as a loss absorption tool, so they are higher risk instruments and investors would expect to receive greater returns than securities issued higher in the capital structure (e.g. senior bonds) to compensate for the increased risk of loss.

They also diversify funding, with Australian retail investors being the main holders of ASX listed hybrids. The OTC market also diversifies funding but with less reporting requirements for the company. Investors in this market are mostly international and domestic institutional investors.

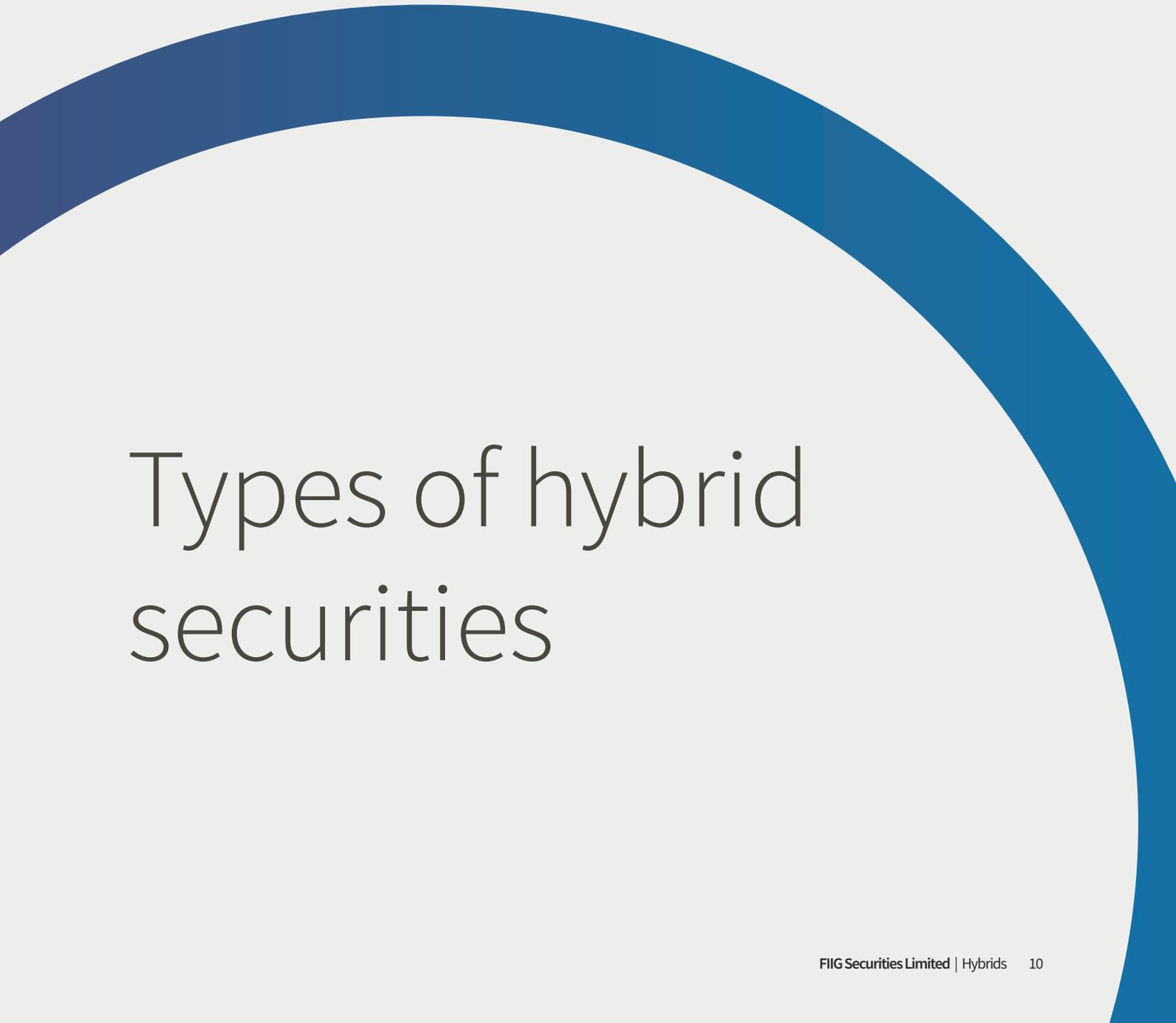
### 02 Regulatory framework

The driver of the changes to hybrid structures has been regulation. The most recent changes are due to the implementation of Basel III, the global prudential regulatory framework for banks, which requires greater financial flexibility in the wake of the GFC. In Australia, Basel III is implemented by APRA, as the regulator of banks and insurers, to ensure the viability of Australia's financial system. Basel III came into force on 1 January 2013 for banks. Regulation of insurers is expected to follow the banks.

### 03 The value of equity credit for corporations

Prior to 2012, when the ratings agency rules changed, issuers could receive 100% "equity credit" status for their hybrid issues. If issues are considered equity, they support the companies' debt ratios. A revision of the criteria saw the amount of equity credit cut to 50% reducing the value of hybrids for corporate issuers. This coupled with cheap bank funding has resulted in just one new corporate hybrid issued since September 2012, the Crown notes (CNWHB).

The higher an issuer's credit rating, the cheaper it is for them to issue debt. In some cases, if the hybrids did not meet the "equity credit" hurdle, and were instead considered debt, the companies may have faced group credit rating downgrades. This would impact the cost and ability to tap the market for additional debt funding. Similarly, the rating agencies reviewed their criteria for providing equity credit for hybrids post the GFC and they require increased flexibility for the issuers. Equity credit also means that the hybrid provides support for the companies' senior credit rating by creating an increased financial cushion.



# Types of hybrid securities

Each hybrid is different and investors should analyse the terms of each security in the prospectus. The list below details the most recent generation of hybrids then works back to describe older variants:

**01** Mandatory converting securities (also known as “bail-in” hybrids, Additional Tier 1 (AT1) or contingent convertible securities (CoCos))

These hybrids qualify as regulatory capital called Additional Tier 1 (AT1) and are typically preference shares issued by banks and insurers. They are mandatorily convertible into an issuer’s ordinary shares after a defined period, assuming certain conditions. Typically they have an issuer call option to redeem for cash (or convert to shares) two years before mandatory conversion. This call is subject to APRA’s approval and is less likely to be allowed in times of financial difficulty. Basel III requirements include:

- o a regulatory capital trigger event where the bank’s capital requirements are not met or
- o if APRA decides the bank is no longer viable.

In either instance, the securities will convert into ordinary shares with a cap on the number of shares an investor receives. The intent is for the investor to absorb some of the losses (i.e. lose capital) when the financial institution is in distress. This makes the latest round (and future) issues of bank hybrids more and more equity like.

A summary of the key structural features of the CBA PERLS VII (CBAPD) are set out below (also see full case study):

Key structural features	Term	Description
Call Date	At 8 years on 15 December 2022	CBA has option to redeem with APRA's approval
Mandatory conversion date	At 10 years on 15 December 2024 and then each distribution payment date	Mandatory conversion subject to share price hurdles
Regulatory triggers	Capital ratio trigger	If the CET1 below 5.125% then will convert into shares with a max of 6.3601. May receive less than \$100 of shares.
	Non-viability trigger	If APRA deems non-viable then will convert into shares with a max of 6.3601. May receive less than \$100 of shares.

**02** Equity credit securities

These hybrids are issued by corporate issuers in order to receive equity credit from the credit rating agencies. Their legal form can be preference shares or long dated subordinated debt ranging from 30 to 60 years until final maturity. They have non-cumulative or deferrable distributions.

The issuer will typically have multiple call dates that are accompanied by small step ups of up to 0.25% that are not a large enough incentive for the issuer to call. The key driver for the issuer to call is the loss of equity credit on call dates. This is a difficult metric for investors to assess as it will be dependent on the rating agencies (each has different rules and they are subject to change) and the company’s ability to refinance at the time. Investors should not assume the company will call on the first call date and they may hold a security with a final legal maturity of over 30 years.

An example of an equity credit security is the Woolworths (WOWHC) which is a hybrid with a 35 year final maturity with an issuer call at five years. The key issues that will influence Woolworth’s decision are the loss of equity credit from the ratings agency, their reputation in the hybrid market and the cost and ability to refinance. For another example see the Crown case study.

**03** Subordinated debt

These securities are regulatory capital for the banks and insurers and typically have a 10nc5 structure (referred to as a 10 non call 5). The final maturity is 10 years and the first issuer call is at five years. In old style subordinated debt (sub debt) securities, the call date was accompanied by a step up in the distribution of 1% to 2%, however, Basel III requirements mean that new style subordinated debt has no step up in interest payment and will include a non-viability trigger.

The key structural difference between subordinated debt and hybrids are that subordinated debt:

- o interest cannot be deferred
- o ranks ahead of hybrids in the capital structure
- o has a known maturity date

Two ASX listed examples of subordinated debt 10nc5s are: the Westpac WBCHB with a non-viability trigger, but no step up and the NAB NABHBs with no regulatory triggers and no step up. Both of these have a final maturity of 10 years providing investors with a known date that capital will be returned to them.

OTC examples of subordinated debt are ANZ's three 10nc5s issues all without step ups: the sub debt maturing in July 2022 and June 2023 do not have non-viability triggers and the June 2024 does have the non-viability clause as it was issued after the 1 January 2013.

These securities are subordinated debt and they are not technically considered hybrids. They have been included for completeness as they are often identified as hybrids in Australian analysis.

### 04 Reset securities

There is only one reset security remaining on issue - the IAG RES (IANG). It is unlikely that any new reset securities will be issued as they don't meet the Basel III rules.

These hybrids were perpetual and typically had a fixed rate for a defined term, normally five years. At the end of the five year period, the hybrids were remarketed where they could be redeemed, converted or a new fixed coupon rate set. These decisions were at both the investor, and issuer's election, or a combination of the two.

### 05 Step up securities (old style)

There are two major bank step up securities remaining in the ASX listed market: the CBA PERLS III (PCAPA) and Westpac Trusts (WCTPA) and both are likely to be called at the first call date. It is unlikely any step up securities will be issued as they do not comply with Basel III or rating agency requirements for equity credit.

These hybrids are technically perpetual and generally have an issuer call option at five years. At the first call date the interest rate will step up, typically by 1% to 2%, and the issuer can elect to call and redeem the hybrids or leave on issue at the new stepped up interest rate. The size of the step up is very important, the larger the step up the more incentive the company has to redeem the hybrids.

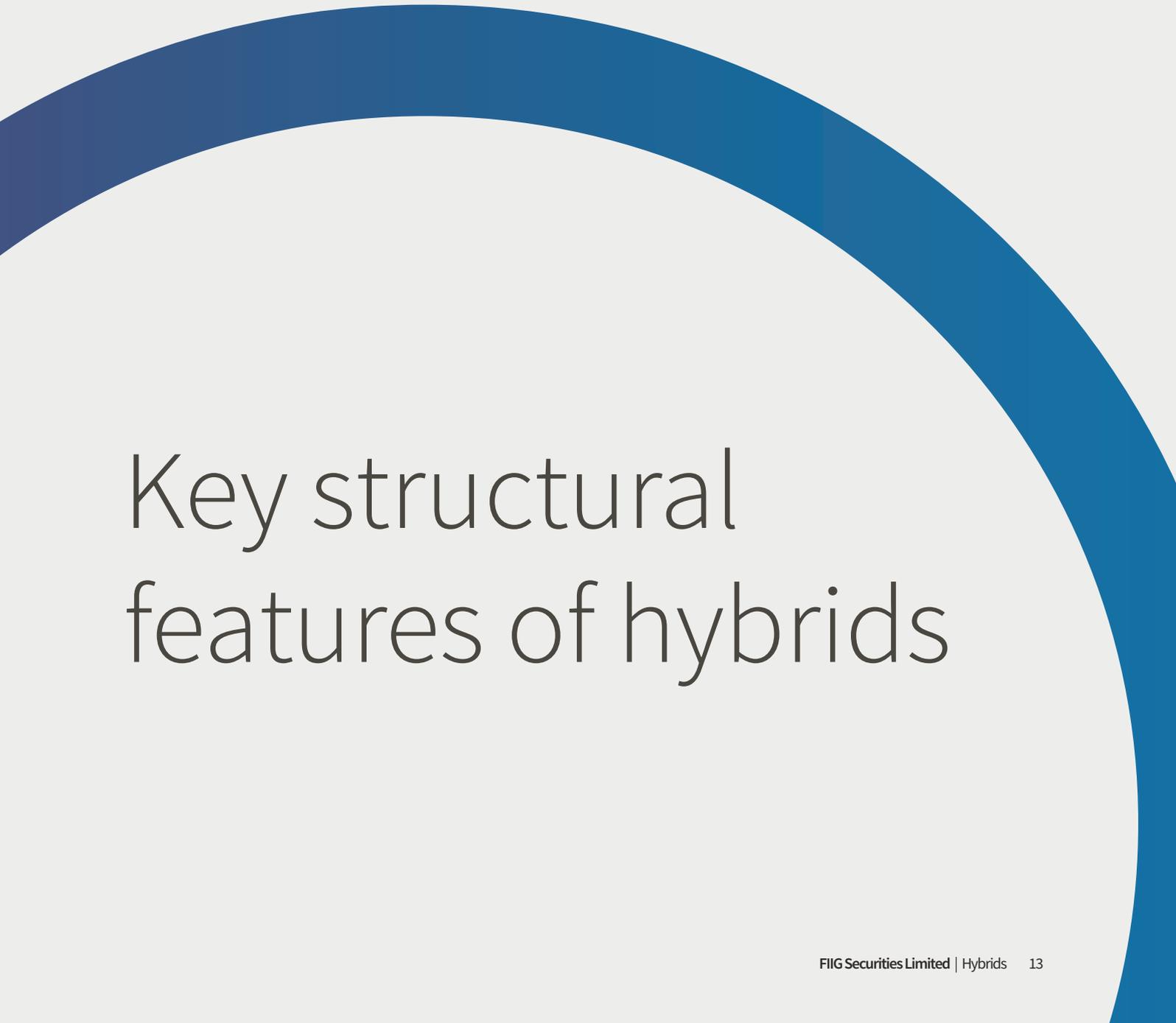
In the OTC market, these include the following AUD issues: NAB Caps 2016, AXA SA 2016 and Swiss Re 2017 and foreign currency issues: CBA USD 2016 and NAB CAPS GBP 2018. All these securities are expected to be called at the first call date.

If the issuer does not call the security and it steps up, it effectively becomes a perpetual security usually resulting in a lower price. As at 31 March 2015, there are five stepped up hybrids on the ASX: Multiplex SITES (MXUPA), Elders hybrid (ELDPA), Nufarm Step-up Securities (NFNG), Ramsey CARES (RHCPA) and Seven Telys 4 (SVWPA).

### 06 Income securities (perpetual floating rate notes)

There are four remaining income securities listed on the ASX: NAB IS (NABHA), Bendigo Bank Notes (BENHB), Macquarie Bank IS (MBLHB) and Suncorp IS (SKBHB). These were the first generation of hybrids and there are unlikely to be any new issues due to the capital losses experienced by investors and changes to regulations.

These hybrids have no step up and despite the existence of an issuer call option, were not sold with the intention of being called unless they could be replaced with cheaper funding. They also have no maturity date and are technically perpetual. See the case study on the Suncorp IS (SKBHB).



# Key structural features of hybrids

Hybrids can be complex securities with a variety of structural features. The following tables outline some of the key terms of hybrids currently on issue in Australia.

Term	Types	Investor considerations
Distributions/ Dividends/ Coupons	Cumulative deferrable	Strong preference for cumulative distributions. How long can the company defer distributions? Is there a dividend stopper preventing payments on ordinary shares and for how long?
	Non- cumulative	Often referred to as discretionary. If the company does not pay distributions they are unlikely to be made up in the future. Check for non-payment required by regulator. Investors should look for a strong dividend stopper as they are reliant on ordinary equity holders being upset at loss of dividends to incentivise the issuer to pay hybrid distributions
	Franked versus unfranked	Can the investor use the franking credits? Investors should look at the grossed up distribution of securities to compare relative value between issues. Investors should be aware that franked payments are delayed.
Put/Call/ Conversion dates	Investor right to convert or get money back (Put)	Increasingly rare and only older style hybrids have this feature. Provides investors with the ability to require the issuer to pay back their capital on the put date.
	Issuer right to redeem (Call)	A common term which depends on economic conditions, regulatory and rating agency requirements and the cost to replace the hybrid capital at the time of the call date. Financial institutions need approval from APRA to call and redeem the securities. Companies do not need to seek credit rating agency approval but may check with the agencies in regard to the possible credit rating implications. Investors also need to consider the companies' reputation, regulatory requirements and rating agency equity credit rules to determine the likelihood of meeting a first call. This is a complex decision matrix and investors should not assume they will get their money back on the first call date.
	Issuer right to convert into equity (Conversion)	A common term; companies are more likely to use this when it is difficult to find replacement capital. The level of the share price is the second factor as companies do not like to dilute shareholders when share prices are low. This is at the companies' option and receiving shares may not suit investors.
Mandatory conversion	Subject to share price hurdles	Securities will be automatically converted into shares if the share price is above a nominated hurdle. Receiving shares may not suit investors who will have to sell them to get their capital back which can be more or less than face value of the hybrid depending on share price movements.
Ranking on liquidation	Subordinated debt	This places investors above ordinary equity and preference shares. Subordinated debt must be repaid at final legal maturity. There are hybrids that have the legal form of subordinated debt but may have additional equity like features. Investors should be aware of where they rank in liquidation.
	Preference shares	This places investors above ordinary equity only.
	Convert into equity	Many hybrids convert to ordinary equity on liquidation. This is the most risky position and increases the chances of investors losing some or all of their capital.
Maturity dates	Dated	When is the final maturity date? This is the last date when the company has to pay back the face value. Investors should be aware this can be as long as 30 to 60 years.
	Perpetual	Is the security perpetual? A perpetual security has no maturity date and means the company never has to pay back investors. The issuer may have options to call the securities but theoretically may never do so. Investors must decide to sell the hybrids to recoup capital.

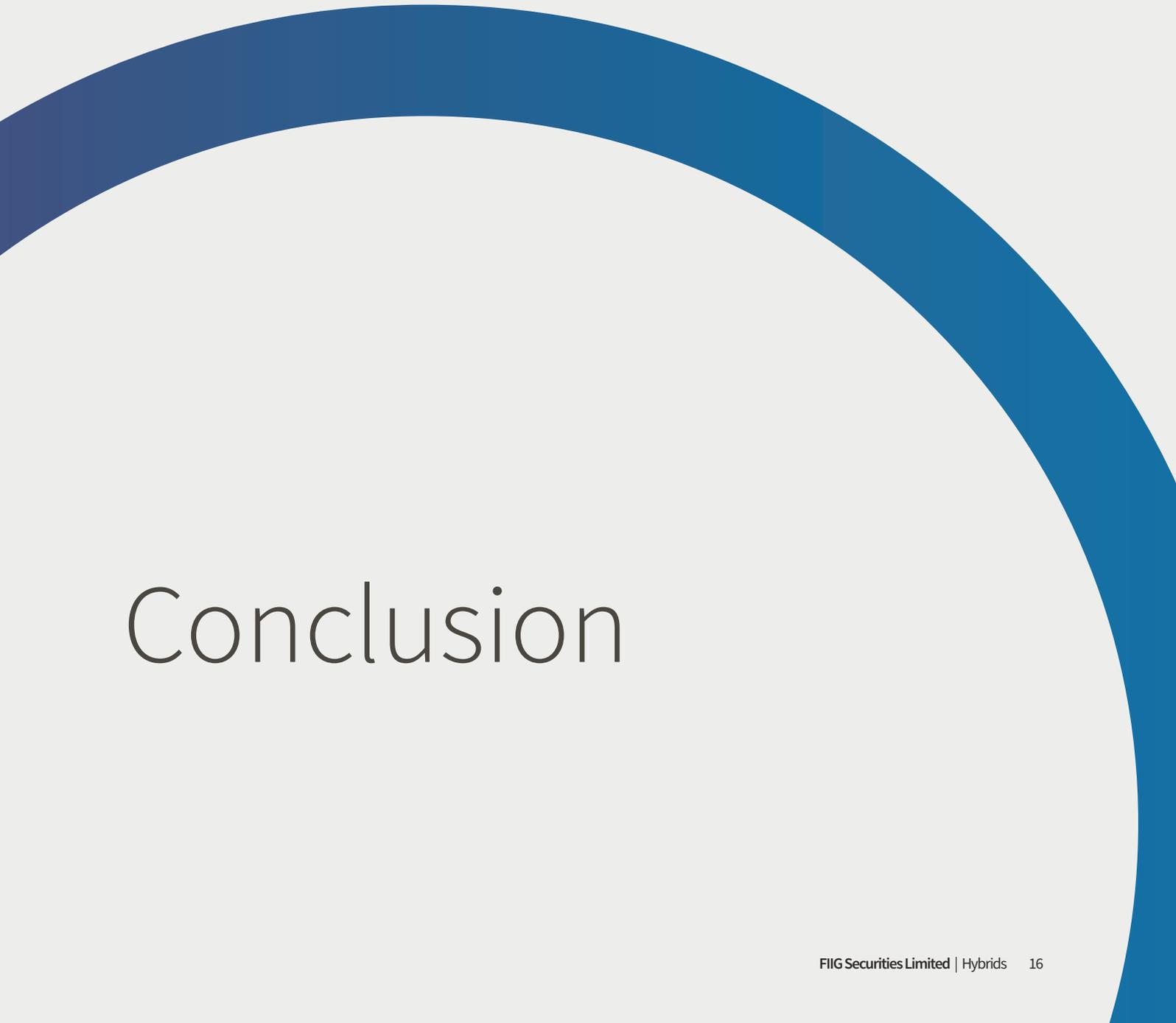
## Key structural features of hybrids

Term	Types	Investor considerations
Ratings agency	Equity credit	The loss of equity credit is a key reason many companies call their securities. This is a complex area for investors as each rating agency has different rules. Investors should not assume loss of equity credit will automatically result in redemption as the financial position of the company and the ability to refinance will be major factors.
Regulatory triggers	Capital trigger	APRA requires that when a specific capital trigger is breached these hybrids convert to equity. They are designed to help the financial institution survive by providing additional loss absorbing capital. Should conversion occur, it is likely investors would lose capital, with the possibility of a 100% loss.
	Non-viability trigger	This is a new untested feature designed by APRA to provide loss absorbing capital for the financial institution where it is non-viable or requires public funds or support to survive. This could result in a loss of capital, with the possibility of a 100% loss.

### Franking

ASX listed hybrids can offer franking credits whereas OTC hybrids do not. Hybrid distributions are quoted on a grossed up basis – this means the stated yield includes the full value of franking credits. For example, the recent CBA PERLS VII hybrid has a discretionary

distribution of BBSW + 2.8% p.a. The first quarterly payment in December 2014 will pay investors a total yield including franking of 5.5% also referred to as the gross yield. The actual cash yield or net yield is 3.85% and franking is 1.65%.



# Conclusion

## Conclusion

New regulations mean the current generation of hybrids are likely to be with us for some time. Yield seeking investors will increasingly have to get used to the new “equity” hybrid world and the increased price volatility.

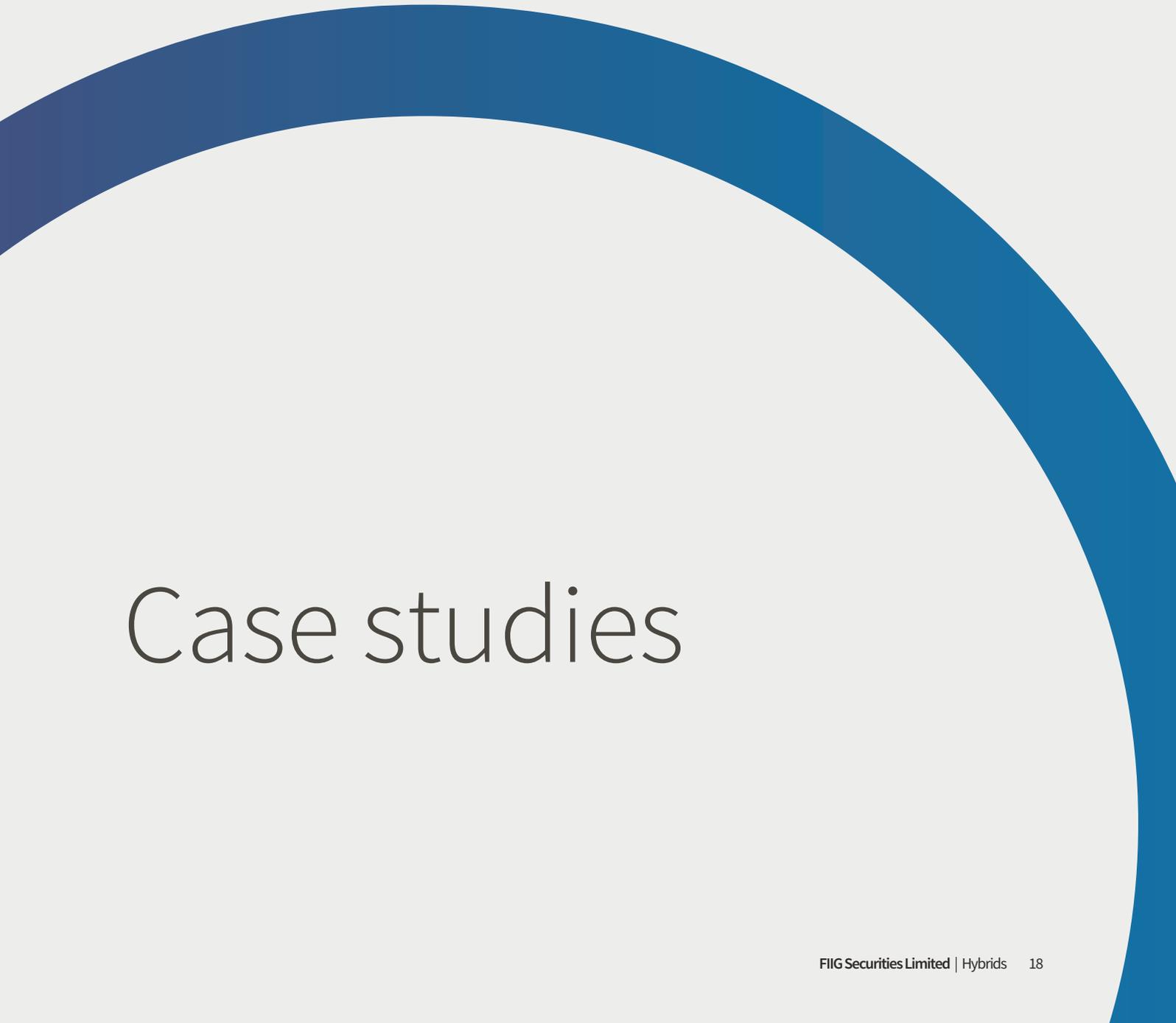
While we have highlighted the risks, the big 4 banks have historically exercised their calls at first opportunity. However, past experience does not dictate future actions. Assessing the likelihood that the hybrids will be called means taking a view on:

- The ability and cost to issue replacement hybrids at call

- Regulators approving the call based on capital adequacy levels

Understanding the structural and credit risk is key to ensuring you receive an adequate return for the risk you are taking.





# Case studies

## CBA PERLS VII Mandatory Convertible: an example of a new “bail-in” hybrid

The seventh PERLS issue from CBA that priced in August 2014, gave investors an unpleasant and unexpected equity-like price fall on listing. Instead of listing at face value, the Perls VII listed at \$97.10. As at 31 October 2014, the price remains below par at \$97.50. The PERLS VII raised \$3bn of Basel III regulatory capital for CBA replacing the \$2bn PERLS V that had their first call date on the 31 October 2014. Over \$1.3bn of PERLS V rolled over into PERLS VII.

The PERLS VII are an example of the new Basel III compliant hybrids that have been designed to meet APRA requirements to provide loss absorbing capital for CBA. APRA includes the PERLS VII as Additional Tier 1 (AT1) in regulatory capital calculations with the intention that these hybrids will support the bank as a going concern in times of distress, meaning they may be used to absorb losses while the Bank remains solvent and continues to operate.

Holders of the PERLS VII, are taking more equity risk than previous PERLS issues.

Key features are outlined below:

**Perpetual security** with an issuer call in 8 years, subject to APRA approval, followed by mandatory conversion into ordinary CBA shares in 10 years (if not previously called) subject to share price hurdles: the share price must be above \$39-\$44 at the time of conversion. If the PERLS VII are unable to convert they will remain on issue until the share price hurdle is met on a later distribution date at which time they will mandatorily convert.

**Discretionary distribution** of BBSW + 2.8% p.a. including franking. For the first quarterly payment in December 2014 provides investors with a cash yield of 3.85% p.a. or total yield including franking of 5.5% p.a.

**Distributions are at the issuer’s absolute discretion** and restrictions on payments may begin to apply where APRA’s definition of equity capital, the Common Equity Tier 1 ratio (CET1), falls below 8%. At that point, CBA will be restricted to distributing 60% of earnings as dividends, distributions on PERLS VII and bonuses to staff (this restriction increases as the CET1 ratio falls further). CBA’s CET1 level as at June 2014 was 9.3% and the dividend payout ratio is 75% suggesting equity dividends will be the first to get cut. PERLS VII distributions preference over equity dividends are protected by an ordinary equity dividend stopper.

**Contains regulatory triggers** to convert the PERLS VII into equity,

- if CET1 falls below 5.125% (Capital Trigger), or
- if CBA becomes ‘non-viable’ without conversion or requires a public sector injection of capital

Both of these triggers are intended to provide a cushion for CBA if it is in distress. As the share price is likely to be depressed, the PERLS VII holder may receive less than \$100 of shares due to the dilution cap, set at a CBA share price of circa \$15.75 by virtue of the maximum conversion number mechanism, meaning conversion at a share price below \$15.75 will result in capital losses.

The PERLS VII are a new style hybrid and have complex terms with the regulator requiring the securities to be loss absorbing. For investors in PERLS VII this makes these hybrids more equity like than the older style mandatory convertibles and reset securities previously issued by the banks. This regulatory structuring and equity nature is likely to result in higher price volatility for the PERLS VII and investors should watch the capital ratios of the banks closely for any signs of deterioration.

## Suncorp Metway (Suncorp): an example of a buyback of income securities substantially below \$100 face value

In June 2014 Suncorp offered to buy back their income securities, the Floating Rate Capital Notes (SBKHB), at a 20% discount to their face value of \$100, resulting in investors who purchased them when they were first issued losing 20% of their capital. Despite being less than the face value, the \$80 Suncorp offered per security was a premium over the \$73 investors could have sold them for on the ASX the previous business day. A majority 58% of the notes were sold back to Suncorp leaving just \$136m outstanding with the remaining hybrids likely to be outstanding for years given they are very cheap funding for Suncorp.

Suncorp issued Floating Rate Capital Notes in December 1998 as a perpetual security that never had to be repaid. The SBKHB paid quarterly floating interest of 0.75% above BBSW and traded at a substantial discount to face value of \$100 due to an increase in the credit margin investors required to hold a perpetual Suncorp credit. For example, Suncorp's mandatory convertible (SUNPE) issued in May 2014 pays 3.40% above BBSW for a security with a similar ranking and an expected six year term.

The buy-back has potential implications for the other three perpetual income securities still trading, the Bendigo and Adelaide Bank Notes (BENHB), Macquarie Bank Income Securities (MBLHB) and the NAB Income Securities (NABHA).

All four securities were issued pre-Basel III regulations on bank capital adequacy and thus do not fully comply with new regulations to contribute to capital. However, there

are complex transition arrangements in place where non-compliant securities may still receive partial weighting towards capital ratios out to 31 December 2021.

While it's important for the banks to hold enough capital to meet regulatory requirements the trade off in regards to repaying these securities is the higher cost of funding needed to replace them.

The success of the \$80 offer by Suncorp would give some confidence to the other banks that they could do the same with their securities. However, NAB's issue, at \$2bn is the largest of the four and is roughly the same cost for the bank as term deposits with the benefit of possibly still contributing to its capital, no maturity date and discretionary coupons.

To assess the likelihood of repayment for other perpetual income securities, investors need to consider:

- 01 Do the securities still contribute to regulatory capital?
- 02 What is the cost of replacement funding – are existing hybrids cheap funding for the bank?
- 03 Is there anything to trigger capital repayment?

In contrast, bonds have the certainty of a firm maturity date where the company must repay investors, thus are lower risk than hybrids that usually have soft maturity dates or are perpetual investments that never have to be repaid.

## Crown Group Finance Limited (Crown): an example of an equity credit security

The Crown notes issued in 2012 are an example of the complexity of the new style hybrid securities. They were created to meet the requirements of multiple ratings agencies to provide equity credit to support Crown's senior credit rating which was under pressure at the time. The structural features required to achieve equity credit result in a weakened position for the investor.

Key features are outlined below:

- 60nc6, the first call date has no step up. The step up does not occur until 2038 and is 1%.
- the coupon is BBSW + 5% p.a., deferrable at the issuer's discretion, subject to a dividend stopper. In the case of mandatory deferral, it would be subject to a dividend pusher. This is a first; it is not the standard hard stopper on ordinary dividends but a pusher which is much weaker. If Crown pays an ordinary dividend while interest is mandatorily deferred they are required to pay the interest within five years. The result is ordinary equity payments made in priority to the notes. This is not a good precedent for hybrid investors.

- mandatory deferral of interest if financial ratios are not met (Leverage ratio > 5.0x and Interest Cover Ratio < 2.5x)
- no investor redemption right
- no investor call on change of control but investors receive a 5% margin step up
- not convertible into ordinary equity

In the worst case scenario, investors potentially own a 60 year security where the interest is deferrable for five years. This is the equity like nature or the equity downside risk. At the positive end of the spectrum, investors may be purchasing a security that is redeemed in six years and always pays its interest. In order to assess these two options (and the multitude of other outcomes in between) investors need to assess the future viability of Crown and the rating agency requirements.

**Goodman Australia Industrial Fund Bond Issuer Pty Ltd (Goodman):** an example of a step up security where the investor was not given the option of repayment and instead offered a coercive exchange.

At issue, investors often expect the issuer to repay the hybrid at the first call date. However, given the complex structure of the various hybrids there are many avenues available to companies to defer repayment.

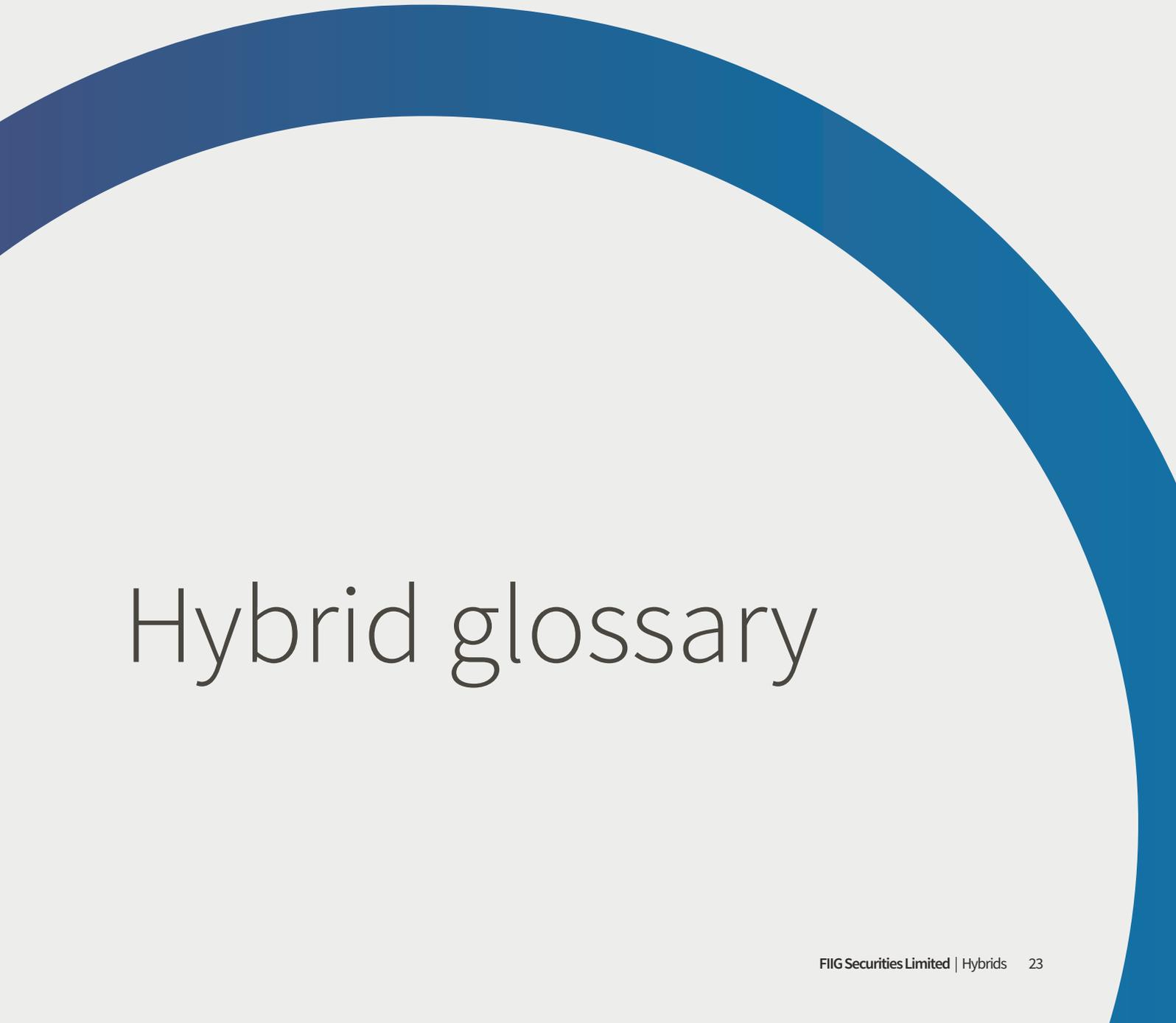
In August 2012, the Goodman Group exercised one such option. The Company announced an offer to exchange its hybrid, Goodman PLUS (GMPPA), for a new equity like hybrid security, disappointing those investors who were expecting them to repay it in May 2013.

Goodman's decision highlighted another outcome that investors may be presented with on the call date - an exchange or rollover into a new hybrid security. Goodman announced a proposal for their investors to exchange their Goodman PLUS hybrids for new terms, with the security to be called PLUS II. If holders elected not to approve the changes they would continue to own the Goodman PLUS and the security would likely trade at a deep discount as it is perpetual. The rollover option provided holders with little choice other than to accept the new terms despite the margin on the new hybrid being below the level where Goodman's would be able to access new capital.

Where investors have no right to request their \$100, as is the case in the Goodman's rollover, this is known as a coercive exchange.

This was a controversial decision by Goodman as many hybrid investors rely on the threat to reputation combined with the ongoing need to access debt capital markets to provide comfort that rated issuers will exercise their option to redeem hybrids at the first call date.

Investors should be aware that there are other possible outcomes for equity credit hybrids. The current raft of hybrid issuers may consider similar options at their call dates in five to six years if their businesses deteriorate. The rollover provides the issuer a way to optically protect their reputation (as they can argue they have offered a replacement security) but a suboptimal outcome for investors who had expected to be repaid, unless accompanied with the option to receive repayment of face value in addition to the option to rollover.



# Hybrid glossary

### **Additional Tier 1 (AT1)**

High quality capital that provides permanent funds, is freely available to absorb losses, ranks behind creditors of the bank and has fully discretionary distributions. These take the form of mandatory convertible securities (MCS) or CoCos and for Australian institutions, comply with the rules set out in APRA Capital Adequacy Standard APS 111.

### **Bail-in**

The ability of the banking and insurance regulator, which in Australia is APRA, to convert securities, both hybrid and subordinated debt, into ordinary equity or where that is not possible write the securities down where the issuer is in financial distress. The intent is for the securities to provide a financial cushion to prevent the requirement for a public sector injection of capital into the bank or insurer to bail it out.

### **Bank bill swap rate (BBSW)**

A compilation and average of market rates supplied by domestic banks in regard to the specific maturities of bank bills. BBSW is calculated at ten o'clock every morning and compiled by AFMA.

The purpose of BBSW is to provide independent and transparent reference rates for the pricing and revaluation of Australian dollar derivatives and securities.

### **Basel III**

The Third Basel Accord is the framework designed to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage in response to the deficiencies in financial regulation revealed by the financial crisis of 2007-08. Basel III was developed by international regulators including APRA and implemented from 1 January 2013.

### **Call date**

The date prior to maturity on which a callable bond may be redeemed by the issuer. If the issuer determines there is a benefit to refinancing the issue, the bond may be redeemed on the call date, at par, or at a small premium to par depending on the terms of the call option.

### **Common Equity Tier 1 (CET1)**

Highest quality component of capital and includes ordinary shares, mutual equity interests, retained earnings, undistributed current year reserves and minority interests.

### **Common Equity Tier 1 ratio**

The ratio of CET1 over risk weighted assets

### **Contingent Convertible (CoCo)**

Contingent convertible bonds are the name used in the global bond markets for securities that qualify as regulatory capital under Basel III. They are also referred to as Additional Tier 1 (AT1) and "bail in" hybrids.

### **Default**

Failure by an issuer to satisfy the terms of a loan or bond obligation.

### **Distribution**

The payment stream on a hybrid is usually referred to as distribution because it is at the discretion of the company.

### **Fixed/Floating interest rates**

Rates on bonds can be fixed (set at the time of issue) or floating. If they are floating then they will be set as a constant margin to a variable benchmark such as the 90 day bank bill rate expressed, for example, BBSW +3.25%. The coupon rate is set by the issuer based on a number of factors including prevailing market interest rates and the entity's credit rating.

### **Hybrid securities**

Hybrids are a broad classification for a group of securities, used by a variety of companies to raise money that combine both debt and equity characteristics. Hybrid securities pay a pre-determined (fixed or floating) rate of return or distribution until a certain date. At that date the issuer may have a number of options including converting the hybrids into the underlying ordinary shares or redeeming for cash or leaving outstanding. Therefore unlike a share the holder has a 'known' cash flow and, unlike a fixed interest security, there may be an issuer option to convert to the underlying equity.

### **Liquidation**

The sale of assets from an entity that has failed to meet commitments on its debt. Proceeds are applied to its creditors under a strict order.

### **Maturity**

This is the date when the security is due for repayment by the issuer. The principal plus any outstanding interest of a particular security will be repaid on this date.

### **Non-viability trigger**

Is a new, untested structural feature of subordinated bonds and hybrid securities implemented to meet Basel III/APRA regulations to provide loss absorbing capital for the financial institution when it is considered non-viable or requires public funds or support to survive. The point of non-viability is unknown and at the discretion of APRA. This could result in up to a 100% loss of capital.

### Over the counter (OTC)

Refers to the sale of securities outside of an exchange, whether electronically or over the phone. Traditionally, most fixed income securities are traded over the counter.

### Perpetual security

A security with regular periodic payments for an infinite number of periods with no maturity date.

### Prospectus

A document disclosing the details and particularly the risks of a security issue where the security can be sold to retail investors under the Corporations Act 2001.

### Redemption

Redemption stipulates an event when debt securities can be bought back or repaid prior to the legal maturity. The securities can be redeemed at a call date at an option of one of the parties (typically the issuer), or upon certain events being triggered. Typically redeemed at par or \$100.

### Retail investor

A retail investor is an adaptation of the term retail client defined in the Corporations Act 2001, that is, an investor who receives a financial product or financial advice is a retail investor unless sections 761G (5), (6) and (7) or section 761GA apply (these provisions relate to wholesale investors a term synonymous with wholesale client used in the Corporations Act 2001). See also 'Wholesale investor'.

### Securities

Securities are defined in section 92 of the Corporations Act 2001 to include:

- debentures, stocks or bonds, issued by a government
- shares in, or debentures of a body such as a corporation
- interests in a managed investment scheme

### Tier 1 capital (T1 capital)

Tier 1 capital is the sum of Common Equity Tier 1 (CET1) and Additional Tier 1 (AT1).

### Unsecured note

A bond or a note that has no security attached and repayment is reliant on the integrity or credit quality of the issuer.

### Wholesale investor

The wholesale investor definition includes sophisticated investors described as, someone who meets certain requirements of the Corporations Law 2001 including:

- having obtained an accountant's certificate dated no more than two years ago that the client:
- has net assets of at least \$2.5 million, or
- has a gross income for each of the last 2 financial years of at least \$250,000
- the purchase price of the product is at least \$500,000

See 'Retail investor'.

### Wind-up

A term used to describe the liquidation of the assets of a company, the payment out of the proceeds of the liquidation and the eventual deregistration of the company.

## Further reading from FIIG

Corporate Bonds Made Simple

Busting the seven key myths about bonds

## What's next?

We hope you enjoyed reading Hybrids.

We encourage you to send any questions, suggestions or other feedback to [contactcentre@fiig.com.au](mailto:contactcentre@fiig.com.au) and a member of the FIIG team will respond to you as soon as possible.

Alternatively, email [contactcentre@fiig.com.au](mailto:contactcentre@fiig.com.au) to request an appointment with a FIIG Relationship Manager.

Register for our weekly newsletter The WIRE, enrol in a free one-hour seminar or webinar, book an appointment or explore our other educational materials.



Sydney | Melbourne | Brisbane | Perth

© 2014 FIIG Securities Limited | ABN 68 085 661 632 | AFS Licence No. 224659 | [www.fiig.com.au](http://www.fiig.com.au) | [info@fiig.com.au](mailto:info@fiig.com.au)

---

The contents of this document are copyright. Other than under the Copyright Act 1968 (Cth), no part of it may be reproduced, distributed or provided to a third party without FIIG's prior written permission other than to the recipient's accountants, tax advisors and lawyers for the purpose of the recipient obtaining advice prior to making any investment decision. FIIG asserts all of its intellectual property rights in relation to this document and reserves its rights to prosecute for breaches of those rights.

FIIG Securities Limited ('FIIG') provides general financial product advice only. As a result, this document, and any information or advice, has been provided by FIIG without taking account of your objectives, financial situation and needs. FIIG'S AFS Licence does not authorise it to give personal advice. Because of this, you should, before acting on any advice from FIIG, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs. If this document, or any advice, relates to the acquisition, or possible acquisition, of a particular financial product, you should obtain a product disclosure statement relating to the product and consider the statement before making any decision about whether to acquire the product. Neither FIIG, nor any of its directors, authorised representatives, employees, or agents, makes any representation or warranty as to the reliability, accuracy, or completeness, of this document or any advice. Nor do they accept any liability or responsibility arising in any way (including negligence) for errors in, or omissions from, this document or advice. Any reference to credit ratings of companies, entities or financial products must only be relied upon by a 'wholesale client' as that term is defined in section 761G of the Corporations Act 2001 (Cth). FIIG strongly recommends that you seek independent accounting, financial, taxation, and legal advice, tailored to your specific objectives, financial situation or needs, prior to making any investment decision. FIIG does not make a market in the securities or products that may be referred to in this document.

The FIIG research analyst certifies that all of the views expressed in this document accurately reflects their views about the companies and financial products referred to in this document and that their remuneration is not directly or indirectly related to the views of the research analyst. This document is not available for distribution outside Australia and New Zealand and may not be passed on to any third party without the prior written consent of FIIG.