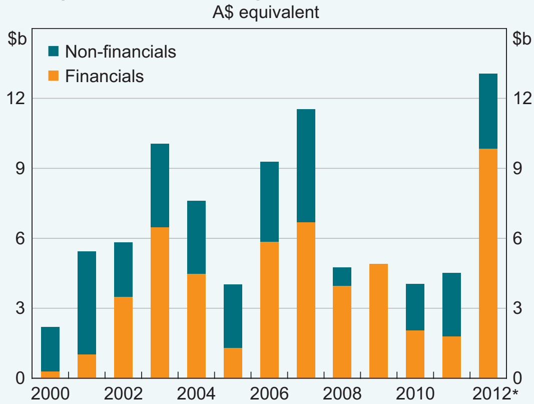
Box C

Recent Trends in Hybrid Issuance

Issuance of hybrid securities by Australian entities has been strong over the past year, reaching levels not seen since before the global financial crisis (Graph C1). The increase in issuance has been driven primarily by Australian banks preparing for more stringent capital requirements introduced by the Australian Prudential Regulation Authority (APRA) in Australia as part of the revised international bank regulatory framework (Basel III). In contrast, issuance by non-financial corporates has been only marginally higher than in recent years.

Hybrid securities are instruments that have characteristics of both debt and equity, typically giving the issuer the ability to at least postpone interest payments. Domestically issued hybrids – the majority of the recent issuance – are usually listed on the Australian Securities Exchange (ASX) and are held predominately by retail investors. Hybrids are attractive to retail investors because they typically offer higher coupon rates than senior debt or term deposits, although they are riskier and often have very long contractual maturities. Banks have historically been the largest issuers of hybrid securities, using them to help satisfy regulatory capital requirements.

Graph C1
Hybrid Issuance by Australian Entities
A$ equivalent



* Includes deals that have been launched, but not completed
Source: RBA

APRA imposes minimum capital requirements on banks and other regulated financial institutions, with an emphasis placed on those forms of capital with the greatest ability to absorb losses ('Tier 1' capital, comprising common equity and Tier 1 hybrids). Tier 1 hybrids are similar to equity and allow an issuer to miss coupon payments without an obligation to honour the unpaid amounts later; usually, these securities are convertible into common equity and have no fixed maturity date. Tier 2 capital is a lower quality form of regulatory capital, and includes Tier 2 hybrids, which are similar to subordinated debt.

The global financial crisis revealed a number of weaknesses in the ability of some forms of non-common equity capital to absorb losses. In response, the revised international capital standards under Basel III impose more stringent qualification requirements on regulatory capital coming from sources other than common equity, with a view to increasing the permanency and loss-absorption capacity of this type of capital.[1] The key changes to capital eligibility requirements, which were finalised in September 2012, include:[2]

- tightening the prohibition on issuer incentives to redeem the security prior to maturity (e.g. specifically excluding step-up provisions that

1 In addition, Basel III increased the size of the required common equity component and the overall quality of Tier 1 capital and reduced reliance on Tier 2 capital.

2 For details, see APRA (2012), 'APRA Releases Final Basel III Capital Reform Package', Media Release No 12.23, 28 September.

require the issuer to increase the coupon rate if the security is not redeemed by a certain date)

- restrictions on the ability of the issuer to call the security in the first five years
- inclusion of a capital trigger forcing the conversion of a Tier 1 hybrid security into common equity if the Common Equity Tier 1 capital ratio of the issuer falls below a specified amount[3]
- the inclusion of a non-viability trigger for both Tier 1 and Tier 2 hybrids allowing APRA to require the security's conversion into common equity or to require its write-off.

Australian banks have re-entered the hybrid market over the past year and a half as APRA has provided more information about what will qualify as capital under Basel III. Since May 2011, when APRA's interim guidance was first announced, gross issuance has amounted to around $9.4 billion (Table C1). Accounting for the redemption of existing hybrids, the issuing banks have raised $2.9 billion in net new Tier 1 capital, which is equivalent to 0.3 per cent of their risk-weighted assets. However, not all of this will qualify as Tier 1 capital under the new regulatory regime. In addition to Australian banks' legacy Tier 1 hybrids, capital recognition of those Tier 1 hybrids issued between May 2011 and September 2012 will be gradually phased out starting in 2013 as part of APRA's transitional arrangements.[4] Australian banks have also issued over $4 billion in Tier 2 hybrids this year, largely to satisfy investor demand for higher yielding debt-like securities.

Table C1: Recent Hybrid Issuance by Australian Banks

Date	Issuer	Market	Issuance amount (A$ billion)	Issuance spread (bps over BBSW)	Reason for issuance as stated[(a)]
			Tier 1 Hybrid Securities		
Sep 11	ANZ[(b)]	Domestic	1.3	310	General
Feb 12	Westpac[(b)]	Domestic	1.2	325	General
Mar 12	Macquarie[(b)]	Offshore	0.2	n/a	n/a
Sep 12	CBA	Domestic	2.0	380	Redemption; general
Sep 12	Bendigo and Adelaide	Domestic	0.3	500	Redemption; general
			Tier 2 Hybrid Securities		
Feb 12	ANZ	Domestic	1.5	275	General
May 12	NAB	Domestic	1.2	275	General
Jul 12	Westpac	Domestic	1.7	275	General

(a) 'General' refers to general corporate purposes; 'redemption' refers to redemption of existing hybrid securities
(b) At minimum interim rules
Sources: RBA; company announcements

3 This requirement only applies if the security is classified as a liability under Australian Accounting Standards.

4 Legacy hybrids, and hybrids issued between December 2010 and March 2012, qualify for 90 per cent recognition in regulatory capital calculations in 2013, with the recognised amount reduced by 10 percentage points in each subsequent year. Hybrids issued after March 2012 that do not meet final capital eligibility requirements are not to be counted as regulatory capital after their first call date.

Non-financial corporates have issued $3 billion in hybrids in 2012, which is similar to the average over the previous decade. The favourable capital and tax treatment of these securities makes them attractive for issuers because the rating agencies treat up to 100 per cent of the capital raised as equity when calculating a company's level of indebtedness, while coupon payments are treated as a tax deductible expense.[5]

Recent hybrid issuance has been well received by investors, with most issues upsized and issued at spreads at the lower end of their indicative ranges.[6] However, the highly structured nature of many hybrids can make it difficult for retail investors to properly assess the investment risks in these securities. The Australian Securities and Investments Commission (ASIC) has issued multiple warnings about these risks in recent times, pointing out that investors are taking equity-like risks but only receiving bond-like returns. ASIC has also highlighted that hybrids won't necessarily be redeemed earlier than their legal maturity, which is often many decades into the future, despite this being expected by some investors.[7] The Bank of Queensland recently chose not to redeem a hybrid security on its first call date, instead giving holders the option of exchanging their investment for a new hybrid security.

5 Recently, Standard & Poor's (S&P) announced a review of its global methodology for determining the equity content of certain hybrids issued by non-financial corporates. The outcome of the review may reduce the extent to which hybrids are counted as equity capital in S&P's calculation of the issuer's indebtedness.

6 On average, the bank hybrids issued since September 2011 raised 250 per cent of their initial offer amount due to the strong investor demand.

7 See ASIC (2012), 'ASIC's Hybrids Warning: Don't be Dazzled, be Wary of the Risks', Media Release 12-207, 27 August.