

Bank hybrids face uncertain future

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The future of bank hybrids still hangs in the balance after global regulators set a timetable for the wind down of the once-popular securities, but did not clarify which types would be culled.

The Basel Committee on Banking Supervision — a consortium of regulators and central bankers — said this week that bank hybrids which failed to comply with new rules would be phased out over a 10-year period commencing in 2013.

In addition, instruments with an incentive to be redeemed would be expected to be phased out at their effective maturity date.

APRA has hinted that it may use faster transition periods for new capital rules than those put forward by the Basel Committee.

For Australian banks the Basel decision means that they will be required to bring forward the date at which they convert instruments, and hybrids that don't meet new definitions will gradually lose their benefit as a source of capital.

Hybrids are a cheaper form of capital than equity for banks because the securities provide regulatory relief, lower interest rates than in the professional market and existing investors aren't diluted by hybrid issuance.

Senior hybrid bankers and analysts said it was too soon to say exactly which local hybrid instruments would not comply with the new rules.

Despite comments from Basel suggesting the characteristics it will look for in future hybrid securities, the rules are currently being debated and will not be finalised until the completion of a committee meeting in December.

What most bankers agree on is that innovative hybrid structures, which were a popular form of issuance until 2006, will not be allowed.

This means that step-up securities, where investors traditionally received additional returns if securities were not redeemed on prescribed dates, must be either redeemed or converted into equity on their first call dates.

Broker FIIG Securities pointed to Commonwealth Bank of Australia PERLS III, the Westpac Trusts and some outstanding securities from Bendigo and Adelaide Bank Step Up Preference Shares as examples of step-up securities that are not expected to comply with new requirements.

It is not clear what the treatment will be of non-innovative hybrids, such as mandatory conversion preference shares, which are the current structure of hybrids.

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During the peak of the financial crisis, when emergency funding was needed to protect creditors, hybrid securities could not replenish capital without the bank collapsing first.

In response, the committee



The Basel decision means local banks must bring forward the date at which they convert instruments. Photo: FRANCES MOCNIK

recently released a paper discussing a new form of capital where regulators would be able to write off or forcibly convert capital instruments into common shares in the event that a bank can no longer support itself.

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All local hybrid issuance over the past few years — banks raised around \$6 billion last year but have not sold hybrids this year — has been via converting preference shares. It isn't clear whether these

securities will meet the new requirements and APRA plans to consult with the industry over the next two years on how it will translate changes in global rules.

Hybrids issued in international markets after last Sunday will not receive transition relief and there will be a regulatory vacuum in the bank hybrid market for some months until proposals are finalised.

Under the Basel Committee's decade-long run-off period, the capital recognition of non-compliant instruments will drop by 10 per cent per year.

The changed landscape governing hybrids is more problematic for European banks, given they form a bigger part of balance sheets there.

APRA currently regulates the proportion of tier one capital that can stem from hybrids. At present, only 25 per cent of tier one capital can be comprised of hybrids.

The Basel Committee has said that the world's banks will have to hold a minimum of 8.5 per cent of the strongest form of capital — known as tier one capital — in reserve by January 2019.

Australian banks are mostly expected to have capital in excess of new minimum requirements. Where there are shortfalls, lengthy phase-in periods mean these are likely to be digestible, especially given strong internal capital generation.