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Writing on the wall for bank hybrids

With the advent of covered bonds bank hybrids are little better than equities

JAMES FROST

EXPERTS are warning retail investors of a pending sell-off in bank hybrids as an unintended consequence of the $6.6 billion in covered bonds issued in this month.

"I think hybrids have to blow out," Justin McCarthy of FIIG Securities says. "If you compare the spreads on major bank senior debt to the hybrids, you are not getting paid. The difference isn't enough."

Hybrids are high-yielding securities issued by companies that deliver investors regular payments, with returns frequently measured by the number of basis points over the swap rate.

When prices go down, distributions or dividends go up and recent bond issues by the banks imply that hybrids are due for a price fall and the yields are about to start climbing.

"We've suggested that clients may want to reassess their positions," RBS Morgans analyst James Lawrence says.

"Effectively, the whole curve is shifting out. Given the pricing for these issues, we would expect spreads to widen further."

Over the last two weeks CBA and Westpac both lined up $6.6 billion in new bond issues backed by specific asset pools known as covered bonds.

Normally this would be good news, but the prices they paid, 175 and 165 basis points over the swap rate, were more expensive than expected. That raises questions about whether hybrid investors are being adequately compensated.

"If you've got senior bank debt trading at the mid-200s, then hybrids should be trading at around 325 to 350 basis points and that's being generous,' Lawrence says.

When the eurozone descended into crisis last year, the Australian government changed legislation to clear a path for this new type of bond in order to ease funding pressures on banks, as international debt markets tightened.

Covered bonds give bond holders a claim over a pool of assets and their introduction was delayed previously because they placed investors ahead of bank depositors. But the prices the banks paid to get these issues away is expected to cause a chain reaction that has yet to show up in the prices of hybrid debt.

"CBA's covered bond issue has repriced the major bank curve" McCarthy says. "The market for hybrids isn't always efficient. If you go back a few years, you were getting overpaid for being in ASX listed hybrids compared with the wholesale instruments. Now it's the reverse."

Hybrid securities were traditionally bought by retail investors seeking higher yields who could not access the corporate bond market where minimum parcels start at $50,000.

The lack of choice open to those with smaller amounts to invest has forced investors into either term deposits or hybrids — so named because they have elements of both debt and equity.

When it comes to investing in debt, capital structure is king. The higher up the capital structure your investment is, the safer your capital is and correspondingly the smaller your return.

From top to bottom that structure consists of covered bonds, senior debt, subordinated debt, hybrids and equity. But what many investors don't realise is that in the event of a wind-up, hybrids only rank a notch above equity and this isn't reflected in the prices being paid today.

"Always look at your returns relative to where they sit in the capital structure," McCarthy says. "Term deposits are paying pretty good margins of about 200 basis points over the cash rate. Compare that with a bank hybrid like a CBA PERLS 3 or a Westpac Trust with a 2016 maturity and you might only be getting an extra 60 or 80 basis points.

"The hybrid holder has taken on call risk; the distributions could be suspended; the prices are more volatile and so on. In theory, covered bonds should be the lowest yielding, then deposits, then senior debt, then sub debt, then hybrids."

The risks hybrid holders face can be broken down into three main categories. The first is capital risk or the chance that you will lose all your money. The second is income risk or the chance that you will not see any of the distributions due to you. The third is call risk or the chance that the term of the security is extended beyond what you anticipated.

"We expect spreads to widen, especially from things like the Westpac CP2 securities, which are trading at margin to 144 basis points over the bank bill swap rate (BBSW) when you compared that to CBA's covered bonds, which were issued at 175 basis points over," Lawrence says.

But don't sell your hybrid portfolio just yet. Analysts like Lawrence expect the after-market for non-bank hybrids such as AFIC and Origin to remain robust as investors seek diversification.

"There is a real demand for securities that haven't been issued by the finan-

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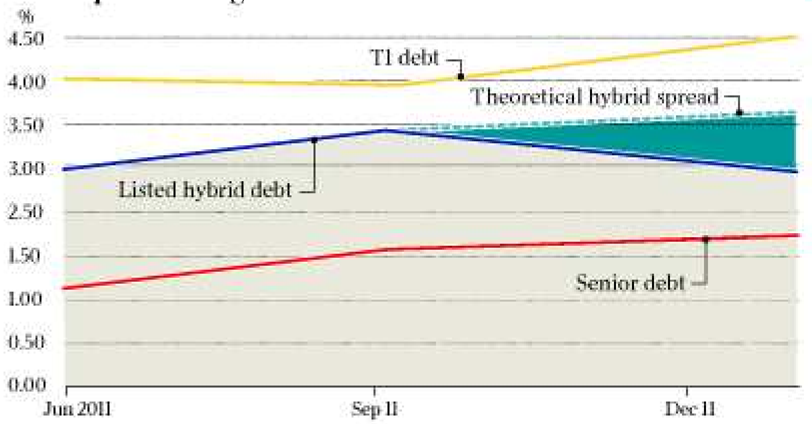
cial sector," Lawrence says.

"You've got S&P downgrading banks, funding costs are on the rise, margins are being squeezed and flow-on effects from that. Woolworths, for example, is a very defensive name and Woolworths Notes II is a very investor-friendly security."

The popularity of those recent issues would seem to support that. But, as for bank hybrids, the writing appears to be well and truly on the wall.

Credit spread change



Source: FIIG Securities