A Background to Hybrid Securities Structuring in Banking and Financial Services

by

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1. Introduction

This paper is an attempt to give some insight into the motivations of issuers of hybrid securities. Hybrid securities, being anything falling in the gap between pure equity and pure debt cover a very broad range of complex instruments. Often, discussion of hybrids focuses on the structures and instruments used, rarely giving any insight into the factors motivating companies to issue hybrids.

This paper is necessarily brief, generalises and trivialises some areas that are complex and worth greater analysis. However, a more detailed analysis would quickly amount to a textbook – I have tried to focus on the big picture and highlight issues that are likely to drive change in this market over the next few years.

My analysis is bank centric – the industry I have worked in for the last 15 years. However, banking in Australia now covers a much broader range of financial services entities than in the past. For example, companies I deal with on a regular basis operate in the areas of insurance, funds management, private equity and infrastructure investment, property investment and management, broking and investment advice, internet broking, mortgage servicing, not to mention banking. The analysis I undertake when looking at hybrid structures applies across most aspects of the financial services industry.

To link this broad range of issues together, I have coloured this paper with a discussion of an example, being the Colonial First State Hybrid Securities ("Colonial Hybrid"). This complex hybrid issue was launched in April 2005 as a retail offering of securities. The retail offer was ultimately not issued, although a private placement with some similar characteristics was completed in 2006. This paper covers some of the major factors driving that issue – the "Why?". Brian Salter in his Case Study paper gives more detail on the structure – the "How?". Peter Gibson in his paper covers the rating agency view of some of these issues.

2. Major Considerations for Hybrid Securities

Structuring and analysis of hybrid structures is ultimately a process of looking for arbitrages. Developing these structures usually consists of looking for discrepancies between the company's view of risk and pricing compared to regulators and compared to the market. Anywhere there is a mismatch there is an opportunity. For example, banks are required to hold at least 2% capital against Australian residential mortgages they have issued. The expected losses on these mortgages are well below 1%. Arguably, this mismatch leads directly to the mortgage backed securitisation issuance from Australian banks.

Issuers have many factors that contribute to the assessment of a hybrid structure and outcome. The major factors I want to discuss are capital impacts; funding; and market access. These factors will come together differently for every issuer and ultimately structuring a hybrid is also a series of compromises across many factors. A bank looking to optimise its regulatory capital position may have very different drivers to a fund manager with limited access to capital markets. The resulting securities from these issuers will look very different and have very different economics. This analysis contributes to the variety of structures and the lack of understanding from many market analysts.

2.1. Capital Factors

Capital analysis for a major financial institution has many stakeholders – from the product manager, the share analyst, regulatory supervisors and so on. There is a natural tension – the lower the capital levels the higher the shareholder returns (within reason); the higher the capital levels, the better the investor and depositor protection. There are three main views of capital in this analysis – the regulator; rating agencies; and the business itself, assessing the required economic capital from internal models.

These agents all try to guide the capital structure and levels for an institution. Generally, capital management tends to only focus on one of these parties at a time, wherever the levels are closest to the limit.

2.1.1. Regulatory Capital

APRA, as regulator for banking and insurance businesses in Australia takes a very different approach to capital regulation from ASIC, as regulator of the funds management industry. With the regulatory overlap through superannuation and financial advice aspects, this means that the major financial conglomerates are regulated by both bodies.

As far as capital levels and structures are concerned, ASIC's approach is to largely ignore capital, and rely on legislative constraints. The capital requirements in a pure fund manager of any significant size are negligible and would be covered by any normal level of cash flow. APRA is the primary driver for banking capital structures, and within the broader financial services conglomerate APRA's approach is very bank centric.

In the past, APRA's approach has necessarily been "one rule fits all". Therefore, the rules applied to capital are inflexible, broad brush and open to all sorts of inequalities and discrepancies at the micro level. This is not a criticism of the framework – just an acknowledgement of the environment that we must operate in. However, this world is changing.

APRA is in the process of implementing new capital standards for banking in Australia, based on the second Basel accord (Basel 2). These changes will have significant impact on the hybrid securities industry. Some of the major changes are:

- Hybrids for banks fall into the category of "residual capital". The new standards split residual capital into "innovative" and "non-innovative" categories, with limits applied to each group. As well as the new definitions and structural constraints, this is also likely to lead to the banks rebalancing their capital position – aiming to optimise the mix of capital.
- Basel 2 capital standards move away from a one rule fits all approach and allow the banks to use internal models to assess capital requirements in some circumstances. Across the industry there will be great variation in how this capital assessment process works, but will ultimately lead to banks adjusting the level of capital they need to hold, and potentially the mix of capital. Additionally, this will change the economics for different asset classes, leading to different dynamics in securitisation and other innovative security classes.
- New rules apply to conglomerates and securitisation that provide the opportunities for more innovative structures, but also provide for more regulatory oversight.

These significant changes leave the banking industry in a state of flux. Currently, six months from implementing the new capital standards, the banking industry still does not have any firm indication of where capital levels will be under the new standards. Once the standards and calculations are fixed, I expect a significant amount of capital markets activity to deal with the changes.

2.1.2. Rating Capital

The rating agencies play a dual role in assessing hybrid securities – they are rating the issuer for the investors, to assess the risk of default and level of security in the instrument. Simultaneously, the rating agencies are assessing the security of the issuer, and the interaction between the various capital instruments of the issuer. This leads to some interesting conflicts within the rating agencies and their views of hybrid securities, but also means that the agencies are focussed on a deeper understanding of risk transfer, rather than how structures fit into the existing rules.

As an interested party in capital levels for Australian banks, Standard and Poor's (S&P) is the primary agency involved. S&P assess bank capital levels on several bases, calculated on a similar methodology to APRA capital levels. Peter Gibson's paper gives some insight into the rating agency assessment process on hybrid securities.

The rating agency process is generally more flexible than APRAs' approach. On the banking side, the S&P approach is broadly aligned with the regulatory capital assessment, but they are much more flexible and open to adjustments that bring the capital assessment back into line with a more realistic assessment of the risks involved in the business.

2.1.3. Business Capital Assessment – "Economic Capital"

Generally, a company with a detailed understanding of the business is going to have the best assessment of the risks inherent in the business, and this would typically result in a lower assessment of required capital. Economic models vary greatly in sophistication across the banking and insurance industries – from minor tweaks to the regulatory framework to major statistical exercises.

For the purposes of this analysis, I'm assuming economic capital represents the business view of the true risks and true costs of operation.

2.1.4. Capital Summary – Colonial Hybrid example.

Within the framework I have described, it is clear there is room for large discrepancies of viewpoints.

The Commonwealth Bank of Australia ("CBA") paid approximately $10bn to acquire the Colonial group in 2000. Of this $10bn paid, approximately half related to the insurance and funds management businesses and a large part of this value is intangible – goodwill. Economically, this goodwill represents expected future earnings from the business.

However, from APRA's bank capital viewpoint, the goodwill has no contribution to the support of deposit holders. CBA would assert that $5bn of goodwill has some value in the support of deposit holders – ultimately the business could be sold if the company was in a position of stress. The rating agency viewpoint is somewhere in the middle – the Colonial business was recognised as having value, but this is not reflected in the key capital metric – ACE ("Adjusted Core Equity"). At the time the Colonial Hybrid was issued, ACE was the key capital constraint for CBA i.e. the measure that was closest to limits and the measure that equity analysts were closely focused upon.

This discrepancy of views is the fundamental driver for the Colonial Hybrid. The Colonial Hybrid raising funds secured against the future fees of the Colonial First State funds management business i.e. secured against the goodwill of the business. To the extent that the funds management business does not earn fees, investors are not paid. This loss absorption delivers capital benefits for CBA. S&P agreed with this perspective and agreed to treat the Colonial Hybrid as equity in the assessment of CBA capital.

S&P's other (potentially conflicting) viewpoint is to examine the structure from the investor's perspective. An independent valuation assessed the value of the fee stream that provides security at $2.8bn. CBA was looking to raise only $650m secured against this asset, and from the investor viewpoint this gives a degree of certainty of repayment. In the end, S&P assessed the structure as an 'A-' rating, giving a high degree of confidence that investors would receive interest and principal as promised.

APRA did not acknowledge any benefit from the Colonial Hybrid. The structure does not fit into the APRA framework and APRA was not in a position to alter the rules to accommodate the issue. At the time, the structure still made sense to CBA without the APRA benefit, because ACE was the primary capital focus. Under the APRA Basel 2 framework it remains to be seen how the Colonial Hybrid will be viewed, but it is likely that some benefit will be recognised.

In summary, the investors' views and CBA's view of the risks in the Colonial business were fundamentally different from the regulatory and rating agency "capital view" of the risks. This provided an arbitrage opportunity for a hybrid structure to "fill the gap" – delivering a significant capital benefit with a price that reflected CBA's view of the risks involved.

2.2. Funding

One significant aspect of hybrid structuring that is often misunderstood is the separation of funding from capital. Banks, particularly in Australia, are highly geared structures – they rely on large scale wholesale borrowing in order to raise the cash to lend to customers or invest in other assets. Capital, by contrast is funds that provide the ability to absorb losses. The distinction is obviously reflected in the cost of these sources of funds. What is not often understood is that the loss absorption does not have to be tied to the use of the cash raised.

In an institution that does not have the ability to borrow large amounts of money, this distinction is often not understood. For example, within the life insurance world, "capital" is often used interchangeably with "funding".

The Colonial Hybrid shows a good example of this distinction. I have previously described how the loss absorption of the structure is tied to the fees of the funds management business of CBA. Within the Colonial Group, there is a significant level of borrowing. The largest use of this borrowing was in the New Zealand insurance business. The Colonial Hybrid provided the opportunity to rationalise the funding of this New Zealand business. The funds raised from the Hybrid were lent to New Zealand, allowing that business to repay a range of existing borrowings from several different sources. This simplifies the funding process for that business and reduces their operational requirements.

Within the Colonial Hybrid structure, the New Zealand business pays interest on this debt raised. That interest is only passed on to investors to the extent that the fund's management business earns fees. If the fees are not earned, the money is kept within the CBA Group.

An interesting feature of this operational structure is that the interest paid by New Zealand is tax deductible in New Zealand. However, in Australia, the "equity like" nature of the payments means that the coupon to investors would attach franking credits. This has a large impact on the economics of the transaction.

2.3. Market Access

Market access is a key factor to structuring a hybrid security for several reasons. I don't intend to provide a detailed analysis of different markets, but just to highlight some of the areas that need to be considered. These issues lead to discussion of how the issue is structured for tax, how the issue is marketed, the size, disclosure requirements, potential risk transfer and pricing.

- Tax issues in different markets are fundamental to the structure of an issue. A franked structure will look very different to an unfranked issue and require very different marketing and different depth of the market. The franked market for hybrid securities is highly variable, as CBA discovered on the Colonial Hybrid.
- Retail issuance immediately leads to an increase in disclosure requirements and limits the complexity that can be achieved. However, a retail issue can be less "rational" on pricing of risks, with investors focussing more on brand names and less on the underlying instrument.
- An institutional investor is more inclined to assess unusual risks thoroughly, but appetites for hybrid instruments vary greatly in different markets. For

example, the US market approached as a whole tends to charge a higher premium for innovative structures. The Australian market for hybrids tends to be of limited depth and have only a few players. The UK and European market tends to prefer longer dated issues and is more accommodating of new structures.

All of these sweeping generalisations have exceptions, but the main point is to consider the target market at the start of the structuring process rather than at the end, because the market will to some extent drive the structure.

The Colonial Hybrid was offered to Australian retail investors as a franked security. This market is highly variable and CBA decided not to continue the issue after a poor response during a time of market volatility. As a comparison, CBA has recently completed the largest ever franked hybrid offering (PERLS IV) of $1.465bn in a time of strong market growth.

CBA later issued Funds Management Securities as an unfranked private placement to offshore investors, with comparable pricing to the Colonial Hybrid. Whilst the issue structure has changed, the desired capital outcome was still achieved.

3. Conclusion – The sum of the parts.

As part of the structuring process for a capital issue, the issues arising from legal, tax and regulatory review tend to result in an iterative process, restructuring to solve problems, and in the process creating new problems. Brian Salter has highlighted some of the legal issues from the Colonial Hybrid in his paper.

I have highlighted some of the changes occurring in banking through Basel 2 capital standards. As mentioned, this is likely to lead to some significant activity in the areas of hybrid securities and structured finance as the rules and economics for Banks enter the new world.

Hopefully, the issues I've raised in this paper give some flavour for the considerations that impact the structuring process. It is important for an issuer to maintain a firm view on the objectives through this process if any complex structure is to succeed. From my perspective this viewpoint separates a good advisor from a mediocre one. The advisor that can offer solutions to problems, rather than just raise them, requires some understanding of this process and the goals that the issuer is trying to achieve.