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A guide to investing in subordinated debt

October 2019

Introduction

Most Australian banks, other authorised deposit-taking institutions and insurance companies (all of which are referred to as 'financial institutions' in this document), raise capital to finance their operations by issuing two forms of securities:

- equity – in the form of ordinary shares. These are typically listed on ASX and have the benefit of sharing in profits but the risk of ranking last in priority of repayment, becoming potentially worthless on insolvency of the issuer; and
- debt – in the form of bonds. Debt financing takes many different forms with different levels of assurance given to investors regarding repayment. Bond holders are paid prior to shareholders in the event of insolvency.

Subordinated debt is a form of debt financing that is receiving increasing attention. This is due to new requirements from APRA (Australian Prudential Regulatory Authority) which compel the major Australian banks to hold more regulatory capital. For this reason, subordinated bonds are expected to become a more significant part of the Australian fixed income universe.

Subordinated bonds have different characteristics to traditional bonds and they can be an important defensive element of a diversified portfolio.

This document explains:

- subordinated debt and how it differs from other types of debt and equity securities offered by financial institutions;
- the Tier 2 Capital requirement that the big four banks must now fulfil;
- the background to this requirement and why it is being implemented; and
- how investors can use subordinated debt in their portfolios and how to access it via VanEck's Australian Subordinated Debt ETF which trades under the ASX ticker 'SUBD'.

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What is subordinated debt?

Subordinated debt has similar characteristics to traditional bonds, however, in times of financial stress it is more like equity and can be converted to shares. It is called 'subordinated' because it sits below 'senior debt' or traditional bonds in the capital structure (see shaded area in Figure 1 below), but it sits above and takes priority over ordinary shares, in the event of insolvency.

For financial institutions, subordinated debt forms part of the buffer they are required to have in order to absorb potential losses in the event of financial distress. This capital is used to protect depositors and policyholders, so that they can feel confident their money is safe. It also protects taxpayers from costly bail-outs.

The following chart provides a simplified example of the capital structure in a financial institution to illustrate how different securities issued by financial institutions rank in priority of payment in the event of insolvency. Priority is given to depositors and senior debt. Shareholders get paid last, if at all.

Figure 1: Simplified capital structure of a financial institution

Investment risk/return	Capital structure		Priority on insolvency
Low  High	Senior debt	Secured debts Deposits Unsecured debts	High  Low
	Hybrids#	Tier 2 Capital (Subordinated debt) Additional Tier 1 Capital ("Hybrids"**)	
	Common Equity Tier 1 Capital (Ordinary shares)		

#Per ASIC Report 365. **Per market convention.

You can see from the above chart that subordinated debt securities (also known as subordinated bonds) rank above ordinary shares and Additional Tier 1 Capital but below senior debt, including traditional bonds, deposits and other unsecured debt obligations. For this reason, subordinated bonds carry more risk than deposits and traditional bonds. However, subordinated bonds are considered less risky than shares and other hybrids, which rank lower in the capital structure.

Please note: although the term "hybrid" is used by ASIC to refer collectively to Tier 2 Capital and Additional Tier 1 Capital, this term tends to be used in the market (by advisers and the media) to describe Additional Tier 1 Capital securities or capital notes. In this document, the word "hybrid" is used to refer to Additional Tier 1 Capital securities or capital notes and "subordinated bonds" or "bonds" refers to Tier 2 Capital or subordinated debt.

Subordinated bonds are more debt-like than hybrids and, generally, interest payments must be met and principal repaid at maturity while the issuing financial institution is solvent. However, it's important to note that in times of financial stress, subordinated bonds may stop making interest payments indefinitely and they can be converted to equity or written off without resulting in an event of financial default which could trigger the collapse of the institution. This is because the purpose of Tier 2 Capital is that it can be absorbed to prevent the failure of financial institutions which are important to the whole financial system.

Since subordinated bonds rank below traditional bonds and are therefore considered more risky, financial institutions typically offer a higher interest rate for subordinated bonds compared to traditional bonds.

Why do banks and insurers issue subordinated bonds?

Australian banks and insurers are required by law to hold a certain amount of regulatory capital. This is to protect depositors and policyholders from unforeseen losses and limit the potential for taxpayers' money to be used to bail out a failing institution, as happened in the United States and Europe during the GFC (global financial crisis). Regulatory capital is classified as either Tier 1, which is essentially the bottom rung on the capital ladder and ranks last on insolvency; or Tier 2, which ranks above Tier 1 on insolvency. Both Tier 1 and Tier 2 Capital are intended to absorb losses. In other words, they may be written off to safeguard higher ranking creditors.

How much capital financial institutions require is determined by APRA. Until recently, Australian financial institutions had issued only modest amounts of subordinated bonds. In July 2019, APRA finalised its 'total loss-absorbing capacity' or 'bail in' requirements for the major banks in order to reduce the prospect of a taxpayer funded bail-out. APRA decided that the major banks should double the amount of Tier 2 Capital they hold.

A short history of APRA's capital requirements: from the GFC to today

The financial crisis of 2008 led to the failures and bail-outs of many large global financial institutions which were considered prior to that point as "too big to fail". Lehman Brothers filed for bankruptcy on 15 September, 2008. Merrill Lynch, AIG, HBOS and Royal Bank of Scotland were among the long list of financial institutions which were teetering on the brink of failure until the US Fed and other central banks around the world started bailing them out. Despite trillions of dollars being spent by governments, depositors and investors were spooked and there was a run on banks to withdraw savings. Borrowers disappeared, leading to plummeting property prices, increasing foreclosures, and share markets followed suit. The financial distress led to governments having to step in to rescue financial institutions and prevent a potential "breakdown in law and order".¹

In response to the fallout from the GFC, the Bank of International Settlements' Basel Committee sought to redraft its universal standards. The new standards would ensure banks around the world could withstand unforeseen losses, unexpected withdrawals and reduce the likelihood that taxpayers would be forced to bail out large institutions again. Basel III, as it was known, was published in 2009, with an implementation deadline of 2019.

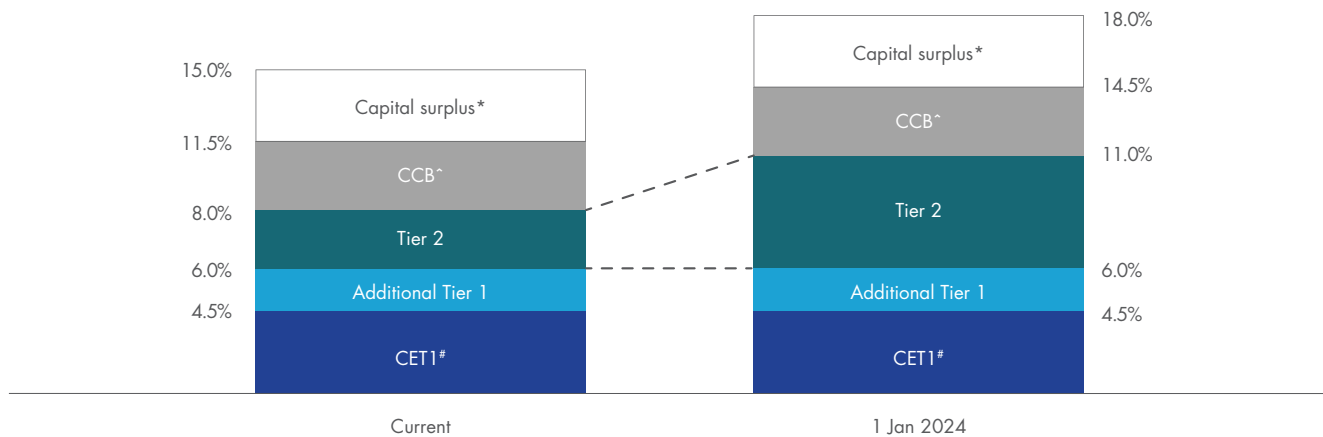
Basel III led to the concept of Total Loss Absorbing Capital (TLAC). TLAC is an additional layer of bonds that convert into equity capital once an institution's debt capital reserves are depleted.

While each country drafted their own rules relating to Basel III and TLAC, Australia's regulators took longer to decide on the specifics, mindful that credit rating agencies and global investors valued the implied government support given to Australia's banks, which has helped lower their costs.

In July 2019, following a period of consultation, APRA decided that the major banks would need to increase the minimum capital they hold. The intention is to boost their TLAC and minimise the need for taxpayer support.

1. In 2008, Alistair Darling, who was the U.K.'s Chancellor of the Exchequer at the time, spoke out and stated that Britain came within hours of "a breakdown of law and order" the day that RBS was bailed-out.

Figure 2: July 2019 changes to the major banks capital structures



~Capital conservation buffer. #Common Equity Tier 1 Capital. *Capital surplus of 3.5% is generally higher than the level D-SIBs may normally maintain - they have acted in anticipation of changes to the capital adequacy framework as a result of the 'unquestionably strong' capital benchmarks. APRA expects the D-SIBs to continue to maintain a normal capital surplus in excess of regulatory capital requirements once such changes are implemented. Source: ANZ.

The above chart shows the expected increase in issuance of subordinated bonds as a result of the new Tier 2 Capital buffer rules imposed by APRA on Australia's big four banks, which are considered Domestic Systemically Important Banks or 'D-SIBs'. We note that there is currently no expectation of an increase in Common Equity Tier 1 Capital ('CET1') or Additional Tier 1 Capital (hybrids) being issued by the big four over the next four years.

To meet APRA's new requirement, the big four banks will need to raise a combined \$50 billion of subordinated bonds over four years, almost doubling the amount of this form of debt.²

Initial concerns that such an expansion in the subordinated bond market would lead to increases in financing costs have not been borne out in practice.

How are subordinated bonds different to traditional bonds?

Loss absorption and non-viability

Subordinated bonds form part of the regulatory capital that banks and insurers are required to hold to protect depositors and policyholders from unexpected losses. For this reason, they are designed to have 'loss absorbing' features. The result may be that interest and capital payments owing to investors in subordinated bonds may be delayed, converted to equity at significantly lower value or completely written off.

Higher risk means higher return

The claims of subordinated bond holders rank below traditional bonds, depositors and other unsecured creditors. This means that if the bank fails, subordinated bond holders will only be paid after all obligations to higher ranking creditors are paid. As a result, subordinated bonds generally pay higher interest than traditional bonds.

Call risks

Unlike hybrids, subordinated bonds generally have a maturity date at which time the institution must repay. Australian dollar floating rate subordinated bonds typically also have a "call date" at which there is an expectation the institution will repay the securities. Subordinated bonds are typically issued for 10 years with a call date five years from maturity. Issuers must obtain the approval of APRA to call the bond early, however, the market usually prices the bonds based on an assumption that they will be called at the specified call date. There is a risk that the issuer will not elect to call the securities at that date, or that APRA will not grant approval, which could negatively affect the price of the security.

2. C. Yeates, 'Big four banks need an extra \$50b by 2024 to meet capital returns', SMH, 9 July 2019.

Why it's important to have subordinated bonds in a portfolio

Australian financial institutions have proved to be a reliable source of income for investors for many years. This income has come in the form of attractive interest payments from government guaranteed deposits and franked dividends from shares or hybrid securities. Despite headwinds, Australian banks and insurers have traditionally paid relatively high margins to access financing from investors.

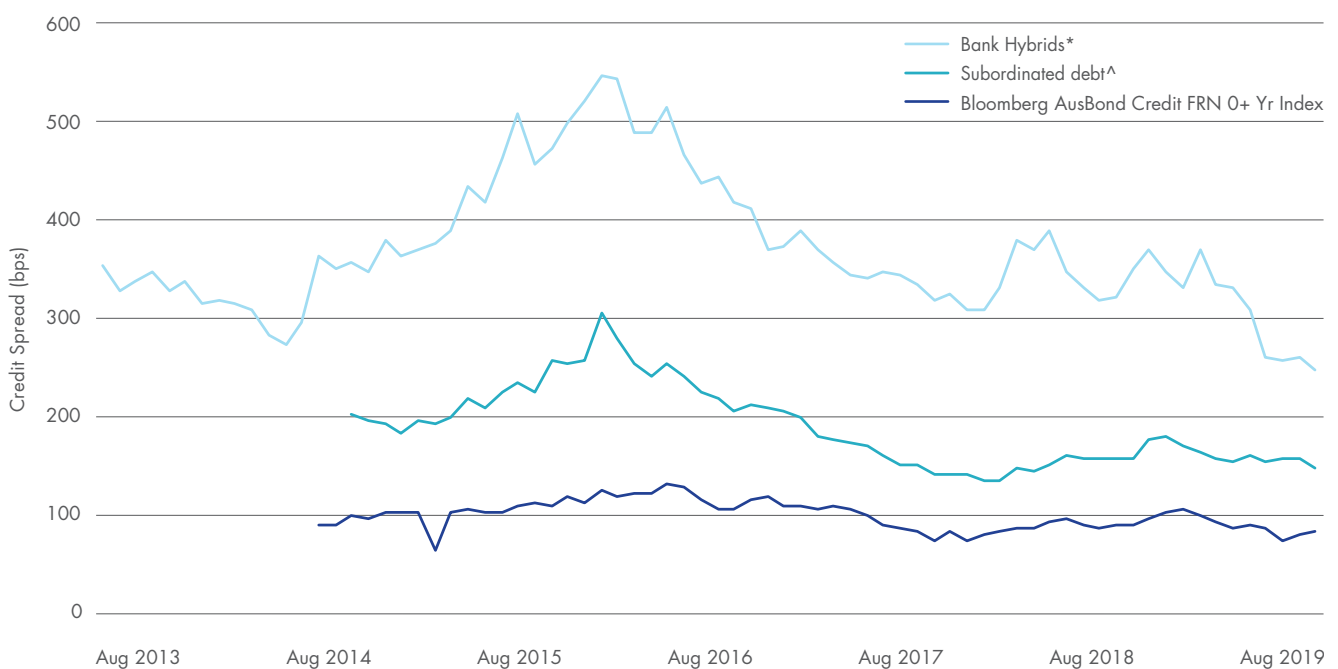
To date, Australian institutions have issued approximately \$60 billion of subordinated bonds. They have not yet formed meaningful parts of institutional or individual investor portfolios. The pending increase in issuance by the big four banks to meet APRA's higher capital adequacy requirements is expected to see a significant increase in the size of the market.

Subordinated bonds can perform two roles in a portfolio:

1. Increase return for a commensurate increase in risk – for investors with large holdings of low-returning cash, term deposits and traditional senior bonds who are willing to take more credit risk, subordinated bonds issued by financial institutions can enhance income;
2. Decrease risk – for investors with above average holdings in high yielding hybrids or shares who are seeking to reduce their credit risk, subordinated bonds may perform a useful role. While interest payments are lower than hybrids, the reduction in return may be modest relative to the reduction in credit risk and price volatility.

At times subordinated bonds can offer attractive opportunities to both increase returns while modestly increasing credit risk or decrease credit risk while modestly decreasing returns.

Figure 3: Credit spreads of Australian floating rate notes, subordinated bonds and bank hybrids



Source: VanEck, Bloomberg Credit spread calculated relative to 3 month BBSW rate. *Bank Hybrids are an equal weighted composite of ANZPD, ANZPE, ANZPF, ANZPG, ANZPH, CBAPD, CBAPE, CBAPF, CBAPG, CBAPH, NABPB, NABPC, NABPD, NABPF, WBCPE, WBCPF, WBCPG, WBCPH, WBCPI. ^Subordinated debt is an equal weighted composite of bonds in the iBoxx AUD Investment Grade Subordinated Debt Index at 30 September 2019.

Accessing subordinated debt

Until now, subordinated debt has mainly been accessible by large institutions. Now investors of all sizes can access a subordinated debt portfolio.

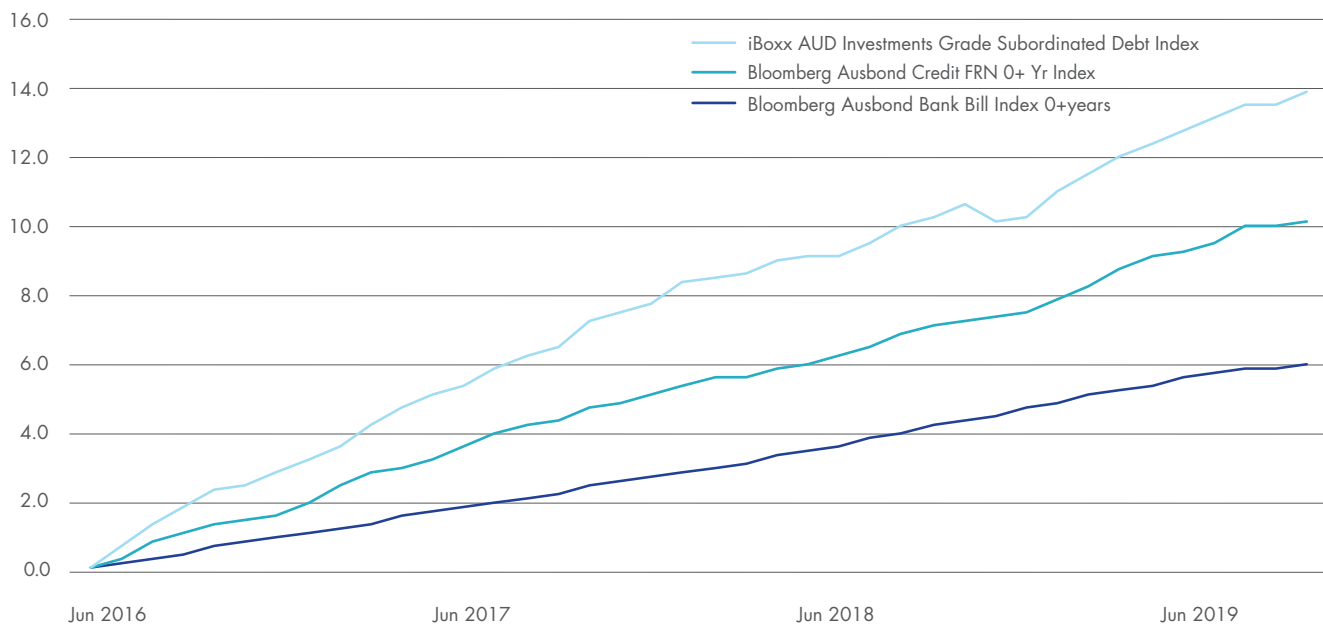
VanEck Vectors Australian Subordinated Debt ETF (ASX: SUBD) is an Australian first, enabling investors to access a portfolio of subordinated bonds via a single trade on ASX. Subordinated bonds can offer attractive returns relative to other fixed income investments.

SUBD tracks the iBoxx AUD Investment Grade Subordinated Debt Index (SUBD Index) which only includes investment grade AUD denominated, floating rate bonds issued by financial institutions that qualify as Tier 2 Capital under the APRA³ rules and hold an iBoxx investment grade credit rating.

SUBD Index has outperformed indices which have a similar sensitivity to interest rate movements (duration), the Bloomberg AusBond Bank Bill Index (default for cash) and the Bloomberg AusBond Credit FRN 0+ Yrs Index.

Figure 4 and 5: Performance of SUBD Index compared to indices with similar duration

Cumulative returns of Australian short bond-duration indices since base date of SUBD Index to 30 September 2019



Trailing performance of SUBD Index as at 30 September 2019

	1 year (% p.a.)	2 years (% p.a.)	3 years (% p.a.)	Since base date of SUBD Index (% p.a.)
SUBD Index	3.33	3.44	3.82	4.10
Bloomberg AusBond Bank Bill Index	1.74	1.80	1.79	1.80
Bloomberg AusBond Credit FRN 0+ Yrs Index	2.88	2.72	2.90	3.01

Source: VanEck, Morningstar, Bloomberg as at 30 September 2019. Returns in Australian dollars. Base Date is 30 June 2016.

Results are calculated to the last business day of the month and assume immediate reinvestment of all dividends and exclude costs associated with investing in the ETF. You cannot invest directly in an index. Past performance information of the indices is not a reliable indicator of future performance of the indices or the SUBD ETF, which may be lower or higher. The iBoxx AUD Investment Grade Subordinated Debt Index was launched on 10 October, 2019. Data prior to the launch date is back-tested data.

3. A reference to APRA in this context includes any equivalent foreign prudential regulatory body.

SUBD Index's higher return has been achieved with higher risk, as measured by standard deviation of returns, as shown in the table below. The table below also includes a calculation for the Sharpe ratio which combines a return measure with a volatility measure to quantify the relationship between the returns and risk. It provides a measure of risk-adjusted performance. The SUBD Index has a higher Sharpe ratio than the other Australian short bond-duration options. This means subordinated bonds have a better risk/return trade-off than traditional bonds.

Figure 6: Risk and Sharpe ratio of SUBD Index compared to indices with similar duration

SUBD Index base date to 30 September 2019			
	Return (% p.a.)	Risk – Standard deviation (% p.a.)	Sharpe ratio (% p.a.)
SUBD Index	4.10	0.53	4.14
Bloomberg AusBond Bank Bill Index	1.80	0.04	0.98
Bloomberg AusBond Credit FRN 0+ Yrs Index	3.01	0.23	3.50

Source: VanEck, Morningstar, Bloomberg as at 30 September 2019. Returns in Australian dollars. Base Date is 30 June 2016.

Results are calculated weekly and assume immediate reinvestment of all dividends and exclude costs associated with investing in the ETF. You cannot invest directly in the Index. The above performance information is not a reliable indicator of current or future performance of SUBD, which may be lower or higher. The iBoxx AUD Investment Grade Subordinated Debt Index was launched on 10 October, 2019. Data prior to the launch date is back-tested data.

Further, when you compare subordinated bonds to hybrids on the same metrics, they are significantly less risky and achieve a higher Sharpe ratio.

With some estimates suggesting the big four banks need to raise \$50 billion to meet new capital adequacy requirements, the subordinated bond market is poised for significant growth. SUBD gives investors' access to this market in a convenient ASX listed ETF.

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