Market adjusts as APRA makes capital call expectation known

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- On 1 November 2022, APRA issued a clarification letter to banks and insurance companies, to 'reinforce existing prudential requirements for Additional Tier 1 Capital or Tier 2 Capital instruments'. These capital instruments are widely held by market participants such as asset managers, superannuation funds, banks, and retail investors.
- These instruments are typically issued in both fixed and floating rate format, with a longer-term maturity (often 10 years or more) and with an issuer option to call the security well prior to maturity (often 5 years prior to maturity for fixed term securities).
- Historically, the market has typically assessed the call likelihood of these instruments as a near certainty. In contrast to this, APRA's communication yesterday emphasised that it needs to be satisfied of the economic and prudential rationale before approving requests to call and replace existing capital instruments with more expensive funding.
- Following this, we now see a greater likelihood that APRA may not approve requests to call, where this is deemed to be uneconomic and without sufficient prudential rationale.

In line with the existing prudential standards, ADIs, general insurers and life companies generally should not call an Additional Tier 1 Capital or Tier 2 Capital instrument and replace it with an instrument with a higher credit spread or one that is otherwise more expensive, as it may create the expectation that the issuer will exercise a call option on other outstanding Additional Tier 1 Capital and Tier 2 Capital instruments with call options.

An exception would be where the issuer can (i) satisfy APRA as to the economic and prudential rationale of the call; and (ii) satisfy APRA that such action will not create an expectation that other instruments will be called in similar circumstances.

- APRA, 1 November 2022

- This clarification is likely to have wide-ranging impacts on the Australian subordinated debt market moving forward. This may manifest in a number of ways:

  – The call option will now need to be priced for existing and new issuance, in contrast to the automatic call assumption that has been market consensus. In general, this will lead to more volatile prices and risk profiles for these securities, and likely higher funding costs for issuers.

  – Individual security features will have an important bearing in pricing this call value. Bullet structures and instruments with high coupons will fare better, while low coupon, floating-rate instruments close to their call date are likely to be the worst affected.

  – For example. Westpac's 16/02/2028 Tier 2 security has an upcoming call in 3 months 02/2023. Pre-APRA communication, this security was trading close to par at ~$100. Should this security reprice to maturity, in line with CBA's recent 5-year issuance at a 2.70% trading margin, this would see a price closer to $94.25. This is clearly a significant adjustment.

- As it stands, sale liquidity for these securities is extremely challenged, with very little activity. Time will tell where pricing settles, though clear risks to the downside are apparent.

- With a pool of issuance from solely the Major Banks in Australia currently standing at $26b, this recent clarification by APRA is likely to see considerable pressure on the pricing on some of these securities going forward. Our flagship Global Credit Income strategy holds less than 5% in affected securities, far lower than many peers. Credit markets can be fickle and tumultuous, but our long-standing focus on diversifying well continues to protect client assets in more difficult market conditions.