FIIG | Factsheet

# Defence Bank Limited

21 February 2022

Sector: Financials
Sub-sector: Banks
Country: Australia
Ownership: Mutual

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### Issuer Outline

Defence Bank Limited (DBA) is a member-owned bank, which commenced operations in 1975 as a credit union under the name Defence Force Credit Union Limited (Defcredit) before changing its name to Defence Bank in 2012.

DBA provides financial products and services primarily, but not limited to, Australian Defence Force (ADF) and Department of Defence (DOF) employees and their families. Defence Bank is one of Australia's largest member-owned banks, it has 33 branches across Australia, more than 81,000 customers, and assets over AUD3bn.

The Defence Home Ownership Assistance Scheme ("DHOAS") was established in 2008 and DBA have been one of three preferred Home Loan Providers ("HLP") since.

### Key Financials (AUDm)

| LTM (30 June) | 2021 |
|---|---|
| Net interest income | 56.4 |
| Non-interest income | 6.8 |
| NI Margin (%) | 2.26 |
| NPAT | 13.9 |
| Gross loans | 2,497.3 |
| Customer deposits | 2,327.6 |
| Gross impairments (%) | 0.08 |
| Credit losses (%) | (0.03) |
| CET 1 ratio (% 30 Sept 2021) | 14.5 |

*Source: FIIG Securities, Company Reports*

### Summary Bond Details

| ISIN | Issue Amount | Ranking | Coupon | Coupon Frequency | First Call[1] | Maturity Date |
|---|---|---|---|---|---|---|
| AU3FN0058244 | AUD 15m | Subordinated Unsecured Tier 2 | BBSW +3.15% | Quarterly | 17 Feb 2026 | 17 Feb 2031 |

[1]*Excludes potential terms that would allow the issuer to redeem prior to the maturity date through a make-whole call*

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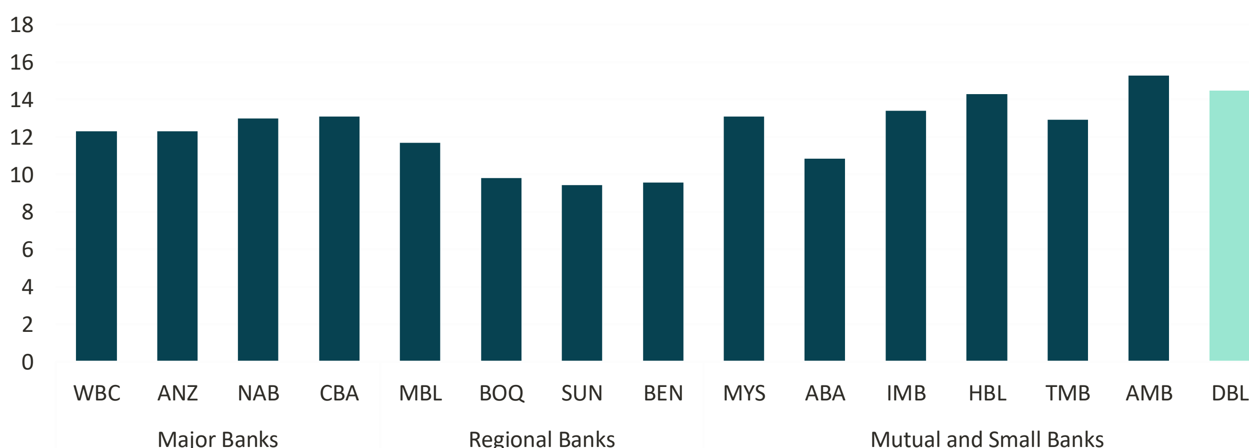
| Tier 2 Structure | |
|---|---|
| Interest Deferral/Cancellation | Interest is deferrable and cumulative if, prior to the payment of interest, the issuer is not solvent or would not be solvent after payment. |
| Non-Viability Trigger | Yes, standard Basel III compliant non-viability trigger. If APRA determines the issuer is at risk of becoming non-viable, the terms of the notes indicate that the primary method of loss absorption will be via write off, in-part or in full. |

### Strengths

- **Focus on lower-risk retail lending underpins strong asset quality**: DBA's strong asset quality is underpinned by a focus on conservatively underwritten residential mortgages, geographic diversification across Australia, and a focus on lending to current and previous Australian Defence Force personnel, who have strong job and income stability, and are eligible for the interest subsidies (~37.5% of a borrower's monthly interest payment) under the Defence Home Ownership Assistance Scheme (DHOAS). Approximately 75% of DBA's mortgage book comprises DHOAS loans. DBA is primarily focused on residential mortgages (~94%) and over 70% of loans have a Loan to Value Ratio (LVR) less than 80%. DBA is one of three lenders selected to provide mortgage loans, under DHOAS, to current eligible and ex serving members of the ADF. This scheme, supported by the Commonwealth Government, is administrated by the Department of Veterans' Affairs (DVA). It typically subsidises a portion of a borrower's monthly home loan interest payment, the associated interest subsidy remaining in place even if a once-eligible borrower no longer qualifies for the scheme, subject to available subsidy credits. Consequently, DHOAS loans can be less prone to refinancing than other loans, mitigating competitive pressures. DBA's strong asset quality as reflected by its very low problem loans to gross loans ratio, which stood at 0.11bp as of 30 June 2021.
- **Sound capitalisation, underpinned by good earnings quality:** DBA is well-capitalised, with a regulatory Tier 1 Capital Ratio of 14.48% (Total Capital ratio of 15.98%) at 30 September 2021. This places the bank at the upper end of peer and industry averages, offsetting to an extent the limited capital flexibility of DBA owing to its unlisted status (see Figure 1 below). The quality of DBA's capital is strong and largely comprising of common equity (retained earnings), supported by a high proportion of earnings with recurring characteristics (net interest income accounts for ~88% of operating revenues).

  Although DBA's minimum capital ratio is not disclosed (APRA will typically require smaller banks to hold additional capital above prescribed minimums), we estimate DBA has more than 5 times its annual earnings in surplus common equity above minimum requirements.

  Figure 1: Bank Regulatory Tier 1 Capital Ratios (not exhaustive)

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- **Solid funding structure:** Retail deposits are the bank's primary funding source, accounting for around 83% of total funding (inc. equity). DBA was also able to access the Reserve Bank of Australia (RBA) Term Funding Facility (TTF) to support financial institutions with low cost funding through the COVID-19 pandemic (closed for drawdown 30 June 2021). DBA's access to wholesale funding compares well with its peers, funding through the TFF represented ~4% of funding in FY21, and other Secured and Subordinated Term Debt (~13%) making up the funding profile of DBA.
- **Sound macro environment and regulatory oversight**: Australian financial institutions benefit from operating in an economy characterised as having a very high degree of economic resilience with low susceptibility to event risk. The Australian economy rebounded strongly after the initial wave of COVID-19 related lockdowns in 2020. Although there remains some level of uncertainty relating to the COVID-19 pandemic, institutional and governance frameworks compare well with overseas jurisdictions, providing an additional level of comfort.

  Australian banks including DBA are overseen by a highly regarded prudential regulator, APRA, who oversees banking, insurance and superannuation, with the aim of maintaining the integrity, safety and soundness of financial institutions. In response to the COVID-19 pandemic, APRA has provided regulatory relief for loans under deferral and the Reserve Bank of Australia has provided low cost funding through the Term Funding Facility (TFF) to enable Banks to support their customers during the period of economic uncertainty caused by COVID-19 (now closed for new drawdown).

### Risks

- **Small market share:** Although DBA is one of Australia's leading home loan providers for Australia's defence force, its market share within the Australian home loan market is insignificant at materially less than 0.1%. As a reflection of its size, the bank also has a relatively high cost base, with its cost to income at ~73%, however the bank continues to improve efficiency through expense management and digitalisation, and its operating expenses to total assets ratio has fallen by 70 bps over the past five years. Additionally, we expect continuing earning headwinds from the low interest rate environment that will pressure the bank's net interest margin. These factors leave the bank and its business volumes susceptible to competitive and margin (profitability) pressures. The bank to-date has managed this reasonably well without a significant shift in its risk profile, highlighting a sound business base (see Figure 3 and 4 below).

Figure 2: Net interest margin

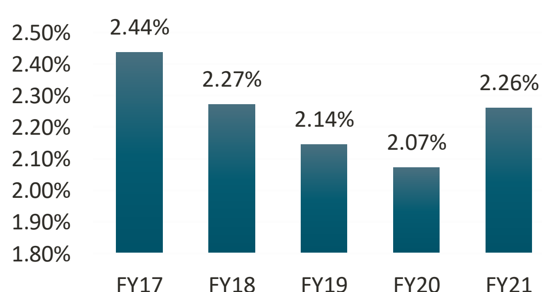
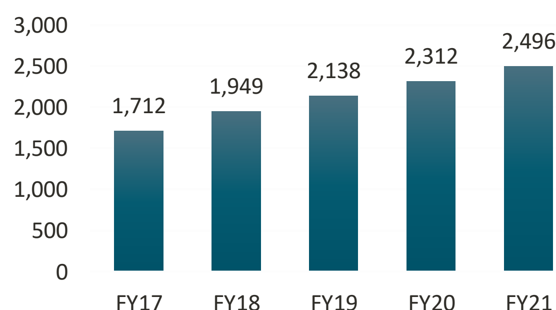



Figure 3: Gross Loan Book (AUDm)




- **Limited business line and profitability:** Although the quality and composition of DBA's earnings are very good, with net interest income accounting for ~87% of operating revenues DBA's lending portfolio maintains a moderately higher proportion of loans with Loan-to-valuation ratio (LVR) greater than 80%, compared to other rated mutual banks. Furthermore, its high concentration in residential mortgage lending may raise challenges amid high household leverage and high uncertainty about the speed and nature of the economic recovery from the pandemic related economic downturn. The DHOAS tiered system encourages ADF members to borrow early in their careers with the ADF. This can lead to reduced deposit sizes and higher LVR loans. This, combined with a predominant exposure to residential mortgages, leaves the bank reliant on favourable residential property market dynamics (primarily house prices and employment), and susceptible to pressures from rising interest rates.

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- Liquidity risk within the bond: A bond's liquidity reflects the ability to sell a bond at a reasonable price (i.e., without causing a significant change in its price) in a reasonable amount of time. Given the size of the issuance (and the issuer), bond liquidity is unlikely to be high within the secondary market.
- Rating downgrades: Ratings on both issuers and issues can be influenced by factors that do not necessarily reflect the financial strength or credit quality of a specific issuer. For example, in early-2020 both S&P and Moody's placed the ratings on a number of Australian financial institutions on negative outlook due to concerns about the economic outlook for Australia, which was revised back to stable in June 2021 as a result of the strong economic recovery after the initial contraction caused by the COVID-19 pandemic.

### Risks relevant to Subordinated Unsecured Tier 2 instrument

- Deeply subordinated ranking: Tier 2 instruments are unsecured and deeply subordinated instruments, ranking ahead only of ordinary shares and additional Tier 1 hybrids. Tier 2 instruments rank behind senior creditors, which includes depositors, senior unsecured and senior non-preferred creditors (mostly relevant for European banks, only).
- Optional call dependent on regulatory approval: Tier 2 instruments include an early call feature where the face value of the notes may be repaid early in cash from a given date stated in the terms and conditions of the instrument. The optional redemption requires regulatory approval, which may not be provided.

  In general, regulators are unlikely to provide approval for a Tier 2 instrument to be called if it results in a reduction in the issuer's capitalisation; regulators are unlikely to provide approval for a redemption or resale unless the issuer has, or is expected to, issue an instrument of similar size to replace the instrument subject to that call. To the extent the optional call was expected not to be exercised, it is likely that the price of the notes will be negatively affected, with this negative price movement being potentially material.
- Write-down following a Non-Viability Trigger Event: A Non-Viability Trigger Event occurs when APRA determines write-off of some or all of an issuer's contingent capital securities is necessary to prevent that financial institution becoming non-viable. Whether a non-viability trigger event will occur is solely at the discretion of APRA. APRA does not define what constitutes a non-viability event and there are currently no precedents under Basel III to determine non-viability. If such event occurs, the issuer may be required to write-off the value of these notes. We note that it is expected that the write-off would be expected to be applied first to AT1 hybrids (if any) and only then to the Tier 2 if the AT1 write-off was not sufficient to restore the issuer to a viable position.
- No equity conversion: Unlike ASX-listed banks that can potentially offer an equity conversion as part of a Non-Viability Trigger Event (because such shares can be issued and traded), DBAis unable to provide the same conversion mechanism, meaning that the only recourse for a Non-Viability Trigger Event is a write-off (either partial or total) of the notes.

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## Financials

The financial summary below represents the consolidated operations of DBA

| FYE June 30 (AUDm) | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|
| Profit and Loss | | | | | |
| Net interest income | 41.7 | 44.3 | 45.9 | 47.9 | 56.4 |
| Non-interest income | 8.4 | 8.1 | 8.1 | 7.8 | 6.9 |
| Total revenue | 49.9 | 52.2 | 53.9 | 55.2 | 64.0 |
| Provision for loan losses (credit losses) | 0.3 | 0.1 | 0.1 | 0.5 | (0.8) |
| Non-interest expenses | (36.7) | (38.3) | (39.5) | (40.9) | (44.1) |
| Net profit after tax | 9.4 | 9.8 | 10.0 | 10.1 | 13.9 |
| Balance Sheet | | | | | |
| Cash and investment securities | 216.4 | 229.4 | 271.3 | 331.3 | 397.7 |
| Gross loans | 1,713.0 | 1,949.9 | 2,139.8 | 2,314.0 | 2,497.3 |
| Allowance for loan losses | (0.3) | (0.3) | (0.6) | (1.0) | (0.3) |
| Intangibles | 0.6 | 0.8 | 0.9 | 1.1 | 0.8 |
| Total assets | 2,031.5 | 2,277.8 | 2,500.3 | 2,750.9 | 3,022.8 |
| Deposits | 1,731.4 | 1,943.4 | 2,080.2 | 2,196.9 | 2,327.5 |
| Term debt (inc. securitisation) | 123.6 | 146.9 | 222.6 | 347.7 | 476.3 |
| Total liabilities | 1,871.9 | 2,108.4 | 2,321.1 | 2,561.9 | 2,819.9 |
| Total equity | 159.6 | 169.4 | 179.2 | 189.0 | 202.9 |
| Credit metrics | | | | | |
| Net interest margin | 2.44% | 2.27% | 2.14% | 2.07% | 2.26% |
| Bad debt expense (credit loss provisions) | 0.01% | 0.01% | 0.01% | 0.03% | (0.03%) |
| Non-performing loans^ | 0.11% | 0.22% | 0.24% | 0.36% | 0.08% |
| Common Equity Tier 1 ratio | 15.0% | 14.4% | 13.9% | 13.4% | 14.3% |

*Source: Company, S&P Capital IQ, FIIG estimates. ^90-days past due and impaired.*

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FIIG The fixed income experts

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