

## STAYING ON TOP OF **THE CURVE**

THE MULTIPLICITY OF POTENTIALLY AVAILABLE ASSET CLASSES HAS YET TO MAKE FUNDING A STRAIGHTFORWARD TASK FOR AUSTRALIA'S REGIONAL BANKS. SECURITISATION IS STILL THE BEST HOPE IN WHOLESALE MARKETS, BUT RETAIL MONEY – IN DEPOSIT AND BOND FORMAT – LOOKS TO BE THE REAL KEY.

In November 2010 Suncorp Bank (Suncorp) priced A\$900 million (US\$901.9 million) in a senior unsecured fixed and floating rate deal. The transaction was the first benchmark, non-government guaranteed deal from an Australian bank outside the big four since 2008. At 110 basis points over swap the transaction priced competitively with securitisation, but that very competitiveness prompts doubts that the deal will spark significant public senior unsecured deals from lower-rated and regional banks.

Suncorp's strong single-A status helped it achieve pricing as tight as it managed in senior unsecured format, but even that level may have been 10 basis points wider than what would have been seen in a residential mortgage-backed securities (RMBS) deal from the same issuer.

Securitisation remains potentially the cheaper option, particularly for banks further down the ratings curve. In that market, senior bank pricing is untested in recent times but could, according to intermediaries, be more in the region of 200 basis points over swap – up to 100 basis points wider than an RMBS market that continues to be bolstered by Australian Office

of Financial Management investments.

However, the boundaries of the securitisation market for regionals are still uncertain. While these issuers typically like the RMBS market, and credit investors indicate some of the best opportunities are still in the RMBS space, new regulatory and rating agency treatment of capital treatment of securitised assets may prove problematic.

A raft of regulatory and ratings agency reassessments of practices in the securitisation market has conspired to require larger segments of subordinated paper in asset-backed transactions. Issuers either have to find capacity to retain these lower-rated notes or place them with third parties, despite the investor base for this type of product being decimated by the financial crisis.

Although the regulatory aspect relates specifically to the use of securitisation for capital relief rather than funding purposes, a number of the non-major banks are trying to tap the securitisation market for this purpose. This remains a serious impediment to them securitising and therefore competing. "Post-crisis, issuers have been largely unable to sell class B notes and

so find themselves required to hold regulatory capital against the entire transaction – not just those retained tranches," comments one market participant.

Some say a more enlightened approach that has regard to the actual amount of risk contained in class B notes may be more appropriate, along the lines adopted in other jurisdictions.

The critical question is how much appetite there is for subordinated tranches, particularly given subordination levels have increased dramatically over the course of the financial crisis, from 2-3 per cent to 6-9 per cent.

IFM has emerged as a major buyer of lower-rated notes of securitisations in Australia. "There have been very good opportunities in this space and we hope that with the major banks using covered bonds in the future we will see more issuance from the non-majors into the RMBS market," comments Bruce Potts, investment director, debt investments at IFM.

While there are other buyers to be found, even houses that have purchased subordinated securitisation notes admit the market remains far from fully functional. "While we don't

buy significant volume at senior level, we are a big supporter of regional subordinated debt and the B notes of securitisations. The assets are great value for investors but the pricing the market is demanding can be a problem for these issuers," admits Cameron Rae, managing director at Laminar Group

Rae is not certain that non-major banks will be able to meet the market in light of capital relief developments. "The market level is much higher than the level at which many issuers are willing to fund, which is making execution very difficult. With authorised deposit-taking institution (ADI) issuers now unable to hold their own B notes without a significant capital hit, new investors need to be found or we could see another freeze in the market."

### Fixed appetite

The Australian government has pledged to offer further assistance to the RMBS recovery by encouraging the development of a bullet RMBS market which could make the product more appealing to real money buyers – crucially by allowing it to be included in benchmark indices. However, the going is slow and expected in some quarters to bear more fruit offshore than locally.

It has been a tough market to stimulate given the small number of fixed rate mortgages originated in Australia. According to the Australian Bureau of Statistics, over 2010 to the end of August – the most recently-available data – just 3 per cent of households financed



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home ownership with fixed rate mortgages. Since the ABS started keeping data in 1991 the average rate of fixed rate finance sits at 6.3 per cent.

Apart from mortgage supply, issuance of this type of structure has been constrained because the Australian Prudential Regulation Authority does not allow what has been the most cost-effective vehicle for fixed rate issuance – master trust structures. In the absence of this structure, fixed rate deals need to include a basis swap to ensure that cash flows from the assets can meet the fixed repayment structure. This increases the cost to the issuer substantially.

Nonetheless, two fixed rate RMBS transactions priced in 2010. BankWest's Swan 2010-2 trust included a bullet tranche while 50 per cent of Bendigo-Adelaide bank's A\$1 billion Torrens 2010-3 deal comprised a series of bullet tranches.

David Hanna, senior portfolio manager at Macquarie Funds Management, says: "We welcome this iteration, especially given that it qualifies for inclusion in the index. This allows for more investment components of the index to be put to use for domestic benefit. RMBS as an asset class is very suited to superannuation money, offering stable and consistent returns which pay off and amortise, and would be a perfect way to fund retirees."

Jeff Brunton, head of credit markets at AMP Capital Investors, believes it is important for bullet product to be developed but he speculates that a better and potentially easier approach might be to simply lobby harder for inclusion of the floating rate product into the index. "There is no real reason why a floating securitised bucket cannot be included in that index," he insists.

One market participant argues that the target investor base for

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this instrument is actually offshore. "Offshore investors want the bullet for different reasons," he comments. "Investors in the UK are familiar with the structure because 99 per cent of deals in that market are fixed rate. US investors like it because their market is primarily a pass-through market and they are looking for this structure to facilitate liquidity. Offshore investors also like it because bullets issued from a master trust have lower prepayment volatility, which reduces the swap costs. As a result issuers can pass on better pricing."

### Retail key

While discussions go on concerning the securitised and senior unsecured prospects for regional banks, the issuers themselves have quietly gone about rebalancing their overall funding mix in favour of retail sources.

For example, at its annual results, presented on February 14 2011, Bendigo and Adelaide Bank (Bendigo-Adelaide) disclosed a retail proportion of funding at 74 per cent at the end of calendar 2010, with the retail component of on-balance sheet funding being even greater at 91 per cent. Suncorp is also now around three-quarters funded by retail.

This is hardly surprising given the extreme cost of senior unsecured borrowing in the post-government guaranteed era and the still-limited

capacity of securitisation markets. Bendigo-Adelaide is if anything moving further away from the wholesale bond market. Having not issued medium-term notes as a merged entity – even, almost uniquely for an Australian ADI, under government guarantee – the bank's wholesale bonds make up no more than legacy positions in the overall funding mix.

According to *KangaNews* data there is A\$590 million of outstanding Adelaide Bank paper in the market, the last of which was priced in 2007 and is set to mature in March 2012, while Bendigo Bank has just a single A\$40 million subordinated maturity remaining with a call date in December this year. Meanwhile, Bendigo-Adelaide has issued A\$3.6 billion of RMBS since March 2010.

### Retail options

Its next development is the issuance of a medium-term note (MTN) of up to A\$250 million in volume – but to a retail investor base. On February 18 Bendigo-Adelaide announced plans to complete just the second vanilla retail bond issue in Australia with a three-year transaction. "The offer enables [Bendigo-Adelaide] to diversify its own funding streams, and it will also be pleasing to be part of an emerging Australian corporate bond market," said the bank's group managing director, Mike Hurst. Market sources have commented on the tight margin – of 140 basis points

over swap – Bendigo-Adelaide is seeking in its retail deal. The price is 30 basis points wider than Commonwealth Bank of Australia's five-year retail deal from 2010 and 15 basis points tighter than the four-year wholesale trade issued by the higher-rated AMP Group Finance Services in February 2011.

Although brokerage costs will increase Bendigo-Adelaide's landed cost of funds, its target retail margin suggests it believes that market will lend to it more cheaply than would likely be the case in wholesale format.

The ever-growing panoply of options available to retail is yet another factor restricting inflows to mezzanine product. Semi-professional, lower-tier institutional investors, formerly big supporters of the subordinated debt market, no longer need to chase yield. "While they can hit their objectives there is no need for them to stretch down the curve. Consequently, generating appetite for lower-rated regional issuance is challenging, but for those willing to look at the regional issuers there is value to be had," says Rae.

The term deposit rates currently on offer – which could be joined by further retail bank MTN issuance – have also extended into the return territory once only accessible by investing in the capital markets. This has taken away a large slice of investor demand.