

# EUREKA *report*



## Term deposit rates turn north

By Justin McCarthy  
July 30, 2010

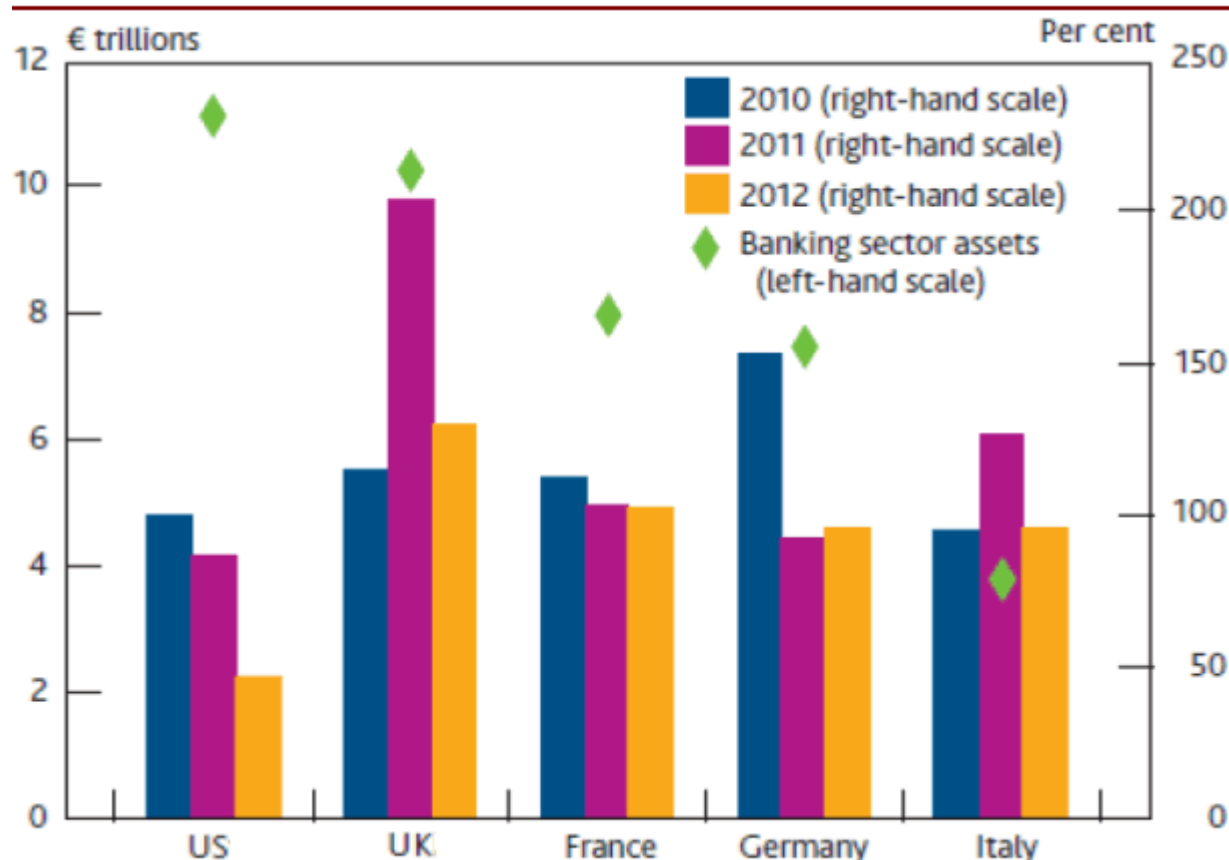
**PORTFOLIO POINT: Expect term deposit rates to rise as banks seek alternatives to expensive overseas funding.**

Numerous media reports over the past few months have suggested term deposit rates were on the way down. I don't believe this is the case. In fact I expect the growing focus on term deposits by the banks to lead to higher deposit rates, in part due to the increasing cost of offshore wholesale funding.

Recent turmoil in global markets surrounding sovereign debt concerns, European stress tests and the US Dodd-Frank Act have put pressure on global bank spreads and led some banks to delay funding programs. Supply concerns, particularly from Europe, have also added to an uncertain outlook for bank issue margins.

The Australian majors have always had a high reliance on offshore markets, particularly Europe, to fund themselves and recent developments are making this more difficult and expensive. As the chart below demonstrates, there is a large glut of bank refinance/supply to hit the market in coming years.

### Banking system refinancing requirements



Source: Bank of England Financial Stability Report, June 2010

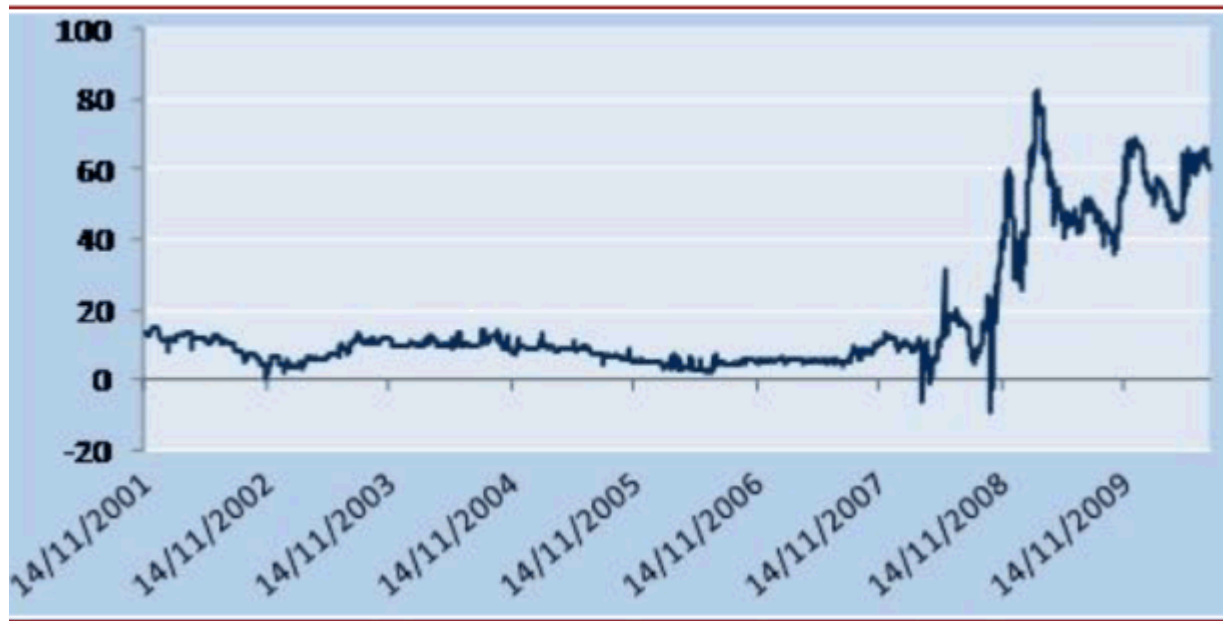
In particular, the UK and European supply task is hefty and it is in the European market to which the Australian majors have traditionally turned to borrow. This "crowding out" results in wider spreads and difficulty in raising large

amounts.

In addition to the supply concerns, converting Euros into Australian dollars remains expensive. The following chart plots the basis swap for the five year EURIBOR-BBSW over the past 10 years.

As you can see, it is historically high at 61 basis points, roughly adding that amount to the cost of raising wholesale funds from the European market. While the US dollar LIBOR equivalent is not quite so extreme at 30 basis points, it still adds to the cost of wholesale funding.

Five-year EURIBOR-AUD basis swap



Source: Bloomberg

So what are the implications of expensive offshore wholesale markets and what is the relevance to term deposit spreads?

The result of these developments in offshore markets has seen the banks focus on the domestic market to conduct a greater portion of their funding. Surprisingly, the domestic market is not a large buyer of major bank debt when compared to overseas markets. So the increased supply of senior bonds in the Australian market quickly outstrips demand and once again leads to widening spreads.

A major bank recently did a five year Australian dollar senior issue at 135 basis points, about 30–40bp above where similar secondary issues were trading just a few months back, indicating the difficult time they are having in raising new funds.

Larger debt raisings conducted by the majors in US dollars and Euros have been as wide as 155 basis points when brought back to the Australian dollar equivalent. Offshore markets are able to provide the size but that is seemingly coming at additional cost.

With securitisation markets unable to provide a material amount of funding for the big four, the only meaningful market left is that of term deposits. As a result of the above we believe that a new round of competition for deposits will soon begin. Signs of special rates are already appearing.

Moreover, recent comments from the major banks have indicated that a greater strategic focus will be placed on deposits as a source of funding. Banks used to spend the majority of their print advertising budgets on mortgage rates but this has now switched to deposit rates.

At the retail end, the government guarantee means competition must be conducted via price, or more correctly deposit rates offered. This ratcheting of retail rates then feeds through to the wholesale market where a greater focus is on the name or institution. The following charts demonstrate what happens in times of intense competition.

### The benefits of competition

The first graph below depicts FIIG's term deposit Indices for various maturities, 90 days out to one year. This takes

the average daily margin over the relevant BBSW/swap rate for each term deposit provider in our database and plots it as a time series for the various maturity buckets.

When the government guarantee was introduced in October 2008 we saw a significant spike in deposit rates. Again, when competition heated up among the major and regional banks in December 2009/January 2010 there was a significant increase in term deposit spreads. While we can't predict the extent of spike, we do expect an upward trend in deposit spreads as a result of the above factors.

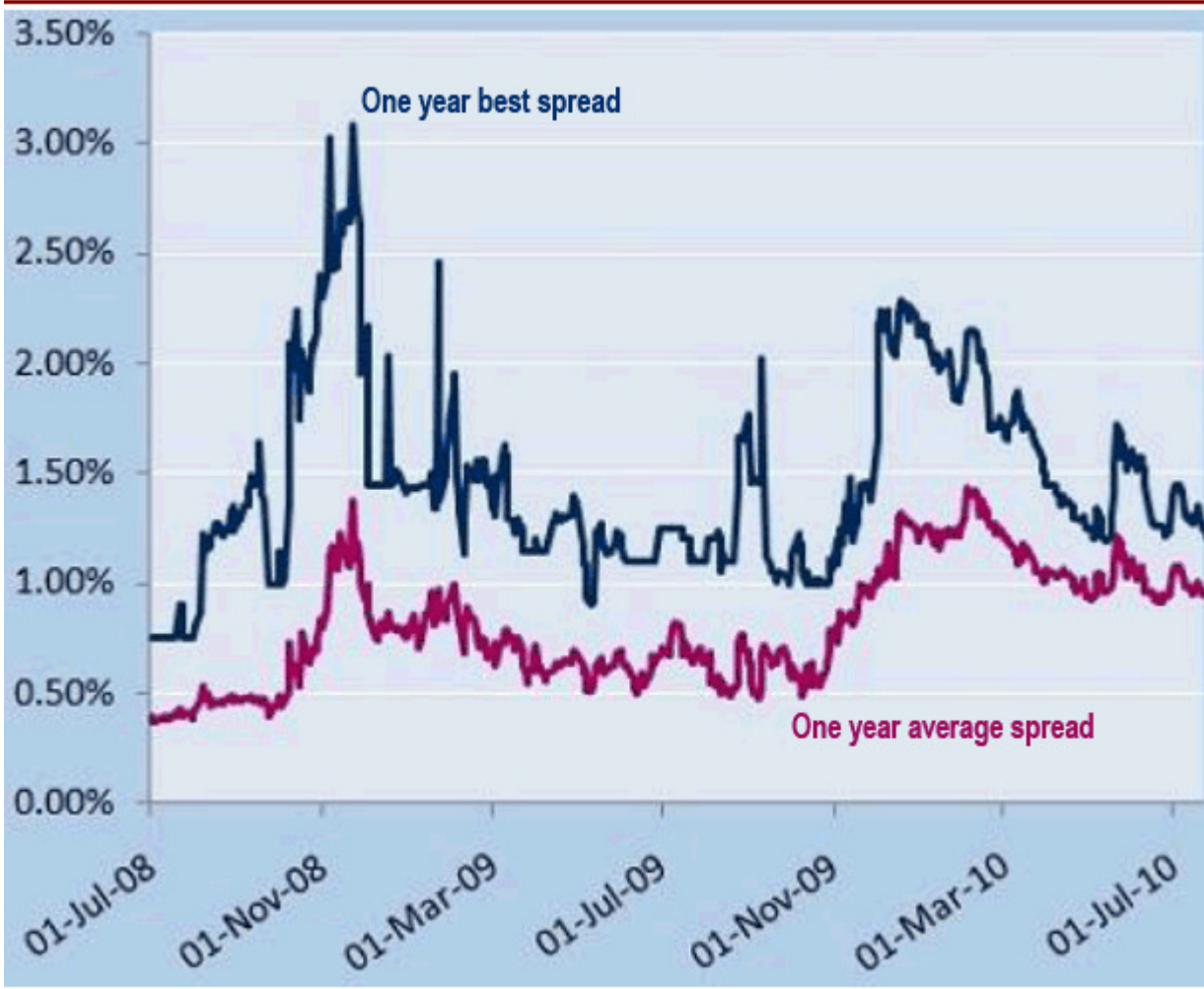
Australian term deposit index spreads over BBSW (daily)



Source: FIG's term deposit indices

The final chart below looks at another benefit of competition: bigger "specials". Using the one-year rate as an example, the chart below demonstrates that the best rate or "special" (blue line) increases significantly more than the average (red line) in times of increased competition.

### One-year term deposit spreads



Source: FIIG's term deposit indices

Typically the best rate is 30–60 basis points above the average, depending on the maturity bucket. However, in times of competition when banks need to really push the boundaries to attract funds, the best rate can be 100–150 basis points above the average. Competition is always good for the investor and we expect that this will increase over time.

•••••

Justin McCarthy is head of research with **FIIG Securities**.