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Unsecured bank bonds are back and looking fine

BRAD NEWCOMBE

THE Commonwealth Bank of Australia is set to become the first local bank to issue an unsecured senior bond to retail investors that will be listed on the Australian Securities Exchange.

The CommBank Retail Bonds Series 1 will have a five-year maturity and be offered at a margin between 1 per cent and 1.15 per cent over the 90-day bank bill swap rate (BBSW) with a minimum interest rate of 6 per cent for the first interest period. The deal illustrates the effect the global financial crisis has had on the funding costs of the banks. A few years ago, major bank hybrids were being issued at margins of 1 per cent over BBSW for five years. Now investors are being offered similar and potentially better returns for a security carrying far less risk. Another comparison is the level where major bank senior unsecured bonds were trading at before the GFC. At the height of the market these securities traded at a margin of just 0.10 per cent over BBSW, a far cry from the levels of present deals.

From a valuation perspective, the security looks reasonably attractive on several measures.

Five-year CBA term deposits are

6.40 per cent at present but interest on these securities is paid annually, not quarterly as with the retail bonds. This inflates the return of the former.

At present BBSW is about 5.03 per cent, meaning the initial coupon on the retail bond will be between 6.03 per cent and 6.18 per cent.

However, this figure doesn't factor in future interest rate movements. With rates expected to increase during the coming years, this understates the return investors should expect to receive on security.

The relevant reference rate to look at when comparing against a fixed-rate term deposit is the five-year swap rate. This figure effectively swaps the floating rate return of the retail bond into a fixed return similar to a term. At present, this rate is about 5.73 per cent, meaning the expected return on the retail bond is between 6.73 per cent and 6.88 per cent. This works out to be a premium of 0.33 per cent to 0.48 per cent more than what a five-year term deposit is offering.

While term deposits under Australian banking and insolvency laws rank higher than the retail bonds on the bank's capital structure, we rate the ad-

ditional risk for being invested in the latter security as minimal. We believe the additional return available from the retail bonds is more than adequate compensation for this extra risk.

Another advantage is that investors will also benefit from having a security that is listed on the ASX and can be liquidated at any time.

The pricing on the deal also compares reasonably with similar wholesale senior ranking bonds issued by the banks. A five-year senior bond issued by the National Australia Bank is trading at about 1.14 per cent over BBSW, bringing it in line with the top end of the indicative margin for the CBA retail bonds.

In fixed income, retail investors typically pay more than wholesale participants for the equivalent product. So it is pleasing to see that retail investors in the CBA deal are set to receive a return similar to that at the wholesale end of the market.

Brad Newcombe is director, listed IRS and fixed income research at FIIG Securities. Disclosure: since this article was written, FIIG has been appointed co-manager of the bond issue.