EUREKA report

# Very low risk, and matching rewards

By Elizabeth Moran
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**PORTFOLIO POINT: They offer banks the chance to raise $150 billion, but low returns mean private investors will be able to do better elsewhere.**

Could Australian banks be about to catch up with the world? Last week draft legislation was introduced that would allow local banks to issue covered bonds, a source of funding that has been available to international banks since the 18th century.

A covered bond is secured against specific assets, which means in the event of default by investors who purchased the bonds have first claim to repayment from the underlying assets. The assets remain on the issuer's balance sheet as opposed to mortgage backed securities (MBS) where the assets are taken off balance sheet.

In 2005, the European market for covered bonds was estimated to be worth €1.8 trillion and had grown by 8% over the previous year. In some of these markets they are available to investors in small parcels, but there is no indication yet about pricing in Australia

Australia's big four banks have been lobbying for a covered bond market for some time as they should offer access to cheaper funding. Covered bonds secured by high quality assets should attract higher credit ratings than the issuer credit rating and therefore tighter spreads than senior debt.

Additionally they are typically over-collateralised, meaning each $100 of covered bonds issued might be backed by, say, $105 of quarantined security/assets, which means less risk.

Based on the over-collateralisation, high quality of the loan assets in the covered pool and the strength of the issuing banks, most covered bonds receive high credit ratings of AA or AAA. In general, their maturities range from two to 10 years, although there is a recent trend towards long term securities greater than 10 years.

As I touched upon earlier, the other reason financial institutions want to issue covered bonds is to diversify funding sources. Australian financial institutions should find ready US and European markets for covered bond issuance. It is also possible that covered bonds will become eligible high quality liquid assets under the new Basel III / APRA liquidity rules for larger ADIs providing a source of domestic demand in years to come.

Draft legislation limits covered bond issuance to 8% of assets, a lower figure than the 10% financial institutions had been seeking.

By our estimates the "big four" will be able to issue up to $150 billion in covered bonds before they reach the 8% cap. Effectively secured debt, covered bonds technically rank above deposits but amounts under $1 million are still government guaranteed under existing rules that end in October this year (see the diagram below).

Because the bonds sit very high in the capital structure, we would expect the spreads over the swap rate benchmark to be very low, somewhere approaching 50 basis points.

The very safe bonds with a low return will appeal to a limited audience. Most individual investors would be better investing in the same institutions, but lower down their capital structure for a higher return, given underlying confidence in the issuer.

Other examples of high quality bonds paying better returns are AAA-rated residential mortgage backed securities (RMBS), paying spreads of roughly 100 basis points; or one of my favoured corporate issuers, GE, whose bonds are trading on spreads of 75–110 basis points for maturities from one to nine years.

It should be noted that senior bank debt risk will increase as the percentage of covered bonds issued increases in financial institutions. Very high quality, low-risk assets will be diverted to these asset pools, theoretically increasing the risk of senior unsecured debt.

**Capital structure, Australian bank**

LOWEST RISK

| Capital Qualification | Example |
|---|---|
| Senior Secured Debt | Covered Bonds limited to 8% of Total Assets |
| Deposits | Deposits junior to Senior Secured Debt but some will be Government Guaranteed |
| Debt | Senior Debt |
| Lower Tier 2 | Dated Subordinated Debt |
| Higher Tier 2 | Perpetual Step-up Securities (Cumulative) |
| Innovative Tier 1 | Perpetual Step-up Securities (Non-Cumulative) |
| Non-innovative Residual Tier 1 | Converting Preference Shares, Perpetual Preference Shares |
| Fundamental Tier 1 | Ordinary Shares Retained Earnings & Reserves |

HIGHEST RISK

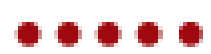
Priority of payment in liquidation (arrow pointing down)

Application of losses (arrow pointing up)

Source: FIIG Securities

Small banks, including mutuals, will also be able to take advantage of the proposed covered bond market once they become a funding option later this year. Smaller banks would still be subject to the same 8% cap on the allocation of assets to covered bonds as other banks.

The Australian Prudential Regulation Authority (APRA) will also have a veto power over covered bond issuance, with the regulator given the ability by the draft bill to direct a bank not to issue covered bonds via written notice.



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