

Better bank investments



By Elizabeth Moran

PORTFOLIO POINT: Shares are not the only investment option on offer from banks.

Last week Moody's credit rating agency announced all four of Australia's major banks (ANZ, CommBank, NAB and Westpac) senior unsecured debt ratings had been downgraded.

This has caught many retail investors off-guard, although in reality the downgrade had been factored into new debt issues since the credit agency put the banks on "negative watch" in January.

The rating change, combined with coming regulatory changes, the prospect of higher interest rates and a more aggressive competitive stance from NAB, mean that this is a good chance for those overweight bank equities to reassess their allocations across the capital structure.

Possible impacts to investments include:

- Paying more for wholesale debt, which may only be marginal, but when you have to borrow billions of dollars a year it adds up.
- The term deposits war is likely to continue. Retail term deposits are deemed "sticky" and very important to the banks.
- New Basel III legislation on the horizon means banks will have to hold more capital in highly liquid investments, denting ROE and lowering returns to shareholders.
- If the banks are deemed systemically important financial institutions (SIFIs) – and there is much contention about this – then they will be required to hold even more poor returning capital, further diminishing margins.
- The banks continually assess cost to income trade-offs. Higher-risk and thus higher-cost investments will require a higher capital allocation and margins for higher-risk ventures should increase to ensure minimum returns are achieved. This may act to reduce the availability of credit or willingness to borrow and constrain bank growth.
- A higher cost of funding will need to be borne by either the shareholder (through lower returns) or the customer (by paying higher margins), for the banks to maintain profitability.
- The banks always have the ability to increase margins to cover higher costs, but NAB's grab for market share means investors should question the bank's ability keep raising rates and fees when a major competitor seems intent on doing the opposite.

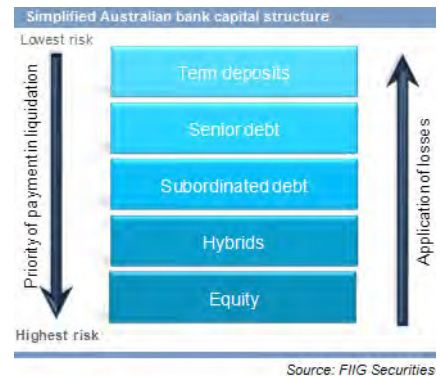
Given these events, it is easy to see why an investor may want to consider dialling down their exposure to bank equities and consider investing in assets further up the capital structure. Remember that the lowest-risk investments sit at the top of the structure and as you progress down, risk increases and returns should increase until you reach equities.

As you can see from the following chart, term deposits sit at the top of the structure and deliver a fixed return for a fixed period, currently between 6% and 6.8%. I still expect term deposits to offer attractive returns but in a growing economy with rising inflation, locking into a long term may not be

wise. CommBank expects four cash rate rises in the next year and although this might not eventuate, I'd keep investments in this asset class short to take advantages of potentially higher returns.

Investors should also consider switching a portion of investment here to slightly higher-risk and higher-return bonds.

A floating-rate note whose coupon changes quarterly to reflect changes in market interest rates would be beneficial.



Source: FIIG Securities

Selection of major Australian bank fixed income investments			
Security	Issuer	Expected maturity	Yield
Term Deposits	ANZ Banking Group	20-May-12	6.00%
	Commonwealth Bank of Australia	20-May-14	6.20%
	National Australia Bank	20-May-16	6.80%
Senior Debt (Fixed)	Westpac Banking Corporation	18-Nov-14	5.57%
	National Australia Bank	05-Nov-15	6.57%
	Commonwealth Bank of Australia - Retail	24-Dec-15	6.93%
Senior Debt (Floating)	Commonwealth Bank of Australia	20-Feb-14	5.39%
	National Australia Bank	05-Nov-15	6.49%
	Commonwealth Bank of Australia - ILB	20-Nov-20	CPI + 3.90%
Subordinated Debt (Fixed)	Commonwealth Bank of Australia	25-May-12	6.38%
Subordinated Debt (Floating)	ANZ Banking Group	05-Mar-12	6.36%
Hybrids	Westpac Banking Corporation	30-Dec-14	7.50%
	Commonwealth Bank of Australia	31-Dec-16	7.75%
	ANZ Banking Group	15-Dec-16	8.00%
	National Australia Bank	Perpetual	8.14%

Note: Term deposit rates are from TermDeposit.com.au and are current as at 20 May 2011
 Note: ILB is an inflation linked bond and CPI is Consumer Price Index

Source: FIIG Securities

Senior debt offers a couple of options – fixed rate bonds (fixed coupon) and floating rate notes (floating coupon tied to an underlying benchmark such as BBSW), as well as inflation linked bonds for those worried about the loss of capital value in a period of high inflation.

Senior bank debt is very low risk, providing known returns from a liquid market, a very good alternative for investors with large term deposit holdings. Most bonds in this category require a minimum face value investment of \$500,000, but CommBank's retail bond, listed on the ASX, has no minimum investment. Larger investments will be able to achieve better returns.

Subordinated debt is a dying asset class, with Basel III set to eliminate its contribution to capital. It is still a target for fixed income investors as I expect the banks will seek to repay this debt and refinance with capital that meets regulatory requirements.

Hybrids or listed interest rate securities are the highest-risk/highest-yielding fixed income investments. Bank investments in this category offer attractive returns as they sit lower in the capital structure and are theoretically higher-risk. However, some are perpetual and you can only recoup capital by selling, so you are relying on a liquid market.

With no minimum investment amounts and confidence in the banks' ability to continue to trade, these investments are especially attractive when compared to higher-risk shares as they are generally less volatile.



Investment in shares is based on the belief that the bank will grow, as will its share price, delivering higher returns than debt investments. Slower or low growth will mean banks will have to seek other (possibly more risky) avenues for higher returns.

Share price volatility is a distinct possibility. Overseas expansion is high



risk. NAB's UK investment has been a drag on returns. The major banks have very high market shares, but domestic growth is limited.

In summary, investors need to assess their appetite for risk, not just return. Major bank fixed income products offers investors a range of risk/return options. A five-year term deposit can earn 6.8%, a face value \$500,000 senior debt floating rate note 6.49% (CommBank's retail bond with no minimum still offers a good 6.93%), near to maturity subordinated debt offers 6.38% and hybrids 8.00% or more.

The "sure thing" equity returns in recent years are no longer so sure with changes in regulation, heightened competition and questionable growth. Maybe it's time you seriously considered adding fixed income to your portfolio. ◆

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