

Instos question covered bonds

Covered bond issue highlights funding difficulty

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Domestic institutions are questioning the added value of covered bonds.

Australia and New Zealand Banking Group's (ANZ) US\$1.25 billion (\$1.24 billion) inaugural covered bond issue has been taken up by offshore investors, with domestic investors turning away from the issue, and its expense highlights the difficulty of raising money in today's financial markets.

ANZ priced its notes at 115 basis points over the mid-swap level, which was considered expensive for the bank by analysts. Westpac Banking Corporation last week also issued its first covered bonds in United States debt markets, with recent legal changes in Australia making such issues possible up to 8 per cent of a bank's assets.

But renewed volatility in financial markets has put other bank issues of covered bonds on hold.

Commonwealth Bank of Australia (CBA) and National Australia Bank (NAB) have reportedly each delayed plans to sell up to \$1.5 billion of covered bonds in international markets.

CBA was ready to make its debut with a euro-denominated five-year issue last week, but a jump in European borrowing costs forced the borrower to delay the offer. A CBA spokeswoman reportedly said the bank would still seek an appropriate window to issue its first covered bond.

NAB was reportedly lining up a similar offer in US dollars, but declined to comment this week on whether it would follow or axe its planned covered bond issue.

Dr Stephen Nash, director of strategy and market development at fixed-income broker FIIG Securities, said while the ANZ issue was expensive, the cost of raising money through covered bonds would likely lessen with additional issuance by Australian banks.

"Being the inaugural Australian covered bond issue in US dollars, an issuer always tends to issue a bit more expensive at the start, but eventually that spread will narrow as investors become more comfortable with covered bonds over time," Nash said.

He said the end benefit to investors was enhanced credit coverage versus senior debt.

However, domestic institutional investors have questioned the value of covered bonds when compared to unsecured bank debt.

"The banks aren't expecting the domestic market to be fertile investor ground, so they are targeting offshore investors that are more comfortable holding secured debt versus unsecured debt," Antares Fixed Income investment manager Ken Hyman said.

"They are looking or targeting an investor based with a AAA requirement, that is offshore investors who have been ravaged by the GFC (global financial crisis).

"For domestic investors to be interested, you would have to see some very mouth-watering margins to be interested in the covered bonds.

"The challenge for the banks is that the domestic investors are relatively comfortable in holding the big banks' unsecured debt, so domestic investors are reluctant to give up a lot of yield for secured assets."

Covered bonds are backed by cash flows from a pool of assets, typically residential mortgages that remain on the bank's balance sheet. In the event of default, the investor has recourse to the pool of assets, as well as the bank itself, resulting in the bonds being assigned AAA credit ratings.

Federal Treasurer Wayne Swan said ANZ's bond issue was evidence recent law changes would offer banks a cheaper source of funding. However, Australia's central bank this week said that was unlikely.

"Any pricing gain obtained from issuing covered bonds is likely to be offset to some extent by a demand from unsecured debt holders for more compensation in the future," Reserve Bank of Australia financial markets assistant governor Guy Debelle said.

"I see the role of covered bonds as primarily broadening the potential investor base rather than a means of reducing overall funding costs for banks. I would expect that covered bonds are likely to be primarily an offshore funding source for the Australian banks with the domestic investor base more comfortable with RMBS (residential mortgage-backed securities)."

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