



Covered Bonds Backfire as Bank Spreads Widen: Australia Credit

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Jan. 31 (Bloomberg) -- Australia's attempt to lower borrowing costs for the nation's largest lenders is backfiring as higher-than-anticipated relative yields on covered bonds roil the market for other bank debt.

The gap in yields between financial debt and the swap rate rose to an almost three-year high after Commonwealth Bank of Australia on Jan. 17 sold A\$3.5 billion (\$3.69 billion) of notes secured by mortgages and guaranteed by the issuer.

The lender paid the widest spread on record to investors for a local financial offering.

"The high spread at which the covered bonds were issued effectively means investors in all other bank securities need to be paid a greater premium," Andrew Gordon, director of fixed-income research at FIIG Securities Ltd. in Sydney, said in a telephone interview yesterday.

"We had clients holding senior unsecured and subordinated paper who sold and bought the covered bonds."

Australia's parliament passed legislation in October allowing local banks to sell covered bonds, which are typically rated AAA because they are backed by a pool of mortgages that stay on a lender's balance sheet and can be sold in a default.

The change was designed to help Australian banks raise wholesale funding at a lower cost than unsecured debt.

Relative Yields

Premiums on five-year senior unsecured notes sold by Australia's four largest banks increased to 185 basis points more than the swap rate on Jan. 17, the most since March 2009, from 157 basis points at the end of last year, according to a National Australia Bank Ltd. index.

Relative yields on European financial debt fell 62 to 279, while spreads on similar U.S. bonds narrowed 43 to 281, Bank of America Merrill Lynch indexes show.

The rising costs will exacerbate funding pressures for Commonwealth Bank, National Australia Bank, Westpac Banking Corp. and Australia & New Zealand Banking Group Ltd., which have an average A\$6.9 billion of debt maturing each month this year, according to Citigroup Inc.

Fitch Ratings said yesterday it may downgrade by one level the four banks because their credit rankings don't reflect their "weaker funding profile."

The long-term issuer default rating on Commonwealth Bank, Westpac and National Australia Bank, rated AA, as well as ANZ Bank, set at AA-, have been placed on "rating watch negative," Fitch said in an e-mailed statement.

Bank Downgrades

The lenders were downgraded by Moody's Investors Service in May, 2011, and Standard & Poor's last month, partly because of their reliance on offshore funding markets. The banks and their units sold a combined A\$22.8 billion of senior unsecured bonds in their home market last year, down from A\$28.2 billion in 2010, data compiled by Bloomberg show.

Elsewhere in Australia's credit markets, the government's benchmark 10-year bond yield fell 1 basis point to 3.74 percent as of 1:06 p.m. in Sydney today, or 187 basis points more than similar-maturity Treasuries.

The Australian dollar, the world's fifth-most traded currency, has dropped 4.2 percent since it reached \$1.1081 on July 27, the highest level since the currency freely floated in 1983. It traded at \$1.0617 today.

The Markit iTraxx Australia index of credit-default swaps that gauges perceptions of corporate bond risk rose 2 basis points to 162 as of 11:38 a.m., BNP Paribas SA prices show.

Biggest Offering

Commonwealth Bank's covered bond sale was the biggest offering of debt in the currency by one of the nation's lenders, according to data compiled by Bloomberg.

Sydney-based Commonwealth Bank, the nation's largest lender, priced A\$2 billion of fixed-rate notes and A\$1.5 billion of floating-rate securities at 175 basis points more than swap rates. The spreads were higher than any paid by the nation's four biggest banks to investors on benchmark domestic senior bonds in data compiled by Bloomberg since 1991.

"The deal came with a new issue premium," Simon Maidment, the lender's head of group funding, said in a e-mailed comment yesterday.

Westpac, Australia's second-biggest bank, priced A\$1.7 billion of 5.75 percent notes and A\$1.4 billion of floating-rate debt to yield 165 basis points more than swap rates on Jan. 24, data compiled by Bloomberg show.

The yield premium on Westpac's 7.25 percent senior, unsecured notes due November 2016 increased 19 basis points to 179 basis points this year, according to ANZ Bank prices.

Joanne Dawson, deputy group treasurer at Westpac in Sydney, had no immediate comment when asked about the impact of the bank's covered bonds on other bank debt spreads.

First Sales

"Covered bond issuance has resulted in senior debt's position as the most highly ranked part of the capital structure being usurped," Vivek Prabhu, an asset manager who helps oversee A\$4.6 billion at Perpetual Ltd. in Sydney, said yesterday.

“The credit spreads on senior debt had to reprice to reflect the increased risk as a result of being subordinated.”

Australia’s banks have sold the equivalent of \$15 billion of covered bonds this year after parliament lifted a ban on the securities in October, according to data compiled by Bloomberg.

The securities were first sold in November, when ANZ Bank and Westpac issued \$2.25 billion of U.S. dollar-denominated bonds in total, according to data compiled by Bloomberg.

Commonwealth Bank opened the euro-denominated covered bond market for Australian banks this month, selling 1.5 billion euros of five-year notes that cost about 220 basis points more than Australian benchmarks once swapped into the local currency, Bloomberg data show.

Mortgage Fallout

Covered bonds sold locally will be “an important funding tool for the banks going forward,” said Mark Mitchell, head of credit at Sydney-based Kapstream Capital, which manages A\$3.7 billion.

“They are keen to build a curve and get a lot of interest, so it would make sense that they would pay more for the deal. If you are a covered bond investor it’s probably a great time to invest in these securities,” Mitchell said.

Higher funding costs for Australian lenders may stop them from reducing mortgage rates if the central bank lowers its benchmark interest rate next month to stimulate the economy, as forecast by analysts.

Reserve Bank of Australia Governor Glenn Stevens will reduce the overnight cash-rate target to 4 percent from 4.25 percent, according to 27 of 30 economists surveyed by Bloomberg on Jan. 27.

Traders are betting on a 62 percent chance of a cut, cash-rate futures show.

Sales of covered securities globally have surged to 57 billion euros (\$75 billion) this month, from 16.5 billion euros in December, as Europe’s sovereign debt crisis spurred investors to seek the safety of the top-rated notes, Bloomberg data show. Europe is the biggest market for the bonds.

“Where spreads go from here will depend on new data from Europe,” Ken Hanton, a senior credit analyst at National Australia Bank, said in a phone interview.