

Don't bank on it

It hasn't been a particularly good month for bank ratings and bank investors around the world. There have been numerous ratings downgrades, significant haircuts being forced on Irish bank bondholders, spreads have been widening and there are talks of more downgrades to come. The world continues to take a hard look at banks following the global financial crisis (GFC). Significant regulatory changes are in the pipeline and agencies continue to tweak their rating approaches. The banks themselves were one of the major causes of the crisis (along with rating agencies) and warrant restructuring, tighter regulation, more transparency and higher liquidity and capital standards. This process of change is underway but it will take a few years. This month has been a reminder that things will be changing.

Starting in the UK, Moody's placed fourteen financial institutions under review for possible downgrade. The change is driven by Moody's reassessment of the amount of systematic support incorporated in the senior ratings for financial institutions globally. They note the downgrade will likely be limited to one notch. The major banks in the UK received as much as five notches of systemic uplift from implied government support as some institutions such as RBS (68%) and Lloyds (40%) remain significantly owned by the government. Given the fragile recovery taking place in the UK, the Government is not expected to reduce its stake in these banks anytime soon. Moody's has noted however, that they do not believe regulators are equipped to deal with the failure of a large financial institution and are therefore less likely to let a bank fail.

In Ireland, the Government has announced that subordinated debt holders of the Bank of Ireland will be forced to take a significant haircut on their exposures. Tier 1 holders will receive only 10% of the nominal value

of their holdings while Lower Tier 2 holders will receive only 20%. This is part of the balance sheet repair required following a significant over leveraging of the Irish banks used largely to fund a speculative housing bubble. Haircuts had been expected but these were harsher than the market had factored in. Some observers note this could just be the beginning and senior bond holders may eventually be forced to take haircuts as well.

Of more significant local interest, Moody's downgraded the four major Australian banks (NAB, WBC, CBA, ANZ) one notch from Aa1 to Aa2. Subordinated debt was downgraded one notch from Aa2 to Aa3 while Bank Financial Strength ratings were downgraded from B to B-. The main concern for the agency is the structural sensitivity to conditions in the wholesale markets which is subject to variability in market sentiment as evidenced by the global financial crisis. While Australian banks have reduced their reliance on wholesale funding it remains an ongoing structural risk which Moody's believes is enough to justify a ratings downgrade. Moody's rating incorporates a two notch rating uplift from systemic support due to high systemic importance.

The downgrade by Moody's had been well and truly factored into the market. The agency had the banks on negative outlook for a considerable period and then on review for downgrade for a full three months before taking action. This helps to explain why the market reaction was very muted with essentially no change in the banks' credit default swap or asset swap spread levels. Some people have argued the Aa1 by Moody's was a bit generous to begin with which also helps to explain the market reaction. The Moody's rating is now in-line with S&P and the change is not expected to have any material impact on the banks' ability to get funding.

Table 1 – Comparisons of highly rated banks

Firm	Moody's	S&P	CDS
JP Morgan	Aa3	A+	79
HSBC	Aa2	AA-	84
Wells Fargo	A1 nw	AA-	89
Deutsche	Aa3	A+	101
UBS	Aa3	A+	102
CBA	Aa2	AA	109
NAB	Aa2	AA	109
ANZ	Aa2	AA	109
WBC	Aa2	AA	109
BNP	Aa2	AA	111
Citigroup	A3 nw	A	135
Soc Gen	Aa2	A+	139
Barclays	A1	A+	141
BoA	A2 nw	A	153
MS	A2	A	157
GS	A1	A	158
RBS	A1 nw	A	206

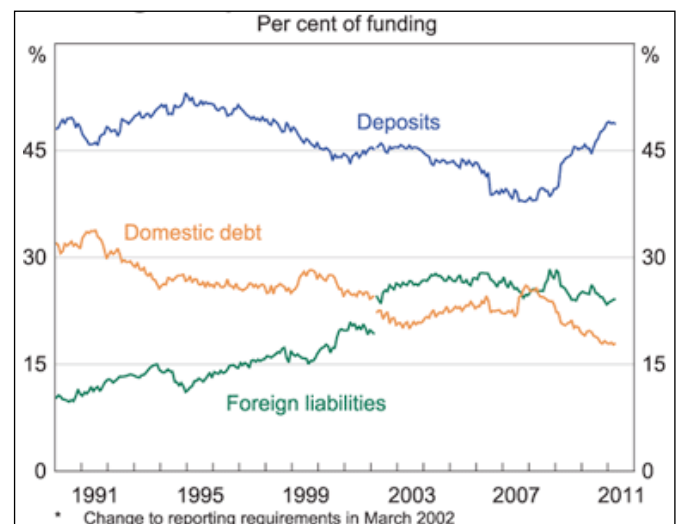
Table 1 compares a number of the highest rated banks in the world including the four Australian majors. There are a couple of interesting things to note. Firstly, despite the recent rating changes, the Australian banks are still considered some of the safest in the world by both the rating agencies and the market. Secondly, note that the credit default swap, Moody's and S&P ratings are identical for all four banks. In other words, the credit profiles of all four banks are considered to be very similar by market observers. Finally, it's interesting to note there is a meaningful dispersion of risk perception between the major US banks. JPM and Wells are considered much safer than Bank of America, Morgan Stanley and Goldman Sachs which is a very different scenario than here in Australia. Moody's has just put three of the largest US banks on review for downgrade due to the higher than average uplift for systemic support.

Another big development taking place in the background is that S&P is reviewing their global bank rating methodology. They are currently getting input from the

industry and will be finalising the new criteria in the third quarter and implementing it in the fourth quarter.

Changes to S&P's Banking Industry Country Risk Assessment is likely to see Australia downgraded from the safest rating of one to the second safest rating of two. This change will likely be driven by Australia's reliance on external wholesale funding, which is the same concern Moody's has. The downgrade is likely to be limited to one notch which will leave the rating in the AA band. S&P is giving the market plenty of time to comment on the proposed changes and a long lead time to implement so the impact on credit spreads should be relatively limited.

Chart 1 – Funding composition of banks in Australia*



Sources: ABS, APRA, RBA

While the agencies are downgrading the Australian banks, it's important to note they have made good strides in recent years improving their funding mix. As the chart above indicates, banks have been increasing their reliance on overseas funding since mandatory superannuation contributions were introduced in the early '90s. Until very recently banks were getting almost 30% of their funding from offshore. The global financial crisis has clearly been a wakeup call to the banks as they have made considerable efforts to improve their funding mix since 2008. The banks have increased depositor funding, extended their

average maturity profile and modestly reduced their reliance on offshore wholesale funding. In addition, for the first time since the early '90s, banks deposits are growing faster than demand for credit which has also helped them to reduce reliance on offshore funding. Moody's expects the banks to continue to reduce their reliance on wholesale funding over the next 12 to 18 months.

What does all this mean for credit investors? The obvious point is that there will likely continue to be ratings migration risks for financial institutions around the world for a while to come. Regulators, rating agencies, investors and banks themselves are still trying to work out what the post GFC financial world will look like. While Australian banks have worked towards improving their funding mix, the argument can be made that they have significant exposure to housing and have been a bit too aggressive lending to that sector. This is a meaningful risk that we believe is manageable but still bears close monitoring.

The big concern with banks is always liquidity and confidence shocks. Deterioration in asset quality is generally easy to spot but confidence in a financial institution can evaporate overnight. That is why as a conservative bond investor we prefer to own banks that are likely to be too big to fail due to their systemic importance and ones that have ready access to central bank liquidity if needed. Given the Australian economy's increasing reliance on commodities and an overvalued housing market, it can be argued Australia could be more sensitive to a confidence shock than others. The world remains roughly as leveraged as it was before the GFC. The leverage has simply shifted from private to government balance sheets. It hasn't really gone away and it won't be going away until we see meaningful growth, write downs or in some cases outright defaults. As investors we have to be sensitive to the fact that higher than normal levels of uncertainty will be with us for some time to come.

Kapstream believes that many of the sectors that offered value in 2010 continue to do so but perhaps are not quite as attractive as they have been given spread compression. These sectors include AAA Australian RMBS securities, financial assets in general and specifically subordinated Australian bank paper of large Australian banks given the very low risk of the securities not being called. Australian credits remain attractive compared to other countries on a risk/return basis however scarcity of issuance has driven credit spreads tighter. Kapstream has very limited exposure to the European banking system and European corporates. Interest rates are likely to move higher over the medium term so our duration remains relatively short. Credit spreads have performed reasonably well over the last year and could be due for a modest correction along with other risk assets but we do not expect any significant spread widening.