

The blow-out in Australian Credit Spreads:

A markets perspective on the re-pricing of risk.

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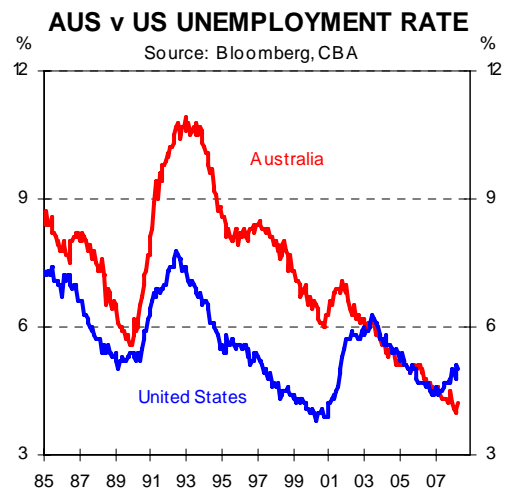
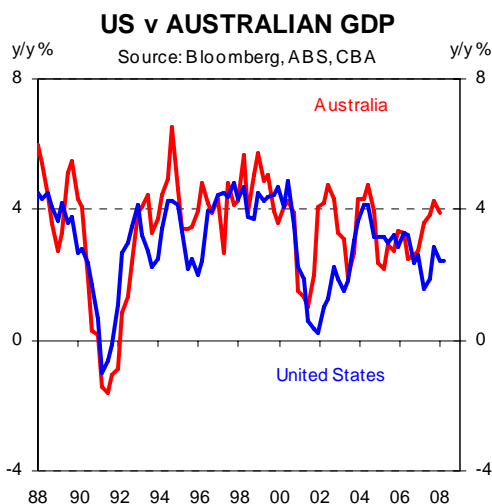
2nd June 2008

Introduction

On most measures, Australia continues to enjoy healthy economic growth, a stable banking system and pent-up demand in the housing sector. Yet, turbulence in markets emanating from the US sub-prime mortgage crisis has had almost as much impact on Australian bank share prices and credit spreads as in the United States. The securitisation market has become dysfunctional. Generally, this has been attributed to a re-pricing of risk and loss of confidence in ratings agencies. That is certainly the case. However, this paper also asks whether Australia's reliance on external funding, a poorly diversified investor base and a lack of flexibility for fund managers and price makers has played a role. The global financial system faces significant challenges over the next year or so, and it is by no means clear that credit spreads will not widen again. However, there is a chance that an easing of these other constraints will allow Australian markets to withstand future challenges more easily than proved to be the case over the past year.

Background

The broad range of economic data suggests Australia's economy has and will continue to significantly out-perform that of the United States. Australia continues to benefit from the global boom in commodity prices. The consequent stimulus to income has underpinned strong economic growth despite sharply rising household debt and interest servicing costs. There are



nagging worries over high house prices, capacity constraints, related inflation pressures and the potential for a turn in the commodity price cycle. The loan-loss cycle has also turned for Australian banks, with all of the majors increasing provisioning for bad debts, mostly due to exposure to companies with large short-term refinancing requirements. Mortgage loan arrears are also likely to rise in the near-term at least. However, the Reserve Bank of Australia (RBA) nevertheless reported in March 2008¹ that:

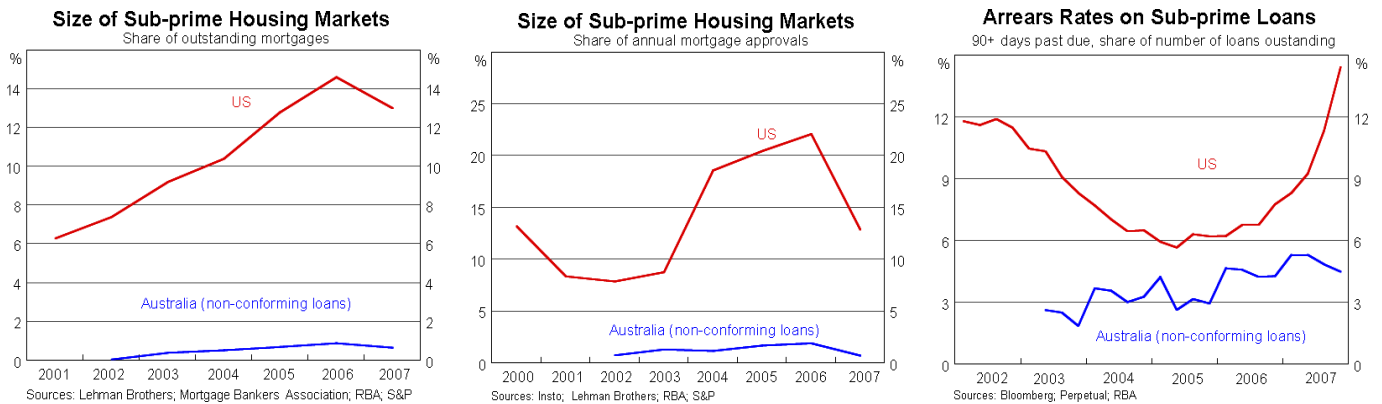
- Australia's banking system remains highly profitable and well capitalised;
- Banks have minimal direct exposure to the sub-prime problems in the United States;
- Credit ratings remain strong and stable;
- Bank deposits have increased strongly and banks have continued to raise significant volumes of funds in both domestic and international capital markets;
- Banks have considerably less risky portfolios than banks in many other countries;
- Ratios of non-performing loans to total loans remain at low levels, with arrears rates having declined over the past six months.

While noting increased funding costs and disruptions to securities markets, the RBA concluded that “despite the strains in global financial markets, the underlying resilience of the Australian financial system, together with the relatively favourable outlook for the domestic economy, means that the system is much better positioned than the financial system of many other countries to cope with the current difficulties.” This sentiment was reiterated by the RBA's Assistant Governor (Financial Markets) on 16 May, when he concluded that “the strength of the Australian banking system relative to those in a number of other countries, particularly the US, and the strength of the domestic economy more generally, has meant that the impact of the global turmoil has been relatively muted [for the Australian financial system].”² He highlighted

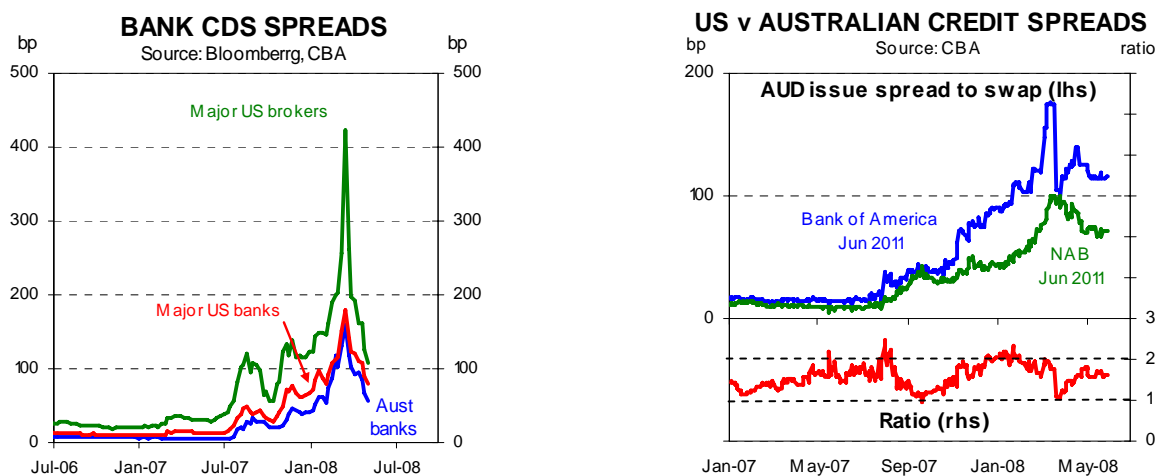
¹ Reserve Bank of Australia, Financial Stability Report, March 2008 (finalised March 25)

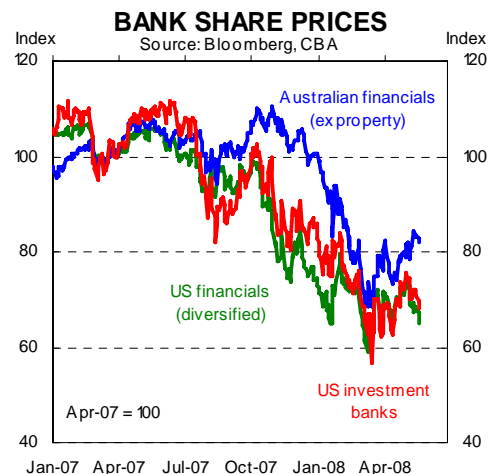
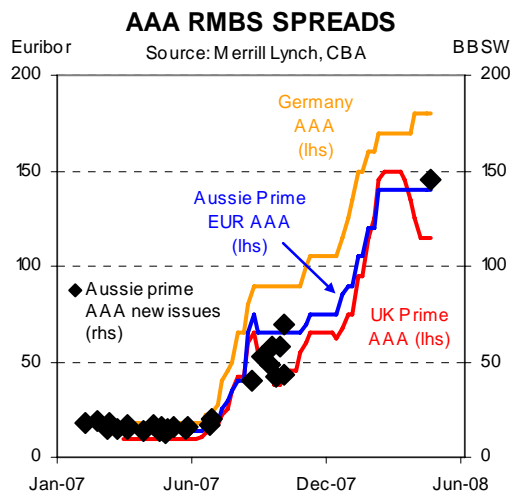
² A Comparison of the US and Australian Housing Markets, Guy Debelle, www.rba.gov.au

the following charts to demonstrate Australian banks much smaller exposure to high-risk mortgages.



Despite these positive comparisons (and many others), the performance of Australia's banks and credit markets has been remarkably similar to the United States and other markets. The following charts show that spreads on Australian bank corporate bonds and credit default swaps have only marginally out-performed comparable US benchmarks. Spreads on residential mortgage-backed securities have actually widened more than in the troubled UK market (though the illiquidity of the market and hence unreliability of the data is also apparent), while bank share prices dropped almost as much as their US counterparts (though have recently out-performed again).





Why have credit spreads widened so much in Australia?

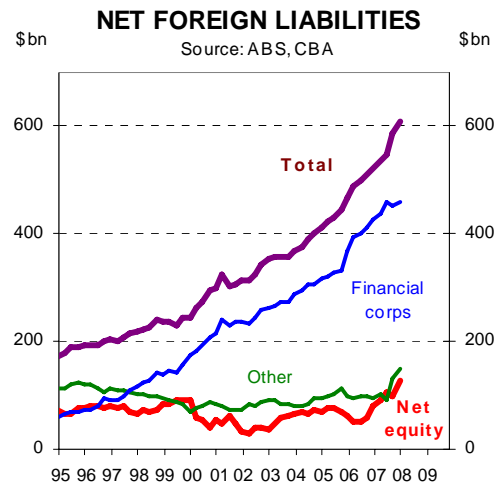
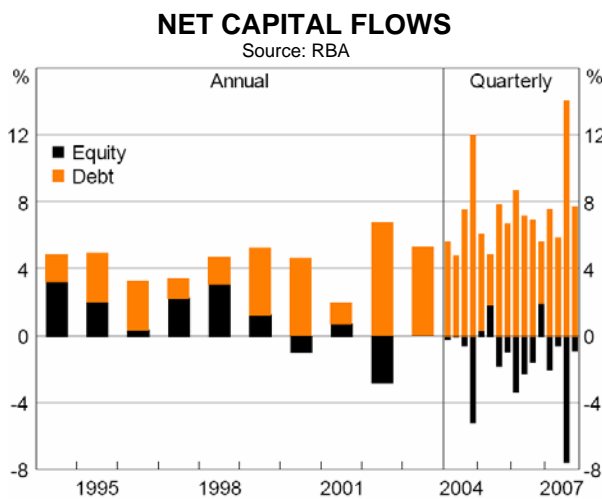
There has been a widespread re-pricing of risk since the first half of 2007. Credit spreads and equity market risk premiums have increased sharply after narrowing steadily for a number of years. Australia has not been immune to this trend. But the extent to which these spreads have increased suggests other factors are also relevant. Experience at the coal-face confirms that structural changes in global markets have materially weakened demand for Australian debt.

Australian savings/investment trends

The structure of Australia's finance system, and particularly our large current account deficit, seems to have played a role. Australia has been a major beneficiary of the so-called 'global savings glut' over recent years. The flow of capital from large current account surplus nations in Asia, the Middle East and other emerging markets has facilitated record levels of external borrowing to fund our savings/investment imbalance. The demand has been fuelled by the nation's need and incentive to gear-up commodity production to meet the global boom in resources. But the on-going appreciation of the Australian dollar, rising domestic asset values

and falling credit spreads in the face of such a large funding requirement suggests the flow has been externally driven, and a product of the global ‘search for yield’.³

The following pair of charts show that the current account deficit has been overwhelmingly financed by debt, and that this has been almost entirely intermediated through the financial sector. Negative net equity flows disguise significant foreign investment in Australia (both portfolio and direct) but by-and-large foreigners have been happy to finance Australian investment through bank debt and securitised assets. This was mainly used to fund the boom in housing in the early part of the decade, but has swung toward to commercial funding over the past four years.

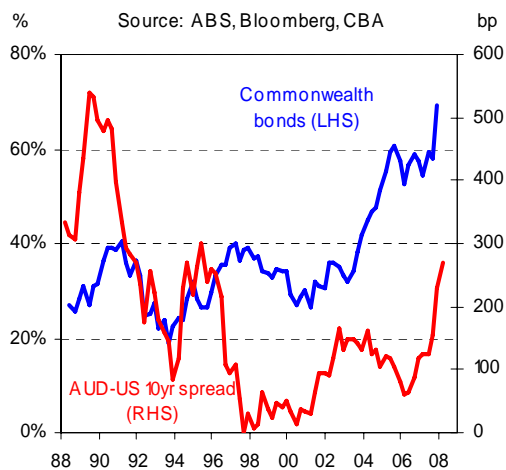


The strength of capital flows to Australia reflects our status as the world’s highest yielding AAA-rated nation. Foreigners owned 70 percent of Commonwealth bonds on issue at the end of 2007, and this is likely to have increased substantially further based on the recent rise in bond spreads to other nations over recent months. Australian cash rates and short-term swap rates have been 1-7 percentage points above the G7 nations for the past decade, with the ‘carry trade’ now a long-established part of the financial landscape. The strength of Asia, commodity prices,

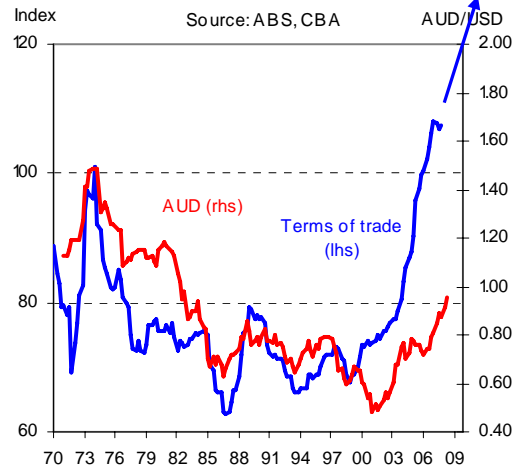
³ Ian Macfarlane, What are the Global Imbalances?, Address to the Economic Society of Australia, 28 Sep 2005

Australia's terms of trade, and the relationship with the Australian dollar, has provided foreigners with the confidence to take on even more AUD-denominated debt than has been issued offshore. The sheer strength of Australia's income growth and the aforementioned health of Australia's financial and housing sectors have allowed Australia to service these higher interest rates with ease.

FOREIGN BOND OWNERSHIP & SPREAD



TERMS OF TRADE & AUD

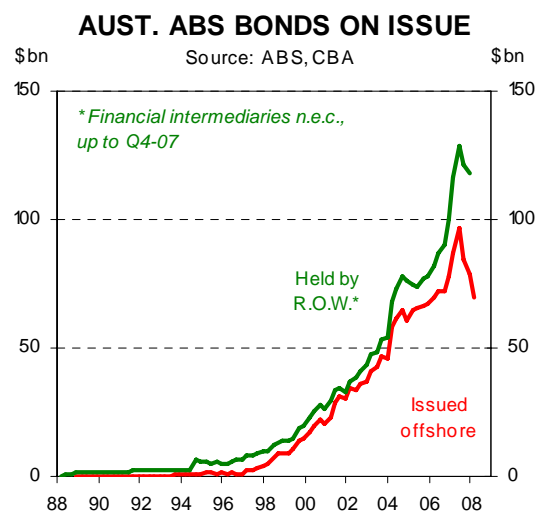
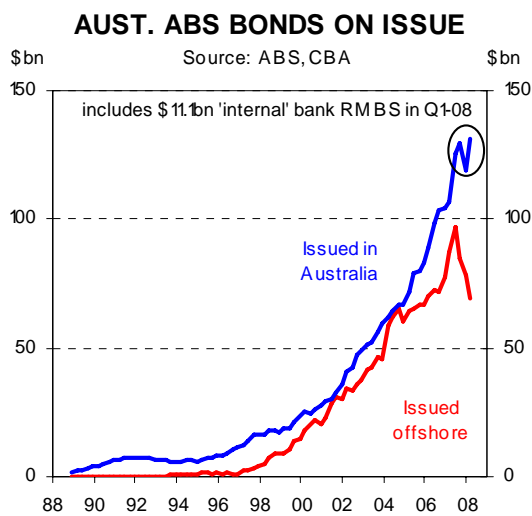


The recent strength of the Australian dollar suggests that these trends remain intact, although there is undoubtedly greater uncertainty over whether households are still comfortably servicing loans following the sharp rise in mortgage interest rates over the past year. However, the reliance on offshore funding also leaves Australia's financial system exposed to changes in global market sentiment and dislocations that have little to do with economic fundamentals (besides the large current account deficit). In 2007, it became apparent that a significant share of the foreign investor base was no longer viable, and that it turned from actively buying to selling AUD debt.

Foreign demand for AUD securities

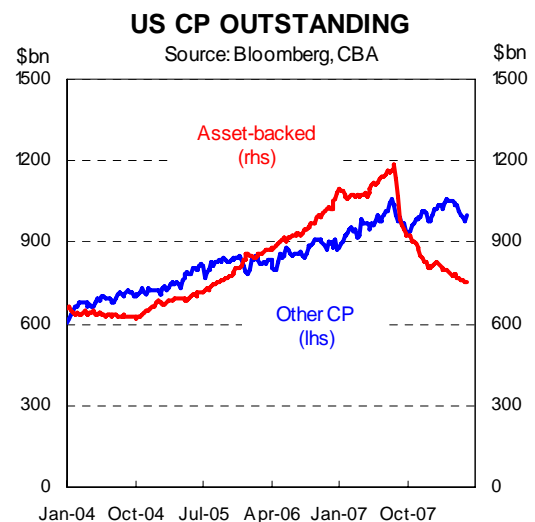
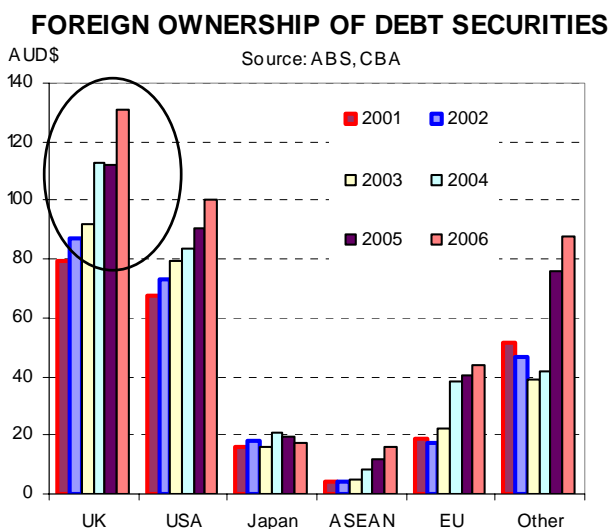
More than a quarter of financial corporations debt issued offshore (which in turn accounts for more than three-quarters of Australia's total foreign liabilities) has been in the form of asset-

backed bonds, almost entirely securitised residential mortgages. As highlighted above, the spread to the bank-bill swap rate of AAA tranches of this debt has increased from less than 20 basis points to approximately 150 basis points over the past year. While re-pricing of risk and loss of confidence in ratings agencies have played a key role in this development, feedback from those involved in the distribution process suggests the destruction of the investor base that previously purchased these securities is a dominant factor.



The impact of changed offshore investor appetite for asset-backed securities is readily apparent in issuance and ownership data published by the Australian Bureau of Statistics. Foreign ownership grew by around 150 percent between 2004 and mid-2007, and by well in excess of foreign ABS issuance. That strong demand, which from an issuer's perspective appeared close to insatiable, played a key role in driving spreads to unsustainably tight levels. That same demand, and relative value considerations, acted to lower bank funding costs and corporate credit spreads. Indeed, the relative attraction of bank funding and loan syndication markets have meant that outstandings of 'true' corporate bonds have stagnated in recent years, with the scarcity value (and diversification benefits) compressing these yields as well.

Detailed data on the exact source of foreign demand for Australian securities is not readily available. However, annual data does show that an increasing share of Australian bonds have been held not in Asia or the Middle East, but Britain, home of the SIVs. The demise of these Structured Investment Vehicles also means that reporting of holdings and activities has now ceased. But Fitch data shows that 96 percent of SIV assets were comprised of highly-rated (90% AA or better) structured products and financial institutions debt⁴, and feedback indicates that a large proportion of this was in Australia. SIV assets under management almost halved over the six months to January 2008.⁵ More generally, asset-backed commercial paper (ABCP) outstandings have been declining since August, indicating that funding to purchase securitised assets is still diminishing.



The switch from insatiable foreign demand for Australian securitised products and bank debt to liquidation of these holdings has had a profound impact on the credit market. In a sense, the collapse in ABCP markets represents a re-pricing of risk, but the knock-on effect to Australia's financial system is more akin to a structural loss of demand. Relative value considerations and

⁴ Derivative Fitch, Rating Performance of Structured Investment Vehicles in Times of Diminishing Liquidity for Assets & Liabilities, September 2007

⁵ Bloomberg and Moodys reports

the impact of credit losses on fund managers (see below) have spread the impact throughout the credit market. The impact on Australian mortgage providers who have developed a business model fully reliant on securitisation markets (13 percent of the home loan market⁶) that now appear to have been systematically under-pricing risk (or at least liquidity) is devastating. The structure of Australia's financial system and reliance on bank intermediation is likely to be permanently changed, though the process of adjusting to the initial withdrawal of structured investment vehicles from Australia's market may be near completion.

Domestic demand for AUD securities

There is nothing to suggest that the loss of the 'structured' investor base will permanently lower asset-backed bond issuance. Packaging of income streams, investor diversification and freeing of bank balance sheet constraints still make economic sense. However, changes to capital adequacy rules limit the appeal for banks to securitise mortgage assets and it will take further narrowing in RMBS spreads and/or widening in bank margins to facilitate a significant re-emergence of non-bank RMBS issuance. But risk-adjusted analysis suggests current spreads are highly favourable for investors, notwithstanding potential changes to ratings categories.

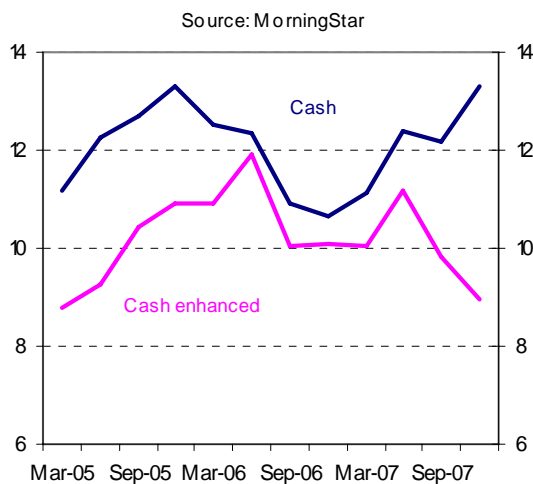
Australian fund managers and investors have been limited in their capacity to take advantage of wide credit spreads, particularly for structured products. Investor returns have been significantly damaged by the blow-out in credit spreads, jeopardising fund manager access to funds.

Amplified by the lack of liquidity in the market, both the threat and reality of fund redemptions appear to have been a major constraint for fund managers, even for those who perceive significant value in spreads.

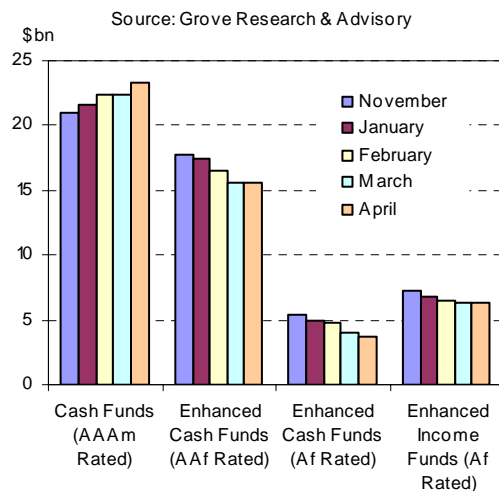
⁶ Australian Bureau of Statistics, 5609.0

The following charts show how funds have flowed from higher risk ‘enhanced cash’ products toward more traditional low risk ‘cash’ funds over the past few quarters. This type of adjustment forced liquidation of positions in riskier funds that has amplified the lack of liquidity in the credit market⁷. Banks similarly face regulatory pressure to churn credit inventory that can amplify selling pressure in markets and reluctance to bid securities offering medium-term value. At the same time, the reliance of many mortgage securitisers on that single source of funding also made investors aware of significant pent-up mortgage supply likely to emerge from ‘full’ warehouses as soon as market conditions improved. Along with the typical uncertainty and herd mentality issues of trending markets, there has thus been little incentive to be an early buyer of widening credit spreads, which typically widen sharply and narrow slowly. These pressures have been most acute in the ABS and floating-rate note markets. But fund managers’ need to sell more liquid investments also helps to transfer the widening of credit spreads across the risk spectrum.

W'SALE FUNDS UNDER MANAGEMENT



WHOLESALE CREDIT FUND SIZE



⁷ Data sourced from Morningstar and Grove Research & Advisory. There are differences in coverage and clear gaps in time series data that suggest these data need to be treated with caution. Morningstar separately reports that there was \$176 billion under management at cash managers in December quarter 2007. The Australian Bureau of Statistics reports that Superannuation Funds held \$111 billion in cash and deposits as of the December quarter, \$37 billion of short-term securities and \$23 billion of non-government long-term securities. Cash Management Trusts had \$46 billion under management. However, the impression conveyed by the charts is consistent with feedback from Commonwealth Bank’s client base.

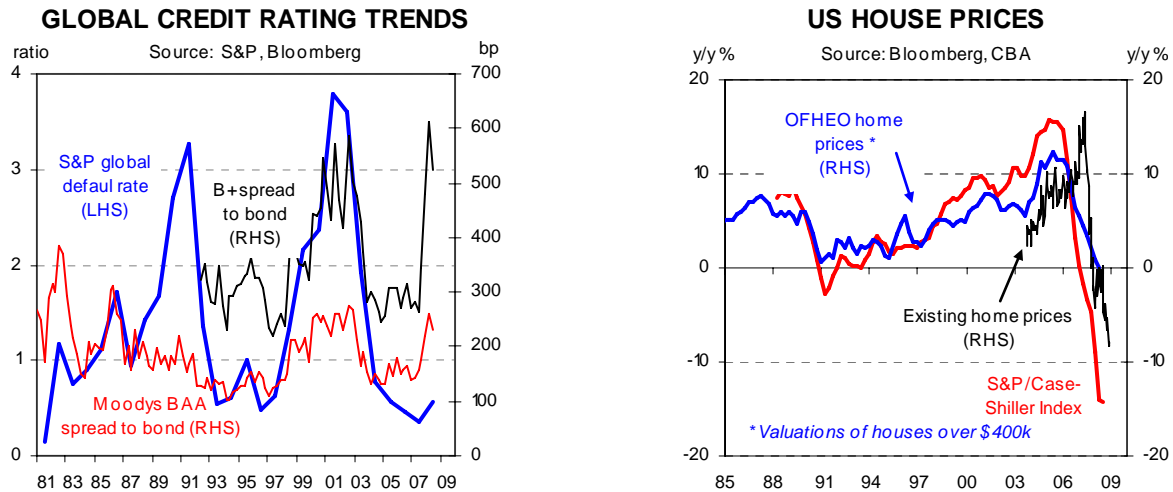
Thankfully, this selling pressure is beginning to reverse, with investor appetite and manager inflows being buttressed by on-going flows into superannuation. Asset consultants are apparently beginning to advise larger allocations to higher-yielding credit markets. Close examination of fund-flow data also reveals some exceptionally large flows into a few cash managers that could be indicative of sovereign wealth fund activity. Entrance of such large (non-mark-to-market) investors is necessary to unlock the value in less-liquid markets.

Still, it would appear that more thorough investigation of the practical pressures confronting banks and fund managers in times of crisis is warranted, including the role of fund advisers and regulators and whether the need to comply with their requirements causes unintended liquidity problems for markets. From an external perspective, the recent experience has suggested that those closest to the credit market and best-placed to determine value opportunities have not had the flexibility to implement those views. In part, this seems to reflect a lack of investor understanding and perhaps education of the liquidity and risk profile of credit markets, particularly the ‘cash enhanced’ segment. Many credit products are inherently hold-to-maturity products and the investor base in those products needs to be aligned with that rationale to facilitate smoother functioning in times of stress.

Outlook

The widening in credit spreads has provided an attractive risk/reward opportunity for investors. At current levels, spreads are discounting high default rates, broadly consistent with a global downturn as severe as those in the early 1990s and early 2000s. Recent commentary from US policy-makers has indicated that they see a risk of a short recession but believe they have applied enough stimulus to ensure it is shallow. Market sentiment has improved notably over the past two months, with data and anecdotes suggesting investors are more prepared to step in to take

advantage of attractive valuations on offer. The bail-out of Bear Stearns and numerous liquidity measures adopted by the Federal Reserve and other central banks has certainly eased concerns over systemic risk in the financial sector (as evident in declining CDS spreads shown above). Financial institutions ability to access more than US\$270 billion of new capital has been very important. All of this suggests the wide in credit spreads, particularly for financials, has passed.

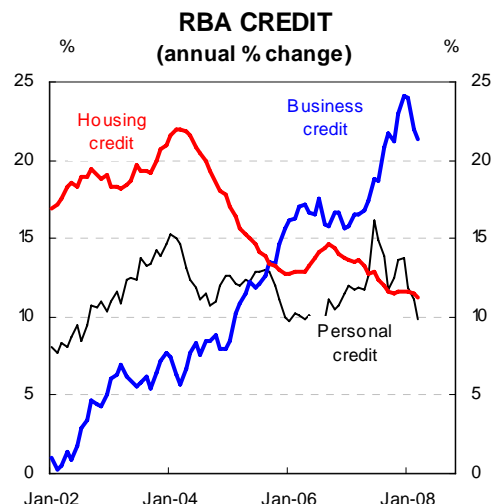
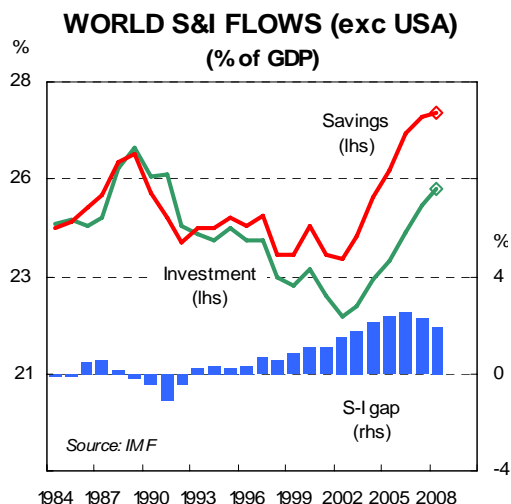


Uncertainty over the economic outlook remains acute, however, and it is far too early to dismiss further widening in spreads. Large losses and capital requirements clearly leave financial institutions fragile in the short-term, and the closure of securitisation markets significantly increases the funding task. Longer-term, the US economy faces structural headwinds related to its low savings rate and large current account deficit that may limit consumers ability to maintain spending levels if employment weakens (as it appears to be doing). Low household savings have been facilitated by steady gains in household wealth over recent decades, but the continuing extreme downturn in housing prices raises the risk of a shift toward a sustained period of deleveraging. The combination of falling house prices and household deleveraging would imply recession and substantial losses for the financial sector. This would likely take credit spreads to new highs for both banks and corporates. The risks provide good reason for investors to be cautious while consumer and housing indicators are still falling. Much depends on confidence.

Australia's markets and possibly the economy would not be immune to these risks should they materialise. On balance, a more benign scenario seems likely and the fundamental strength of Australia's economy and financial system should see credit spreads gradually contract from here. This confidence is reinforced by the knowledge that most of the transitional impact of the demise of SIVs has already been felt. Domestic fund managers have also had time to adjust to the flight of more risk averse capital from illiquid credit markets and it seems long-term value players have stepped in. Renewed spread widening would cause pain, but probably not result in the same liquidity problems as over the past year.

Australia's large current account deficit does, however, remain an unresolved issue. This should be easily funded in a benign global environment, but the potential for disruptions in a less benign environment has already been demonstrated. The seizure of securitisation markets, shrinking global bank balance sheets and investor losses over the past year suggest it will take some time for risk appetite to fully return. Risk premiums will likely stay elevated. But the forces behind the 'global savings glut' remain in place and Australia is very well-placed to capture those flows due to an increased ability to pay.

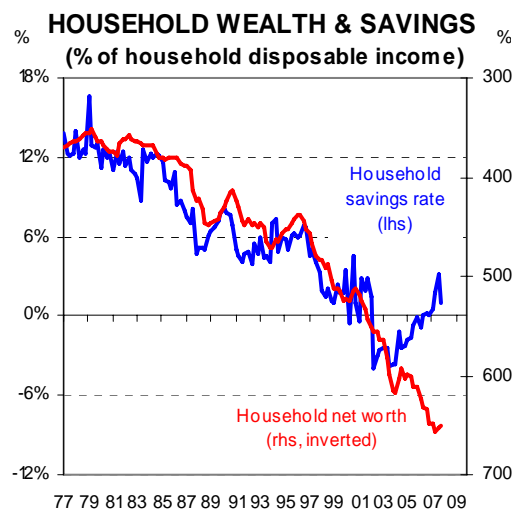
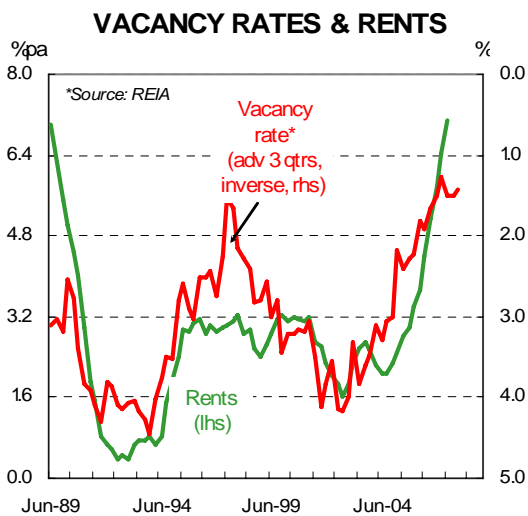
The ability to attract global funding should largely depend on the ability to re-pay the debt, or the attractiveness of the equity investment on offer. In particular, more discerning global investors are now likely to demand that capital provided is directed toward expanding productive potential, rather than plunged into housing or Government spending. Investors temporarily forgot these rules when investing in US sub-prime and other high-risk products over recent years, but, thankfully, Australia was engaging in some balance sheet repair during that period.



Housing credit growth has halved over the past four years, while business credit growth has quadrupled (before slowing this year amid the worst of the market dislocations). State Government borrowing and spending is accelerating as infrastructure spending picks up, but operating balances remain in surplus and the Commonwealth' overall surplus has increased. Lending is being channelled to enhancing the capacity of the economy. In fact, the re-direction of investment away from housing has been large enough to lead to a shortage of housing supply, resulting in falling vacancy rates and sharply rising rents. In contrast to the United States (and along with a number of other cultural and structural differences), this dynamic provides comfort that home mortgages are also a secure investment in Australia and that funds will continue to flow to the sector.

The investment boom in infrastructure and resources capacity, combined with on-going historically high commodity prices, is expected to sharply lift export receipts over the next few years. The Reserve Bank has also been tightening monetary policy to constrain growth in domestic demand and inflation pressures, which should slow growth in imports. So a narrowing in the trade deficit may contribute to a reduction in the current account deficit and the call on global savings. Strong income growth could prevent that reduction from being achieved, but that

income growth at least provides the capacity to service the rise in foreign liabilities. And there has been a promising rise in the household savings rate over recent years, which has finally broken the long-term nexus with household wealth. The cost of servicing Australia's liabilities may rise, but that is more likely to be due to increases in the Reserve Bank cash rate and benchmark borrowing costs to cool growth than rising credit spreads necessary to offset risk and attract global savings.



Conclusion

There has been a global re-pricing of risk in the wake of the US sub-prime mortgage crisis. However, it is surprising that the rise in Australia's corporate credit spreads and financial sector risk premiums has almost matched that of the United States given superior economic and financial performance. This appears to reflect Australia's heavy reliance on external funding, which meant that the disruption to global securitisation markets and destruction of ABCP-funded investment vehicles had a large impact on the demand/supply equation for Australian credit products. Lack of liquidity in the credit market and consequent widening in credit spreads may also have been exacerbated by the lack of flexibility banks and fund managers have to take advantage of cheapening spreads due to mandate and regulatory constraints. That pressure,

exacerbated by the one-off discrediting of the credit rating process for structured products, seems to be passing.

These problems for the Australian market seem transitional in nature and there is good reason to believe Australia would more clearly out-perform foreign markets if credit spreads widen again. The latter risk cannot be ruled out due to the threat of recession and a number of structural headwinds confronting the US economy and housing sector. Australia also continues to face a large current account deficit, but, unlike the United States, evidence suggests that the capital inflows have been directed to enhancing productive capacity, particularly in the lucrative resources sector. Australia's reliance on external financing leaves the nation heavily exposed to global financial shocks. But the strong fundamental outlook for the economy, slower housing credit growth and an improved household saving performance suggest Australia is well-placed to pull through any such shocks more easily than it did over the past year.

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