The blow-out in Australian credit spreads: a markets perspective on the repricing of risk

With the global repricing of risk in the wake of the US sub-prime mortgage crisis, the increase in Australia's corporate credit spreads and financial sector risk premiums have almost matched those in the United States. This appears to reflect Australia's heavy reliance on external funding, which has left us vulnerable to disruptions in global securitisation markets.

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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 bank share prices and credit spreads in Australia as in the United States. The securitisation market has become dysfunctional. Generally, this has been attributed to a repricing of risk and loss of confidence in ratings agencies. However, this paper examines whether Australia's reliance on external funding, poorly diversified investor base and lack of flexibility of fund managers and price makers have also 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 and other constraints will allow Australian markets to withstand future challenges more easily than has been the case over the past year.

The broad range of economic data suggests Australia's economy will continue to significantly outperform the US economy. Australia continues to benefit from the global boom in commodity prices which has underpinned strong economic growth despite sharply rising household debt and interest servicing costs. There are nagging concerns about high house prices, capacity constraints, related inflation pressures and the potential for a turn in the commodity price cycle. Despite the economy's strong underpinnings, these developments mean that the loan loss cycle has turned for Australian banks. All the major banks have increased provisioning for bad debts from low levels, 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) reported in March 2008[1] that Australia's banks remained profitable, well capitalised, with access to funding and good credit ratings and were a low-risk investment.

While noting increased funding costs and disruptions to securities markets, the RBA concluded that 'despite the strains in global financial markets, the underlying resilience

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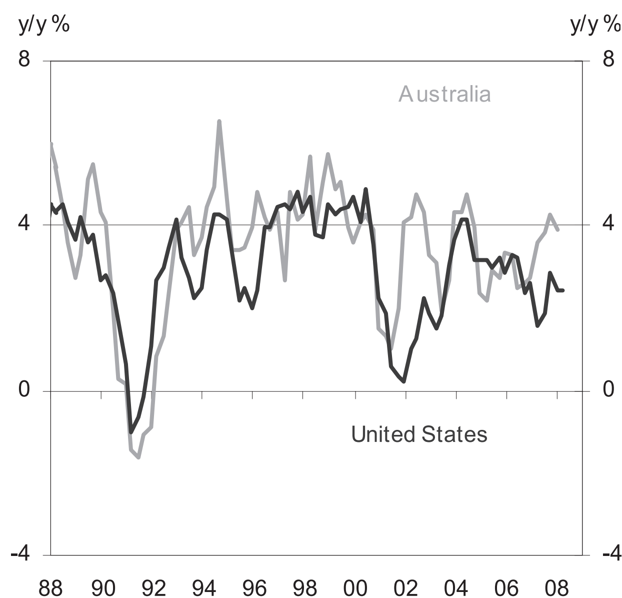
of the Australian financial system, together with the relatively favourable outlook for the domestic economy, means that the system is much better positioned than the financial system of many other countries to cope with the current difficulties'. This sentiment was reiterated by Guy Debelle, RBA Assistant Governor (Financial Markets) on 16 May 2008, 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 that the very low proportions of non-conforming loans in Australian bank portfolios relative to US banks' sub-prime loans demonstrated their 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 those in the US and other countries. The following charts show that spreads on Australian bank corporate bonds and credit default swaps have only marginally outperformed comparable US benchmarks. Spreads on residential mortgage-backed securities (RMBS) have actually widened more than in the troubled United Kingdom 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 more recently outperformed them again).

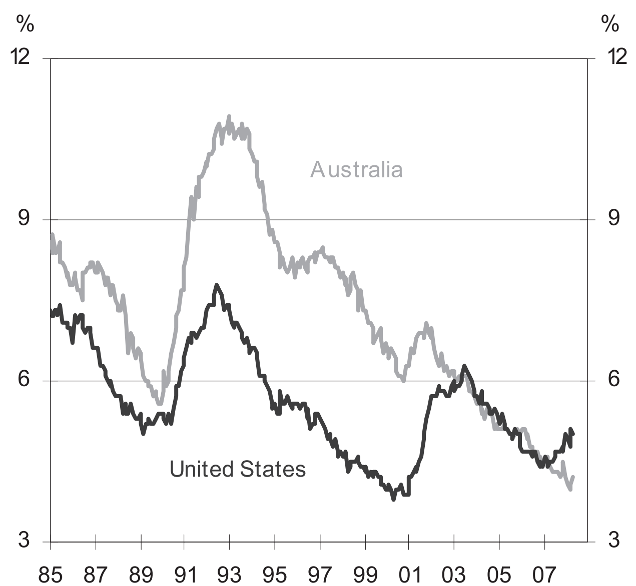
There has been a global repricing of risk in financial markets since the first half of 2007. Credit spreads and

FIGURE 1: **US and Australian GDP**



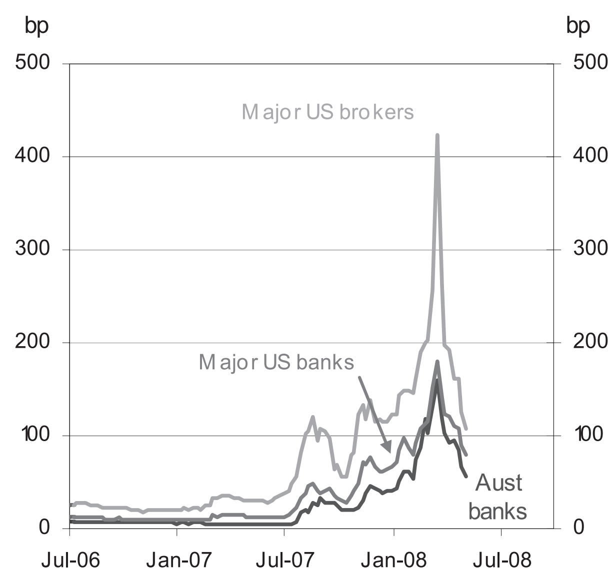
Sources: Bloomberg, ABS, CBA.

FIGURE 2: **US and Australian unemployment rate**



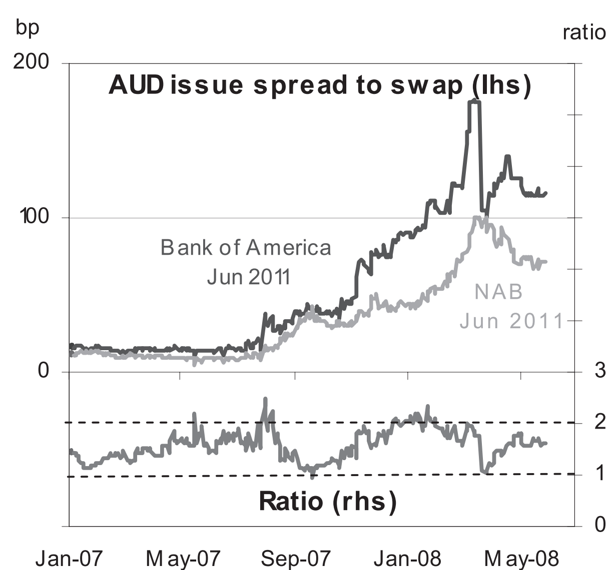
Sources: Bloomberg, CBA.

FIGURE 3: **Bank CDS spreads**



Sources: Bloomberg, CBA.

FIGURE 4: **US v Australian credit spreads**



Source: CBA.

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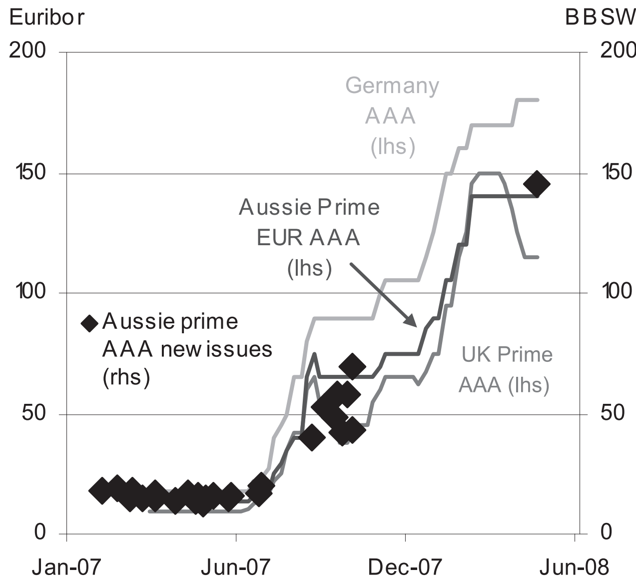
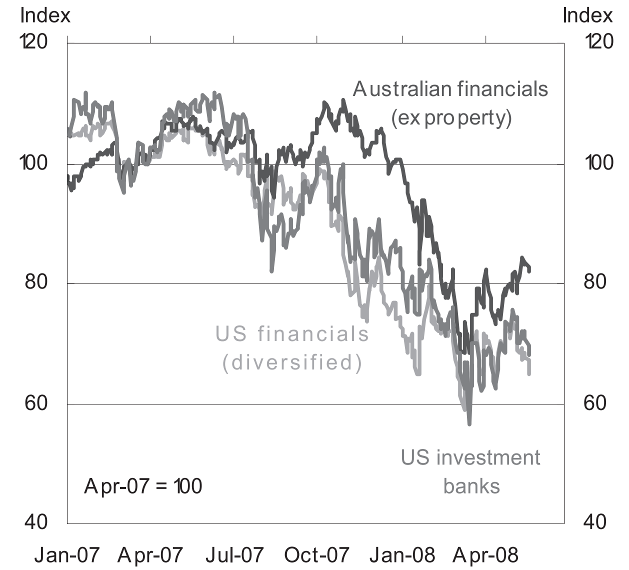
FIGURE 5: AAA RMBS spreads



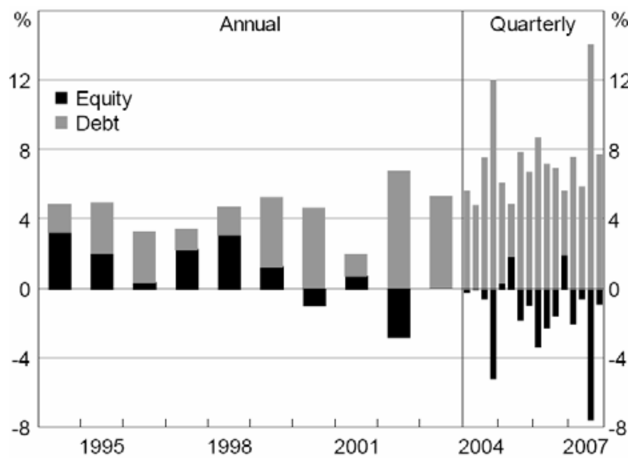
Sources: Merrill Lynch, CBA.

FIGURE 6: Bank share prices



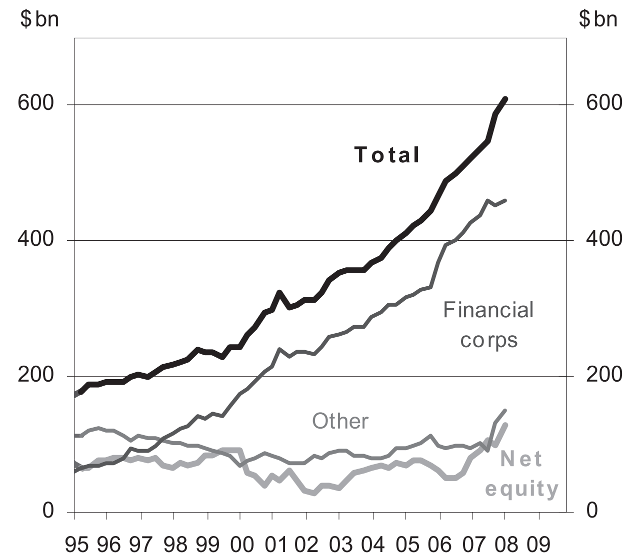
Sources: Bloomberg, CBA.

FIGURE 7: Net capital flows



Source: RBA.

FIGURE 8: Net foreign liabilities



Sources: ABS, CBA.

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 coalface 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 its 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 the country's 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 ongoing 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]

Figures 7 and 8 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 foreigners have, mostly, been happy to finance Australian

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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 been used more for commercial funding during the past four years.

The strength of capital flows to Australia reflects its status as the world's highest-yielding AAA-rated nation. Foreigners owned 70% of Commonwealth bonds on issue at the end of 2007. Australian cash rates and short-term swap rates have been one to seven 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, Australia's terms of trade, and the relationship with the Australian dollar, have 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 health of its financial and housing sectors have allowed Australia to service these higher interest rates with ease.

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 investors had turned from actively buying to selling AUD debt.

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).

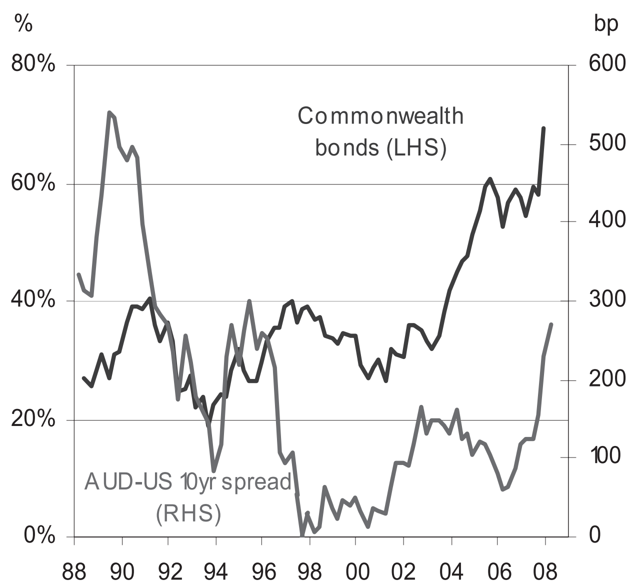
Foreign demand for AUD securities

More than a quarter of financial corporations' debt issued offshore (which 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 repricing 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 that the destruction of the investor base for these securities is a dominant factor.

Changed offshore investor appetite for asset-backed securities (ABS) is apparent in issuance and ownership data published by the Australian Bureau of Statistics. Foreign ownership grew by around 150% between 2004 and mid-2007, and 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; the scarcity value (and diversification benefits) have compressed these yields as well.

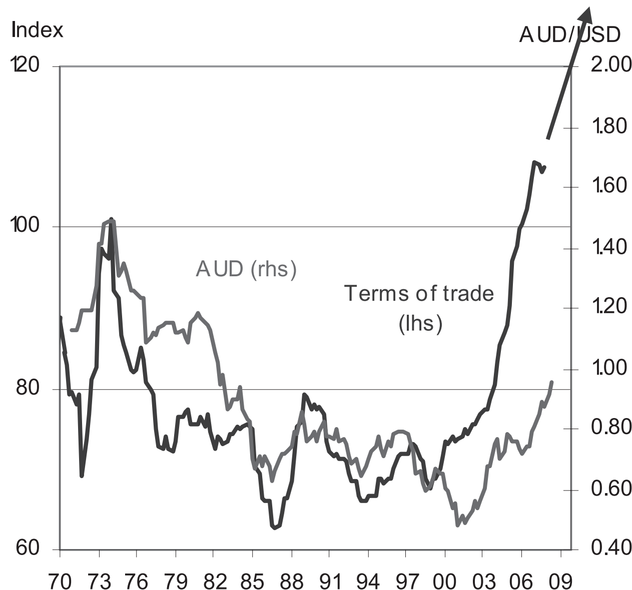
Detailed data on the exact source of foreign demand for Australian securities is not readily available. However, annual data does show that an increasing share of Australian bonds has been held not in Asia or the Middle East, but in Britain, home of the structured investment

FIGURE 9: **Foreign bond ownership and spread**



Sources: ABS, Bloomberg, CBA.

FIGURE 10: **Terms of trade and AUD**



Sources: ABS, CBA.

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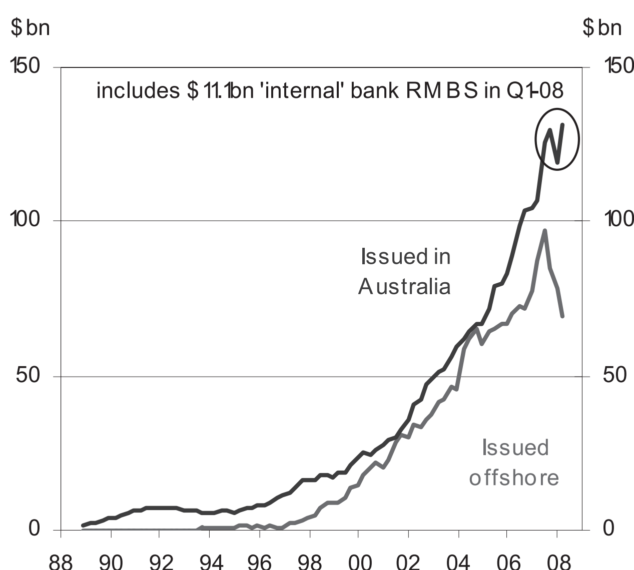
vehicles (SIVs). The demise of SIVs means that reporting of holdings and activities has now ceased. But Fitch data shows that 96% of SIV assets were comprised of highly rated (90% rated AA or better), structured products and financial institutions' debt,[4] and feedback indicates that a large proportion of this debt 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 2007, indicating that funding to purchase securitised assets is still diminishing.

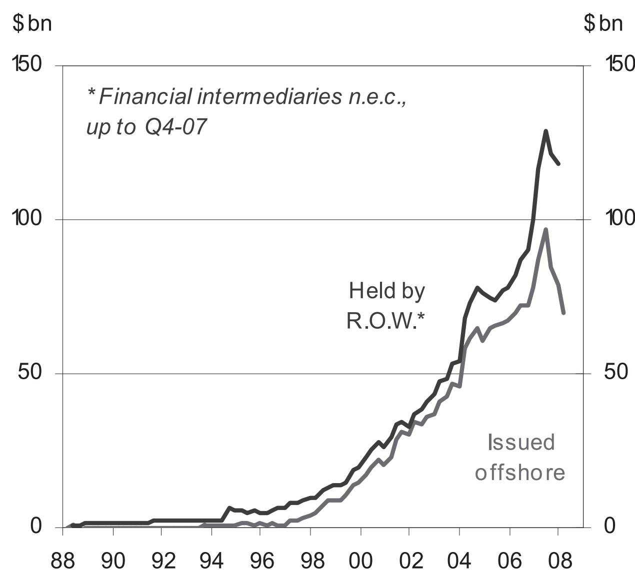
The switch from insatiable foreign demand for Australian securitised products and bank debt to liquidation of these holdings has had a profound impact on the credit market. In a sense, the collapse of ABCP markets represents a repricing of risk, but the knock-on effect to Australia's financial system is more akin to a structural loss of demand. Relative value considerations and the impact of credit losses on fund managers has spread the impact throughout the credit market. The impact on Australian mortgage providers, who developed a business model fully reliant on securitisation markets (13% of the home loan market[6]) that now appear to have been systematically underpricing risk (or at least liquidity), is devastating. The structure of Australia's financial system and reliance on bank intermediation is likely to radically change, though adjustment to the initial withdrawal of SIVs from the Australian market may be nearly complete.

FIGURE 11: **Australian ABS bonds on issue**



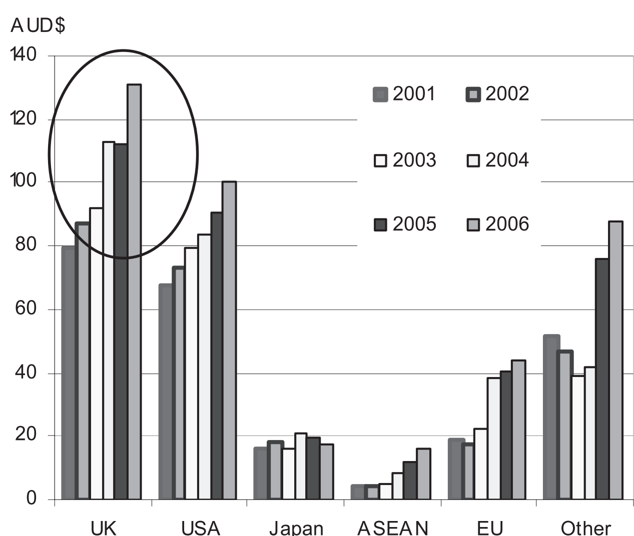
Sources: ABS, CBA.

FIGURE 12: **Australian ABS bonds on issue**



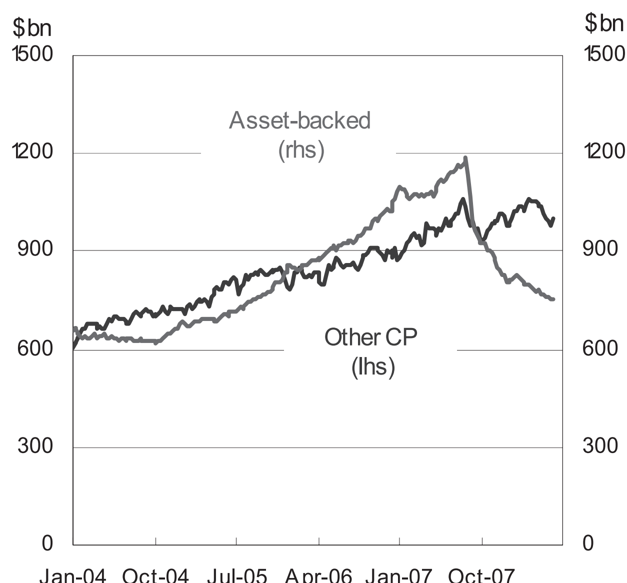
Sources: ABS, CBA.

FIGURE 13: **Foreign ownership of debt securities**



Sources: ABS, CBA.

FIGURE 14: **US Commerical Paper outstanding**



Sources: Bloomberg, CBA.

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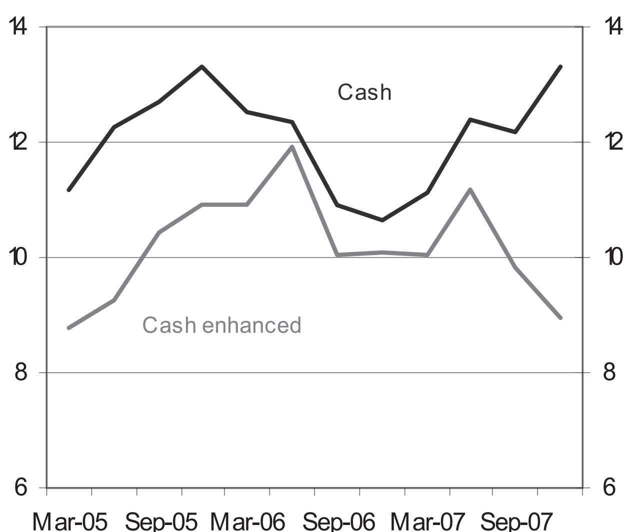
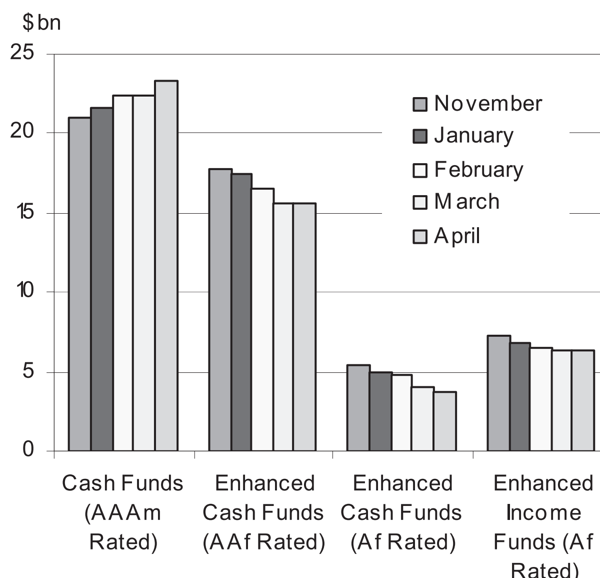
FIGURE 15: **Wholesale funds under management**



Source: MorningStar.

FIGURE 16: **Wholesale credit fund size**



Source: Grove Research & Advisory.

The destruction of a large share of the 'structured' investor base does not, however, imply that asset-backed bond issuance won't recover in time. Changes to capital adequacy rules may limit the appeal for banks to securitise high-grade mortgage assets. A further narrowing in RMBS spreads and/or widening in bank margins is also needed 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. Over time, packaging of income streams, investor diversification and freeing of bank balance sheet constraints still make economic sense.

Domestic demand for AUD securities

Australian fund managers and investors have had limited 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 have been major constraints for fund managers, even for those who perceive significant value in spreads.

Figure 15 and Figure 16 show how funds flowed from higher risk 'enhanced cash' products towards more traditional low risk 'cash' funds in the aftermath of the credit crisis. This adjustment forced liquidation of positions in riskier funds, which amplified the lack of liquidity in the credit market.[7] Banks similarly face regulatory pressure to churn credit inventory, which can increase selling pressure in markets and reluctance to bid for securities offering medium-term value. At the same time, the reliance of many mortgage securitisers on a single source of funding 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 of trending markets, there has 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.

This selling pressure is beginning to reverse, with investor appetite and manager in-flows buttressed by ongoing flows into superannuation. Asset consultants are beginning to advise clients to make 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. The entrance of such large (non mark-to-market) investors is necessary to unlock the value in less-liquid markets.

Still, more thorough investigation of the practical pressures confronting banks and fund managers in times of crisis is warranted, including into 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, those closest to the credit market and best placed to determine value opportunities have not had the flexibility to invest accordingly. 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 hold-to-maturity products and investors need to have the ability and intent to hold them until they mature to facilitate smoother functioning in times of stress.

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Conclusion

There has been a global repricing 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 have almost matched those of the United States, given Australia's superior economic and financial performance. This appears to reflect the country's heavy reliance on external funding, which has meant that the disruption to global securitisation markets and crippling of ABCP-funded investment vehicles have 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 have also been exacerbated by the inability of domestic banks and fund managers to take full advantage of cheapening spreads, due to mandate and regulatory constraints.

Notes

1 Reserve Bank of Australia 2008, *Financial Stability Report*, finalised March 25.
2 Guy Debelle 2008, 'A comparison of the US and Australian housing markets', RBA, May. www.rba.gov.au
3 Ian Macfarlane 2005, 'What are the global imbalances?', address to the Economic Society of Australia, 28 September.
4 Derivative Fitch 2007, 'Rating performance of structured investment vehicles in times of diminishing liquidity for assets & liabilities', September.
5 Bloomberg and Moody's reports.
6 Australian Bureau of Statistics, 5609.0
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.

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