Feature

Year of living dangerously

For issuers, investors and intermediaries 2008 was a perilous year, with challenges including a paralysed primary debt market for non-bank issuers and a swamped secondary market leading to untenable pricing. *KangaNews* explores the dark days of the Aussie debt markets – and the glimmers of light.

BY LAURENCE DAVISON AND KIMBERLEY GASKIN

I haven't spent all my bullets yet – I'm waiting until the glimpse of spring becomes more pronounced before committing fully." So said UBS Global Asset Management (UBS)'s head of Australian fixed income, Anne Anderson, in mid-2008 when asked by *KangaNews* about buying opportunities in the Aussie dollar debt markets. By the end of the year she was quietly pleased she did, with the reality of redemption fever gripping Australian fund managers and a raft of cheap, high-quality bonds available in an overcrowded secondary market.

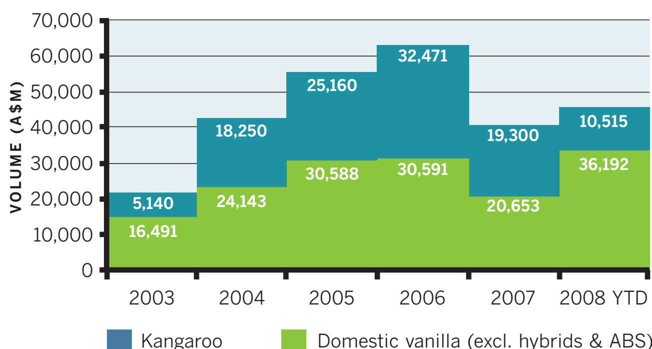
By the end of November 2008 fresh revelations about the ongoing viability of Citigroup and a US$300 billion rescue package for the bank had reignited fears of systemic risk. Market participants were surveying a landscape littered with the corpses of many seemingly unassailable institutions and the shrill ring of numerous shotgun marriages still in their ears – not to mention the ongoing cavalcade of negative economic data.

NON-BANK ISSUANCE STILTED

While Australia continues to avoid the worst of the malaise, its capital markets have not been immune to the contagion. By December 15 2008 domestic and Kangaroo issuers had brought a total of A$46.7 billion (US$29.9 billion) of vanilla debt to the local market (see chart opposite). While this is a slight improvement on 2007 volumes, the 2008 numbers were given a last-minute boost when Commonwealth Bank of Australia (CBA) priced A$2.2 billion of government-guaranteed debt on December 10, followed by National Australia Bank (NAB)'s A$2.5 billion guaranteed deal on December 12 (see box on p14). Overall in 2008 the domestic issuance picture is distorted somewhat by the way large deals from Australia's big four banks buoyed deal volumes over the year. By common consent, a large proportion of many of these deals was purchased by fellow banks after the September 2007 widening of repo criteria by the Reserve Bank of Australia (RBA) to include bank debt, leading balance sheet investors to spend the first half of 2008 buying up their peers' bonds as liquid, yielding assets.

Each of the big four banks substantially stepped up their domestic borrowing in 2008 (see chart on p11), while other sectors found it close to impossible to price public deals. What

AUD VANILLA PUBLIC ISSUANCE



SOURCE: KANGANEWS DECEMBER 15 2008

some intermediaries termed the buyers' strike was so severe that just two non-bank deals – *KangaNews*'s Domestic Vanilla Deal of the Year, from AMP Group (see p29) and a small A$42.5 million inflation-linked bond from University of Wollongong – were brought to market in 2008. Meanwhile, there was not a single Kangaroo bond from an issuer rated below triple-A (see box on p12).

The twin effect of the big four banks' dominance was a significant increase in the average tranche size of vanilla bonds in 2008 – at A$355 million it is up by A$128 million on the previous record year in 2005 – as liquidity books cut big tickets from bank issues, combined with a collapse in average tenor in 2008 (see chart opposite). Average deal maturity for Australian domestic deals dropped off a cliff, from 6.3 years in 2006 to 2.6 years in 2008; if and when the investor base does return the main issuers will undoubtedly be scrambling to increase the term of their funding.

LIQUIDITY IS PARAMOUNT

By the end of 2008 liquidity management was proving to be the most vexed issue for Australian institutional investors as redemption phobia gripped many fund managers while repo fixation played a key role in changing the shape of bank investor portfolios. Comments one investor: "Many buyers are positioning themselves for redemptions so are not participating in new issues. The question all market participants are musing is simply: what is a liquid instrument?"

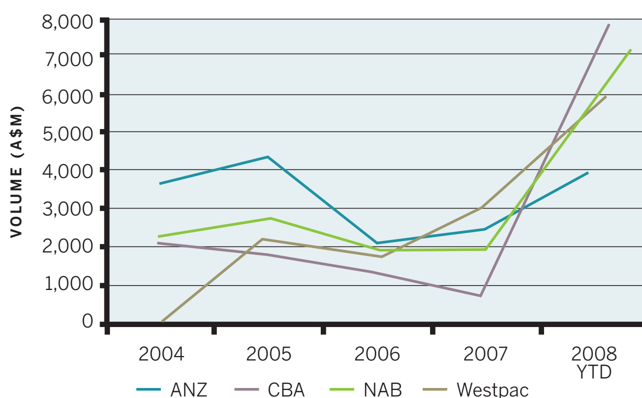
The answers do not seem to be as simple as investors once thought. All the buyers interviewed by *KangaNews* indicate their key priority is their own liquidity management and that strategies in this area are under scrutiny.

James Meighan, senior portfolio manager, fixed interest at IAG Asset Management (IAG) in Sydney – who, as an insurance investor has a particularly stringent liquidity strategy mandated by the Australian Prudential Regulation Authority (APRA) – believes a new age of conservatism will justifiably sweep the fund management community. "Why try to enhance returns on the part of the portfolio you need to fund the whole business?" he asks. "Although there have been some surprises in terms of illiquidity, fund managers really should have a rational understanding of which instruments are truly liquid – that's what they are paid for."

Many investors are redefining their understanding of liquid instruments in the wake of the volatility and more recent liquidity shocks – most notably the decline in liquidity being felt in supranational, agency and semi-government bonds as a new sector of government-guaranteed bank debt emerges and as sovereign risk has started to appear less stable.

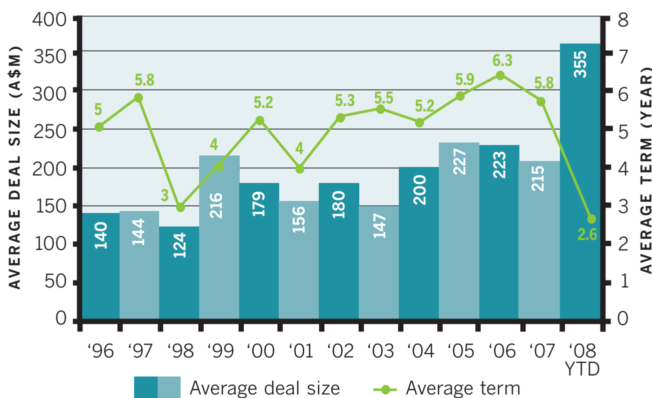
One liquidity portfolio manager at a major bank says he did not buy any traditional supranational, sovereign and agency (SSA) bonds in the second half of 2008. "If we wanted to liquidate a certain part of the portfolio what would be the price? There wouldn't be a price – that's the problem," he comments.

AUSTRALIAN BIG FOUR BANKS'
DOMESTIC VANILLA FUNDING



SOURCE: KANGANEWS DECEMBER 15 2008

AU DOMESTIC VANILLA AVERAGE TERM AND DEAL SIZE



SOURCE: KANGANEWS DECEMBER 15 2008

UBS's Anderson found it impossible to vote for a Kangaroo Deal of the Year precisely because she feels the SSA sector has proved to be much less liquid than expected, in a year when the Kangaroo market has comprised nothing but SSA deals (see box on p12). "I didn't want to buy anything because swap spreads were on the way out, and because the bonds simply weren't liquid. My absolute focus has been on preserving liquidity," she explains.

Similarly, Malcolm Alley, portfolio manager at Aberdeen Asset Management (Aberdeen) in Sydney, says the market is clearly less enamoured of supras and semis. "They are definitely less liquid compared with the first half of 2008. We expect to see quite a bit of switching out of SSAs and semis into government bonds over the next few months," he comments.

For Kumar Palghat, Sydney-based managing director at Kapstream Capital, the appeal of SSA debt has waned significantly over the last 12 months due to uncertainty over macroeconomic conditions in so many Western nations. "I wouldn't own any sovereign debt in any country because of the

Feature

THE SKINNY *KANGAROOS*

WHILE THE DOMESTIC VANILLA AND SECURITISATION MARKETS SUFFERED BADLY IN 2008 WITH AGGREGATE VOLUMES DOWN AND THE POOL OF BUYERS MASSIVELY REDUCED, NOWHERE WAS THE CREDIT MARKET MALAISE QUITE AS PRONOUNCED FOR ISSUERS OUTSIDE OF THE SOVEREIGN, SUPRANATIONAL AND AGENCY (SSA) SECTOR AS THE KANGAROO MARKET.

In 2006, the last year entirely unaffected by the credit crisis, borrowers rated below triple-A accounted for 49 per cent of Kangaroo issuance, with the Kangaroo market overall representing just a fraction more than domestic vanilla term borrowing in Australia.

In 2008 the Kangaroo market made up just 29 per cent of total domestic vanilla issuance and the contribution to that figure from non-SSA issuers was zero (see chart below).

The main reasons for the drought are clear: outside the SSA names, the list of the biggest issuers in the Kangaroo market reads like a *Who's Who* of battered financial institutions (FIs).

Morgan Stanley has issued A$5.705 billion (US$3.6 billion) of Kangaroos, Citigroup A$5.4 billion, Merrill Lynch A$5.305 billion and ever onwards. Perhaps the best news is that the collapsed Northern Rock and Lehman Brothers took down no more than A$1.8 billion of defaulting Kangaroos as they fell.

And while the chances of a return of a US bank to the Australian market are still regarded as vanishingly small in the foreseeable future at least, some intermediaries are refusing to accept the Kangaroo FI market is dead in the water.

One Sydney banker tells *KangaNews* there are a handful of offshore banking names – all European – which have steered clear enough of the icebergs potentially to raise investor interest.

One such issuer is Spain's Banco Santander, which visited Australian investors in November 2008 (see KangaTrends p2). In addition, the impact of government guarantees on the appetite for offshore names remains to be seen as 2009 approaches.

While the non triple-A market literally cannot sink any further than its 2008 level, there is also some concern that conditions have turned systemically against the SSAs as well.

After a highly encouraging start to the year, top-rated Kangaroo volume collapsed in the second half of 2008 with no public Kangaroo deals done after early August, while the last significant deals in terms of size were issued in June (see chart below).

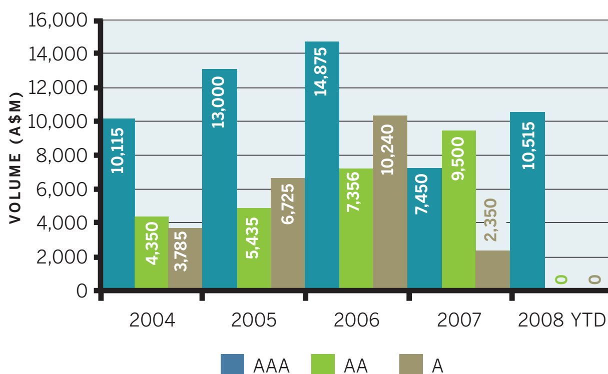
The triple-A universe is becoming ever more crowded, with most of the world's bank debt now government-guaranteed. SSA issuers have seen their primary market spreads blow out from a comfortable sub-swap level in Europe to swap-flat or, in the case of some agency issuers without explicit government support, up to 50 or more basis points over (see KangaTrends p3).

Even before that, the example of another non-core market – Canada's Maple – must send a shudder through Kangaroo market watchers. Having grown impressively before the credit crunch, leading many to believe it would outstrip Australia as the number one non-core dollar funding market, Maples barely registered a pulse in 2008.

There is no sign that the Kangaroo market will punish SSA issuers any more than other global funding sources, though, so the return of triple-A issuers may just be a matter of a settled basis swap and more robust demand.

After the cataclysms of the past year, intermediaries are reluctant to rule anything out. However, one Sydney banker with experience of the SSA Kangaroo business comments: "I don't think we will have a 2009 in Australia like 2008 in Canada – the Kangaroo market is too mature. The experience of 2008 shows the list of potential issuers may be smaller than in the past, even just in the SSA space, but I am confident we will see some deals in the first quarter."

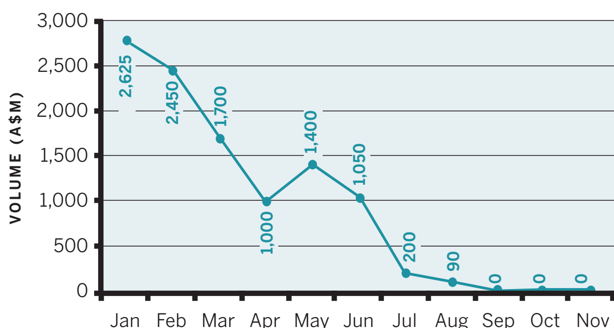
KANGAROO ISSUANCE BY CREDIT RATING



SOURCE: KANGANEWS DECEMBER 15 2008

KANGAROO ISSUANCE BY MONTH

JAN 1 – NOV 30 2008



SOURCE: KANGANEWS DECEMBER 15 2008

fiscal situation, particularly in the US," he comments – a theme echoed by a number of other investors. In addition to the deteriorating fiscal position of major governments, many financial institutions are offering debt backed by government guarantees at more attractive levels than outright sovereign debt.

THE SEMI CONUNDRUM

In the short term, the position of SSAs as a proxy for government bonds looks like it has been compromised – although the position of government bonds the world over is hardly as unimpeachable as it used to be. At the same time, semi-government securities – which had along with SSAs been cleaning up in the early months of the credit crisis thanks to flight-to-quality and flight-to-liquidity instincts – took a few body blows over 2008. These included the revision in ratings outlook on the state of New South Wales; a long delay in the passage of legislation making the domestic bonds of semi-governments free of interest withholding tax (see KangaTrends p4); the sharp decline in the Aussie dollar in the second half; and the beginnings of a flood of government-guaranteed bank bonds issued in December (see box on p14).

The new pricing benchmark initiated by CBA with its triple-A rated government-guaranteed bonds issued on December 10 had a significant impact on semi-government spreads. CBA priced A$300 million of five-year government-guaranteed floating rate notes at 120 basis points over the bank bill swap rate and A$1.9 billion of five-year fixed rate guaranteed bonds at 120 basis points over swap. At the same time, the bank issued A$500 million of three-year non-guaranteed paper at 160 basis points over swap. Analysts report semi-government bonds moved out 30-40 basis points on the day the CBA bonds priced.

Stephen Knight, chief executive at New South Wales Treasury Corporation in Sydney, says: "This is what happens when you create artificial markets. It is interesting to consider the impact of a A$2.2 billion new issue on the existing A$150 billion-plus of semi and SSA bonds. This is a further case of unintended consequences arising from the creation of artificial structures."

UBS's Anderson said before the domestic banks started pricing government-guaranteed deals that the bonds of semis were still relatively liquid according to her definition: the ability to monetise quickly at a reasonable price. "I know I can still monetise semis – although I might pay away five to 10 basis points," she commented. But with semis then pricing around flat to swap Anderson was not sure they would continue to fit that definition in the long term.

It is clear that the repricing of all asset classes – and most recently the shift in the value of semis and SSAs – is the great unknown for investors as 2009 approaches. How the various sectors will price relative to one another as perceptions of liquidity change and, more importantly, as supply-demand dynamics shift will determine the shape of portfolios for years to come.

THE DEATH OF DIVERSIFICATION?

With the Australian government expected to go into deficit at some point in 2009, supply of commonwealth government securities will increase, as will supply of semi-government bonds as the states look to fund their operations and infrastructure plans. Add to this the possibility of a glut of sovereign-guaranteed bank paper and that spells an awful lot of government risk for portfolios.

Anderson says the shifts have changed the direction of portfolio analysis already, with the focus now not so much on sector allocation positions but rather on bottom-up securities selection. "With so little credit in the market and so much sovereign and guaranteed paper out there, investors will need to assign a value to the sovereign guarantee, the underlying issuer and liquidity of the issue," she explains.

Kapstream's Palghat would like to see not only better analysis, but faster movement and more responsibility taken by poorly-performing managers. "People don't adjust portfolios quickly enough. It's astonishing how slow most have been over this period of crisis to change their investments and to fire extremely bad fund managers," he says.

Palghat adds that investors need to learn there is no true diversification: "This crisis has demonstrated just how correlated markets are. The best we can do in the future is separate risk-seeking and defensive assets properly, and definitely not intermingle the two in any fund – let alone one that needs to be highly liquid."

THE GREAT GUARANTEE DEBATE

There are still some mixed feelings about the efficacy and necessity of the Australian government's Guarantee Scheme (see box on p14).

For most investors it was necessary at the time, to stave off potentially catastrophic loss of confidence in the national banking system. Comments Anderson: "Although some may since have revised their position, there's no denying that there was a very real threat to the financial system at the time that only a guarantee of this kind could have overcome."

In addition to a boost in confidence, another real benefit was already emerging by year-end as the guarantee seemed to be encouraging offshore issuance by Aussie banks, which could help unlock the basis swap. By December 16 three Australian banks had between them priced US$6.8 billion of government-guaranteed bonds in rule 144a reg S format (see box on p14).

However, some investors are not convinced the guarantee will hold much more than short-term attraction for investors. David Hanna, portfolio manager at Macquarie Funds Management in Sydney, said before the first domestic government-guaranteed deal priced: "The first Aussie bank to issue might do alright, and the second, but by the third and fourth issues I suspect it will begin to put some pressure on the market's ability to digest guaranteed issues from around the world, and this in turn should impact spreads."

GUARANTEE KICKS IN

AT THE START OF DECEMBER AUSTRALIAN BANKS FOLLOWED THE LEAD OF THEIR INTERNATIONAL PEERS BY ISSUING BONDS BACKED BY THEIR GOVERNMENT'S GUARANTEE. AS 2008 ENDED THE MARKET WAS STILL COMING TO TERMS WITH THIS STYLE OF ISSUANCE.

In the week beginning December 8 US$8.9 billion equivalent was issued by six Australian banks in the domestic and offshore markets. The following week a further US$1.1 billion was added via increases to three of these deals.

While the market is still digesting the impact of the new sector bonds, there are already signs of significant consequences for semi-governments and sovereign, supranational and agency (SSA) Kangaroo bonds, as well as conflicting opinions on pricing.

ANZ Banking Group (ANZ) and Westpac Banking Corporation (Westpac) both priced three-year rule 144a reg S US dollar deals on December 9, at 100 basis points over mid-swaps. Commonwealth Bank of Australia (CBA) became the first bank to price government-guaranteed bonds in the domestic market on December 10, issuing 2013 bonds for an unprecedented size of A$2.2 billion (US$1.4 billion) in two tranches. It also brought A$500 million of five-year domestic unguaranteed bonds.
On December 10 Macquarie Bank priced a five-year US$1.7 billion rule 144a reg S deal, while Suncorp-Metway sold A$1.1 billion of three-year bonds in the domestic market. National Australia Bank added A$2.5 billion of three- and five-year domestics on December 12.

Despite rumblings around the merits of the pricing CBA achieved, it seems on face value the domestic market offered a better funding cost than CBA's peers achieved offshore.

In the weeks leading up to CBA's deal general market commentary focused on the lack of appetite from domestic investors for government-guaranteed bank paper. However, CBA was convinced there was demand and the success of its deal proves the point. Says Peter Christie, Sydney-based head of corporate securities origination at CBA: "Including the non-guaranteed 2011s, only 18 per cent of the bonds priced sold to offshore investors, while real money accounts bought 62 per cent of the combined trade."

Analysts say if the ANZ and Westpac deals had been swapped back into Aussie dollars on the day the CBA deal priced they would not have been able to achieve a better rate than 115 basis points over swap on a fully-hedged basis. Add to this the 70 basis points they pay for the guarantee, and the real funding level for the issuers is 185 basis points. This level makes CBA's rate of 160 basis points over swap on its unguaranteed 2011s and an all-in cost of 190 basis points over for the goverment-backed 2013s look attractive.

With its domestic transaction CBA effectively repriced the domestic triple-A curve. Analysts estimate that on the day the CBA deal priced semis moved out between 30 and 40 basis points as investors switched out of semis into the new guaranteed bank bonds. Some outward movement in the spreads of SSAs was also reported, although this was less visible as these are not as actively traded as those of the semis.

Some market participants suggest CBA priced its bonds too expensively. But Christie says it was only a matter of time before a domestic government-guaranteed deal was done and the price was always going to be dictated by the market. "It is true that in the current environment credit is not as global as it was and that credit markets are displaying more of a home-market bias," says Christie. "So it makes sense that Aussie investors view paper from local banks more favourably than do offshore investors."

But the rush to price guaranteed trades across the globe also had an impact, Christie says. "The week before we priced our domestic deals there was significant demand at a lower price. The levels moved out in the week of pricing, partly as a result of the ANZ and Westpac deals pricing offshore. This proves there is still a global element to pricing and it shows the levels CBA paid were fair and made sense from a global point of view."

There is no doubt that before government-guaranteed debt started being issued by Australia's banks, the general tone in the market regarding the guarantee initiative was rather negative. Says one fund manager: "I thought we were nearing the end of the real crisis before the notion of a domestic guarantee was introduced. The guarantee has exacerbated the liquidity issues by encouraging a huge movement of cash away from asset managers back to the banks." He believes the solution to Australia's liquidity issues does not lie in banks repoing great sheaves of paper with the RBA, but in asset managers buying back into the market. "That is the underlying problem," he notes.

However, despite general misgivings in the market about the level of demand from domestic investors for government-guaranteed bank paper, all three such deals priced in December reported solid local investor participation – and from fund managers as well as bank books. CBA reported 82 per cent of its bonds went to local buyers, while 63 per cent of investors were real money accounts. Suncorp-Metway – which priced A$1.1 billion of three-year domestic bonds on December 11 – saw a dozen local investors participate in the deal, more than half of which were real-money accounts. And NAB reports that of the 43 tickets sold in its A$2.5 billion domestic guaranteed deal priced on December 12, 80 per cent of investors were Australian, while 36 per cent of investors overall were fund managers.

GUARANTEE COULD AFFECT VIABILITY OF INSTITUTIONAL FIXED INCOME INVESTMENTS

However, there is concern about the impact the government guarantee on retail deposits could have on the very viability of institutional fixed income investments.

Robert Camilleri, senior manager, credit at Aviva Investors in Melbourne, has seen money fly out of superannuation funds and into bank deposits as retail

investors realise that a guaranteed term deposit is a better bet than a balanced fund with associated market risk.

"People have even been selling bank paper to put the money into bank accounts – which makes sense when you can get 5 per cent plus in a deposit with a full guarantee," he says. "There has to be a relative cost to the guarantee, because offering government risk with higher-than-government return slants the playing field for everyone else."

Camilleri believes guaranteed deposits should not be allowed to offer a return above the front-end sovereign cash rate, with a capital charge introduced by APRA on anything above that level.

While falling interest rates have dampened the appeal of bank deposits for retail investors, towards the end of 2008 banks had also started to complain that yield hunting by retail investors was preventing them from dropping their deposit rates in line with tumbling headline interest rates, as to do so would lead to depositors shifting to more attractive offerings elsewhere. As a result, while the government's guarantee scheme has created a massive boost to banks' deposit bases, it has yet to really ease their own lending circumstances.

IMPACT OF GUARANTEES ON ABS MARKET

By mid-December 2008 the vanilla non-government market remained in some confusion about the medium-term impact of the guarantee and participants in the asset-backed market were experiencing equal uncertainty.

Comments Aberdeen's Alley: "It is plausible that we will see government-guaranteed paper crowd out the residential mortgage-backed securities (RMBS) market. Given liquidity is so important for managers you might see some managers preferring to hold a more liquid government-guaranteed bond rather than an RMBS security."

In 2008 the securitisation market experienced a true *annus horibilis* with investors, issuers and intermediaries alike having little cause for rejoicing. Public securitisation volume of A$11.3 billion in the year to December 15 2008 was tracking at just 19.6 per cent of the 2007 volume of A$57.8 billion (see chart on this page). Pricing was subject to wild swings and primary issuance had all but ground to a halt by virtue of the overhang of very high-quality paper spewing out of the rapidly deleveraging offshore structured investment vehicles (SIVs). All in all, it was a tough market.

Public securitisation deals continue to be small, short and expensive. The last time a single tranche of over A$1 billion came to market was June 2007 and just four tranches of A$500 million or more were sold in 2008 to December 15; in 2006 alone there were 14 different A$1 billion-plus tranches. Over the course of 2008 the market seemed to settle on pricing of around 130 basis points over swap for the top portions of new RMBS deals. But this level is only borderline sustainable for issuers and, investors say, is still tighter than paper they can pick up in the secondary market.

The size of the overhang means the primary market was effectively crippled in 2008. Comments Sean Carmody, head of fixed income at Barclays Capital Global Investors Australia (Barclays) in Sydney: "Pricing cannot normalise in this environment because as soon as spreads come in a little we see huge selling of Aussie dollar product out of the SIVs and other leveraged players, which pushes spreads right back out again."

The primary market did not stand much of a chance against so vicious a cycle, particularly with spreads on short-term asset-backed commercial paper so favourable.

While market participants both domestically and offshore acknowledge there has been minimal impairment of credit quality on Aussie triple-A RMBS, until the paper in the SIVs is absorbed the wild volatility in pricing is unlikely to abate.

Many investors believe the primary market activity that occurred in 2008 did so at an artificial level because a number of transactions look like primary deals but were effectively done on a private placement basis.

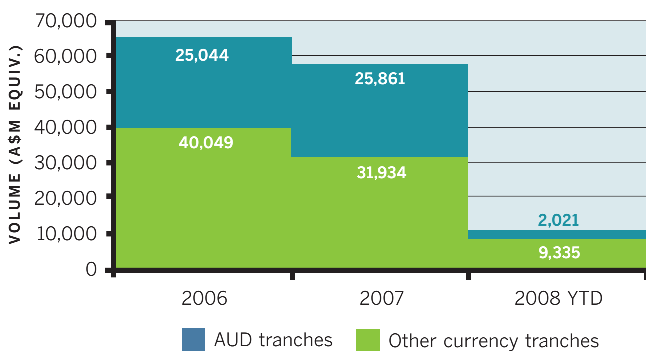
Apart from these quasi-public deals, the Australian market in 2008 was characterised by big volumes of internal securitisation activity as banks sought to access the newly-opened repo window provided by the Reserve Bank of Australia (RBA).

In the year to mid-November the size of the RBA's repo book had more than doubled since the credit crisis began, to over A$60 billion. According to data from *KangaNews* and Macquarie Bank, A$126.8 billion of internal securitisation deals were done in the year to December 3. Market participants point out, though, that such a pace is unlikely to occur in 2009. As Carmody says: "There's probably not that much left for the banks to do."

THE GOVERNMENT WALLET

One beacon of hope for the Australian bond market in 2008 came from government initiatives which offered new potential buyers for asset-backed and other highly-rated securities. This news came as a relief, particularly as with the destruction of the SIV buying base, issuers and

AUSTRALIAN ISSUERS' PUBLIC SECURITISATION VOLUME



SOURCE: KANGANEWS AND MACQUARIE BANK DECEMBER 15 2008

RETAIL INVESTORS DOMINATE *HYBRIDS*

THERE WERE ONLY SIX PUBLIC HYBRID TRANSACTIONS DURING 2008, ALL FROM BANK ISSUERS. ALTHOUGH THE DEALS WERE NOTEWORTHY FOR BEING BROUGHT IN TRICKY MARKET CONDITIONS, MARKET PARTICIPANTS AGREE THEIR APPEAL WAS MOSTLY FOR RETAIL INVESTORS. HYBRID OBSERVERS ARE CONFIDENT THE MARKET WILL COME BACK IN 2009.

When canvassing the investor market for its 2008 awards, *KangaNews* intended to offer a triumvirate of gongs – covering house, deal and issuer of the year – in the Australian hybrid securities market. But over the course of the voting process the fact that institutional investors had largely steered clear of these deals was reaffirmed. And although issuers had notable success marketing hybrids to the retail market in 2008, it was clearly inappropriate to give hybrid awards from an institutional fund manager perspective on this occasion.

As late as June there had been some hope that fund managers could be persuaded to buy hybrids. A hybrid deal launched that month by Macquarie Bank was in the unfranked format which offers the best fit in institutional investors' portfolios. But although that deal netted a respectable A$600 million (US$384 million) for the issuer it became clear that fund managers were simply not biting to any great extent.

The next transaction, also launched in June by Westpac Banking Corporation, was a franked deal and despite the acknowledgment that institutional demand would likely be minimal that offer was upsized, to A$950 million from A$600 million, when it was finalised on June 26.

However, even the retail opportunity was not sustained all year, with intermediaries acknowledging by the end of November that the window for hybrid deals in Australia had in all likelihood closed for 2008, with several potential deals not now expected to come to market. Hope remains, though, that 2009 will offer opportunities for both on- and offshore issuers in the tier one (T1) space.

By the beginning of December 2008 there had not been a completed hybrid transaction in Australia since ANZ closed its A$1.081 billion (US$691 million) convertible preference share offer on September 30. Bendigo and Adelaide Bank (Bendigo-Adelaide) pulled a hybrid offer on November 5 and nothing concrete emerged from rumoured market soundings on hybrid issues taken by Westpac, National Australia Bank (NAB) and Commonwealth Bank of Australia.

"The environment is not right for hybrid issuance at the moment, and Bendigo-Adelaide is not the only illustration of that," said Nicholas Chaplin, director and head of hybrid and structured securities at Westpac Institutional Bank in Sydney towards the end of November 2008. "I don't think there will be a hybrid deal in the remainder of this year – it is too close to Christmas for retail investors, the market is too thin and there is still no sign of institutional investor interest."

Chaplin says retail buyers are no longer oblivious to the ability to bargain hunt in the secondary market. He explains: "One significant issue – which I think was the biggest cause of the Bendigo-Adelaide deal being pulled – is that secondary margins in major bank hybrids are so wide that retail investors can get big four hybrids at levels as wide if not wider than where Bendigo-Adelaide was going to come – and retail advisers are aware of that."

Rupert Daly, Sydney-based head of hybrid capital at Deustche Bank – one of three lead managers on the planned Bendigo-Adelaide deal – also cites secondary market activity as a factor which pulled the rug out from under the recent transaction.

Between the deal's launch and its withdrawal, Daly says there was negative press coverage of the Australian hybrid market as well as significant secondary market outflows from existing securities, with many existing hybrids sold down to annual lows. As a result, demand for the Bendigo-Adelaide transaction which had been shown in advance of the deal could not be firmed into sufficient bids.

Daly also highlights ongoing structural changes as a distraction for retail investors. "The most important factor remains the government guarantee," he says. "It will be interesting to see how that plays out but if guaranteed retail rates continue to be offered at the same level they are at present it certainly reduces the incentive to put money to play elsewhere. Logic dictates that over time those deposit rates should fall

intermediaries were impatient for new investors. Market participants are looking to the Future Fund to buy more securitised bonds, although any such investment is likely to be relatively small. On October 20 the fund revealed A$1.67 billion of investment in mortgage-backed securities issued by major and regional domestic banks and signaled its intention to invest in more over coming years.

Of more significance were Treasury initiatives around the investment mandate of the Australian Office of Financial Management (AOFM) – the government agency responsible for debt management. On May 20 it was announced that the mandate would be expanded to allow it to invest in a broader range of assets – including semi-government and SSA bonds. During the year the AOFM started putting its new investment strategy in place, giving a boost to the domestic investor base for Kangaroo and semi-government bonds.

Then in September, Treasury announced that the AOFM would in the 2008/09 financial year buy A$8 billion of triple-A rated primary RMBS assets, with at least half that amount earmarked for the non-bank sector for the specific purpose of encouraging competition in the mortgage and housing markets (see KangaTrends p6).

RMBS participants welcome the AOFM initiative, but warn it is by no means a solution; "It's just not enough," says Carmody. And it remains to be seen if it will really boost liquidity by encouraging real money investment in RMBS.

but I continue to be surprised by the markets at present."

Since the apparent drying up of demand for hybrids, potential issuers have been looking elsewhere for equity funding, with NAB, Westpac Banking Corporation and Bendigo-Adelaide announcing share offerings towards the end of 2008. The first two banks raised A$3 billion and A$2.5 billion, respectively, while Bendigo-Adelaide announced its intention to enhance its T1 and total capital position through an equity offering to existing shareholders.

Although the target size of the Bendigo-Adelaide share offering was not disclosed at the time of writing, the firm did target a minimum of A$75 million from its withdrawn hybrid. That deal was expected to appeal in particular to existing shareholders, and bank chairman Robert Johanson said in the announcement of the new share offering: "The bank's large and loyal shareholder base has always been a great strength of this company and we look forward to building on that."

In the medium term, however, there is hope that retail investors will start to look at hybrid securities again. Tricia Ho, director, hybrid capital at UBS in Sydney, comments: "Although we understand why some people think the hybrid market is dead at present that is not the view at UBS. The extent to which retail money will switch into deposits is limited before it has to look for duration, and the feedback from our retail distribution networks is that those buyers remain interested in the rates and terms of hybrid deals from the right issuers."

Furthermore, an across-the-board increase in T1 capital ratios is unlikely to reduce borrower desire to do deals in the hybrid space. Chaplin says: "There is going to be issuer demand for hybrid deals in 2009. Even though the regulatory requirement is only for a 4 per cent T1 capital ratio there has been pressure from the Australian Prudential Regulation Authority behind the scenes for that level to be up around 8 per cent, and in my view that could increase – to 10 per cent or more – in 2009. Despite the cost of achieving that kind of ratio, this is not the time to argue with that kind of requirement; banks need to shore up their balance sheets first."

Chaplin believes the hybrid market will initially return in something similar to the form it has previously had – driven by domestic financial institution (FI) issuers with the eventual emergence of appetite for offshore names from the same sector. He believes this latter kind of deal, structured for retail investors, could in fact lead vanilla issuance as the first sub triple-A rated Kangaroo transaction since the credit crisis.

"It is probably true that at present there is more chance of taking a hybrid deal from a strong, familiar offshore name to a domestic retail investor base than there is of bringing a vanilla Kangaroo to the institutional market," Chaplin claims. "An offshore hybrid won't happen before there has been a domestic deal and probably not in Q1 2009, but it also won't have to be priced as widely as the existing Kangaroo hybrids are marked in the secondary market – over 600 basis points over bills."

In terms of where an issuer might come from, he says: "The initial focus would be on around half a dozen European FI names that so far haven't suffered too badly. However, an offshore corporate retail hybrid deal is not entirely unrealistic for the right name. It would be tricky because a retail transaction must be listed on the Australian Stock Exchange. The issue for investors would eventually come down to yield."

Ho's focus is on the corporate side of the market. She says there is no reason conceptually why retail investors cannot fill some of the gap in corporate funding left by the reduced lending capacity and appetite of the banking sector. Where corporate names – both domestic and offshore – have previously found it easy to borrow through the banks they may in future find cheaper funds in public, retail markets. "The big question for us is when a corporate name is going to come to market," she comments. "Bank debt is drying up overall – the big four simply cannot continue to fund all of corporate Australia – and we believe retail funding has great potential in 2009."

Ho continues: "The money is still there in the retail market, as is shown by the success of bank hybrid deals this year and reinforced by the feedback we get from our retail distribution networks. Those investors are concerned about concentration in the financial sector and would like to see a deal from one of the best corporate names."

Ho stresses that name familiarity is key to accessing the retail market for hybrids, but even when conventional deals prove impossible it is possible to find hybrid funding. In October UBS placed A$250 million of exchangeable securities for property firm GPT Group in a private placement to Singaporean investment firm GIC Real Estate, in conjunction with a A$1.3 billion equity issue.

AOFM initially announced it would buy A$200 million to A$500 million of new issues as a cornerstone investor via two pairs of deals to be completed in 2008. The first two deals executed under the initiative were from FirstMac and Members Equity Bank, which both issued A$600 million transactions. Of the A$1.2 billion combined volume from these two issuers, just A$200 million was sold to non-AOFM investors.

The second two deals were from Challenger Financial Services (A$824 million) and Resimac (A$609 million). External investors bought just over A$400 million of these deals. Meanwhile, the AOFM injected A$500 million into each of these four transactions.

As a result, by the end of the year the AOFM had spent A$2 billion of the A$8 billion mandated by the government. The following round of deals will take place in 2009 and the government agency has yet to decide whether the next request for proposal will ask for bids on the remaining A$6 billion for the 2008/09 financial year, all in one go.

The four deals completed in 2008 that were supported by the AOFM reveal an increasing level of external investor participation. However, without the AOFM's cornerstone investment the transactions would not have been possible. It remains to be seen whether fund managers will be tempted into further participation in deals initiated by the AOFM over the course of 2009. •