

WHILE YIELD IS ELUSIVE, ATTRACTIVE INCOME OPPORTUNITIES IN BANK CREDIT STILL EXIST

In November, QIC's Liquid Markets Group published "Historical Australian Monetary Policy actions today, create headaches for cash investors" following historic RBA policy actions revealed on Melbourne Cup day.

The forward guidance from the RBA – now tied to actual inflation getting sustainably back into the 2-3% target band range – portrayed an intention to hold the policy rate low (near zero) for at least three years.

In that paper, we argued this environment would encourage investors to think hard about how much liquidity they truly need and, had been illuminated.

In this follow up paper, we look at the cause of the sharp compression in bank funding costs, and what this means for investors in term deposits (TD's), negotiable certificate of deposits (NCD's) and bonds. We also consider the bank capital structure, to ascertain where attractive risk adjusted returns remain available for investors.

The Changing Bank Funding Environment

Australian Banks currently have access to unprecedented levels of liquidity, a dynamic we believe is unlikely to change in the immediate future.

We see three main drivers behind this recent boon for bank liquidity:

1. Banks access to the RBA Term Funding Facility (TFF);
2. The large deposit growth seen since the beginning of the COVID-19 health crisis; and
3. Falling bank credit assets driven by reduced risk appetite and cautious lenders.

These liquidity drivers are outlined further below. This liquidity wave along with all-time low interest rates, are impacting the ability of investors to generate attractive yield on their cash investments.

1. RBA Term Funding Facility (TFF)

As part of the response to the COVID-19 crisis, the RBA introduced a Term Funding Facility (TFF). The TFF provides direct (collateralised) loans to Australian Deposit-Taking Institutions (ADIs) including domestic banks. The TFF is structured as a three-part \$200bn programme drawn down progressively until June 2021.

The TFF is priced at an attractive rate of 0.1%. This fixed rate facility has essentially changed the funding model of domestic banks by displacing the need for wholesale senior issuance.

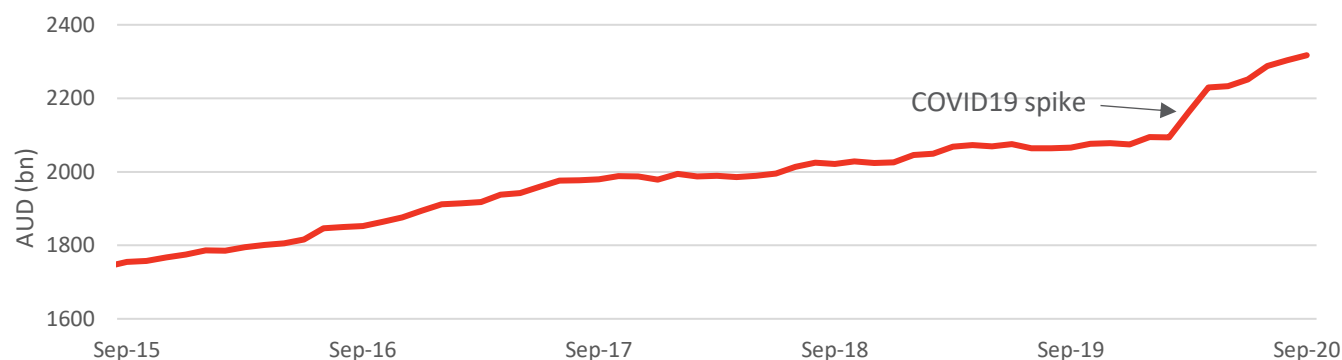
2. Large bank deposit growth

COVID-19 prompted increased risk aversion and reduction in the propensity, and ability, to spend. As a result, domestic banks have received a sharp increase in deposit flow. This behavioural response is broadly consistent with the acceleration of deposit growth during the Global Financial Crisis in 2007/08. The present acceleration is a bit stronger and more sustained, mostly reflecting three factors:

1. Reduced ability and willingness of households and firms to spend;
2. More immediate and generous Government transfer payments; and
3. Relatively higher trust in banks.

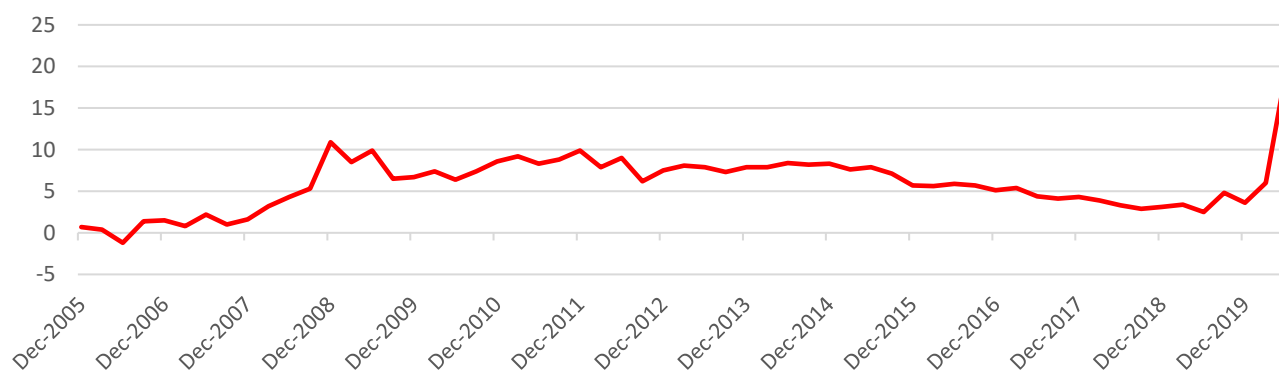
Deposit growth should ebb as the economy re-opens, spending recovers, and Government transfer payments taper. However, for the foreseeable future, deposit funding will remain strong.

Deposits at ADIs



Source: RBA and QIC

Australian Household Savings Rate (%)

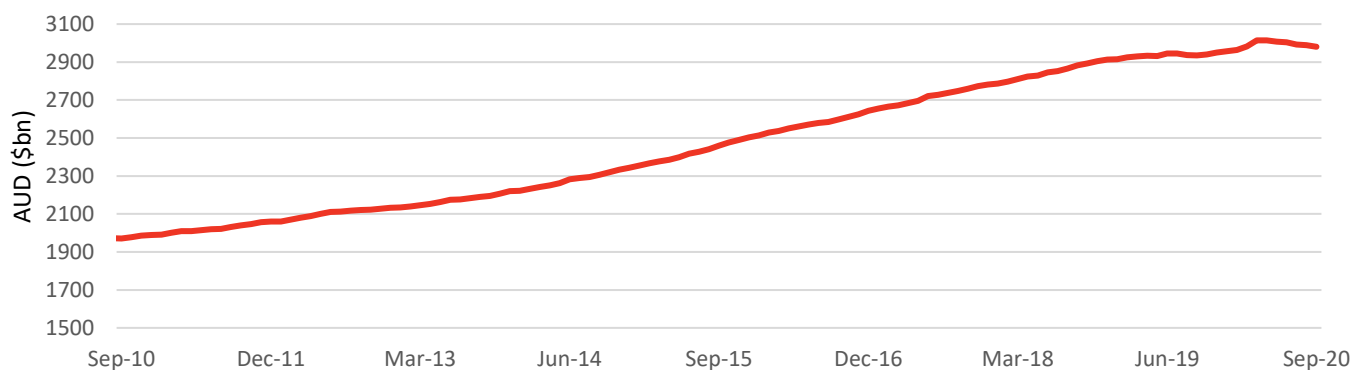


Source: ABS

3. Falling bank credit assets

Reduced risk and investment appetite on the part of retail and SME borrowers has contributed to a reduction in new loan volumes. In addition, several larger corporates have moved to reduce debt levels through equity raisings. While household mortgage lending has surprisingly remained soundly positive, it has very much been owner-occupier led while investor lending has trended down. The uncertainty around the COVID-19 health crisis that is still playing out at a domestic and global level, is also generating a note of caution from lenders, one that has impacted asset growth. For the first time-ever we have seen credit assets at domestic banks fall consecutively for six straight months.

Total ADI Assets

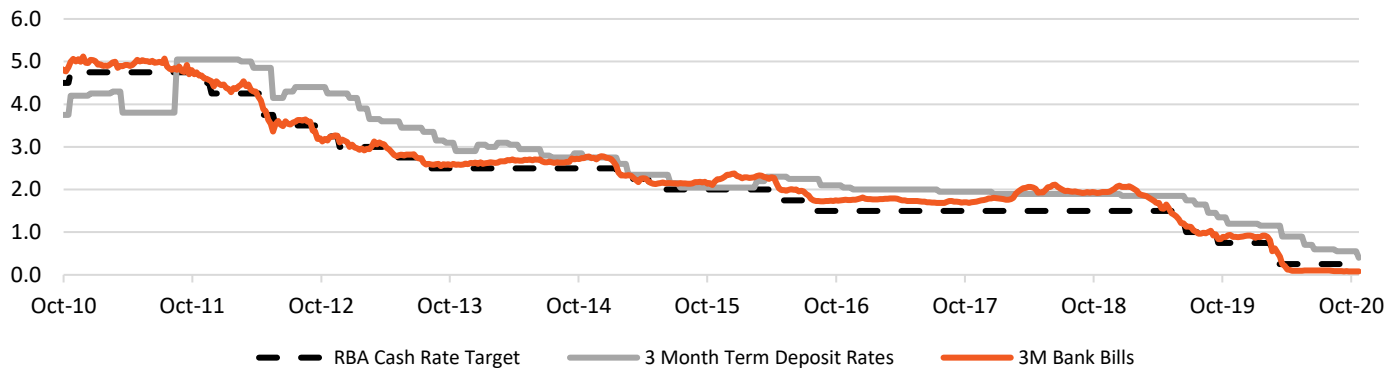


Source: RBA and QIC

Market implications – yield will remain elusive however income opportunities still exist

It has been difficult for cash investors to source attractive opportunities given the current unprecedented levels of bank liquidity coupled with the RBA delivering conventional and unconventional policy to achieve near zero cash rates. We expect this environment to remain for the short to medium term at least.

The below chart highlights the sustained fall in the RBA cash rate, 3-month Bank Bills and 3-month Term Deposits.

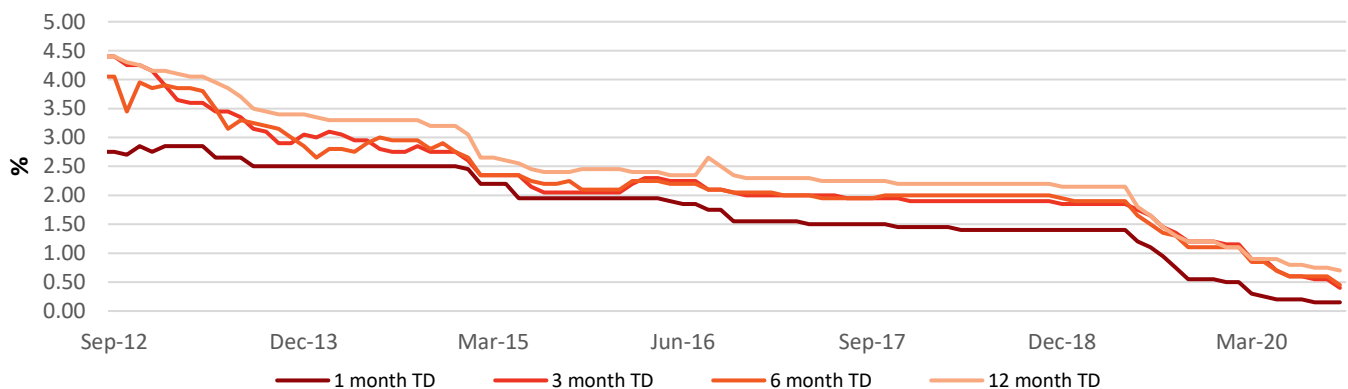


Source: Bloomberg, RBA (3-month term deposit rates are the retail rates quoted by the RBA)

Term Deposit market

Term Deposit rates have been particularly impacted with rates continuing to fall precipitously. We think that in this market, there will be continued downward pressure.

AUD Term Deposit Rates



Source: RBA and QIC

Finding the 'sweet spot' in the bank capital structure

Bank regulation since the GFC has required large banks to significantly strengthen their capitalisation. In Australia, APRA's 'unquestionably strong' requirement has similarly seen the domestic banks increase their capitalisation to record high levels. As a result, the common equity tier one capital ratios of Australia's four major banks are among the top quartile globally (i.e. ANZ, NAB, CBA and Westpac – commonly referred to as the major banks). This has placed domestic banks in a strong position to withstand economic pressures of COVID-19 and provides a substantial going concern loss absorption buffer beneath senior and subordinated bonds.

*Source: QIC

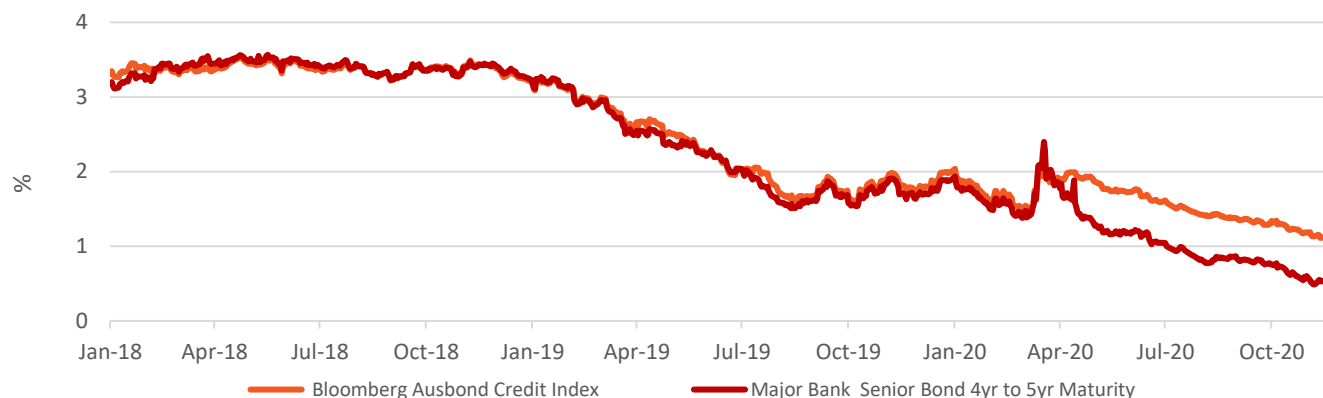
A typical domestic bank capital structure*:



Senior bond yields have sharply compressed

The TFF principally fulfils senior bonds funding for banks at a rate of 0.10% with a tenor of three years. Not surprisingly, the yields on offer for investors in the major banks' senior bonds have significantly outperformed the credit index and compressed to just above the TFF.

Major Bank 5yr Senior Yield Vs Credit Index Yield



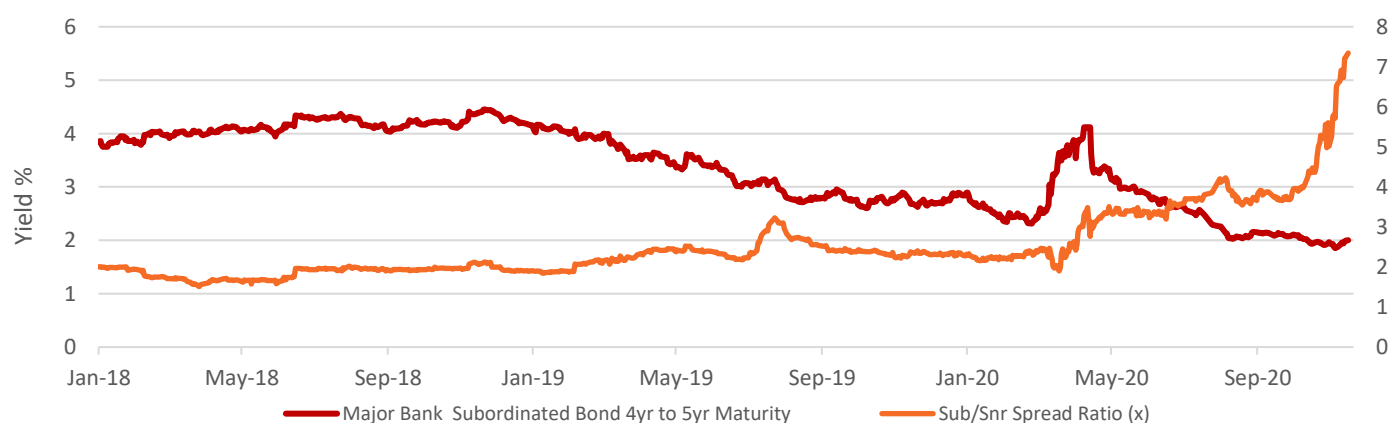
Source: Bloomberg and QIC

Subordinated bonds are the 'sweet spot' - and offer the attractive risk adjusted returns

When we assess a bank's capital structure, in a low-yield world, investors should consider the banks' subordinated bonds. We see subordinated bonds as offering both attractive absolute yields, as well as relative yields versus bank senior bonds. Unlike senior bonds, we expect to see healthy subordinated bond issuance to continue, as major banks move towards their APRA Total Loss Absorbing Capital (TLAC) targets in 2024 (major banks need to continue to issue subordinated bonds to meet the regulator's prudent guidelines). We believe this will provide an opportunity for investors to add precious yield to their portfolios with an appropriately sized allocation to subordinated bonds.

The chart below highlights the attractive opportunity subordinated bonds present when looking on an absolute yield or on a relative ratio versus senior bonds (i.e. the spread of a major bank subordinated bond is over 7 times the spread of a major bank senior bond of a similar maturity).

Major Bank 5yr Subordinated Yield (LHS) and Major Bank 5yr Sub/Snr Spread Ratio (RHS)



Source: Bloomberg and QIC

As outlined above, domestic banks are in a robust position to withstand the current economic upheaval, partly due to prudent regulatory oversight preceding the crisis. As bank-related issues are not at the centre of the current crisis, we do not see banks coming under the same stress as during the GFC in 2008. **In this unique situation, we see banks as playing an integral part of the solution.** While credit losses are likely to increase significantly above the average economic cycle level, banks are in a considerably better position to absorb these losses, benefitting from significantly stronger capital and liquidity positions as well as supportive regulatory measures. It is for the above reasons, that **we view subordinated bonds as the 'sweet spot' for investors that are looking to identify attractive risk-adjusted yields.**

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