THE BUTTERFLY EFFECT

As the Australian regulator joins its international peers in initiating a reassessment of bank liquidity, participants from a multitude of market segments are beginning to anticipate intended and unintended consequences for their own activities. *KangaNews* explores the impact of regulatory changes on real money and bank investors, as well as triple-A issuers.

BY KIMBERLEY GASKIN

Australia's banking system suffered far less than other developed nations from the fallout of the crisis. Even so, the Australian Prudential Regulatory Authority (APRA) has made it clear it will not assume that just because one bullet was dodged it should not beef up body armour against a future barrage.

On September 11 APRA released a discussion paper on its prudential approach to Australian authorised deposit-taking institutions' (ADI) liquidity risk. The paper outlines proposed changes to the regulator's current prudential approach to liquidity risk managemnt for ADIs, as set out in *Prudential Standard APS210 Liquidity* (APS210). The review is aimed at strengthening the resilience of ADIs to liquidity risk and improving APRA's ability to assess and monitor their liquidity risk profiles.

Among the proposed changes to APS210 the one causing the most concern to bond market participants is the determination of what constitutes liquid assets for stress-testing purposes. Right now, APS210 provides little guidance on this point. APRA has indicated it will follow emerging international consensus among prudential supervisors that liquid assets should be high-quality assets that can be readily sold or used as collateral in private markets, even when those markets are under extended stress. Also, as a backstop, liquid assets should be eligible central bank collateral for normal market operations. APRA proposes to adopt this definition of liquid assets in APS210 and also says in the discussion paper that in most currencies, sovereign bonds will be the assets that most clearly satisfy these criteria. The regulator is now seeking industry comment on whether there are other AUD-denominated assets that might be considered liquid, consistent with the above criteria.

APRA's consultation process ends on November 30 and market participants anticipate it will take time for new regulation to be decided and implemented – potentially six months or longer. Nevertheless, there is concern that the Australian regulator will take a restrictive stance regarding what comprises liquid assets, with significant consequences for both borrowers who fall outside the golden circle and investors – even real money buyers who will not be directly affected by the new regulations.

In principle there is no doubt that market participants accept the need for significant change in liquidity requirements for bank liquid portfolios and that some old ways of thinking about the purpose of a liquid book are ripe for change. Michael Malone, Bank of Scotland Australia Branch (BoS)'s Sydney-based treasurer, points out that the costs of an illiquid banking system are much higher than the costs associated with minimising liquidity risk. "Liquidity shouldn't be seen as a profit centre *per se*. It is a key priority of any bank and the global shift we are seeing towards ensuring that commercial banks in general hold more liquid assets and term out their liability

profiles further will likely have impacts on total business models," he says.

Anne Anderson, head of fixed income Asia Pacific at UBS Global Asset Management (UBS) in Sydney, believes the changes were inevitable. "There has to be a significant dilution of liquidity in a holistic sense and a contraction of the assets banks are allowed to hold," she comments.

APRA's proposals are not just about liquid assets but about a reassessment of liquidity across balance sheets. So the decision on which securities are considered liquid should be viewed in this light. By the same token, the proposals indicate a clear emphasis on defining liquidity beyond repo eligibility. Malone explains: "There has been much focus on liquidity buffers following the release of the APS210 discussion paper. However, that paper contemplates a much wider range of measures to ensure that banks don't ever get themselves into a position that would contemplate them materially using those buffers. The test for eligible liquidity buffers should be more than just stock lending in open market operations at a central bank. That is an important test but the sale of an asset under stressed market conditions is equally, if not more, important."

SSAs' STATUS UNCERTAIN

There is a strong possibility that some asset classes will no longer be considered liquid by APRA especially as the early signs from Europe – from where APRA is believed to be taking a strong lead – indicate that some asset classes are being excluded (see box on p14). Included in the threatened assets are Kangaroo bonds from some supranational, sovereign and agency (SSA) issuers – and with domestic bank balance sheet investors having been a major part of the bid for these bonds in recent times, that in turn means a potential threat to what has been a reasonably buoyant market even during the crisis.

In the UK – where the Financial Services Authority (FSA) has already released its ruling on what assets are considered liquid (see box on p14) – supranationals have been given the nod but agencies, even those with explicit government guarantees such as KfW Bankengruppe (KfW) (AAA/Aaa/AAA), are not included in the new definition. This is despite the fact that KfW will raise €75 billion (US$111.2 billion) in 2009; only supranational European Investment Bank (EIB) (AAA/Aaa/AAA), with €80 billion to raise, has a bigger funding task in the global supranational and agency sector.

Eila Kreivi, head of funding for the Americas and Asia Pacific at EIB in Luxembourg, says the feedback she is getting from Australia suggests there will simply not be enough supply of alternative liquid securities to cut off big supranational names like EIB. "It is early days to say anything definitive about the APRA discussion but most banks seem to think this will not be negative for repo-eligible Kangaroos – probably on the contrary," she states, pointing out that a lack of supply of AUD rates product leaves a gap that supranationals will usefully fill.

And with a range of investors and issuers who spoke to *KangaNews* for its annual SSA Yearbook, published in October 2009, indicating that their definition of liquidity includes not only the type of entity but also the amount on issue, there is a case to be made for the bigger Kangaroo-borrowing agencies on volume alone. By all measures KfW, for example, should be considered as extremely liquid – and has been until now, even compared with a number of supranationals. "KfW is one of the most liquid names in most markets in which they operate, including Australia," affirms Enrico Massi, Sydney-based managing director and head of debt capital markets at RBC Capital Markets (RBCCM) in Sydney.

If an argument on the liquidity of at least some agencies is not successful, SSA issuers are divided as to how a change in status that emphasises the liquidity quality of supras and sovereigns over agencies will play out. Kreivi says she has yet to see any early shifts in pricing between agencies and supras to reflect the change. "In principle it should all be positive for us but the concrete implications and the scale of numbers we are talking about are all still unclear."

The uncertainty has not had an immediate impact on primary market activity, with early October seeing a flurry of deals in the SSA Kangaroo space including several notable moments: World Bank's (AAA/Aaa) record A$1.4 billion two-tranche deal (see KangaTrends, p5); a single day with three SSAs visiting the market for a total of A$1.45 billion (see KangaTrends, p3); and a market return for Kommunalbanken Norway (KBN) (AAA/Aaa) (see KangaTrends, p4).

Although there was a heightened level of offshore participation in October's deals – KBN, for instance, saw 60 per cent of its book filled by international investors – there has been a positive response to the signs of diversification of demand. "We were pleased to see that KBN was able to issue a new five-year Kangaroo. Like Bank Nederlandse Gemeenten (BNG) (AAA/Aaa/AAA), KBN lacks an explicit government guarantee but the uncertainty around the amendment to APS210 did not prevent domestic and offshore real money investors from buying their paper,"

"Anything taken out of APRA's liquid asset list will be a real negative for that sector because it will remove some of the buying base, which will affect relative performance of the sector."

SEAN CARMODY BARCLAYS GLOBAL INVESTORS

SECOND-GUESSING APRA: THE *EUROPEAN LEAD*

THE AUSTRALIAN PRUDENTIAL REGULATORY AUTHORITY (APRA)'S SILENCE ON HOW IT WILL DEFINE LIQUID ASSETS AFTER THE ANNOUNCEMENT OF ITS APS210 CONSULTATION PROCESS – BEGAN ON SEPTEMBER 11 – HAS STARTED A GUESSING GAME. SIMILAR REGULATORY MOVES IN EUROPE PROVIDE SOME CLUES, HOWEVER.

Having initially proposed the restriction of the list of securities considered liquid for local banks' risk management purposes to a short list of government debt instruments, UK regulator the Financial Services Authority (FSA) has broadened the list in the final version of its new liquidity requirements to include both Australian government bonds and those issued by supranationals.

After opening its consultation on the liquidity requirements in December 2008 the FSA published the final version on October 5. In the document laying out the updated requirements, the regulator says of the original liquid asset definition: "A majority of respondents considered that our proposed approach was too restrictive; the most common view was that the regulatory definition of liquid assets should be whether the assets could be discounted at central bank liquidity facilities."

Although that feedback has not resulted in repo eligibility becoming the only necessary criterion for an asset to be considered liquid, the FSA has broadened the list of allowable securities to include supranationals and the Australian government alongside sovereign securities from European Economic Area countries and the US, Switzerland, Canada and Japan rated Aa3 or above. Single-sovereign agencies, even those with explicit government guarantees, are not mentioned.

Australian market participants are viewing the UK developments with interest since in determining its future direction, APRA is believed to be keeping a close eye on developments in Europe. The final FSA decision could therefore be significant, as could the ongoing consultation process being undertaken by the Committee of European Banking Supervisors (CEBS) – which runs until October 31.

CEBS's July 7 consultation document is less specific than the FSA on what assets might eventually be considered liquid, though it does suggest a two-tier system may emerge based on the severity and duration of crisis that liquidity is being tested against. Even in more challenged circumstances, the document hints at a broader definition than government-only securities, however, as covered bonds are named as allowable assets.

The document adds that for less intense but longer duration stress events (at least one month), banks may hold a wider set of liquid assets subject to the bank demonstrating the ability to generate liquidity from them under stress within the specified period of time.

All this ties in with the liquidity principles set down by the Basel Committee on Banking Supervision's Working Group on Liquidity in September last year, which also gave a two-tier approach to the composition of liquid asset portfolios depending on the nature of the stress situation.

However, even in the most severe case there is wriggle room for assets other than government securities to be considered liquid. The principles state: "A bank should hold a core of the most reliably liquid assets, such as cash and high-quality government bonds or similar instruments, to guard against the most severe stress scenarios. For insuring against less intense, but longer duration stress events a bank may choose to widen the composition of the cushion to hold other unencumbered liquid assets which are marketable (ie can be sold or used as collateral in sale and repurchase agreements) without resulting in excessive losses or discounts."

Again, repo eligibility alone is not enough as the principles continue: "There are some general characteristics which tend to increase the liquidity of a given asset including: transparency of its structure and risk characteristics; ease and certainty of valuation; central bank eligibility (though that in and of itself does not confer ready market liquidity); depth of the market for the asset, including holdings of the bank relative to normal market turnover; and the bank's own name and presence in the relevant markets."

comments Bianca Ydema, senior manager capital markets and investor relations at BNG in the Hague.

A critical consideration is the extent to which the definition of liquidity should be based on product alone. During the crisis the European sovereign bond sector demonstrated that even government bonds can be illiquid. For some months only Bunds and French government bonds were liquid, as they are able to be delivered into futures contracts. Some sovereign bonds – such as those from the Republic of Finland, which is a very strong triple-A credit – were not liquid at all. "The classification of supranational or semi-government or sovereign does not make or break liquidity, nor does the existence of market-making agreements. What gave Bunds and French government bonds the edge in Europe in terms of liquidity was their trading pattern," comments Stefan Goebel, Rentenbank's Frankfurt-based co-head of treasury.

Australian domestic banks have already begun working on shifting trading of SSAs from their credit to their rates trading desks as they are all liquidity products. "If APRA wants to test which non-commonwealth government securities (CGS) are liquid, they should look at who is trading the product. If a product is traded by credit traders who generally keep their positions flat, it is not likely to be liquid. But if a product is traded by the same people who make their living from actively seeking flows – the rates traders – that is a good indication you are talking about a reasonably liquid product," explains Goebel.

Goebel's point that government bonds are not immune to illiquidity is critical. While Australian CGS were not subject to

"If a bank genuinely believes holdings of supras, certain agencies, or other instruments are a useful liquidity risk management tool above or in addition to any other minimum regulatory asset requirements, they should hold those assets as part of their liquidity strategy."

MICHAEL MALONE BANK OF SCOTLAND AUSTRALIA

significant illiquidity during the most recent crisis, there is no doubt that – despite the government's increased funding task as it moved into deficit – supply of CGS is still limited. This means there is simply no way domestic sovereign bonds can fill bank liquid portfolios on their own – particularly as Australia's less-than-anticipated deficit may end up curtailing the projected issuance of CGS over the next five years.

At the end of June 2009 the total face value of CGS on issue was A$101.1 billion, comprising treasury bonds totalling A$78.4 billion, treasury notes totalling A$16.7 billion and treasury indexed bonds totalling A$6 billion. This falls well shy of the A$250 billion or so one market participant projects bank liquids portfolios will require. And there is some concern that in highlighting CGS as the most liquid of liquid assets, APRA and other regulators may in fact undermine the very liquidity they hold so dear. RBCCM's Massi explains: "There is always the danger of a reduction of liquidity of the CGS market if a large component of the investor base needs to hold these assets."

Not only will Australian bank balance sheets be looking to suck up as much supply of CGS as possible, but in light of the FSA's announcement of the inclusion of Australian sovereign bonds in its liquid asset list, there will be a raft of offshore bank buyers also looking to invest. And with estimates that up to 70-80 per cent of CGS is held by foreign investors and this trend unlikely to change, the supply of CGS for domestic buyers is inherently limited. One of the big, unintended consequences of APS210 could therefore be the hoarding of CGS by domestic and offshore bank investors. "We could end up with a something that looks like the New Zealand bond market, where liquidity is totally invisible as investors buy and hold and the lack of tradability begins to impact the futures market," says one market player.

INVESTORS COMPARE LIQUIDITY

Market participants believe semi-government securities will fall within the final definition of liquid assets. This is despite the fact that for a good few months from the end of last year – when the sovereign guarantee for banks was announced – until May this year – when the government announced it would guarantee semi-government bonds – nobody could have claimed that semi-government bonds were liquid. In fact, primary market activity from this sector came to a virtual standstill and there were widespread reports of a hiatus in secondary market trading as the spreads on semi bonds blew out to unprecedented levels before the announcement of the sovereign guarantee.

Even so, investors certainly seem to regard the lack of activity in the semi sector earlier on this year as an aberration that does not affect their overall view that, in the hierarchy of triple-A securities, the bonds of semis are placed just under CGS. "Semis had their moments, but they did pass the liquidity test," comments UBS's Anderson. "However, bank paper and SSAs – even including supranationals – certainly do not have the same liquidity as semi-governments."

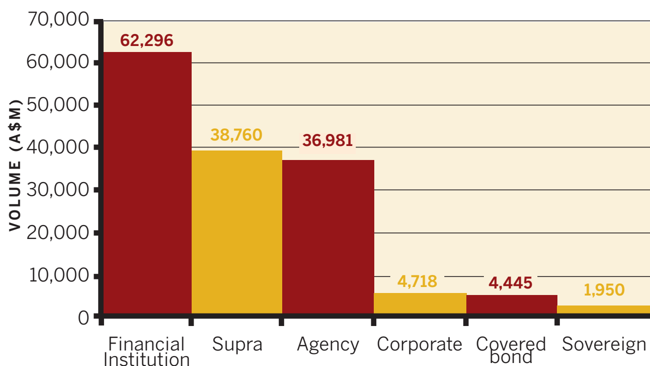
"At any given point there were 10 banks willing to make prices on CGS, while semis had their share of pricemakers. But there are only two real pricemakers in the Kangaroo market and they were running up against liquidity constraints so could not continue supporting the market to the same extent," adds Sean Carmody, head of fixed income Australia at Barclays Global Investors (Barclays) in Sydney. "Bid-offer spreads on SSAs went very wide and although you could shift them if you were prepared to lose a lot, they were very far from normal."

Investors concede that since the nine-month halt in primary market activity ended in April 2009, the Kangaroo market has come back strongly. In fact, with A$14.75 billion issued in the market in the year to October 20 – A$14.5 billion of which was issued by SSAs – this has been a record year for SSA Kangaroo volumes. The level of issuance means that, considering the breakdown of the Australian Kangaroo market (see charts on p17), any move to exclude agencies from the definition of liquid assets will be quite significant. Of A$103 billion total outstanding volume, supranationals account for A$31.8 billion or 31 per cent; agencies for A$25.8 billion or 25 per cent; and sovereigns A$600 million or 1 per cent. Over 2009 the proportions swung towards supranationals as investors around the globe went into extreme defensive mode, with this issuer group accounting for A$9.55 billion or 66 per cent of the A$14.5 billion issuance volume from the SSA sector in the year to October 20, versus A$4.75 billion or 33 per cent of issuance from agencies.

Nevertheless, among the top five overall Kangaroo issuers two are agencies – KfW has issued A$11.25 billion and has A$8.75 billion outstanding, while Rentenbank has issued A$7.9 billion and has A$5.7 billion outstanding.

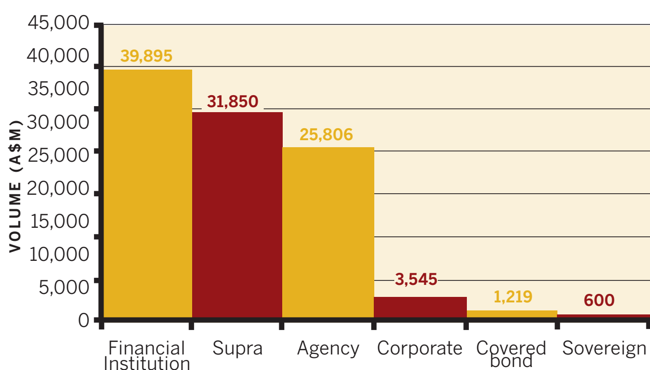
Without APRA's liquid stamp, some investors fear there will be no natural buying base for Kangaroos. Jeff Brunton, head

TOTAL KANGAROO ISSUANCE PER SECTOR (1996-YTD)



SOURCE: KANGANEWS NOVEMBER 3 2009

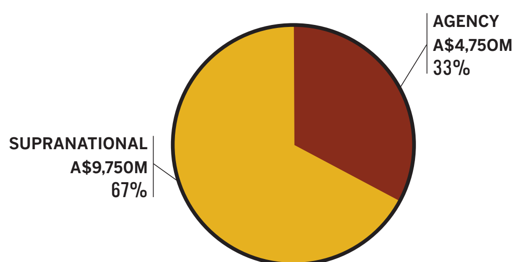
OUTSTANDING KANGAROO BONDS PER SECTOR (1996-YTD)



SOURCE: KANGANEWS NOVEMBER 3 2009

VOLUME (A$M) OF KANGAROO ISSUANCE PER SECTOR

JAN 1 – OCT 20 2009



SOURCE: KANGANEWS OCTOBER 20 2009

of credit markets at AMP Capital Investors (AMP Capital) in Sydney, says the product has been bought primarily by rate investors rather than credit investors: "Kangaroos don't usually offer enough added return above the risk-free benchmark for credit investors, and if bank balance sheets cannot buy for their liquid portfolios it could be hard to find big pockets of domestic demand."

But the Kangaroo market has experienced – and survived – significant shifts in its investor base in the past. For example, when the Reserve Bank of Australia (RBA) included bank bills in its repo-eligible list in 2004 bank liquid portfolio investors quickly lost their appetite for repo-eligible Kangaroos in favour of the more liquid assets on offer.

Certainly, some groups of offshore investors – particularly central banks – have hardly been consistent buyers of Kangaroo bonds, with their appetite varying depending mostly on the performance of the Aussie dollar. For example, in the first wave of Kangaroo deals this year, domestic accounts dominated the books. More recently, though, offshore buyers have returned to the Kangaroo market in size, taking the lion's share of deals priced since September (see KangaTrends p2-4). In part this renewed appetite from international investors is a function of strong demand for Aussie dollars as Australian interest rates remain among the highest in the developed world – at 3.5 per cent and rising. "Yield differentials and currency outlook are driving international investors to gain further exposure to Australian dollars," says RBCCM's Massi.

These offshore buyers could provide a counterweight to domestic bank balance sheet investors if their appetite for SSAs diminishes.

Having proved itself as a mature market with its ability to survive the waxing and waning of appetite from different investor groups, nobody is saying the Kangaroo market will collapse if all SSAs are excluded from APRA's definition of liquid assets. In fact, intermediaries emphasise that while structurally removing pockets of demand will hardly help the market, they expect it to remain vibrant. "Kangaroo bonds are a global product and most offshore buyers hold them as part of their investment portfolios. Fortunately, the market is by no means dependent on one particular investor base, which means there will always be buyers for different reasons and at different times," says Massi.

At the same time, the investor base is migrating naturally as the cycle shifts and spread levels contract, lessening the dependency on bank buyers. Sven Lautenschläger, international funding officer at L-Bank in Karlsruhe, says as triple-A spreads have normalised over the last few months, and some triple-As have returned to sub-Libor levels, the investor dynamic has shifted again, with fewer bank balance sheet investors buying as the pick-up to Treasuries has lessened. "In the most recent US dollar and euro deals you can clearly see the traditional agency investors have returned to the market, particularly central banks," he explains. "They are now taking up part of the demand that has disappeared from bank investors."

The loss of a significant investor group will be felt, but the proven diversity of the buying base bodes well. "Liquidity hinges on having a diverse set of investors who take diverse investment decisions. If you have the five basic categories of investors to tier the market – that is, domestic funds, domestic banks, offshore central banks, offshore fund managers and retail – you have sellers and buyers at different times and you avoid the situation of all investors behaving completely directionally in buying and selling the product," explains Rentenbank's Goebel.

CHANGING PORTFOLIOS

At this stage, investors and intermediaries report very little reactive switching to the FSA's and APRA's announcements, although some investors report a halt in willingness to take on further exposure to banks or other non-government assets as APRA appears to be looking to kill the myth that banks buying other banks' paper constitutes a liquid asset. "Traditionally, ADIs have been big buyers of other banks' paper," says one Sydney-based balance sheet investor at a major international bank. "Real money investors may have to step into that void if, as is being currently debated, APRA does not include ADI, or potentially ADI government-guaranteed bank paper, in its definition of liquid assets. The ramifications of such a ruling will be enormous."

According to data from APRA, at the end of September Australian banks had some A$73.6 billion in cash and liquid assets. This represents around 16 per cent of banks' total assets – 22 per cent if self-securitisations are included. According to the RBA, of that 16 per cent 0.29 per cent is in cash, 2.31 per cent in CGS and semis and 13.42 per cent in deposits with and securities issued by ADIs (see table on this page). There is no standard ratio of liquid assets for banks as APRA uses a model-based methodology to determine the buffer, but at an average of 16 per cent, market participants agree most banks are likely to be well above required limits.

Bank liquid portfolios have clearly been beefed up over the last 24 months. In July 2007 the total amount in liquid assets and cash was 13.78 per cent, with 0.39 per cent in cash, 1.05 per cent in CGS and semis and 12.34 per cent in deposits with and securities issued by ADIs. The domestic banks hold the most liquid assets, but there is some considerable difference between them. According to APRA's monthly banking statistics, at the end of September 2009 National Australia Bank held A$15.8 billion in cash and liquid assets while the larger Westpac Banking Corporation had only A$4.96 billion (see table on this page).

What is immediately clear is that the bank balance sheet will no longer be seen as a source of profit. There are significant costs associated with the enhanced reporting and stress testing requirements implicit in APS210, which will, in fact, make balance sheet management a much more costly business. It will likely be more expensive to term out rather than to hold more liquid assets, which probably explains the strong focus on how APRA will define liquid assets.

In the current environment bank investors report a focus on CGS and semis, an appetite for guaranteed bank paper, and only very select interest in supras. Asset-backed securities (ABS) did not resonate with any of the bank investors interviewed, although market statistics indicate some have been active buyers this year.

A key challenge going forward is managing portfolios that seem bound to grow while maintaining reasonable diversification. Comments Charles Finkelstein, treasurer at Citi in Sydney: "The issue for balance sheet investors right now is the size of their portfolios. They are all much larger than 18 months ago – at the moment we are three times our pre-crisis size."

This size has driven significant diversification away from bank bills and into sovereign and government-guaranteed assets, regardless of cost. Adds Finkelstein: "Previously we didn't hold much in CGS due to the cost, but now the size of the portfolio and the heightened consciousness of liquidity risk have driven us into those assets."

While some market participants seem to be bracing for a wave of selling when APS210 really hits home, one bank investor – who will not go on the record – is not convinced that will need to happen, primarily because the banks are already sitting on more liquid assets than are prudentially required. "We hold way more in liquid assets than is realistically required. I doubt there will need to be more selling – it's more that our buying patterns will change," he comments. "We are already seeing banks building up their T1 liquidity ratios by buying govvies and semis and banks are likely to keep those assets APRA does not deem liquid for other portfolios that do not directly constitute the liquidity buffer."

In the end, bank investors will need to ensure they don't abrogate responsibility for defining liquidity to the regulator. "Ultimately, liquid portfolio managers need to be comfortable that what they hold is liquid," says Malone at BoS. "Regardless of the final outcomes of APS210, if a bank genuinely believes holdings of supras, certain agencies or other instruments are a useful liquidity risk management tool above or in addition to any other minimum regulatory asset requirements, they should hold those assets as part of their liquidity strategy."

AMOUNT HELD IN CASH AND LIQUID ASSETS
JUL 2006-2009 (PER CENT)

	Notes, coins, bullion & deposits with the RBA	CGS and semi-government securities	Deposits with, and securities issued by, ADIs	Total
Jul 06	0.40	0.54	11.80	**12.74**
Jul 07	0.39	1.05	12.34	**13.78**
Jul 08	0.49	0.82	14.9	**16.22**
Jul 09	0.29	2.31	13.42	**16.02**

SOURCE: RESERVE BANK OF AUSTRALIA JULY 31 2009

AMOUNTS HELD IN CASH AND LIQUID ASSETS
AT SEPTEMBER 2009 (PER CENT)

Bank	Per cent
National Australia Bank	15.8
ANZ Banking Group	7.2
Commonwealth Bank of Australia	6.6
Westpac Banking Corporation	5.0

SOURCE: AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY SEPTEMBER 30 2009

REAL MONEY BUYERS MOVING

In this environment, real money investors – who are not regulated by APRA and therefore will not be directly impacted by APS210 – report they have still been changing portfolios over the course of the year. They anticipate more change ahead as APS210, in impacting one buying base, indirectly affects the whole investor community. While they

THE *IMPOSSIBLE DREAM*: COVERED BONDS

DEVELOPMENTS IN LIQUIDITY REGULATION OFFSHORE AND APS210 MAY END UP PROVIDING SOME EXTRA MOMENTUM FOR APRA TO FINALLY RELAX ITS STANCE ON DOMESTICALLY-ISSUED COVERED BONDS.

The UK's Financial Services Authority (FSA) is engaged in ongoing consultation regarding its liquidity regulations with the Committee of European Banking Supervisors (CEBS), which appears to be less specific than the UK regulator on what assets might be considered liquid, indicating that covered bonds should be named as an allowable asset.

Comments Alex Sell, chief operating officer at the Australian Securitisation Forum (ASF): "Covered bonds are more likely to be a valuable source of liquidity, providing, as they potentially could, a cheaper form of liquidity than commonwealth government securities (CGS) from a liquid assets management perspective as they are typically of equivalent credit rating (triple-A). But they must be repo eligible, just like CGS, to enjoy that liquid quality."

Covered bonds would solve part of the funding dilemma domestic banks are facing, supplying volume, duration and asset and liability matching. They could also supply another product for rates-based investors who have bought the sovereign-guaranteed bank paper issued in such volume over the last year.

They would also add an extra dimension to competition within the triple-A universe, says Jeff Brunton, head of credit markets at AMP Capital Investors (AMP Capital): "Covered bonds may look and feel like and compete with guaranteed bank paper in terms of yield and protection."

The Australian Prudential Regulation Authority (APRA) has indicated it has an open mind about covered bonds' role in the overall management of liquidity by banks from a liability management perspective. However, the regulator remains opposed to allowing domestic banks to issue covered bonds due to its obligations under the Banking Act in terms of depositor preference.

Past attempts to lobby for covered bond issuance by Australian banks have failed due to APRA's view that ring-fencing assets for covered pools runs the risk of leaving issuing banks' remaining asset base too small to cover liabilities to deposit holders.

However, the debate has been given a new lease of life this year – the ASF submitted a proposal directly to the Commonwealth Treasury – effectively bypassing APRA – in July arguing that increased depositor protection in Australia is enough to alleviate APRA's concern that covered bonds could subordinate retail depositors in the event of bank failure.

And there are indications that domestic investors would also be happy to embrace such a product. Says Brunton: "Covered bonds may be an attractive alternative because you face both the collateral and the originator, so when the collateral pool performs badly, more equity can be accessed."

remain heavily invested in triple-A assets, some rotation based on fundamental value is starting to emerge. Between CGS, guaranteed banks, semis and SSAs, the UBS Composite Bond Index is now 80 per cent triple-A. This compares with 69 per cent in October 2008 and 65 per cent in October 2007.

Carmody at Barclays points out that with inflows increasing into fixed income again as the drive to rebalance falling equity values has waned, there will be more automatic buying of supras, regardless of what happens with APS210. "If we triple our assets, even if we only move to benchmark weight in supras we'd still be buying more. If we are comfortable with the credit risk we might tilt a little above benchmark in supras relative to govvies and semis because the spread is still good compared with historical levels," he comments.

The relative value equation has certainly moved fund managers out of CGS to some extent over the course of the year. Says Anderson: "We have reduced our exposure to CGS and increased allocations to semis, sovereigns and corporates – either through physical paper or via credit default swaps." Brunton says AMP Capital's portfolios are slightly overweight asset-backed securities (ABS), while Carmody is seeing good opportunities at the shorter end in triple-B rated non-major banks and offshore banks with a domestic guarantee.

Lance Pupelis, head of fixed income at Aviva Investors in Melbourne, says his firm has been overweight semis and guaranteed banks over 2009 – a consequence of the dislocation creating relative value opportunities in those markets. He remains a supporter of unguaranteed bank paper, but hasn't been a buyer of SSAs over the course of the year. Pupelis sees the biggest buying opportunities in global credit. Nearer to home, with the market pricing in a cash rate of 5 per cent by the end of 2010 and three-year nominal bonds with a 5 per cent handle, he is keen on that part of the curve: "There is a lot of value in the three-year part of the curve as the market has largely priced interest rates returning towards more normal settings."

"Semi-governments had their moments, but they did pass the liquidity test. However, bank paper and SSAs do not have the same liquidity as semis."

ANNE ANDERSON UBS GLOBAL ASSET MANAGEMENT

> "Kangaroos don't usually offer enough added return above the risk-free benchmark for credit investors, and if bank balance sheets cannot buy for their liquid portfolios, it could be hard to find big pockets of domestic demand."

JEFF BRUNTON AMP CAPITAL INVESTORS

As to how APS210 will impact them, real money investors emphasise any regulation that impacts demand will affect all investors. "Anything taken out of APRA's liquid asset list will be a real negative for that sector because it will remove some of the buying base, which will affect relative performance of the sector," comments Carmody at Barclays.

APS210 IMPLICATIONS FOR ABS

As portfolios of institutional and bank investors begin to change, market participants are also considering the implications of new regulation on the definition of liquid assets for the asset-backed market, with these securities very unlikely to be deemed liquid by APRA. While on the surface the advent of APS210 may look to be a negative in terms of removing demand, there may in fact be some positive outcomes for a securitisation market long in need of a break.

On the supply side, volumes in the domestic ABS market continue to be very small. In the year to November 1 A$11.1 billion of ABS had been issued in the domestic market, with A$7.5 billion supplied by the Australian Office of Financial Management (AOFM)'s buying programme mandated by the Commonwealth Treasury. On October 11 the Treasury announced it would extend the programme by up to A$8 billion. Although the volume figure in ABS issued by Australian entities for 2009 is likely to top last year's A$10.5 billion, it will still be leagues away from the A$65 billion and A$58 billion issued by domestic ABS borrowers both offshore and onshore in the glory years of 2006 and 2007.

With the market still undecided on the eventual impact of the AOFM's redoubled support efforts, there is some uncertainty on what impact APRA's proposed amendments to APS210 will have on the ABS market. Nobody expects APRA to include ABS in its list of eligible assets. Anderson at UBS comments: "A number of factors lend liquidity to a market, including the existence of a hedging mechanism that facilitates the buying and selling of securities in the market. Residential mortgage-backed securities (RMBS) do not have a direct or a close proxy hedge. They simply don't meet the definition of liquid."

Alex Sell, chief operating officer at the Australian Securitisation Forum (ASF) in Sydney, says the industry group does not predict APRA will permit ABS to form part of ADIs' liquid assets as the depth of liquidity is not there in secondary markets. "However, to the extent that ADIs have performed so-called internal securitisations that are RBA repo-eligible, we would expect that to form part of their overall, diversified source of liquidity and be recognised as such," he comments.

The ramifications of APS210 for the home lending market could be vast. "In unwinding the multiplier of leverage, bank profitability will suffer significantly. So the regulation will force banks to increase the net interest margin," comments Rob Camilleri, director at Laminar Advisory in Melbourne.

This is bad news for home owners, who may face increased lending rates, but it does create an interesting proposition for the ABS market. If direct balance sheet lending is that expensive, banks might return to capital markets for their funding. "We could potentially see more need for securitisation in this kind of environment," argues Camilleri.

The need may be there but investors will not necessarily be interested. While bank balance sheet investors have not been the driving force behind the ABS market, they have certainly been players. Hard numbers are impossible to come by, but Camilleri claims banks were active purchasers of repo-eligible RMBS. "They bought a lot of the short-dated tranches," he comments. "While the AOFM-led deals probably didn't suit bank balance sheet investors, they were active prior to the government buying programme and have been involved in deals that fell outside that programme."

A recent example of this is Macquarie CountryWide's A$265 million commercial mortgage-backed securities deal. The final book comprised over 70 per cent real money accounts with the remaining 30 per cent going to bank investors. The buy-in from bank balance sheets was greater than historic averages prior to the financial crisis.

The problem with the ABS market is that the international bid has not yet come back in the same way it has for Kangaroo bonds, so there would be no extra demand to take up the slack – no matter how small or large – left by bank balance sheet investors. And fewer investors is the last thing the securitisation market can tolerate, with full recovery still a distant prospect. Having said that, some glimmers of interest have started to emerge. Some 16 per cent of ME Bank's A$1.25 billion SMHL Securitisation Fund 2009-2 was sold to offshore investors, which some market participants see as a beacon of hope for the restoration of the international buying base.

At this stage the impact of APS210 on ABS, Kangaroos, semis, guarantee bank paper and the many iterations of Australian-issued debt instruments is all theory until APRA decides just how hard to flap its wings. •