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Downgrade would hit banks hard

The funding costs of Australia's big four banks would likely rise and some of their debt could be dumped by investors if Australia lost its AAA credit rating.

Andrew Papageorgiou, founder and investment manager of Realm Investment House (Realm), doesn't believe there would be much impact on Australia's sovereign credit default margin or on global demand for Australian government bonds if Australia's sovereign credit rating was downgraded to AA+.

"When all is said and done, it's a pretty small number of countries that still have AAA ratings," he said, adding "there's still a general shortage of high-quality liquid assets globally."

However, Papageorgiou thinks a credit downgrade would affect the broader economy via the potential impact on the banking sector. The big four get a two-notch rating upgrade from the major credit ratings agencies due to their too-big-to-fail status.

"If everything starts to notch down one tier, there would be consequences," he said.

Firstly there is the fact that the major banks currently source much of their wholesale debt offshore. There's a propensity in the marketplace to use a ratings-based approach to derive fair value for assets. As such, if the banks' senior credit ratings were downgraded to reflect the cut to the sovereign rating that would affect their funding costs.

"Right now they have the market exactly where they want it" but that wouldn't be the case if their credit ratings were a notch lower and credit markets weren't so benign. In such an environment, it would likely increase their reliance on domestic deposits, a more expensive source of funding.

Smaller bank risk

It would also potentially push some of their deeply subordinated debt and hybrid securities into non-investment grade, again making that costly source of debt even more expensive, but also limiting some investors' ability to buy it.

For example, Realm holds some higher-yielding subordinated debt and hybrid securities, all of which is currently investment-grade.

However, it can only a hold of maximum of thirty per cent of its portfolio in sub-investment grade assets so if banks' credit ratings fell a notch, "they could be forced out of our portfolio or they would need to deliver higher returns," said Papageorgiou.

Smaller banks could also be caught up in the flow-on effects. Suncorp Bank, for example, has a credit rating of A+, a notch below the big banks' AA- credit rating. If the major banks ended up with A+ credit ratings, Papageorgiou thinks investors would find it a bit hard to swallow that the Queensland bank is of the same credit quality as the big four.

So for the banking sector, there are definitely implications if Australia's sovereign credit rating is downgraded.

NAB runs for cover

Within a couple of weeks of highlighting it has the most capacity of the four major banks to issue covered bonds, National Australia Bank (NAB) priced €750 million of seven-year covered bonds at a margin of 26 basis points (bp) over the mid-swap rate.

It was evidently very successful as initial price talk was for a spread of 28bp. Around 70 investors bid for the paper, with bids topping €1 billion.

The final pricing is in line with what Westpac achieved on its €1 billion seven-year covered bond two months ago.

Other new issues last week included ANZ pricing $1bn of three-year floating rate notes (FRN) at a margin of 53bp over bills, ANZ New Zealand pricing NZ$175 million of two-year FRNs at a margin of 45bp over bills and Westpac pricing €120 million of five-year euro medium-term notes at a margin of 45bp over Euribor. There were also several small private placements.

According to analysts at NAB, the pricing of ANZ's FRN was equivalent to what Westpac achieved last week on its US$2.5 billion three-year fixed- and floating-rate debt, demonstrating that the pricing in the domestic and US markets are "sitting pretty much on top of each other" at the shorter end of the yield curve.

FIIG brings Adani Abbot Point Terminal to market

On Friday FIIG Securities announced it had closed its largest ever bond deal. The $100 million six-year transaction for Adani Abbot Point Terminal was over-subscribed.

Adani owns the Abbot Point terminal that services the Galilee and Bowen coal fields in Queensland. The bonds are rated BBB- and will pay semi-annual coupons of 6.10 per cent.

It is the ninth issue that FIIG has brought to the market, most of which have been unrated. It is another demonstration of the interest from institutions, private investors and self-managed superannuation funds in higher-yielding vanilla debt away from the wholesale debt market for institutional investors which accounts for 99 per cent of the Australian bond market.

"For those investors to fill a $100 million transaction proves private investors have the appetite and capacity to invest in fixed income and their comfort and confidence," said Paton. "I think that is the path investors will take when fixed income becomes more mainstream."

"This bond is the first of a number of long-tenor mandates FIIG will bring to the market, in addition to our growing unrated issuance program which has included a range of quality mid-cap corporates," he said.

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