Harbour Investment Horizon

Outlook for Bank Credit Ratings

Harbour Investment Horizon 05/05/2017 contactus@harbourasset.co.nz +64 4 460 8300

According to both Standard & Poor's (S&P) and Moody's, the major Australian banks' credit ratings are on a negative outlook classification. The big four New Zealand banks' credit ratings would also be downgraded alongside their parents. On Monday, the Australian Government Budget release may provide the catalyst for a ratings downgrade.

Implementation of international banking regulations, further capital raising, and risks within the banking industry itself may also impact credit ratings within the next two years. In this *Investment Horizon* we review these influences.

Given a downgrade would align the banks with many of their global peers, it is expected to have a muted impact on corporate bond returns. Nevertheless, some investors may need to reconsider investment guidelines, to avoid forced selling that may be required to bring portfolios' back within their current investment guideline parameters.

Figure 1: Summary table

Influence	Summary
Australian Government	S&P has a negative outlook on the Australian Government. It may be a close call whether a coalition government without a strong majority can demonstrate the requisite fiscal discipline to satisfy S&P. **Pages 2 -3**
Bank Industry	Any re-acceleration of house price growth may cause S&P to downgrade it's assessment of the banking industry's credit risks. If done in isolation, this will not impact major banks' senior credit ratings. It may, however, have an impact if done in combination with other rating drivers. An increase in loan losses or a deterioration in profitability will likely result in Moody's downgrading the banks' credit rating. Moody's applies a higher rating currently than S&P. **Pages 3 -4**
Capital Position	The banks have raised a vast amount of capital since the Global Financial Crisis (GFC). It may be plausible that they raise further capital, sufficient to offset any downgrade. However, in that case the ratings agencies may also deem that any additional capital means that the likelihood of Government support has diminished. **Page 5**
Basel III	If the Australian Prudential Regulation Authority (APRA) adopts bail-in as mooted by the Basel banking committee, the likelihood of Government support will be reduced, leading to a downgrade. We would assign this a lower probability, given the breakdown in the Basel Committee's agenda. **Page 5**
Overall	Avoiding the downgrade will likely be a close shave. Nevertheless, we believe it is prudent to prepare for such an event, most likely driven by the Australian Government losing its AAA credit rating.

Apparent contradiction

On the surface, with loan losses very low, capital significantly higher, and improved underwriting standards since the GFC, it seems illogical that banks could have a lower credit rating in 2017 than 2009. The GFC experience taught us that banks were riskier than the prevailing wisdom. History is just that; looking forward, we agree with market sentiment that rising exposure to elevated house prices make banks riskier in 2017 than in 2013.

Sovereign downgrade

In order to achieve a strong credit rating, the Australian Government needs debt to be low - given the nation runs a large and persistent current account deficit, and relies on a significant portion of external debt to fund its high household debt. The Australian Government does have a modest net debt position of close to 40% of Gross Domestic Product (GDP). However, the Government has continued to under-deliver on its budget projections and this debt has been rising.

New Zealand lost the coveted S&P AAA rating in 2011. Now Australia's membership in the elite group of eleven sovereign states is threatened.

A level of sovereign support is explicit in a bank's credit rating. If S&P downgrades the Australian Government's rating, the major banks' rating will fall in step.

S&P: *AAA (negative outlook)*

S&P placed the Australian Government's AAA rating on negative outlook in July 2016[1]. The negative outlook primarily reflected a lack of demonstrable fiscal resolve to arrest a continuation of budget deficits. Evidently, it appears S&P had little faith in the Turnbull administration's belt tightening ability given its weak mandate.

The agency also questioned the credibility of the budget, which included significant savings yet to be ratified by Parliament, and forecasts of key economic variables exceeding the agency's own.

Moody's: *Aaa (stable outlook)*

In the wake of an inconclusive election result on July 2 2016, Moody's downgraded its outlook on the Australian sovereign. Moody's resorted to strong words highlighting the need to address a deteriorating fiscal situation. However Moody's draws more comfort in the low level of debt. While the agency notes the trajectory of this debt, levels are forecast to remain at a limit consistent with an AAA rating across its forecast horizon.

Moody's also points out the diversity of their economy, retirement provisioning and a growth outlook underpinned by solid demographics.

Harbour view

Based on S&P's communications, the key judgement is whether the Government has shown enough fiscal resolve in tackling the deficit. This Monday's budget will be telling. We think it is a close call whether the Australian Government will lose its AAA rating. More important than publishing a

[1] Standard & Poor's publishes both a local and foreign currency credit rating for sovereign issuers. Under Standard & Poor's methodology, a bank's standalone credit profile is adjusted according to government support. This adjustment is based on the local currency rating of the sovereign. There are circumstances under which a foreign currency rating can be downgraded while the local currency rating remains unchanged. Standard & Poor's has made it clear that in Australia's case the ratings will move in tandem.

prediction of what is a close call, is to note that regardless of the outcome of the budget, we expect the risk of a downgrade to linger for a few budgets yet.

Fiscal resolve:
The Government has managed to pass much of its planned savings measures through parliament. This has proved particularly challenging. Following an MP defection, governing is unlikely to get any easier any time soon. However, there was one unexpected budget boost over the period, as the Government had to make a concession on one of its key policy pillars in making planned universal business tax cuts only applicable to small business.

Key budget details leaked to the press do not provide confidence that the Government will take meaningful action on the course of deficits. This is consistent with having such a weak mandate. While they are likely to reduce university spending, they appear unwilling to reform property taxation. They are talking up an initiative to take infrastructure funding, so-called 'good debt, off the balance sheet; S&P will be having none of that.

Temporary Factors:
To be clear, we believe S&P's judgement regarding the Government's resolve to return to surplus is more important than near-term budgetary performance. At the time of the outlook downgrade, S&P noted optimism in the Treasury's forecasts. We expect time has ruled in favour of the Treasury which may result in a positive update of budgetary performance on Monday. Downgrading an entity at a time when it has exceeded S&P's own forecasts would provide the agency with an awkward communications challenge. This might just be enough to hold off a downgrade, for now.

If it does indeed scrape by this budget, it remains to be seen whether a government with a weak mandate will be able to stem the tide in years to come.

Bank industry

In addition to a marginally weaker sovereign backstop, vulnerabilities have risen within the banking sector itself as households have increased their exposure to even higher house prices.

In August, Moody's placed the Australian banking industry on negative watch. At a similar time, S&P also sounded a warning.

Moody's: Outlook Negative

Moody's starts with a one notch higher rating of Aa2, equivalent to S&P's AA. The agency has downgraded its outlook as it expects the Australian banking sector's profitability, and hence ability to organically generate capital, to diminish in coming years.

Moody's also notes that risks have increased, given subdued income growth and increasing under-employment, while credit has grown at a faster rate than nominal GDP.

S&P: Outlook Negative

Last November S&P downgraded its outlook for the Australian *Bank Industry Country Risk Assessment* (*BICRA*). The agency's main concern lies with growing levels of private sector credit and rising house prices.

Harbour view

Moody's

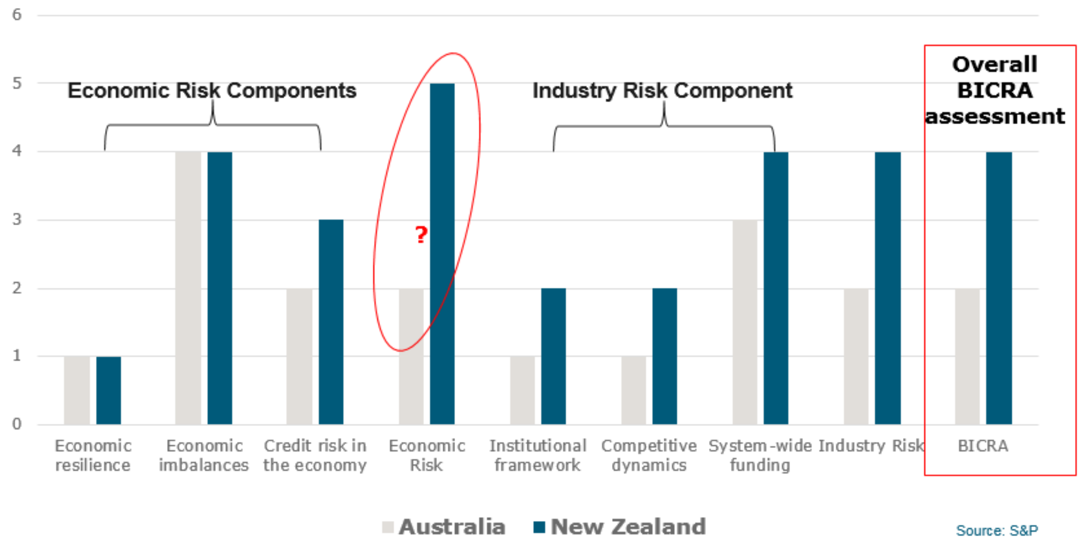
We sense Moody's is paving the way for a downgrade in a well-communicated, measured way. That said, we do not see this as imminent, given many of the factors Moody's cited that could have led to a downgrade have abated, namely:

- The banks have demonstrated the ability to hike rates out of sync with the Reserve Bank of Australia. The political focus on housing affordability has provided cover to avoid public scrutiny.
- An abatement in credit growth has taken some of the heat out of deposit competition.
- While asset quality did not play a significant bearing in Moody's negative outlook, it was a potential catalyst. For now, loan losses remain benign.

The materiality of Moody's action is less, given their higher ratings starting point.

S&P
On a scale of 1 to 10, with 1 being the strongest, NZ's BIRCRA was downgraded to 4 in 2015, with S&P citing *"increased risk stemming largely from rising house prices in Auckland and these risks are accentuated by the structural external weakness in the New Zealand economy".* In our view NZ's BICRA rating is inconsistent with Australia's 2 score.

Figure 2: Go Figure



In part, this may be S&P treating NZ harshly. It seems unfair for elements of the NZ economy to be categorised alongside Malaysia and Uruguay. In part, this may be because S&P are being relatively generous to Australia.

While this inconsistency may be righted in time, analysis is likely to be more fruitful if based on the more tangible markers cited by the agency.

For the time being, housing credit growth in Australia has slowed thanks in part to the Reserve Bank of Australia (RBA)'s macro-prudential rules. For now this factor is unlikely to provide the knock-out. House price growth, on the other hand, is flashing a warning. While the most recent April data show tentative signs of slower growth, the annual rate remains at a high level, and the size of the deceleration appears muted in the context of new macro-prudential tools and rising mortgage rates. We also note that if prices fall too quickly, banking sector risk also rises.

Basel III Implications

Equity provides a layer of protection for bank debt holders. But in times of severe stress, it can be difficult to raise new capital to stave off a failure. The Basel Committee on Banking Supervision has recommended that banks increase their total loss-absorbing capital (TLAC) or debt that can be bailed-in in the event of stress. This provides for faster recapitalisation (and more capital) to avoid a disorderly bank failure[2].

These recommendations are also designed to reduce the need for government support. S&P currently categorises the Australian Government as providing a *High Likelihood of Extraordinary Government Support.* In the event Australia adopts the Basel recommendation this will likely reduce to a *Moderately High* likelihood of support. As such, Standard & Poor's would switch to a different scoring matrix resulting in a downgrade, all else being equal.

The Basel agenda has been undermined following disputes between European and US bank regulators. APRA, the Australian regulator, is unlikely to forge ahead implementing TLAC unless Basel members reaffirm this recommendation.

Increased Capital

While TLAC might be on the back-burner, APRA continues to focus on capital adequacy.

In November 2014 the Financial System Inquiry made the recommendation that Australian deposit taking institutions hold "unquestionably strong" capital levels. This directive has led to an increase in capital of almost $90bn being raised by the major Australian banks since the GFC.

APRA indicated that it will formally define "unquestionably strong" in coming months. It has repeatedly referenced the top quartile of global peers, a definition it may officially adopt. While the banks sit just inside the top-quartile at the time of APRA's last assessment, that quartile is also edging up. The trend for more capital continues, albeit at a lesser pace. The broking community is divided about the need for future capital with some analysts predicting the job is almost done, whereas other analysts believe $25bn in additional capital will be raised in the next two years.

S&P judges the major banks as *adequate* in its *Capital Assessment,* a score which combines quantity and quality of capital. Based on its methodology of calculating a capital ratio, termed *Risk Adjusted Capital,* the majors currently range between 9% and 9.7%, up from around 7% pre GFC. A ratio sustained above 10% would result in an upgrade. We estimate this would require in the order of an additional $20bn in capital across the sector.

It is therefore possible that the banks raise a sufficient amount of capital to ostensibly receive an upgrade, based on a higher *Capital Assessment* score. But a catch-22 may lurk; S&P may then decide that the regulator has done its job in protecting the public purse from failure and therefore offset the positive with a downgrade to the *Likelihood of Extraordinary Government Support.*

Sequencing

While S&P's sovereign rating methodology guidelines are intricate and contain many ratings permutations, we can make the following generalisations:

---

2 As an aside, in one of his last speeches, former RBA Governor Glenn Stevens provided a timely reminder to yield-chasing retail investors that Tier 1 & 2 capital can be converted to equity before equity holders bear any losses.

- If the *BIRCA* alone is downgraded the rating of the major banks' senior debt will remain unchanged, while their subordinated debt will be downgraded.
- If both the *BICRA* and the sovereign rating are downgraded the senior debt rating will be downgraded to A+; the same rating as if the sovereign rating alone is downgraded.
- Changing the *Likelihood of Extraordinary Government Support* or the *Capital Assessment* combine differently with the other two factors. It is possible that the banks face a two-notch downgrade. We think the more significant move is a downgrade from the AA ratings band to the A ratings band. That is, a move from AA- to A+ is more significant than a downgrade from A+ to A because portfolio holdings limits are typically based on broad ratings bands rather than increments within the band. Portfolio limits can alter funds' appetite for securities.

Investment implications:

We refute any argument that a change in the sovereign rating leads to a purely technical ratings downgrade. The downgrade is the result of the sovereign having less capacity to support the banking system.

However, A+ remains a strong rating in global context. But it will diminish the Australian banks' competitive advantage in global funding markets, upon which they are reliant. We estimate that bank spreads would widen in the order of 10-20bps in longer maturities. This is not particularly large in the context of moves in base rates. However, a move wider in bank spreads is coming at a time when funding costs are generally rising, placing pressure on bank net interest margins. To the extent funding costs rise across all sources of funding and is not captured in a further re-pricing of mortgages, the recent positive trend in bank EPS growth may reverse. This could have a material impact on perceptions of bank equity valuations.

While the impact on portfolio performance may be modest, we believe it is prudent to prepare for a downgrade. Many portfolios are governed by guidelines that ascribe lower capacity for lower ratings. The unprepared may end up as forced sellers. It is also prudent to rethink the implications for derivative positions.

Simon Pannett

Investment Analyst

Harbour Asset Management

made using the Investment Statement, which should be read carefully before an investment decision is made. The price, value and income derived from investments may fluctuate in that values can go down as well as up and investors may get back less than originally invested. Where an investment is denominated in a foreign currency, changes in rates of exchange may have an adverse effect on the value, price or income of the investment. Reference to taxation or the impact of taxation does not constitute tax advice. The rules on and bases of taxation can change. The value of any tax reliefs will depend on your circumstances. You should consult your tax adviser in order to understand the impact of investment decisions on your tax position. No person guarantees repayment of any capital or payment of any returns on capital invested in the funds. Actual performance will be affected by fund charges. Past performance is not indicative of future results, and no representation or warranty, express or implied, is made regarding future performance. To the maximum extent permitted by law, no liability or responsibility is accepted for any loss or damage, direct or consequential, arising from or in connection with this presentation or its contents.