CREDIT SUISSE

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Extract from the Credit Suisse Global Income Fund Feb-2009 monthly report

Focus on Australian Bank Capital Securities (Australian Bank Hybrids)

April 2009

Key takeaways

- Australian bank capital securities are significantly cheaper in off shore markets.
- Globally bank capital securities, including securities issued by Australian Banks have sold off significantly.
- We believe that Australian banks offer lower risk and better value than overseas bank hybrids.
- The Global Income Fund is positioned to provide exposure to this opportunity for local Australian investors.

1. Australian bank capital securities are much cheaper offshore.

ASX listed bank hybrids are trading at low historical levels. However, investors can take the same credit risk in Australian banks in offshore markets and receive a higher yield. It is no coincidence that brand name Australian financial institutions, such as Westpac and AMP, are marketing new deals to retail investors at relatively low yields. For example, the Global Income Fund has exposure to the Westpac USD 5.256% hybrid that is priced at $44.80. <u>This price implies an additional yield of 4.5% per annum above the new Westpac Tier 1 issue. This annual difference in yield translates into a valuation difference of around 35%.</u> This pricing differential is a common theme with ASX listed hybrids trading more expensive than offshore comparable deals for all four Australian major banks. While some investors may get comfort from investing in ASX securities that they can see, these ASX securities are certain to under perform over the medium term. The Global Income Fund has exposure to all of the offshore deals issued by Australian banks, as listed in Table 2.

Table 1. Comparison of Australian dollar deals, Euros and US dollar deals.

								Security Rating		
Name	Currency	Credit Margin	Current Price	Yield to Maturity	Yield to Call	Running Yield	M.Dur	S&P	Moody's	Size M
WESTPAC BANKING CORP - WBCPA T1	AUD	4.7%	$ 92.5	7.7%	8.7%	8.1%	7.0	A+	Aa3	$ 500
WESTPAC FUNDS MANAGEMENT - WCTPA T1	AUD	3.7%	$ 69.9	8.3%	NA	8.4%	7.1	A	NR	$ 500
WESTPAC BANKING CORP - WBCPB T1 [new deal]	AUD	3.7%	$ 100.0	8.4%	8.0%	8.4%	7.1	A+	Aa3	$ 700
WESTPAC CAPITAL TRST IV - USD T1	USD	8.2%	$ 44.8	11.9%	20.3%	12.2%	7.7	A+	Aa3	$ 525
Difference [to new deal]		4.5%	-$ 55.2	3.4%	12%	3.8%				
AUST & NZ BANKING GROUP - (ANZPB) T1	AUD	5.3%	$ 90.0	8.1%	9.5%	9.6%	6.4	A+	A1	$ 525
ANZ CAPITAL TRUST III - Euro T1	EUR	9.4%	€31.0	12.8%	27.3%	7.4%	7.5	A+	Aa3	€525
Difference		4.1%	-$ 59.0	4.7%	18%	-2.2%				
CBA PERLS IV (CBAPB)	AUD	3.4%	$ 82.8	7.0%	10.6%	6.0%	3.0	A+	A2	$ 1,465
CBA PERLS III (PCAPA)	AUD	4.3%	$ 65.0	8.7%	13.1%	9.0%	10.7	A+	NR	$ 1,164
CBA CAPITAL TRUST I - USD T1	USD	16.0%	$ 51.7	19.4%	19.4%	8.0%	4.8	A	Aa3	$ 550
Difference [to CBAPB]		11.7%	-$ 13.3	10.7%	6%	-1.0%				
NATIONAL AUSTRALIA BANK - (NABHA) T1	AUD	4.9%	$ 62.0	8.2%	NA	8.2%	10.0	A	Aa3	$ 2,000
NATL CAPITAL INSTRUMENTS - Euro T1	EUR	11.9%	€29.6	15.2%	24.0%	9.1%	8.4	A+	Aa3	€400
Difference		7.0%	-$ 32.4	7.0%		0.9%				

Source: Credit Suisse

All yields/margins are in natural currency (i.e. Euro currency issue). True conversion of a yield into AUD yield will gross up the yield a further (+2.67% for USD and +1.64% for Euro) interest differential.

Credit Margin = Option Adjusted Spread to worst

M.Dur = Modified Credit Duration

As at the 27 February 2009

2. Global bank capital securities have sold off significantly in recent times.

Why have they sold off so significantly?

Offshore capital securities have suffered a lot of negative events.

- Huge bank losses in the US and UK markets.
- An increased possibility of coupon deferral because of these bank losses in the UK and US.
- Further fear that government nationalisation will force coupon deferral or conversion to ordinary equity.
- The ratings agencies are revisiting the ratings of bank capital securities which will likely result in downgrades.
- Forced selling by investors who can not hold non-investment grade bank capital (i.e. insurers etc).

Why do Australian capital securities trade cheaper in offshore markets than on the ASX?

- Offshore investors have historically been the dominant holders of Australian banks hybrids issued in EUR or USD. These investors have been aggressively selling along with their US and UK bank hybrids because they believe that Australian banks will eventually face the same problems that US and UK banks are currently facing.
- Australia is perceived to have an expensive housing market and is sensitive to the economic cycle through commodities.
- Local retail investors like local brands. They support ASX hybrids because offshore capital securities are more difficult to access. Offshore securities require large minimum investment sizes, long-term currency hedges and possibly interest rate swap hedges.
- Retail investors tend to be more passive investors, without the same constraints as institutional mandates.
- The current ban on shorting financials securities on the ASX has made it difficult for institutional investors to arbitrage the missprising.

3. Are Australian banks are better placed than US and UK banks?

Positives

- The Australian banking system benefits from structural differences to those offshore.
  - Australian mortgage lenders benefit from full recourse unlike US mortgage lenders.
  - Australian home owners do not receive tax breaks interest payments which encourages quicker repayment of principal.
  - Australian monetary policy stimulus has a more direct benefit to the Australian economy with 80% of home owners borrowing using floating rate mortgages.
  - Quality of earnings are superior to offshore banks
  - Australian banks currently have much stronger capitalised with Tier 1 at 8.5% versus approx 5.5% in 1990's.
  - Carry cost of non-performing loans is much lower (lower interest rates).
  - Australian unemployment starting point is currently much lower than in the late 80's early 90's downturns.
- A major weakness was overseas wholesale funding has been removed with the Australian government ensuring funding access.
  - Government mortgage securitisation market.
  - Government deposit guaranteed.
  - Government guaranteed overseas funding.
- The Australian government has sponsored a banking Oligopoly (80% of system credit versus 35% in US)
  - Bank competitors have been squashed in the liquidity squeeze.
  - Net interest margins are now rising.
- Moody's recently reported that *"The Australian government has strong financial flexibility to support the financial system if required, and to stimulate the economy without impacting its own Aaa rating"*.
- Although Moody's recently revised the outlook on ANZ, WBC and CBA to negative because of *"the potential for the deepening global economic downturn to have a protracted impact on the banks' asset quality and earnings".* Moody's retains a senior rating of Aa1stating that,
  - *"the banks remain solidly positioned within the Aa category*
    Australian banks do not have significant exposures to "toxic assets"; where exposures to offshore, structured securities exist at all, they are limited relative to international peers
  - *The banks have not been engaged in subprime mortgage lending; collateral cover is high, and there is no over-supply in the Australian housing market."*

Negatives

- The Australian economy is lagging the global economy.
- The Australian banking system has little diversity which means higher concentration risk.
- Australian banks are more dependant on the government AAA credit rating because of the support from the senior debt and deposit guarantee program.
- Comparatively they do have a low deposit base (from 50% now 60% of funding).
- There are significant fears offshore about the Australian housing market being too expensive.
- Previously Australian banks had low net interest margin (now improving).

4. Why invest in a diversified fund rather than directly in bank capital offshore?

- Concentration to the one industry, issuer or one part of capital structure increases volatility. For example, bank capital had a negative 13.5 percent excess return in February.
- Globally a number of credit assets are cheap not just bank capital securities. Having diversity reduces risk of underperformance, while other sectors may be outperforming. For example, Syndicated Loans has been the best performing credit asset class year to date, while bank capital has underperformed significantly.
- Interest rate and FX risk has to be actively managed. A rebound in interest rates or the Australian dollar could cause poor performance even though the capital security has outperformed.
- Selecting the best priced securities is obscured by embedded options and pricing complexities.

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