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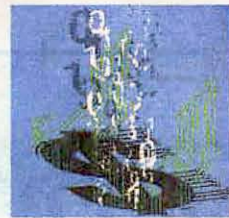
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■ Offshore search for capital ■ Credit rating challenge ■ Push for new funding options

Banks in \$135bn funds chase

Matthew Drummond and **Jonathan Shapiro**

The heavy reliance of Australian banks on international financing will force the big four banks to seek about \$135 billion in wholesale funding this year despite efforts to find more secure sources of funding.

Weak demand for credit from Australian businesses and households, and growth in deposits, has eased the immediate funding pressures on lend-

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ers, but senior bank executives fear a strong rebound in credit growth would stretch their funding tasks and force them to ration credit or risk losing their prized AA credit ratings.

Westpac Banking Corp treasurer

Curt Zuber, whose bank must secure about \$40 billion in funding during 2011, said Australia needed to find more ways to import the capital necessary to grow its economy.

"There's no doubt that when we talk

about long-term industry strategy, what are the things that could play out over the next 10 to 15 years, our current system looks like it could get stretched in a different environment," he said.

"There are a lot of people in the industry saying things have to change at some point over the next decade to ensure that we have a sustainable financial system that allows the country to grow at its potential."

The financial crisis has prompted

regulators, rating agencies and investors to pay greater attention to how banks fund themselves, putting Australia's major lenders under the gun for their heavy reliance on wholesale money markets. Those markets slammed shut during the financial crisis, forcing the federal government to guarantee bank bonds.

Analysts estimate the four majors' wholesale funding tasks for 2011 will be about \$135 billion. This is less than

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Banks in \$135 billion chase for funding

From page 1
the \$151 billion in funds raised during 2009 but remains well above the \$106 billion raised in 2008.

ANZ Banking Group's deputy chief executive officer, Graham Hodges, said the game had changed from the days before the financial crisis, when banks could always find more cheap money to meet credit growth.

"Banks need to be better managers of their balance sheets in an environment where liquidity and funding are a key constraint," he said.

The major banks' cost of raising new debt has stabilised in recent months, suggesting less pressure for further interest rate rises out of step with moves in the official cash rate.

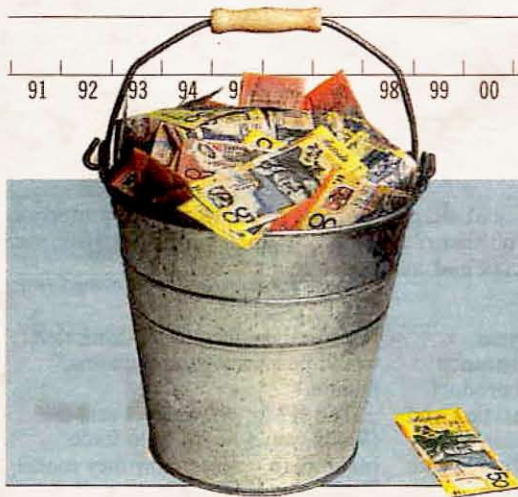
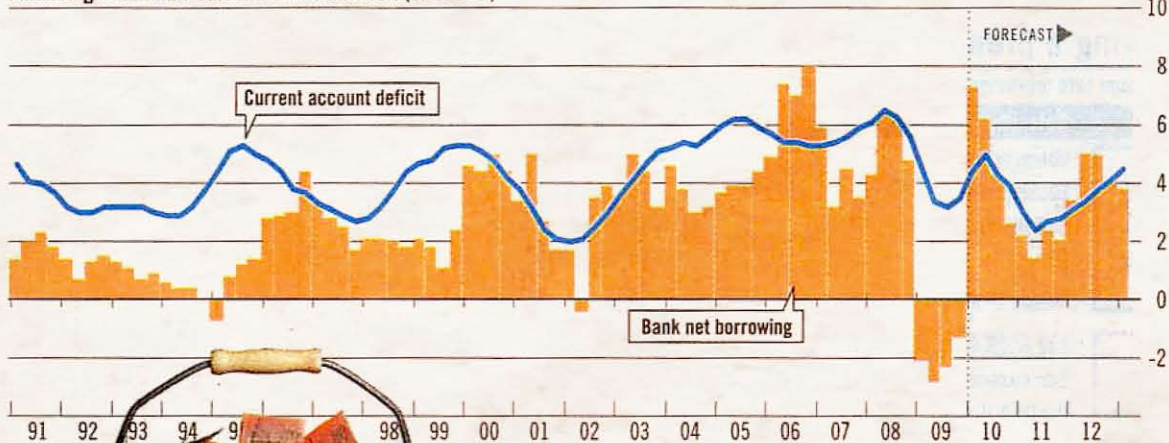
However, as banks replace older debt raised cheaply before 2008 with new, more expensive debt, overall funding costs have kept rising.

Westpac's chief executive, Gail Kelly, told the Senate banking inquiry last week that she expected funding costs to peak in about 18 months.

Ratings agency Moody's Investors Service has warned that the major banks' dependence on wholesale funding is the most significant negative issue faced by the Australian financial system and the most likely reason for a downgrade to their AA credit ratings.

Funding gap

Financing Australia's current account deficit (% of GDP)



\$135 billion

The amount the big four banks need to raise in wholesale funding this year. Australia's banks have a heavy reliance on offshore financing.

the funding for domestic banks would continue to rise as you pay up more as you continue to raise funds," he said.

"The more you raise over the period and the greater funding task you have, the more likely you have to pay a higher spread for those funds and that will feed into your cost of funds," he said.

"As funding costs go up those borrowers who could have borrowed from you may choose to go direct to market."

Deposits, the safest source of funding, provide 45 per cent of bank funds, up from below 40 per cent in 2006 and 2007. Banks have pushed out the average length of their wholesale funding by reducing the amount of short-term debt from above 30 per cent to 20 per cent and increasing long-term debt, which is the most expensive funding source, to about 25 per cent.

Last year Treasurer Wayne Swan announced legislation to allow banks to issue covered bonds, which will provide some help in meeting their funding task. Covered bonds are a cheaper form of funding than standard unsecured bonds because banks provide additional security to investors by pledging assets as security. This means covered bonds attain a AAA rating.

Patrick Winsbury, a senior vice-president at Moody's, said there were some signs that the problem was fixing itself. He cited research from the Reserve Bank of Australia that mining companies were raising their own money offshore and putting the excess in Australian banks as deposits.

"If they [the banks] keep having smaller funding tasks and they have more deposits than that's good for ratings," he said.

"We have to look at the banks from a fairly narrow perspective. Our issue is while Australia as an economy does not have high government debt, from our narrow perspective the banks have a high level of wholesale funding in a world where confidence is sensitive."

Commonwealth Bank of Australia is the most reliant on wholesale money. The bank raised \$54 billion in its financial year to June 30, 2010. CBA has indicated it plans to raise slightly less in 2011.

Westpac is the second most reliant. It raised \$43 billion in the 12 months to September 30, 2010, the other major banks' balance date. Westpac has said it expects to raise between \$5 billion and \$10 billion less than it raised in 2010.

National Australia Bank raised \$28 billion in 2010 and plans to raise

about the same this year, while ANZ raised \$26 billion. ANZ has not given any guidance on funding in 2011.

When term funding is measured as a proportion of total assets, each of the big four are in the list of the world's heaviest issuers of wholesale money, according to UBS.

Credit across the banking system grew by about 3 per cent in 2010, well below the 12 per cent growth averaged between 1994, as the economy came out of the recession, and 2008, when growth stalled as a result of the financial crisis.

Meanwhile, the amount of money in bank deposits has been growing at between 5 and 6 per cent, allowing banks to ease their reliance on wholesale money. During 2010 the four major banks added \$80 billion to their collective deposit books, while their loan books grew by \$70 billion.

Credit growth is expected to be muted this year because of weak demand from households and businesses. But Oliver Wyman, a consultancy, estimates that if credit growth rebounded to 8.5 per cent, which is below the average of the past decade, and the growth in deposits trailed off then the big four banks would need to borrow a total of \$1.3 trillion in wholesale money.

That figure is \$100 billion more than Australia's annual GDP.

To support such a funding task, the big four would need to issue \$300 billion in bonds each year, Oliver Wyman calculated. This is more than double this year's funding needs of \$135 billion. It would also make Australian banks even more vulnerable to tremors in international financial

posed significant risks. "Our banking system is already one of the world's biggest borrowers in global markets. In the short term that doesn't look to be much of a problem because credit growth has slowed right down over the last six months and most expectations are that credit growth will remain at the low end for a while," he said.

"But over the next 10 to 15 years it's



Banks need to be better managers of their balance sheets in an environment where liquidity and funding are a key constraint.

Graham Hodges, ANZ Banking Group's deputy chief executive

markets. Typically about 60 per cent of the wholesale money raised by Australian banks comes from offshore investors.

Morgan Stanley estimates that both deposit growth and loan growth at the four majors will stay at 6 per cent during 2011. But should loan growth rise faster than expected, bankers doubt deposit growth will keep up, making banks even more reliant on wholesale funding money.

Mr Zuber said such a scenario

not hard to imagine a scenario where credit growth grows faster than deposit growth, and in some way, shape or form we have to get foreign capital into our country."

One way this could occur is for more companies to issue their own bonds to offshore investors.

Australia's corporate bond market is small relative to other economies but Mr Hodges predicted it would grow as bank funding costs rose.

"What you probably would find is

Oliver Wyman said annual issuance of covered bonds by global banks was relatively small, averaging between just €200 billion and €300 billion (\$273.8 billion to \$410.7 billion). It expects Australian banks will raise only about \$20 billion in covered bonds each year.

The Reserve Bank estimates the cost for an Australian bank to raise funds by selling three-year bonds has risen to 1.2 percentage points over the government bond yield compared with 0.5 before the crisis.

Mr Zuber said while funding was more expensive, access remained good for Australian banks, which have fared better than their northern hemisphere peers.

"Demand for high-quality Aussie paper is very good," he said. "US banks have been dealing with problems around foreclosures, so they're on the nose. Clearly the problems in Europe around Ireland and elsewhere have raised questions about the health of a lot of European banks. And there are still question marks over where regulation will land in Europe and the UK. So we become the best of a not so good crowd. We stand out."

Last year saw funding costs start to rise for Australian banks as offshore investors fretted about a housing bust in Australia, but Mr Zuber said those concerns peaked four or five months ago.