BofA SECURITIES

Liquid Insight

Don't pay BOB: bank funding task falls

18 April 2023

Rates and Currencies Research
Global

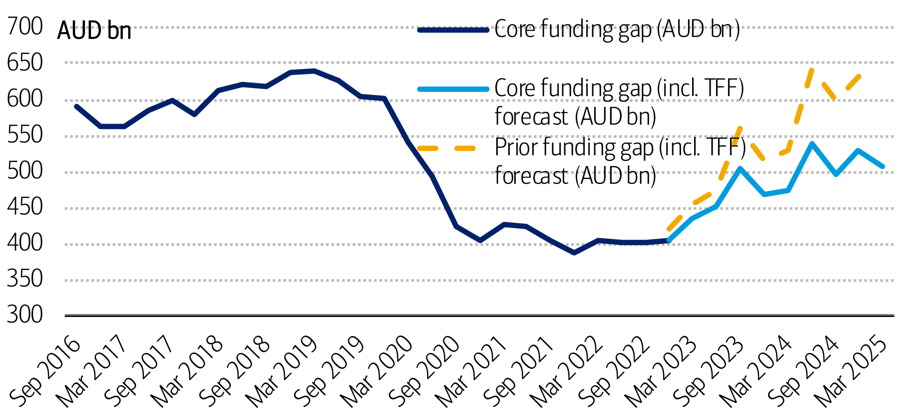
Key takeaways

- We lower our forecast for AU bank funding tasks. Tighter spreads make long-term wholesale issuance attractive.
- Super fund cash allocations have fallen but likely to act as source of liquidity in a risk event.
- The AT1 and AT2 maturity profile in 2023/24 is manageable, but AT1 bond issuance faces headwinds.

By Oliver Levingston and Lefu Li

Exhibit 1: Core funding gap likely to fall to $106bn

Lower estimates driven by downward revisions to deposit and credit growth forecasts



Source: BofA Global Research, Australian Prudential Regulatory Authority (APRA), Reserve Bank of Australia (RBA)

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AU bank funding tasks fall

We have amended our forecast for the core funding gap, which falls to $106bn out to March 2025 on the back of lower credit expansion and robust deposit growth (Exhibit 1). Tighter spreads make long-term wholesale issuance attractive at these levels, and we see banks meeting their funding task primarily through a mix of deposits and long-dated issuances. Super fund cash allocations have fallen but, in our view, the superannuation system is likely to be an additional source of deposit funding in case of a credit event.

Our forecast is consistent with our bank equities analysts' decision to revise down their estimates for system credit and deposit growth over the forecast period. In this note, we discuss the near-term outlook for deposit and wholesale funding, the importance of super funds' asset allocation decisions, and the outlook for AT1 and AT2 capital bonds issued by major AU banks after the offshore bank turmoil in March.

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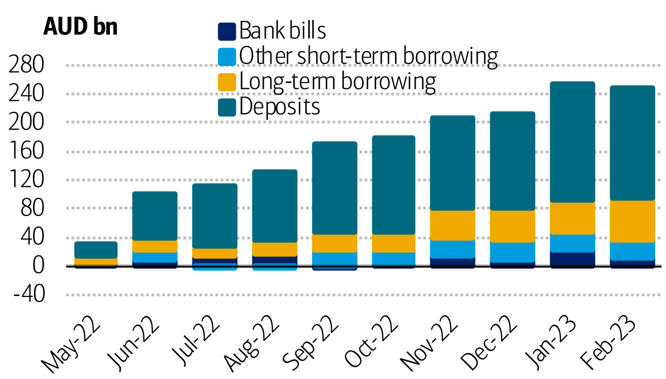
New normal for bank funding

After reducing our assumptions for major banks' credit and deposit growth, we no longer forecast a return of wholesale funding requirements to 2016-19 levels. Trend levels for wholesale funding are likely to be defined by three trends:

1. **Deposit funding likely to remain robust:** Since the RBA started hiking rates in May 2022, deposit funding has contributed more than $150bn of $240bn additional funding to AU banks. As the hiking cycle matured, business deposit growth decelerated but household and financial deposit growth remained robust. Our commodity team has upgraded their forecast for iron ore (see Global Metals Weekly – 4 April), Australia's largest bulk commodity export, which suggests net cash inflows into the banking system from offshore will continue adding liquidity.

Exhibit 2: Deposit growth has reduced funding task since May 2022
Deposits likely to remain strong



Source: BofA Global Research, Bloomberg

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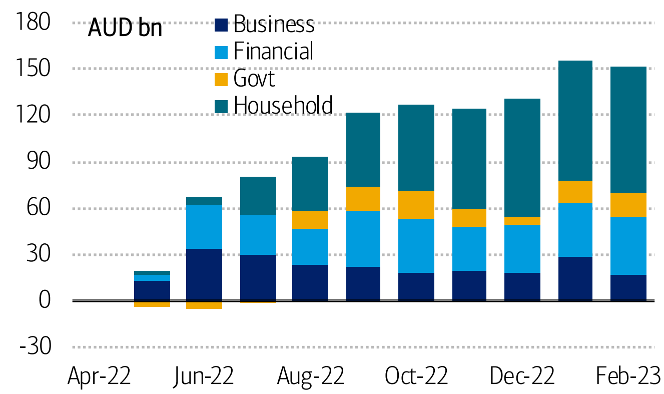
Exhibit 3: Household deposits still fuelling cash growth
Business deposit growth declining as financials stabilize



Source: BofA Global Research, Bloomberg

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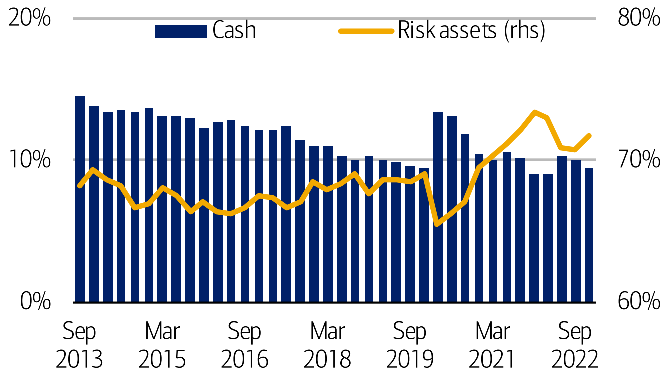
2. **Super fund cash allocations will provide buffer in slowdown:** Superannuation fund cash allocations fell again in Q4 2022 as allocations to risk assets surged (Exhibit 4). Australian and listed international equities continued to attract the majority of additional inflows from superannuation funds (Exhibit 5). Industry super funds have seen a surge in AU fixed-income investments as cash allocations fell, suggesting a slightly more cautious outlook than the system as a whole (Exhibit 6). A surge in cash allocations in March 2020 indicate that super funds will provide significant additional liquidity in a crisis, adding receiving pressure to bills in the aftermath of a tail-risk event.

Exhibit 4: Cash allocations continue to fall

Cash allocation down from 13.5% in March 2020 to 9.5% in Dec 2022



Source: BofA Global Research, APRA

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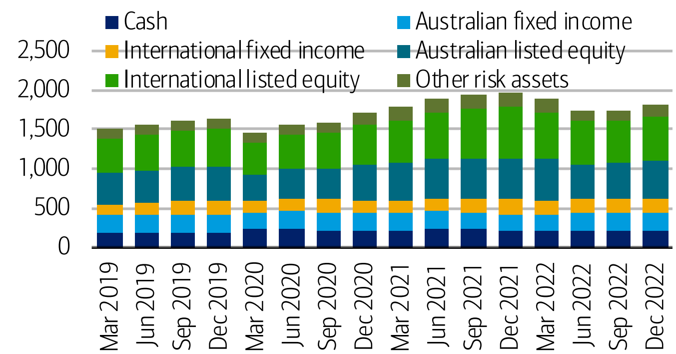
Exhibit 5: Super inflows to equities continue to rise

Cash allocations spiked in March 2020



Source: BofA Global Research, APRA

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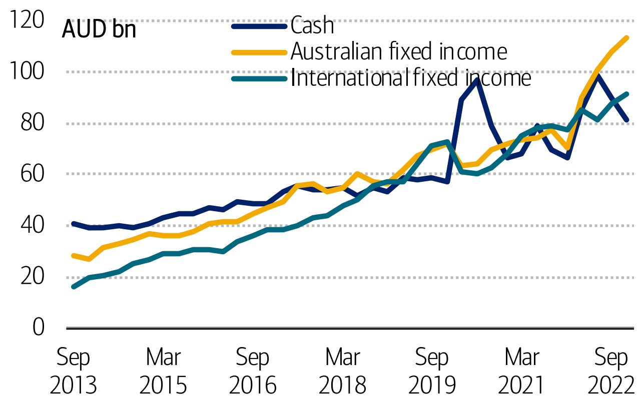
Exhibit 6: Industry super – allocations to cash drop, fixed income surge

Cash holdings have been volatile since March 2020



Source: BofA Global Research, APRA

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3. **Major bank wholesale funding tasks will continue to be met through long-term issuance and deposit funding**: The TFF substantially reduced the major banks' funding requirements, and we continue to see banks meeting their funding task through long-term wholesale issuance (Exhibit 7). Major banks tend to have a weighted average maturity of around 4.5-5.0 years to match the average life of their assets (primarily, residential mortgages). Although bank issuance usually steps down in Q2/Q3, banks' wholesale issuance in 2023 is in line with volumes in 2022, which saw the highest level of issuance since 2009 (Exhibit 8). Although yields have returned to levels around 2016, a lower spread to 3m bank bills suggests banks are likely to maintain a strong appetite for issuance at current levels while attracting new deposits with rates around the same level.

Exhibit 7: The TFF depressed long-term wholesale funding
Bank issuance in 2023/24 likely to remain elevated

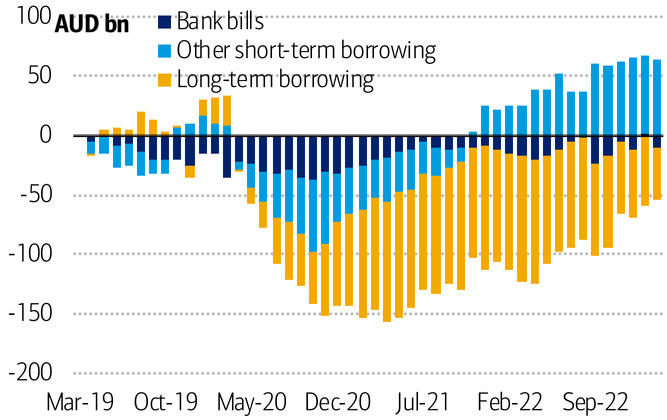

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Exhibit 8: Yields on 3-7yr issuance rising, spread to BBSW falling
2023 set for record issuance

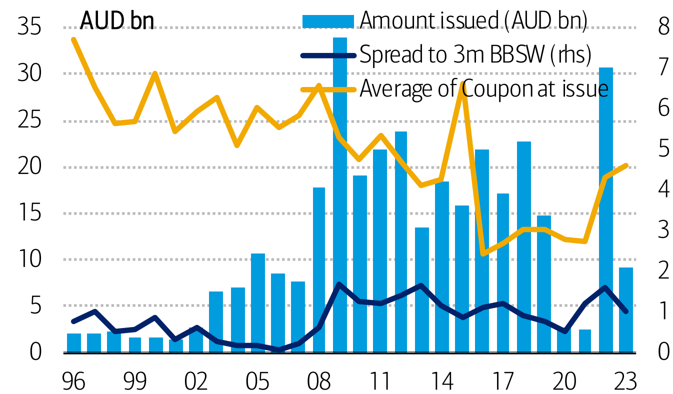

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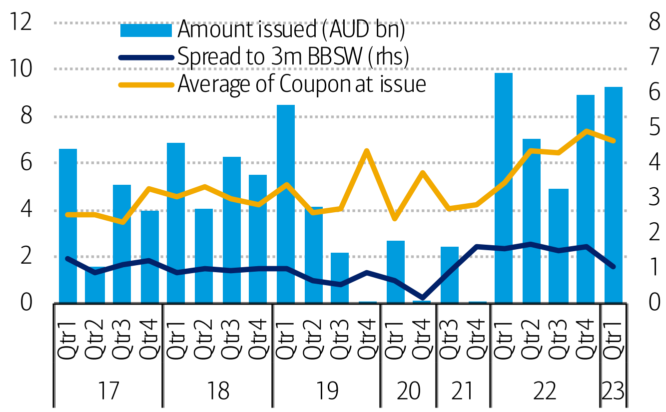
Exhibit 9: Spreads fell sharply in Q1 23
Long-term issuance to rebound strongly in May



Source: BofA Global Research, Bloomberg

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Australia AT1 and tier-2 funding costs

After the credit events in US and Europe, we note the yield level has increased substantially for Australia AT1 bonds. AT1 bonds with a call date in 2027 are currently yielding about 10% with a par value below 90. The price has dropped about 5pt from end-Feb 2023, as yields widened 40bp. However, investor sentiment is much better for tier-2 bonds, especially since Deutsche Bank's early redemption of a tier-2 bond on 24 March 2023 (see our European team's report: Deutsche Bank: What about DB?). In terms of tier-2, the newly issued NAB 10-year bullet tier-2 was trading at 248bp, with a G-spread and a dollar price of 103.2. The yield is 6.0%, lower than the issuance yield at 6.4%, which looks very decent for a 10-year bullet bond.

We believe Australia banks should be still able to issue USD tier-2 at a reasonable price. We note ANZ, CBA and NAB issued in total USD2.7bn-equivalent tier-2 bond year-to-date. This has helped them to raise their tier-2 buffer with only about USD4-5bn funding gap now vs USD7bn at end-2022.

Exhibit 10: Update our estimations on the tier-2 shortfall at end March'23
The universe of this exhibit covers the tier-2 bonds in different currencies. The amounts all in USD bn.

	Total Tier 2 outstanding	Tier 2 Shortfall in Feb.23*	New issued tier 2 issued	Current Tier 2 Shortfall
ANZ	16.0	1.5	0.7	0.9
CBAAU	16.5	3.5	1.2	2.3
NAB	14.1	0.2	0.8	(0.7)
WSTP	15.6	1.1	-	1.1
MQGAU	5.1	0.8	-	0.8

Source: Bloomberg.
*Feb. 8, 2023, please see our report Banks - Australia: Australia banking sector credit outlook 2023 08 February 2023
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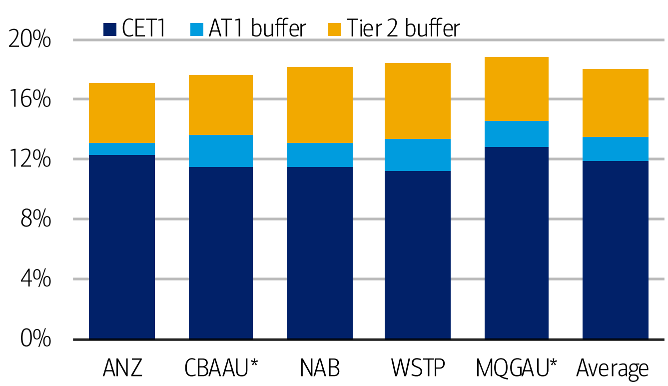
Challenging picture for AT1; tier-2 better positioned

In general, we do not expect to see much AT1 issuance in 2023 given the strong capitalisation of Australian banks and high Australian AT1 yields. Tier-2 issuance for the rest of 2023 should be about USD4-5bn based on the tier-2 shortfall estimation. Australian banks have strong capitalization with average CET1 ratio /tier-1 /CAR at 11.9%/13.6%/18.0%. Australian banks may continue to face difficulty in AT1 issuance if cash rates remain unchanged across the forecast period, as our economists expect. High non-call risk, particularly for the Australian banks, as well as concerns about AT1's write-off globally given the developments in Europe and US mid-size banks make the outlook for AT1 issuance challenging. AT2 bonds are likely to remain a sustainable asset class given the capital regulation framework has been focused on tier-2 buffers since 2019 when APRA confirmed a tier-2 buffer at 5% of risk-weighted-assets.

The maturity wall seems very manageable with about USD2bn tier-2 matured/called in 2023, and that for 2024 at USD5.7bn. Among all tier-2 bonds, only USD300mn in 2023 and USD800mn in 2024 are denominated by USD, so the refinancing need in the USD bond market is quite manageable, in our view. The outlook for AT1 bonds, especially the USD-denominated AT1, is more challenging. We note that investor appetite is likely to be limited and given yield to call (YTC) at 10% for USD-denominated AT1, banks are unlikely to maintain significant issuance in this market.

Exhibit 11: Australian bank capitalisation
In general, Australian banks have strong capitalization, with average CET1 ratio /tier-1 /CAR at 11.9%/13.6%/18.0%.



Source: BofA Global Research, Company disclosure
* For CBAAU the most recent period is Dec-22 as YE is June; for MQGAU, most recent period is 1H23 as YE is March; others' most recent period is FY22 as YE is September
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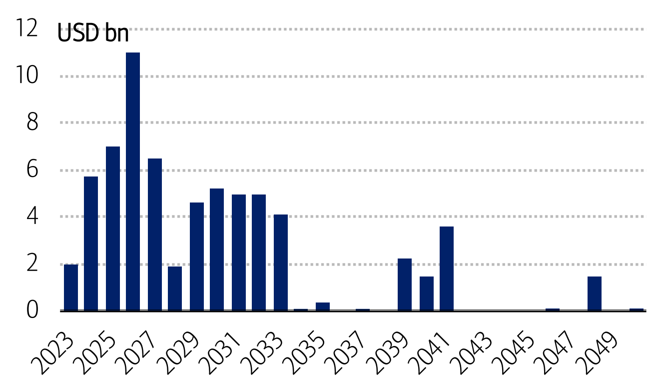
Exhibit 12: All-currencies tier-2 maturity profile
The maturity wall seems very manageable with about USD2bn tier-2 matured/called in 2023, and that for 2024 at USD5.7bn.



Source: BofA Global Research, Bloomberg
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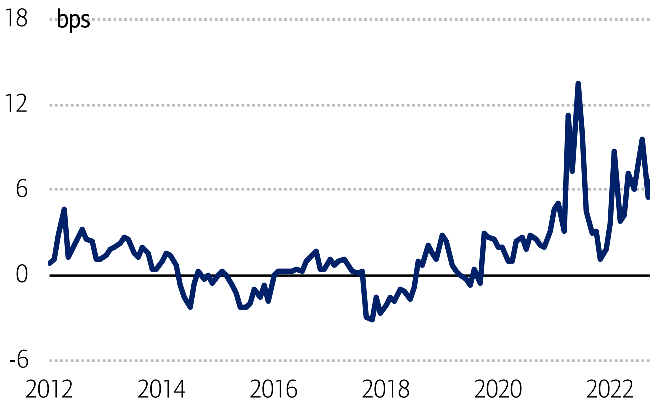
Trading a lower funding task

The best expressions of a lower wholesale funding requirements for the major AU banks are forward-starting and term BBSW-OIS basis (BOB) flattening trades. The BOB curve is trading steep on the assumption that funding conditions will tighten. 1s2s BOB spiked to around 10bp during the banking turmoil in March and is currently trading around 6bp (Exhibit 13). In both cases, though, the near-term risks of further steepening from abundant liquidity in the front dates make us cautious to enter the trade and we look for better levels or a clear catalyst to trade loose funding markets.

Our recommendation to receive 2s3s 6s3s has moved closer to target and was premised on funding normalization. We close the position at 0bp (target -1.8bp, entry 0.6bp).

Exhibit 13: Receive 1s2s BOB at more attractive levels

Positive carry but current level has two-sided risks



Source: BofA Global Research, Bloomberg

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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- After the IMF, **Global FX Weekly**, 14 Apr 2023
- Finger on the pause button**, Global Rates Weekly**, 14 Apr 2023
- As the market dust settles, **Liquid Cross Border Flows**, 3 Apr 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: After the IMF 14 April 2023

Global Rates Weekly: Finger on the pause button 14 April 2023

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