

# No guarantees on bank bonds

**Niko Kloeten**

With hundreds of millions invested in subordinated bank bonds, New Zealanders are being warned their investment is at risk if another financial crisis unfolds and governments refuse to bail out banks.

Nearly all the major banks issued bank bonds during the global financial crisis and New Zealanders were heavy buyers, believing them to be a sound investment when compared with failed finance companies.

A subordinated bond is similar in concept to a second or third mortgage in that others will be repaid first.

But NZ Funds Management investment strategist David Wilson says bank bonds should no longer be considered a risk free investment as governments around the world realise their countries would have been better off had they left banks to fail.

"Before the crisis, investors were given the implicit assumption that governments would bail out banks if they failed. That is not the case today."

The Reserve Bank recently released a consultation paper putting the onus on a bank's shareholders to assume the financial burden in the event of a failure. Subordinated bondholders fall

into this category.

"The next time around governments won't guarantee bondholders and people may lose money. This is a risk which investors need to be cognisant of," Mr Wilson said.

New Zealand Institute of Economic Research chief economist Shamubeel Eaqub agreed that making an investment based on the

hope of being bailed out is a bad idea.

However, he said New Zealand banks are among the safest in the world and the risk of bank insolvencies is very low with or without support from the government.

"The banks expanded overseas into mezzanine financing and taking on more risk than they tradi-

tionally would. Our banks are quite vanilla and boring, which is good for a bank."

A more accurate comparison would be to the finance companies, he said: "What happened in Ireland is what the Blue Chips did in New Zealand."

Mr Eaqub said the government's response to major company failures is always hard to predict, using its

decision to bail out AMI as an example.

"There are no clear and hard rules as to where the government is going to be involved.

"Nothing is riskless – not even governments are riskless. People have to realise the government doesn't have the financial capacity to bail more companies out."

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"In hindsight, countries such as Ireland have learnt they simply could not afford to bail out their banks and now the whole electorate has to pay for imprudent lending."

At the height of the global financial crisis, Ireland lent its banks approximately 36 billion, protecting not only the banks' depositors but also bondholders, many of whom were overseas investors.

As a result of the bailout, Irish government debt as a percentage of GDP has risen from under 30% to over 100% and is forecast to rise further, forcing the government to go cap in hand to the EU and the International Monetary Fund.

"This is quite a different result from Iceland, which let its banks default and is arguably in a better position today than Ireland," Mr Wilson said. "As a result, in the next banking crisis governments will not be as fast to guarantee banks. Instead they are likely to do the opposite and let them fail."

This leaves subordinated bank bondholders in a significantly riskier position than before the global financial crisis.