Major Australian banks are well-positioned to navigate potential headwinds in domestic housing market

by NUS-CRI Market Monitoring Team

- **NUS-CRI Agg 1-year (median) PD of major four banks exhibit stable credit risk amid surging inflation and rising interest rates due to strong fundamentals.**
- **Rising cost of living, coupled with rising levels of household debt, is expected to impact the credit health of Australian banks which have substantial exposure to housing loans.**

Australia's central bank, the Reserve Bank of Australia (RBA), raised interest rates by 25bps to 0.35% for the first time since 2010, joining a growing number of central banks around the world that are tightening their monetary policy in an effort to combat rising inflation, as Australia's Q1 2022 inflation rate reached 5.1%. With rising consumer and house prices, the impact of higher borrowing costs has put a spotlight on the Australian banking industry, which is dominated by four major banks (Major four banks[1]). Though an increase in lending rates may positively impact banks' margins, the resultant impact on asset quality, especially a potential uptick in non-performing loans (NPL) from the real estate sector, may provide some headwinds to the domestic banking industry. As seen from the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) in Figure 1a, the median PD of the industry has marginally increased since the announcement of the rate hike. This may be driven by an expectation of increasing future credit losses from household borrowers due to their inability to absorb the rising borrowing costs. Similarly, the NUS-CRI Aggregate (Agg) (median) Forward 1-year Probability of Default (Forward PD[2]) also increases over the next 12 months, potentially crossing the BB+ Upper bound when referenced to the PDiR2.0 bounds. Regardless, the major four banks remain relatively safe compared to their peers, with their median PD being closer to the 20th percentile PD of the whole industry (See Figures 1a and 1b).

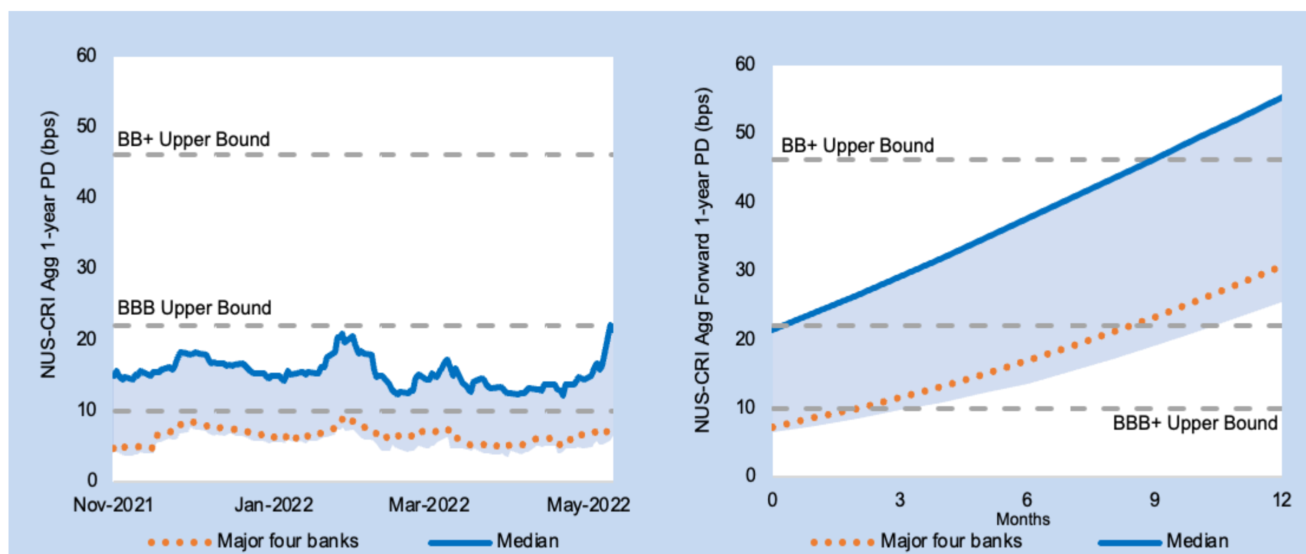

Figure 1a (LHS): NUS-CRI Agg 1-year (median) PD of major four banks with the 20th and 50th percentiles of the Australian banking industry from Nov-2021 to May-2022, with reference to PDiR2.0 bounds[3]. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD of major four banks with the 20th and 50th percentiles of the Australian banking industry as of May-2022, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

[1] The major four banks of Australia consist of the Australia and New Zealand Banking Group, Commonwealth Bank of Australia, National Australia Bank, and the Westpac Banking Corporation.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

[3] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

The interest rate hike by the RBA provides a tailwind to Australian banks' margins as the industry is set to benefit from a potential increase in their net interest income. However, the risk of rising inflation, in conjunction with an increase in variable mortgage costs for households, threatens the asset quality of Australian banks. The major four banks have already stated that the increased lending costs are set to be passed on to households, with the home loan variable interest expected to increase by 25bps. With rising house prices and relatively low wage growth, an increase in the variable interest rate of household mortgages may raise concerns of rising systemic risk across the Australian financial markets as households are faced with a rising debt burden. As such, the domestic banking system may face the risk of rising NPLs arising from this loan segment, especially as close to 60% of credit extended by Australian banks as of 2021[4] has exposure to the housing market.

A potential source of relief in the current economic environment for the industry is its strong fundamentals. The major four banks were able to maintain strong capital positions (See Figure 2a) as they emerged from the pandemic. The pressure on the banks' NIM, which persisted for the past two years due to increased competition in the housing market and record-low interest rates, may ease going forward as the RBA may potentially hike rates further in the near term should inflation concerns persist. Moreover, due to their strong provisioning position, the major four banks may be well-placed to absorb any impact on asset quality. Additionally, the Australian Prudential Regulatory Authority (APRA) had proposed to increase capital buffers above minimum prudential requirements to sustain the strength of Australian banks amid a potential increase in systemic stress witnessed by the banking industry due to their exposure to the housing market.

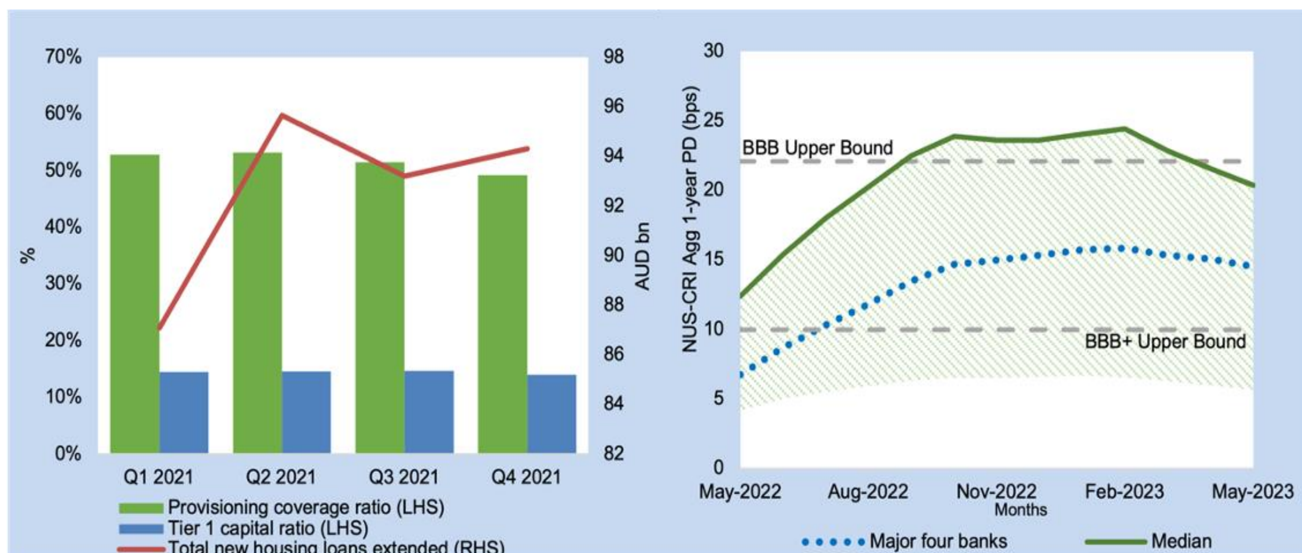

Figure 2a (LHS): Quarterly provisioning coverage and Tier 1 capital ratios of major four banks for 2021 and total new loans extended for housing purposes by the industry. Figure 2b (RHS): Stressed NUS-CRI Agg 1-year PD of major four banks with the 20th and 50th percentiles of the Australian banking industry based on the rising cost of living. *Source: APRA,* Australian Bureau of Statistics*, NUS-CRI, BuDA v3.3.0*

Australian households will most likely feel the brunt of the interest rate hike in the form of higher additional monthly expenses, subjecting their relatively stagnant incomes to increased pressure, and raising concerns as to whether they will be able to afford their mortgages. Since the 1990s, house prices have risen from 2.5 times annual median household income[5], to more than 6 times, making Australian households one of the most indebted in the world. The housing prices boom is expected to continue for the remainder of 2022 before declining in the subsequent years. The impact of the rising cost of living on the Australian banks' credit risk can be measured using the NUS-CRI Bottom-up Default Analysis toolkit's (BuDA) stress test scenarios. Figure 2b shows that median stressed PD for the major four banks is expected to marginally increase and continue its uptrend in the short-run, in contrast to the steeper deterioration in credit health for the rest of the industry, suggesting that strong fundamentals provide insulation against unfavorable changes in the credit environment.

Aside from the expected consecutive hikes in interest rates, the 3-year Term Funding Facility[6], which gave banks access to cheaper funds, is set to expire between Mar-2023 and Jun-2024, posing an additional headwind as

[4] Housing is also a common collateral for credit extended by banks to SMEs. Though a decline in the housing market caused by RBA's policy cooling doesn't necessarily lead to credit losses, it does diminish the value of the collateral and may impact the banks' capital positions should there be a large decline in the value of houses.
[5] The rapid increase in housing value had pushed Australian households in a panic-buying frenzy for fear of missing out, highlighting the high level of credit extended to households pressuring household debt (See Figure 2a).
[6] Funds supplied by RBA at extremely low interest rates to aid banks overwhelmed by falling interest revenue during the time of the pandemic.

Australian banks would need to face higher costs for refinancing debt. By then, the Australian banks' credit health as a whole would have potentially improved from the anticipated correction of house prices, which typically signifies that the economy has cooled down and mortgage rates have stabilized, as households will then be able to reallocate the freed up portion of their incomes to maturing debts. In the meantime, the Australian banks may directly benefit from increased interest revenues owing to higher rates.

Credit News

European corporate bonds hit by steepest sell-off in at least 20 years

May 12. Recent expectations of interest rates and worsening economic outlook have deteriorated the condition of the European corporate bond market as investor demand has fallen by over 10%. Expectations of rising interest rates stem from the response strategy followed by US federal reserve to combat high persistent inflation – a situation that Europe currently faces. The war in Ukraine and lockdowns in China have further exacerbated Europe's economic outlook and consequently worsened investor demand. Bonds of all brackets are affected with high-yield bonds of lower "junk" credit rating being relatively safer compared to the European junk bonds, whose returns are predicted to fall over 10%. Overall, the corporate bond spread has drastically widened reflecting investment skepticism. (FT)

Bonds backed by car loans are selling at fastest pace in years

May 14. Auto ABS issuance is at a multiyear high as investors burnt by tumbling credit markets pile into the instruments. Companies have sold USD 58bn of asset-backed securities backed by auto loans, a 20% increase YoY. Asset-backed securities usually don't fare well during periods of economic turmoil as consumers may find it increasingly difficult to service debt obligations during these periods. However, auto ABS are backed by cars and cars have recently witnessed a surge in prices of almost 14% as compared to 2021, driven by a shortage in chips. Additionally, as the bonds usually have a short maturity and as unemployment figures remain low, investors are confident that consumers will continue payments on loans in the short term. As a result, auto ABS have registered a fall of just 2.6% this year as compared to a fall of 13% in high-grade corporate bonds. (Bloomberg)

China's dollar-bond misery is set to deepen with Fed tightening

May 11. The real estate debt crisis, interest rate hikes by the Fed, and COVID-19 lockdowns have clobbered Chinese dollar-denominated debt. Chinese dollar bonds have fallen 9% in 2022, with issuance in the securities also down 38%, the lowest level in the past 6 years. The market continues to reel under the property sector crisis which resulted in a series of defaults by Chinese developers. With major global central banks hiking rates as inflation surges, resultant volatility in currency and rates markets add to the pressure on Chinese dollar bonds. A weaker yuan means that Chinese companies' debt service costs have increased and so have refinancing risks. The increase in policy rates has reduced the demand for Chinese assets, with Chinese companies finding it difficult to raise capital from offshore bond markets. (Bloomberg)

US junk bond market starts to crack under inflation and supply fears

May 13. As inflation soars and companies grapple with supply chain bottlenecks, the USD 1.5tn junk bond market is beginning to show signs of stress. The junk bond market has thus far remained largely insulated from the current economic turmoil due to bond issuers' stable cash position. However, with several companies reporting an adverse impact on operations driven by the Ukraine war, supply chain crisis, and rising inflation, the junk bond index was dragged down to its lowest level in 17 months. (FT)

China Tech sector's dollar-bond selloff attracts bargain hunters

May 13. Chinese markets have presented an attractive investment opportunity as Chinese tech firms' stock spread widens. The spread started widening around Feb 2022 since worries about China's new regulatory measures and their impact on the e-commerce, online education, and gaming industries set in. This, coupled with the uncertain economic outlook due to the pandemic and weakness in US investment-grade debt, had sent technology stock dollar-bond spreads soaring, with companies such as Alibaba Group Holding Ltd witnessing a widening of up to 80 basis points. Notably, the regulatory measures do not affect the tech firms' repayment abilities, hence the higher spread makes them a relatively safe and attractive investment. (Bloomberg)

China's exporters battered by lockdowns and global inflation (FT)

Turkey dials up the pressure on banks as lira slides (FT)

Sri Lanka stumbles toward its first default on foreign debt (Bloomberg)

Regulatory Updates

BOE's Ramsden says more rate hikes needed to tame inflation

May 12. England braces for yet another interest rate hike as inflation is projected to climb to over 10% by the end of the year. Currently, the economy faces economic uncertainty resulting from global factors which have bumped up food and energy prices. However, an interest rate hike is expected to soothe inflation to optimal levels of 1.35% by 2025, although at risk of heightened unemployment and recession in the economy. Consequently, there are increasing concerns about the effect policy would have on the labor market and costs of living which would affect the economy's functions and the lives of the citizens. (Bloomberg)

Christine Lagarde sends clear signal that ECB will raise rates in July

May 11. Economists have declared that the first increase of interest rate in Eurozone for more than a decade is almost certain to go ahead, after Christine Lagarde signaled that she would support raising the ECB's main interest rate in July. The Ukraine war is leading to negative supply shocks and cost pressures in Eurozone causing Eurozone inflation to hit a record 7.5 percent in April, almost four times the central bank's target of 2 percent. The hawkish shift brings the ECB closer in line with the US Federal Reserve and the Bank of England, which both raised rates recently. However, Lagarde said ECB would aim to "normalize" rather than "tighten" monetary policy, meaning that it would only raise rates slowly to continue supporting activity. (FT)

BOE Chief sees 'apocalyptic' risk from soaring food prices (Bloomberg)

Fed's Mester backs half-point rate hikes in June and July (Bloomberg)

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