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Australian Bank Ratings Holding Up As Cheap Money And Rising Residential Property Prices Entice Australian Households

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Rising residential property prices in Australia, particularly in the most populous cities of Sydney and Melbourne, is not unknown. Nor is the lack of confidence in Australian housing, even if it appears residential property price growth could taper as affordability pressures and a growing chorus of caution from regulators come to the forefront. Nevertheless, we believe strong property price growth over the past year or so has been indicative of a resurfacing of risk within Australia's housing market. At the heart of our observations are the forces driving the recent surge in property prices. Those forces include increasing investor participation in response to historically low interest rates. In our opinion, the risk is that these conditions are translated by some households into a self-reinforcing feedback loop, pushing up demand on the back of increased leverage as a result of a cyclical low in interest rates--all against a backdrop of slower income growth and soft employment prospects. For those recently entering the housing market, we believe mortgage repayment pressures are likely to emerge for some, particularly those who are highly leveraged.

We believe Australian banks are generally well placed to contend with any heightened risks that might emerge in response to mortgage-repayment pressures. Principle among the factors supporting our view is our expectation that pressures that do come to pass are likely to be largely confined to recent market entrants. However--and while we consider the following scenario to represent more of a tail risk event--if mortgage-repayment pressures and/or a broader retrace in residential property prices, which is likely to be accompanied by or in response to higher unemployment and materially slower growth was to emerge, we would expect negative rating pressures to emerge across Australia's banking system.

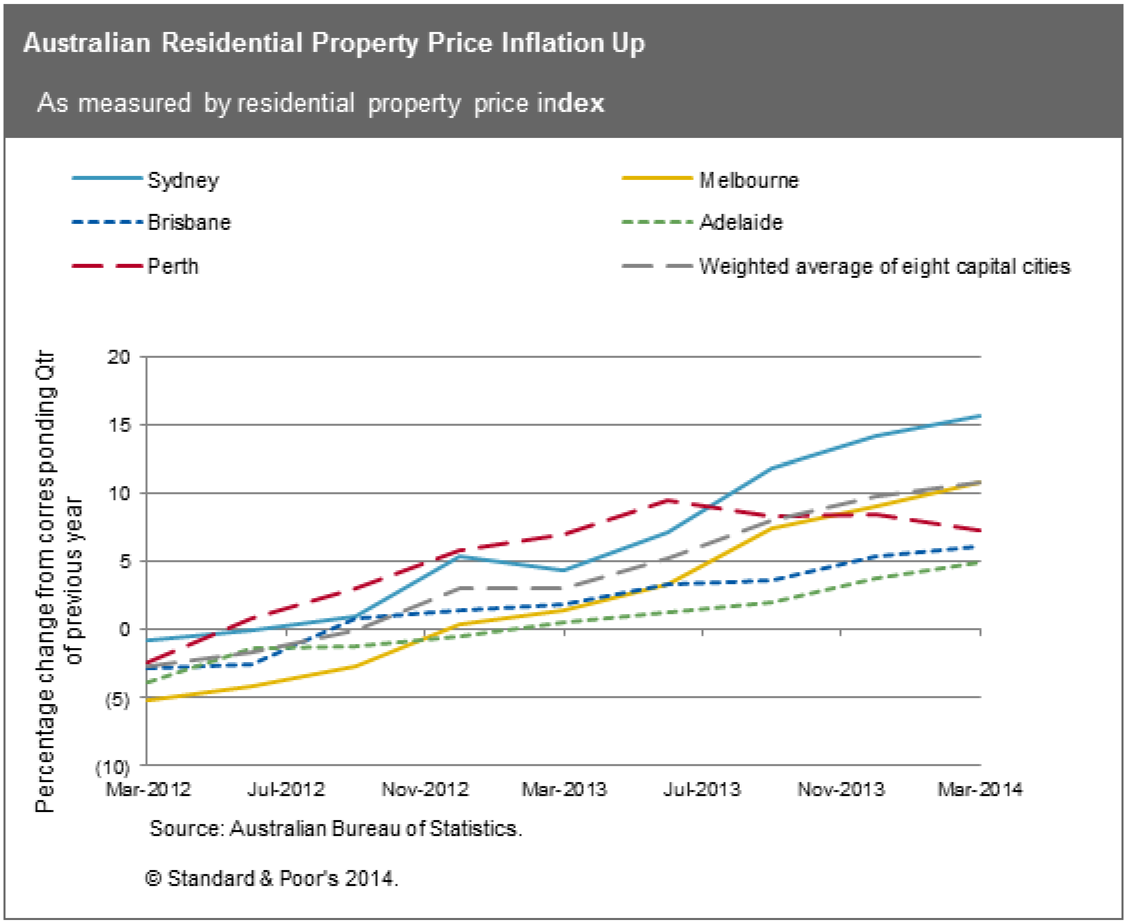
OVERVIEW

- Underpinned by historically low interest rates and increasing investor participation, residential property price inflation has picked up noticeably in the past year or so, particularly in Australia's most populous cities, Sydney and Melbourne.
- We believe affordability pressures, coupled with soft employment and income growth prospects, are likely to slow property price inflation, although a number of variables cloud this outlook.
- Nevertheless, we believe mortgage repayments could become an emerging problem for some households, particularly those who've recently entered the housing market and are highly leveraged.
- In our opinion, the Australian banking system is relatively well placed to absorb increased credit costs in response to mortgage-repayment pressures without triggering negative rating outcomes. We note, however, that our economic trend risk trend for Australia as it affects the banking sector is negative.
- Standard & Poor's continues to monitor other emerging issues that may impact bank ratings in Australia, including those that may arise stemming from the Australian Financial System inquiry.

Australian Residential Property Price Inflation Up As Confidence Remains Buoyant And Risk Appetite Resurfaces

Residential property prices in Australia have been steadily rising in the past two years or so, with Australia's most populous cities, Sydney and Melbourne looking decidedly strong (see chart 1).

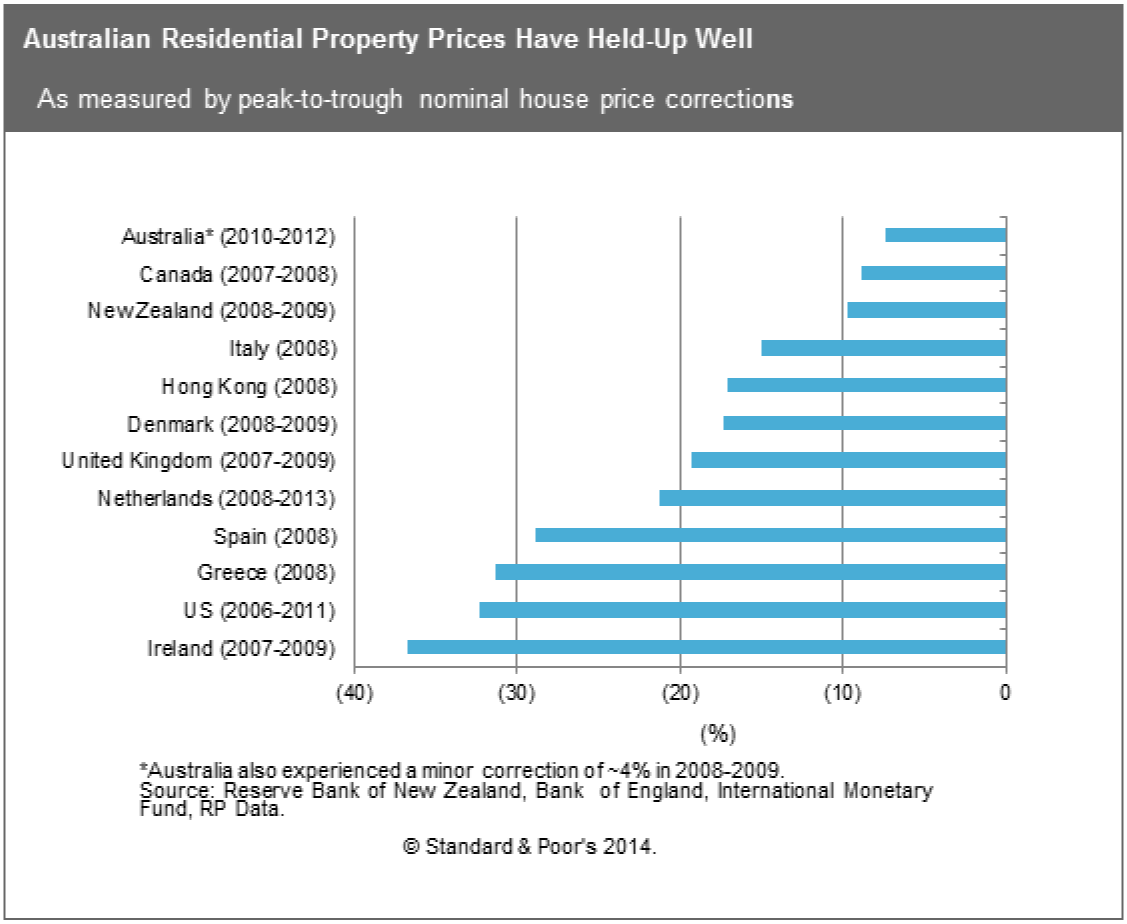
Chart 1



Investors particularly have re-appeared with enthusiasm during this period, accounting for around 40% of lending approvals (including refinance) over the past two quarters or so, in a level last seen in late 2003 (source: Australian Bureau of Statistics). Further to this, we believe the pipeline for investor interest in Australian property is likely to remain healthy, with increasing demand from offshore investors and self-managed superannuation funds, and, anecdotally, other market participants such as first-home buyers opting to invest in lieu of occupying, which could see investor participation increase further.

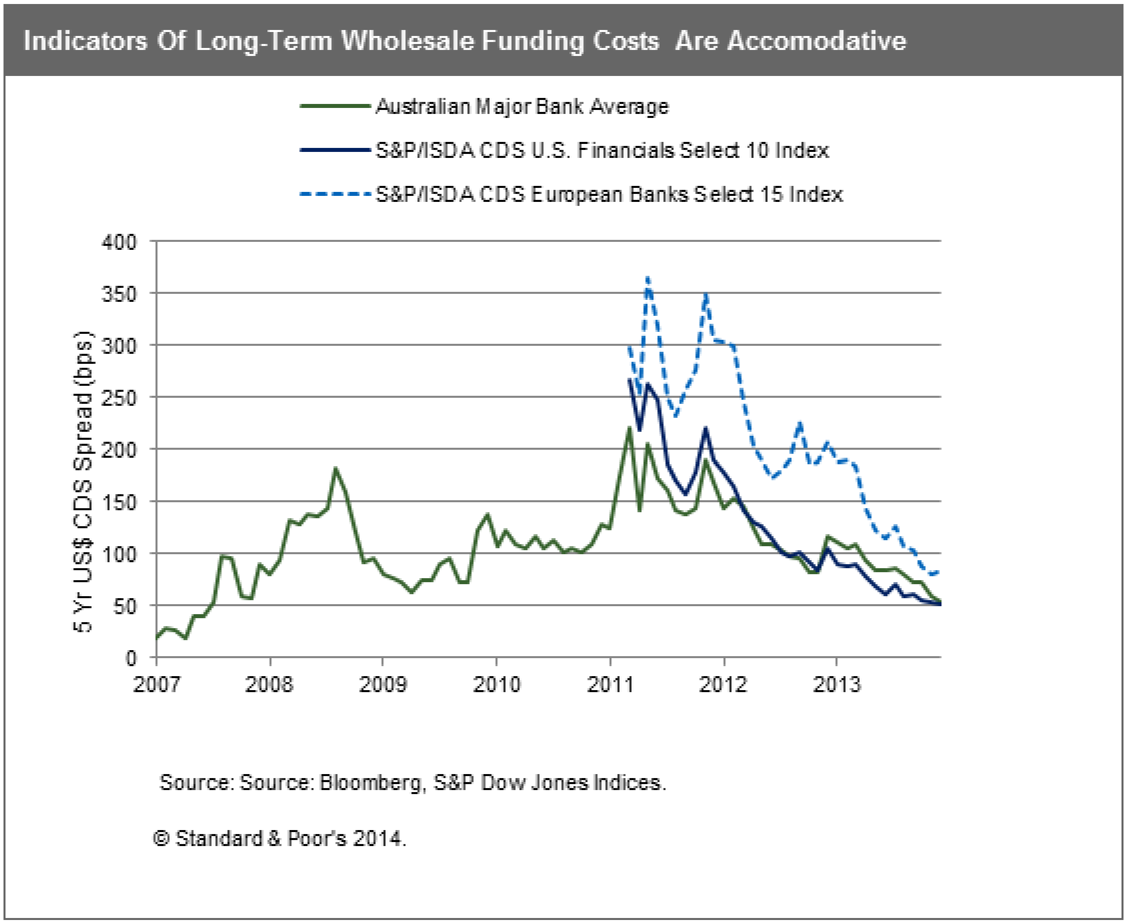
In many respects it's perhaps unsurprising that confidence in Australian housing remains buoyant, particularly given the demand-side incentives in Australian property, the seemingly perpetual supply shortages (prolonged by population growth), and the fact that property prices in Australia, despite a period of modest correction, haven't experienced the same levels of retrace that has become commonplace in much of the developed world in the years leading up to and following the global financial crisis (see chart 2).

Chart 2



At the same time, Australia's banking system, like many other banking systems around the world, has benefited from progressively cheaper funding conditions as a result of the unprecedented levels of accommodative monetary policy, both locally and abroad (see chart 3).

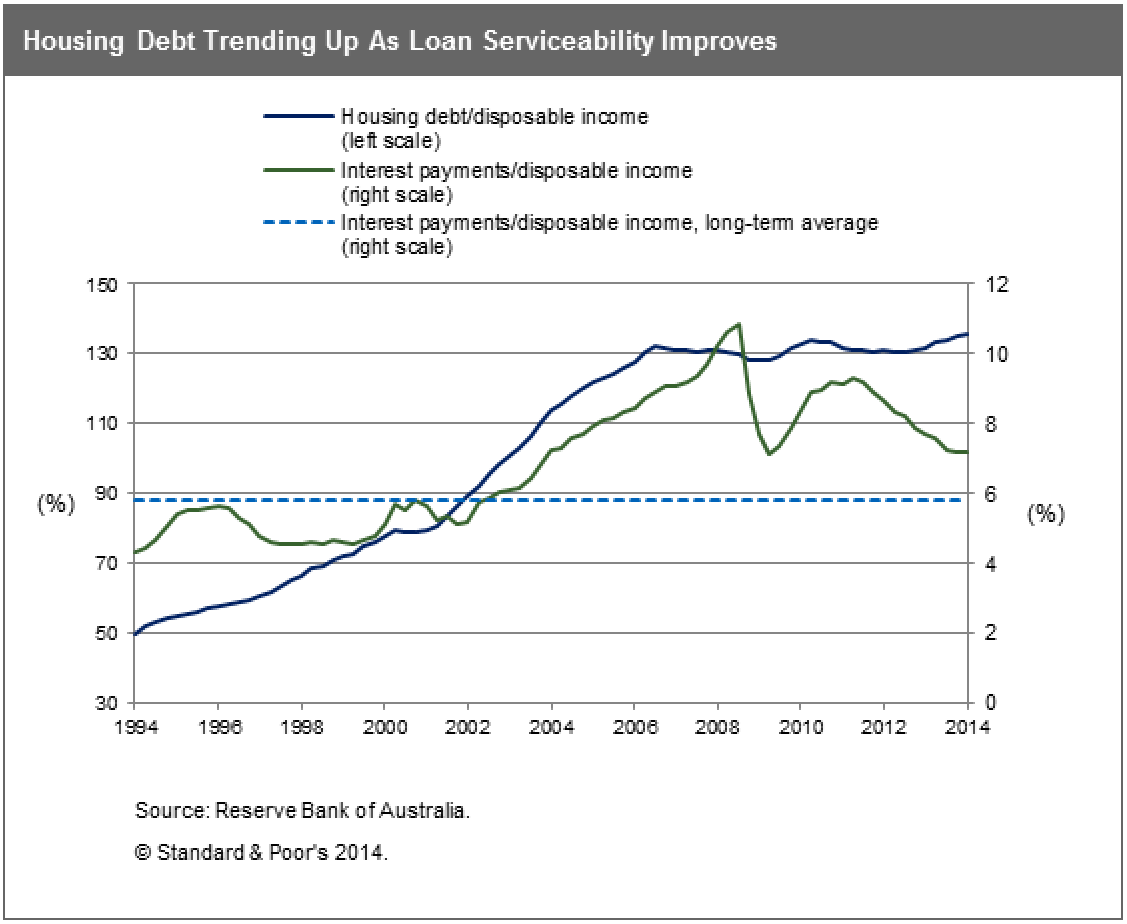
Chart 3



All else being equal, falling interest rates have brought improvements to lending serviceability and, after a brief period of balance-sheet restoration, renewed lending demand, with Australian households--and investors especially--at the forefront. These easing conditions, coupled with seemingly unwavering confidence in Australian housing, have provided the backdrop for increased risk within Australia's banking system, in our opinion.

Loan serviceability has improved as a result of falling interest rates, yet remains some 20% above long-term averages (see chart 4); the rate of household credit growth may be slower than what had become the norm (perhaps [ab]norm) for most of the 1990s and 2000', but looks set to gradually continue rising, with private survey data suggesting the proportion of households favoring real estate as a "place to save" has recovered to levels last reached in the boom years of the early 2000s--indeed, housing debt has recently picked-up again after a prolonged period of stay (see chart 4). At the same time, the number of those households entering the housing market with high levels of leverage (measured as a loan-to-valuation ratio of greater than 80%) remains reasonably high, at around 35% (of new lending applications) (source: Australian Prudential Regulation Authority).

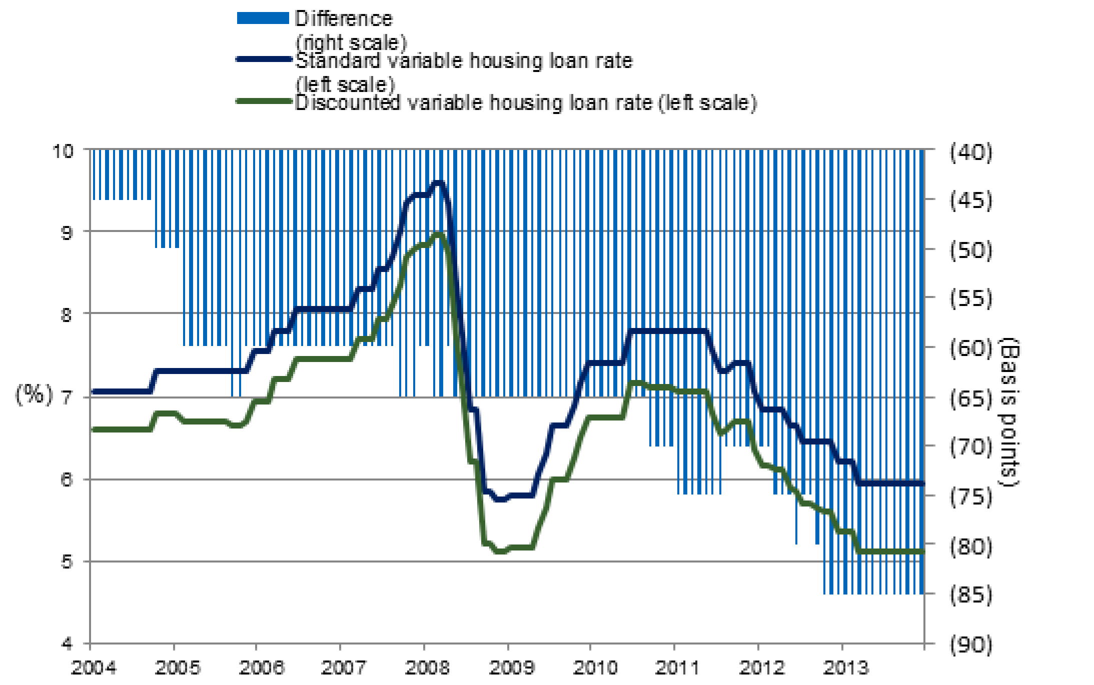
Chart 4



Australian banks also appear to be competing more aggressively on price (as measured by the difference between the standard variable rate and discount variable rate on housing loans), partly as a result of the relatively lower credit growth, in our opinion, and which we consider a likely indicator of a higher tolerance for risk (see chart 5).

Chart 5

Australian Bank's Competing More Aggressively On Price



Source: Reserve Bank of Australia.

Confluence of Low Interest Rates, Price Discounting and Rising Residential Property Prices Mask Increased Risk of Increasing Mortgage-Repayment Pressures

With national income growth trending at around 4.0%-4.5% annually (source: Australian Bureau of Statistics) and (nominal) residential property price growth across Australia's major capital cities closer to 10.0% for the year ended June 30, 2014 (source: RPData), we believe affordability pressures could put downward pressure on recent house price inflation, particularly as soft employment conditions and falling terms of trade are unlikely to support a stronger outlook for income growth. The growing chorus of caution about residential property prices emanating from Australian regulators could also weigh on recently strong price growth. However, we acknowledge a number of variables that cloud this outlook, most notably investor appetite--which shows little prospect of dampening--and the possibility that interest rates haven't bottomed, which could drive a further decoupling in price-to-income fundamentals.

Nevertheless, we believe the strong residential property price inflation is likely to be translated by some households into a self-reinforcing feedback loop, pushing up demand on the back of increased leverage as a result of a cyclical low in interest rates--all against a backdrop of slower income growth. In our opinion, the risk is that mortgage repayments become an increasing problem for some households, particularly those recently entering the housing market, when interest rates begin to rise. A further shock to national income growth could also weigh on labour market conditions and add to the mortgage repayment pressures of some, in our opinion. We believe this could be transmitted through falling terms of trade, possibly bought about through a slowing China.

Mortgage holders have been offered some respite through low interest rates, with prevailing lending rates between 150 basis points and 250 basis points below long-term averages. Indeed, focusing on Australia's capital cities (which account for close to two-thirds of Australia's population), and by adopting the prevailing discounted variable housing loan rate, we estimate that since June 2012 (around the same time property prices commenced the current cyclical upswing) to June 2014, mortgage repayments (principal and interest) for new market entrants have remained reasonably steady at around 37% of median household disposable income*. By comparison, we estimate that through June 2010 to June 2011 mortgage repayments were between 43% and 46% of median household disposable income, before trending lower from late 2011 through to mid-2012 in response to falling interest rates.

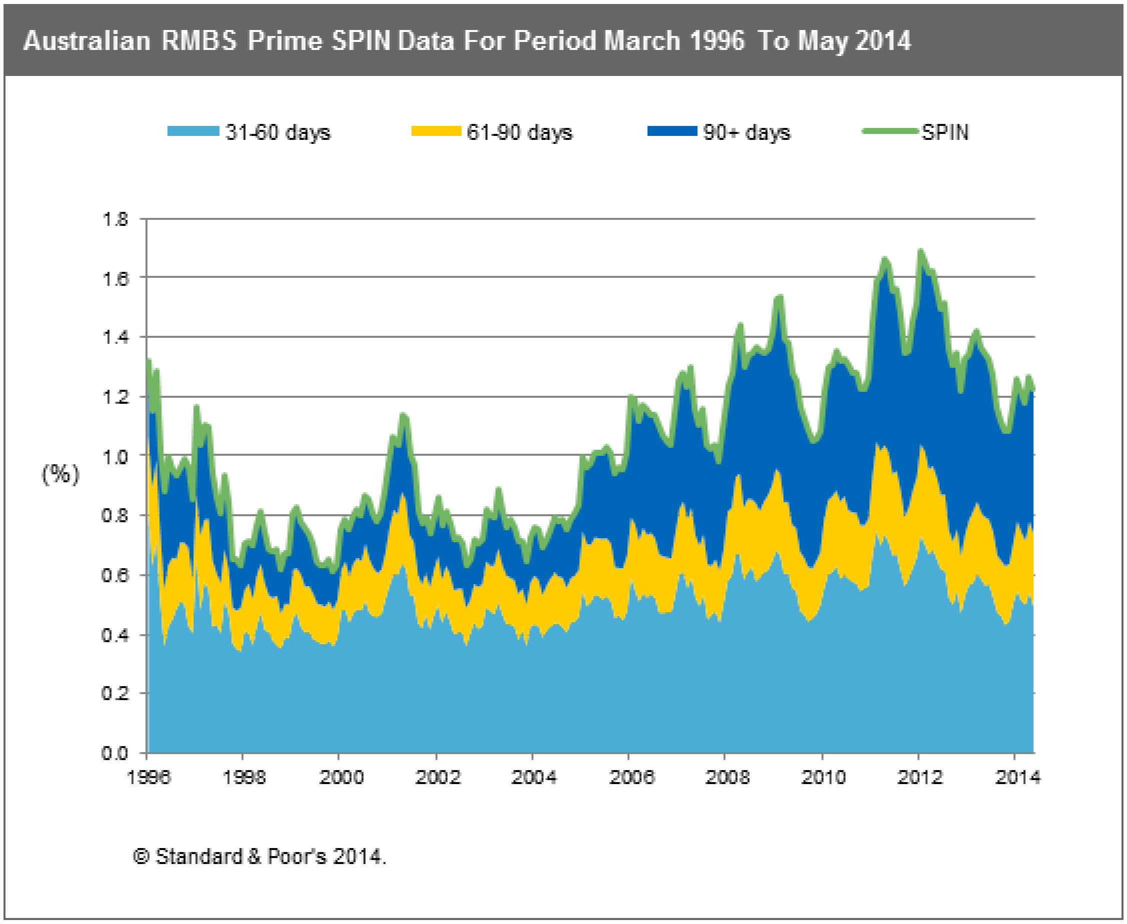
While a return to higher interest rates could still be some way off--with the RBA intimating that interest rates could stabilise for a while--our base case assumption is for interest rates to increase by 100 basis points by year-end 2015 (see Credit Conditions: Challenges Remain For Some Asia-Pacific Sectors In Q2 2014). If we assume income and residential property price growth remain unchanged throughout this period, we estimate that mortgage repayments for some households could gradually increase toward half their disposable income, particularly those households that are either on standard variable lending rates or that transfer to standard from a discounted variable lending rate; we note that in recent years those households on standard variable lending rates were contributing around a further 2%-3% of their disposable income to principle and interest repayments (relative to those on discounted lending rates).

In our opinion, the more likely scenario involves a slowing in residential property price inflation as affordability pressures take hold, with something closer to national income growth. Even still, mortgage repayments for some recent market entrants will continue to absorb a significant proportion of disposable income, leaving them vulnerable to increased mortgage repayment pressures as a result of either rising interest rates or lower income growth.

Australian Banking System Well-Placed As Risks Start to Resurface

The Australian banking system has a relatively high level of exposure to residential property, accounting for about 60% of outstanding credit (Source: Reserve Bank of Australia). This concentration, in our opinion, is a natural red flag and key risk factor facing Australian banks, offsetting the typically lower-risk nature of residential property lending (see chart 6).

Chart 6



As part of our base case expectation we believe short-to-medium term credit pressures are less likely to emerge for Australia's banking system should credit costs rise in response to mortgage repayment pressures. In the first instance, we believe Australian banks are generally well placed to contend with higher risks, should they emerge, as they are well-capitalized by international standards, and, at present, enjoy a very good asset quality experience. Secondly, we expect these pressures that do emerge to be largely confined to recent market entrants; we believe the Reserve Bank of Australia's recent observations--and our own interactions with lenders--indicating increased prepayment activity, is likely to be reflective of broader and more seasoned exposures. Further, Australian banks typically apply an interest rate buffer anywhere up to two percentage points as part of their underwriting, which should ensure many recent entrants are afforded some headroom to absorb a rising interest rate environment, although slowing income growth may negate this somewhat. Finally, loss given default levels are also expected to be tempered somewhat by mortgage insurance coverage, which is a common requirement for higher-leveraged exposures in Australia.

However--and while we consider the following scenario to represent more of a tail risk event--if mortgage-repayment pressures and/or a broader retrace in residential property prices, which is likely to be accompanied by or in response to higher unemployment and materially slower growth, was to emerge, we would expect negative rating pressures to emerge across Australia's banking system.

Standard & Poor's continues to monitor other emerging issues that may impact bank ratings in Australia, including bank resolution developments and others that may arise stemming from the Australian Financial System inquiry.

Related Research

- Australian Banking Sector Outlook: Ratings Resilience Anticipated For 2014, Feb. 11, 2014
- Credit Conditions: Challenges Remain For Some Asia-Pacific Sectors In Q2 2014, June 9, 2014
- A China Hard Landing Would Risk Downgrades For Australia's Financial Institutions' Ratings, Aug. 11, 2013
- No Impact On Australian Financial Institution Ratings Following The Australian Financial System Inquiry's Interim Report, July 23, 2014

*Assumptions: Median household disposable income (capital cities only) estimated in 2009-10 at ~66,300, which is equal to the median gross household income (source: ABS Household Income Survey) less income tax and superannuation and life insurance expenditures (source: ABS Household Expenditure Survey). Median household disposable income estimated in 2010-11 at ~73,300, which is equal to the median gross household income (source: ABS Household Income Survey) less estimated income tax and superannuation and life expenditures, which have been inflated by the same growth rate in median gross household income (during 2010-11). Median household disposable income as at May 2014 estimated at ~82,750, which is equal to estimated figure in 2010-11 and inflated by growth in gross disposable income since then, including estimates for April 2014 through to June 2014 (Source: ABS National Accounts).

Mortgage repayments (on a 25-year loan) have been calculated by taking the prevailing median aggregate capital city dwelling price (source: RP Data Rismark) and the prevailing discounted variable housing loan rate (source: RBA), and assumes a loan-to-valuation ratio of 80%.