## Banks - a look behind the curtain

October 2021

- Financial stability is important – banks can magnify or minimise economic shocks.
- Reforms post GFC meant the banks were able to withstand the pandemic and help offset its impact.
- More capital and changes in funding were crucial – APRA stress tests underline bank resilience.
- Watch the property market – property is the Australian banks biggest exposure.
- Lending to sectors most exposed to the pandemic is relatively small.

Banks have always been something of a polarising topic of debate in Australia. We either love'em or hate'em. But all would agree that banks are an essential component of a modern economy:

- The banks bring savers and borrowers together in a way that allows the economy to efficiently allocate resources, to grow more rapidly than otherwise and contribute to higher living standards.
- The banks provide a safe haven for savers.
- The banks, as intermediaries, reduce information costs for savers and borrowers.
- The banks ensure transactions are processed quickly and efficiently through the payments system.
- The banks are a key conduit for monetary policy and macroprudential (regulatory) policies.

These key roles mean that the banks have the power to *magnify* or *minimise* shocks to the economy. It is why policy makers such as the Australian Prudential Regulation Authority (APRA), the Reserve Bank of Australia (RBA), Australian Securities & Investments Commission (ASIC) and the Australian Treasury worry so much about financial stability.

And, of course, the regulators (and investors) have had plenty to worry about in recent times. The pandemic, the ensuing policy response and associated economic fallout provided a major "stress test" for the Australian financial system.

The banks were not immune to the stresses in play. But the good news is that the banks ultimately passed the stress test and emerged in pretty good shape. In the words of the RBA's recent *Financial Stability Review*, "financial systems have remained resilient – despite the ongoing effects of the COVID-19 pandemic – and are supporting economic recoveries".

## The big picture

Concerns about financial stability were elevated at the start of the pandemic. And a significant part of the policy response was designed with the idea of financial stability in mind.

The RBA, for example, cut interest rates, partly to ease loan interest payment strains. They established a Term Funding Facility to provide banks with "cheap" money. APRA "guided" the banks to limit payments to shareholders. Capital positions improved as a result. The banks also helped cushion households and businesses by offering temporary loan repayment deferrals. Team Australia at work!

Financial markets did what they normally do. And that was price in the worst-case scenario. Chart 1 tells the story. The Oxford University Index of Policy Stringency measures the number and strictness of government policies designed to deal with COVID-19. The Index is a useful indicator of the evolving pandemic, policy response and economic fallout. A fall means more stringent policy settings. Bank share prices closely tracked the ups and downs of the Index in 2020 and the first half of 2021. But a distinct divergence became apparent from mid year as it became clear the banks were faring much better than expected.

The banks were not immune to the negatives at work, of course. There was an increase in arrears and non-performing loans in 2020 (Chart 2, previous page). But loan performance subsequently improved through 2021.

Bank profitability reflected these evolving dynamics.

**Chart 1**

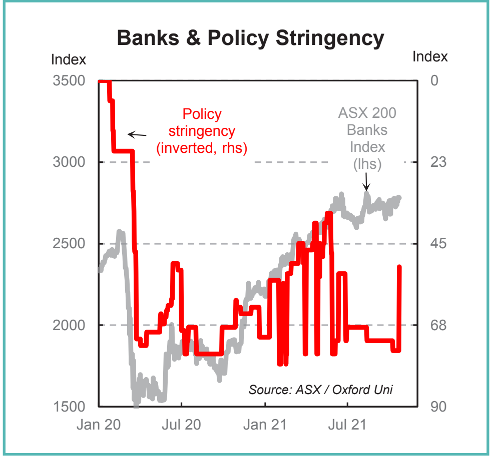
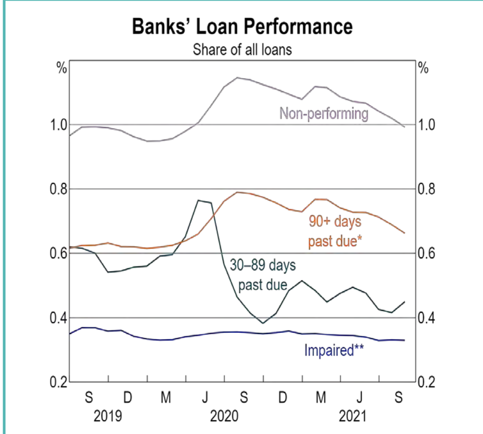
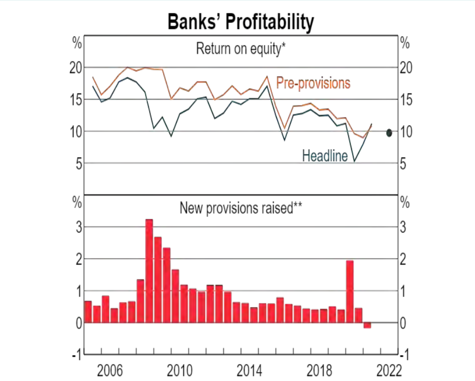



**Chart 2**




* Loans where payments late by 90 days or more and well collateralised
** Loans 90+ days past due and not well collateralised or where repayment is doubtful
Sources: APRA; RBA

**Chart 3**




* Dot represents forecast based on 12-month forward earnings
** Bad and doubtful debt charge as a share of average assets
Sources: APRA; RBA; Refinitiv

Bank profitability was hit in the initial phases of the pandemic as provisions for bad and doubtful debts were increased (Chart 3). But the economy and financial system dodged the pandemic bullet and profits recovered quickly.

The return on equity is back to pre-pandemic levels and, based on 12-month forward earnings, expected to stay there (black dot on Chart 3).

Wider net interest margins as funding costs fell helped (Chart 4). And there is a payoff for bank prudence. Provisioning for much worse outcomes than actually occurred is now being wound back, helping headline profits.

The better-than-expected outcomes reflected:

- underlying strength in balance sheets;
- the rapid recovery post initial lockdowns;
- policy support.

## Double vaxxed

The underlying strength of bank balance sheets was the dividend from the changes that followed the global financial crisis in 2007-09. The regulators ensured the banks were “double vaxxed” in the post GFC world by lifting capital ratios and changing funding composition.

CET1 capital is considered the highest quality capital. There are no repayment or distribution obligations on CET1. The international standard minimum CET1 capital ratio is 4.5%. APRA has added a buffer to this because they want the Australian banks to be “unquestionably strong”. That brings the ratio up to 10.5%. And then the banks have added their own margin for error. The current CET1 ratio is over 12% (Chart 5).

Over the same period, bank funding has shifted in a way that involves more “sticky” deposits. Domestic deposits now account for 60% of bank funding (Chart 6). Bank exposure to (perceived riskier) wholesale funding markets is now lower.

Given strong capital positions, APRA removed restrictions on banks’ capital distributions. Some banks have initiated share buybacks and increased dividend payments as a result.

## Blowing up the bank

Regulators are paid to worry. And one expression of that worry is the never-ending series of stress tests they impose on the banks as they try to “blow up” the balance sheet. These tests were particularly stringent during the pandemic.

**Chart 4**

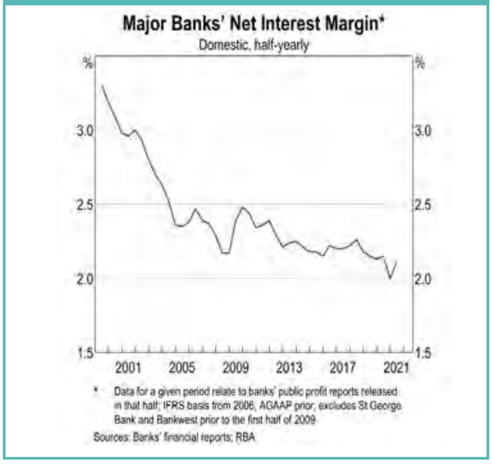



**Chart 5**

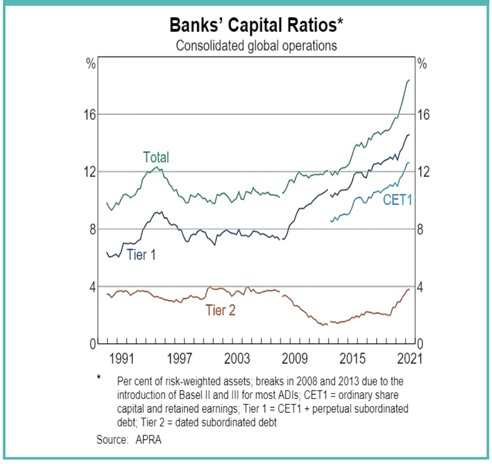
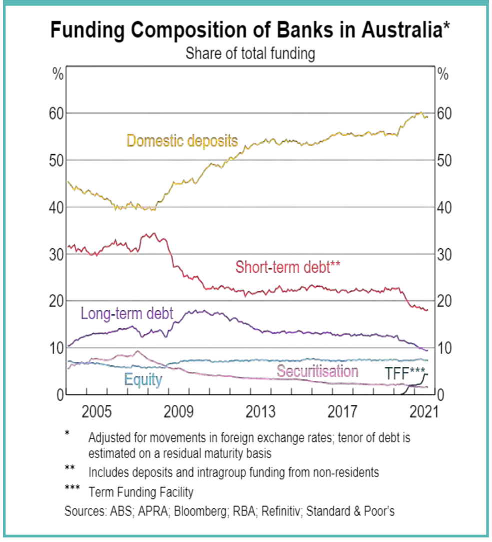



**Chart 6**



The worst case "Severe Downside Scenario" developed by APRA involved:

- GDP falling by 15%;
- unemployment rising to over 13%; and
- house prices falling by more than 30%.

Capital ratios would fall but are sufficient to absorb the losses in the Severe Downside Scenario (Chart 7). APRA concluded that the test results showed "the banking system is well positioned to withstand a very severe economic downturn".

## Paying the piper?

One effective policy response to the pandemic was the RBA's Term Funding Facility. The banks hoovered up some $180bn of funding at 0.1%. But this money has to be repaid in 2023 and 2024 (Chart 8). It will be a sizeable task (4% of overall bank funding). But bank liaison envisages little difficulty in replacing the funds.

The other funding issue investors should think about is Australia's move into a current account *surplus*. This topic was the focus of an *iPartner's* piece back in June.

The current account balance measures the gap between domestic savings and investment. The typical *deficit* recorded in Australia for most of the period since 1788 required net borrowing from the rest of the world (Chart 9). But a surplus means we are now net lenders. Our exposure to the whims and tantrums of global funding markets is reduced.

There are some other important implications for financial markets and investors:

- Countries with current account surpluses are often viewed as less risky because they are not reliant on global funding markets. They are often viewed as "safe-havens" in times of financial stress. Interest rates, on average, are lower than in countries that run deficits.
- Countries with surpluses tend to have "stronger" currencies for much the same reasons. The risk of precipitous depreciations is seen as less likely. The overall volatility of these currencies is lower as well.

## What to wacth - Pt 1

One early-warning indicator of financial system stress worth watching is the "credit gap" developed by the BIS. It's based on the idea that what is important is the size and speed of any move in credit from "normal levels". This indicator is sending benign signals at present (Chart 10). It's also worth watching because it was co-authored by RBA Governor Phil Lowe.

**Chart 7**

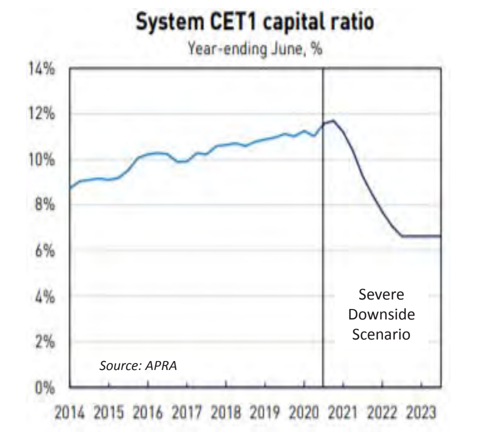



**Chart 8**

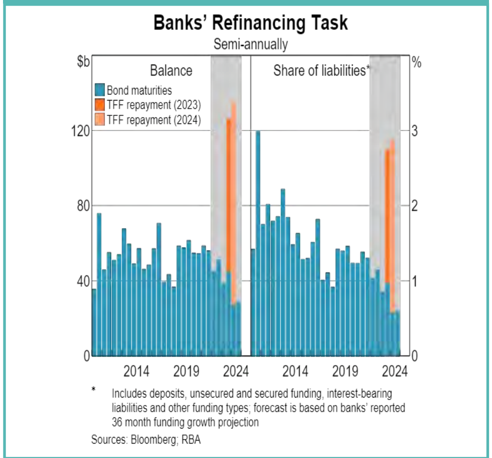
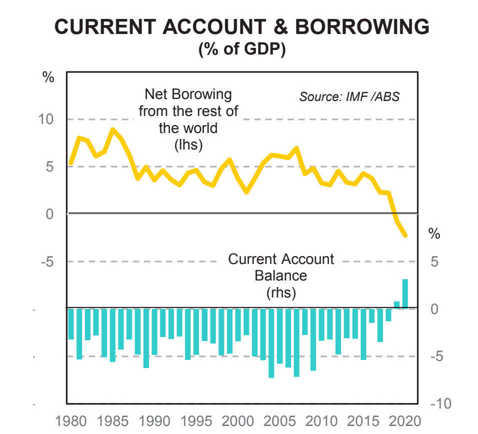



**Chart 9**



No doubt he has the latest version in his chartpack!

The other area to watch is the property market. It is the banks biggest exposure (Chart 11). Residential property accounts for 66% of bank books. And commercial property a further 8%.

Residential property is especially in focus at present given there is a housing boom underway.

We shouldn't be surprised about the boom. If you slash interest rates to near zero then housing lending and prices will respond. But there is a prevailing view that somehow the Australian housing market is different. And riskier.

There is little difference in reality. Housing lending has picked up in many countries (Chart 12). And so have house prices (Chart 13). The Australian experience sits in the middle of the range on any global comparison.

## The macroprudential blowtorch

Nevertheless, the strength of the Australian housing market produced the inevitable concerns about financial stability.

Despite these concerns, the RBA is clearly reluctant to use interest rates to cool the market. And despite these concerns, APRA notes that the banks have maintained lending standards. Nevertheless, they have taken a step down the macroprudential path by lifting the interest rate margin on loan serviceability.

What should also be noted is that the issues that generated a macroprudential response back in 2014-17 are notably absent. Back then, the regulators worried about too much investor activity, too much interest-only lending and too many high LVR loans. The share of lending in all those categories is declining at present (Chart 14).

The implication is that the main risks to financial stability (and the banks) come from the economy – either a negative income shock or a drop in dwelling prices. These economic shocks then feedback into bank balance sheets and create a financial stability risk.

Neither of these risks is the central case at present.
The consensus is for a decent economic rebound and falling unemployment as lockdowns end. The RBA sees little in the way of upside inflation risks. And they insist that any interest rate rises are unlikely before 2024 at the earliest.

The consensus among economists at the major banks is that Australian house prices will rise by 20% in 2021 and a further 5% in 2022 (Table 1).

**Chart 10**

**BIS Credit Gap**
**(devaition of credit:GDP ratio from trend)**

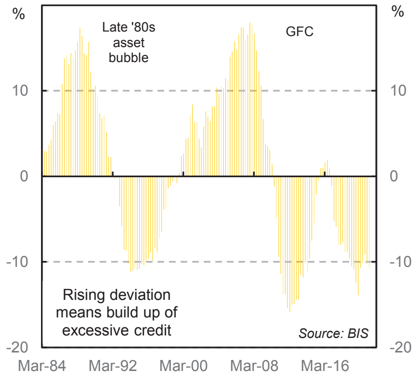



**Chart 11**

**Bank Real Estate Exposures**
**(% of total loans)**

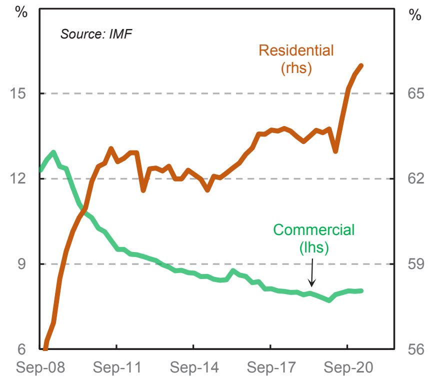
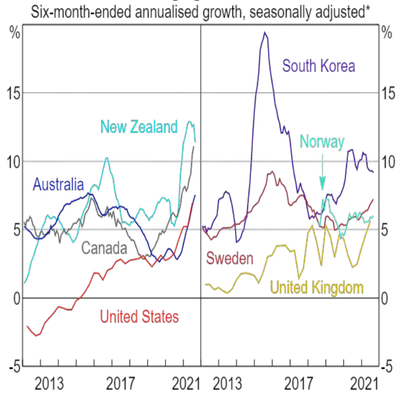



**Chart 12**

**Mortgage Credit**
Six-month-ended annualised growth, seasonally adjusted*




* Data for the United States and United Kingdom are two quarter annualised rates

Sources: national sources; RBA; Refinitiv

**Table 1: Dwelling Price Forecasts (%pa)**

| | 2020 (a) | 2021 (f) | 2022 (f) |
|---|---|---|---|
| Sydney | 3 | 24 | 5 |
| Melbourne | -1 | 18 | 7 |
| Brisbane | 4 | 21 | 8 |
| Adelaide | 6 | 17 | 6 |
| Perth | 2 | 12 | 6 |
| Hobart | 6 | 23 | 6 |
| Darwin | 9 | 19 | 7 |
| Canberra | 8 | 24 | 8 |
| **Australia** | **2** | **20** | **6** |

*Source: CBA / NAB / WBC / ANZ*

Increasing the safety margin on the interest rate used to assess loan servicing ability will reduce borrowing capacity. If maximum loan size is reduced, then the flow of lending into the housing markets should slow. And housing conditions should cool. Bank lending and profitability could be lower as a result. But the recent CBA results throw some doubt on this conclusion.

CBA's analysis of its book shows that only 8% of borrowers take out the maximum loan (Chart 15). Most borrowers don't. So while maximum loan sizes may be lower, actual borrowing could be little affected.

The CBA results also show that borrowers have been taking out their own form of insurance as well. Many borrowers kept repayments unchanged as mortgage rates fell in recent years. They have built up a significant repayment buffer as a result. Some 34% of CBA borrowers are more than two years ahead in their repayments (Chart 16).

It's also true that 37% of CBA borrowers have less than 1 month's protection. But that share reflects new borrowers (who haven't had time to build a buffer), investors (who want the tax benefits) and structural issues (those on fixed rates where additional payments are not allowed).

## Commercial property

Commercial property exposures remain a risk to financial stability and the banks. But overall exposures are low and lending standards have been maintained.

Overall, the regulators don't seem particularly concerned.

**Chart 13**

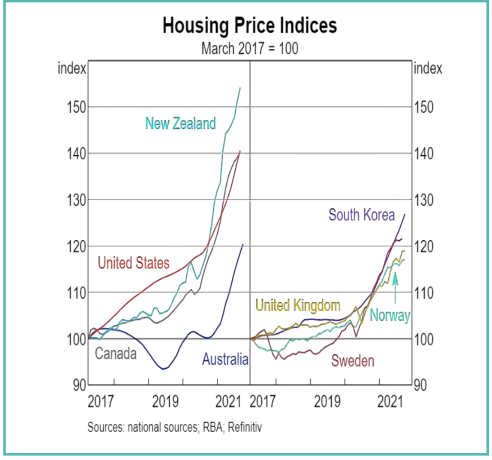



**Chart 14**

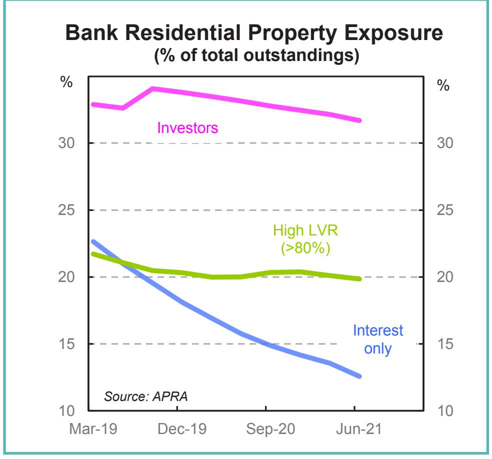
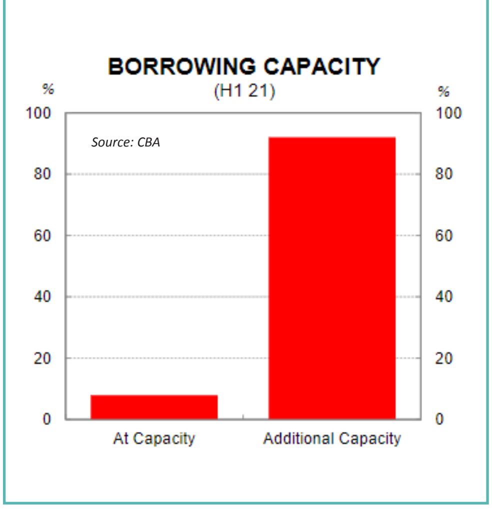



**Chart 15**



The two areas most exposed to the pandemic are offices, as we all work from home, and retail, as we all shop online.
The resultant risks are:

- offices - valuations look high relative to fundamentals like rents (Chart 17); and
- retail – vacancy rates are elevated in most property types - and especially in central business districts (Chart 18).

A lot of the activity in the office space actually reflects foreign buying (Chart 17). And a larger-than-usual share of lending activity in the commercial property space has come from foreign banks. The domestic banks have been relatively restrained in their commercial lending in the post GFC period (Chart 19).

## What to watch - Pt 2

One interesting admission during the pandemic came from Google. It seems they really do know where you are!

They have used the data collected by apps such as Google Maps to see how the public's movements have changed during the pandemic relative to a pre-COVID baseline.

The data shows a sharp pull back in mobility around workplaces and recreation & retail associated with the various pandemic-driven lockdowns (Chart 20). But recoveries have followed previous lockdowns. And the early indications from the NSW data post the latest lockdown are encouraging.

## Beyond property

It is not all about property. Banks do lend to other sectors as well. And here it seems that the banks have been lucky.

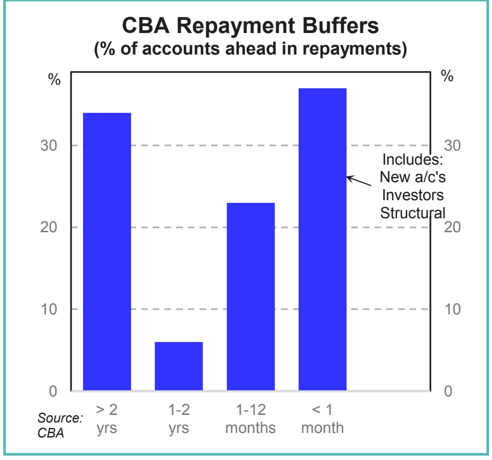
The industries most affected by COVID-19 – such as accommodation & food, healthcare, education, IMT, and arts & recreation – account for a relatively small share of bank lending (Chart 21).

## The hidden message

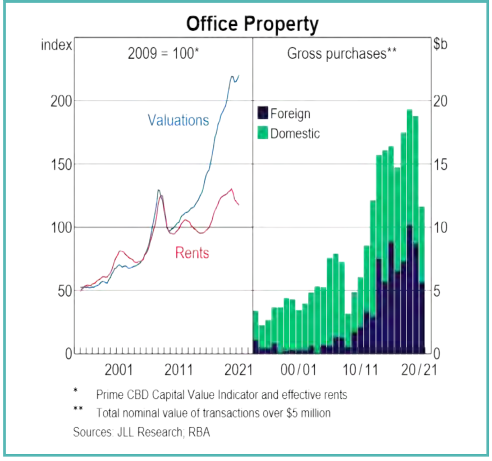
One of the surprising outcomes of the past year or so is the decline in business insolvencies and personal bankruptcies (Charts 22 & 23).

The drop partly reflects policy actions. Temporary business relief measures and income support gave helped.
So insolvencies and bankruptcies may just be lagging indicators - with the bad news still to come.

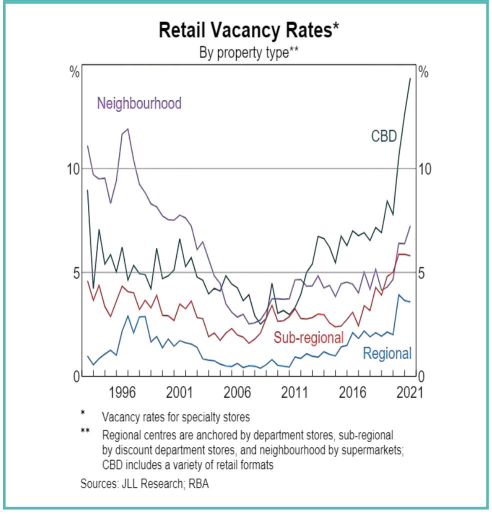
### Chart 16




### Chart 17




### Chart 18



But the hidden message in these outcomes is that policy makers are on the job. They know what to do. And they are well placed to deal with issues as they arise.

## New risks

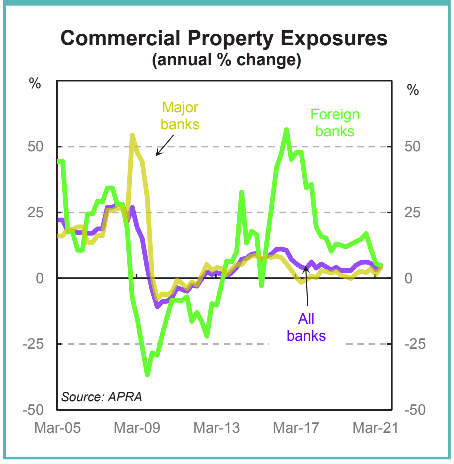
Cybercrime and climate change are not new risks. But the amount of attention these risks are now receiving from the financial regulators is.

Data from the Australian Cyber Security Centre shows financial sector cyber incidents had a greater impact in 2020/21 than in the previous year (Chart 24). The RBA has noted that "a significant cyber event that has the potential for systemic implications is at some point inevitable".

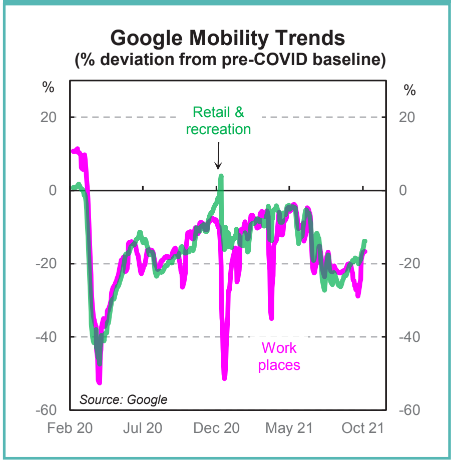
Climate change can affect the banks via any impact on asset values and income streams. The outcome is uncertain. But APRA is stress testing the banks through its new Climate Vulnerability Assessment program.

Meanwhile, I'm off to renegotiate my home loan!

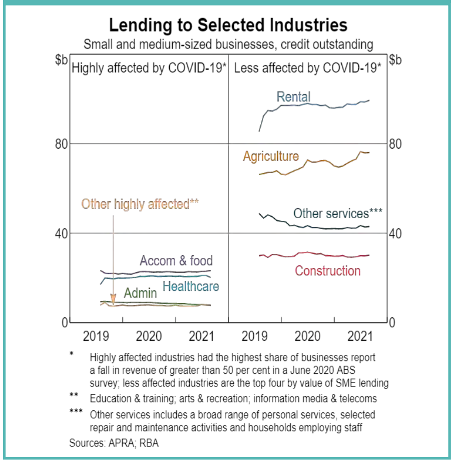
### Chart 19



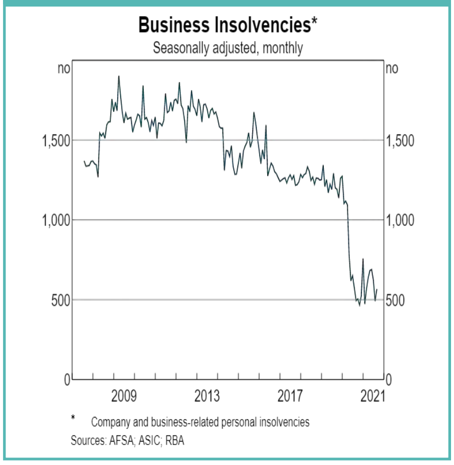

### Chart 20



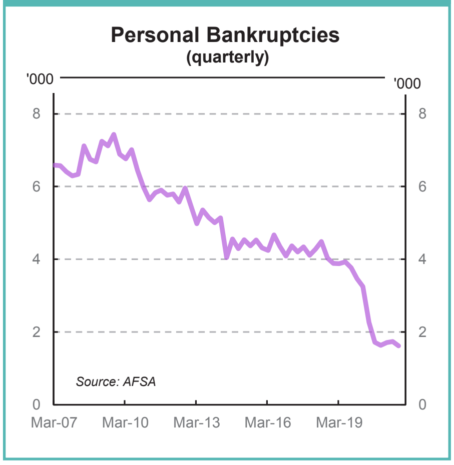

### Chart 21



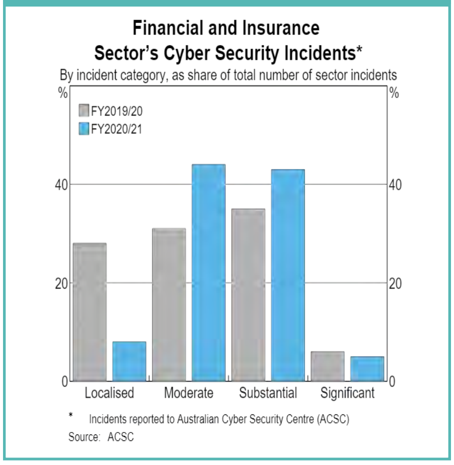

### Chart 22




### Chart 23




### Chart 24



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