Concern over Australian banks’ stability if housing bubble bursts

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The fact that the Australian financial system did not experience a meltdown or even significant bankruptcies as a result of the 2008 global financial crisis was hailed by politicians and media pundits as proof of the soundness of the country’s banks and financial regulation, in contrast to those elsewhere.

This was always a fiction. The seemingly “exceptional” experience of the Australian financial system had nothing to do with the control exercised by the regulatory authorities but was the result of its particular relationship to the global economy. Australia is a net importer of capital and finance, rather than an exporter.

Consequently, the Australian banks were not investing in dubious financial assets placed on the market by various US finance houses as took place in some other countries. Their chief activity was raising money on international markets in order to finance loans to their clients, with the result that around 40 percent of their funds came from that source.

The global crisis did not bypass Australia as maintained by the official mythology. It just manifested itself in a different way. In early October 2008, the major banks found they could not raise any money on international markets to roll over their debts. Had the funds cutoff continued they were just a few days from insolvency. They were only able to resume international borrowing when the Rudd Labor government provided a guarantee it would stand behind them, allowing them to borrow a total of $120 billion.

It has now emerged this was not the only problem facing the banks. This week the Australian Broadcasting Corporation (ABC) current affairs program “7.30” revealed that before the financial crisis the Australian Prudential Regulatory Authority (APRA) feared that lending standards had become so lax the banks faced the risk of an unprecedented rise in mortgage defaults.

Over the preceding period there had been a major shift in the banks’ loan activity. In 2000, every $1,000 of home lending was matched by the same amount for business. By 2010, the proportions were $1,000 to $600. In 2000, home loans comprised 43 percent of the lending of Australia’s four major banks. By 2010, this had risen to 57 percent and had become the major source of bank profits.

According to ABC reporter Stephen Long, who gained access to the unpublished APRA analysis, the regulator found that on the eve of the 2008 crisis, the banks had lowered lending standards so far that they “had been able to issue nearly three-and-a-half times as many loans as they otherwise could have.” About 14 percent of the loans were not serviceable when they were approved.

APRA forecast a “massive and unprecedented rise in the number of people who couldn’t make their home loan payments, with a 75 percent home loan delinquency rate in September, 2009” if the economic environment remained unchanged.

However, that environment did change dramatically with the onset of the global crash in September 2008. Ironically, this actually averted a home loan crisis in Australia as the Reserve Bank drastically lowered official interest rates, from 7 percent to 3 percent, the Labor government initiated a stimulus package and the government’s loan guarantee staved off a liquidity crunch.

But there is a growing sense that the housing finance crisis that could have erupted seven years ago has only been deferred, and is set to return in a more explosive form. Since the 2008 crisis, the level of household debt in Australia has risen to 130 percent of gross domestic product (GDP), compared to a global average of 78 percent and is the highest in the world.

While incomes have stagnated—there has been barely any rise in real wages for the past four years—mortgage debt has almost doubled, to $1.4 trillion, since APRA made its earlier warning.

Interviewed for the ABC program, Steven Munchberg of the Australian Bankers’ Association gave the standard response when questioned about this situation. He did not believe there was a crisis because Australians traditionally put a lot of their savings into housing. And while there were high house prices, “that’s something that’s monitored very closely by both the banks and the regulators.”

This view is increasingly being questioned internationally. In February, UK-based economist Jonathan Tepper issued a report stating that Australia was in "one of the biggest housing bubbles in history." Over the past few years, some 40 percent of mortgages were interest-only loans, taken out as a form of investment in the expectation that house prices would keep rising. He described this "Ponzi scheme" as a "disaster waiting to happen."

Last month, the business magazine *Forbes* published an analysis by Australian economist Steven Keen in which he placed Australia among the top seven countries likely to experience a debt crisis in the next one to three years. Keen based his list on countries where the private debt to GDP ratio exceeded 175 percent and where the increase in debt over the past year exceeded 10 percent.

Keen has warned for some time of an unsustainable housing bubble and has made previous predictions about a collapse that have not been fulfilled. Consequently, there has been a tendency to dismiss his latest analysis. But the fact that it was taken up by a well-known international business publication shows that concerns are growing.

Responding to the Keen-*Forbes* analysis, Capital Economics chief Australia and New Zealand economist Paul Dales told the *Australian Financial Review* that the risk of a debt crisis could be receding. While total Australian debt was 205 percent of GDP and had risen by 13 percentage points in a year, borrowers had money in offset accounts, he claimed. The real problem would only start to emerge when the Reserve Bank of Australia began to raise interest rates.

The notion that homebuyers have money tucked away is another convenient fiction. In both Melbourne and Sydney, Australia's two largest cities, where house prices have risen at rapid rates, working class as well as middle class families are on a knife edge as they seek to pay off loans which can range anywhere from half a million to a million dollars. The median price for a house in Sydney is already around the $1 million mark.

Even a small rise in interest rates, a period of unemployment for either member of a married couple, a period of illness or some other financial problem could create a financial disaster.

Having sat on its hands while the housing boom escalated, there are signs that even the regulatory authority APRA is worried. It has been putting pressure on the banks to increase their capital ratios to combat the impact of any property downturn.

Last Friday, APRA's executive general manager of supervision and support Charles Littrell said the concentration of lending by the four major banks was of "perpetual concern" to APRA. "It is a significant issue of concern to us that close to two thirds of [the big four banks'] balance sheets are exposed to property—mainly housing loans."

In the past year, Littrell continued, this concern had grown because of "the point we are at in the cycle." This was a reference to signs of a downturn in the housing and property markets, with prices and rents starting to stagnate or even fall in Melbourne and Sydney.

APRA chairman Wayne Byres said conditions were "eerily similar" to those of 2008.

Last week, there was a "whiff of fear," as one commentator put it, about the position of the banks when ANZ, one of the big four banks, announced it was increasing its provision for bad debts by $100 million. Westpac, another member of the big four, announced its bad debts were also rising. Apart from property, the banks are being impacted by the downturn in the mining industry.

The increased ANZ provision was a drop in the ocean compared to its overall balance sheet, yet it triggered another 10 percent fall in the share prices of the major banks, which have already dropped substantially since mid-2015. This is a sign that the situation is more serious than official pronouncements indicate.

After initially lowering their dependence on overseas financial markets following the 2008 crash, the banks have returned to the model of financing lending by overseas borrowing, taking their global exposure to an unprecedented 53 percent of GDP.

With ongoing worldwide financial turbulence, and the end of the China boom, the crisis that was previously averted could be re-emerging.