S&P downgrades small banks amid warnings of Australian housing slowdown

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International credit ratings agencies and financial commentators have stepped-up their warnings that the super-inflated Australian housing market may be on the precipice of a major slowdown. Fears are mounting of a broader crisis in the financial system, which is heavily exposed to mortgage debt.

On Monday, ratings agency Standard and Poor's (S&P) downgraded the credit quality of 23 Australian financial institutions, including the bulk of the country's regional and rural banks.

S&P explicitly linked the move to the danger of a "correction" of the housing market. In a note outlining its decision, it stated: "[E]conomic imbalances in Australia have increased due to strong growth in private sector debt and residential property prices in the past four years."

Housing prices have doubled in Sydney and Melbourne, the centre of the east coast housing bubble, over the past eight years. Median house prices in Sydney are over $1 million, while in Melbourne, they are more than $900,000.

The boom has been financed by a frenzy of domestic and overseas investment, fuelled by interest rate cuts by the Reserve Bank and the policies of successive governments, Labor and Liberal-National alike, which have promoted speculation.

S&P continued: "[W]e believe financial institutions operating in Australia now face an increased risk of a sharp correction in property prices and, if that were to occur, a significant rise in credit losses."

The ratings agency commented on the extent to which the financial system as a whole is exposed to the property market, noting that residential home loans constitute around two thirds of bank lending assets.

The downgrades were relatively minor, and the country's big four domestic banks were not among those targeted. Unlike the smaller regional banks, it is likely that they would be propped up by the government in the event of a financial crisis, as they were in the aftermath of the 2007–08 economic crash.

S&P warned, however, that in the event of a housing slowdown, "all financial institutions operating in Australia are likely to incur significantly greater credit losses than present." The *Australian Financial Review* declared in an editorial that the smaller banks were the "housing canaries," and raised the prospect of a crisis for the major banks if they were not backed by the government in the event of a property crash.

The downgrades followed a particularly blunt assessment of the housing market by JCP Investment Partners, one of the country's largest fund managers, in a proprietary report that was extensively cited in the *Australian Financial Review*.

JCP commented that "as exuberance towards the Australian home grew to now irrational levels, the old credit rules of thumb appear to have been left by the wayside."

It noted that whereas in the past, standard procedure was for the banks to loan no more than three times gross income, the average for residential loans was now six times income. The report drew particular attention to loans to young professionals, numbers of whom have a debt greater than seven times their income. According to HSBC, Australian debt to income ratios rose from 167 percent in 2011, to 190 percent in the final quarter of last year.

The JCP report pointed to the rise and rise of interest-only loans, which do not require the borrower to pay off any of the principal for a fixed-term of up to seven years. According to earlier figures, such loans make up around 40 percent of all housing loans, and close to 60 percent of loans to investors.

JCP stated that "interest-only could be Australia's sub-prime," drawing a comparison with lending practices that played a key role in precipitating the 2007– 2008 financial crisis. The report noted that all institutions are exposed to risky interest-only debt. It commented: “Interest-only loans proliferate throughout the mortgage book, across cohorts and circumstances.”

The report anticipated a collapse of the housing bubble, predicting “smaller mortgages deleveraging, flat-to-decreasing house prices and exuberant-to-melancholic animal spirits [that] will likely expose much bad lending behaviour.”

The contradiction between stagnant or declining incomes and rising house prices has been underscored by the latest wage figures, released this month, which showed growth of just 1.9 percent, for the year to March. The figure, a historic low, is well below the rate of inflation. The widening divergence is creating a crisis for millions of heavily indebted home owners.

A study by Digital Finance Analytics at the beginning of the month found that 767,000 households were in mortgage stress in April, up from 669,000 the previous month.

Some 32,000 households are currently unable to meet repayment demands with their current income and an estimated 52,000 more are at risk of defaulting on their loan next year. S&P reported that mortgage arrears of more than 90 days were up in March to 0.62 percent of all housing loans, compared to a figure of half a percent for most of the past decade.

Renters, who are faced with the flow-on consequences of the rise in house values, are being priced out of the market. This month’s Rental Affordability Index found that average rent was 29 percent of income across Sydney. According to most measures, 30 percent or more of income on housing costs constitutes “rent stress.”

The report, conducted by SGS Economics & Planning, stated that rental affordability is at an unprecedented low in Sydney, with pensioners, students and the unemployed unable to afford virtually all dwellings, and working families increasingly having to move to outlying areas of the city.

Regulatory and government authorities, which have promoted the boom, are now caught in a dilemma. Any attempt to cool the market, including through interest rate hikes, could precipitate a full-scale collapse of borrowing, triggering a marked fall in house prices and a crisis for the major financial institutions.

Some commentators warned of these dangers, in response to average falls in house prices of around one percent across the country over the past four weeks. The small decline, which has occurred in all capital cities except Brisbane, was partly on the back of limited restrictions by the major banks on new interest-only loans. The response to the moves, which did not affect existing interest-only loans on the banks’ books, underscored the fragility of the entire market, and its dependence on investor confidence.

The extent to which the property bubble is a product of speculative investment was further pointed to by figures released by *Bloomberg* yesterday, documenting a rise in new residential mortgage-backed securities to $10.5 billion this year, more than double the comparable figure in 2016.

The securities are highly speculative investments, based on a series of mortgages which are packaged into a loan that can be invested in, and traded on. Over half of the securities have been issued by non-bank lenders. Similar practices played a key role in the outbreak of the 2008 financial crisis.

Asked about the growth of the mortgage securities market, Peter Riedel, finance chief of Liberty Financial Pty, a non-bank lender, told *Bloomberg* that there was a need to put “capital to work in an environment where cash isn’t giving you any return at all.” In other words, the turn to speculation is bound up with the deepening crisis of the real economy, and fears that productive investments will not yield sufficient returns. Corporate investment in new equipment, buildings and machinery fell in each quarter last year.

This reality highlights that the various cosmetic housing policies in the federal Liberal-National government’s budget, along with those put forward by the Labor Party opposition, will do nothing to avert a “correction” of the real estate market. A collapse of the speculative bubble would wipe out hundreds of thousands of construction and related jobs and have catastrophic consequences for millions of homeowners.