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50 per cent of Australian bank capital could vaporise

Last week's bank ratings downgrade was largely a side effect of Australia's historic housing bubble and the over-extended banks that feed it. Standard & Poor's stated that the increase in its economic risk factor which triggered the rate cut was the result of growing household debt, of which the major factor is the overinflated family mortgage, making our financial system vulnerable. An OECD report released in March found Australia's ratio of household debt to GDP is the third-highest in the world at 123 per cent, which along with other economic factors has created "extreme vulnerabilities". S&P also pointed to Australia's general economic weakness, including high debt levels and current account deficit.

The S&P review stressed that residential home loans represent two-thirds of bank assets and that a sharp correction in the property market would result in banks incurring major losses. Twenty-three banks, credit unions and finance companies were downgraded as a result.

In a May report, JCP Investment Partners warned that a collapse of the housing bubble could wipe out 17 to 50 per cent of the capital of Australia's major banks. The size of the wipe-out would depend on the severity of the crash. The JCP models, based on varying assumptions, warn of a 50 per cent collapse under their most extreme scenario (not necessarily the worst possible), 20 per cent in an Irish-style housing crash, or 17 per cent in the most conservative scenario.

JCP provides a chart (**Fig. 1**) which shows skyrocketing speculation fuelling the housing bubble, in the form of investor mortgages. The report also says that interest-only loans—which have increased from around 30 per cent in 2012, to 42 per cent—could be Australia's "sub-prime".

Another chart reveals that around half our mortgage debt is held by people whose debt is more than four times greater than their gross income, meaning they are not well placed to pay off this debt, and could easily go into default at any time. The report found that the average loan-to-income ratio is now 6.4:1; once upon a time banks would never lend more than three times a household's income.

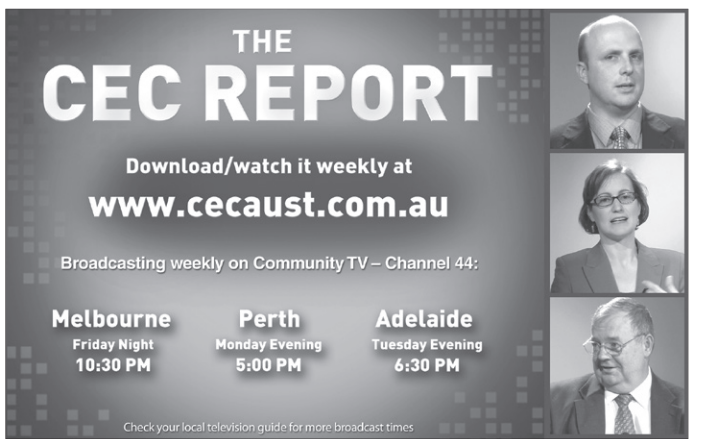

Fig. 1 (Source: *AFR*)

The leaders of the Reserve Bank, APRA and ASIC, among others, have all warned about the overheated housing bubble.

Super exposed

Another danger associated with the bloated property bubble is the heavy exposure of self managed super funds (SMSFs). According to a report by Credit Suisse based on Australian Tax Office figures, by December 2016 SMSFs held around $162 billion worth of direct property investments (not including real estate investment trusts, etc). This was nearly a quarter of all SMSF money, and more than what is kept in either cash or term deposits, which came to $157 billion.

An increasing number of super funds are borrowing to buy property, which magnifies the risk. Buying property through self-managed super funds appears to be heavily promoted by banks and other financial agencies, as well as by the real estate industry.

A growing portion of property investment—super or otherwise—is being directed into commercial real estate, such as supermarkets, fuel stations or child care centres. The headline of the 17 May *AFR* blared "'Insane' commercial property market at risk of correction", and reported the raging appetite for commercial property in Sydney, Melbourne, Brisbane, and even regional areas. In its recent Financial Stability Report the Reserve Bank of Australia also raised concerns.

The fast-growing commercial debt bubble in the USA appears to be collapsing, with lending into the sector in decline. Banks there have tightened standards for commercial real estate loans, on which US$9 trillion of commercial mortgage-backed securities are based, as delinquencies and defaults sharply rise.

The twisted logic of Too Big To Fail

By Elisa Barwick

When Standard & Poor's downgraded 23 Australian financial institutions on 22 May it excluded the Big Four banks and Macquarie because of the "implicit guarantee" provided by the federal government, meaning that the government considers these banks Too Big To Fail (TBTF) and will not let them collapse for fear of the consequences.

There was a twist in S&P's announcement, however, namely that it detects there is a changing sentiment towards the banks, and their TBTF status may not last forever. S&P banking analyst Sharad Jain told the *Australian Financial Review* on 23 May that "Australia is 'highly supportive' [of its banks], but we have flagged there is some degree of negative momentum to move from 'highly supportive' to 'supportive'."

The move by the rating agency follows the government's 2017-18 federal budget proposal to tax bank liabilities. While this could be read as "negative momentum", within financial circles it is widely considered to formalise the previously implicit guarantee of TBTF banks by the government. Further, Australian Bankers' Association (ABA) chief executive Anna Bligh has weighed in to state that the government would not let *any* Australian bank collapse, meaning they are *all* Too Big To Fail. It is doubtful a federal Treasurer would allow any bank to default or close its doors because of the resulting contagion, Bligh said, according to *AFR* on 28 May.

The true "negative momentum" against banks is the increasing demand from all parliamentary parties for serious regulation of the financial sector, the low end of which is the demand for a Royal Commission, the high-end, Glass-Steagall banking regulation. The support for splitting banks such that they may only engage in deposit-taking or speculation, but not both, is gaining ground in Australia both as the collapse of the housing bubble threatens our overextended lenders, and as momentum for the policy, based on the 1933 legislation in America, reaches fever pitch there.

Buried in financial press of the last week are a few clues about the "negative momentum" the ratings agencies are most interested in. At least two agencies indicate they would downgrade the major banks if the government announced it would no longer bail them out, because of movement towards the alternative to bailout—the "resolution framework", otherwise known as "bail-in"—adopted by the G20 and advocated in the final recommendations of ex-Commonwealth Bank CEO David Murray's 2014 Financial System Inquiry.

The fact that ratings agencies would downgrade banks that Murray claims would be "unquestionably stronger" within such a framework—i.e. banks no longer guaranteed by the government because losses will hit depositors and bondholders rather than the taxpayer (or so the theory goes)—proves this is no solution to the TBTF problem at all. Consequently, the ratings of hybrid bonds sold by the major banks fell in the wake of the S&P downgrade, as did their subordinated bonds. These are the instruments considered "bail-inable". Even Murray told the *AFR* on 24 May that it was difficult to reconcile how measures designed to increase stability of the banks could result in a downgrade.

S&P's Jain laments in his discussion with *AFR* that although the government is beginning to move against the banks, there has been no progress towards implementing such a resolution framework: "There has been little action [on these measures] so our base case remains", he said. Fellow ratings agency Fitch announced that it was watching closely to see if moves towards a bank resolution framework would "quantify who would wear the losses in the case of a catastrophe", in the words of *AFR*'s James Frost. Fitch's Tim Roche said moves to such a framework would "potentially change our assumptions around sovereign support". Then, the ratings of the Big Four and Macquarie would be up for revision. In its Policy Outlook for our banks, Fitch says it expects Australia will "ultimately adopt the global [resolution] framework", albeit moving "only gradually".

At the 14-15 November 2015 G20 summit held in Antalya, Turkey, all G20 nations—including Australia—signed up to the Bank for International Settlements' Financial Stability Board (FSB) proposal for a global "bail-in" regime. Described as a "common international standard on total-loss-absorbing-capacity (TLAC) for global systemically important banks", that standard had been, however, considerably watered down before the November 2014 Brisbane G20 due to a concerted campaign by the Citizens Electoral Council to expose the FSB's agenda.

TLAC refers to the categories of a bank's liabilities earmarked to be bailed in when the bank is in trouble. The original plan was that all deposits beyond those guaranteed by the government, and all junior (or subordinated) bonds would be bailed-in, i.e. confiscated in order to keep the banks afloat in the event of a crisis. The CEC generated such an outcry from the population, which led to bad press for this proposal, that just prior to the G20 Leaders' Summit FSB chair Mark Carney announced that TLAC would comprise only so-called *bail-inable bonds*.

Australian banks are not on the list of Global Systemically Important Banks (G-SIBs) covered by the G20 agreement, but as far as Australia's economy is concerned they are systemically important, and this is confirmed by the moves of the ratings agencies. S&P's Jain to *AFR*: "The [major banks] are highly systemically important because [a failure] could have material consequences for the banking system and the broader economy."

Europe introduced its own EU-wide bail-in regime at the beginning of 2016, known as the Bank Recovery and Resolution Directive, but the first opportunity for its use—during the Italian banking crisis—failed. To avoid what would have been enormous popular outrage Italy refused to follow the new protocol. EU banking authorities, aware that the collapse of Italian banks would set off a chain-reaction collapse in the European system, had no choice but to let it slide. At the height of the crisis even Deutsche Bank chief economist David Folkerts-Landau said that "to stick so strictly to the [bail-in] rules would cause greater destruction than setting them aside."

All round, it is clear that robbing people's accounts to deal with TBTF will not work, and in fact poses a greater risk to the banking system. It is time to really end TBTF—with Glass-Steagall.