Bank stocks pricey, but don’t lose sleep over their mortgage lending

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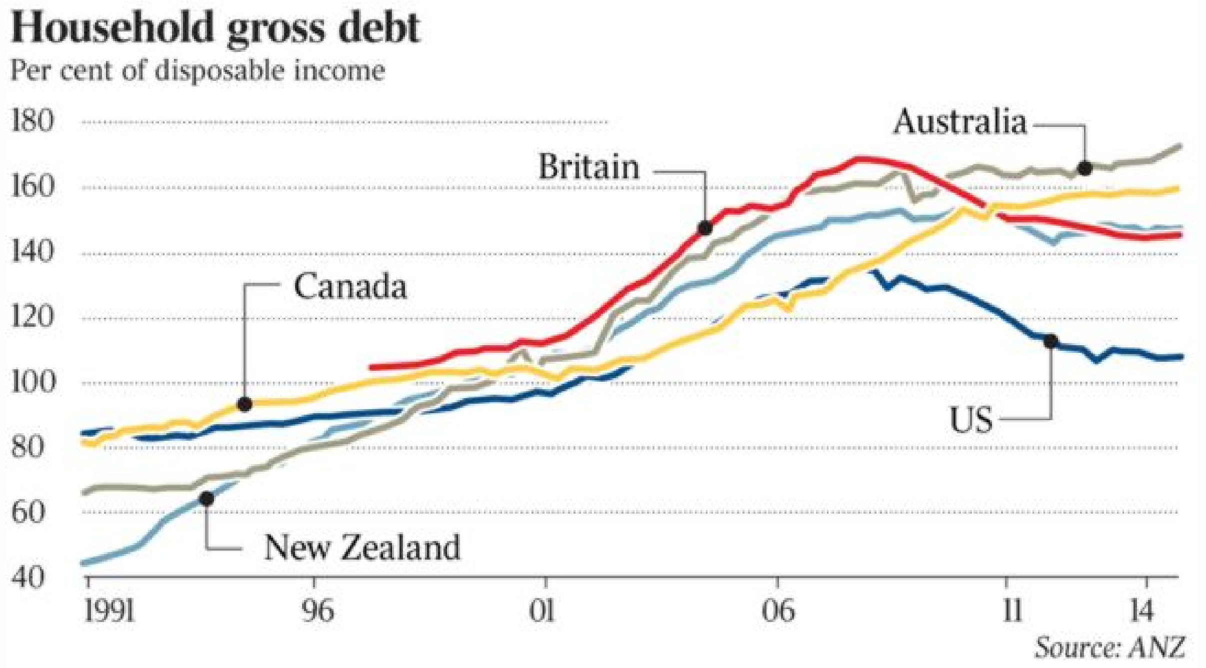

Debt. *Source:* TheAustralian

AUSTRALIAN households hold assets of $9.5 trillion and debts of $2.2 trillion; household net wealth is $7.3 trillion.

Commentators often fret over the liability side of households’ balance sheets, and particularly the level of mortgage debt; rarely is attention given to the assets we hold or the (impressive) statistic of our net wealth. Our households hold more debt, relative to income, than households in comparable countries — and that’s seen as creating problems, among them severe financial stress and the heightened risks facing bank shareholders.

A small minority of borrowers will be financially crushed by their mortgage debts — especially people with heavy borrowing, who bought a house at an over-the-top price, become unemployed, face serious illness or whose partners go through difficult and costly separation.

Currently, mortgage delinquencies stand at less than 0.5 per cent of outstanding mortgages and are trending down — thanks in part to low interest rates. Australians largely avoided the “subprime” borrowings (called “low-doc” loans here) that blighted US low-income households and mortgage providers. Since the global financial crisis, our banks and financial regulators have required more conservative loan-to-valuation ratios on mortgage loans.

People need be aware of the similarities of debt, alcohol and gambling: abstinence is fine; moderation can add some spice and variety to life; but excesses are dangerous.

Another — and very different — concern about the high level of household debt arises from the heavy exposure of our banks to mortgage lending.

The median house price in Australian is, relative to income and rents, among the highest in the world.

Were house prices to take a tumble, banks would face big writedowns and losses, dividends would be cut, and bank shares would plunge in value. Over the years, and particularly in 2014, these sorts of concerns have discouraged a wide range of investors from holding shares in Australian banks.

ANZ Bank recently released an interesting research paper, by David Cannington and Katie Hill, and called "Household debt: a house of bricks or straw?" It takes a close look at the servicing costs of household debt, now and in prospect. The report makes a convincing case that the current level of household debt is "comfortable", given interest rate levels, household assets and growth in household income.

Currently, the average household is making interest payments equivalent to 8 per cent of disposable income; the ratio will fall to about 7.5 per cent following last week's cut in the cash rate. Looking ahead, "there are good reasons to expect households will be able to absorb higher debt servicing ratios more easily than in previous hiking cycles".

Many households are making excess repayments on their mortgages as interest rates fall. Also, balances in mortgage offset and redraw facilities (which are not measured as negative mortgage debt) have built up to 15 per cent of outstanding mortgage balances.

The report cautions that, "while unlikely, household debt stress could be triggered by a sharp increase in interest rates combined with a step-up in the unemployment rate and negative housing equity". Fortunately, that's an unlikely combination of events, at least in the next few years.

As the authors point out, it would take an unlikely severe economic shock, such as another global finance crisis including a sharp increase in funding costs that raised interest rates by 1.5-2 percentage points, an escalation in unemployment and significant falls (of 20-30 per cent nationally) in house prices "to drive an episode of stressed household deleveraging".

In my view, bank shareholders don't need to be losing sleep at this stage of the cycle about the high level of bank lending for housing.

Bank shares are highly valued — but banks are profitable, paying good dividends, and seem likely to be untroubled by their housing loans for the foreseeable future.

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