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Worsening household credit conditions drive Australian and Korean Banks' credit risk higher

by Amrita Parab

- **Rising interest rates, in the face of worsening household credit conditions, catalyze an increase in the credit risk of Korean and Australian Banks as shown by the NUS-CRI Agg PD**
- **Though the credit risk outlook is at a higher level for Korean banks compared to their Australian counterparts, NUS-CRI Agg Forward PD showcases a converging trend**

Rising inflation levels across the Asia Pacific are seeing several economies in the region rapidly raise interest rates in tandem with the global macroeconomic environment. Two economies that have been at the focus of this monetary tightening exercise are South Korea and Australia. Both economies have been experiencing a ballooning housing market since the beginning of the pandemic in conjunction with increasing household leverage. As such, with households now feeling the brunt of the worsening financing environment, pressure is put on the asset quality of banks in both countries. As seen from the NUS-CRI 1-year Aggregate (median) Probability of Default (Agg PD) for South Korean and Australian banks in Figure 1a, credit risk for the sector has been steadily increasing, though relatively muted for Australian banks compared to their South Korean counterparts. The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[1]) in Figure 1b showcases the opposing trends in credit risk outlook over the next 12 months with the Forward PD of the two banking sectors converging above the BB upper bound when referenced to PDiR2.0[2] levels.

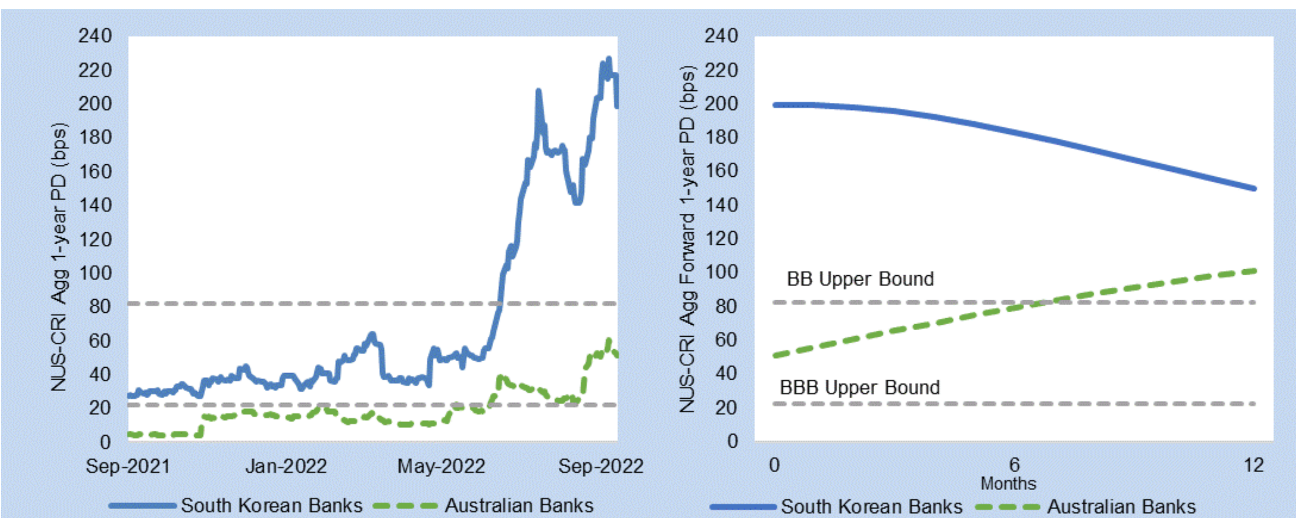

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for South Korean and Australian banks, with reference to PDiR2.0 bounds from Sep-2021 to Sep-2022. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for South Korean and Australian banks as of Sep-2022, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

With rising inflation amidst ongoing supply chain woes, expectations of an aggressive monetary policy stance taken by the Bank of Korea (BOK), and fears of lackluster corporate performance, investor sentiment in South Korea's public markets has been diminishing. Korean banks have seen their market capitalization take a hit, with the KOSPI 200 Financial Index decreasing by close to 18% since the beginning of Jun-2022. Adding to the woes are recession fears that are driven by a hit on household disposable income, which has been depleting due to the increasing debt-servicing burden as mortgage-repayment pressures rise. It is not going to be surprising, given that the market still expects the BOK to raise interest rates over the coming months, to see an increase in pressure on Korean banks' asset quality due to an uptick in NPLs arising from private credit extended

[1] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

to households. With almost 80% of outstanding household loans linked to floating rates, an increase in interest rates has a direct impact on the debt service burdens of households.

A potential silver lining that could aid in mitigating the increase in NPLs across the sector, and reduce the credit risk outlook for Korean banks is their relatively strong fundamentals. Aggregate (median) Tier 1 capital ratio stands at 14.37%, while aggregate net-interest margin stands at 2% in Q2 2022.[3] Though an uptick in NPLs will impact the banks' profitability and loss buffers, government policies, such as the refinancing fund introduced in Jul-2022, which allows applicants to refinance and switch from floating to fixed-rate mortgage loans, can aid in mitigating short-term sustained losses. Furthermore, in an effort to boost their capital ratios, Korean banks have been increasing their issuance of AT1 'CoCo' bonds. As seen in Figure 2a, issuance of these contingent convertible notes, which can be considered as additional tier 1 capital under Basel III, has been increasing to levels already surpassing the amount issued in 2021 during the first eight months of this year, and closing in on the peak issuance witnessed during 2020 at the initial onset of the pandemic. However, it is important to note that pressures are still faced by Korean banks on their balance sheets, especially if a recession occurs should the BOK potentially adopt a more aggressive monetary policy stance. In such an adverse scenario, the credit risk of Korean banks remains well above the BB upper bound when referenced to PDiR2.0, as suggested by the heightened level of the Forward PD in Figure 1b despite its decreasing trend.

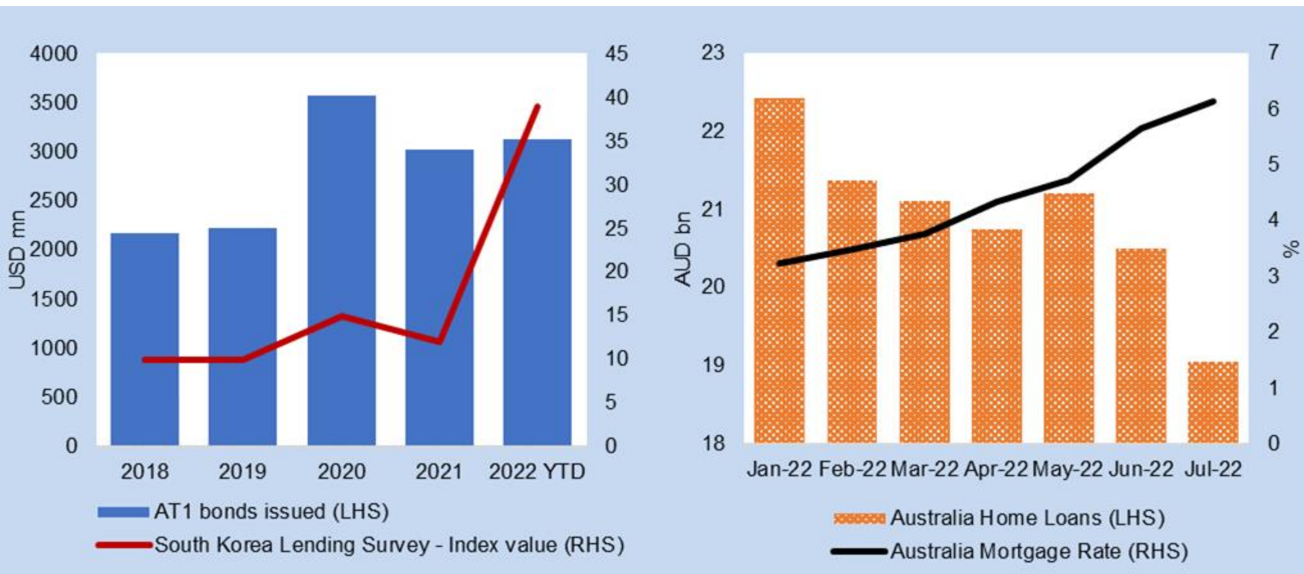

Figure 2a (LHS): Amount of additional tier 1 bonds issued by South Korean banks; South Korea lending Survey - Index value[4]. Figure 2b (RHS): Amount of home loans and mortgage rate for Australia between Jan-2022 to Jul-2022. *Source: Bloomberg, Trading Economics*

Further south, the household debt to GDP ratio in Australia has climbed to 119% as of Q4 2021, the second highest in the world. Similar to the narrative in Korea, the ease of financing post-Covid-19 drove housing prices to peak. Albeit later than the rest of the world, Australia has started to hike interest rates as of May-2022. This hawkish stance is likely to follow through 2022 as the RBA tries to bring inflation under control, consequently affording no reprieve for homeowners. Housing prices falling at the fastest pace since the 1980s signal a slowdown in demand as consumers contend with a higher cost of living amidst higher borrowing costs. An increase in delinquencies across this lending segment as debt service burdens are poised to increase may lead to deterioration in asset quality, worsening the aggregate credit health of the Australian banking sector[5]. Moreover, a slowdown in the mortgage loan market could further weigh on NIMs, especially because Australian banks may not be able to fully leverage on increasing rates, considering that 40% of their outstanding loans bear a fixed interest rate. However, given that the RBA is lagging in its rate hike schedule relative to the rest of the world, the downside is likely to come through over the next few quarters as corroborated by the Forward PD in Figure 1b.

Presently, with 40% of the loan book on fixed-rate loans, many borrowers may not see an immediate increase in debt service burdens. However, with close to three-quarters of the currently outstanding fixed rate mortgages expiring over the next 12 months, the percentage of variable loans in Australian banks' loan portfolios may increase. Though this may bode well for their profitability in the short run as banks are able to transfer higher funding costs to new variable loans, it is also a double-edged sword, as higher delinquency rates could impact

[3] Data from Bloomberg.
[4] Source: Bank of Korea survey of loan officers at 204 institutions between June 15-30; indicative of household credit risk.
[5] Residential housing mortgages are the largest single-sector lending segment for the big 4 Australian banks.

Australian banks' asset quality as household borrowers that face an increase in their repayment cost could bear an increased burden of repaying an additional 20%. These pressures, especially in the global context of a slowing economy, could lead to lower credit growth, and vis-a-vis lower potential interest income, arising from the mortgage loan portfolio for Australian banks. Signs of a decrease in credit extended to households are already being shown with the value of new home loans tumbling by 7% in Jul-2022 (See Figure 2b).

Going forward, although the South Korean and Australian banks face similar headwinds stemming from high household debt and a slowdown in the mortgage market, Forward PD suggests differing trends in the credit risk outlook for the sectors. South Korea's Financial Services Commission, which had put in place a slew of regulations to bring household debt under control, has from Jun-2022 begun lifting regulations, potentially indicating the pressures in the mortgage market may soon ease. With signs of softening inflation, the BOK has also taken a less aggressive stance by opting for smaller rate hikes. These developments provide support to the mortgage loan market and potentially improve South Korean banks' credit health. On the other hand, the RBA has become aggressive with a cumulative 2.25 percentage points hike since May-2022. As looming fixed rate loan maturities threaten to push debt burdens higher, potential asset quality deterioration drives the Forward PD of Australian banks higher.

Credit News

Debt bailouts, commodities fuel wagers on Africa's frontier debt

Sep 17. African Eurobonds, which suffered massive selloffs at the start of the year, witness some turnaround as some major investors, such as BlackRock Inc, Neuberger Berman Group, and UBS Group AG, return to African frontier debt. Rescue packages, such as bailouts and waivers on loans, along with surging commodity prices, have led to improved expectations regarding the performance of this asset class. Consequently, African Eurobonds yields have declined since Jul-2022, however, remain much higher than their 10-year averages. Investors are specifically optimistic about Angola's bonds, as the country witnessed a large improvement in its leverage ratios, while its currency also outperformed its global peers. (Bloomberg)

Chinese corporate dollar debt issuance falls at record pace

Sep 15. Chinese corporates' demand for dollar debt has plunged 46% YoY in 2022, a much larger drop than their APAC counterparts and the rest of the world. China's shift away from the dollar debt market and towards domestic yuan-denominated bonds is largely due to the diverging approaches employed by the Fed and PBOC to support their respective economies. The dollar has been appreciating on the back of rising interest rates, which has made borrowing in dollar-denominated bonds more costly to foreign investors. On the other hand, PBOC has adopted monetary easing to lower financing costs for Chinese corporates and has increased regulations for the sale of long-term offshore notes, making the domestic debt market more attractive. (Bloomberg)

Slowing growth exacerbates debt strains, corporate bankruptcies loom - IIF

Sep 14. Slowing growth continues to push up global debt levels, this is especially true for the emerging markets. Of late, the global debt to GDP ratio has risen to 350%. For the emerging markets, the same ratio increased by 3.5bps to 252%. Looking at absolute numbers, there has been an overall fall in world debt, dropping by USD 5.5tn from Q1 2022 to Q2 2022. Likewise, for the emerging markets, there has been a USD 0.6tn decrease. The falls in absolute levels have been driven by the strengthening dollar against other currencies and a slowdown of issuance on the back of rising financing costs. IIF believes that a soft landing is increasingly unlikely on the back of an expected rise in corporate bankruptcies. (Reuters)

Chinese banks likely to push lending rate cuts to later in year

Sep 19. On Sep 20, 2022, the Chinese banks are due for another rate decision. Most economists surveyed by Bloomberg forecast expect the one-year loan prime rate to stay the same at 3.65%. Similarly, the five-year LPR is likely to be kept the same. The central bank needs to maintain a delicate balance amid the aggressive US interest rate hikes and CNY's ongoing depreciation passing the 7 per dollar mark to its weakest level since Jul-2020. Nonetheless, expectations remain for the cuts to come in later this year as PBOC remains accommodative. (Bloomberg)

Emerging Asia's worst bond market to get boost from falling oil

Sep 15. South Korean bonds show signs of recovery as inflation rates slip to 5.7% on the back of falling oil prices. Falling consumer prices and expectation of economic slowdown could also signal a slower pace of rate hikes. Economists in a Bloomberg survey expect the central bank's rate to stabilize at 3% over the next 12 months as compared to the one-year one-day swap market expectations of over 3.5%. As such, a softening in Korea's hawkish outlook may cause the nation's bonds to bounce back - a possible reversal from the 21% losses to dollar-based investors since the start of the year. (Bloomberg)

U.S. BNPL consumer debt set to hit USD 15bn by 2025 - study (Reuters)

Buyout giants face deal squeeze as private lenders turn cautious (Bloomberg)

Foreign investors snap up Indian bonds set for inclusion in global indexes (Reuters)

Regulatory Updates

Central banks set to hit peak rates at faster pace

Sep 18. After the inflation data for August returned unfavorable figures in the US, the Fed reiterated that it is prepared to do whatever it takes to curb inflation. The unconditional war on inflation signals that interest rates are set to increase further, and possibly at a quicker pace. Other central banks have also echoed the Fed's sentiments, amid concerns that should the interest rates not be increased fast enough, inflation might spin out of control, making it harder to rein it back within targets. Such statements mean that monetary authorities might be willing to sacrifice their respective economies to bring inflation under control, as the contrary could result in a more severe downturn. In turn, the market, which had previously expected the significant rate hikes to occur in 2023, is shifting its bet to a sooner monetary policy tightening in 2022. (FT)

Big regional banks might face new rules for dealing with a crisis

Sep 18. Regional banks have enjoyed exemptions from some of the more stringent capital requirements on bigger banks even after the 2008 financial crisis as regulators have been more focused on the latter because of their size, complexity, and global reach. However, recently, the Fed has set forth that large regional banks' resilience should also be monitored especially as their significance in the financial system increases following their growth. To do so, the regulators are considering that rules on capital and liquidity cushions be extended to them. Such new requirements might prompt the regional banks to raise long-term debt, even as most of them typically fund their operations through deposits. This pivot towards a more costly funding also increases costs for consumers. These additional requirements might encourage consolidation instead, to ease the impact of increased compliance costs. (WSJ)

Federal Reserve to keep interest rates above 4% beyond 2023, economists predict (FT)

Russia cuts benchmark rate by 50 basis points (FT)

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