Profitability woes and heightened funding pressures worsen the credit risk outlook of Australian banks

by NUS-CRI Market Monitoring Team

- **Worsening NUS-CRI Agg PD for Australian banks shows the subsector's heightened credit risk profile in tandem with the increase in the policy cash rate by the RBA**
- **NUS-CRI Forward PD's increasing term structure also suggests that heightened refinancing pressures amidst a transitory profitability pinch will worsen the financial strain faced by Australian banks**

The Reserve Bank of Australia's (RBA) term funding facility (TFF) which is due to mature in the quarters ending between Sep-2023 to Jun-2024 is exacerbating the funding capabilities, and vis-a-vis the credit profiles, of Australian banks[1] that are already operating in tight credit conditions after the central bank raised interest rates to an 11-year high of 4.1% in Jun-2023. As seen from the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for Australian banks in Figure 1a, Australian banks' credit risk profile has substantially worsened in tandem with the policy rate hikes by the RBA, suggestive of the pressures felt on Australian banks' balance sheets and asset quality. In the near future, the heightened borrowing costs are going to continue pressuring banks to compete on deposit rates, pinching profitability prospects in the near term as slowing economic growth poses headwinds toward potential loan book expansion. As such, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) in Figure 1b suggests that the credit profile of Australian banks is to remain pressured, crossing well into the BB upper bound territory when referenced against PDiR2.0 bounds[3]. The Forward PD reflects the heightened funding pressures facing Australian banks over the next 12 months, as competition over funding deposits thwarts profitability prospects, and the quality of their loan book deteriorates under poor macroeconomic conditions.

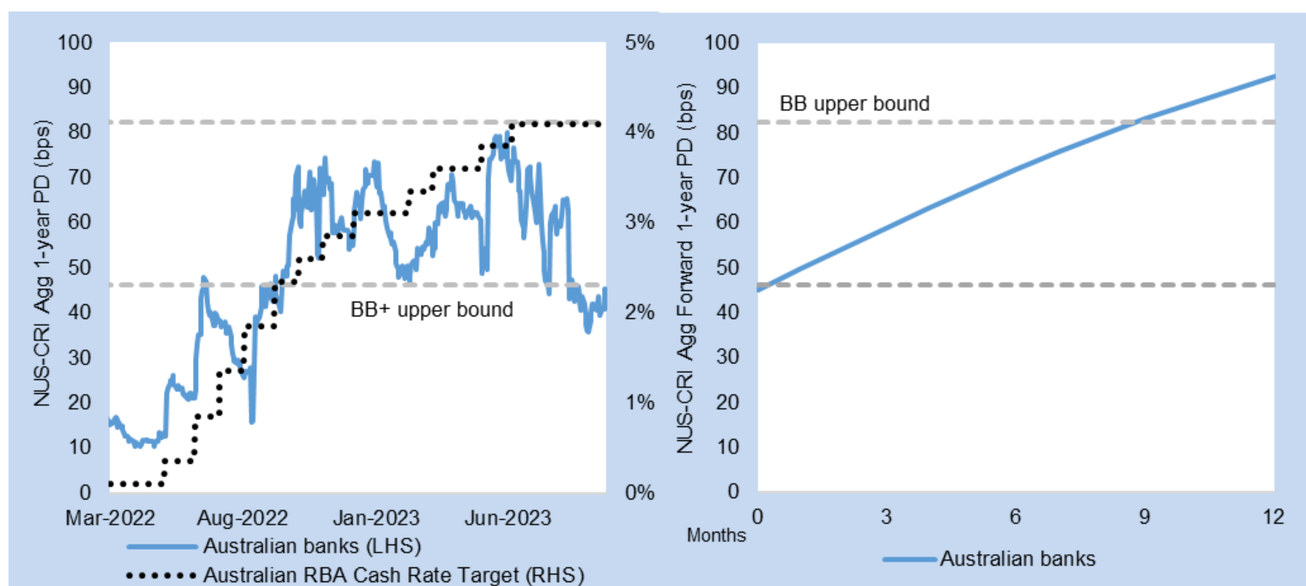

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Australian banks with reference to PDiR2.0 bounds, and the RBA's cash rate policy target. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Australian banks as of Sep-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI, Bloomberg*

[1] Australian Banks in our sample include those that are domiciled under the NUS-CRI industry classification system as Banks and Diversified banks in Australia.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted as similar 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, conditional on the firm's survival in the next 6 months.

[3] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by 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.

Over the past two years, Australian banks have enjoyed the benefits stemming from both higher stimulus-driven credit growth in 2021-2022 and the aggressive rate hikes undertaken by the Reserve Bank of Australia (RBA) since mid-2022. In the first half of 2023, Australia's largest banks reported record profits buoyed by an expansion in NIMs and moderate growth in lending. The NUS-CRI Agg PD of Australian banks also showed improvement and declined below the BB+ upper bound possibly benefitting from the improvement in profitability. However, despite posting record profits, Australian banks face a series of headwinds in the near future which may bite into profitability. Mortgage lending has historically been the main profit driver for Australian banks. As mortgage costs rise, the moderating credit growth has sparked intense competition amongst Australian banks(see Figure 2a). The competition in the mortgage market has negatively impacted the banks' margins prompting them to expand into the business lending segment to support profitability. With corporate insolvencies on the rise, the banks' foray into business lending remains fraught with risk. Additionally, banks' operating costs also remain pressured, driven by rising wage and technology costs. Elevated wages and higher investment spending by Australian banks are expected to drive a decline in bank profits by as much as 10%.

From a funding perspective, the TFF provided by the RBA expires in 2023-2024, pushing banks to raise additional funds at higher costs, thus pressuring their profitability. As seen in Figure 2a, to compete for funding, average deposit rates have increased by close to 2.5 percentage points since last year. Though these deposits are relatively sticky, higher competition could see banks with relatively weaker deposit bases facing withdrawals. Australian banks have continued to tap into the bond market as well, despite borrowing at a premium as repayment pressure rises post the end of pandemic-era stimulus. In the first three quarters of 2023, Australian banks have already issued close to USD 96bn in bonds, an increase of more than 25% over the same period last year (see Figure 2b). Taking on higher borrowing costs, in an environment where margins are already going to be stressed, is likely to lead to higher repayment pressures in the short term until the TFF maturities expire.

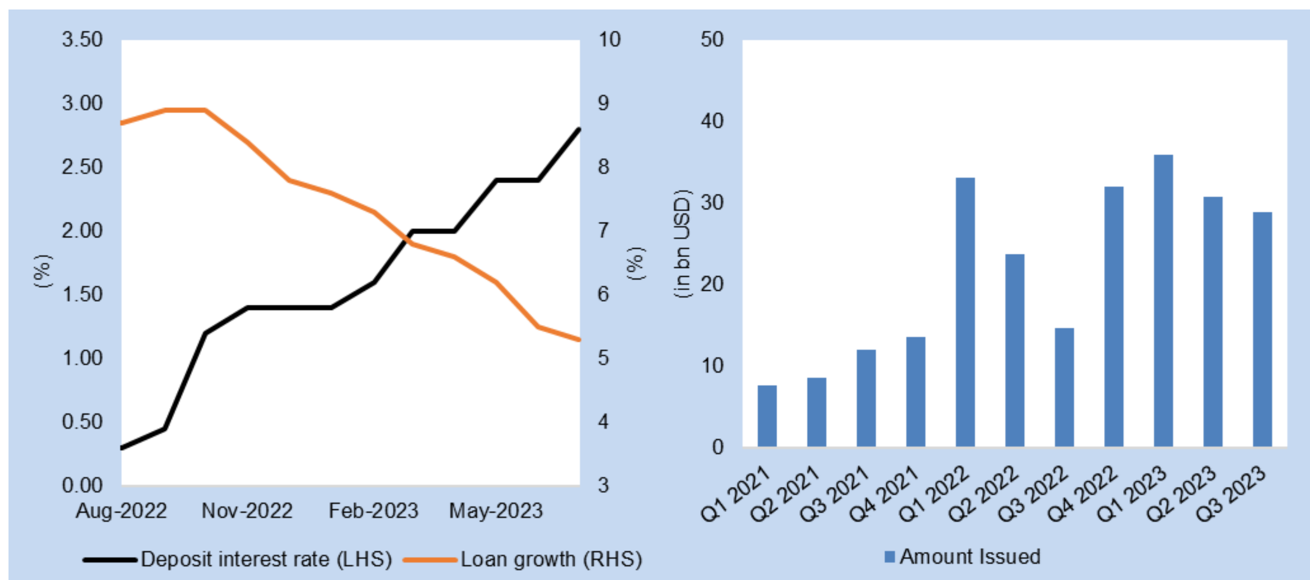

Figure 2a (LHS): Loan growth and the deposit interest rate of Australian banks. Figure 2b (RHS): Amount of bonds issued by Australian banks *Source: Trading Economics, Bloomberg*

The Australian banks have been shedding businesses like insurance and wealth management in recent years, leaving their assets too concentrated on mortgages. As the interest rate continues to rise, mortgage borrowers might be under great pressure to meet their interest repayments. In Q1-2023, Australia experienced a 16bps QoQ increase in mortgage arrears lasting 30 days or more, reaching a level of 0.98%. This upward trend persists from the historically low levels seen since 2002, and it may suggest that borrowers are beginning to feel financial strain as a result of inflation and growing borrowing costs. Apart from the housing mortgages, the asset quality of commercial real estate (CRE) loans might also deteriorate given the contracted demand in the CRE market due to the increasingly popular hybrid working mode. What draws a silver lining is that the major banks in Australia[4] exhibit a manageable level of exposure to CRE, ranging from 6% to 8% of their total Exposure at Default (EAD). They have reduced their risk appetite towards CRE since the last financial crisis and limited the loan-to-value ratio to 65%. In contrast, foreign bank branches and other domestic banks have reported stronger growth in the CRE sector compared to the domestic major banks.

[4] Namely Australia and New Zealand Banking Group Limited (ANZ), Commonwealth Bank of Australia (CBA), and National Australia Bank, Limited (NAB), and Westpac Banking Corporation (WBC).

Looking forward, Australian banks may witness a deterioration in asset quality as mortgage payments weigh on Australian households, which are some of the most indebted households in the world. Major banks such as the Commonwealth Bank of Australia (CBA) expect that the fierce competition in the mortgage market will continue in 2024. The subsector had already discussed incorporating potential mortgage holidays that would reduce the burden of increasing non-performing assets on their balance sheets, and if the current crisis continues, the subsector might potentially look back at introducing similar strategies to mitigate losses emerging from the household loan segment. When taken in conjunction with the funding pressures already faced by the banks, the current tough operating environment may hamper the credit health of Australian banks as indicated by the Forward PD in Figure 1b.

Credit News

Global debt pile hits record high of USD 307tn

Sep 19. Global debt reached a new high in the first half of this year, climbing by USD 10tn to approximately USD 307tn, with the debt-to-GDP ratio rising to 336 percent by June. This surge in debt, mainly in mature markets such as the US, Japan, UK, and France, is driven by rising interest rates, which are a significant factor affecting sovereign credit ratings. Developed markets are seeing interest expenses rise faster than debt or revenue, ending a period of relatively flat interest bills despite growing debt levels. There is also concern about the increasing interest expenses for local currency emerging market debt, which makes up over 80 percent of their total interest costs. This escalating debt and interest cost scenario could lead to debt restructuring challenges, particularly for emerging markets, as traditional tools are geared toward addressing external debt vulnerabilities. The IMF has also warned about the need to address debt vulnerabilities and reverse long-term debt trends to create fiscal space for new investments and economic growth. (FT)

JPMorgan adds India to pivotal bond index

Sep 22. After years of negotiations between the Indian government, banks and investors, JPMorgan has decided to include India in its benchmark emerging-market bond indices, potentially catalyzing billions of dollars into the country's government bonds. The move comes as investors prefer to distance themselves from exposure in Russia, after its war with Ukraine, and China, after lagging economic growth sentiment. A total of USD 330bn worth of 23 Indian government bonds will be added to its Government Bond Index – Emerging markets benchmark from Jun-2024. The move also follows after India's central bank issued a rupee-denominated bond that had no restrictions on foreign ownership, making JPMorgan's inclusion the first of its kind among other benchmark providers, aiding the Indian government in reducing borrowing costs. Rating agencies in general give India their lowest investment-grade rating. (FT)

China developer slump deepens to USD 55bn as debt woes mount

Sep 25. Chinese property stocks experienced their sharpest drop in nine months amid escalating worries about the possible liquidation of China Evergrande Group and increasing industry distress. Bloomberg Intelligence's developer shares gauge plummeted by up to 6.4% on Sep 25, resulting in a USD 55bn loss in valuation this year. Evergrande nosedived by 25%, while China Aoyuan Group contributed to the gauge's decline with a record 76% slump upon resuming trading. Despite developers banking on the upcoming Golden Week holiday to boost home sales, the recent downturn in property shares suggests relief may be fleeting. Concerns persist over potential defaults and regulatory inquiries in the sector, leaving investors grappling with a barrage of negative news. Chinese property junk US dollar notes remained mostly stable, trading at distressingly low levels below 15 US cents. (Business Times)

Debt market titans see fiscal risks and rising defaults

Sep 24. Prominent figures in finance are expressing concerns about the global economy. James Zelter of Apollo Global Management doubts the possibility of an economic soft landing. Ares Management's Michael Arougheti worries about the risk of a fiscal accident, while others predict rising defaults due to the looming refinancing of riskier debt. Despite relatively stable credit markets, they anticipate challenges as higher interest rates impact consumers and companies. This sentiment reflects ongoing unease among money managers, given a record global debt of USD 307tn in H1 2023. Economic weaknesses are emerging, and governments with pandemic-induced debt are grappling with higher interest rates, raising fiscal concerns. (Bloomberg)

India's market regulator relaxes rules for mandatory bond market borrowing

Sep 22. India's market regulator, the Securities and Exchange Board of India (SEBI), has announced its intention to eliminate penalties imposed on companies unable to fulfil mandatory bond market borrowing quotas. This decision follows SEBI's proposal last month, which was influenced by market feedback suggesting that borrowing from banks remains a more cost-effective option compared to raising funds through bond issuances. Under the current regulations, large companies are mandated to secure 25% of their incremental borrowings through debt securities issuance. Failure to meet this requirement results in a

penalty of 0.2% of the deficit in the borrowed amount. SEBI has decided to remove this penalty and, instead, introduce incentives to encourage companies to utilize the bond market for their borrowing requirements. (Reuters)

Mexico's Cemex in talks to refinance USD 3bn bank debt (Bloomberg)

Laos debt at 'critical level' with China payments still opaque (Bloomberg)

German borrowing costs hit highest since 2011 on ECB rate bets (Bloomberg)

Regulatory Updates

Fed officials flag further hikes even after holding steady

Sep 23. U.S. Federal Reserve officials have issued a cautionary note, suggesting the possibility of further interest rate hikes despite their decision to maintain the benchmark federal funds rate within a range of 5.25% to 5.50% at their recent meeting. Three policymakers voiced uncertainty regarding the completion of the battle against inflation. Their remarks, while acknowledging a slowdown in price increases, underscored the potential for future rate increases and an extended period of tight monetary policy. It's important to note that the decision to keep the interest rate unchanged was unanimous among Fed officials. However, their projections show that while they expect to begin reducing interest rates next year as inflation eases, the pace of rate cuts will be slower than previously anticipated (Reuters)

BOJ's Ueda tamps down speculation of rate hike, pressuring yen

Sep 22. Bank of Japan Governor Kazuo Ueda has quashed talk of an imminent interest rate hike, reaffirming the central bank's commitment to its ultra-loose stimulus measures. This decision has exerted pressure on the yen's value. In its recent announcement, the BOJ maintained its negative interest rate and left the parameters of its yield curve control program unchanged as expected by market experts. Furthermore, the central bank reiterated its readiness to augment stimulus measures promptly if necessary. Governor Kazuo Ueda, during a press briefing following the decision, emphasized that the circumstances for adjusting the negative interest rate have not substantially changed, implying that a policy shift is not imminent. (Bloomberg)

Fed governor calls for transparency, accountability in AI models (American Banker)

Turkey raises interest rates for fourth time since June (FT)

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