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Banking royal commission duds depositors

by **Christopher Joye**

Nobody seems to have noticed that the royal commission's mandate is biased in favour of the imprudent over the parsimonious.

It has spent most of its time agonising over the tiny number of "bad" borrowers who defaulted on their interest and/or principal repayments and none contemplating the plight of the millions of depositors who underwrite these loans.

Every borrower who fails to meet their obligation to service a loan threatens the safety and security of Australian depositors' hard-earned savings.

And since a large bank's equity capital is typically leveraged 19 times, it does not take many loans to go foul before they risk blowing up these institutions, as we learned during the global financial crisis.

If just 5 per cent of CBA's total credit exposures were written off, this would completely wipe out CBA's $45 billion of equity capital that safeguards depositors from the prospect of losses incurred in bankruptcy. (Only around half of all bank deposits by value get the benefit of the government guarantee.)

The recent Australian political impulse to push banks to be softer on bad borrowers – an artefact of the absence of any recession, and hence near-death banking experiences, for 27 years – transfers wealth from the prudent majority to this spendthrift minority while also raising the probability of banks going bust.

The Labor Party's brain-explosion in the form of its 2009 "responsible lending laws" – which irresponsibly sought to shift accountability for repaying loans from the borrower to the lender

(yes, that should sound bizarre!) – fundamentally undermined the integrity of Australia's otherwise world-class financial system.

Shift the blame

Politicians who have never worked in the real world decided it might be popular to allow borrowers to wriggle out of loans they have defaulted on if the lender has not verified their ability to repay it.

That's like saying the courts cannot prosecute burglars if the owner of the stolen property cannot prove they tried to protect it. Finders keepers!

It's a slippery legal slope that is fraught with "moral hazard" by incentivising borrowers to behave irresponsibly knowing they can blame the big bad banks ex post facto if their investment does not work out while ignoring the consequences for the poor folks funding these loans (ie, depositors). BankWest anyone?

Thank heavens the regulator, ASIC, wittingly or unwittingly made the responsible lending laws nebulous and non-scalable, which means that how they apply varies on a case-by-case basis.

This make it practically difficult to prove a lender behaved irresponsibly (as demonstrated by test cases finding in favour of lenders) and almost impossible to run an effective class action litigation across scores of borrowers with varying circumstances.

After decades of highly providential prosperity, Australians appear to have forgotten that the GFC was brought about by loose lending standards – as manifest by the boom in sub-prime lending – and the ability of US borrowers to walk away from their "non-recourse" loans with zero personal accountability as a result of political populism.

It was the "anti-deficiency" statutes in states like California that prevented lenders from pursuing bad borrowers personally through bankruptcy processes that led to default rates on US loans that were literally 20 times higher than what has historically been evidenced in Australia.

And of course this, in turn, necessitated trillions of dollars of taxpayer bail-outs of failing financial institutions.

Legal recourse

Aussie banks have legal recourse to both the property that serves as collateral protecting a loan and any other financial resources the borrower possesses outside their home.

It is precisely because domestic mortgagors have so much downside risk if they miss repayments (in contrast to their US peers) that they have been so diligent in satisfying these obligations.

The (defaulting) property developer donors who convinced some in the Coalition to help Labor establish the royal commission hope they can engineer a shift in the balance of power away from depositors towards borrowers.

But in dismissing the bogus BankWest conspiracy theories advanced by these vested interests – in the same vein this column eviscerated them back in 2015 – Commissioner Kenneth Hayne has shown he is not easily conned. (Curiously, Labor repeatedly rejected arguments to investigate the banks while it was in power.)

Out-of-cycle rate hikes

With this in mind, it is heartening to see five lenders – including AMP, Bank of Queensland and the industry super fund-owned ME Bank – lift home loan rates as funding costs soar, wresting control of monetary policy away from the Reserve Bank of Australia, which has been asleep at the wheel.

Many think that after being cowed into submission by the royal commission, the major banks will not have the courage to recoup their own costs. If they don't, they will have to cut deposit rates and/or impose lower returns on shareholders, which include most Australians.

The big four are nonetheless within their rights to follow in the footsteps of smaller lenders and recover the dramatic increase in funding costs, as they did during the GFC.

The last thing we want is irrational banks being pressured by silly politicians to behave imprudently in a manner that puts depositor savings at risk.

Funding costs have jumped for several reasons. First, Donald Trump has introduced new taxes on the cash held by US companies overseas, which they are repatriating back to the US.

This has forced our banks to increase short-term interest rates to attract new money to replace the cash they've lost.

Concurrently Trump, who loves debt, is running enormous budget deficits (juxtaposed against Australia reporting a surplus over the past seven months).

The US treasury has been funding these deficits by issuing more government bonds at the same time as the Federal Reserve has stopped buying them.

This increase in debt supply while demand has declined has boosted the price of money for all borrowers, including our banks.

Ratcheting costs

The quarterly rate at which institutions borrow money via the bank bill market has ratcheted up from 1.75 per cent to 2.1 per cent. In addition, banks are having to pay higher credit spreads above this cash benchmark to borrow money via bonds and hybrids.

These spreads have increased by between 0.20 per cent and 1.0 per cent annually depending on the security, which are big moves.

It has meant that investors are capturing spreads on the major banks' hybrids and senior bonds that are between four and nine times larger than what they earned in 2007, which is one reason why the hybrid market performed strongly in June.

While CoreLogic's latest house price index results imply that the housing correction has slowed down dramatically, out-of-cycle increases in mortgage rates will ensure that the value of our bricks and mortar will not inflate again any time soon.

That's not a bad thing: an orderly normalisation in the national house price-to-income ratio is tremendously "credit positive".

If Labor comes to power at the next election and doubles capital gains tax on investment properties while eliminating negative gearing, residential real estate is sure to be a dud asset class for years to come.

The author is a portfolio manager with Coolabah Capital Investments, which invests in fixed-income securities including those discussed by this column.

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