Funding outlook 2016

An extract from Australian Mortgage Report 2016

Australia’s macro economic conditions support a continued strong outlook for the housing market

*Deloitte partners **Graham Mott** and **Heather Baister** explore the outlook for funding in 2016.*

Funding: a sticky challenge?

Funding, and its impact on the Australian residential mortgage market is an area of focus as market participants and commentators analyse whether the slow start to 2016 is a precursor to a tough year ahead. Although the funding markets have come a long way since the financial crisis, access to liquidity is sensitive to global political and economic events. So what was the impact of the events of the last 12 months on mortgage originators, both ADIs and non-bank lenders, and how will this impact both the competitive landscape and consumer over the next year?

Impact on Net Interest Margin (NIM)

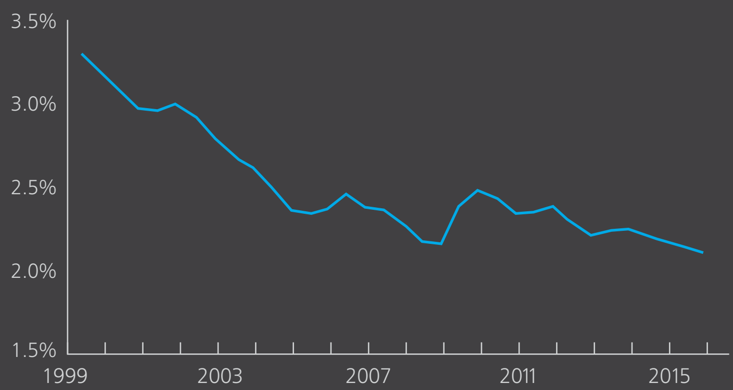
With the cash rate falling in early 2015 and reduced again mid-year, the two key challenges for banks was the management of margins and continued pressure to deliver expected returns on equity (ROE). Despite the out of cycle rate increases designed to protect NIM and buffer the impact on capital from regulatory change, average ROE fell slightly for most banks in 2015 as a result of increased competition and wider funding spreads at the end of 2015. NIM fell by almost 5bps between December 2014 and December 2015 across the majors.

Although there are a number of distinct factors that influence margins, this year, unlike many previous years, the developments do not appear weighted in favour of the largest market participants. This is contingent of course on the wholesale funding cost increases in early 2016 not being too prolonged. If they level off, we expect a commensurate levelling of the playing field ahead.

Deposit pricing

Given the major banks currently rely on deposits for 60-65% of their funding needs, how they manage their deposit pricing continues to dominate funding trends.

Figure 1: Major banks' net interest margin*
(domestic, half-yearly)



*From 2006 data are on an IFRS basis; prior years are on AGAAP basis; excludes St George Bank and Bankwest prior to the first half of 2009. *Sources: Banks' Financial Reports; RBA*

The introduction of the new liquidity coverage ratio (LCR) in 2015 – designed to ensure that financial institutions have the necessary assets on hand to ride out short-term liquidity disruptions has changed the nature of a 'desirable' deposit for banks.

Sticky retail customer deposits are now highly desirable, which has meant bonus offers on many savings accounts that are in excess of those being offered on term deposits.

By contrast, there is little commercial incentive for the banks to compete aggressively for wholesale deposits given their requirement to cover such funding with 100% High Quality Liquid Assets (HQLA) under the new rules.

Since the beginning of 2016, a number of banks increased rates on term deposits to provide funding diversity and counter the increased funding costs in the wholesale market.

Throughout 2015 and expected to continue in 2016, there have been greater penalties for any early redemption of term deposits to improve their 'stickiness' and deter customer driven redemption.

There has also been change in the deposit mix with growth in transaction deposits (traditionally a low earning deposit account) as borrowers have utilised the availability of interest offset accounts which have been growing rapidly.

Utilising this structural feature allows customers to use their funds to save on interest charges given the rates charged on mortgages are significantly higher than those earned in a traditional deposit account. (See Figure 3)

Wholesale funding

The trend of tightening spreads on wholesale funding continued throughout Q1 to Q3 in 2015, reversing in Q4 2015 and early 2016, as uncertainty over the downturns in the Chinese economy impacted the debt markets and spreads began to widen by around 20% between November 2015 and February 2016.

While these events are not welcomed by the market, and remind us of the susceptibility of funding to global political and economic events, the macro economic conditions in Australia, with its relatively low unemployment rate (6%), net immigration and minimal credit loss history, support a continued strong outlook for its housing market. Albeit at normalised growth rates, rather than the tremendous 20% rates seen in 2013-2015.

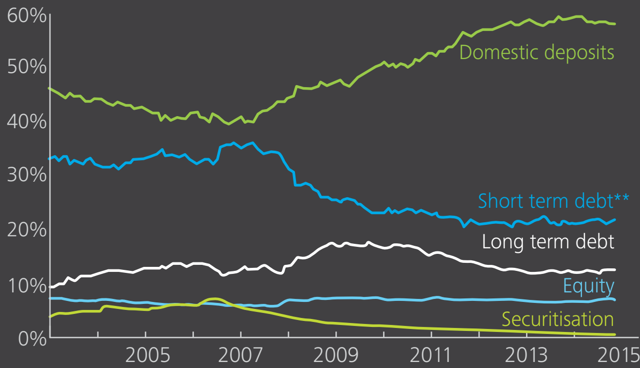
This quality collateral supporting Australian ADI balance sheets, should equate to continued demand for wholesale product, though it may be at a higher price, given global economic factors.

Inevitably, if the widening spreads continue through 2016, these costs will be borne by the underlying customer, or be at the expense of ROE.

Given banks' recent willingness to move their interest rate adjustments out-of-cycle, we suspect consumers, rather than shareholders, (though these can be and often are one and the same), will absorb much of the increases in cost.

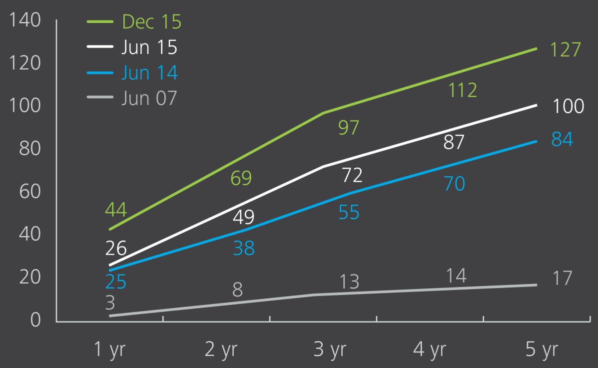
Over the mid-term, if the relatively benign system growth is compounded by high mortgage prepayments, we expect protecting market share will become increasingly important, with banks concentrating on improving total value per customer (rather than simply mortgage NIM) by doing their best to increase the number of products and services per customer.

Figure 3: Funding composition of banks in Australia*
(share of total funding)



*Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

Figure 4: Indicative funding cost curves
(margin to BBSW, bpts)



Despite the recent increase in wholesale funding costs, banks continue to benefit from the roll-over of the expensive term funding raised in 2011-12, when spreads were considerably higher. However this benefit is rapidly eroding. The graph in figure 4 shows the increased funding spread payable as at February 2016 compared with six months earlier.*

Basis risk, which results across all funding sources from the standard variable rate mortgage tracking the cash rate, whereas wholesale funding is priced as a margin above the Bank Bill Swap rate (BBSW), also increased in 2015 and 2016 to around 30bps, making the cost of basis swaps more expensive.

The same can be seen in cross currency swaps pricing for offshore issuance and is becoming increasingly significant to ADI treasury departments. Figure 5 below shows how a major banks' blended funding (wholesale unsecured and secured) curves have changed in recent years. Additionally, short term wholesale funding has diminished significantly, as ADIs reacted to the LCR rules by limiting its use given it requires 100% HQLA coverage.

Securitisation as a funding mechanism

The Australian RMBS and ABS markets were also strong throughout the first three quarters of 2015 with large issuances from major banks. However this then slowed significantly in Q4 2015 as debt markets became volatile. The first RMBS issuance of 2016 by CBA was $1.6bn compared with their initial issuance in 2015 of $2bn.

There was also a significant widening of spread of 50bps to 140bs over the corresponding period (albeit for slightly longer tenor). We are aware of other RMBS deals coming to market at slightly tighter spreads, but they are still expensive compared with 2015. (See figure 6)

Non-bank lenders need to be able to continue to access the securitisation market and will be impacted more than the banks by a prolonged rise in spreads, as they lack the flexibility to use increased deposit funding or covered bonds, to tide them over. However they often have borrowers who are less able to refinance quickly in response to increases in rates, and can therefore protect margin through customer pricing.

The largest non-bank lenders in Australia continue to have strong support from ADIs, with healthy warehouse capacity and a proven track record of delivering on their issuances, including calling all deals on time. The strength of the non-bank lender industry is important for consumers, as they are often the more flexible and agile originators, as well as being the source of much of the product innovation in the Australian market historically. This is demonstrated by continued investor support for non-bank lender issuances in early 2016.

The securitisation industry also received a boost towards the end of 2015, with the proposed revision to APS 120 *Securitisation* announced by APRA, which will likely support the issuance of master trusts. Master trusts have the advantage of allowing date-based calls, which in turn reduce swap costs and provide greater certainty to investors. As a result, the securities issued are attractive to a wider range of investors than the traditional pass-through structures used by Australian RMBS. Additionally, the costs of setting up a program can deliver benefits over a longer period, as master trusts can be used on a revolving basis to avoid the need to continually tap the market.

Figure 5: Average long term funding costs (margin to BBSW, bpts)

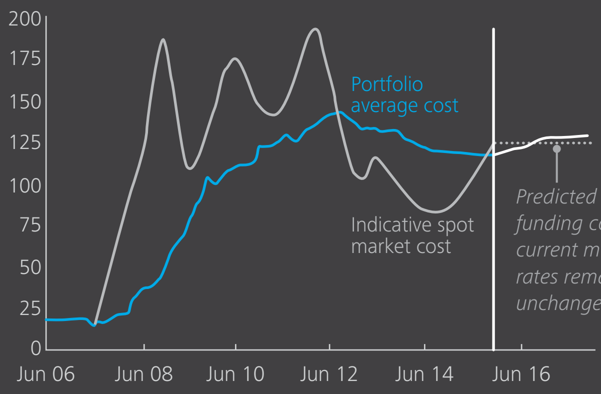
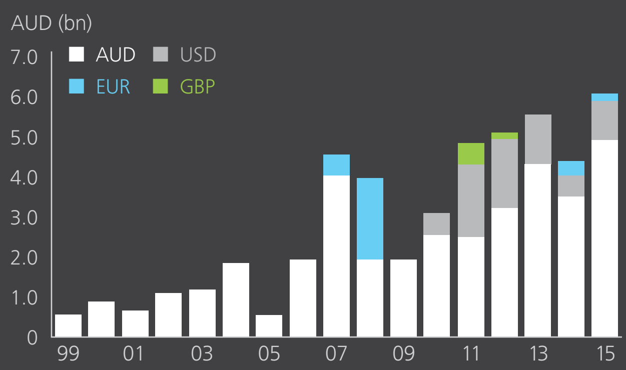


Figure 6: Australia ABS issuance (AUD)



Source: Macquarie Debt Markets Analysis © Macquarie Bank

* Source: CBA Investor Presentation Feb 2016.

The competition for customers means originators continue to keep mortgage rates low and pressurise NIM

We think master trusts will be less appealing to the small ADIs due to their complexity, and need for a strong pipeline of mortgages required to access the cost benefits of the structure. We therefore envisage small to mid-tier ADIs to continue to be more reliant on basic wholesale funding and deposits.

APS 120 will also impact non-bank lenders through the likely rise in the cost of warehousing as a result of the capital implications on banks providing that funding. Market participants have indicated that this will be approximately 20 bps across facilities, although it should be partially offset by improved liquidity and investor appetite resulting from the ability to use date based call features.

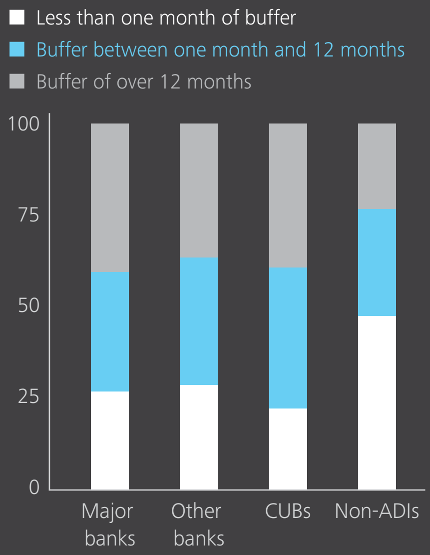
Competition and customers

During 2015, competition among all players for new business was so intense to counteract the low system growth that resulted from continued high prepayment rates (CPR). Customers continued to use the low interest rate environment to pay down their loans, particularly through off-set accounts, and grow increasingly savvy as to how best to use them instead of traditional redraws or P&I pay down structures, when they required flexibility. Offset accounts grew faster than any other type of account in 2015 and currently make up approximately 6.5% of at-call transaction accounts. Customers are also continuing to access the benefits of the low interest rate environment by paying down their loans faster than their contractual obligations. At the end of 2015, two thirds of borrowing was covered by at least one month's repayment buffer. And for around a third of the loans for which data was available, the buffer was greater than 12 months.**

This demonstrates some of the capacity of borrowers to absorb any potential, albeit modest, near term interest rate rises and is a strong indicator of the serviceability of loans. (See Figure 7)

** RBA speech 'Some Effects of the New Liquidity Regime' 16 December 2015

Figure 7: Repayment buffer (marketed RMBS; share of value of loans; includes offset account balances)



The low wholesale funding costs in mid-2015, that assisted in narrowing the gap between major bank spreads and non-ADI spreads, benefitted customers through enabling market participants to offer low mortgage borrowing rates, reflecting the aggressive pricing and increased competition (particularly in the mid-tier ADI space).

The competition for customers has meant originators continue to keep mortgage rates low and pressurise NIM.

Major banks have focused on growth of market share, and together with other ADIs, done so through enhancing broker relationships as well as analytics to identify how to reduce refinancing. Upfront broker commissions have increased since 2014, and many ADIs are now focusing on the speed and quality of service they provide brokers in an attempt to differentiate the value proposition for customers.

This has enabled above system growth for a number of mid-tier ADIs like CUA, AMP and Macquarie, and some highly competitive prices for borrowers, with discounted variable rates of under 4% offered by a number of market participants.

Throughout 2016, there will need to be some careful thought given to the on-going pricing strategy as a number of ADIs have had to attract and raise deposits or tap more expensive wholesale funding markets in order to finance increased growth. Again this will create further pressure on NIM as the more profitable back-book continues to pay down.

Regulatory developments

During 2015, APRA announced an increase in the amount of capital required for Australian residential mortgage exposures by ADIs accredited to use the internal ratings-based (IRB) approach to credit risk. This included the major banks and Macquarie.

This change will mean that these dominant lenders in the Australian property market will increase their average risk weight on Australian residential mortgage exposures from approximately 16% to at least 25%.

This will result in narrowing the advantage that the IRB banks have over the rest of the market which, for ADIs, use a standardised risk weights calculation consistent with the direction of the global Basel changes.

The impact will take effect on 1 July 2016, although the major banks have already increased their capital reserves to be well positioned for the change.

APRA estimates the impact of the changed requirement to be approximately 80bps on minimum capital currently held for the IRB banks. This announcement was widely expected, and is seen as a boost to the regional and mid-tier ADIs which have long held the view that the IRB banks enjoyed an unfair competitive advantage. It will be seen to level the field and improve customer choice.

Summary

Twelve months in from the LCR introduction, the effects have impacted bank pricing liabilities, particularly short term wholesale funding and deposits. With interest rates forecast to remain low in the near term, credit growth is expected to continue at a steady and reasonable rate of around 5% throughout 2016.

The majors are expected to keep one eye squarely focused on global markets including the US, where the first US cash rate increase in nearly a decade occurred in 2015. The major ADIs will focus on efficiently managing their assets and liabilities, and particularly their deposit mix and pricing, with capital management increasingly under scrutiny.

Mid-tier ADIs have a real opportunity with the capital changes benefiting their competitive position. They will need to carefully weigh up growth against profitability, particularly now 2016 funding spreads could erode the relative improvement from capital changes.

For non-bank lenders, while still largely reliant on wholesale markets, the opportunity continues to be in the near prime rather than prime sector, where a premium can be priced-in, due to less competition from the banks.

Customers should continue to benefit from competition in the market, though interest rates cannot stay this low forever. However the high levels of prepayments and the increased focus by APRA on serviceability, demonstrate that there are sufficient buffers in most portfolios to ensure the continued strong performance of the Australian mortgage market, and its funders.

The buffers in most portfolios are sufficient to ensure the continued strong performance of the Australian mortgage market, and its funders www.deloitte.com.au

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