

AUSTRALIAN PROPERTY RESEARCH

FUNDING PRESSURE ALLEVIATES

9 SEPTEMBER 2011

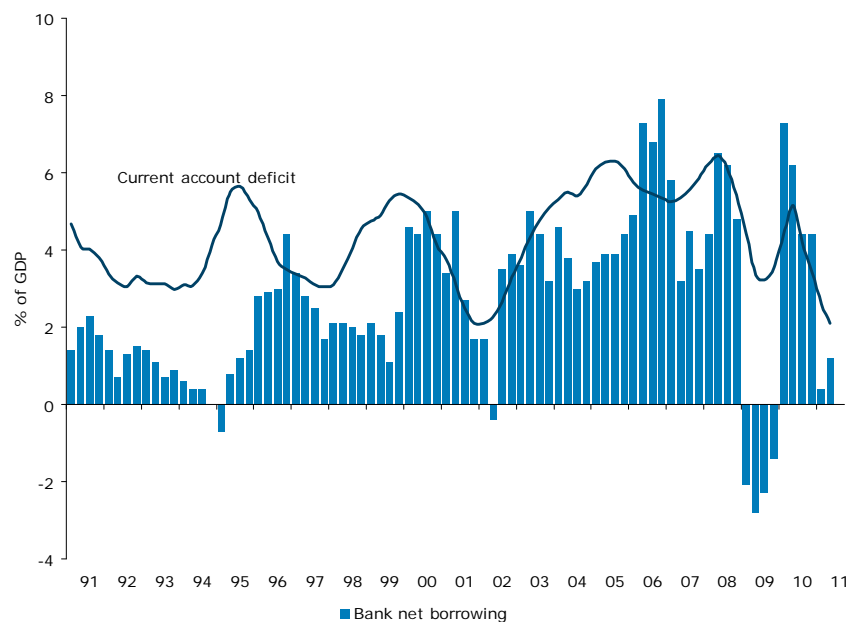
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KEY POINTS

- Banks' role as key 'current account funders' has been much reduced in the past few quarters. More of the same can be expected over the medium-term. The longer-term importance of intermediaries in funding economic growth is also up for grabs with private saving outcomes critical to the ability and need for banks to grow their books.
- Recovery in private debt capital markets will be slow, but will present an additional challenge for banks, particularly in the corporate space. Mortgage securitisation on the other hand is expected to recover more slowly, allowing banks to hold onto the lion's share of business in this market.
- On the plausible expectation that consumers remain or will be forced (by policy) to remain 'well behaved' for quite some time and that 'China growth' continues to underpin export receipts, there is good reason to expect structural 'achievements' in current account deficit. The investment boom is the other side of the equation and will be bucking against any structural improvement.
- A more comfortable banking sector balance sheet in the years ahead should allay global investor and ratings agency concerns about the underlying liquidity of Australia's banking system with the banking sector funding gap expected to narrow to its lowest level in two decades.

FIGURE 1. BANKING SECTOR NET OFFSHORE BORROWING HAS REDUCED SHARPLY



Source: ABS

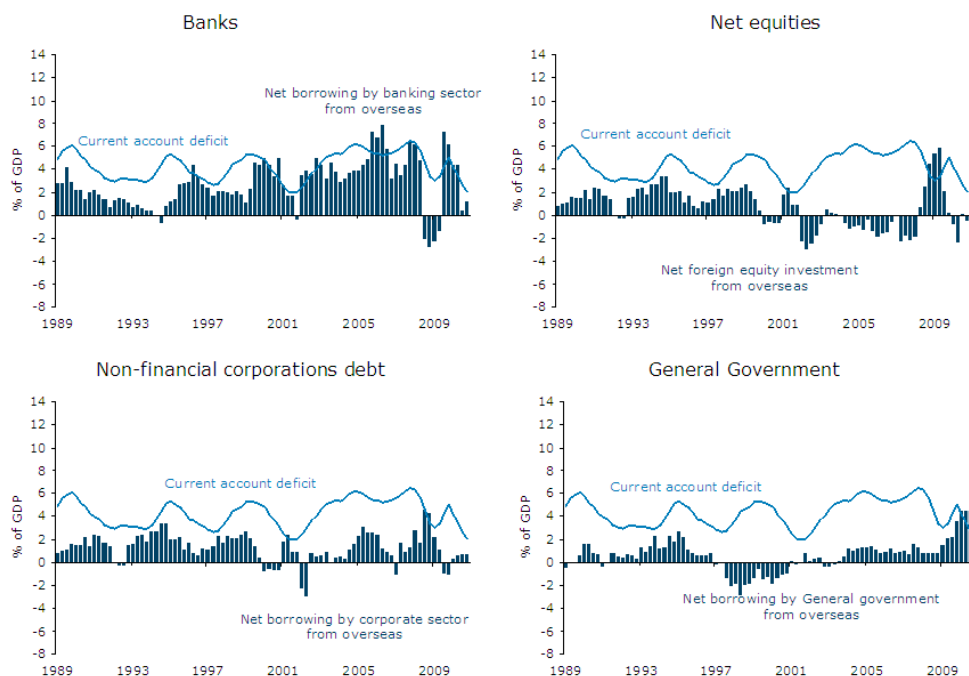
IMPROVED SAVING

An improved *household* saving rate and a relatively flat investment performance since 2004 has facilitated an **8% of GDP turnaround in the household sector's contribution to the current account deficit** (5% of this turnaround was post-GFC). Indeed, the household sector has detracted from the current account deficit for the first time since the mid-1990s. This has also been facilitated by continued sluggishness in dwelling investment expenditure. The 'surplus' saving is effectively available for other sectors to invest.

An improvement in *corporate* sector saving over the last two years reflects a solid profit recovery since the GFC, having had almost as significant an impact (6% of GDP) on the CAD as the household sector. But while the household sector has been detracting from the CAD recently, the corporate sector remains a net contributor to the CAD, reflecting a traditionally high propensity to invest. This of course has in the past generated healthy demand for business debt (intermediated and self-issued). Interestingly, the corporate sector has only ever detracted from the CAD around recessionary periods, reflecting the need to preserve capital (i.e. by cutting investment spending by more than the profit decline). That *this* sector continues to add to the CAD in 2011 is symptomatic of a relatively healthy Australian economy and investment environment.

Deterioration in the *government* sector's fiscal position following post-GFC support to the economy has seen this sector become a net contributor to the CAD for the first time in over a decade. Both higher investment spending and falls in government saving (government consumption rising faster than revenue) explain this development and is represented conceptually by the "net fiscal balance". However, given the stated intention by the federal government to return the commonwealth budget to surplus by 2012/13, the government sector should once again have a 'neutral' impact on the CAD. The *level* of the CAD then will reflect the balance between *private sector* saving and *private sector* investment over this period.

FIGURE 2. HIGHER HOUSEHOLD AND CORPORATE SAVING REDUCE CAD

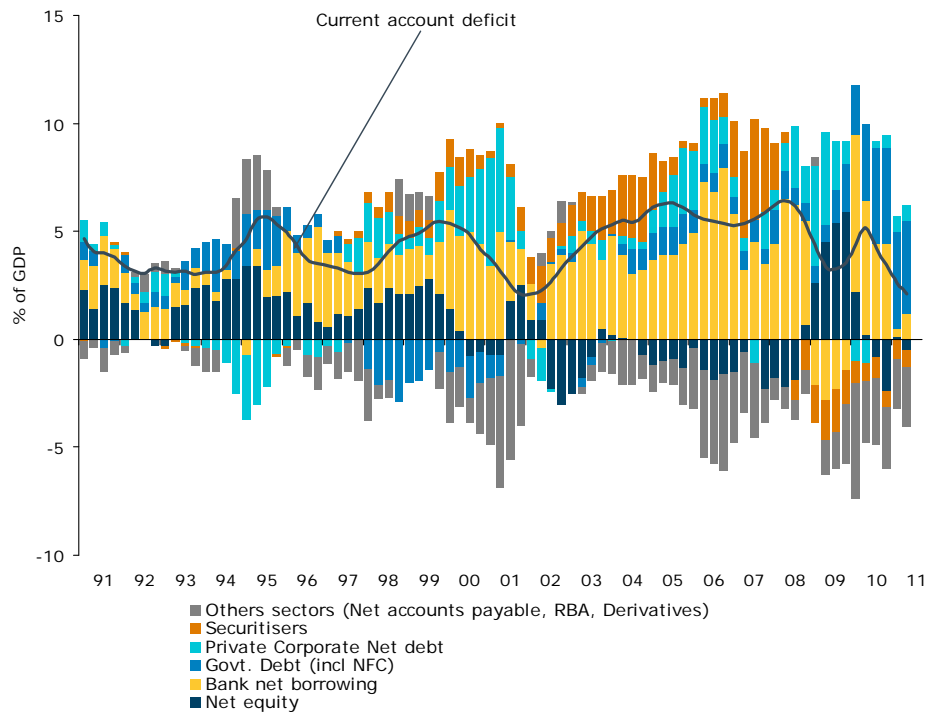


Source: ABS

These developments also reflect the way the CAD has been financed recently (see Figure 3). Whereas banks have been a persistent and key conduit for funding private sector domestic activity, recent shifts in private sector saving and investment behaviour have washed through to shift the composition of offshore funding:

- Public sector fiscal stimulus to support a post-GFC economy has spilled over by increasing its call on foreign saving;
- Internal strategies to strengthen corporate balance sheets have reflected in continued sluggishness in corporate debt issuance, including to offshore investors;
- Mortgage securitisation activity remains relatively dormant with the main investing sector (SIVs) virtually closed for business. The net run-down of exposures is continuing, albeit at a slower pace in recent quarters;
- Net equity inflows have reduced substantially, reflecting a gradual thawing of global markets since GFC which has seen Australian pension funds increasing offshore exposures once again. Growing reticence among offshore investors around currency risk has tempered foreign equity inflows in the first half of 2011;
- Banks have played a significantly reduced role in funding from offshore recently as lower loan volumes growth and strength in core deposits reduce the need for wholesale funding, including from offshore (yellow bars in Figure 3).

FIGURE 3. GOVERNMENT SECTOR TAKES OVER FROM BANKS



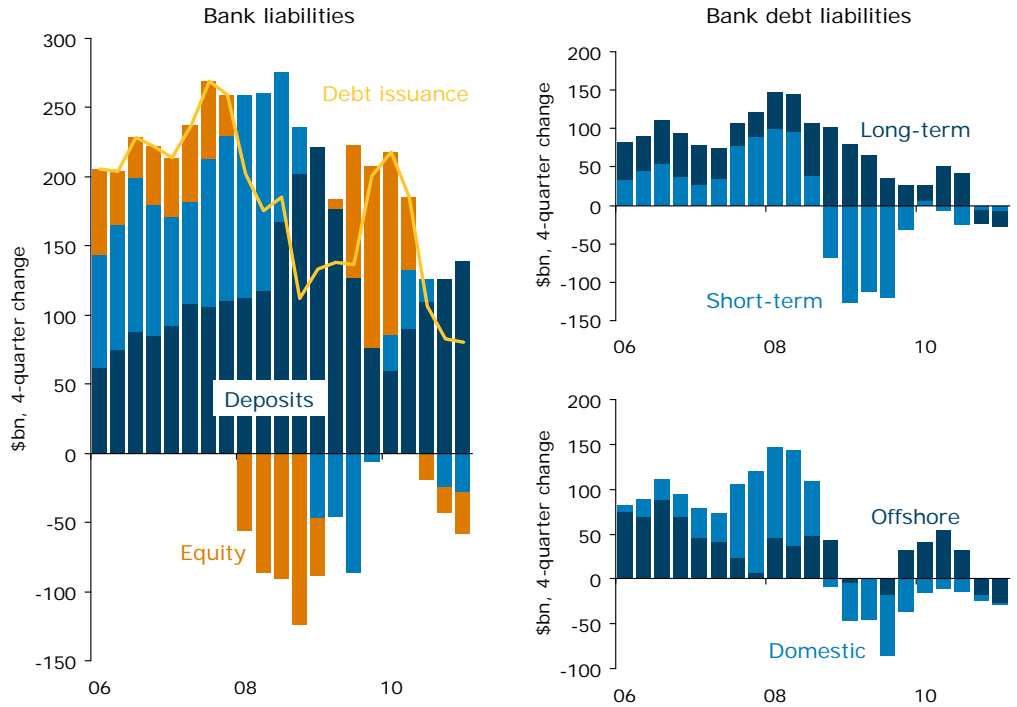
BANK BALANCE SHEETS

Banking sector balance sheets have experienced considerable upheaval since the GFC from a variety of interdependent forces:

- Higher corporate and household saving (boosting core deposits; reducing loan demand and loan balances);
- Relatively sluggish dwelling investment (reducing new loan demand);
- Shift in housing market sentiment (reducing loan demand, accelerating loan repayment);
- Probable downward shift in the hurdle rates of return on capital stock (reducing loan demand);
- Banking sector re-pricing for risk (reducing loan demand);
- Household sector reassessment of optimal level of debt (seemingly accelerating loan repayment).

These forces have impacted fundamentally on the trajectory of both sides of bank balance sheets – but in different directions, leading to a notable narrowing in the funding gap and a significant fall in wholesale fund reliance. Whereas banks were ‘terming’ out immediately after GFC (replacing short-term debt with longer-term maturities), the most recent trend suggests *even long-term exposures* are running off for the time being.

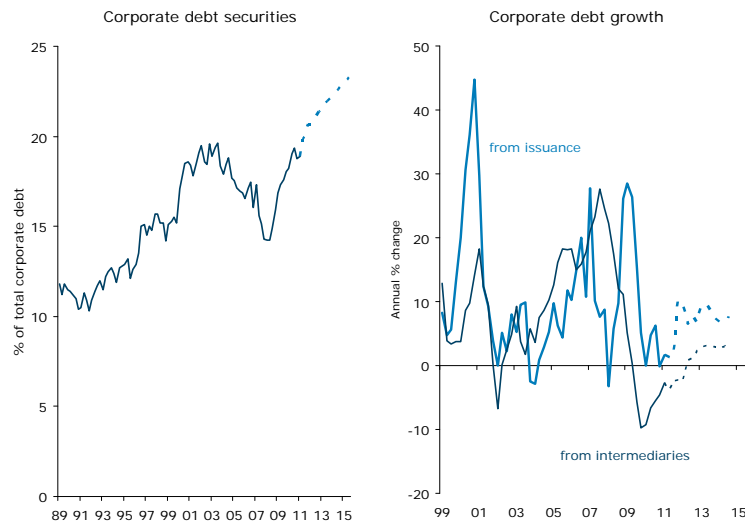
FIGURE 4. BANK LIABILITIES GO 'CORE'



Sources: ABS, ANZ

Shifts in the penetration of capital market debt will also be influencing the trajectory of intermediary balance sheets over the medium and longer terms. While borrowing by business has been subdued since the GFC, the impact on bank balance sheets has been compounded by an increasing share of this already lower demand being satisfied via corporate issuance. While there is some scope for intermediaries to compete more aggressively for high-grade corporate debt, post GFC shifts in bank funding costs vis a vis more highly rated corporate issuers suggest opportunities in this market are being squeezed.

FIGURE 5. CAPITAL MARKETS PRESENT AN ADDITIONAL 'DRAG' FOR BANKS

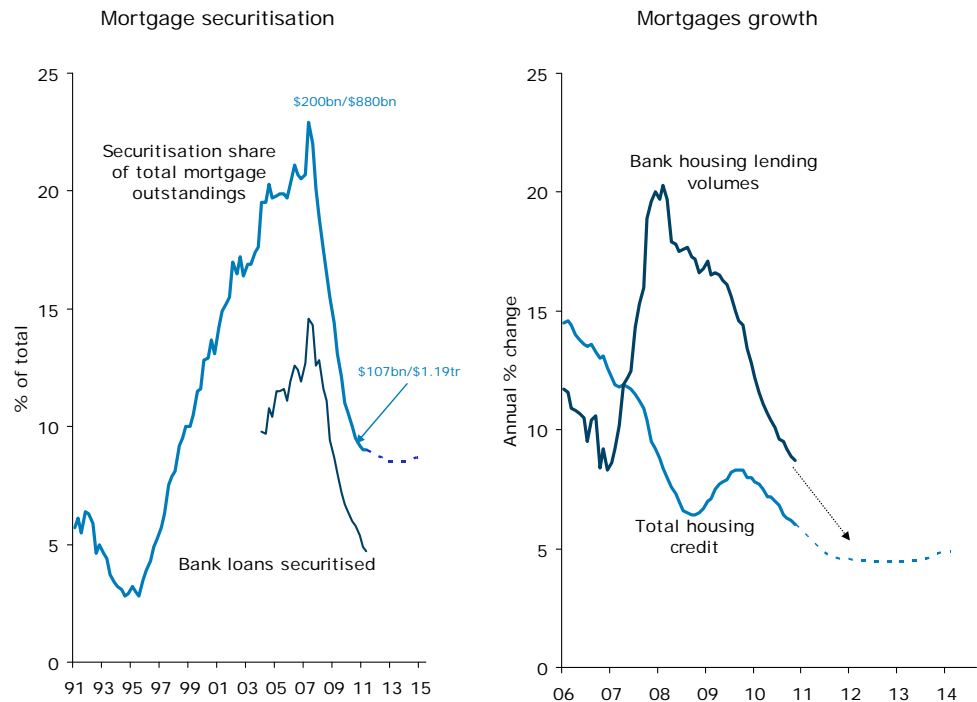


Sources: RBA, ABS, ANZ



Conversely, in the mortgage market, a relatively dormant securitisation market is buffering ongoing deceleration in total mortgage volumes (sluggish new demand and a rising repayment rate). However, while banks are 'enjoying' a record share of new mortgage lending, this is insufficient to counter the broader fundamental slowdown.

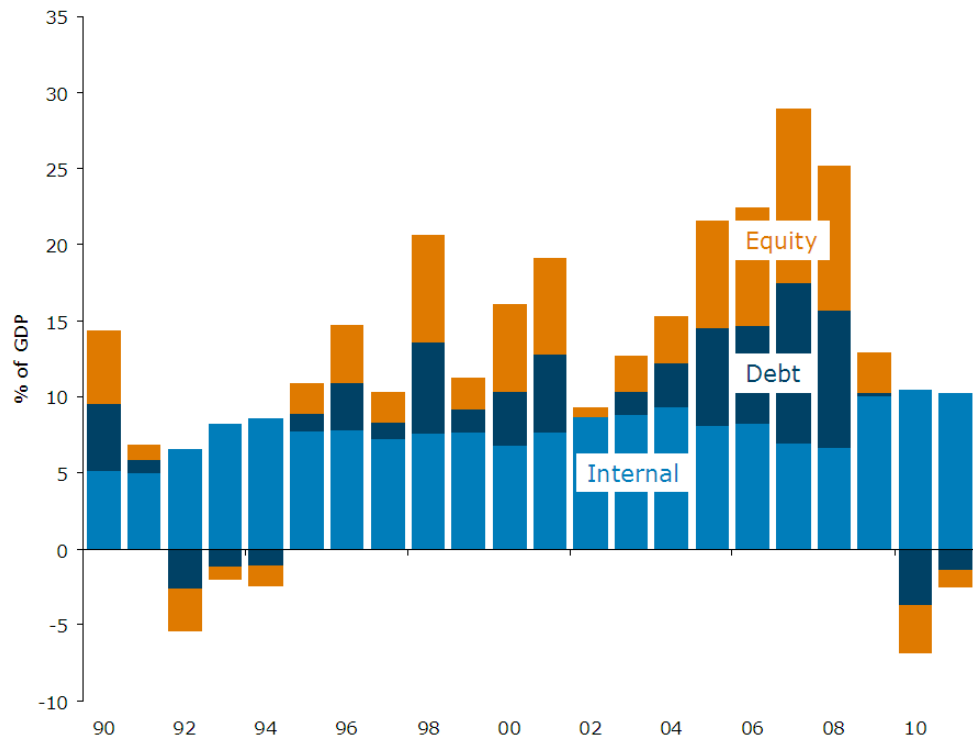
FIGURE 6. MORTGAGES, ON THE OTHER HAND...



Not unrelated, but affecting the liabilities side of the banking balance sheet, a sizeable lift in saving is boosting the deposit base. The drivers supporting household deposits (incomes growth, consumer caution and a struggling equities market) remain intact. Together with emerging perceptions that house prices will effectively 'flat-line' for a while should continue to see 'cash parking' maintained. This sentiment suggests loan demand by householders will remain sluggish, further reducing the net borrowing position between households and banks and alleviating bank funding pressures even further.

Pressure on bank balance sheets is also being alleviated by the corporate sector. A healthy profit performance and a wave of post-GFC equity raising combined with a relatively pedestrian business investment cycle has to date limited the need or desire to access external debt markets. This is reflected in the contraction in corporate debt and more particularly that owed to banks.

FIGURE 7. CORPORATE SECTOR CASHED UP, SHEDS EXTERNAL FUNDS



Sources: ABS, ANZ

LOOKING AHEAD

The GFC was a harbinger for shifting behavioural patterns. While the transition to a post-GFC environment inflicted considerably less pain upon the Australian economy than most other economies, the legacy has nonetheless been pervasive.

The lift in household saving rates is symptomatic of this behavioural shift and has already altered the pattern of funding flows around the economy and (via its impact on banks) also from offshore. Fortuitously, an “unprecedented boom” in Australia’s terms of trade is also having considerable impact on funding patterns. The forces are currently expected to sustain improvement in current account deficit - towards its lowest level in several decades.

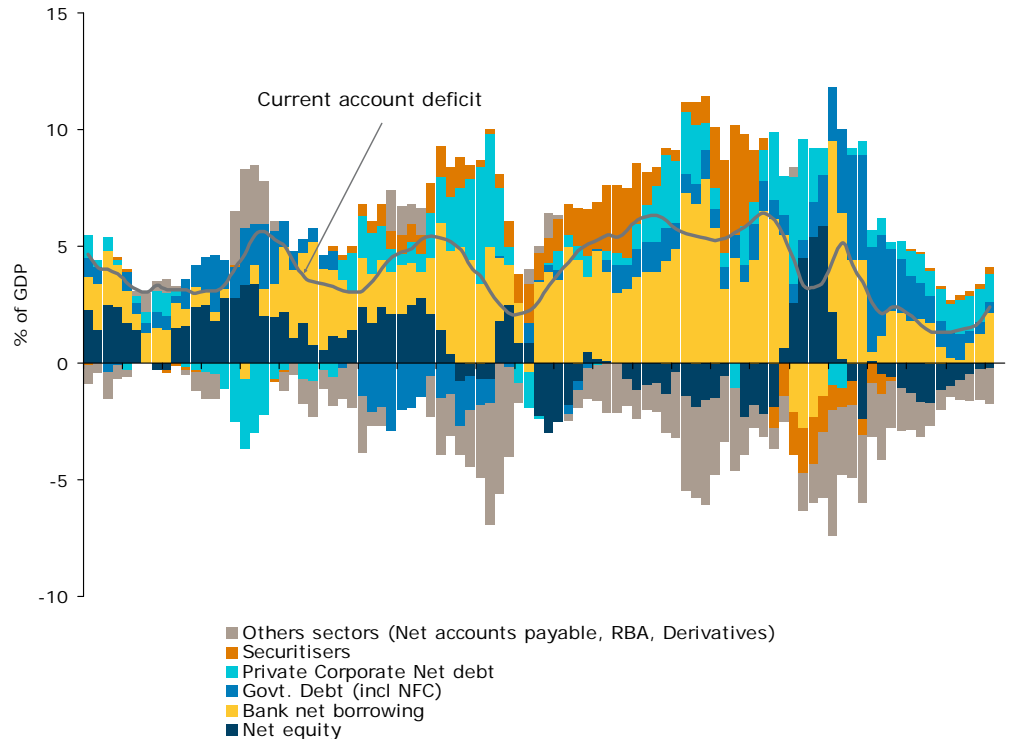
The impending investment boom is the other side of this macroeconomic development and will challenge any structural improvement in the current account deficit generated by higher savings and favourable resource sector conditions. This battle of forces highlights why pre-occupation with Australia's CAD is misguided. Earlier ANZ Research reports on funding issues have underplayed the significance of persistent current account deficits in Australia given that this condition is symptomatic of a country having more investment opportunities than it can fund domestically. Ultimately, the ability to fund the current account will depend upon among other things, serviceability, investor perception of such, confidence in economic management and outcomes.¹ Strong investment, if well formulated, while lifting the CAD, secures longer-term cash flows that will generate jobs, incomes, economic growth. The current account deficit might even shrink!

There are macroeconomic risks in either direction: commodity prices may not be sustained, undermining return on investment and support to the current account improvement; the investment itself may be delayed or shelved, which in many respects will represent self-preservation and should ameliorate current account pressures but by the same token restrict future cash flows; the consumer may revert to pre-GFC patterns and reduce saving rates once again - this presents a different set of challenges – particularly for RBA and economic management more generally but also for intermediaries who may once again be presented with an environment suggestive of more rapid credit growth. Outcomes may test the comfort zones of policy makers and bank management decision makers with each having considerable policy leverage over such outcomes (e.g. cash rate, credit risk policies).

However, on the plausible expectation that consumers remain or will be forced (by policy) to remain 'well behaved' for quite some time and that China growth continues to underpin export receipts, there is good reason to expect considerable 'achievement' in reducing the CAD in coming years (in a structural sense at least) and that growth of financial aggregates will remain within comfort zones at least for a while.

¹ Foreign funding – Bring it on, June 2010, Foreign funding – go with the flow, December 2010. Copies of these reports can be obtained by contacting research@anz.com.

FIGURE 8. WHAT FUNDING PROBLEM?



Sources: ABS, ANZ

This is a double-edged sword for intermediaries. Naturally, the prevalence of banks as key current account deficit 'funders' will be much reduced as will the oft-cited wholesale funding task that has caused much angst in the immediate post-GFC environment. This task will be even further reduced if private debt capital markets continue to take market share from intermediaries.²

Furthermore, given much of the prospective investment is being undertaken by a resource sector that is likely to have both considerable cash reserves and favourable debt-issuance capabilities, the funding of such investment to a considerable degree may be resolved in large part, unilaterally (self-funded) or bilaterally (corporate issuance).

More generally, sustained improvement in domestic saving outcomes suggest economic growth and associated investment can be sustained with less reliance on debt funding than in the past. This has clear implications for the trajectory and shape of bank balance sheets. It also raises some interesting strategic questions for intermediaries who will have some but not overriding leverage over how fast their balance sheet can grow.

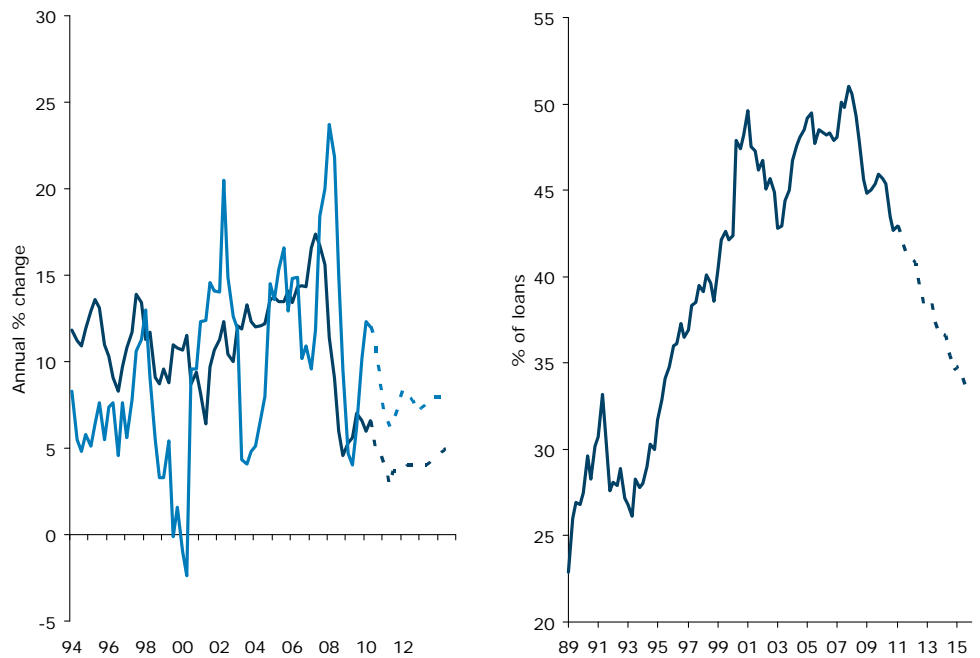
It is plausible that the post-GFC saving and borrowing patterns will continue for sometime before petering or possibly reversing. Our projections suggest healthy deposits growth and relatively subdued lending growth will see the banking system funding gap reduce to a 15-20 year low by 2014.

² This is a strategic question for banks but competitive forces are nonetheless reducing opportunities in this market – good from a funding perspective, not so from a bank balance sheet growth perspective.

This is presenting as a more comfortable balance sheet structure in the years ahead which should (based on numerous post-GFC sentiments) allay global investor and ratings agency concerns about the underlying liquidity of Australia's banking system. By the same token, it represents an intermediary sector that is experiencing a series of exogenous shifts cutting across the bulk of its balance sheet and highlighting a much reduced trajectory for the leading side of the balance sheet - lending.

While it does suit intermediaries and other stakeholders for the time-being to 'enjoy' the benefits, there are dangers in relying too much on the more benign circumstances should market forces require banks and other deposit-takers to once again expand balance sheets, lift wholesale exposures, increase mortgage lending etc. faster than appears on the horizon.

FIGURE 9. HEADING TOWARDS THE 'SAVINGS BANK' DAYS?



Sources: ABS, ANZ

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