

A perfect storm... in a teacup

Tim Farrelly | farrelly's | 06 October 2017

Time and again, we hear that the Australian banks have a huge vulnerability to a downturn in the residential property market. The shrillest commentators suggest massive losses await – even insolvency. Look what happened in the US! Look at Ireland! Look at the liar loans! Look at the record levels of household debt!

We suggest they may be better served looking at the real life stress test being conducted right now in Western Australia.

Since 2012, we have seen the WA economy contract by 17%, unemployment rise from 3.6% to 6.5% – and, according to CoreLogic, median Perth property prices have fallen by almost 12% since their peak in October 2014. Property prices in WA mining regions have fallen much further.

What has been the impact of this perfect storm been on the banks' loss rates on residential loans?

Well, Westpac has reported that the losses on their WA residential loan book has doubled from 0.02% per annum to 0.04% per annum. To put this in perspective, if this result was reproduced nationwide, it would reduce WBC profits by an almost invisible 0.6%. This is in line with the results of farrelly's own bank stress testing model.

What if things get much worse? What if we test for an implausible fall in nationwide housing prices of 35% and a 10% default rate on residential loans? farrelly's stress testing model predicts that this may reduce bank profits by around 18%. It's not pretty, but it's a very long way from life threatening. A one-year 20% cut in dividends reduces 10-year returns by less than 0.2% per annum.

Despite all the talk, the fact that Australian banks loan books are heavily concentrated in low risk mortgages rather than high risk corporate loans should be a source of comfort not fear.

This then begs the question – why do equity managers, bond managers and other commentators continue to perpetuate this myth? Self-serving lies or ignorance? Neither explanation does them any credit. We should call them out.

Just saying.



Tim Farrelly is principal of specialist asset allocation research house, [farelly's Investment Strategy](#), available exclusively through PortfolioConstruction Forum. Tim is a member of [PortfolioConstruction Forum's core faculty](#) of leading investment professionals.
