– DAILY COMMENTARY BY THE CURVE TEAM –

INTEREST RATE RISK IN AUSTRALIA

17th of April, 2018

As the market takes a well-earned break from geopolitical tensions, it is worthwhile to investigate the current interest rate risk in the Australian Financial System.

The Reserve Bank of Australia released their half-yearly Financial Stability Review last Friday. This document discusses household and business finances, personal credit and regulatory developments but most noteworthy and relevant to our world is a three-page excerpt discussing a few key points about the current interest rate risk in Australia.

Firstly, in comparison to global financial institutions, Australian financial institutions are exposed to a low level of interest rate risk themselves. This interest rate risk is mostly borne by customers and policyholders. Phillip Lowe was notably cautious on this point last week when he highlighted that a significant amount of interest-only home loans will now transition into the conventional loan where principal repayments now kick in. Borrowers with variable loans bear much of the risk of a rising interest rate environment so this is another reason why Lowe is overly cautious when considering a rise in the official cash rate.

Our banks have historically made their money from lending long (typically long-term mortgages) and borrowing short (taking short-term deposits from investors and cash accounts). This positive carry is brilliant for the banks where the yield curve is upward sloping, whereby the net interest margin (NIM) is pretty wide. In a period where the yield curve is flat or when short term interest rates are rising, the NIM on the trade narrows and the banks find themselves at risk.

Short term interest rates have been rising in Australia since late February. The nature of these short term liabilities for the banks mean depositors can constantly reinvest their short-term deposits at higher rates as they frequently mature. The banks on the other hand, may have locked in their interest rate return in long-dated fixed-interest assets and so now are exposed to the risk that short-term rates eat into their NIM or asset earnings. The good news in Australia though, is that 80% of Australian housing loans are priced using a variable rate that can move with the short-term fluctuations, and therefore the risk is not so high.

Secondly, potential price changes in fixed-income securities expose the banks to interest rate risk. As interest rates go up, the price of fixed income securities goes down because the future fixed-coupons are actually worth less given the higher interest rates on offer today. Again, Australian banks are in a comparatively good position to deal with interest rate risk because these securities are roughly 5% of their total assets, when these securities can make up about 1/5 of the assets of other strong economies.

The banks are regulated by APRA and as such, they are required to report on the extent of their interest rate risk. APRA and a range of other legislation including LCR and Basel have made the banks hold sufficient capital in times of crisis or unforeseen economic losses due to a sharp change in interest rates. As touched on above, the Australian banks are still fairly exposed to interest rate risk but these measures and regulations have put them in a comparatively good position when considering other banks globally.

The RBA minutes for the April meeting will be released later this morning. Governor Phillip Lowe has been banging on for some time about the growth story being a gradual and incremental one, so there are unlikely to be any surprises in the minutes. Therefore what we can expect is that Lowe forecasts a gradual decline in the unemployment rate, and an eventual pick up in wages and inflation.

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