Luck of the Irish

- **There were some recent headlines about the "Irishness" of the Australian housing market and the consequent dire outlook for Australian banks.**
- **We believe the Australian housing is nowhere near as bubble like as Ireland and not too far removed from most other OECD housing markets ie interesting but not near term calamitous.**
- **However, it's important to understand the aftermath of expensive housing and what it means for bank equity and AT1.**

Are we like Ireland?

As most readers most likely did, we recently read a very good article by the highly regarded JCP Investment Partners group who worried about the increased prevalence of high loan to income (LTI) ratios in the Australian housing market and the increased risks that this posed to the Australian banks. JCP Investment Partners alluded to the Irish experience where the whole banking system was nationalised after it collapsed due to the GFC and the bursting of the housing bubble. Their calculations concluded that Australian banks could lose up to 20% of their equity. That was the first time we've ever heard the Irish comparison and it intrigued us, because Ireland was really, really nasty. In any case, it looks (to us) like house prices are peaking in Australia, and it's worth examining whatever precedents we can find to map out a path for Australian banks.

Ireland; now that was a bubble

The chart below shows property values in different markets for the 15 years prior to the peak and what happened after the peak. The value at peak (year 0) is 100% (2007 in Ireland and the US, 2017 in Australia?). It is clear that Ireland was on a real tear and the quintupling of property prices in 15 years even beat the extraordinary California Dreaming experience (the rest of the US was nowhere near as bad). Mind you, Sydney's last 5 years are clearly looking bubbly (but not the rest of Australia).

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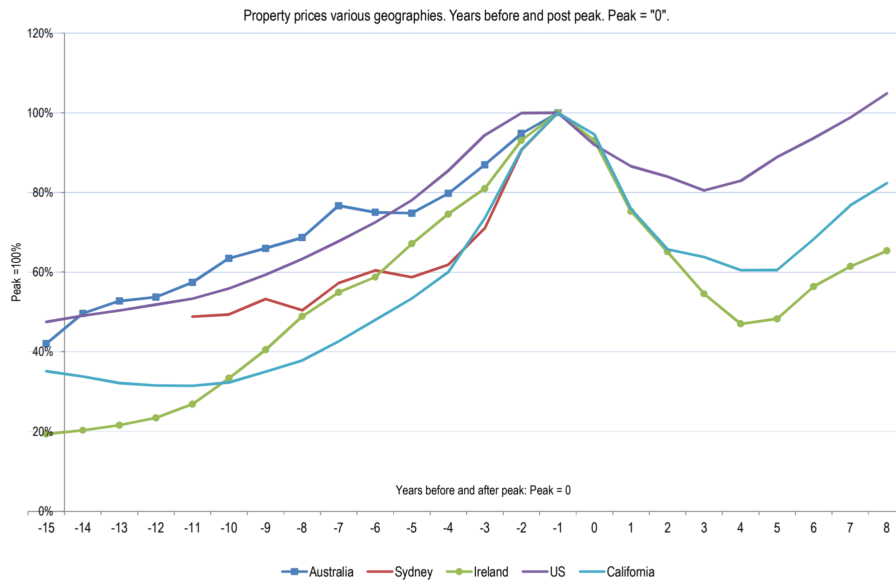
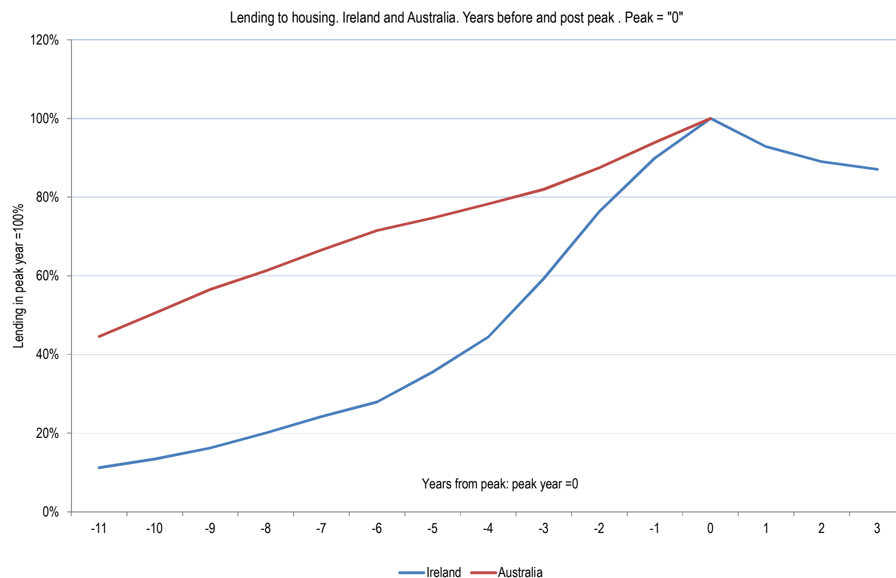


We're not Irish part 1: this has been a credit free boom

We've always held the view that real property bubbles require a lot of loose lending and that is one major difference between Ireland and Australia. The chart below shows lending to housing. We've based the peak year to 100% and once again the Australia/Ireland comparison falls down. Over the 10 years before the bubble peak, housing lending quintupled in Ireland (i.e c24% p.a. growth) compared to the doubling of total credit for Australia (8% p.a. growth). The amount of credit extended to the Australian system is still high, but it pales compared with Ireland. The 24% p.a. growth rate is the only statistic you need to understand to appreciate just exactly how big a bubble the Irish housing market had become.



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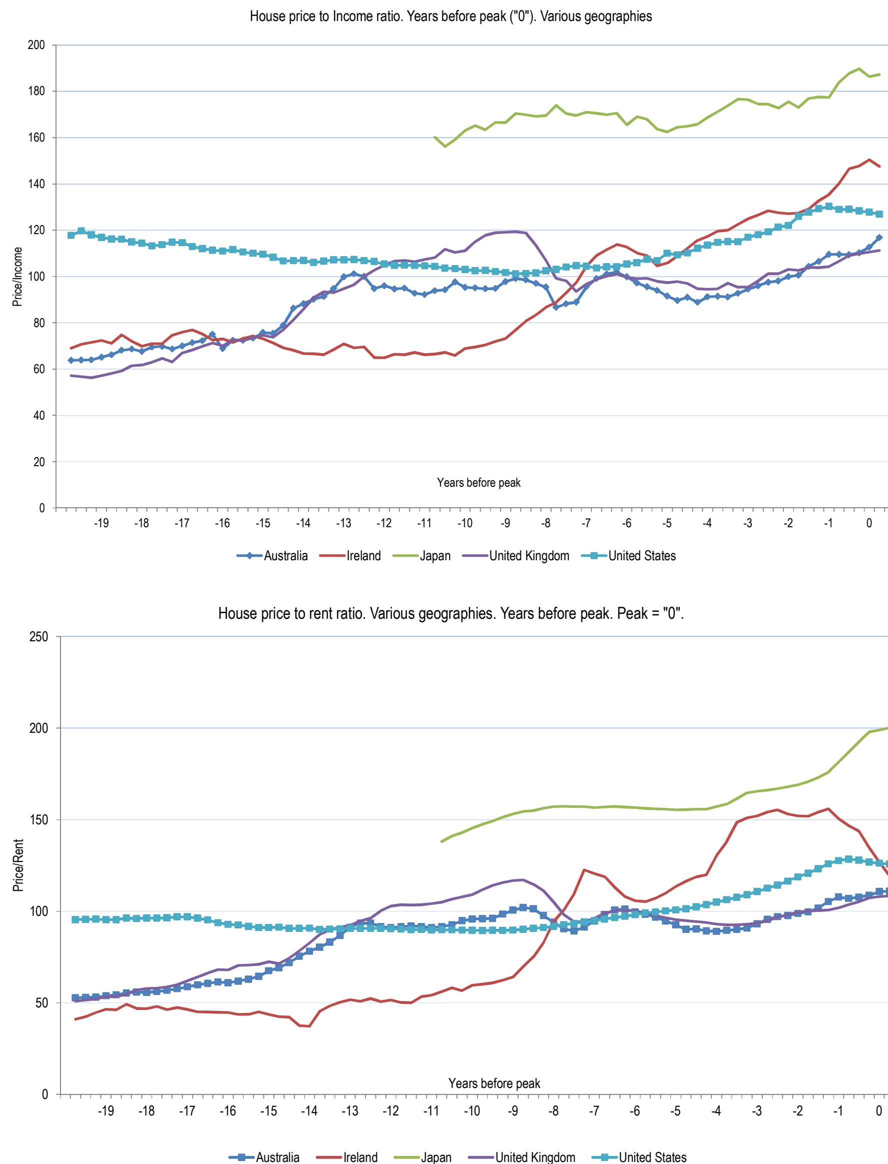
We're not Irish part 2:

We've also shown the house price/income ratio and house price/rent ratio charts for Australia and Ireland. They are actual ratios, so it's a like for like comparison. We've added the same data for the US and UK. To show you what a real bubble looks like, we've included Japanese ratios. What should be clear from the charts is that, although there is no doubt that Australian house prices are high by almost any indicator, it's clearly not Ireland. On these measures, Ireland property prices were around 20% - 30% higher than Australia. Arguably, Australia is probably less of a bubble than was seen in almost all of the OECD economies.



And the Irish lending was

We understand JCP Investment Partners' concerns about high LTI lending in Australia, but Australian banks have been quite conservative about the other mortgage risk factor:

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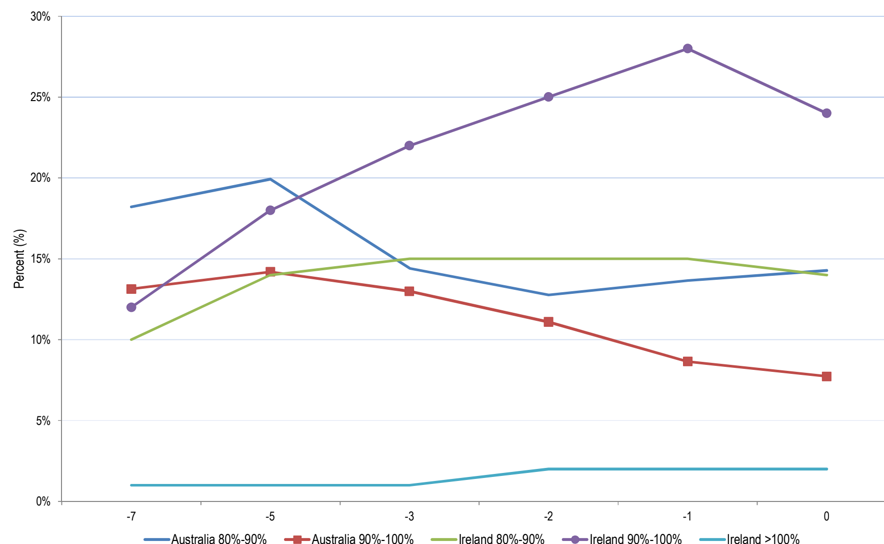
loose

the Loan to Valuation (LVR). We think that's quite important. As a broad rule of thumb banks loses are around 15% - 20% on a loan when it defaults: it takes a year to evict tenants and they're not paying interest, there are transaction costs and valuations are always an art not a science. So if the property market is stable, it's difficult to lose money on 80% LVR loans which is why the Australian banks require borrowers to take mortgage insurance if they borrow more than 80%. The charts below show the proportion of high value lending between in the 7 years before the peak. As is abundantly obvious, Irish banks not only lent more to high LVR borrowers, they increased the proportion as the bubble increased. If there is any giveaway to a real bubble, it is banks who lend more than 100% LVR. That has, to our knowledge, never happened at a bank in Australia (unless there is additional collateral). In contrast the Australian banks not only didn't do as much high LVR lending 5 years before the peak, they materially reduced the amount of 90%+ LVR lending. Currently, it's around 8% of all lending. In 2007, which is when the Irish bubble peaked, almost a quarter of lending was going to 90%+ LVR. It's not shown on the chart, but in Ireland there was an extraordinary high amount of second mortgage and equity release lending going on as well. That's what happens in bubbles that go on too long or which are too big; people get a sense of permanency.



So do we agree with JCP

- We think the "Irish" reference is either a headline grabber or wrong. Ireland was an almost insane bubble. Australia is arguably less of a bubble (on valuation terms) than the rest of the OECD economies. In terms of bank exposure to risky high LVR loans, it is clearly not a bubble.
- We believe JCP may have made a methodological error which means that their estimates of bank equity losses is overstated: so the 20% expected loss of Australian bank capital under JCP's scenario and 50% loss under the Irish scenario are more like 16% and 40% respectively. If this happens, it will still be material. JCP's losses are also much higher than the results of the 2 RBA stress tests, notwithstanding stress tests are only as good as the assumptions and if it's 'garbage in', it will be 'garbage out'. We do

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agree however that the effects of house prices peaking is an unknown, there are likely to be side effects and it is not yet fully priced into bank equity.

Effect on hybrids

One of the more interesting aspects of the first chart which shows the path of house prices (and it's more obvious as you look at the full cohort of OECD economies) is that the post boom fall in house prices averages around 12%. Most of these happened in the post GFC period and the unwinding of this "bubble" will be different. But if we work on a 12% we can only get some damaging years for bank profits, but no material effect on bank solvency, or more importantly "viability". However, we watch and are prepared to change our minds.

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