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Realm Investment House builds model to measure Australia's financial risk

Thanks to low interest rates, housing is not the largest expense item for many middle-class families. **Tamara Voninski**

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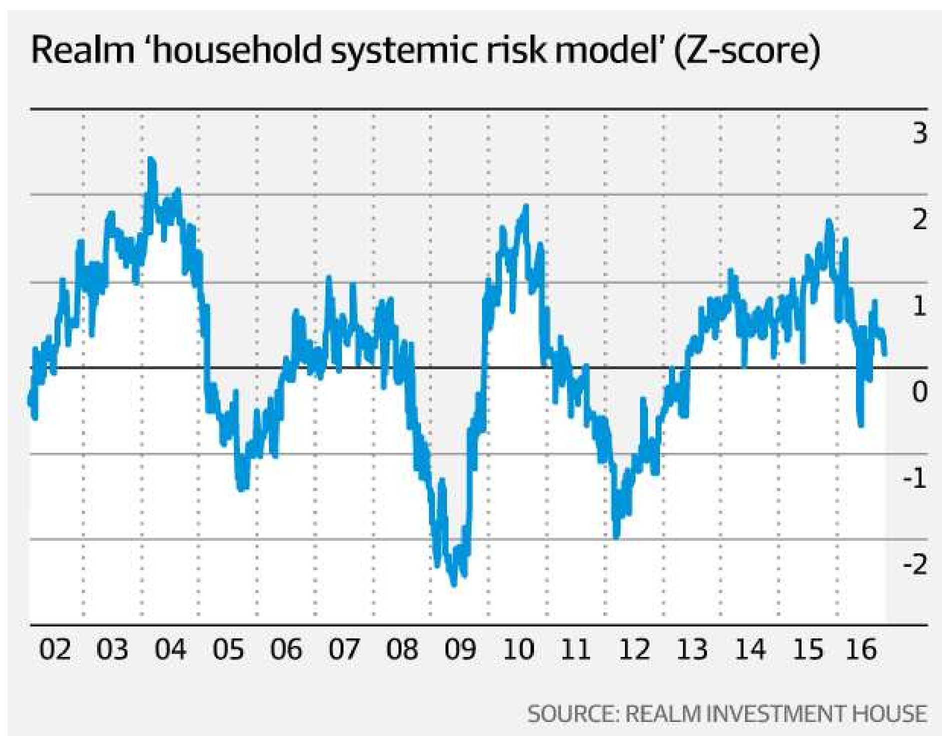
by **Jonathan Shapiro**

In Australia, housing lies at the epicentre of our financial system. So tracking changes in the financial health of households is critical for investors monitoring the risks of a systemic shock.

Melbourne-based boutique credit fund Realm Investment House certainly thinks so and has developed its own "household systemic risk model" to track the changes in how likely a "tail-risk" housing related event is from occurring.

Realm's Andrew Papageorgiou and Rob Camilleri explained how the model uses options theory to track the P&L (profit and loss) and balance sheet of Australian households in aggregate, and emphasises the rate of change in risks, rather than the absolute level of risk.

The output is what is known as a Z-score, which indicates the extent to which their measures of risk such as overall leverage and interest rate cover have deviated from previous means or averages.



Melbourne fund Realm has developed a model to assess household systemic risk based on the change in factors relating to leverage and interest rate coverage.

So where is the Z-score at the moment? It may be comforting to know that it has declined significantly over the last 12 months to just above zero, down from a measure of almost 2 a year ago.

The good news is that Realm says its model shows APRA appears to have been effective in reducing and managing systemic risk by tightening conditions on investor and interest only loans.

But Mr Papageorgiou and Mr Camilleri say "no one should underestimate the importance of low cash rates" to maintaining the balance sheet health of the average Australian household.

"The reduction in rates has taken the household mortgage payment from comfortably the single largest expense item in the household P&L, to on-par or below education expenditure and staples."

Finding balance

But this now means that lifting interest rates will increase risk, rather than manage it, as it has in the past.

"Modelling increases in interest rates on our metrics right now has the capacity to perversely increase rather than reduce systemic risks," the Realm pair said.

"This tells a story of the fragility of household cash-flow statements, and the underestimation of very high liabilities in an absolute sense."

Low rates are doing an "incredible amount of heavy lifting in providing the average Australian household and the Australian banking system with a buffer from a

significant cyclical event.

"Absolute debt levels are very high however banks and the regulator are now doing a much better job in reducing speculation and risk multipliers such as investor and interest only lending."

So we can take comfort that regulators are identifying and proving effective in managing the build up of risks in the system. But their actions and low rates can only provide temporary cover.

"It is critical that this period corresponds with an increase in wage growth and private investment which can then in turn bring the system back to a balanced position," Realm says.

For now there are some important conclusions we may be able to draw about the state of Australia's household balance sheet.

'Macro-prudential' policies

One is that so-called "macro-prudential" policies which manage the extension of credit by banks into the economy are set to become more important.

Realm says the model has a good track record of identified instances where risk build ups have "captured the attention" of the regulators and prompted action from either the Reserve Bank, in lifting interest rates, or more recently the Australian Prudential Regulation Authority, in tightening lending conditions.

At present given the collapse in private investment and stagnant wage growth, the Reserve Bank has effectively been sidelined from any role in managing housing risks, with greater responsibility passing to APRA.

Banks therefore are likely to have far less "degrees of freedom" in determining how they lend.

"We may have already seen APRA and the system take the first tentative steps towards banking becoming a form of financial infrastructure, which could have ramifications for the structure and the nature of banking in this country well into the future."

Another insight is that ability for the Reserve Bank to raise interest rates is likely to remain severely constrained in the short- to medium-term at least. The quantum of household debt remains large and the sensitivity of borrowers to changes in interest rates has increased.

In that context, the large sell-off in long-term Australian bonds, as a Trump-induced spike in US rates, is worth monitoring. After falling to almost 1.80 per cent in July of this year, the 10-year rate has spiked to 2.78 per cent – a near 1 per cent move – that would have resulted in a capital loss of about seven per cent.

The sell-off shows no sign of ending but if bond rates keep rising – and the chances of the Reserve Bank being able to raise rates doesn't – bonds may once again prove an attractive.