Will bank inquiry bash big four stock?

The public grilling could not have come at a worse time

JAMES KIRBY

How will investors fare in the wake of the sensational stories emerging from the royal commission into banks?

It is only the second week of what will be a year-long exercise — with an interim report due in September — but already it is clear the level of law-breaking and misconduct is much worse than even the most jaded cynic might have expected.

Bank chiefs are hoping this review of what looks like a decade of rampant misbehaviour will end when the inquiry itself ends. The chief executive of NAB, Andrew Thorburn, has expressed his hopes for "a close" on bank investigations. He must be dreaming.

So far the inquiry has just looked at one area — consumer finance. But already it is clear that commission-driven banking has sunk to new lows. Meanwhile there has been a gradual outsourcing of what used to be professional banking to car dealers (auto finance) and gym instructors (mortgage "introducers").

As an investor the first line of damage is obvious: the chances of you being well served by a bank or insurer when getting a loan of any description are poor.

According to the consumer group Choice, which has tried to do the numbers in the specific area of credit card insurance, there is a 10 to one chance you will be sold junk insurance (that is insurance not worth its price) if you take out a credit insurance policy. That's a view from the outside.

A scarier survey is from inside. At Aussie Home Loans (now a wholly owned CBA subsidiary) — which has arguably been the worst of the operations yet to front the royal commission — an internal staff survey showed that more than half of the staff thought they "need to bend the rules" in order to get things done.

In fact, the company only recently stopped brokers from approving their own loans and getting commission for them.

Earlier in the week we found out that CBA knowingly sold tens of thousands of insurance policies to customers who could never claim. In fact CBA has already agreed to refund $16 million plus interest to 140,000 customers of its personal loan and credit card products.

CBA first in firing line

In these early weeks of the inquiry it is difficult to say what the stockmarket impact will be. But already it is clear that CBA is the biggest loser so far. Indeed TS Lim at stockbroker Bell Potter has made the observation that CBA has the most "downside risk" from a looming crackdown on rogue players in mortgage broking.

Senior Counsel Assisting the royal commission Rowena Orr questions a witness at the inquiry this week

POOL

CBA and Westpac are actually the biggest users of broker origination, with this business representing about 10 per cent of overall operating performance.

Needless to say, with roughly one third of the value of the entire ASX locked into the four banks — ANZ, CBA, NAB and Westpac — the risk to investors is high.

The immediate risk is that overseas institutional investors, who hold about one quarter of all Australian bank stocks, get nervous about increased compensation and compliance bills and start selling.

Worse still, these fresh revelations of poor practice — and regular scandals at every single one of the big four banks — come at a time when bank stocks have been underperforming the wider market as a mediocre growth outlook and high capital requirements weigh on the sector.

There is no silver lining for banks in the face of this extended trial in the court of public opinion. But maybe one of the "Big Four" could get into the boardroom and have the gumption to stand apart and repurpose the bank as the one which leads the rest out of the mire.

Just imagine the response from customers and shareholders if one bank actually emerged as a leader which could be lauded for its high level of professionalism. Of the big four, Westpac had the best claim on this mantle with its history of tight credit standards and generally conservative management.

Under chief executive Brian Hartzer the bank might still aspire to this place in the pecking order but the commission has shot a hole in any current claim for the higher ground. One of the horror stories from this week's hearings was a carer on Centrelink who had a loan approved late at night through Westpac subsidiary Bank of Melbourne. The bank never verified the information from the car dealer, the car itself later caught fire. The deal was a debacle with Westpac later agreeing to pay $20,000 after the intervention of the Consumer Law Action Centre.

Phew ... and we have yet to hear what the financial planners have been up to. They are up next at the commission in the weeks ahead.

But one thing is beyond doubt. Two decades after the Wallis Inquiry unleashed the era of "disclosure" as a key arm of policy in financial services and many years after successive governments fell in behind the ill-defined "four pillars policy" (which protects the big four from takeovers) we now see a permissive protected oligopoly where sales comes first and customers come second.

Pitting parents against their children in dividend debate — offspring lose

ROGER MONTGOMERY

Bill Shorten's attack on capital gains tax discounts for investment properties, on negative gearing and on franked dividends is nothing if not ringing the bell on round one of a generational war.

He's simply pitting the same Millennials he believes all voted for same-sex marriage against the old fogies that he believes did not. And watching the ABC's *Q&A* this week you could see his plan working. Millennials — those born after 1982 — believe that anyone with a share portfolio is an undeserving rich-lister. What's more, they probably shouldn't be getting cash returns, rebates or refunds from the government.

The question from the Millennials seems to be: "Why should asset-rich retirees get away with paying negative tax rates for owning shares, when younger workers like me front up at the office each day and lose 30-50 per cent?"

Millennials can't see the future. They don't believe they will ever get old, they will ever retire themselves or they will ever have a share portfolio or a million dollars, and that's where they're wrong.

Millennials are the children and grandchildren of the very people Shorten is attacking. Voting for these Labor policies is a vote against your parents and grandparents. It could well force your parents and grandparents to sell assets to supplement their income, leaving them with less to give to you when they eventually die.

Shorten's proposal will erode the value of the asset base your family has built; in many cases it will force them to sell assets to supplement their depleted income, robbing many Millennials of any chance of receiving any kind of gift from their parents or grandparents while guaranteeing those same Millennials will have to work longer and harder than any generation ever before them. A millennial born in 1982 will be turning 37 this year. And in 33 years they will be 70 years old. One million dollars today, at 3 per cent inflation, will be worth just $377,000 when they turn 70. In other words, having $377,000 today is what it will feel like in 2051 if you have one million dollars.

If you're a Millennial and your parents have given you this article to read or you're reading it yourself, you need to get started investing in property, shares and managed funds as soon as possible, but there are a lot of hurdles in the way. There may be a family to build, holidays to go on, and children to raise and shower gifts on at Christmas.

Here's The Numbers

So what is the solution? Well, first, let's look at the problem for those who are worst hit by this proposal.

Living solely on the Age Pension isn't easy. As at September 20, 2017, the full Age Pension was only $1348.40 a fortnight or $674.20 a week for couples. And this is only payable if both are eligible. The full pension is only available to you if you earn less than $150 a week in other income — for example, from a share portfolio — and if you are a homeowner, have less than $380,500 in other assets — for example, in a share portfolio or industry super fund.

> Parents and grandparents could sell assets to supplement their income, leaving them with less to give to you when they eventually die

So, let's suppose you, or if you are a Millennial, your grandparents or parents, meet the criteria for a full Age Pension and they have the maximum income and assets permissible.

Total weekly earnings would be $824.20 a week, and of that, $150 a week comes from your investments. Curiously, for a couple with two children, the Australian poverty line is $895.22 a week. Importantly, the average weekly rent for a one-bedroom flat in Sydney's inner ring is $660, and it's $490 a week in the middle ring (a little better in other cities). At best that leaves just $334.20 a week for a couple to live off. Discounted travel will be possible and concessions are available for medication, but try running, insuring and maintaining a modest car, going to dinner or having a holiday with what's left. And you can forget about replacing the car when it conks out. It's bloody tough.

Now, at the risk of getting a little technical, let's suppose the $150 a week of allowable extra income is all from fully franked dividends and franking credits from a portfolio of shares valued at $380,500. In fact, if your parents or grandparents have a share portfolio of $380,500, it is likely the actual dividend income would be higher than $150 a week, disqualifying them from the full Age Pension. In the board game Monopoly it's what you might call a "Go directly to jail" card.

If $150 a week represented the grossed-up fully franked dividend, it means the Taxation Office is paying your parents or grandparents $45 a week. And that $45 is what Shorten wants to take away.

Despite our increased reliance on superannuation to fund our retirement, many Australian retirees with a little super continue to supplement their income with at least a part government Age Pension. And every dollar makes a serious difference to their retirement lifestyle, as they automatically qualify for a pension concession card and associated discounts. What is most offensive is that Labor's proposal ignores the fact our parents and grandparents made the decision to stop work based on a calculation of how much they will earn after they retire. They cannot reverse that decision the way Shorten is reversing dividend imputation.

And his belief that Millennials can be tricked into ripping off their own grandparents, and ultimately themselves, is frightening

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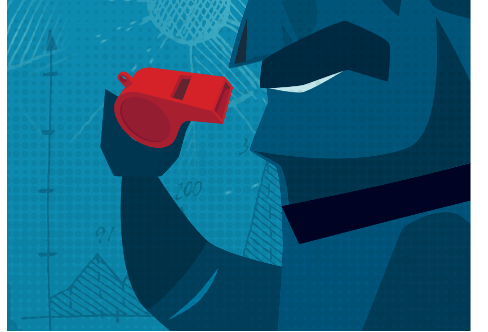

Q: Could you please explain how franking credits work on share dividends? We are retired and rely on income from the Age Pension, our allocated pensions and our small portfolio of Australian shares. We also rely on tax refunds to supplement our income. We are concerned about the impact of any change to franked dividends as proposed by Bill Shorten last week.

A: Dividends paid to shareholders by Australian resident companies are taxed under a system known as imputation, where the tax the company pays is imputed to the shareholders. The tax paid by the company is allocated to shareholders as franking credits attached to the dividends they receive. A dividend may range from no franking up to a tax credit of 30 per cent, depending on the tax paid by the company.

If a company declares a fully franked dividend of 70c, this amount would be received by the shareholder as a dividend. As the dividend is declared "fully franked", we know the company would have paid 30c tax. Therefore, for tax purposes, the shareholder would declare income of $1, incorporating the 70c dividend and the 30c tax credit. The tax credit can be used to offset income tax payable, or in the event that there are franking credits that cannot be offset, the shareholder can make application for a refund of the franking credit to the tax office.

It is this ability to claim back a franking credit that is causing controversy. On March 12, opposition treasury spokesman Chris Bowen said Labor's tax reforms would abolish this tax benefit. The policy does not seek to abolish franking credits but, rather, to abolish the tax refund for those who have credits in excess of the tax they offset.

For those who claim franking credits and who are still liable to pay tax, there is no change. Those who will be most affected will be those paying no tax due to low income who have investments generating franked dividends. Treasury estimates there are about 1 million Australians with taxable income of less than $37,000 who may be affected. Others affected will be investors in retirement income streams such as account-based pensions who pay no tax on earnings within the fund.

Charities and not-for-profits have been exempted.

Dividend franking was introduced by the Hawke Labor government in 1987. From July 1, 2000, amendments were made to the policy by the Howard Liberal government, enabling taxpayers to claim franking credits as a cash refund from the ATO. For retirees, these franking credit refunds are a source of supplementary income to offset falling interest rates and reductions in pension benefits as a result of changes to asset test thresholds.

If this proposal was to become law, there are measures investors should consider, such as diversifying investment portfolios to include investments that do not wholly rely on franked dividends to generate income; and including investments that generate partially franked dividends or dividends with no franking credits. These may include investments that generate income from offshore or international investments. Examples of these could be managed funds investing offshore, international shares or property trusts with investments held domestically or offshore.

Look for managed or direct investments that focus on the yield regardless of franking credits. Be careful of hybrid investments where the yield is derived or boosted as a result of franking credits.

Yield must be sustainable regardless of tax policy, especially in retirement. If you are relying on investment or fixed incomes in retirement, focus on lower risk and diversified income sources.

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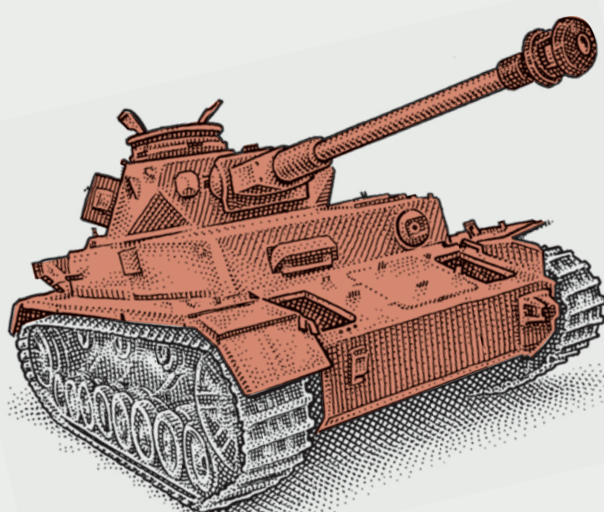

War of the Words

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