SECTOR BANKING

Don't bet on a comeback yet

As banks' profit margins are squeezed, shareholders will feel the pain

The big four banks represent 27% of the S&P/ASX200, so it is unsurprising that they form an even larger part of most investors' portfolios, and their recent share price falls have not gone unnoticed. Since their individual recent highs, CBA and Westpac shares are down 18%, NAB is almost 20% lower and ANZ is 13%, so what should investors do?

In the long run, bank profits drive share prices. In turn, profit growth is driven by the growth in the loan book (largely mortgages) and the bank's net interest margin (NIM), which is the difference between what the bank earns from its activities (mainly lending) and what it costs the bank to borrow money. The most important thing to understand is that both NIM and mortgage book growth are under pressure.

Here's why. Aggregate bank mortgages amount to $1.5 trillion (with 80% variable and priced off the bank bill swap rate or BBSW). These mortgages (assets) are significantly larger than the deposits of $800 billion (liabilities) used partly to fund them. Consequently, the banks rely on offshore funding. The other consequence is that mortgages are a major cash rate repricing asset that cannot be funded at cash rates. So how do the banks match the revenues and costs of their assets and liabilities?

The answer is that they tend to use longer-term offshore funding and use swaps to reduce duration risk between long-term wholesale funding and the cash-rate-repricing home loan assets. The problem, however, is that the shortest they can swap is 90-day bank bills (90 BBSW). Then periodically the banks use the less liquid overnight index swap market (priced off LIBOR) to swap from 90 BBSW to the overnight cash rate (OCR).

There is an indirect link between LIBOR and bank funding. Importantly, LIBOR rates have surged since 2015 and this has pushed up BBSW rates, even though the Reserve Bank is unlikely to raise the overnight cash rate. Consequently, the overnight spread between the cash rate and BBSW has widened and the Australian dollar basis swap versus overnight index swap is elevated. If the latter persists, it increases the cost of hedging back to the $A OCR, and rates for SMEs, corporations and institutions (referenced to BBSW) will gap up. Banks would have to increase variable housing rates but the royal commission may put a limit on their ability to do so and therefore housing product net interest margins have to fall.

If that all seems a bit technical, don't worry. Just remember that as rates internationally go up – if they do – the pressure on bank margins increases, so that even if the Reserve Bank doesn't lift rates the banks may have to lift their mortgage rates. However, the royal commission and revelations of improper lending may make passing on the additional funding costs difficult and put bank profit margins under pressure.

And all of this is heaping burning coals on the effects of the Australian Prudential Regulation Authority (APRA), imposing new capital requirements requiring the big four banks (which account for more than 80% of the mortgage market) to have more capital. This is great for the banking system's continuity and durability but not so great for shareholders, who have in effect committed more capital for the same profit.

In 2014, APRA also acted to tighten standards for interest-only loans, required serviceability assessments for new loans to be more conservative, added an interest rate "buffer" of at least 2% above the relevant benchmark rate (with a floor of at least 7%) used in-loan serviceability assessments and limited the growth of investor lending (to 10% annually). This lending growth cap has since been removed; however, mortgage commitments to investors have slipped to the lowest since January 2012.

In July 2015, APRA also announced, with effect from July 1, 2016, changes to the treatment of residential mortgages for banks able to use the internal ratings-based (IRB) approach to credit risk for capital adequacy purposes (mainly the big four banks). In essence, for every dollar of equity the banks hold, they simply cannot lend as much to residential mortgages.

And in early 2017, APRA tightened standards on interest-only lending. Among other things, banks were required to limit new interest-only lending to no more than 30% of new mortgage lending. Just two years before, interest-only loans were 45% of all new mortgages written.

When laid out this way and combined with declining house prices – a major driver of mortgage churn and therefore mortgage system growth – it is obvious that investors will have to lower their expectations for the banks' profit growth and therefore share price appreciation. And all that presumes that there are no shocks to the systems either from overseas or from sharply declining real estate prices.

For all the banks the suggestion is about the same. Our current outlook is that prices have not yet fully reflected a deterioration in property markets, consumer indebtedness and sentiment, nor the possibility of further increases in funding costs.

A short-term view on all the banks is to be underweight or lighten. However, a long-term investor may prefer to hold, especially if they acquired their shares before capital gains tax and are more concerned with income than prices.

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1 Commonwealth

A weak third-quarter result was primarily due to weak net interest income on the back of slightly slower loan growth and weak NIM. This is concerning given the other banks have reported stable NIM (or higher for Westpac) due to lower funding cost spread. NIM, however, will come under increased pressure in the last quarter of the year given the jump in BBSW. Increased capital charges emanating from the current political and regulatory climate require an increase in the capital retention, resulting in a lower outlook for return on equity.

ASX code CBA
Price $68.98
52wk ▲ $85.12
52wk ▼ $67.67
Mkt cap $121.4bn
Dividend $4.30
Dividend yield 6.23%
PE ratio 12.59

■ **LONG-TERM HOLD**

2 Westpac

The first-half 2018 result was stronger than expected. The strength, however, was largely due to a much higher than expected net interest margin (NIM) boosted by the markets business and another period of lower bad debt provisions. These are expected to "mean revert" in future periods. At the same time, operating costs were disappointing. While the base case valuation is circa $30, a degree of caution is warranted given the threat of a potential credit squeeze.

ASX code WBC
Price $27.90
52wk ▲ $33.68
52wk ▼ $27.25
Mkt cap $95.5bn
Dividend $1.88
Dividend yield 6.74%
PE ratio 11.86

■ **LONG-TERM HOLD**

3 National Australia

Its first-half 2018 result was essentially in line with expectations, with a higher than expected NIM offset by higher than expected operating costs. Management's guidance suggests aggregate operating costs could be well above expectations. Bad debt provisions remain extremely low by historical standards. As with the other banks, revenue growth is expected to continue slowing. NAB has flagged its intention to sell or demerge its MLC platform. While this would liberate capital, it would also remove relatively high incremental return earnings from the group mix.

ASX code NAB
Price $26.16
52wk ▲ $32.98
52wk ▼ $26.01
Mkt cap $71.2bn
Dividend $1.98
Dividend yield 7.57%
PE ratio 11.97

■ **LONG-TERM HOLD**

4 ANZ

The first-half 2018 result was better than expected at the cash profit level due to better cost control and extremely low bad debt provisioning offsetting weaker than expected revenue and higher tax. At the pre-provision and tax line, however, the result was below most of the broker forecasts. The outlook for ANZ is little different from that for the other three major banks. ANZ and its board, is in my opinion, dithering on the decisions required to defend itself against disruption. If it doesn't disrupt itself, those willing to work with Alipay for example, will.

ASX code ANZ
Price $26.68
52wk ▲ $30.80
52wk ▼ $26.11
Mkt cap $77.2bn
Dividend $1.60
Dividend yield 6%
PE ratio 11.14

■ **LONG-TERM HOLD**

Prices as at close of business, 15-Jun-18. Charts as at 14-Jun-18.