SECTOR BANKING

Profit pool set to shrink

Greater use of technology could have a bigger impact than misconduct revelations

With reporting season out of the way, it's necessary to revisit the most widely held sub-sector of the market for private investors – the banks. The royal commission has monopolised the headlines and there are likely to be some enduring implications for the major banks in terms of increased regulation and potentially some brand damage.

However, the challenges extend well beyond the royal commission implications. One issue we believe receives little focus but has major implications for long-term returns is the potential for technology to dramatically change the cost of financial products over the next five years.

A large proportion of the labour costs relate to the middle and back office processing of transactions, which despite the heavy investment by the banks in technology over the past five years remains a very manual process. Improvements in the capabilities of technology through continued advancement of artificial intelligence will progressively provide an alternative to manual processing of transactions, leading to significant improvements in speed and a reduction in errors and costs.

Given the scalability of technology relative to human labour, cost bases become more "fixed" rather than "variable". This could radically change the competitive dynamics because the incremental profit generated from the extra dollar of revenue is significantly higher in a business with a predominantly technology-delivered product base. A shift from pricing products on the basis of average costs to marginal/incremental costs could see the price of financial products fall dramatically, materially reducing the profit pool for the industry.

Before reading each bank's comments, keep in mind that we believe Westpac and NAB are trading slightly below intrinsic value but better value may yet emerge.

Roger Montgomery is the founder and CIO at the Montgomery Fund. For his book, Value.able, *see rogermontgomery.com.*

Commonwealth Bank share price

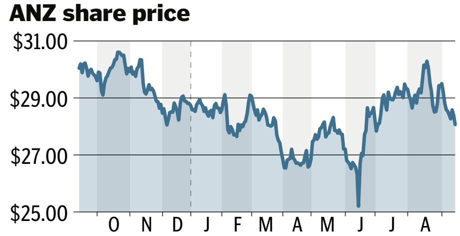
❶ Commonwealth

It was comments by Matt Comyn, CBA's CEO, that were most important for investors with the executive revealing investors should expect rising defaults as more borrowers are migrated from interest-only to principle and interest loans. P&I loans are also lower margin for the bank. We should expect profit growth to moderate.

ASX code CBA
Price $71.50
52wk ▲ $82.66
52wk ▼ $67.22
Mkt cap $125bn
Dividend $4.31
Dividend yield 6%
PE ratio 13

HOLD

ANZ share price



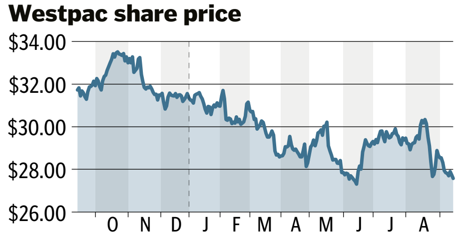
❷ ANZ

There is little doubt in my mind that ANZ and its peers would have preferred to raise mortgage interest rates by more than the 0.12%-0.15% announced recently. The royal commission will ensure that the banks' ability to recoup the full negative impact of rising wholesale funding costs will be harder, compressing margins for some time.

ASX code ANZ
Price $28.15
52wk ▲ $30.80
52wk ▼ $26.08
Mkt cap $80.6bn
Dividend $1.60
Dividend yield 5.7%
PE ratio 12

HOLD

Westpac share price



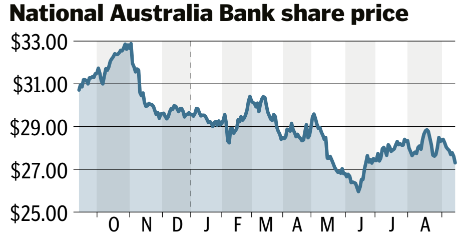
❸ Westpac

Westpac's move to raise interest rates out of cycle reveals the financial pressure stemming from rising wholesale rates for all banks. Credit growth is also likely to moderate as falling property prices and lending policy changes – as a consequence of the royal commission and APRA's response to David Murray's financial system inquiry – reduce the liquidity and appetite of would-be property buyers.

ASX code WBC
Price $27.76
52wk ▲ $33.68
52wk ▼ $27.24
Mkt cap $94.7bn
Dividend $1.88
Dividend yield 6.8%
PE ratio 11.3

HOLD

National Australia Bank share price



❹ National Australia

NAB is the only bank, at the time of writing, that has not raised rates on mortgages. Its owner-occupier principle and interest standard variable rate loan now sits at 5.24%, or about 0.14% lower than its rivals' offer. And while the decision to leave rates unchanged may win the bank some shares, it is unlikely to be enough to offset the broader pressure on margins and credit growth from an overextended household sector.

ASX code NAB
Price $27.35
52wk ▲ $32.98
52wk ▼ $25.90
Mkt cap $74.6bn
Dividend $1.98
Dividend yield 7.25%
PE ratio 14

BUY

Prices as at close of business, 14-Sep-18. Charts as at close of business, 13-Sep-18.