# Forest emerging

## Trends continue – as do challenges and uncertainties

Banking Matters | Major Banks Analysis
June Quarter | August 2019

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# Trends, challenges and uncertainties from half year continue

In the June quarter, banks saw longstanding headwinds on industry performance continue to grow, albeit slowly. Based on two banks' reporting, market data and anecdotal evidence, it appears that the key trends we highlighted in May[1] continued, as did the risks and uncertainties. We called those trends the 'forest for the trees' and, to continue the analogy, believe the forest is emerging more clearly, if slowly.

Based on two banks' reporting and market statistics, it appears that key financial indicators for the quarter remain flat or are deteriorating and signs of improvement are limited and formative, though we do see some quarter-on-quarter variability. In such an environment, the immediate priorities for banks remain unchanged. Those priorities include customer remediation, fulfilment of Royal Commission and Prudential Self-Assessment commitments, and completion of asset disposals.

At the same time, they must do all this without losing sight of the imperative to invest in productivity, culture, customer centricity and innovation to compete in the industry of tomorrow. We summarise their progress on all these priorities in the report enclosed, and will provide further detail in our November analysis of FYE 2019, as well as in our upcoming Hot Topic **Back to fundamentals: rethinking our relationship with consumer credit in Australia** in September.

1. See PwC Report 'Forest for Trees: seeing the next era for banking in Australia', PwC Major Banks Analysis,1H'19. May 2019

# Too early to call a 'bounce'

**The headwinds to growth we've described for some time were well underway in the June quarter, with the much-anticipated post-election 'bounce' not yet visible in balance sheets or financials.**

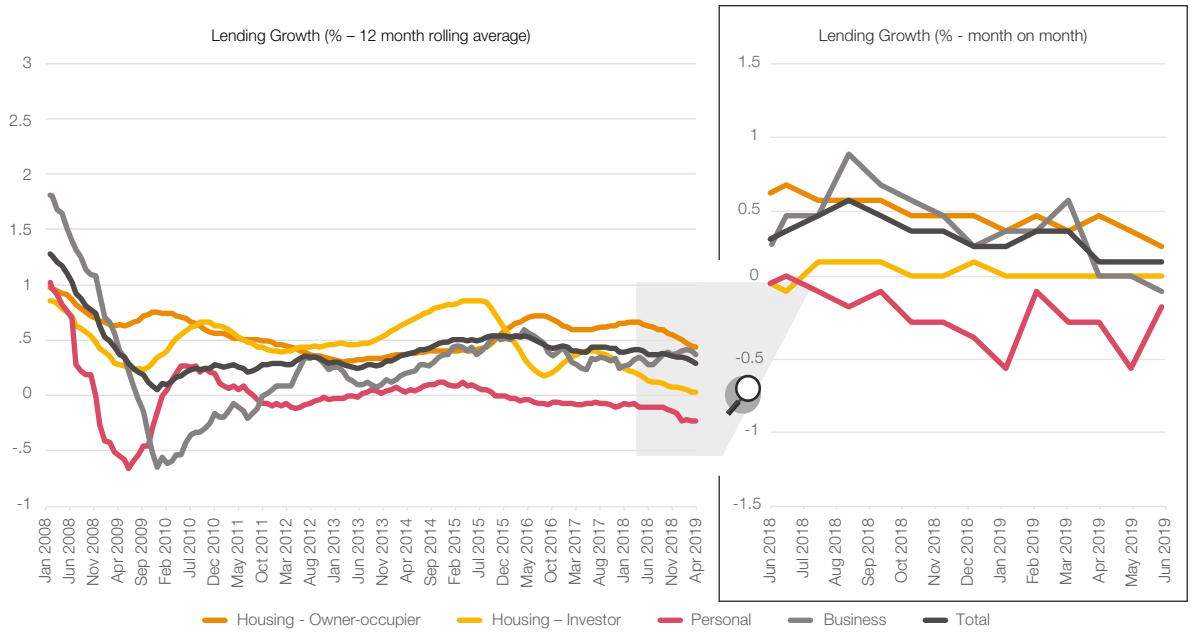
Growth in the credit market continued to slow, even as macroprudential and monetary intervention seeks to buttress it.[2] Meanwhile, the anticipated post-election 'bounce' has yet to materialise in bank balance sheets (though it is still early, and this may yet happen).

House prices appear to have stabilised and in many areas are growing again, auction clearances are up, and there have been widespread reports of an uptick in the Australian Bureau of Statistics' measure of housing commitments through June.

However, the uptick to date is small and, to the extent it reflects increased refinancing, would be matched by a proportional rise in outgoings for other banks once they are drawn down. Unlike in past cycles, stretched and uncertain households may be less likely (or indeed able) to use the occasion of a refinancing to take equity out of their homes and so increase their total borrowing.

For all these reasons, it will take some time before we know how the credit growth dynamic will play out, and even longer for these changes in sentiment to begin registering in financials.[3] In the meantime, credit growth trends remain pointed down **(Exhibit 1)**.

**Exhibit 1:** Annual lending growth by category, seasonally adjusted




Source: Reserve Bank of Australia

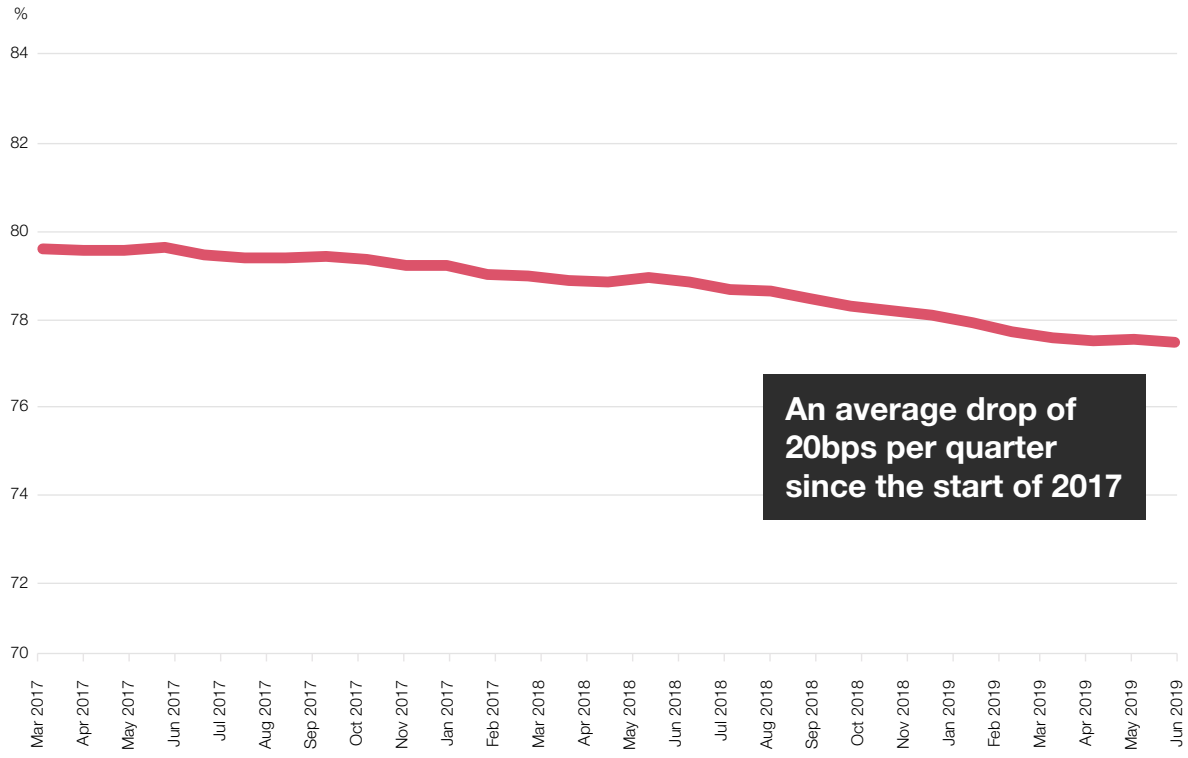
2. In particular, two consecutive cuts to the RBA cash rate, pressure on banks to pass on that cut, and APRA's removal of the 7.25% 'floor' for mortgage serviceability assessment.

3. Eg. ~90 days for loan settlement and another 30 before appearance in public data, meaning a change in sentiment in May might not be apparent until November

What's more, as we argue in our upcoming Hot Topic on the future of consumer credit,[4] we aren't optimistic about the prospects for sustained reinvigoration of Australian mortgage growth, whether from a market or societal standpoint.

Unfortunately for the major banks, not only is credit growth falling, but their share is as well. This is illustrated in **Exhibit 2** and, although the loss of share is slow (~20 basis point per quarter), it is a steady headwind which, in a low-growth environment, can be a material drag on growth – especially if it accelerates and then adds additional pressure to margins.

**Exhibit 2:** Majors continuing to lose share




Source: Australian Prudential Regulation Authority

4. PwC Hot Topic: Back to fundamentals: Rethinking our relationship with consumer credit in Australia, coming in September, 2019

# Performance remains very tough, costs in focus

**In addition to market share and growth (discussed previously), key financial metrics continue on a flat or downward trajectory, notwithstanding some quarter-on-quarter variability such as the slight uptick in June quarter net interest margin (NIM) relative to prior-comparable period (pcp). This reinforces the hard yards required for the banks to support performance, especially on core costs.**

Due to the limits of financial disclosure in the June quarter[5] it is not possible to report on aggregate major bank financials as we do in both May and November each year.[6] However, based on data available and information from market statistics, we can make conjectures about the quarter as a whole. These are summarised in **Exhibit 3**, and suggest that most metrics were flat or deteriorated in the June quarter relative to the quarter before. The exceptions were NIM and bad debt expenses, both of which improved slightly in the June quarter though largely due to deterioration in the previous one. In both cases the longer-term outlook appears negative.

5. One bank publishes a trading update and another full-year results from which June-quarter financials can be estimated by subtraction from their HY and 3Q reports. The other two banks do not release trading updates but will report FY results which we shall analyse holistically in November.

6. See PwC Report 'Forest for Trees: seeing the next era for banking in Australia', PwC Major Banks Analysis,1H'19. May 2019.

**Exhibit 3:** Indicative 3Q vs 4Q trends

| Metric | Q-on-Q | Movement | Outlook |
|---|---|---|---|
| **Cash earnings** | ↓ | Down on an underlying basis (i.e. excluding notable items and customer remediation), driven by cost growth | Continued pressure ahead, driven by a combination of cost, margin (see below) and ongoing evolution of the credit cycle |
| **Net interest margin** | ↑ | Up slightly for both banks q-on-q due to combination of discounting in prior periods and reduced costs of wholesale funding | Rate outlook predicted by (flat) ten-year Australian yield curve and (now inverted) US curve to put increasing strain on bank margins, though headwind from the shifting portfolio mix in home lending (away from interest-only and investor) may be tapering |
| **Non-interest income** | ↔ | Though not disclosed, one bank appears flat and whilst the other was up, this is after a fall in the March quarter | Medium-term to fall as divestments of many fee-earning businesses are completed whilst traditional banking fees are rationalised or removed |
| **Operating expenses** | ↑ | Driven by expenses for risk and control uplift reported by one bank, as well as customer remediation | Ongoing pressure as short-term imperatives to redress issues in risk and control outweigh (short-term) benefits from productivity investment |
| **Expense to income** | ↑ | Though not disclosed for the quarter, we deduce it is up, driven by significant 'negative jaws' implied on revenue growth and cost pressures | Additional pressures on cost as described above |
| **Bad debt expense** | ↓ | Down slightly in both banks' reporting after (relatively) significant rise in prior quarter | Continued increase as industry normalises after historically-low level, though low rates may prolong current performance |
| **Credit provisions** | ↑ | One bank very slightly down on quarter whilst the other is up, driven by increased delinquencies | As above |
| **Lending growth** | ↓ | Losing share in a slowing market. Bank by bank performance will vary | Uncertain outlook given the combination of already highly-indebted consumers, regulatory recalibration against political and economic steps to stimulate credit growth.[7] |

7. Coming soon: September Hot Topic: Back to Fundamentals: rethinking our relationship with consumer credit in Australia.

# Risks and uncertainties remain unchanged

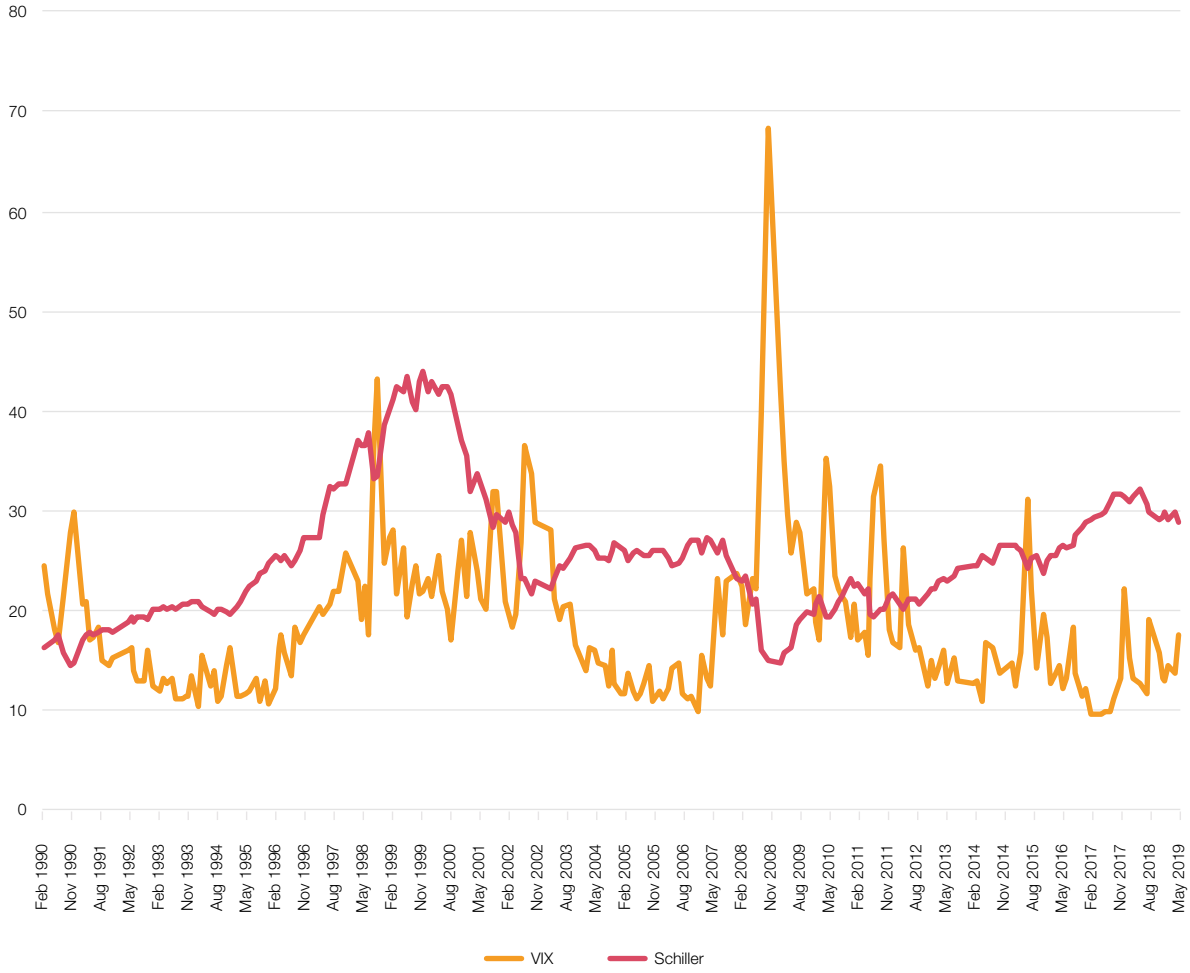
**Risks and uncertainties facing the industry and global environment remain as we've described before, though perhaps more visibly reflected by markets than in the past.**

Finally, we have felt for some time that global macroeconomic risks were biased to the downside, and we continue to hold this view. However, market sentiment appears to reflect these risks, and commentary suggests they are well understood, or at least better reflected in key indicators than they appeared to be not long ago.

Returning to our favourite index of systemic exuberance (the 'Fear and Greed' chart illustrated in Exhibit 4), we see that whilst global equity valuations remain near what has long been considered a threshold of 'exuberance' (with a New York Stock Exchange Shiller PE still around 30, though falling to 28.5 this week), rising implied volatility suggests there is much less sanguinity in these valuations than, say, in 2017 when we raised this issue before.

Needless to say, the market disruption underway this week highlights the merit of this cautious outlook.

**Exhibit 4:** Fear and Greed - risks biased to the downside




Source: Yahoo Finance and Chicago Board Options Exchange

In this uncertain global environment and faced with significant resetting of societal expectations locally, portfolio divestments are underway, and are expected to deliver surplus capital to balance sheets in the coming year. The two banks reporting in August both announced that they were 'on track' towards:

- Meeting the 'unquestionably-strong' requirement for Core-Equity Tier 1 capital
- Addressing the recommendations of the Royal Commission final report
- Executing the actions following their own prudential self-assessments.

In all cases, the significant increase in both investment and operating expense attributed to 'risk and compliance' is some testament to the seriousness with which the industry grapples with the task at hand. The same can be said for deliberate decisions to forego fees, or to invest in features and services that will help customers avoid inadvertently incurring fees. One bank alone estimated that the foregone revenue resulting from one of these measures may exceed $400m on an annualised basis.

We will revisit these themes again in November.

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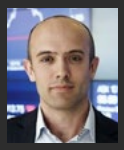

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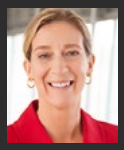

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