Major Banks Analysis

June Quarter Snapshot

Banking Matters | August 2017

Steady as she goes?

Our review undertaken in May found that Australia's major banks worked hard in the first half of 2017 to maintain momentum. This was in an environment of an uncertain domestic outlook, aggressive competition, potential technological disruption, low rates and ample credit supply. In response, we observed the major banks realigning their operating models and cutting costs to compete. The continued growth in Australian housing lending and reductions in credit losses were the twin engines propelling earnings and returns.

In the quarter just passed (April, May, June), the story remained largely unchanged as major bank executives executed the strategic and portfolio choices made to date. Slow but consistent progress has been maintained on earnings; future capital requirements are becoming clearer; in the short term, margin pressure has somewhat abated, and cost management appears, at least for now, to be pushing ahead. It's a position that observers appear to like, and that some are even calling 'steady', with the outlook to the end of the year seemingly clear: another very strong set of results is predicted.

Despite the current sense of calm, it's still worthwhile contemplating any clouds that might lie on the horizon. Our reflections, notwithstanding the significant efforts the banks are making to transform their operating models, are that a number of risks skew to the downside, and that 'tail risk' in the overall environment may be at its highest level in a decade. Factors include the narrowness of the industry's short-term profit drivers, fragility in the global financial system, changing monetary policy around the world and unprecedented levels of geopolitical risk.

All of this is happening while community expectations of banks and their leaders continue to rise to new levels. Shareholders remain as demanding as ever; while customers, business partners, governments and regulators are seeking a level of transparency, accountability and hands-on control that, in Australia at least, we haven't seen before. The **Banking Executive Accountability Regime (BEAR)**, established in the most recent Federal Budget and described in more detail in our Hot Topic, is just the latest example of this trend. It won't be the last.

Banks, however, are not passive observers in this environment, and have tools at their disposal to influence their destiny.

In light of recent events, banks will be carefully reviewing how such risks are considered as part of their overall risk frameworks, processes and controls, alongside consideration of planned or existing investments that have the potential to significantly streamline decision-making or improve responsiveness (for example, BEAR itself). Much of this is underway but we should question whether there are ways it can be accelerated. In addition, there may be opportunities for the banks to take select risks off the table, as well as to pre-position themselves for an environment of heightened volatility.

June quarter snapshot: earnings up, propelled by same key trends seen in March

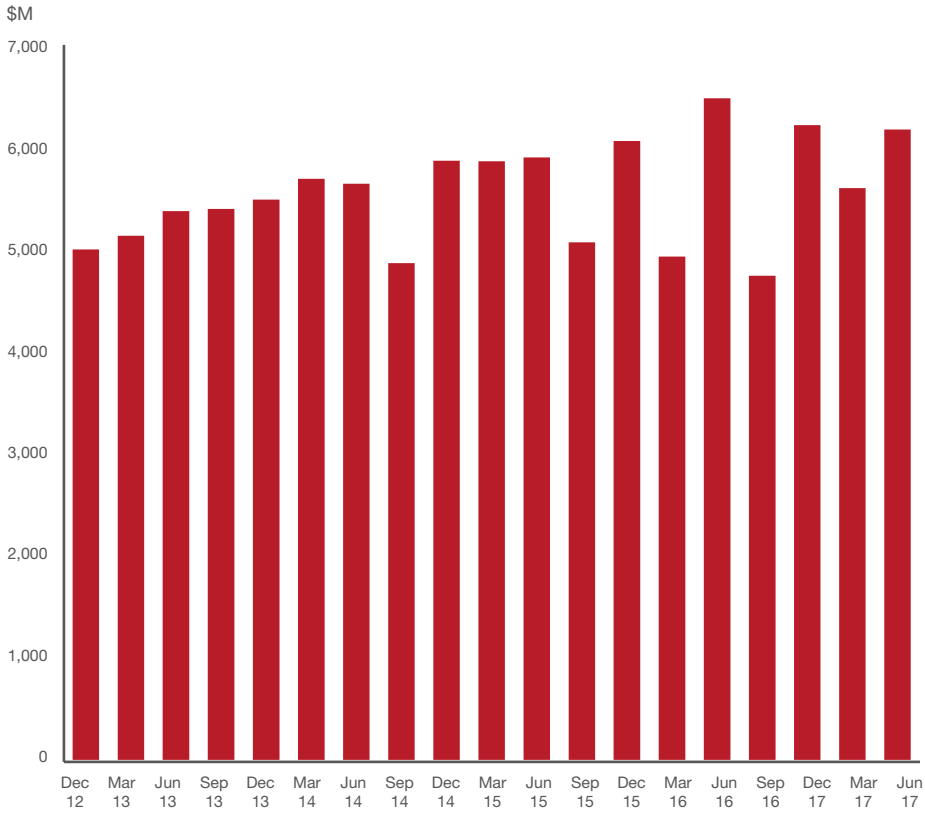
While we don't see detail from all banks at the quarter, disclosures and system data do give us enough to infer certain trends.

In simple terms, although there has been significant quarter-on-quarter variability (for example in 2016, when banks carried out significant restructuring), the overall upward trend in earnings appears to have continued in the June quarter, as illustrated in Chart 1.

Similarly, banks are making measured steps to ensure they can comply with the 2020 Common Equity Tier 1 target of 10.5 per cent, as best understood today. At least one bank may achieve it (albeit based on current RWA settings) within the current financial year due to asset disposals already in train.

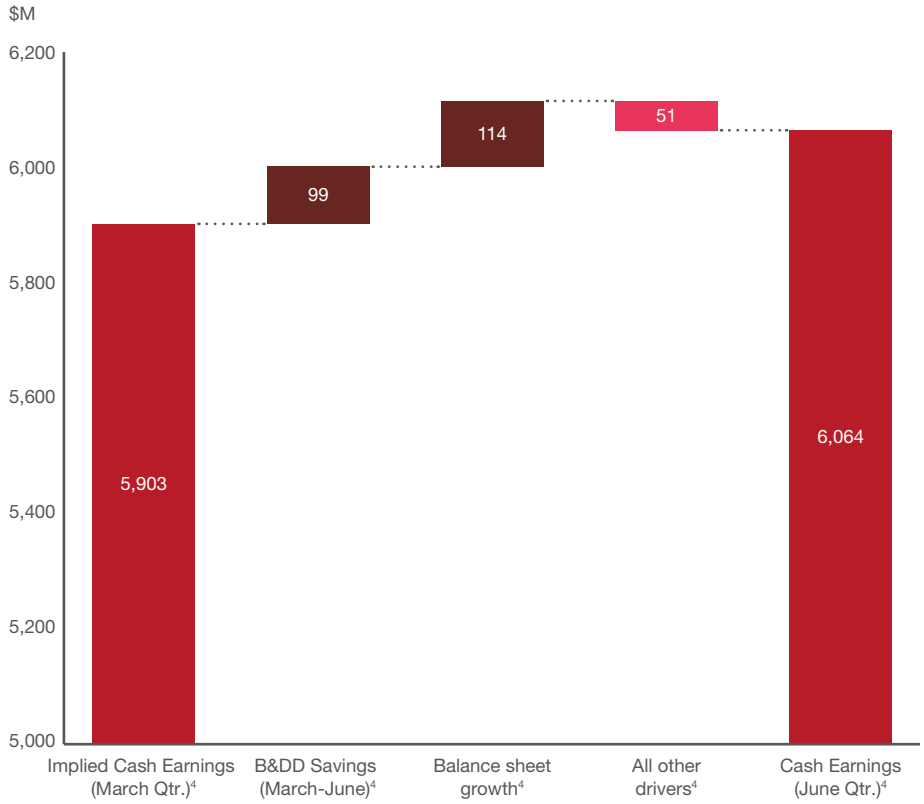
The growth in earnings for the quarter appears to have two main drivers: reduced bad and doubtful debts (B&DDs) and continued balance sheet growth, especially in mortgages. As shown in Chart 2, these two drivers alone accounted for over 130 per cent of the total net increase in (adjusted)[3] cash earnings over the quarter. This growth has been partially offset by reduced markets income, given low levels of volatility and fee income, changes in portfolio mix, costs, and other factors.

Chart 1: Cumulative cash earnings for available data[1] by quarter, 2013–17[2]



Source: Company statements and PwC analysis

Chart 2: Implied cash earning bridge for March–June 2017



Source: Company statements and APRA's Monthly Business Statistics and PwC analysis

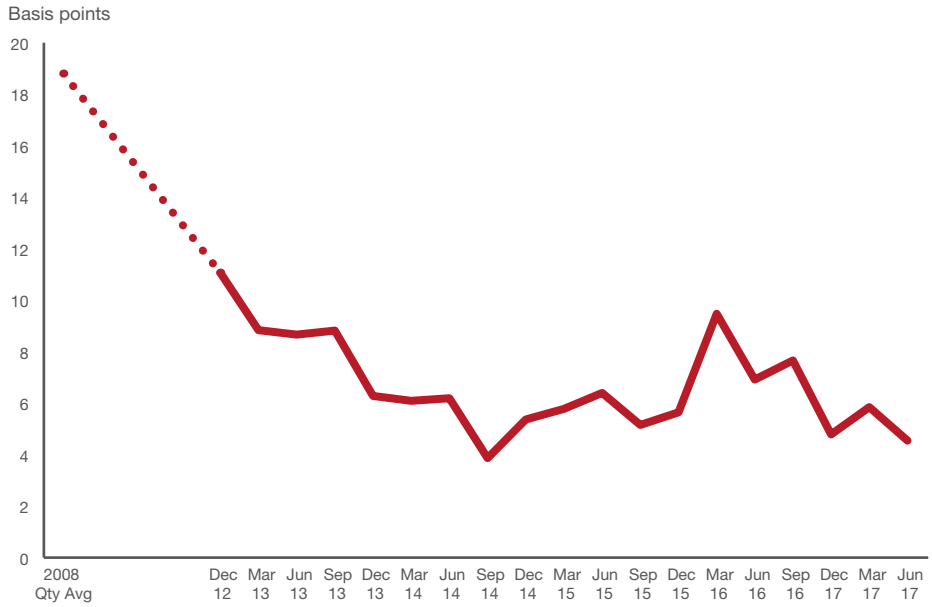
1. Since 2012 WBC has elected not to release quarterly results updates.

2. Second and fourth quarter cash earnings for each bank estimated as the difference between reported HY and FY results and reported 1st and 3rd-quarter earnings.

3. For the purpose of this analysis, ANZ March quarter CE was set to equal the average quarterly earnings over both the December and March quarters due to substantial intra-half variation.

4. In order to drive a basis of earnings for the bridge, a number of adjustments and assumptions have been implied from bank announcements.

Chart 3: Consolidated bad and doubtful debts charges by quarter, 2012–17 for available data[1]



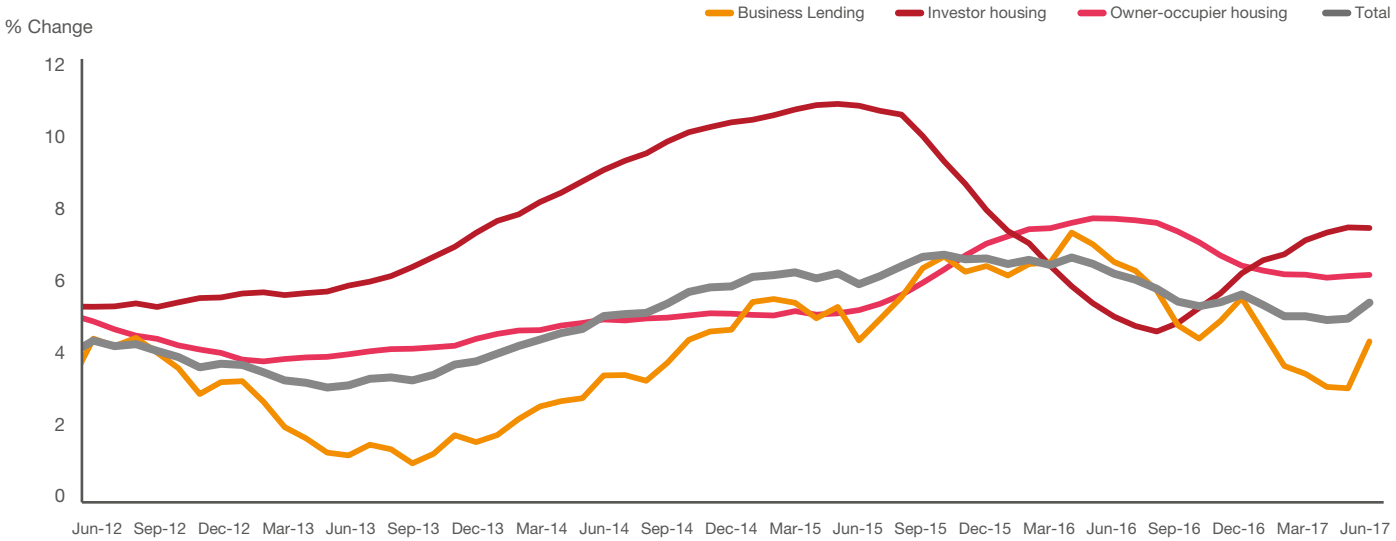
Source: Company statements and PwC analysis

These earnings trends have been in train for some time.

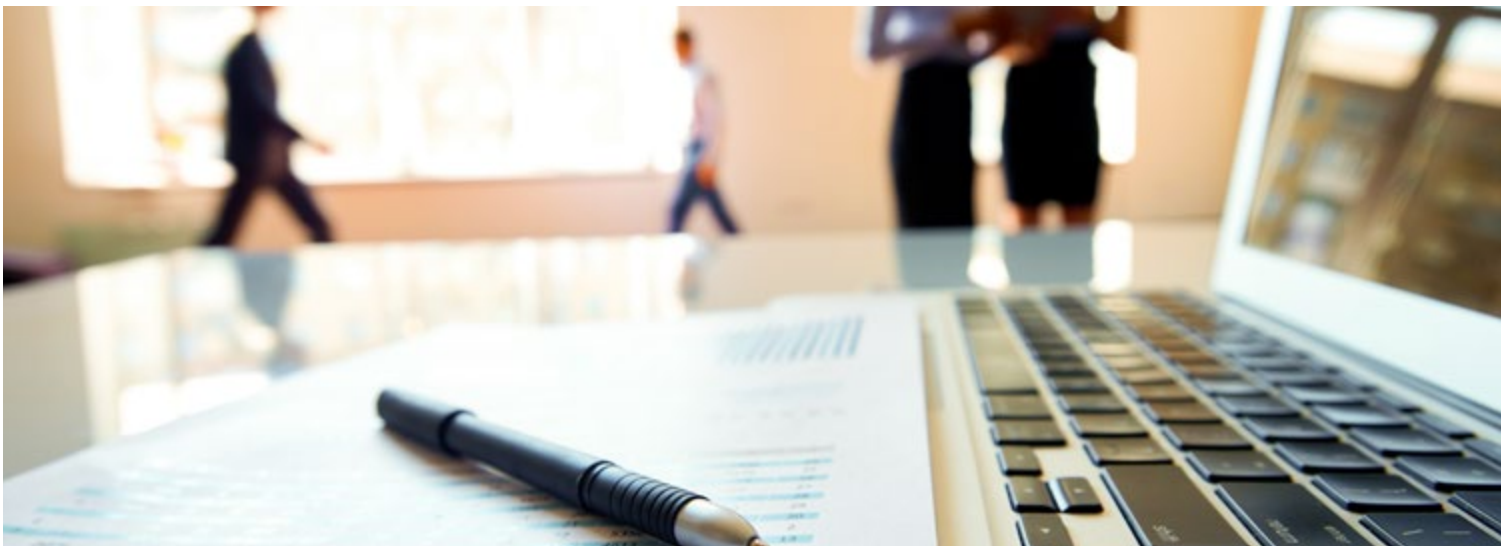
As illustrated in Chart 3, credit losses (normalised for balance sheet size) have been on a downward trend since 2008 and are approaching historic lows.

Similarly, balance sheet growth also continues to deliver for the banks, although the narrative has become a little more complex than it was when growth was dominated by investment home lending. As shown in Chart 4, mortgage growth on an annual basis continues to moderate. When we look at purely the recent quarter, this moderation is more stark, especially for investor housing - as intended by the regulators. Notwithstanding this moderation, mortgage growth remains the dominant driver, with only early signs of any pick-up in business credit.

Chart 4: 12 month rolling lending growth by category, 2012–17, seasonally adjusted

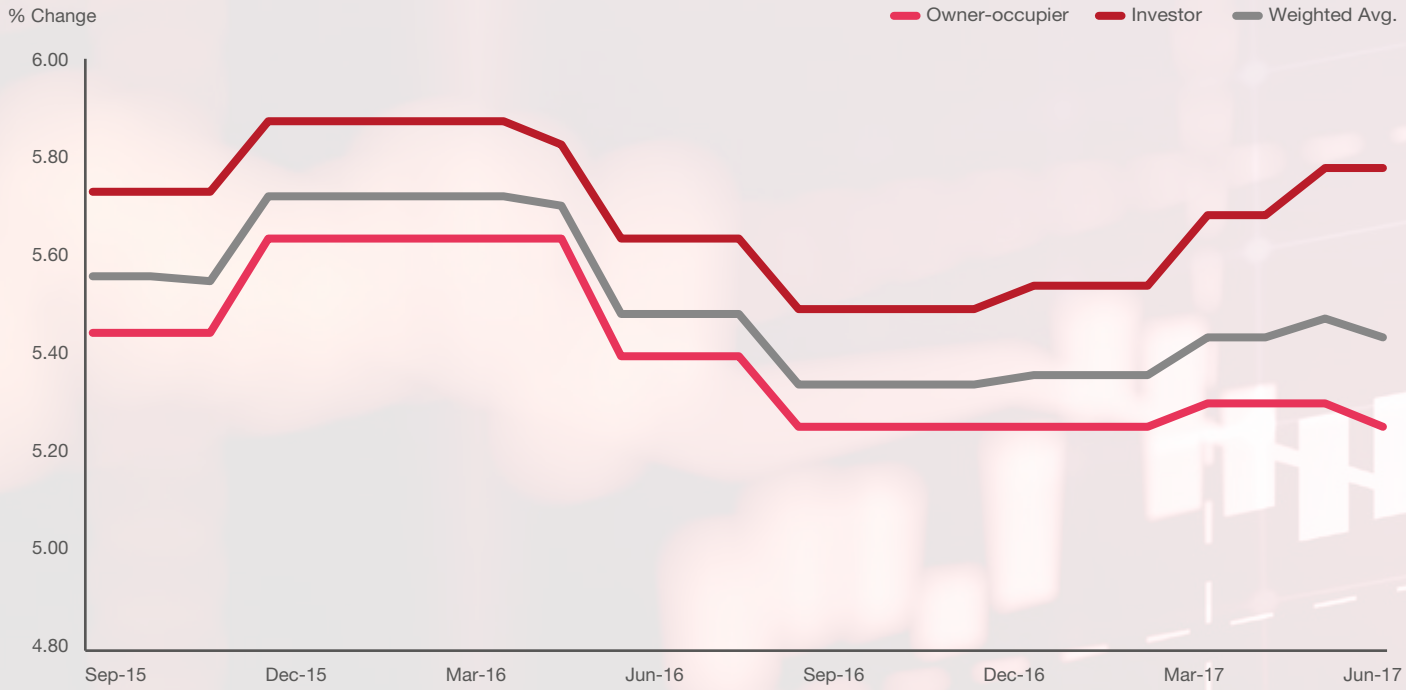


Source: RBA financial aggregates



[1] *Since 2012 WBC has elected not to release quarterly results updates.*

Chart 5: Monthly advertised mortgage rates by type, 2015–17[5]



Weighted average: weighted by outstanding mortgages by type, back book as well as front book

Source: RBA financial aggregates

[5] *RBA monthly 'indicator' lending rates: Note that these rates represent market-wide mortgage rates, not just major banks.*

As for margins, although banks did not reveal these specifically for the March quarter, disclosures about revenue growth and monthly gross loans & acceptances (GLAs), as well as associated management commentary, suggest they were flat overall for the quarter. These were supported by the substantial repricing of investor and interest-only home loans over the first half of 2017. However, one would have to expect further repricing of this nature particularly on back books to be unlikely given scrutiny over mortgage pricing decisions. As future origination begins to skew more towards owner-occupiers and principal and interest (P&I) borrowers who will be offered lower rates, we expect that in the absence of another catalyst for repricing, mortgages may shift from tailwind to headwind on overall NIM, the early signs of which perhaps are illustrated by Chart 5[6].

Clouds ahead? Macro-fragility and rising customer and community expectations

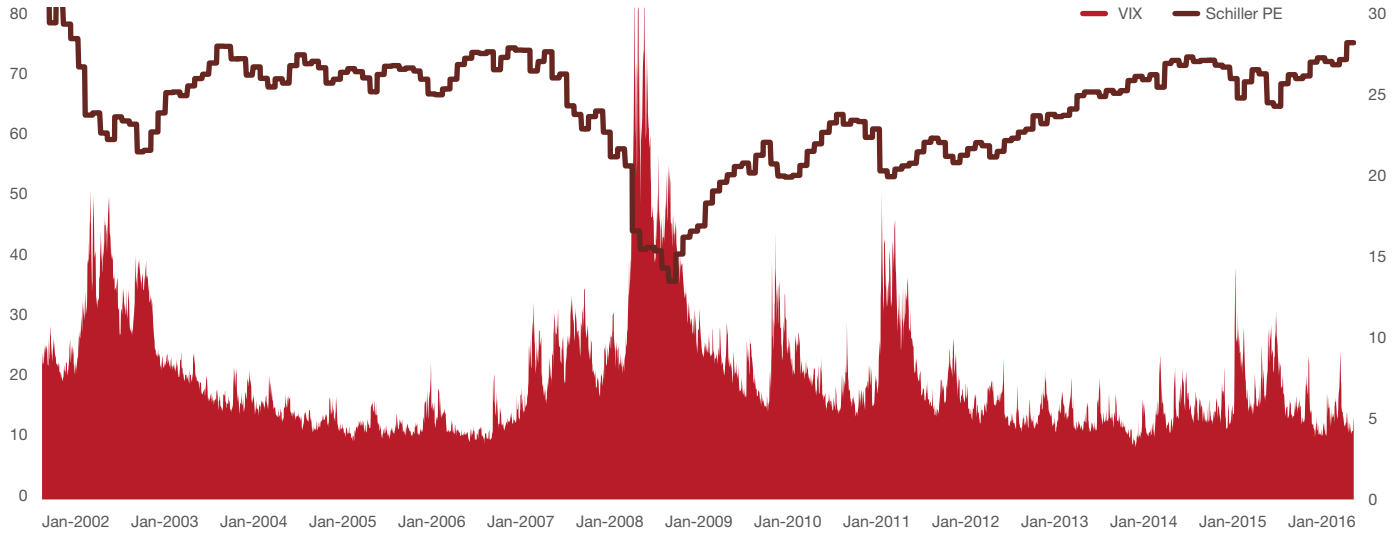
When looking at financial metrics around the world it's impossible not to notice an unusually high level of market confidence (consumer confidence is another matter). Equities in New York, options in Chicago, and property developers in China all suggest a consensus that the turbulence of the past decade is behind us, and the near future may hold more opportunity than risk.

In the US, the well-known 'fear and greed' index (equity valuation vs. implied volatility) is showing a level of confidence normally only seen at the height of bull markets (see Chart 6).

This confidence reflects a global economy that may be showing signs of growing closer to potential, as well as the socioeconomic realities behind the distribution of economic rewards (hence the disconnect with consumer confidence). It would therefore be wrong to say that the confidence is baseless. However, it does contrast with important and well-known signs of structural instability. For example, central banks around the world are tightening policy settings at the same time that levels of public and private sector debt are reaching unprecedented highs, including now in China.

[6] *Advertised and not realised rates: Empirical evidence suggests discounts have been harder to get, especially for INV and IO borrowers. Thus, in the short term, even without headline price rises, NIMs may continue to find support as borrowers seeking to refinance investor and IO loans find conditions less favourable.*

Chart 6: Historical Price Index Comparison Analysis



Source: Bloomberg

The US is once again approaching its debt ceiling in a political context that is no less dysfunctional than when it last skirted the edge of default. What's more, after the longest bond bull market in history, credit spreads (and therefore the cost of funds for corporations and banks) have more scope to rise than fall.

On top of all these traditional economic factors, we must consider the unprecedented geopolitical risks facing the world today. It was not long ago when talk of Grexit – or even a breakup of the Eurozone – sent markets scrambling and bank boards rushing into scenario-planning workshops. Today tense warlike rhetoric between nations is stretching the boundaries of scenario planning to new limits.

At the same time, community expectations of banks and bankers continue to evolve. Bank executives and directors at the highest level are being forced to consider the consequences of staff behaviour throughout the organisation. Business practices in areas from customer service to sales, internal risk management to product development are receiving a far greater level of public and regulatory scrutiny than in the past, or from almost any other industry today, including highly regulated ones such as energy, transport, healthcare and defence. BEAR, the subject of our Hot Topic, is merely the latest manifestation of this trend.

In short, we see pressure on the major banks continuing, even under these 'steady' conditions. Should the environment revert to something more 'normal', or even get worse, these pressures could compound rapidly.

No need to wait and see

The good news is that banks have tools at their disposal to prepare for an environment that may be very different in twelve months. Stress testing of risk management frameworks has evolved considerably in recent years but has yet to be holistically tested. Prioritisation and acceleration of investments under consideration or underway may enable a shift in the enterprise risk profile to something more appropriate to future conditions. We will argue in the attached Hot Topic that BEAR offers one such opportunity, but there are many others, including in mortgage origination, cybersecurity, robotics and artificial intelligence, payments, data-sharing and identity management.

Finally, scrutiny of the balance sheet after several years of restructuring may reveal opportunities to take additional risk off the table and the ability to reposition when conditions change.

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