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Impact of the Financial Crisis on Australian Banks

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The Australian banking industry has not been immune from the global financial crisis and the world wide recession which is currently taking place.

The Australian economy has now gone formally into recession with unemployment and bankruptcies rising and business investment and confidence contracting. The impact of the global financial crisis on the economy is accelerating and is likely to get worse.

The banking industry, lead by the four major banks ANZ Bank, Commonwealth Bank, National Australia Bank and Westpac, has however been much more resilient in the face of the financial crisis compared to the severe impact it has had on many banks, financial institutions and financial markets in the US, UK and Europe.

There are a number of reasons for this.

- Due to some salutary lessons from the credit crisis, severe recession and near death experiences some major Australian banks had in the early 1990s, banks subsequently reassessed much of their credit, risk and lending policies. This has created a much stronger and more reflective basis to avoid overt risk, 'not to forget' some of the hard lessons learned from that period and to be prepared for the impact of credit cycles.

- Australia has developed a very strong regulatory model and an astute, if not fairly tough and interventionist approach by the banks regulator, the Australian Prudential Regulatory Authority (APRA) a government controlled agency. APRA has, for instance, had a very aggressive approach to the implementation of Basel II and required compliance with the stringent requirements on banks much earlier than many other countries. It has also been stress testing the Australian banks ever since the onset of the credit crisis.

- Australian banks had, up until the financial crisis, 14 years of solid profit growth and overall conservative strategic growth and financial management. In particular, Australian banks have avoided what is known as low doc lending (a type of sub prime product approach) and buying financial instruments like collateralized debt obligations. As one CEO of the major banks has recently said, "*they (the major Australian banks) stuck to the core business of banking*".

- Also contributing to the banks position has been the fact that the Australian economy leading into the credit crisis was in a comparably strong (growth) position feeding off the resource boom and demands from China. The government had a budget surplus which was used initially to stimulate the economy in view of the crisis. That position has now changed with the government committing itself to significant budget deficits in order to continue the fight of trying to minimise the impact of the financial crisis on the economy.

- Once the more serious impact of the financial crisis began, the Reserve Bank acted fairly swiftly to begin a process of substantially reducing interest rates after making an earlier mistake in lifting interest rates to control inflation when the signs of the crisis were looming. These rate cuts, given the high level of Australian home ownership, have given significant relief to mortgage holders.

- In addition, the government has created much needed stimulus by way of cash hand outs rather than tax cuts and has also boosted the residential real estate market with a first home buyers grant that has kept mortgage lending at reasonable levels primarily benefiting the banks; some banks now have a back log of mortgage applications as a result also helped cushion falls in real estate prices along with general shortages of housing accommodation due in part to Australia's growing population from migration.

- No banks in Australia have received or needed any direct government funding or capital injections as yet. No Australian banks have been nationalized nor have we come close to any suggestion that any bank may be headed down that path. This could have been different for some of the smaller banks in Australia had the government not acted to introduce a government guarantee on deposits very soon after the second phase of the crisis occurred in 2008. Early evidence suggested that some of the smaller banks could have been vulnerable to customers withdrawing significant depositor funds and switching to the bigger banks.

- All major Australian banks have remained comparably profitable, well capitalized and funded. Latest results indicate a combined half yearly profit of the four major banks in excess of AUD 8 billion which is an excellent result taking into account the financial crisis. These banks have seen their deposits substantially increase as a result of the safe haven effect by investors moving into cash and have had no trouble accessing international debt/capital markets in terms of raising wholesale funding albeit at a price. A number of the majors have also had successful capital raisings which were oversubscribed.

Major Australian banks have now moved up into the top 20 of banks in the world by market capitalization, still maintain the rare AA credit rating and are also regarded by Global Finance as being in the top 20 of the safest banks in the world. To add to this, it has been reported that the Australian and Canadian markets were the only major banking markets to post positive total shareholder returns in the first quarter of this year.

Consolidation and Competition

Australian banks have taken advantage of both the deposit and whole lending guarantees offered by the government which has benefited both sides of the ledger. Acquisition opportunities have arisen with the Commonwealth Bank of Australia acquiring Bank of Western Australia Limited (BankWest) and St Andrew's Australia Pty Ltd (St Andrew's) in October 2008 through the execution of a sale and purchase agreement with UK based HBOS plc. The purchase did not extend to HBOS's other Australian businesses – Capital Finance Australia Ltd, BOS International (Australia) Ltd and HBOS's Australian Treasury operations.

Prior to this, and before the second phase of the financial crisis of September 2008, Westpac had successfully acquired Australia's fifth largest bank, St George. St George was a very important regional bank competitor to the big four and had stolen market share from them through their very focused product and highly regarded personal service approach. Whilst an important player in providing competition to the big four, it was also apparent that the bank, whilst remaining profitable and well capitalized, was going to struggle with the onset of the credit/financial crisis in raising competitively priced funds.

This development, coupled with the acquisition of BankWest by CBA, has considerably weakened regional bank competition in Australia and left only Suncorp, Bank of Queensland and Bendigo Bank as the other main regional bank players in Australia. All these banks have however been weakened by the impact of financial crisis and in particular their higher cost of funding compared to the majors banks. Suncorp is subject to further acquisition speculation by at least two of the major banks and Bank of Queensland is actively looking for a strategic partner given a recent profit decline of 25% and increasing cost of funds problems. Bendigo Bank, the smallest of the regional banks in Australia, is focused on capitalizing on its community banking model which has shown to be the backbone of its success and with a very wide shareholder base driven by community needs, looks perhaps less vulnerable that the other two.

This, coupled with a decline in non bank competition, has given the four major banks more market share, pricing/ margin power and business generally. In the longer term, it is most likely that the four major Australian banks will emerge from the current financial crisis much stronger and dominant in the Australian market. Concerns are now however being raised about competition verses stability in the financial system. The competition regulator, the

ACCC, has said that further consolidation of the Australian banking market would raise serious questions in relation to competition issues. Pressure is also is mounting from regional banks about an uneven level playing field where regional banks are forced to pay more for their wholesale lending and deposit guarantee compared to the majors because of their lower credit rating.

Funding Shortages in Commercial Property Market – A New Solution

There has been much speculation about the position of major international banks in Australia and their withdrawal from the Australian market, particularly in the commercial and corporate segment. More recently, a number of these banks operating in Australia have denied that this is the position.

Initially, this raised major concerns as to how our market would cope with the ability to fund billions of dollars in funds to be rolled over and in excess of the ability of the Australian banks to fill this void. In particular, the commercial property market looked vulnerable. The government has estimated at least 100,000 to 150,000 jobs could be at risk in this sector and was forced to review what it could do.

With this in mind, the government has formed with each of the four major banks, the **Australian Business Investment Partnership** (what has been dubbed the "Rudd Bank" after current Prime Minister Kevin Rudd) to fill potential funding shortfalls in the commercial property market. It has been reported that the commercial property sector has bank debt totaling $165 billion according to APRA figures which approximately $30 billion is provided by foreign banks. All four majors have indicated that it will be critical to implement the Rudd Bank given the inability of them alone to fund the needs of this market.

The government will contribute an initial $2 billion to be matched by $500 million contribution from each of the four major banks. In addition, the initial capitalization could be extended through the issuance of government guaranteed debt to create up to 30 billion in available capital. More recently the government is mooting the idea of expanding the operation of the Rudd Bank to include loans in any area of commercial activity. The concept still however faces some political hurdles in terms of getting the enabling legislation passed to implement it.

Executive Pay

The Australian government has announced that it will crack down on executive renumeration by reducing the size of golden handshakes for company executives and introducing criminal sanctions for boards that breach the very tough rules. This will see a cap being implemented on termination payments that would fall from up to seven times total annual pay to a threshold of just one year's salary before shareholder approval is required. At the same, the government announced that a Productivity Commission enquiry would be made into executive pay across the board.

Banks are feeling the both the public, government and market pressure in respect of this issue. Macquarie Bank announced earlier this month that it would be cutting cash bonuses to preserve capital. In addition, it has been reported that only the CEO and 8 other senior executives of Macquarie will be entitled to receive share options. In a further development, the CEO of Commonwealth Bank of Australia has most recently announced that he will take a 10% pay cut and that his 10 person executive committee will take a 5% cut. Pressure is now mounting on other CEOs and their executives from other major banks to follow suit. These pay reductions are also consistent with both pay freezes and other salary reductions in some other major commercial companies.

Summary

Overall, and at present, the Australian banking industry is in comparably good shape, very stable and has assisted the Australian economy from being insulated from the more severe impacts of the financial crisis than it would otherwise have been the case. The flow of credit to households and business has generally continued without too many obstacles and blockages. Demand for credit whilst falling in the latter part of last year appears to be leveling off although still substantially down a year ago. Government figures indicate that borrowing for housing is rising as interest rates fall and with government incentives such as the first home owners grant previously mentioned but which is unlikely to be extended in the May budget.

Generally however it is unlikely that we will see any recovery in credit demand in the short term due to further recessionary fears and job losses which are accelerating as the economy heads into what may be a fairly severe recession. As a result, major banks balance sheets could come under some pressure from potential losses across consumer, business and corporate markets depending on how hard and long the recession lasts.