Newsletter December 2012

Banking in Australia – A year in review

2012 began with a number of challenges and potential difficulties for businesses and operations of the Australian banks. Some of these are outlined below.

One of the most significant was that offshore wholesale funding markets were still were difficult to access and segments frozen due to impacts of the Eurozone crisis. Of particular concern were the prospects of incurring protracted higher long term funding costs and the constraints of relying too heavily on the covered bond markets which were providing a major avenue in a narrow corridor for their multi billion dollar funding needs. Australian banks are restricted to issuing no more than 8% of their total assets via covered bonds.

Concerns of a further slowdown in the economy, lack of consumer confidence, reduced demand for credit particularly in the housing sector, Australia's high dollar, falling commodity prices and how vulnerable China's economy would be in the face of the global slowdown. This could particularly affect demand for Australia's resources which has been a major factor in the growth of the economy.

In addition, falls in property prices that occurred in 2011 were the subject of speculation that this was the start of a major correction of the real estate market in Australia. There are a number of views, also supported by a major ratings agency, that the real estate market in Australia is significantly overvalued. Obviously any major correction could have significant ramifications for Australian banks given their very heavy lending exposure to that sector.

How regulation would change the way banks do business and in what areas. Particularly what further pressures, costs and other ramifications they would face from the implementation of Basel III's capital requirements and potential additional levels of capital over and above these requirements.

Interest rate policies and the government's confrontation with banks that any interest rate reduction to the official cash rate should be fully passed on to customers but which banks had started to resist on the basis of rising funding costs not related to the cash rate i.e. cost of deposits and wholesale funding.

How to implement further productivity improvements and cost containment in the face of anticipated further reductions in credit volumes as households continued to deleverage and businesses take a very cautious approach to debt and investment.

Comparative Challenges Australian Banks Do Not Face

Unlike many banks in other jurisdictions in e.g. the UK and Europe in particular, Australian banks have not had the enormous balance sheet challenges, critical adjustments and disadvantages that many of these banks have had to address. Neither have they been subject to any government bailout or direct taxpayer funding that has resulted in any regulatory directions or other pressures to divest businesses or assets. They have also not faced any major corporate losses or writedowns on the asset side of their books perhaps with the relatively small exception of NAB that is suffering from bad debt problems with its two subsidiaries in the UK Clydesdale and Yorkshire banks.

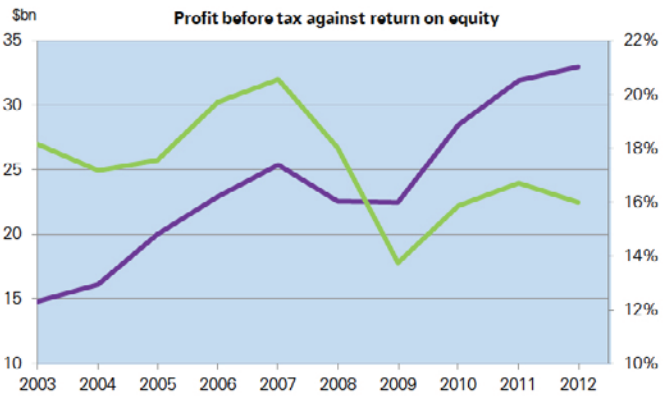
Whilst their balance sheets have and are being reshaped in response to global and local impacts, they are some of the healthiest in the world. This means there is still enormous flexibility to grow assets, invest in businesses/partnerships, raise capital and make acquisitions. Cost containment has however been a focus and will continue to be. In terms of labour cost, the number of full time employees were reduced this year by 6,600 averaging between 2.6% and 5.4% of their respective workforces.

For the future, they are very unlikely to face the concept of ring fencing their retail/SME banking operations from any investment banking business that will be implemented in the UK and is also being possibly considered in different parts of Europe; or the Volcker type restriction in the US of trading on your own account. This potentially gives the Australian banks further comparative and competitive advantages in a global environment.

Results in 2012

In the face of these challenges, some of which improved during the year e.g. access and lower costs in wholesale funding markets, interest rate claw back by banks from the official cash rate, a stablising property market with some signs of slight increases in values and less than expected impacts from economic adjustments in China, the major banks have had another comparatively excellent profit year.

Although not increasing their profits to the same extent from 2010 to 2011, they have kept the profit graph pointing upwards but with a return on equity that continues to move in the opposite direction.



Source: KPMG

Major highlights from this years results are as follows:

Westpac had one of its best results to date based on market analysis and investment sentiment, increasing its profit (before tax) by 4.1% to AUD 8.862 billion. Cash earnings from the bank's Australian retail and business banking units were higher than the previous year's up 14 per cent to $2.1 billion as deposits and loans grew. In addition, the acquisition of St George Bank (following the global financial crisis) and formerly the fifth pillar of the Australian banking industry, has started to bring home further rewards for the bank and also reflected the success of its multi brand strategy. The bank used a five year bank wide rebuild strategy to achieve this.

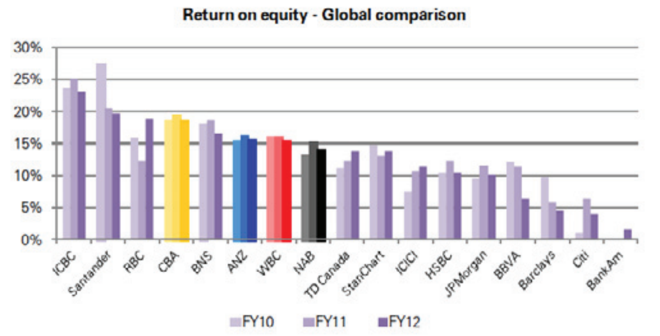
ANZ increased its profit (before tax) by 4.2% to $7.99 billion with a number of highlights including its continued success of its Asian offshore strategy growth and where group revenue outside Australia and New Zealand was 21%. As part of this, ANZ has been able to benefit from that diversification and gained $15 billion in deposits from its Asian operations. Overall, it was able to grow its deposits by 12% and use this to claim that it has the lowest wholesale funding requirements of its competitors. It stood high on the awards table as bank of the year, mortgage lender of the year and business bank of the year. It was also recognized as a top 5 corporate lender in Asia.

CBA, Australia's largest bank increased its profit(before tax) by 10% to $9.96 billion under a new CEO Ian Narev with bad debts falling and an increase in the Australian banking business with average interest earning assets up by $32 billion despite softer demand for credit. There was a decline in return on equity (but still the highest of the major banks at 18.6%) which was due to volatile markets affecting its markets business and wealth management plus steadily rising cost of funds and a lag affect in lifting the rates CBA charges its customers. It also invested $1.3 billion for the year in a range of growth initiatives including technology, productivity, organic retail banking in Indonesia, Vietnam and China. It has been a leader in technology compared to its competitors and this is emerging as a major differentiator for the bank. The investment is showing results in critical areas and financial reports indicate that it was responsible for allowing it to pick up 38 new corporate transaction banking accounts compared with a normal year run of 6 or 7.

NAB was the worst performing of the major banks and suffered its first decline in earnings since 2009 with a fall in its profit before tax of 8% to $ 6.15 billion after its UK subsidiaries Clydesdale and Yorkshire Banks were hit with a major increase in bad debts, principally in the commercial real estate sector and a sharp drop in their profits. There were also some further bad debt provisions of business customers in Australia. This is a major concern for NAB where it had earlier in the year announced a major restructure of those banks, plans to cut job numbers and pull out of the commercial property sector. Its ongoing comparative lack of performance at an investor level is fueling criticism of the board and its most senior executive level. NAB is however hamstrung by its UK operations with little option to sell them given current market conditions and the drag that it has been causing on the balance sheet. It has otherwise topped customer satisfaction ratings in the retail space (the first time any major has broken through 80%) primarily through being a price discount leader, has made market gains, maintained good margins and has solid underlying revenue and profit in many other parts of the business.

The overall result of the majors is very credible not only taking account of global conditions but also the fact they have increased their profits in a low growth economy, with lower demand for credit, intense competition for deposits, higher overall cost of funding and declining interest margins.

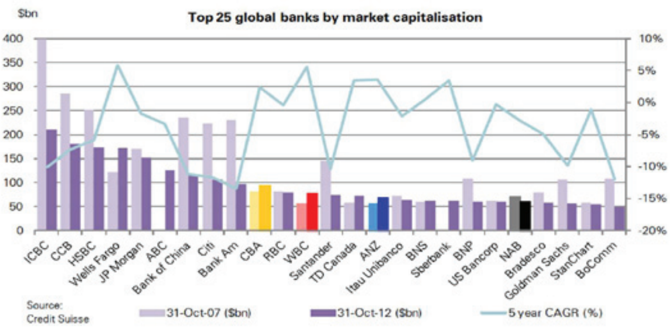
The major Australian banks are also very strongly capitalized (see below) and are building substantial liquidity buffers and asset profiles with all banks now exceeding $100 billion (cash, government, bank, corporate securities, internal RMBS and other) the best being CBA having in excess of $140 billion in liquidity assets. This is all in response to new Basel III liquidity ratios.



Source: Dow Jones Companies & Executives, SEC & other company filings
NOTE: Bank of America (BankAm) ROE was negative in FY11 and FY10.

Whilst return on equity has fallen this year, by comparative standards major Australian banks are still some of the stand outs on a global basis. Many banks and particularly those in the northern hemisphere continue to produce ROEs below 10% but in Australia rates are still close to or in excess of 16%.

Unlike many other banks being forced to deleverage and systematically reduce risk weighted assets to meet capital requirements, some of the majors in fact increased their risk weighted assets in 2012 e.g. namely ANZ and CBA with only marginal decreases for the other banks. Overall, Australian banks increased their total assets by almost 4% to $2,798 billion. Asset quality remained largely in tact with loan impairment charges comparatively low.



In terms of market capitalization, Australian banks are now the third largest in the world behind China and the US. With a sector that has a market capitalisation of close to $300 billion, this means that only China and the US have banking systems worth more. A UBS analyst earlier this year noted that this amount could buy Goldman Sachs, Standard Chartered, Deutsche Bank, US Bancorp and Britain's entire domestic banking system. It also outstrips its equivalent in the European Union, which takes in 27 countries with a population of 500 million and gross domestic product of $17.5 trillion. Australia's population is yet to break 23 million and its GDP is $1.4 trillion.

Prior to the global financial crisis, Australia's banks would not have ranked anywhere near the top 25 banks in the world. The position has changed largely due to the severe impact that the crisis has had on so many other countries and their banking systems whilst Australian banks have remained comparatively stable and resilient. Effectively their market capitalisation is back to where is was largely before the crisis in 2007/8. UK and eurozone banks have seen their market capitalisation dramatically shrink in comparison.

How Much Capital Against Market Concentration

Debate continues in terms of how much capital Australian banks should be required to carry.

From January 1, the Australian regulatory body APRA will require a minimum common equity tier one ratio of 4.5%. From January 2016, a further capital conservation buffer of 2.5% will apply to bring the common equity tier one ratio to 7.0%.

Although Australian banks are now significant banks by global standards, they have not been judged by the Financial Stability Board as "systemically important" and will not be required to create further additional capital outside Basel III requirements unless APRA decides otherwise.

Those banks judged to be systemically important will have to hold up to 2.5% (depending on how each of the banks on that list are graded/some will only require 2% and others 1%) of risk weighted assets in common tier one equity on top of the minimum 7% requirement.

The Australian bank's position is not however without criticism. The International Monetary Fund said in a report last month (November 2012) that Australia's largest four banks should be required to raise billions of dollars in extra capital because of the very high degree of concentration and dominance over the industry. That dominance is now touching in excess of 80% of the market and rising as high as 88% in the mortgage market. It is almost double the average of the largest four banks in other developed countries' bank systems the report concluded.

The IMF believes this creates risks for the economy and reliance on offshore funding which leaves the banks exposed to common shocks and disruptions to funding markets. The latter issue being the fundamental reason why credit rating agencies reassessed Australian bank ratings in 2011 and have continued to point this out as a major vulnerability for the future.

The report further noted that that Australia's financial system had grown rapidly, with assets at about 340 per cent of GDP due to the expansion of home loans and tax-effective superannuation. It further highlighted risks to banking including high household debt, high property prices and the industry's dependence on volatile offshore funding markets.

While the IMF says Australia's banks are well capitalised with good asset quality, it says a higher capital threshold for systemically important institutions is desirable to further bolster financial system stability.
Stress testing of the major banks by APRA however suggests they are likely to withstand severe shocks, including scenarios where there was a severe recession and bank-run type scenario. Banks would however require liquidity support from the RBA to withstand an extreme funding shock.

Needless to say the major banks have rejected the IMF's findings with the industry arguing that APRA's conservative approach on capital definitions means that Australian banks hold more capital than otherwise would be the case according the Australian Banking Association. This is also supported by the evidence which we have reviewed from the 2012 results where the tier one capital ratios for all the majors is in excess of 10% and common equity tier one is already in excess of 7% even though that requirement does not need to be met until 2016. Generally, Australian banks are more highly capitalized than most markets around world.

Adjustments of Australian Banks in Response to Regulation

Common to all banks, changes to regulation and in particular capital costs and liquidity requirements are changing what banks will focus on particularly in the business and corporate banking space in the future. A sustainable return on capital (and that capital being largely pure equity) and properly weighted for risk is growing to be of paramount importance.

These are matters that Australian banks are already very focused on where Westpac recently announced that unless commercial property delivers cross sell activity like transaction banking, it will become less attractive from a return on equity point of view. Commercial property is not only affected by the higher level of capital but also through cycle impediments which creates further risk. This is all notwithstanding the fact that Westpac's latest result showed a decline in bad debts from commercial property developers.

Long dated and riskier lending will also likely be substantially restrained such as infrastructure and project finance which requires a much longer commitment of funds, has higher risk and very high capital backing. This may create challenges for major corporates and other companies from the resources sector in particular for the future. Currently however these types of deals are still being done by the Australian banks and is part of their business that needs to be written for the benefit of the balance sheet at least for the time being.

Other areas such as trade finance where the nature of the business is relatively secure and short term will be more attractive given lower capital requirements. Major banks have been working on building this part of the business for some time but will face strong competition from international banks operating in Australia as well in the Asian region where there is strong trade growth.

The Interest Rate Battle with Government

Like many banks globally, Australian banks have been suffering from a decline in their interest margins although they have been able to keep growing their interest income as reflected in this years results.

Interest rate policy and setting has put the major banks and the government on a continuous collision course. Every month on the first Tuesday the Reserve Bank announces whether there will be any change to the official cash rate. With rate reductions being implemented this year as a way of stimulating the economy in the face of further slowdown, banks have been facing widespread criticism for failing to pass on full rate cuts to their customers. The banks argue that they need to claw back some of the rate reduction because of rising cost of funding that is not reflected in the cash rate, including the higher cost of deposits and wholesale funding.

In addition, some banks namely ANZ have sort to deflect an immediate decision by announcing in January this year it would implement interest rate decisions on the second Friday of each month giving it more time to consider its position following any Reserve Bank announcements. This also gave it further room to create the unthinkable and increase interest rates in February and April this year when the Reserve Bank kept interest rates on hold.

Banks have however been prepared to take the flack from customers in not passing on the full rate cut and in some cases affecting customer satisfaction rates. The government has also vehemently criticized those decisions particularly as it frustrates the full impact of its monetary policy and the impact on the economy. It is also a particularly sensitive issue for customer mortgages given the high level of home ownership in Australia.

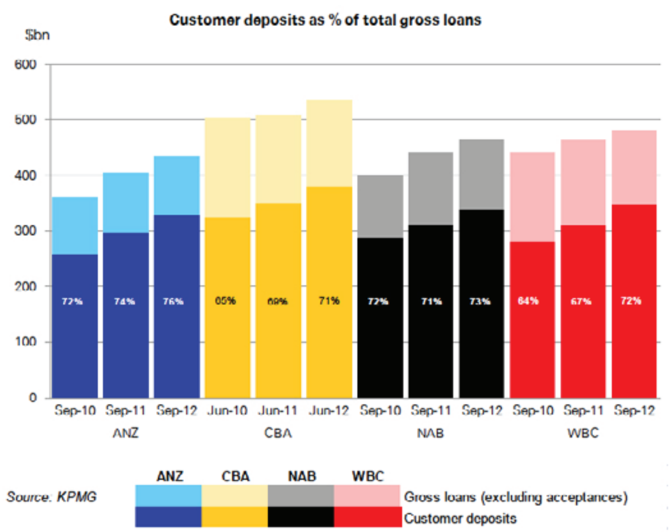
Recent reported analytical figures however give good reason why banks are prepared to battle this out given the impact on the bottom line. For every basis point held back of a Reserve Bank move on the cash rate, it is contended that this is worth between $8 million and $12 million in earnings. With the rate reduction earlier this month of .25% by the Reserve Bank and with most banks clawing back 5 basis points, this amounts to almost $50 million bottom line per bank.

Every rate reduction by the Reserve Bank this year for the most part has not been fully passed on by banks to their customers. The official cash rate now stands at 3%.

Funding

The easing of global market conditions earlier this year due largely to initiatives of the European Central Bank has taken the pressure off major banks in terms of their higher funding costs and created more flexibility in accessing global wholesale funding markets.

Banks have however been able to reduce their dependency on wholesale funding through increasing their customer deposits. This, according to KPMG, has enabled the majors to effectively fund loan growth entirely from customer deposits which in turn has reduced their reliance on short term and long term wholesale funding. That is a very welcome and promising development for the Australian banks for the time being.



Whilst building of deposits has been a way of creating further resilience to funding risks, the Australian banks will still need to work on other long term solutions to deal with future global shocks that could seriously affect the ability to fund their balance sheets. One CEO recently warned of a looming funding crisis that will have some dramatic impacts on lending unless other alternatives can be found including opening up of the superannuation industry and giving tax breaks for deposits.

Adapting to Transformation

One of the most significant challenges that banks face across the globe is to understand how banking is being reshaped, what banks are doing in response to transform their businesses, making them more resilient to future shocks and adapting their businesses to unprecedented regulatory change.

Australian banks have shown their ability to do this not only in the last four years but also helped by experience when they had to respond to serious challenges of the past including a major banking crisis of the late 1980s and early 1990's caused by a massive corporate and property credit and asset bubble that burst. Since then, Australian banks have learned to adjust many of their strategies across their operations, create stronger and more robust credit and lending systems, remain wary of high risk taking, being able to focus on their core strengths and strategies, be smarter with technology, increase their efficiency/cost/income, grow their businesses mainly organically but also where necessary make substantial acquisitions and to adjust their businesses/models in anticipation of economic cycles.

Tough regulation has also been a factor but banks have been able to respond and meet stringent requirements including being some of the first banks in the world to comply with Basel II well ahead of schedule and ongoing rigorous stress testing by APRA. A strong regulatory and compliance culture has developed and generally been adhered to. When things have gone wrong, Australian banks are quick to recognize mistakes and learn from them.

Since the global financial crisis and notwithstanding the advantages they have had, Australian banks have been able to not only adapt but also be opportunistic with their strategies continuing to look for growth , making acquisitions and capitalizing on their market power.

As they enter the firth year since the global financial crisis, they are extremely well positioned to face the challenges and opportunities of their domestic and global markets in 2013, but with a funding vulnerability that continues to shadow them.

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