Will COVID-19 Cripple the 4 Banks?

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Bank profits have been falling since 2015, but the latest half-year was particularly dismal. Loan growth was weak even before COVID-19 arrived on the scene, and the banks were already paying hefty remediation charges for their crimes against their clients. Are the COVID-19 loan impairment charges going to be the straw that breaks the camel's back?

At first sight, 2020 looks like the perfect storm for the big four banks. The three banks reporting for the March 2020 half-year announced a 33% fall in cash earnings to $8.3bn. This meant that their aggregate return on equity fell by 540 basis points to 6.5% – the lowest level since the GFC. Their aggregate net interest margin (NIM) slipped 3 basis points to a record low of 1.93%. In such circumstances, it is not surprising that bank boards chose to follow the regulators' advice, cutting or suspending their dividends. Will another 12 to 18 months of COVID-19 loan write-downs depress bank profits and dividends even further?

The answer to this question depends on how many bad loans the pandemic will cause. Because Australia has not had a recession since 1992, investors naturally use the GFC and the 1991-1992 recession as yardsticks for the probable size of the bad loan charges. The GFC led to annual bad loan charges of 0.75% of gross loans, acceptances and advances (GLAA). The 1991-92 recession saw annual bad loan charges exceed 3% of GLAA.

Recessions of the 1960s, 1970s and 1980s were generally less damaging. Bad loan charges were unusually high in 1991-1992 due to the end of the 1980s boom, which had created bubbles in many asset classes. In addition, bank lending practices in the 1980s were extremely loose, which is why ANZ and Westpac came close to insolvency. (The author had a bird's eye view of these disasters because he was a fund manager and a banking analyst at the time.) Bad loan charges were relatively high in the GFC because this was a banking crisis which triggered a recession, rather than the other way around.

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VIEW PROFILE

All $ figures in millions of Australian Dollars.

	Australia and New Zealand Banking Group Limited	Commonwealth Bank of Australia	National Australia Bank Limited	Westpac Banking Corporation
	03/2020	06/2019	SEP '19	03/2020
	183 DAYS	181 DAYS	183 Days	183 DAYS
	Final/	Final/		Final/
Loan Composition				
Real Estate Mortgage Loans	263596	467361	343915	445663
Real Estate Mortgage Loans / Total Loans (%)	39.86	60.86	55.13	61.48
Commercial & Industrial Loans	170760	1955	-	155322
Commercial & Industrial Loans/ Total Loans (%)	25.82	0.25	-	21.43
Consumer & Installment Loans	12380	179263	12594	19854
Consumer & Installment Loans/ Total Loans (%)	1.87	23.34	2.02	2.74
Leases	1518	4410	12763	-
Leases / Total Loans (%)	0.23	0.57	2.05	-
Foreign Loans	212527	107992	-	104029
Foreign Loans / Total Loans (%)	32.14	14.06	-	14.35
Other/Unspecified Loans	865	-	222829	-
Other Loans / Total Loans (%)	0.13	-	35.72	-
Deposits				
Demand Deposits & Other Transaction Accounts	14410	357573	264229	44557
Demand Deposits & Other Transaction Accounts / Total Deposits (%)	2.21	57.96	56.76	7.64
Savings & Time Deposits	323924	179237	201254	437033
Savings & Time Deposits / Total Deposits (%)	49.67	29.05	43.24	74.97
Foreign Deposits	313859	80131	-	101330
Foreign Deposits / Total Deposits (%)	48.12	12.99	-	17.38
Other/Unspecified Deposits	-	-	-	-
Other Deposits / Total Deposits (%)	-	-	-	-
Total Deposits	652193	616941	465483	582920

Source: FactSet Fundamentals, Arminius Capital

We believe that the COVID-19 recession will not be as serious for the banks as 1992 or 2008 were. On the lending side, banks have run their loan books quite prudently since the GFC, when the worst of the loans and the worst of the bank managers were cleaned out. Residential mortgages now make up more than 60% of loan books, but residential mortgages have far lower default rates than consumer credit, SME loans, or commercial property loans during recessions.

On the borrowing side, most of the economic victims of the lockdowns are young and poor, which means that they haven't been able to borrow very much. This can be seen in the fact that the mortgages now in deferral are 10% of the total by number, but only 7% by value. Although Australia's aggregate household borrowing has risen, it is concentrated at the top end of the income scale, where collateral is stronger and the loan-to-valuation ratio is lower.

$250bn of loans are now on "deferred interest". Home loan deferrals total $173bn, and up to 20% of these borrowers are said to be in difficulties, according to the Australian Financial Review of 16 June 2020. The banks are likely to extend the deferrals for owner-occupier loans, as well as trying to restructure them. Orderly disposal of the worst-case mortgages is likely to cause losses averaging 20% on about 15% of the $173bn, implying write-downs of $5.2bn. Personal loans and small business loans will have a higher incidence of problems and a lower recovery rate, but the total dollar amounts of loans outstanding in these categories are much smaller.

We are forecasting a W-shaped recovery rather than a prolonged downturn, so the majority of economic victims should be back in work within six months, unlike many recessions. This forecast is based on Australia's success in controlling the coronavirus. It may be revised downward if the pandemic worsens in China or the USA.

Therefore, we expect the current rate of bad loan provisioning to be adequate. The charges in the March 2020 half-year totalled $5.7bn, equivalent to an annualized rate of 0.42% of GLAA. Credit provisions now

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VIEW PROFILE

total $20.7bn, against GLAA of $2,770bn. The regulators' insistence on "unquestionably strong" bank balance sheets has pushed Common Equity Tier 1 (CET1) up to $193.7bn, or 10.93% of Risk-Weighted Assets.

All $ figures in millions of Australian Dollars.	Australia and New Zealand Banking Group Limited	Commonwealth Bank of Australia	National Australia Bank Limited	Westpac Banking Corporation
	03/2020	12/2019	03/2020	03/2020
	183 DAYS	184 DAYS	183 DAYS	183 DAYS
	Final/	Final/	Final/	Final/
Capital Adequacy - Fully Phased In				
	BASEL III(ADV)	BASEL III(ADV)	BASEL III(ADV)	BASEL III(ADV)
High Quality Liquid Assets	209400	89028	152000	121000
Liquidity Coverage Ratio	139	134	136	154
Capital Adequacy - Transitional				
	BASEL III(ADV)	BASEL III(ADV)	BASEL III(ADV)	BASEL III(ADV)
Total Capital	**69407**	**77953**	**63203**	**72314**
Total Capital Ratio (%)	15.5	17.4	14.61	16.29
Tier 1 Capital	**56295**	**63218**	**51761**	**57455**
Tier 1 Capital Ratio (%)	12.5	14.1	11.96	12.94
Common Equity Tier 1 - Total	**48331**	**52380**	**44960**	**47982**
Common Equity Tier 1 Ratio (%)	10.8	11.7	10.39	10.81
Common Equity Tier 1 Before Adjustments	61309	70891	56240	66347
Total Adjustments to Common Equity Tier 1	-12978	-18511	-11280	-18365
Additional Tier 1 - Total	**7964**	**10838**	**6801**	**9473**
Additional Tier 1 Before Adjustments	8430	10838	6801	9473
Total Adjustments to Additional Tier 1	-466	0	0	0
Tier 2 Capital	**13112**	**14735**	**11442**	**14859**
Tier 2 Capital Before Adjustments	13935	14756	11542	15101
Total Adjustments to Tier 2 Capital	-823	-21	-100	-242
Risk Weighted Assets	449012	449154	432666	443905
Leverage Ratio	5	6.1	5.2	5.66
Leverage Exposure	1124399	1040423	988245	1014212

Source: FactSet Fundamentals, Arminius Capital

From the banks' point of view, the pandemic has bestowed on them the unexpected benefit of delaying or weakening the longer-term threats to their standard business model. Their net interest margins are underwritten until 2023 by the Reserve Bank's $115bn borrowing facility, which allows the banks to borrow at 0.25% (compared to the current wholesale cost of funds of around 1.0%). The COVID-19 crisis has made life harder for neobanks and fintechs by raising their cost of capital, as well as by discouraging consumers from changing banks. Similarly, the advent of "open banking" (customer data portability) on 01 July will have little effect so long as consumers remain risk averse.

Looking out beyond 2021, we forecast that the Big Four banks will earn an average return on equity of 10% (CBA 11%, the other three 9%) once the Australian economy returns to normal. We assume that dividends will be cut by approximately 33% (CBA) or 50% (the other three), implying that payout ratios will settle at sustainable levels of 50% to 70%. At current share prices, this implies fully franked yields of 4.5% to 5.0%.

On this basis, the Big Four are attractive for income, but – as in the last decade – investors seeking capital growth will do better in other industries and other countries. The market forces which constrain the banks' earnings and dividend growth will only become stronger as the memory of the COVID-19 crisis recedes and consumers become less risk averse. Australian households are already highly geared, so long-term growth in housing loans must rely on rising population and on rising per capita incomes. The effects of competition from fintechs and neobanks will increase as consumers become more adventurous. In short, the banks' rapid growth between 1992 and 2007 was the result of strong economic growth, light-handed regulation, and limited competition: none of those conditions will be present in the 2020s.

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