Australia's Banks Are On The Road To Recovery

13 November 2020 | Marcel von Pfyffer, Arminius Capital

- The ANZ, NAB and WBC results for the September half-year suggest that their bad loan problems will be smaller than expected, because loan deferrals are falling faster than feared.
- NAB had the best underlying result.
- Banking sector profits are likely to bottom in FY21, then recover at 10% to 15% pa for the next two years, taking dividends to about 4.5% fully franked.
- Risks to this scenario include more outbreaks in Australia and renewed economic downturns in the US and Europe.
- We continue to believe that, although the banks will recover over the next two years, they will underperform the market in the long term.

NAB had the best underlying earnings for the year ended 30 September 2020, in terms of a rising net interest margin and solid profits before provision charges. ANZ and Westpac met consensus forecasts for cash earnings because their provision charges were lower than expected. (CBA has a June year, so its September quarter update will be unaudited and will contain less information.)

The big question for bank investors is the size of the loan losses caused by COVID-19. Banks increase their provisions for bad loans a year or so before they write off the loans, especially in the present situation where they have been granting temporary loan deferrals since April. This time around, banks are in closer contact with their risky borrowers, therefore they are better able to assess the risks and manage the problem loans individually.

Below is APRA's summary of the deferred loans at 30 September. It is clear that the situation was improving then, even before the re-opening of Victoria. Therefore we are confident that the banks' provisioning will be adequate, and it is possible that the banks will be able to boost profits in 2022 and 2023 by writing back some of their loan provisions.

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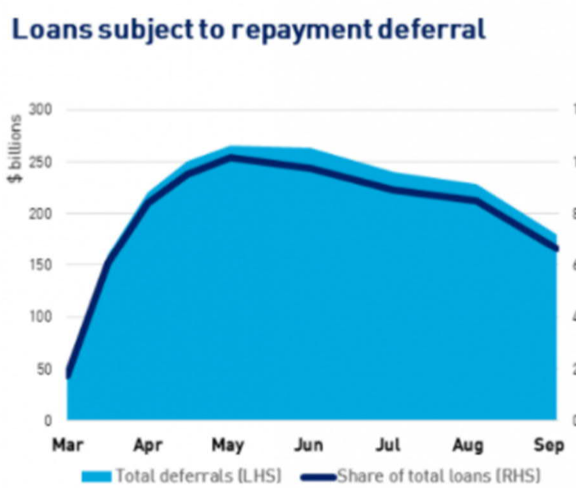

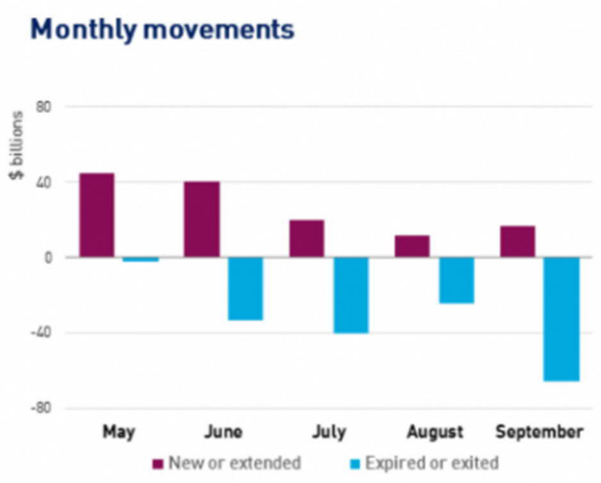

Rising costs are an issue for all banks, because the need to spend more on technology to cope with fintech and neobank competitors, not to mention the ongoing modifications of the traditional business models in the wake of the Hayne Royal Commission. Over the next five years, the simplification and automation of existing processes should reduce operating costs.

In the wake of the pandemic, the fintechs and neobanks are less of a threat to traditional banking, because many of them have found it harder to raise equity and to win new customers. In the UK, where the neobanks have gained more market share, their operational and share market performance has often been disappointing. But this does not mean that the threat has gone away – rather, that the Big Four have been given a couple of years' respite to improve their own processes.

Like the banks in the rest of the developed world, Australian banks have enjoyed a rush of deposits as households built up their forced or precautionary savings during the first phase of the pandemic. This surge of cash has helped our banks reduce their funding gap, which is the amount they have to borrow from wholesale capital markets.

Unlike many other jurisdictions, Australian banks are "unquestionably strong" with Common Equity Tier 1 (CET1) ratios in the top quartile globally.

The market is not yet convinced that the banks are on a smooth path to recovery. According to consensus forecasts, bank earnings per share will bottom in FY21, then grow by 10% to 15%pa in each of the next two years. This growth – plus the lifting of the 50% payout cap – will raise dividend yields from 3.5% in FY21 to about 4.0% in FY22 and 4.5% in FY23.

But the market is right to harbour doubts. Mass vaccination is not possible before the second half of 2021, so Australia is still at risk of further coronavirus outbreaks. If the Melbourne lockdowns were repeated in

Sydney or Brisbane, economic recovery would stall for at least one quarter. Global risks also remain high: the US in particular may suffer a double-dip recession unless new stimulus packages are legislated soon.

In the longer term, the banks still face the four strategic threats described on our 24 July 2019 paper BANK TO THE FUTURE II: higher standards, cryptocurrencies and payment systems, fintechs and neobanks, and ultra-low interest rates. These threats have temporarily receded, but they will return once the pandemic crisis is past. These threats are among the main reasons why we expect the long-term returns of the banks to be about 1%pa below the 10.2%pa long-term return of the Australian share market.

ANZ announced a 42% drop in cash profit to $3.76bn (EPS 133c) for the year to September. The bank's return on equity collapsed to 6.2%, compared to 10.9% in FY19. The regulatory limit of 49% on payouts meant that a final dividend of 35c was declared, making 60c fully franked for the year (FY19 was 160c with a 76% payout ratio).

The main reason for the profit fall was the rise in provisions for bad debts triggered by COVID-19. The charge for bad debt provisions was $1.67bn for the first half and $1.06bn for the second half, making $2.7bn for the year, and taking the total loan loss provision to $5.0bn ($3.4bn in September 2019). The second half charge was less than expected, suggesting that the worst may be over.

A key measure of the size of the bad debt problem is the ratio of individual provisions to gross loan assets. This moved up from a "normal" 0.13% in FY19 to 0.53% in the first half of FY20 and 0.33% in the second half. In our opinion, this means that the current level of provisioning is adequate, so the annual charge should trend down from here.

Out of ANZ's 1.0m residential borrowers with $275bn in loans, 95,000 had sought deferments. Of the 55,000 contacted so far, 79% are returning to full payments. That leaves 51,000 borrowers (with $19bn in loans) still on deferment. Also on deferment are $4bn in commercial loans and $3bn in New Zealand loans.

The second half charge for customer remediation reached $188m post-tax, more than double the first half figure of $91m. ANZ also took $322m in goodwill write-offs, extra software amortization, and minor charges in the second half. The cumulative post-tax provision for customer remediation now stands at $1.59bn, compared to $1.22bn a year ago and $0.53bn two years ago. (The balance sheet provision was flat at $1.1bn.) The rise in the second half of FY20 was a surprise, but we expect that the annual cost of customer remediation will trend down from here.

NAB announced a 26% drop in cash profit to $4.73bn (EPS 147c) for the year to September. The bank's return on equity slid to 8.3%, compared to 12.4% in FY19. NAB paid a 30c interim dividend and a 30c final dividend. The full-year total of 60c fully franked (FY19 166c) was constrained by the regulatory limit of 49% of statutory earnings.

NAB continued to strengthen its position in the home lending market, with successive improvements in its net interest margin (NIM) from 1.16% in the March 2019 half to 1.30% in the September 2019 half, then to 1.37% in the March half and 1.42% in the September half.

Mortgage deferrals fell from $37bn at June 2020 to $14bn at 23 Oct, equivalent to less than 5% of mortgages. Business loan deferrals fell from $19bn at June 2020 to $5bn at 27 Oct, equivalent to less than 5% of mortgages.

Impairment provisions rose from $1.16bn in the March half to $1.60bn in the September half. The provision for expected credit losses (ECL) rose from $3.9bn at Sep 2019 to $6.0bn at Sep 2020. At year end, collective provisions amounted to 0.94% of gross loan assets.

Westpac disappointed investors on several fronts. Earnings dropped in all divisions, costs rose faster than expected, total lending fell 3%, and the bank lost market share in mortgages.

Westpac announced a 62% drop in cash profit to $2.61bn (EPS 72.5c) for the year to September. The bank's return on equity collapsed to 3.8%, compared to 10.5% in FY19. Because the bank had cancelled the interim dividend, the final dividend of 31c fully franked was the full-year dividend (FY19 174c), hitting the regulatory limit of 49% of statutory earnings.

The biggest single notable item was of course the AUSTRAC charge of $1.44bn. This is of course non-recurring. Customer refunds and associated costs amounted to $0.44bn, down from $0.96bn in FY19. Write-downs of goodwill and intangibles came to $0.61bn (zero in FY19).

But there were positive signs. Impairment charges dropped from $2.24bn in the March half to $0.94bn in the September half. In deferral packages, Westpac had provided $54.7bn for mortgages and $10.1bn for business loans. By 28 October, the deferral packages were down to $16.6bn and $1.0bn respectively, roughly equivalent to 4% of mortgages and 2% of business loans.

The provision for expected credit losses (ECL) rose from $3.9bn at Sep 2019 to $6.1bn at Sep 2020, but Westpac has slightly better provision coverage than its competitors.