Reserve Bank cuts risk capital exodus for banks

Jonathan Shapiro and **Aleks Vickovich**

Updated Oct 1, 2019 — 7.13pm, first published at 6.31pm

A Reserve Bank cash rate approaching zero will push bank profits to multi-year lows and force more savers out of deposits and into riskier investments to generate a sufficient income, according to investors and analysts.

Commonwealth Bank, the nation's largest lender, said yesterday it would withhold as much as 0.12 percentage points of the Reserve Bank's 0.25 percentage rate cut from mortgage customers. NAB withheld 0.10 percentage points.

CBA cited the challenge of managing the interests of 1.6 million borrowers, 6million depositors and retiree shareholders that relied on the dividend for income.

However it is the growing anxiety of interest-starved depositors that could present the biggest challenge for the nation's banks.

Andrew Papageorgiou of Melbourne-based fixed-income fund Realm Investment House said ultra-low deposit rates were forcing savers to look beyond deposits to avoid drawing down on their capital.

‘‘We are starting to see a real capitulation at a household level where the opportunity cost of remaining in deposits is just too high,’’ he said.

"The concern is that the rate cuts have their desired effect - and that capital is mobilised [to leave the banks]"

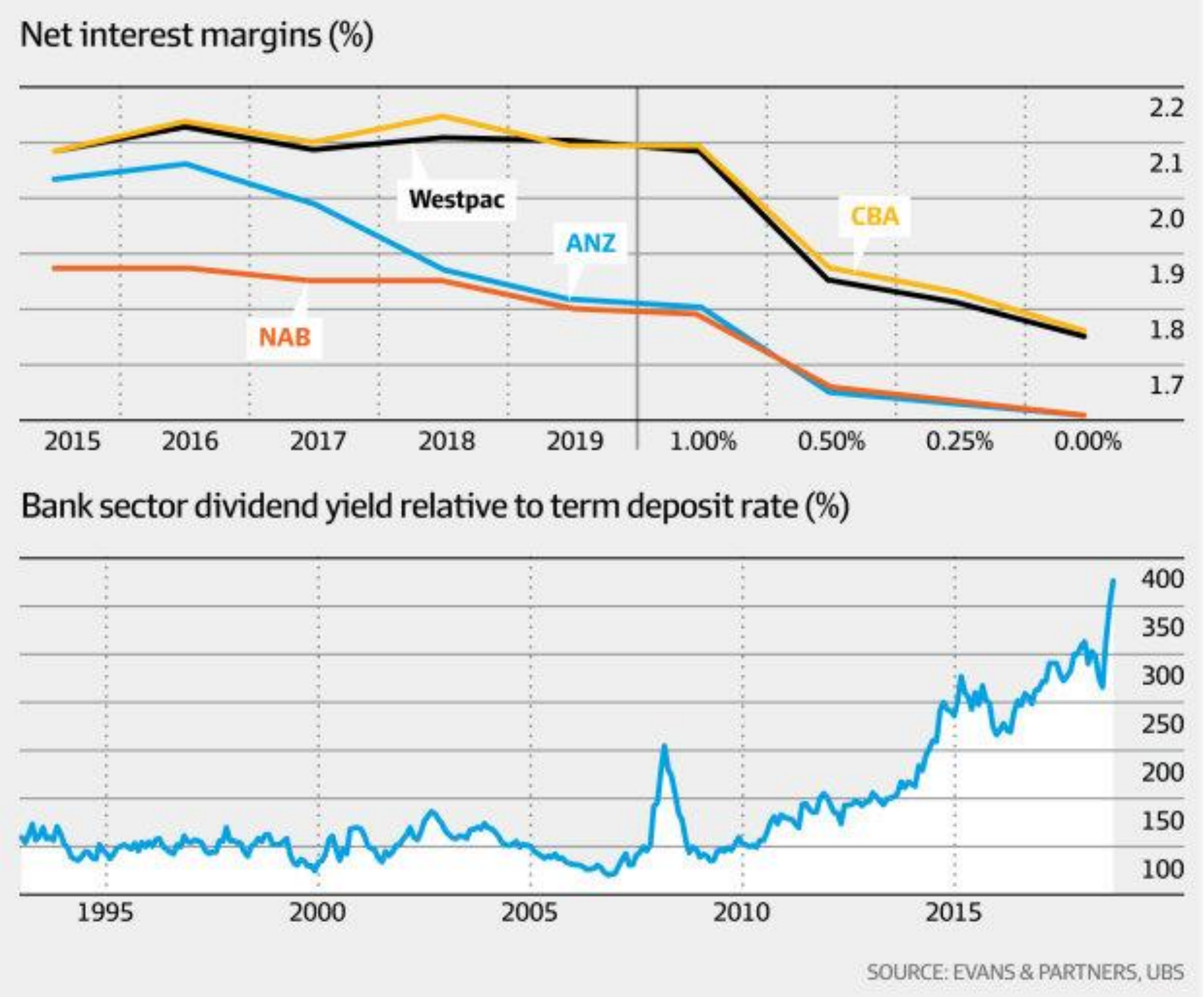
While the Reserve Bank rate cut was widely expected by economists and interest rate traders, all eyes were on the major banks, who are facing a margin squeeze – a battle to maintain their share in home loans and potential pressure to retain deposit capital in search of higher returns.

The immediate challenge, according to bank analysts, is to counter the profit squeeze they will face from a cash rate that is heading towards zero. There was an expectation they would withhold as much as a third of Tuesday's reduction.

Margin squeeze

Ultra-low interest rates hurt the banks in two ways. The first is that with each reduction in the cash rate, a growing share of deposits can no longer be repriced because they already pay at or close to zero interest rates.

CBA, for instance, said it was ‘‘not feasible’’ to apply the full rate cut to $160 billion of deposits which were ‘‘at, or near, zero rates’’.



Australia’s banks are further hurt by falling bonds rates as they re-invest a portion of their assets in bonds with an average maturity of three years.

The collapse in medium-term bond rates will slowly erode income from this portfolio as funds mature and are reinvested.

Evans & Partners analyst Matthew Wilson told clients that if the Reserve Bank was to cut the cash rate to zero or close to it, the return on equity of all four major banks would fall below 10 per cent.

http://www.afr.com/business/banking-and-finance/royal-commission-stability-threat-a-worst-case-outcome-20171206-gzzy9d

The fall would result from a decline in net interest margins of between 10 and 15 per cent and was largely due to a reduction in the interest earned from free funds.

UBS banking analyst Jonathan Mott said he expected the banks to pass on 30 basis points out of the next 50 basis points of interest rate cuts, but said the run-off of hedges (replicating portfolios) remains a material ‘slow-burn’ drag on net interest margins.

"With ongoing revenue pressure, we expect further dividend cuts and banks to rebase target ROEs to more realistic levels for an ultra-low rate environment," he told clients.

"As bank ROEs fall, they are willing to finance riskier loans as the ROE reduces the weighted average cost of capital."

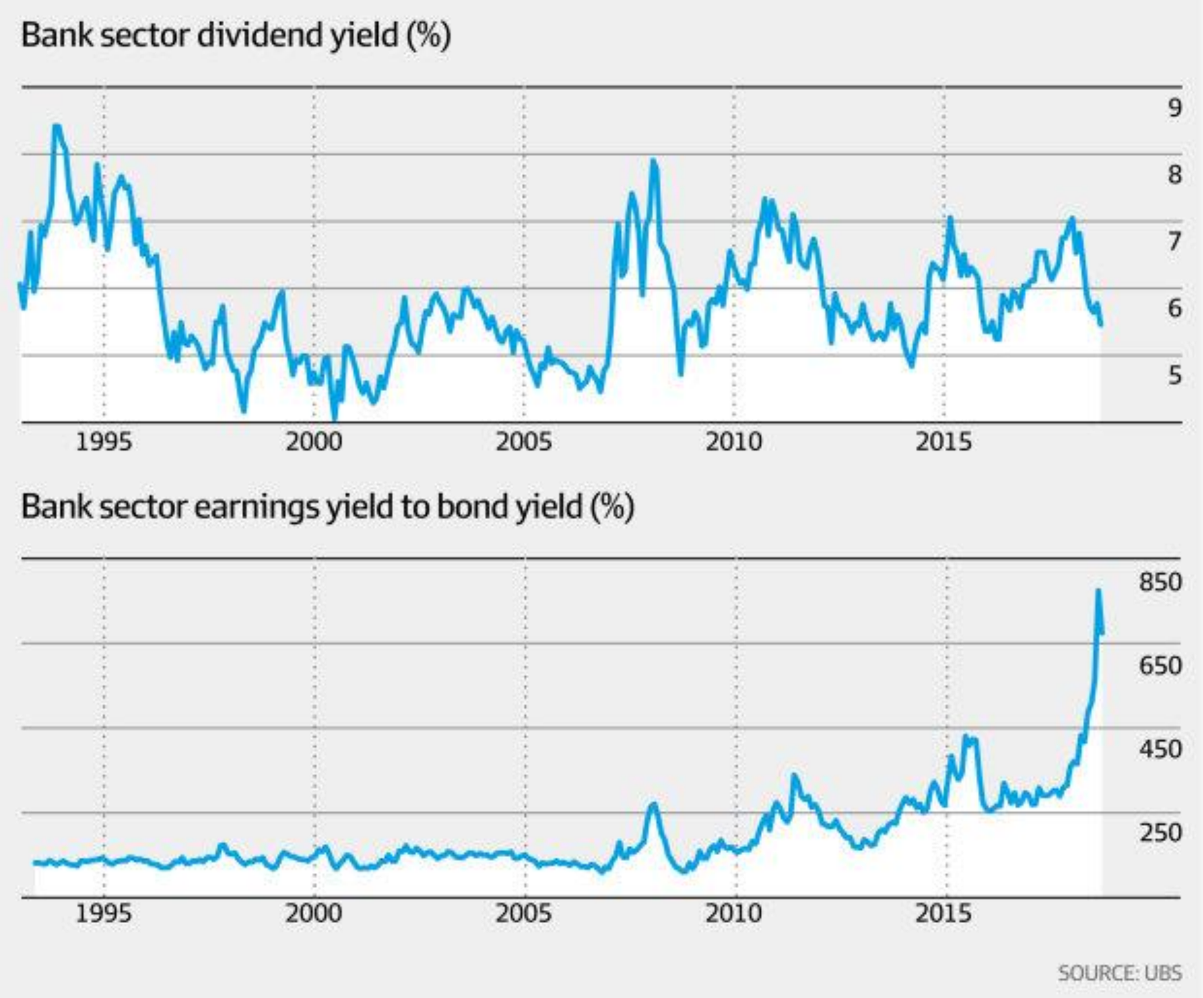
Rush for dividends

The sharp fall of interest rates has created a dilemma for investors in bank shares that are seeking higher returns in response to falling deposit rates.

The relative value of bank shares, as measured by the dividend yield, has increased materially relative to bond rates and term deposit rates that have fallen sharply.

However those low interest rates reduce the profitability of the banks and their ability to deliver those sought-after dividends.

AMP Capital chief economist Shane Oliver said the critical question for investors was whether they valued a ‘‘decent income flow’’ or ‘‘absolute stability in capital value’’.



The critical question for investors to ask is what is most important – getting decent income flow from their investment or absolute stability in its capital value.

"If it's the latter then stick with bank deposits," Dr Oliver said.

"If it's the former then shares offering decent sustainable dividends and unlisted commercial property and infrastructure are attractive," he said,

Don Hamson of Plato Investment Management said an interest rate ccut could "lead to an increased investor demand for dividend paying stocks, potentially raising the capital values of some."

"Bank margins and earnings can be challenged as interest rates go lower – the lower they go the higher risk of bank earnings and dividend cuts," Dr Hamson said.

"I can't see banks increasing the attractiveness of term deposits under that scenario."

http://www.afr.com/business/banking-and-finance/royal-commission-stability-threat-a-worst-case-outcome-20171206-gzzy9d