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Customers hit harder than investors in quest for gold plated banking system

By Jonathan Shapiro
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Australia's big banks have been telling everyone who has cared to listen that it's the man on the street who will make our financial system "unquestionably strong".

And on Wednesday, Westpac delivered on the threat, slugging its mortgage customers with a 20 basis point rise in the standard variable home loan rate, almost a full Reserve Bank rate increase.

While the banks have responded to prudential speed limits on investment property lending by cranking up the rates for speculators, Westpac's move is significant in that it hits all borrowers, not just landlords who are at the heart of concerns about an overheated property market.

The move which accompanied a $3.5 billion capital raising brings into stark focus the debate on whether shareholders or customers should pay to make Australia's banking system stronger.

On this occasion they're both being asked to dip into their pockets. But who is bearing the greater brunt?

As Westpac pointed out, the bank would need to increase the amount of capital it will have to hold against its mortgage book by 50 per cent. But what does this actually mean for customers and shareholders?

Let's use an example of a $1 million home loan. Under the old capital calculations and requirements, the banks would only have to hold $12,800 of capital against the loan. Assuming they are able to make a 50 basis point profit margin for shareholders (an assumption made by the regional banks in their submissions to the financial system inquiry), the banks would make a profit of $5000 for a return on equity of 40 per cent.

But under the new capital requirements - which Westpac says is 50 per cent higher, they must hold around $19,200 against a $1 million loan. So to make the same 40 per cent ROE, they need to extract around $7,500 or a 75 basis point profit margin. All up, that would require an increase in home loan rates of 25 basis points.

On that maths, the 20 basis point rates rise Westpac has announced goes most of the way to covering the difference - but not all the way.

And Westpac shareholders will certainly feel like they're covering a large part of the increased capital bill after being asked to raise another $3.5 billon of equity capital and having watched the bank's the market capitalisation slide by about 23 per cent since a 12-month high of $124 billion in March.

It's also worth remembering that banks have even more customers on the deposit side who have generally benefited from higher deposit rates over the past five years, as banks have scrambled for funding. The stability of the funding they provided meant they were rewarded for making the banks safer at the expense of shareholders.

Rates squeezed

But they've seen deposit rates squeezed of late and they too could be coughing up, in the form of lower deposit rates.

On balance, many analysts still believe that customers rather than shareholders are bearing a little more of the capital pain.

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"On our numbers, if they can crunch their costs of funding down by about 10 basis points and then also keep 10 basis points of the next couple of rate cuts – assuming they materialise – there's every chance the banks will not be materially worse off than they are right now on a per share basis," says Andrew Papageorgiou of Melbourne-based fund Realm Investments.

Hugh Dive, a portfolio manager at Aurora Fortitude, says shareholders will manage to avoid much of the cost as banks have proved very effective at passing on costs through reduced discounts on mortgages, lower term deposits and wider spreads on business loans.

"Effectively, we see that it will be lenders, rather than shareholders that will bear most of the cost for "gold plating" of the Australian banking system, though the banks will have to be careful about putting through rate increases given the quantum of the profits they are currently reporting," he said in a note published in August.

Some believe the cost should broadly be neutralised. David Murray, one of the architects has said on several occasions and again this week that the dominant pricing power of the big banks should not result in customers paying for the system's safety. A safer, better capitalised bank should be able to attract a lower cost of capital, both debt and equity, with the savings passed on to customers.

"If it ends up being customers, it's fair to suggest that this is a monopoly and the ACCC has failed the Australian consumer here," says Papageorgiou.

Within the debate it is hard to ignore the intentions of regulators and even the central bank.

In a speech last month, the head of the Australian Prudential Regulation Authority wondered if it was time to debate what is an appropriate return on equity for bank shareholders.

"[The chair of APRA Wayne] Byres has highlighted that there needs to be a debate around where a fair and sustainable ROE should be, and posed it as a regulatory consideration, which in a capitalist banking system tells you a lot," Papageorgiou says.

And of course, there's the Reserve Bank. In a telling response to a recent question about whether the capital requirements would force home loan rates up, governor Glenn Stevens said he thought that was the point.

This could play into the hands of the Reserve Bank by giving them greater scope to cut interest rates, and place downward pressure on the currency, without putting upward pressure on house prices. The lower rates would leave households neutral provided the banks passed on most of the cut or cuts.

Dive points to Sweden as an example where the system and shareholders turned out to be winners when, in 2012, new capital requirements halved housing credit growth. But the repricing of home loans by the banks led to an expansion of margins and an earnings per share increase of about 15 per cent.

Westpac shareholders who are dipping into their pockets for an additional $3.5 billion will be hoping that scenario plays out here.