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Bad debt charges spook bank investors

The sharemarket was once again gripped by anxiety that rising bad debts at the banks could point to more trouble ahead.

by Jonathan Shapiro

The value of the major banks fell by almost $25 billion in two brutal days on the sharemarket because investors are worried credit losses will accelerate and hurt profits.

The four major banks fell between 2.4 per cent and 3.4 per cent on Tuesday, following Thursday's revelations by ANZ Banking Group and Westpac Banking Corp that soured corporate and consumer loans would force them to increase bad debt provisions.

ANZ's news that bad debts will rise by $100 million cut its market value by $6 billion.
ANZ shares are down 10 per cent from their recent high over the past five trading days, putting them into a correction.

The other major banks are not far behind, falling between 9.4 per cent and 6.2 per cent over the same period.

Watermark Funds Management financials analyst Omkar Joshi said ANZ's third increase in bad debt provisions in seven months suggested either the bank had not been conservative enough planning for bad loans or isn't on top of its corporate loans.

He said "second order" effects from the resources slump could hit the banks, such as loans to businesses that provide services in regions where the primary industry is mining or corporate loans for infrastructure.

Commonwealth Bank could be hit, given its big business in Western Australia as a result of its BankWest acquisition, he said.

Aurora Funds Management investor Hugh Dive said an increase in bad debts was inevitable from their current low levels and tougher regulation had limited competition in the recent benign credit environment.

"In a situation where bank bad debts begin to climb, we would expect that the banks would naturally respond – as they have in the past – by repricing their loan book upwards to account for higher risks and cutting costs such as reducing headcount and discretionary expenditure like advertising," he said.

The high profitability of the banks means they're easily able to absorb losses from the business banking portfolio, he said. The big four banks reported about $30 billion of after-tax profits last year and provisions for bad debts were around $3.8 billion.

Downturn source of pending credit losses

The downturn in commodities and energy prices is the likely source of pending credit losses but the exposure of the banks is relatively small – a combined total of $65 billion of about $4 trillion of assets, according to credit analysts.

Credit rating agency Moody's calculated the total exposure of the banks to the resource sector at 3 per cent of total loans. It also warned of 'second order macro-economic risks' as the effect of lower commodity prices feeds through the economy.

"Ultimately, it could translate into a more broad-based economic slowdown and softer labour markets than currently anticipated," the rating agency wrote in a report published earlier this year.

The report pointed to evidence of stresses in the mining services sector and residential mortgage portfolios in Queensland and Western Australia.

Mr Joshi said the impact that the release of bad debt provisions as loan losses have been lower than previously accounted for has inflated the growth of big bank profits – which on an underlying basis have been growing at 3 to 5 per cent rather than 7 to 9 per cent.

Now that those provision releases are close to exhaustion, the banks will have to restock them, which will affect profits in exactly the opposite manner.

The impact of stalled profit growth means that in the absence of dividend cuts, dividend pay-out ratios will rise to uncomfortable levels.

Compounding this are new accounting standards that compel banks to account for potential losses earlier via the expected loss model making it difficult to use provisioning to smooth profits over time.

While sharemarket investors are concerned about the impact of rising bad debts on profits, credit investors are more concerned about the potential for loan losses to cut into the bank's financial reserves.

Andrew Papageorgiou of Realm Asset Managementsaid his fund had studied events that could meaningfully hurt the banks. Soured corporate loans are unlikely to be a big problem because of the size of the banks' total loan books, their ability to diversify and the profits from house mortgages.

Mortgages the weak point

Mortgages are the banks' weak points, he said. Losses on mortgages have been infinitesimal and may remain that way, but there are risks, he said.

"What they cannot soak up is an American and Spanish-style, Greek-style housing event," he said.

Investors should be mindful of several factors in assessing the potential stresses on the banks' home loans, such as how quickly a problem could hit house prices and the whether houses could be sold in a crisis.

The firepower of policymakers shouldn't be underestimated. So long as the Reserve Bank interest rates are above zero, he said, there is no reason to panic.