Apr 1 2016 at 11:49 AM
Updated Apr 1 2016 at 1:44 PM

Bad debts are the least of the big banks' worries

by Jonathan Shapiro

The nature and timing of Australia's next banking crisis is a permanent fixation, as Reserve Bank governor Glenn Stevens lamented when he was asked to speak on this topic last month in Sydney.

This, he said, is "the economic *zeitgeist*", a consequence of the long shadow of the 2008 financial crisis cast on the banking system which has grown more powerful and systemically important to the nation since those precarious days.

But how vulnerable is the banking sector and where will the future threats emanate? That question will run central to discussions at *The Australian Financial Review's* Banking & Wealth Summit on Tuesday and Wednesday.

The gathering comes as the market grows anxious about early signs that falling bad debts are now rising, while elevated property prices – particularly among apartments – that have propelled bank profits may now be starting to fall.

Students of financial history know all too well that risks take many forms, and crises are by their nature hard to anticipate. The prospect of credit losses rising from their low base or the heat coming out of a rampant housing market, partly engineered by concerned regulators that have curtailed credit to speculators, have been well flagged.

But the size of the financial sector, which accounts for one tenth of economic output and about a third of the stock market capitalisation, means no threats can be taken for granted.

Dangerous incentives

Ross Barry, the head of research at First State Super and author of the book *Crisis and Complexity* has devoted much of his time understanding the threats to the banking sector given it has become one of the largest exposures for most superannuation funds.

He believes incentive structures for management, that encourage them to chase high returns even as net interest margins are narrowing and global regulators force stricter capital rules upon them are a crucial aspect of stability.

"The elephant in the room for me is the mismatch between senior executives' return-on-equity targets of 15 per cent or more, while regulators would probably prefer them to adapt to a more sustainable model, with longer-term funding and lower returns of 10 to 11 per cent over time", he says.

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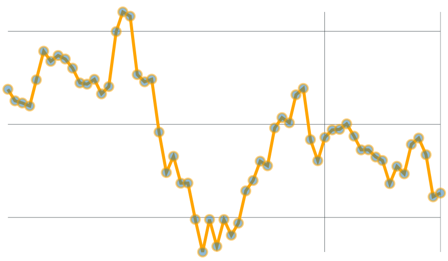

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The consequence, he says, may be behaviours that are counter to the interests of customers.

"High ROE targets, for instance, may explain why bank CEOs haven't done much historically to curb the wretched dealing room culture. A big part of the solution is to change bank executive remuneration to remove short-term incentives and penalise them financially for misdemeanours that occur on their watch."

While some researchers are casting their minds further into the future, many threats are emerging in the here and now. The anxiety among investors, and galvanised international short sellers that have upped their bets against the big banks in recent weeks, was palpable this week in the wake of unexpected announcements from ANZ and Westpac that provisions for bad debts would rise by a combined $125 million.

That figure was a mere fraction of the $37 billion of annual profits generated by the big four banks, and arguably didn't justify the $25 billion that was wiped off their market values in just two trading sessions.

End of credit nirvana

Until that point, the banks had revelled in a credit 'nirvana'. Low interest rates, rising asset prices and a robust economy pushed defaults to levels not seen since the 1980s, helping them to ever rising profits.

Many believe the threat is overstated. The banks are big and ugly enough to absorb soured corporate loans, or even soured sectors without skipping a beat.

"The banks are good at managing idiosyncratic exposures. You would define those as sectors and the faces and names within the economy – I don't think you are living in an age where these [risks] are underestimated by the banks," says Andrew Papageorgiou of Realm Investments.

Instead, he says, the risks lie in the trillion dollar mortgage books of the big banks. This is the single largest exposure, accounting for two-thirds of the bank's total exposure. Mortgages, however, have proved both safe and profitable for the banks with loan delinquencies tending to track at below 1.50 per cent of their mortgage pools.

It would take a major systemic crisis, Papageorgiou says, to cause meaningful dent to the bank's balance sheet, such as a rise in unemployment to 10 per cent or a meaningful increase in inflation which drives rates higher. But it's not impossible. For instance, a stagflation scenario that is occurring in Brazil where inflation is rising but growth has stalled would be 'toxic' for the mortgage market. Most likely it would stem from a global shock, rather than an Australian specific crisis, he believes.

While new threats have emerged, the Australian banks' perennial vulnerability are their heavy reliance on offshore funding. To plug the gap between the loans they've extended and the deposits they've gathered they must go cap in hand to global bond and money markets. A global shock, or a loss of confidence in the Australian banks, would leave them unable to fund themselves without some form of government support.

The latest banking statistics showed that this risk is not abating; but rising with CBA credit analysts pointing out that the latest official lending statistics showed that the 'funding gap' between new loans and deposits grew to $59 billion, the highest since 2012.

Investors hold the risk

Rob Mead, the head of portfolio management at international bond giant PIMCO, says most risk in the banking sector resides largely with equity investors, who have become hooked on ever-rising share prices and dividends as the banks have continued to deliver record profits.

"It is hard to identify where earnings growth will come from and more capital will be required to be raised, so this is very much an equity story."

"The banks are profitable and the returns on equity are better but it is always an issue historically in a developed economy when the banking sector is over 20 per cent of the total market capitalisation," London-based analyst Ian Harnett of Absolute Research Strategies told the *AFR Weekend* earlier this year.

"It's just very difficult to continue generating the earnings," he says.

Mead has still identified four risks posed to the big banks. The first is funding costs, which are rising at all parts of the capital structure as they require ever-increasing amounts of equity capital deposits and long-term wholesale debt to finance their growing home loan books.

He also cites elevated house prices as a risk, and says regions in which supply increases will see higher delinquency rates, which have already started to materialise.

Finally "consumer indebtedness is already elevated and as a result the cushion is limited in terms of a potentially weakening employment backdrop."

Balance sheet recessions

This point lies at the heart of the bearish case for Australia's banks. At almost 180 per cent of GDP, Australians have the highest relative amount of debt in the world. That does not portend a crisis. Papageorgiou points out it's 'coverage ratios' that blow things up' or, ie, the inability to service loans. And there's no imminent risks there given interest rates are low. But 'balance sheet recessions' can have a equally devastating suffocating effect.

"Household debt is at a level where it will constrain growth – and supports the view that we may fall into a deflationary haze. The headroom for debt expansion has been exhausted."

As governor Stevens suggests, we're almost waiting for the next crisis. But he also notes that the steps taken by global and domestic regulators has arguably made the banks as safe as they've ever been. A seven year long roll-out of measures aimed at boosting levels of capital so more losses can be absorbed while altering funding models so that banks can better withstand runs.

More recently the Basel Committee, which oversees global banking rules, sought to modify the use of models to set how much capital they must set aside for a particular loan.

The David Murray-led inquiry into the financial sector initially seemed as though it would clear a path to reduce constraints on the banks instead laid a blueprint to ensure even more stringent requirements; demanding that they stack up as the safest 25 per cent in the world.

If anything the risks are of the so-called unintended consequences of regulatory actions, such as changes in financial market structure, or the rise of the shadow banking sector which is less constrained by new rules. This comes at a cost to shareholders, which because of the oligopolistic market power of Australia's banks, has been passed on to customers.

First State's Barry however is mindful of a future where tougher banking rules and big data technology means other pools of capital such as superannuation funds or online peer-to-peer lending platforms bypass banks and provide credit directly to new projects, companies and households.

"Financial crises have always followed waves of financial innovation – I'd be more concerned in the future about ill-conceived product proliferation, customer data mining or a cyber-attack than a housing collapse or spikes in wholesale funding costs," he says.

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