Big banks face regulatory risks but are set to post strong results

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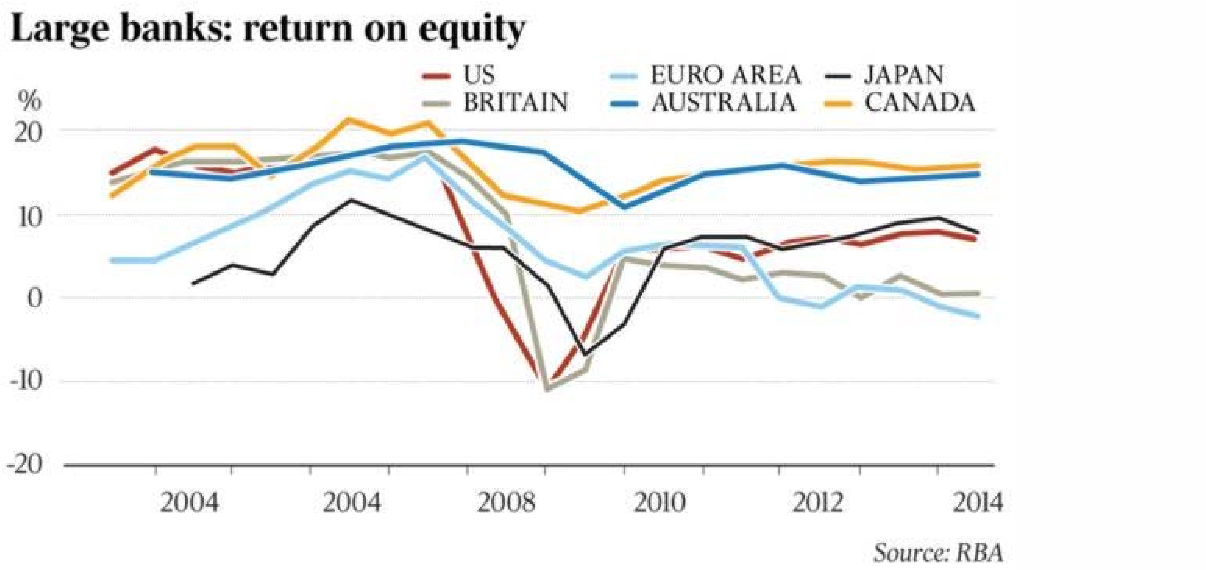

Return on equity. *Source:* TheAustralian

THE recent plunge in share prices of Australian banks mainly reflects concerns — somewhat exaggerated it would seem — with the possible impact from changes in bank regulation.

The new framework of regulation will incorporate both an international component — the Basel III reforms — and changes from the recommendations of the Financial System Inquiry. Banks, especially those considered "systemically important", will need to maintain stronger equity capital bases. Macroprudential regulation to stem the flow of bank lending for investment housing is also likely.

Certainly, the changes being made or considered in bank regulation will create challenges, risks and uncertainties for banks — and bank shareholders. That said, I agree with the conclusion of Deutsche Bank banking analyst James Freeman that market sentiment towards the Australian banks has likely turned too negative.

On his calculations, the recent sell-off has improved the valuation support for bank shares. In price/earnings terms, the major banks have been trading at a 5 per cent discount relative to the overall market. And their 12-month forward dividend yield has likely been raised to 6 per cent (plus franking).

As Freeman puts it, "While regulatory risk does pose a threat, the financial impact looks limited in the near term and the upcoming bank reporting season should reveal strong results with improving momentum for future earnings growth".

The latest Financial Stability Review issued by the Reserve Bank also sets out a broadly comforting assessment of the current state of banking.

For the first time since before the global financial crisis, banking systems in all major economies are showing signs of improvement.

In Australia, "banks' capital ratios edged up again; their asset performance continued to steadily improve; and their profitability remained robust. In addition to their current low bad and doubtful debts charges, the major banks' higher profitability relative to international peers appears to partly reflect operational efficiencies."

Australia's major banks in aggregate have a capital base equal to 9 per cent of risk-weighted assets; their broader capital ratio stands at 12.3 per cent.

Non-performing loans make up just 1.1 per cent of total loans; on housing loans, the proportion is 0.6 per cent. Provisions for bad and doubtful debts are at a historically low level as a share of total assets. And as the chart shows, major banks' annual return on equity has since 2010 averaged about 15 per cent.

The major worry expressed in the review is that global and Australian financial systems have been buoyed by generally strong risk appetite on the part of investors; strains could quickly re-emerge were there to be significant reassessment of risk. Within Australia, there's concern that banks' lending practices may not be conservative enough "for the current combination of low interest rates, strong housing price growth and higher household indebtedness" — and could create a speculative demand that amplifies the housing cycle.

The RBA acknowledges that, at least for some time, the danger is to households rather than financial stability. The bank is clearly preparing the way for the introduction of some direct regulation of bank lending, to curb lending to investor housing. Direct controls were used extensively from the 1950s to the 1970s; those of us around at the time learnt that such controls lose their effectiveness as funding arrangements are rerouted; and they don't cause lasting harm to bank profitability.

Recently, the average of forecasts for the major banks had their profits slowing from 13 per cent in financial year 2014 to 9 per cent and 5 per cent in 2015 and 2016, respectively.

That's partly because charges for bad and doubtful debts are low and will not be contributing to further profit growth. Also, competition is reducing banks' margins. Overall, the outlook for bank earnings may not be as gloomy as market sentiment would suggest.

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