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Major banks analysis: How do you know when you have turned a corner?

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The four major banks in Australia have now reported their full-year earnings for 2009 and in doing so show that they have navigated the most challenging period in international banking markets in over 60 years with considerable success. Michael Codling and Hugh Harley outline some of the key findings following PricewaterhouseCoopers' analysis of the Australian major banks annual results for 2009.

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While bad debt expenses have doubled, income growth has been strong and this has enabled them to hold the reduction in aggregate underlying cash earnings to just 2.4%.

Key elements of their combined underlying cash earnings are:

- Very strong net interest income growth driven by margin expansion as well as volume growth in some segments.
- Reduced wealth management earnings following equity market declines.
- Significant increases in financial markets revenue.
- Continued focus on cost management.
- A near doubling in bad debts expense compared to 2008.
- Overall only a modest reduction in underlying cash earnings for the year.

In 'big picture' terms, the banks have earned combined cash profits of $18bn in FY07, $17.5b in FY08 and $17.1bn in FY09. During this period, the bad debt expense has climbed from $2.4bn in FY07 to $6.7bn in FY08 and to $13.1bn in FY09. Clearly, if the bad debt expense returns to more 'normal' levels in the future, the banks appear well positioned to improve their earnings.

Four major banks combined performance – $A million – underlying cash earnings

	FY09	FY08	09 vs 08
Net interest income	43,789	36,556	19.8%
Other operating income	22,268	21,307	4.5%
Total income	66,057	57,863	14.2%
Operating expense	29,097	27,091	7.4%
Core earnings	36,960	30,782	20.1%
Bad debt expense	13,211	6,714	96.8%
Tax expense	6,577	6,464	1.7%
Outside equity interests	103	112	(8.0%)
Underlying cash earnings after tax before significant items	**17,069**	**17,492**	**(2.4%)**
Statutory results	13,701	16,505	(17.0%)

Source: PricewaterhouseCoopers analysis of the major banks' results for 2009

This result for FY09 reflects the fact that the economic and financial environment in Australia has been less turbulent than expected at the start of the calendar year, with the Australian economy dodging recession, growth in unemployment slowing, and less volatility in overseas wholesale funding markets. Residential property prices have stabilised (and in some segments increased), while commercial property prices have continued to weaken but in an orderly and relatively benign manner. Equity investors, not least the domestic superannuation funds, have been willing supporters of equity raisings.

In this environment, the banks have been able to increase their aggregate net interest income by 19.8% in FY09. This was driven by margins improving for the third half-year in a row as the banks repriced their loans; plus the banks benefited from the 'flight to safety', which resulted in a 13.4% average increase in their deposits. Another highlight was the significant increase in financial markets revenue, although this tailed down in the second half.

Looking to the year ahead, we expect economic growth in Australia to be in the order of 2% to 2.5% in 2010, compared to 0.4% in 2009. In other words, we expect an ongoing economic recovery, but with the economy still growing below trend. While growth may yet again surprise on the upside, there are a number of uncertainties remaining for the international financial system and the international economy which add to the risks for the year ahead:

- Many financial institutions in the northern hemisphere are still carrying substantial portfolios of toxic assets.
- The underlying trade and capital imbalances between the major economies remain.
- The dramatic growth in public sector debt in many western economies may create funding challenges for wholesale markets.
- Stimulatory packages are being phased down in many economies.
- Interest rates cannot remain at historic lows indefinitely.

Taken together these considerations suggest that the operating environment for the domestic banks is on an improving trend, but with a risk of periods of volatility in financial markets driven by offshore events. We also expect the ongoing improvement in domestic economic conditions to translate into only modest improvements in the demand for bank borrowing until well into 2010, as households and businesses continue to take a cautious approach, strengthening their balance sheets and being wary of the potential for higher interest rates.

On the regulatory front the change process still has a long way to go. It seems clear at the international level that the approach is one of significant refinement to the existing frameworks rather than root-and-branch reform. The timetable set out by the G20 in Pittsburgh is nonetheless ambitious, stretching out to at least 2013, and Australia has little option but to fall into line with that timetable. Inevitably the net effect of the changes will be to raise the cost of deposit raising and lending by banks which will, at least in part, be passed on to customers.

The liquidity risk management proposals recently released by the Australian Prudential Regulation Authorities (APRA) illustrate this point. The proposals will translate into

requirements for the banks to increase their 'as normal' holdings of low-yield liquid assets, in particular of the limited pool of Australian government bonds. Inevitably this will increase funding costs which will flow into higher lending rates and, at least potentially, lower bank lending. We support the direction of these proposals but believe certain aspects, such as the definition of liquid assets, need review so as to ensure that the right balance is struck between system stability and efficiency needs.

We do not support calls for a major review of the Australian financial system. The system has shown its ability to withstand extraordinary external pressure, albeit with some government underwriting. It may be that a major review is warranted in a few years' time when we really can be confident that all the disruption of this crisis is behind us and we can look back dispassionately. By then we will also understand the full extent of changes to the international regulatory environment. In the meantime, what is required at present is a focus on specific, actionable changes in policy which can help the economy adjust to a post-global financial crisis (GFC) world and return to trend growth as soon as possible.

Possible policy actions which fall into this category for banking include: reducing tax rates on domestic deposits, which we believe is a matter of priority; confirming future deposit insurance arrangements; abolishing interest withholding tax to encourage foreign banks to operate in Australia; and facilitating the growth of a much deeper corporate bond market in Australia. We would also like to see changes to policy to stimulate the securitisation market further, because more activity in this market will assist with both funding and competition more generally. However, we suspect that the international debate about securitisation still has a long way to run (especially 'skin in the game' requirements), which may make quick changes to domestic requirements difficult.

Beyond navigating 2010 and impending regulatory change, the challenge for banks will be to harness sufficient funds – both debt and equity – to meet the investment needs of the Australian economy in a post-GFC world. In the medium and long term, the potential for investment in the Australian economy may be unprecedented, driven by factors including export demand for resources, infrastructure requirements for rapid population growth, Australia's enhanced reputation as an international investment destination, and responding to climate change.

In one way the funding challenge for the major banks has been disguised by the GFC, because while there has been a much greater emphasis on deposits for funding, the deposit market itself has been growing quickly at 20%-plus. Now that the deposit market is returning closer to trend growth, this begs the question of the banks' ability to grow funding sufficiently quickly to meet the lending needs of the economy. Hence our emphasis above on reducing tax rates on bank deposits.

Inevitably though, a return to those lower trend rates of deposit growth at a time of stronger economic growth will require the banks to review carefully their use of wholesale funds and, in particular, offshore funds. Indeed the banks play a key role as a conduit of foreign borrowing into Australia, having borrowed a total of $115 billion from overseas in the past year.

In turn, this is why the retention by the Australian majors of their AA credit ratings has been so important. Assuming no major disruptions in international financial markets, we believe that the combination of international confidence in both the Australian major banks and in the Australian economy more generally will ensure that the Australian banks continue to be able to find willing overseas lenders to fund their operations.

Rather, over time, the issue may be more around the banks' own willingness, from entirely justifiable risk management considerations, to expand their offshore borrowings relative to their domestic liabilities, bringing us back again to the critical importance of growth in domestic deposits. Given an outlook of only modest growth in demand for borrowing in the short term, we do not expect this to be a binding constraint, but it may emerge as an issue should demand for borrowing accelerate.

As we have previously argued, Australia has come through the GFC precisely because of the combination of a strong and profitable banking system in tandem with robust economic policy and industry supervision. The need for this balanced approach of strengths from all sides will be just as important to ensure that Australia takes maximum advantage of its current strong position.

The banks themselves focused on strengthening their balance sheets in FY09, with aggregate tier 1 capital rising by 118bps. As a consequence, their combined average return on equity over the past year has been 13.1%, compared to an average of 16.6% in FY08. The increased level of capital now held will likely lead to a re-evaluation of the longer-term returns that a highly regulated bank should achieve.

The banks' competitive position in the market hasn't been so strong for many years, and we expect that margins will continue to increase in FY10 and bad debt expenses will moderate. However, system credit growth will take some time to recover, and fee income will remain under pressure, particularly in light of recent initiatives to reduce or eliminate certain fees.

So where does this leave us? After two consecutive years of negative growth in underlying cash earnings – 2.4% in FY09 and 3.0% in FY08 – we believe the corner may have been turned. At the half-year stage, the PwC banking gauge predicted that the banks' underlying cash earnings for FY09 would finish relatively flat on FY08, as they did. We would be cautiously optimistic about FY10, with expectations of good earnings growth in FY11. The PricewaterhouseCoopers banking gauge is more bullish, predicting that the banks' underlying cash earnings will increase by 13.9% in FY10.

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