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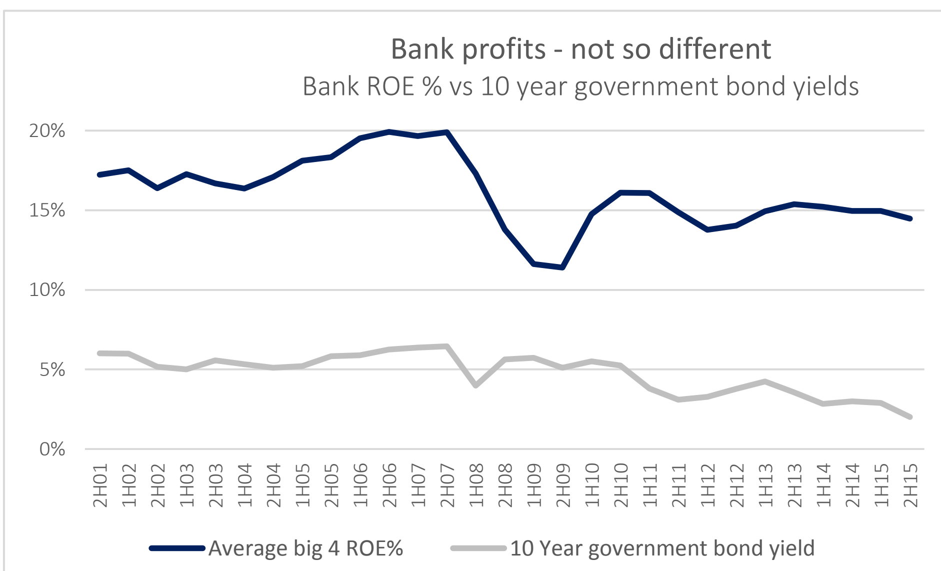
Banks profits – Goldilocks

Some politicians are bleating Australian bank profits are too high. Some financial commentators are fretting saying they are heading too low. At Spectrum we see bank profits from a credit viewpoint as about just right. Often lost in the commentary is perspective. When benchmarking Australian bank profitability against government bond yields profitability margins have not changed a great deal over time. Nor are they notably higher than many other commercial banks around the developed world. Looking forward the big 4 Australian banks are set to deliver further healthy profits for at least the next year. Crucially, from a credit standpoint, the long, strong profit track record gives the banks a strong ability to raise capital – including during times of financial turmoil. This helps underpin the safety of the largest component of the Australian corporate bond market – banks.

Too low, too high – depends on what you compare it to

Falling returns on equity or ROE% for Australian banks is a concern for some in the financial community. True profits have fallen. But so too have bonds yields. When one takes the perspective of the lower yield environment the profitability of the big 4 Australian banks* is fairly similar to the past.

As the graph below shows, the ROE% of the big 4 has a fairly stable margin over the 10 year Australian government bond yield in recent years.



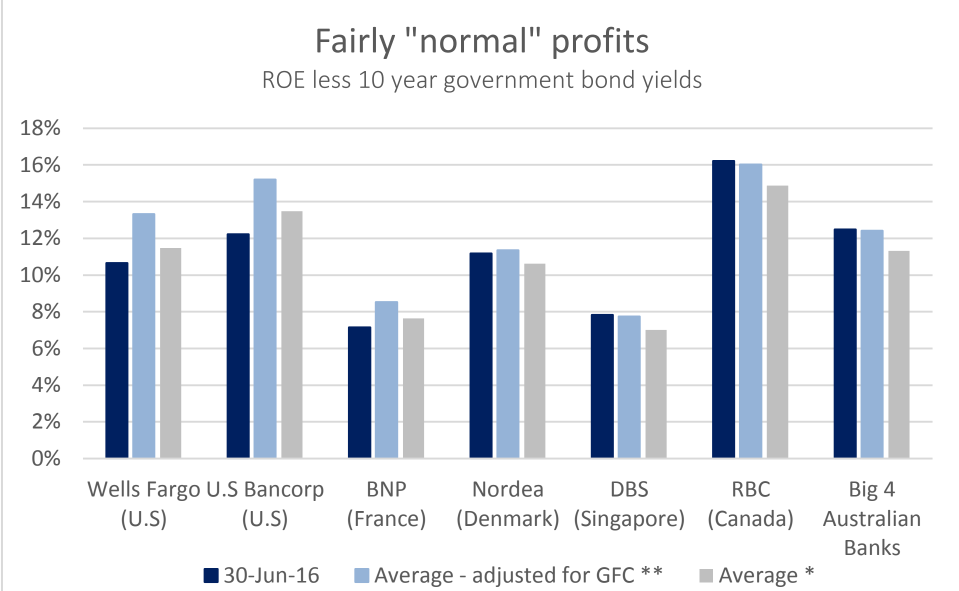
- *big 4 Australian banks are ANZ, Commonwealth Bank of Australia, National Australia Bank and Westpac

Comparing Australian bank average profitability premium in recent years, it is currently a little higher than average. But when the periods soon after the GFC are taken out, the big 4 profitability premium is at around the longer term average.

Australian bank profitability premium – fairly stable			
	1H16	Adjusted for GFC **	Average since 2H01*
Average big 4 ROE%	14%	17%	16%
10 Year government bond yield	2%	5%	5%
Gap	**12%**	**12%**	**11%**
* half year ROE annualised less period end 10Y relevant government bond yield since 2H01 until 1H16			
** 5 half year results starting from 2H08 removed from calculation -2H01-1H16			
Sources: Spectrum, Reuters, RBA			

Global perspectives

For developed world commercial bank profitability premium analysis we get a similar outcome to Australia's. Like in Australia global bank profitability has fallen. But when one adjusts for the far lower yield environment they too are currently sitting at comparable levels to recent history.



Sources: Spectrum, Reuters, RBA

Why is it so?

The key reason for lower nominal bank ROE in a lower interest rate environment is banks have more assets than liabilities. This surplus of assets earns a return reflective of the prevailing interest rates. The higher the interest rate, the higher the income on this surplus.

The second reason is commercial banking in its essence is a cost-plus business. The main cost is for funding its balance sheet. That is the cost of deposits and other borrowings. The banks charge borrowers a margin over this cost. This margin covers expected loan losses, overheads and a profit margin. The size of the margin does not automatically change when bond yields move.

To illustrate the theory we provide a simplistic bank balance sheet, profit and ROE in two different interest rate environments. That is where assets generate 10% - scenario 1 and where they generate 3% - scenario 2. Lending margins are set at 2% and overheads are the same dollar amount.

Bank profitability – different environments, different profitability

		Scenario 1			Scenario 2		
Bank Balance Sheet		yield	$		yield	$	
Assets	100	10%		10	3%		3
Liabilities	90	8%		7.2	1%		0.9
Equity	10						
Net interest income			$	2.8		$	2.1
Overheads (% of assets)		0.5%	$	0.5	0.5%	$	0.5
Net profit before tax			$	2.3		$	1.6
Tax (30%)			$	0.7		$	0.5
Net profits			$	1.6		$	1.1
ROE%				**16%**			**11%**
ROE % less cost of funds %				8%			10%

Source: Spectrum

What the analysis shows is that the ROE% is vastly different under the two interest rate scenarios. The gap is from the higher returns on the surplus of asset over liabilities.

Yet the profitability margin over the cost of funds – a proxy for government bonds – is actually better in the low interest rate environment.

In reality this higher relative return and typical lower default rates in a lower interest rate environment also promotes lower borrowing margins for bank customers – which is what is currently happening in many banking markets including Australia.

Be careful what you wish for

Some want Australian banks to make less profit. They claim they are gouging customers or not lending to the worthy. Sure our banks are a long way from perfect. But to encourage banks to go against their judgement on what loans to make or at what prices to make them is at odds with a sustainable strong banking system.

So too would be an unbridled pursuit of higher profits from the banks. To achieve this would encourage the banks to take greater risks.

Clearly the rules and their enforcement for banks could be improved. So too could some of the business and remuneration practices at the banks. That said we expect common sense to prevail and the current de-regulated but supervised system to remain largely intact.

Goldilocks environment

At Spectrum we see the current level of profitability at banks reflects balanced risk-return profiles at the Australian banks – or a "Goldilocks" like environment – not too hot, not too cold. This gives them a strong ability to generate profits, raise capital and to service its coupons on its bonds and dividends on its hybrid capital. As banks make up around 40% of the Australian corporate bond market this helps underpin the safety of this asset class.

What we did not include in the analysis

We did not include banks with large investment banking operations such as J.P Morgan. The reason is investment banks are fee and trading profit businesses distinct from the cost-plus business of a commercial bank. Also we did not include U.K banks. These banks have had to meet large pay outs over recent years from the mis-selling of Payment Protection Insurance. This has markedly dragged down their profitability.

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Spectrum Asset Management manages the Spectrum Strategic Income Fund. This fund invests in A$ corporate securities of which the majority are floating rate notes. The intention is to make this portfolio relatively immune from the bond yield volatility which can, in turn, hit equity and fixed income markets. The fund is also designed to deliver an income stream while generating capital gains from time to time. For more information and how to invest please go to our website http://spectruminvest.com.auor contact your mFund brokerhttp://www.asx.com.au/mfund/foundation-members.htm#tabs-218. Spectrum and the author have investments in either securities mentioned in this report or comparable securities