

Banking Industry



CPMD Workshop on Banking, Health and Education 2018

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Thinking About the Banking System

Functions

- Access to Payments Systems
- Intermediation – connecting savers and borrowers
- Risk Management – financial products
- Information Processing and Management

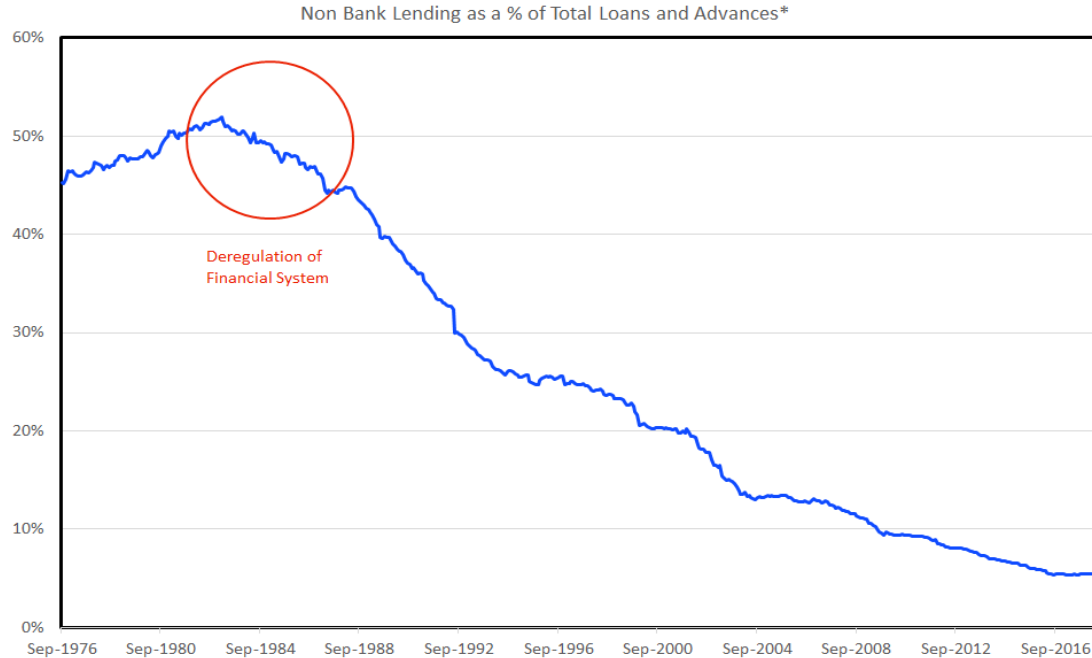
Stakeholders

- Shareholders/Executives
- Customers
- Employees/Executives
- Community

The External Environment

- Regulation and social licence
- Economy
- Interest rates
- Technology

A Very, Very, Very, Very Short History of Australia's Banks



Notes: *Total loans and advances made by all financial intermediaries

Source: RBA, EQ Economics

Australia's Banking System 2018

Royal Commission into Financial Services Industry in final stages.

- Unusual event focused on conduct rather than system.
- Last major inquiry into banks in the mid 1930s.

Regulation:

- Post GFC reforms of bank capital and liquidity requirements nearing completion.
- Some further new requirements related to loss absorbing capital.

Economic Environment

- Big 4 banks heavily exposed to residential property (mortgages and SME lending).
- House prices falling and credit growth slowing.
- Interest rates near/at near record low levels while unemployment rate near cyclical low (5%).

Performance of Australia's Banking System

Profitability

- Banks are highly profitable although growth has stalled in recent years.
- The Return on Equity (RoE) of the banks is between 10% and 12%.

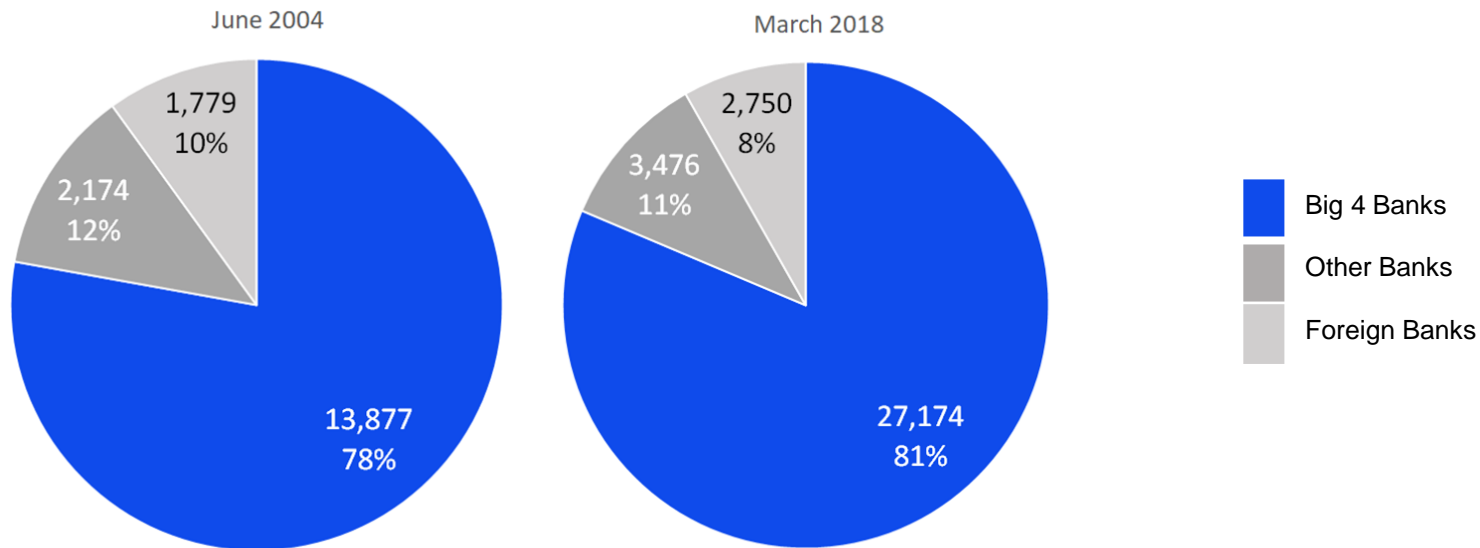
Dividend Policy

- An important feature of the Australian banking landscape is the strong focus on paying dividends (yield is still 6%).
- Dividends have been maintained despite pressures on profitability – pay-out ratios are rising to record highs at around 80%.

Capital and Liquidity

- The Australian regulator is satisfied that Australia's banks are 'unquestionably strong' (CET1 of 10.5%)
- Meeting all new liquidity requirements (Liquidity Coverage Ratio average is 130% versus 100% minimum).
- Capital levels have risen by about 50% since the GFC according to the RBA.

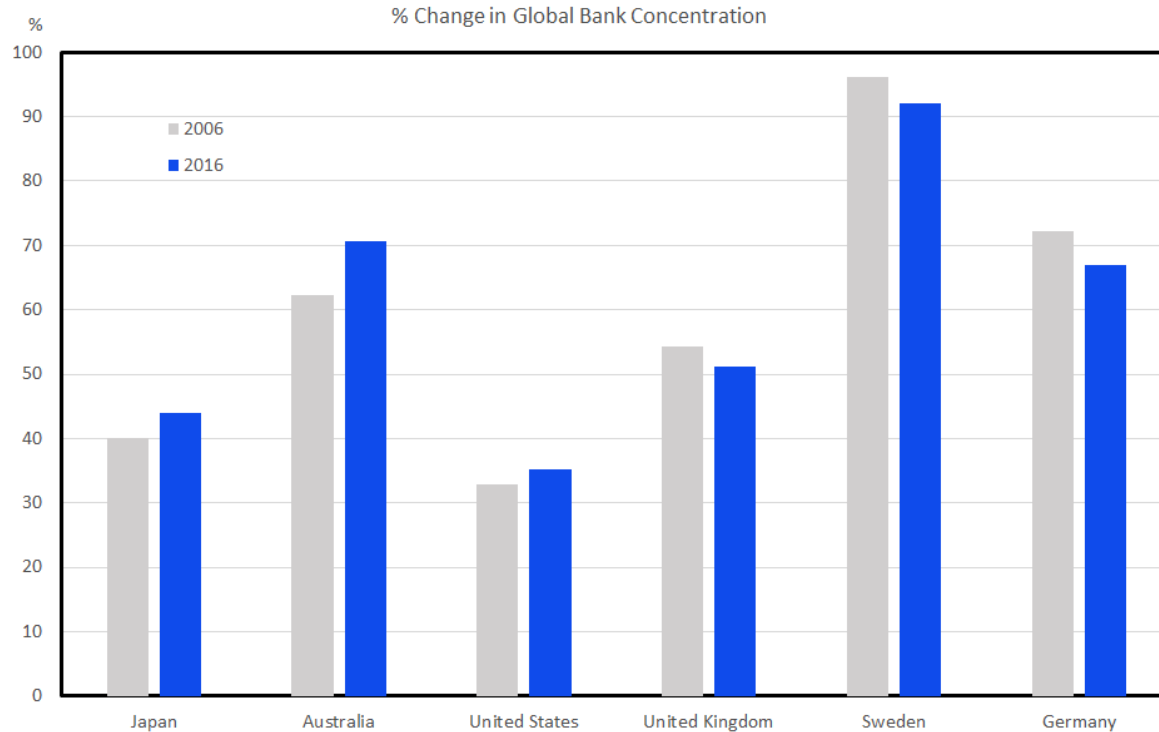
Share of Total Bank Interest Income Generated by the Big 4 (\$Millions)*



Note: *As a percentage of total interest income across all banks

Source: APRA, EQ Economics

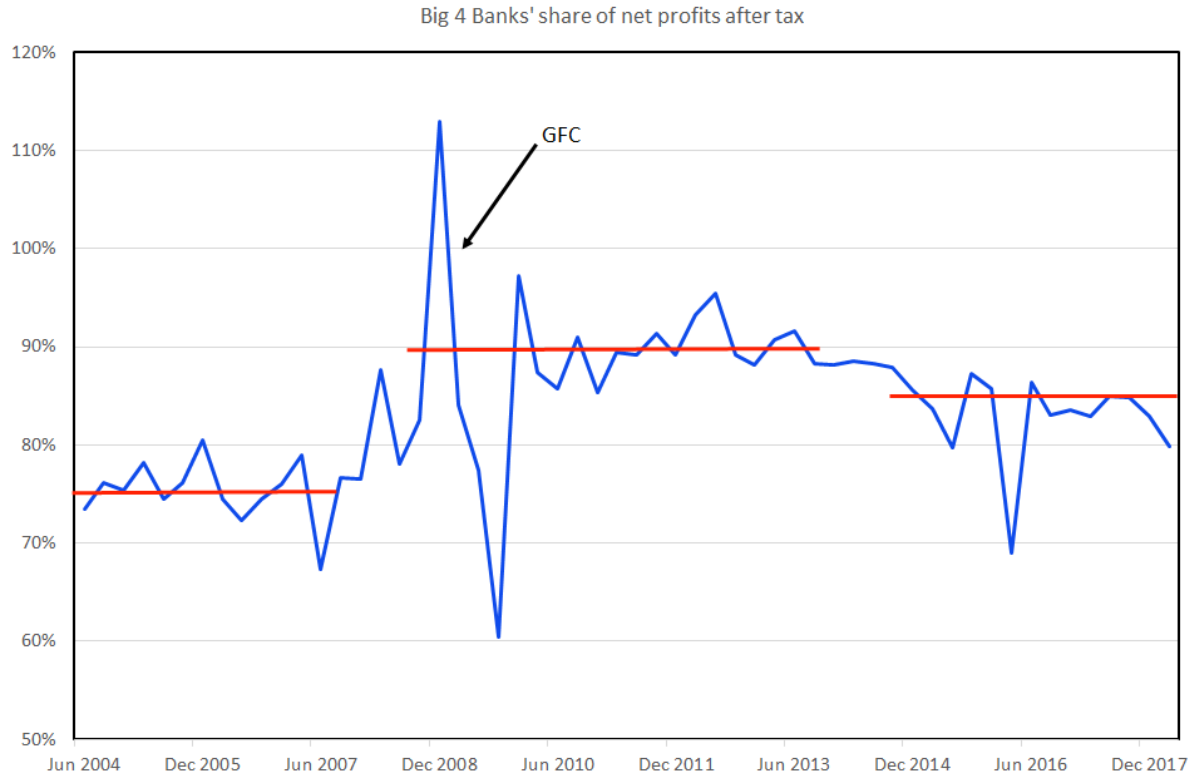
How Does Australia Compare?



Note: Bank concentration measured by share of assets of the 3 largest commercial banks in each country

Source: World Bank, EQ Economics

How Big are the Big 4?



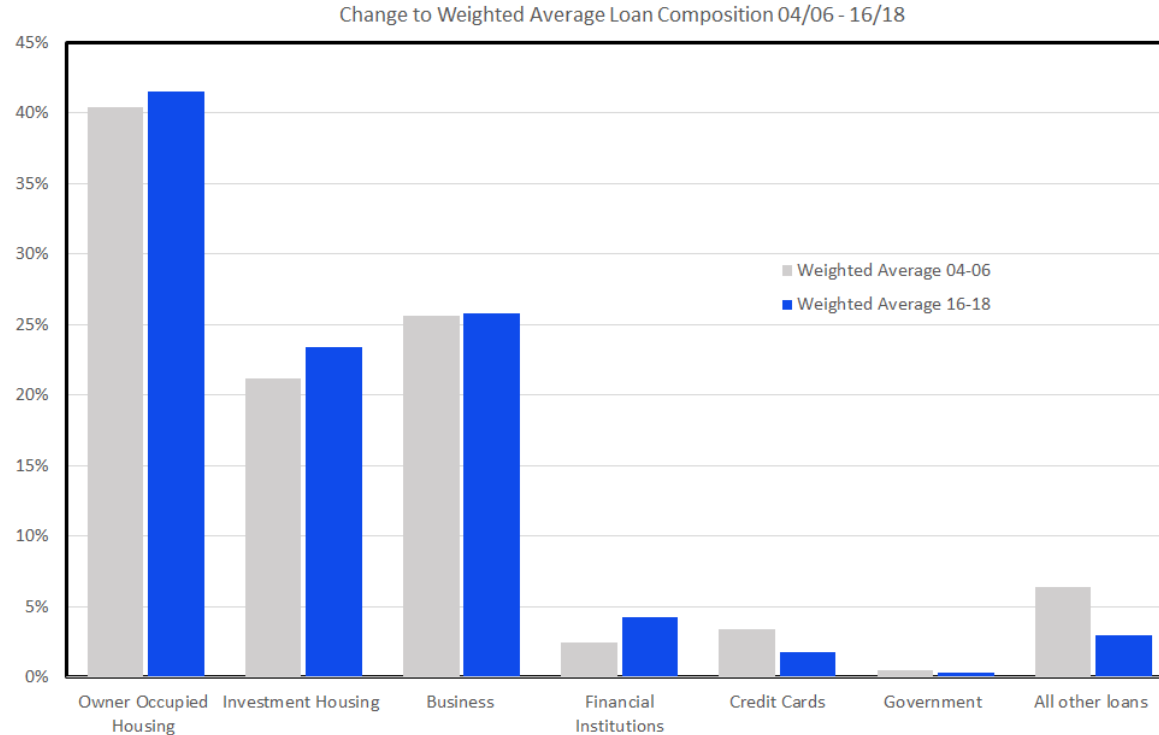
Concentration and Consolidation: The Riskiness of the Australian Banks

- Are Australia's banks becoming too similar, too simple and too concentrated?

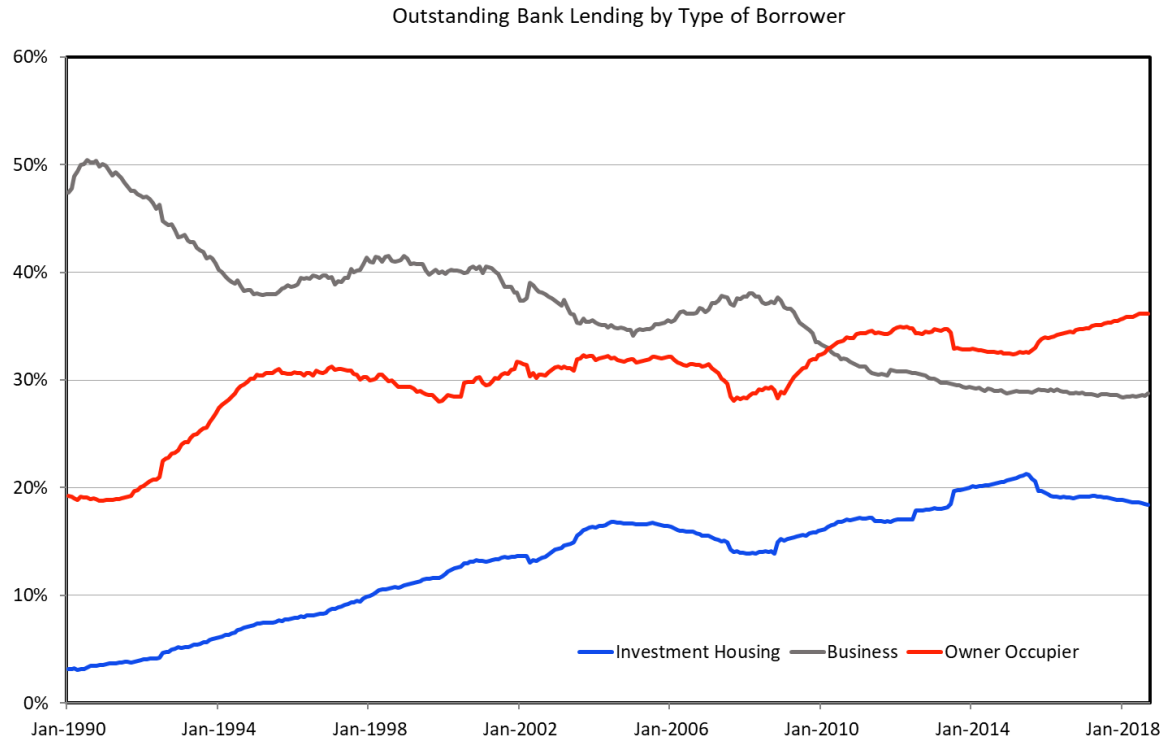
Areas of consolidation beyond the loan mix:

- Selling off international businesses (ANZ, NAB) will increase geographic concentration.
- Selling business units:
 - Wealth and Superannuation
 - Insurance
 - Finance companies
- Simplification of products and business models driven by regulation and technology.
- Risks:
 - Macro prudential risks from concentrated/similar revenue streams.
 - Macroeconomic risks from banks returns (dividends) and credit supply.

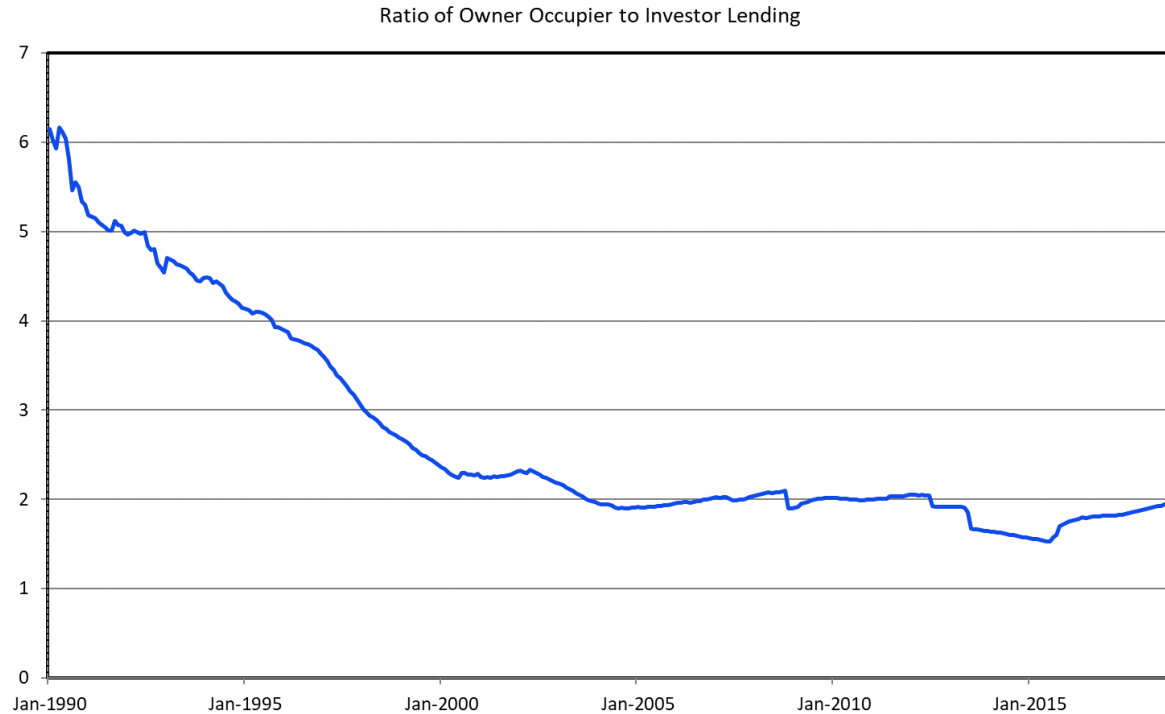
Banks Are Becoming More Specialized – the Loan Mix



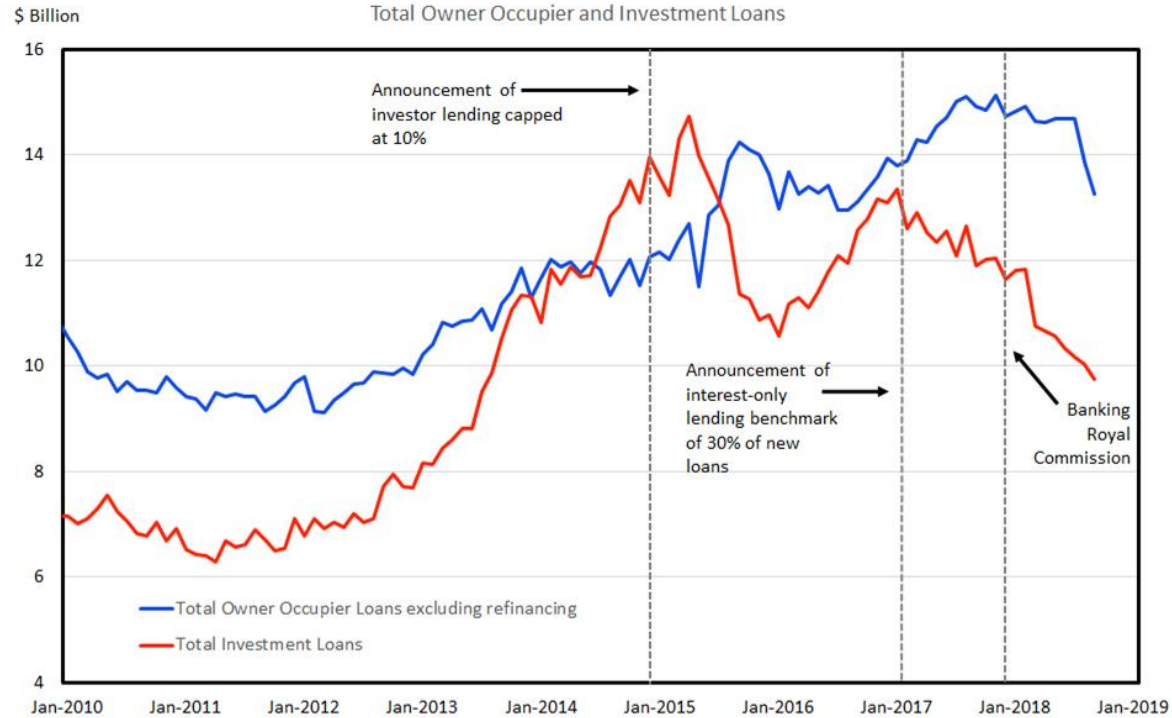
Outstanding Bank Loans by Borrower Type



Ratio of Owner Occupier to Investor Mortgage Loans

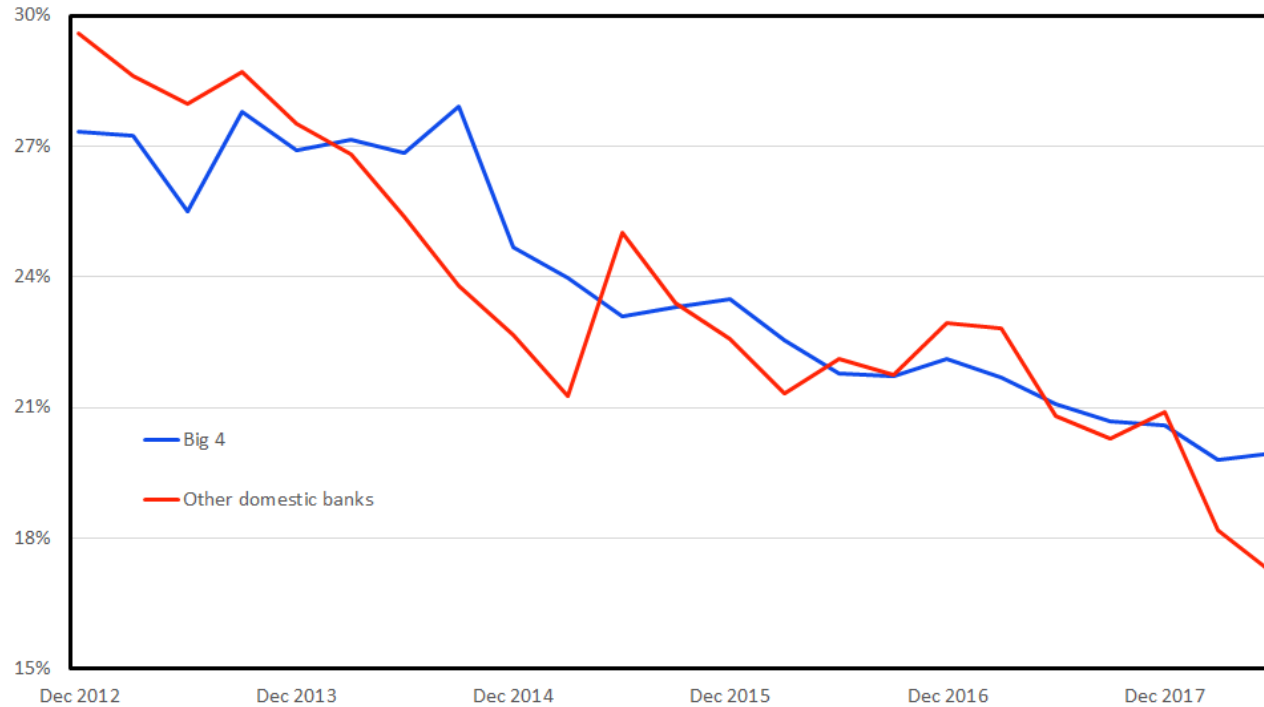


New Mortgage Lending and Macro Prudential Regulation

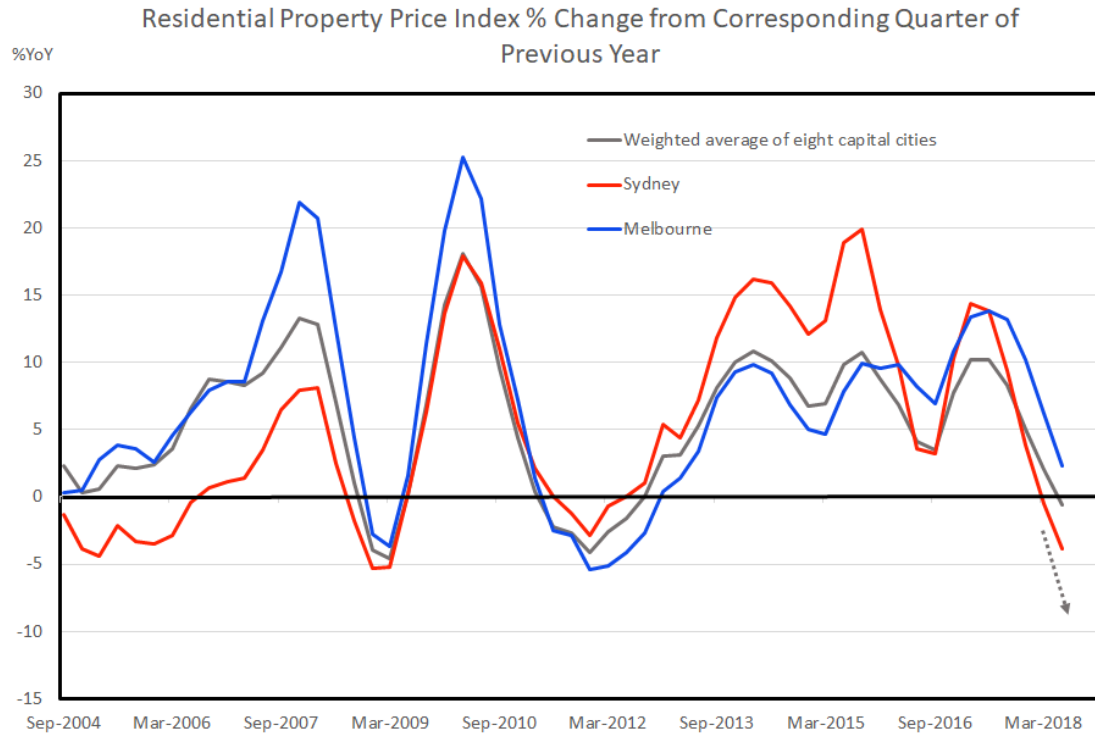


High Risk Mortgages on the Decline

Share of New Residential Loans with Loan to Value Ratio's of more than 80%
(Big 4 vs Other Domestic Banks)



Property Prices



From 'Bad Apples' to Systemic Misconduct: a Macro Perspective on the Royal Commission

“Temper your sense of justice”, Ian Narev, CEO, Commonwealth Bank of Australia revealed at BRC

The Interim Report of the Royal Commission identified a serious breakdown in conduct across the Australian banking system with particular attention being paid to the Big 4.

These issues have been identified as cultural. Profits were put before all else.

Features of Australia's banking system:

- Dividend policy and the focus on shareholder returns (stakeholders and competition);
- Culture Creep and the internationalisation of Australia's major bank management (from long-term gatekeepers to short-term profiteers)
- The illusion of success in navigating the GFC and loss of corporate memory from last bank crisis.

From 'Bad Apples' to Systemic Misconduct: a Macro Perspective on the Royal Commission

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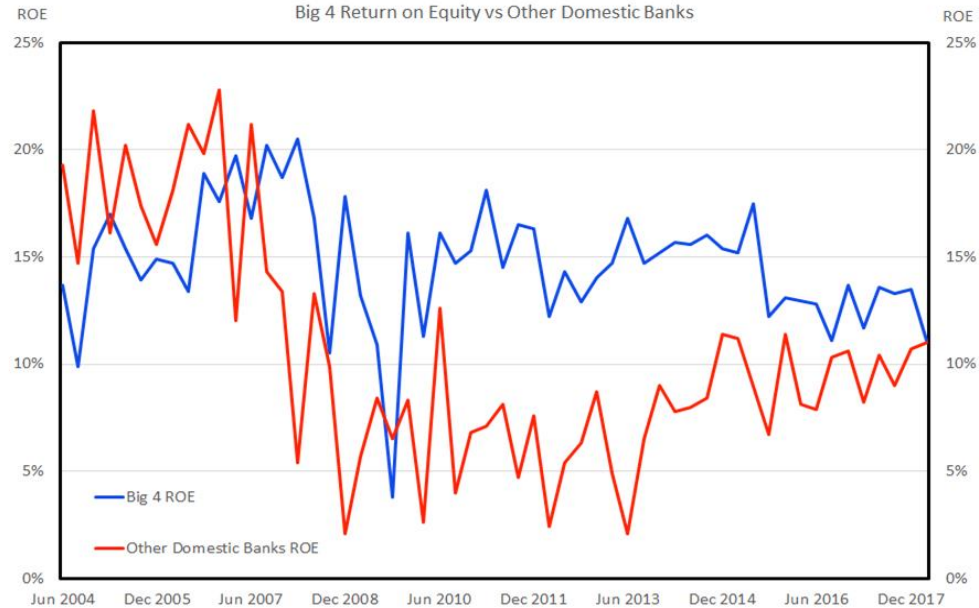
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- From 1995 to 2010, there was an increase in the flow of foreign professionals into the big 4 banks either from overseas, or by Australians with international banking experience.
- Based on my observation of the market, and dealing with counterparties, this led to a cultural change in banking, where it became all about the money with a focus on short term profitability.
- Bonuses not tied to formal outcomes but to the approval of the manager charged with dispersing them, have a largely unrecognised power to change culture quickly. I believe this was a factor in changing the culture of bankers from 1995 to 2010, reinforcing the influence of global banking culture.
- Also evident through the case studies from the Interim Report of the Royal Commission, was that the use of financial incentives and bonuses acted as a catalyst for unethical behaviour by agents.

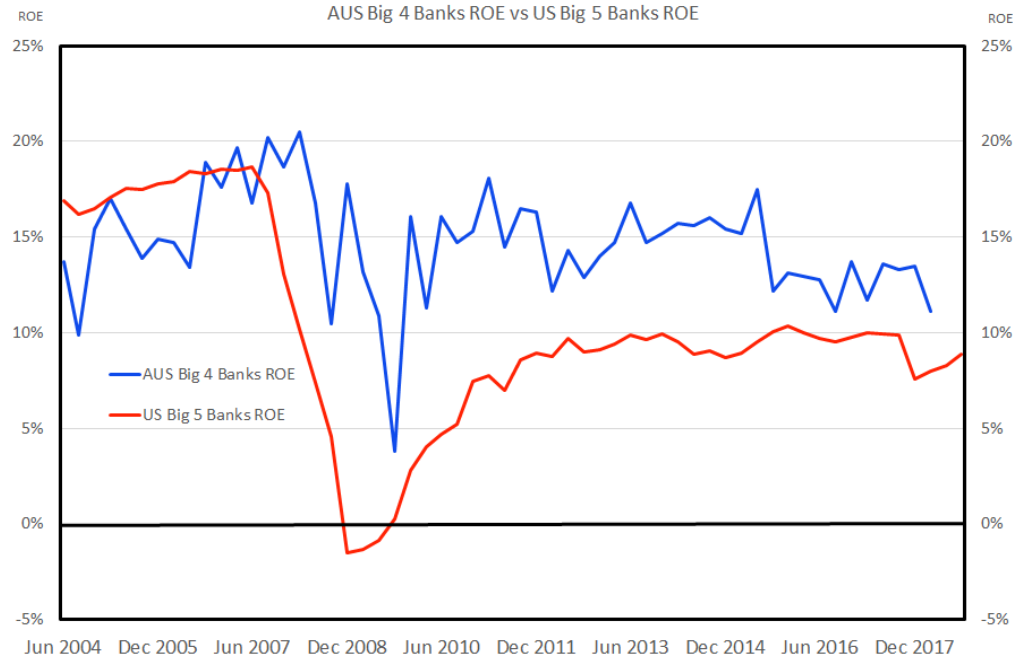
Excess Returns I: Other Banks Operating in Australia



Note: Quarterly data and outlier for Australia's Big 4 Banks ROE (March 2016) removed
 Outlier for Other Domestic Banks (June 2015) removed

Source: APRA, EQ Economics

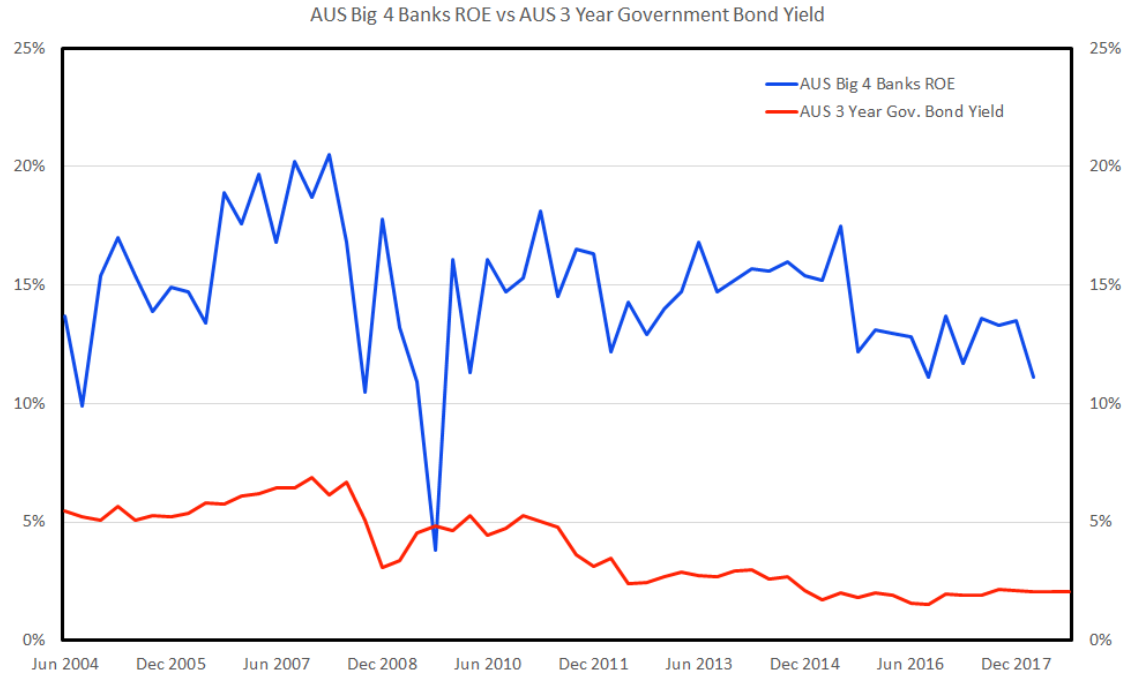
Excess Returns II: US Banks



Note: Quarterly data and outlier for Australia's Big 4 Banks ROE (March 2016) removed.
 Big 5 US banks refer to JP Morgan, Bank of America, Wells Fargo, Citigroup and US Bancorp

Source: APRA, Bloomberg, EQ Economics

Excess Returns III: Risk Free Rate

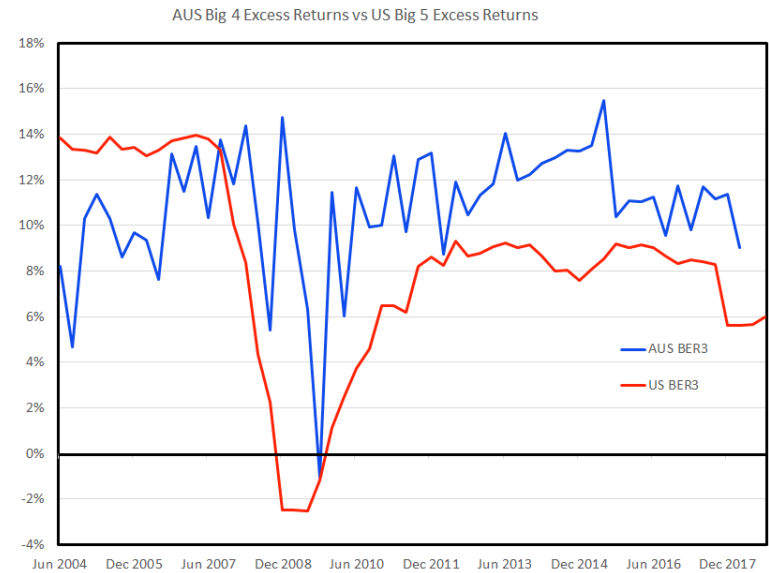
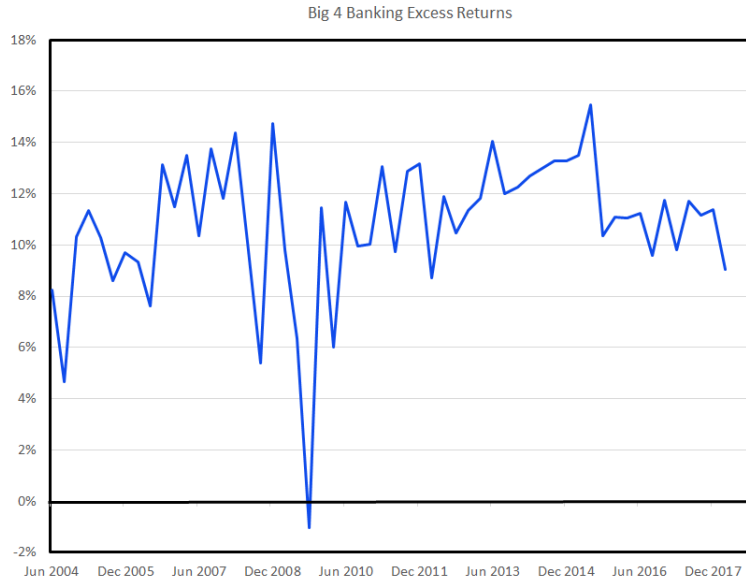


Note: Quarterly data and outlier for Australia's Big 4 Banks ROE (March 2016) removed

Source: APRA, Bloomberg, EQ Economics

Bank Excess Returns

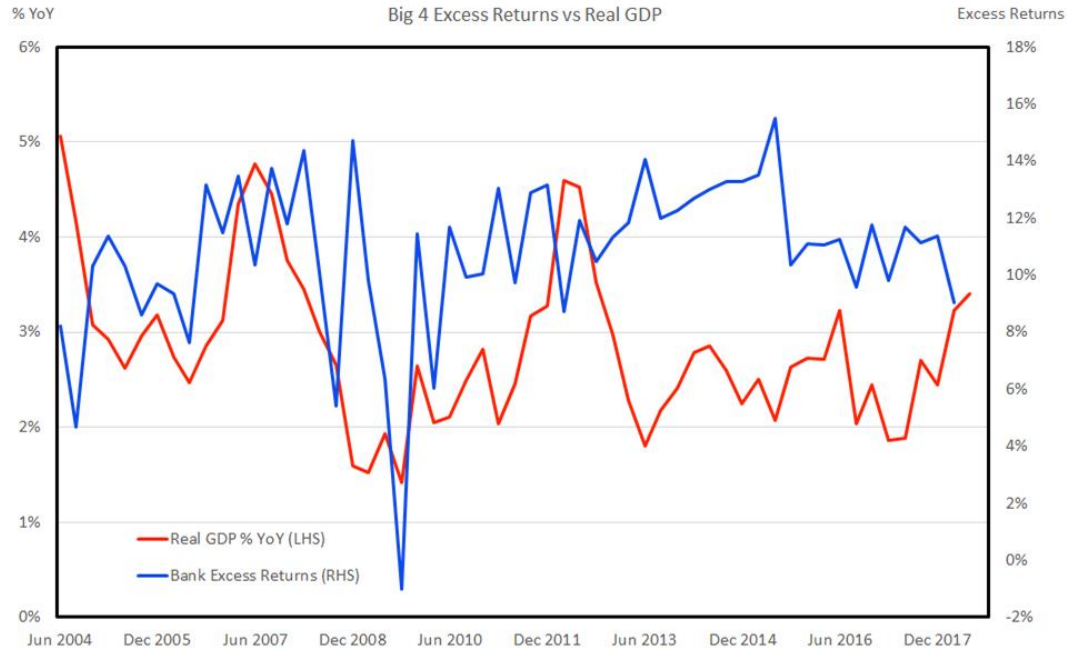
Big 4 ROE less 3yr risk free rate



Note: Quarterly data and outlier for Australia's Big 4 Banks ROE (March 2016) removed.
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Source: APRA, Bloomberg, EQ Economics

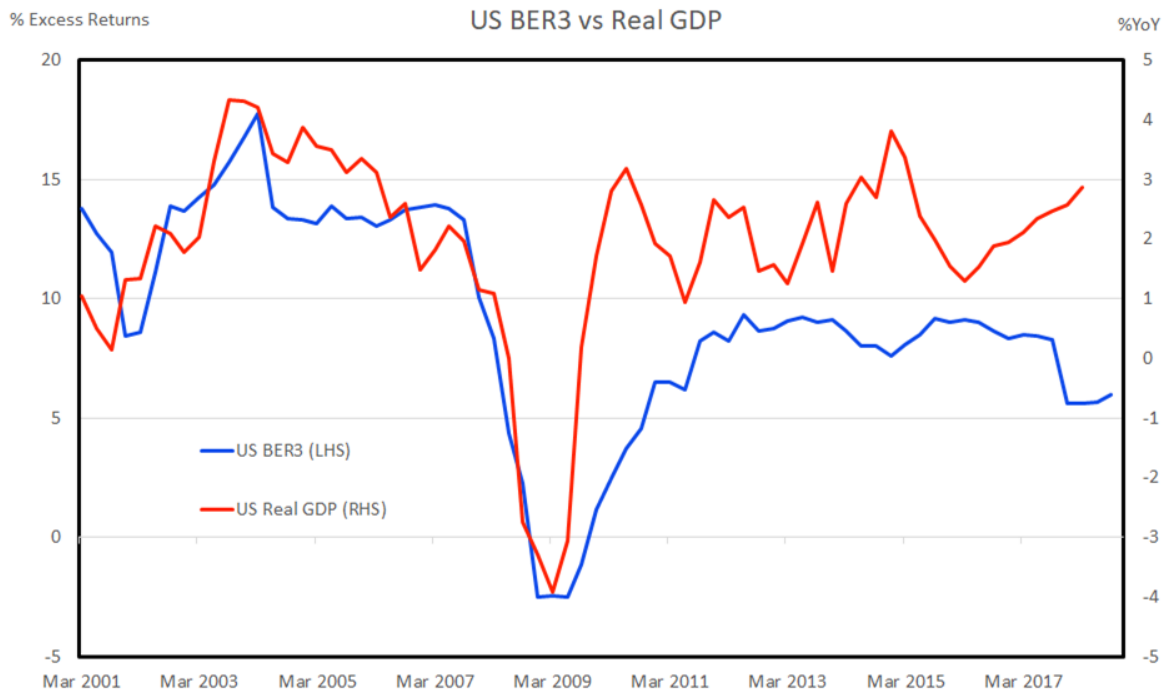
Big 4 Excess Returns & Economic Cycle



Note: Quarterly and outlier for Australia's Big 4 Banks ROE (March 2016) removed

Source: ABS, APRA, Bloomberg, EQ Economics

US BER3 vs GDP

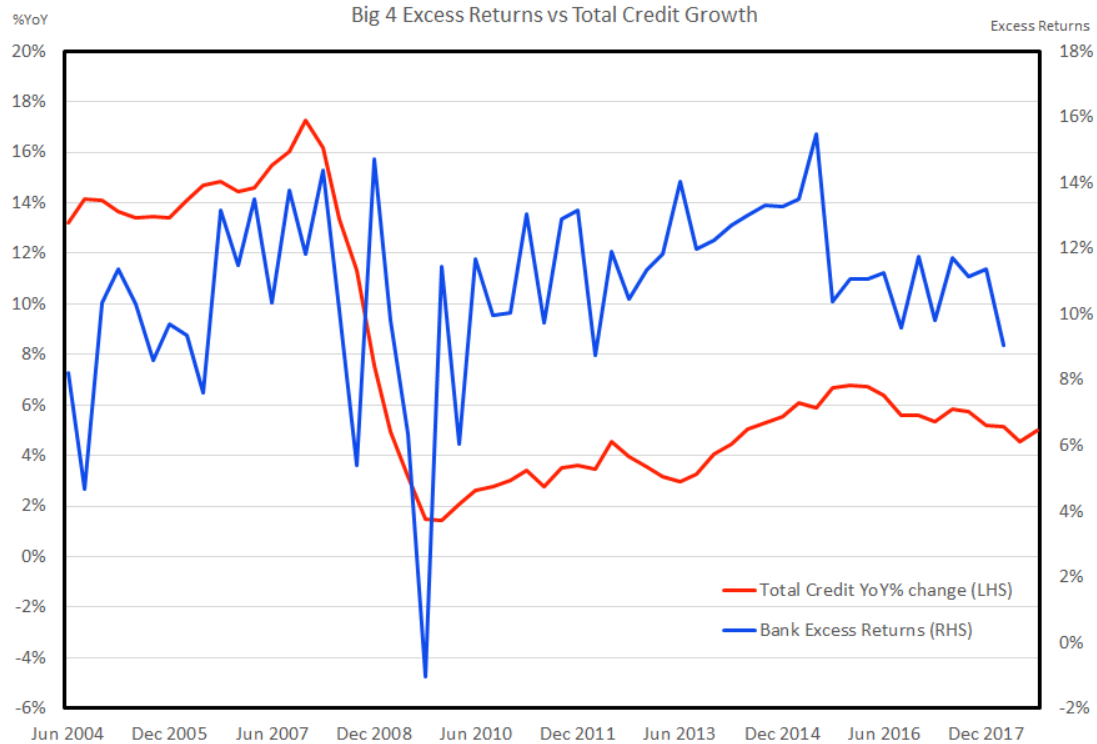


Note: Quarterly data

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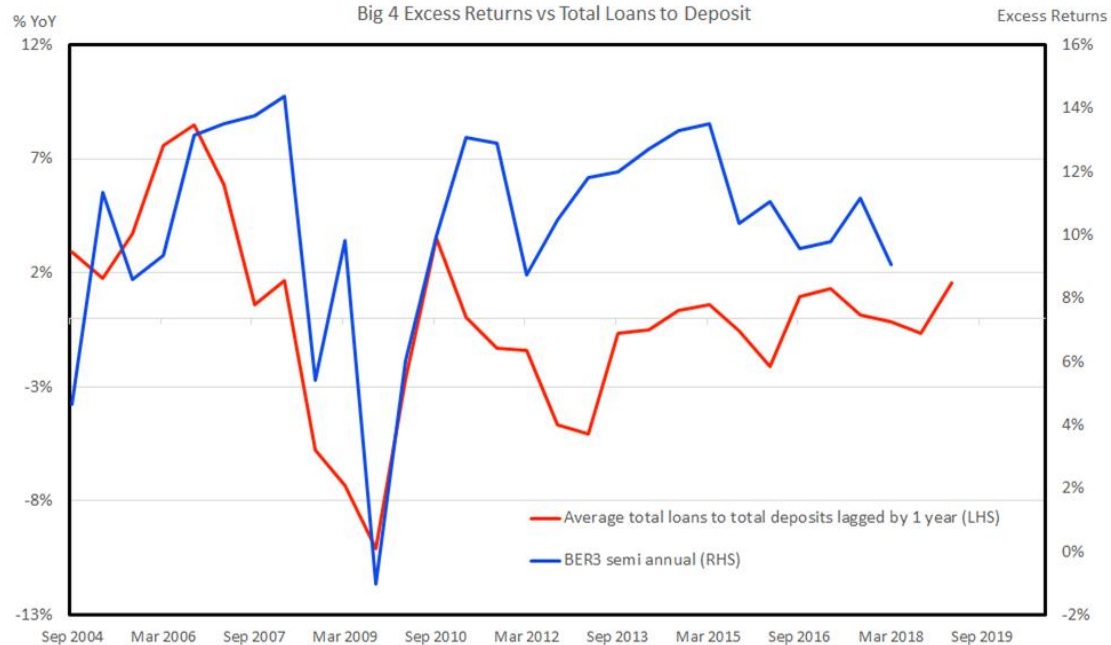
Source: Bloomberg, EQ Economics, FRED

Big 4 Excess Returns & Credit Cycle



Source: APRA, Bloomberg, EQ Economics, RBA

Big 4 Excess Returns & Funding Cycle



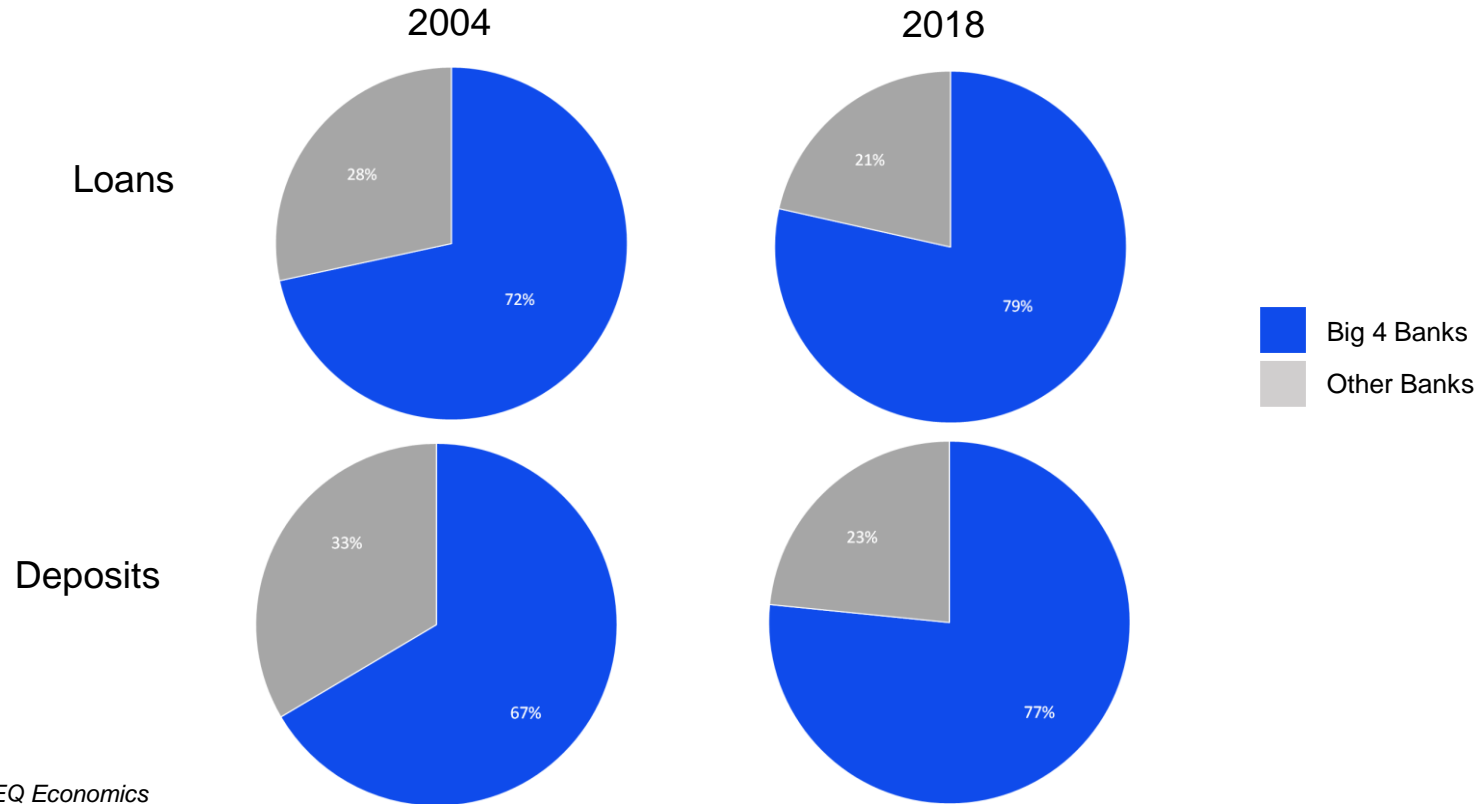
Note: Semi-annual data, outlier for Australia's Big 4 Banks ROE (March 2016) removed.

Source: APRA, Bloomberg, EQ Economics

Some Questions

- Why did the Board/Executive of the Big 4 fail to revise down their expected returns after the GFC?
 - Dividend Policy and Competition
 - Executive Remuneration, time horizon and the merging of principal and agent
- Why did customers allow this to happen?
 - Asymmetric information and complexity
 - A tiered structure of trust

Two Tiers of Trust in Banking



Thank
you

