BT Investment Solutions

Who is afraid of the big bad banks?

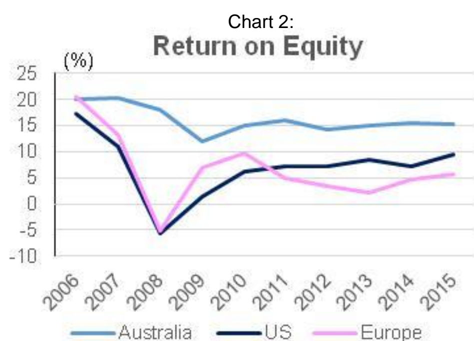
3 March 2016

The Australian banks have been caught up in concerns affecting global banks, with share prices falling sharply since the start of the year. We argue that this is unjustified given the strong fundamentals of the domestic banking system. Lending volumes are improving, credit quality remains strong and capital is adequate. Funding costs are rising slightly, but Australian banks source an increasing proportion of funding from deposits. Valuations have fallen sharply and much bad news is now factored into prices.

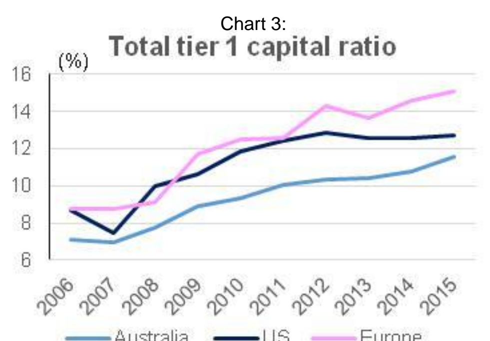
Global banks have sold off sharply since the start of the year amid heightened concerns around the health of the US and European banking sectors. Investors have been worried about the impact of negative interest rates on bank profitability, the prospect of rising corporate defaults in the energy sector and the general slowdown in global economic activity. Australia's banks have not been immune from the selloff, as shown in Chart 1.

Source: Bloomberg

While some of these concerns are justified, the global banking sector has improved its resilience since the global financial crisis. Bank profitability has improved, loan-loss provisions have returned to pre-crisis levels while capital levels have risen as shown in charts 2 and 3. Meanwhile, most banks in the advanced economies do not appear to have large exposures to the energy sector.



Source: Bloomberg



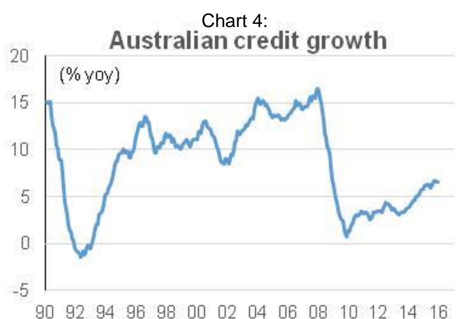
Source: Bloomberg

Moving closer to home, Australian banks continue to have solid fundamentals. These include:

+ Credit quality remains firm, with bad and doubtful debt charges at low levels. Housing and business loan serviceability remains favourable. Modest corporate gearing and low interest rates support the outlook for business loans, while households have built up large mortgage buffers equal to more than two years of scheduled repayments.
+ Lending volumes have been steadily improving since the depths of the financial crisis as shown by the credit growth changes over time in Chart 4.
+ Banks have the ability to reprice their loan book as shown in chart 5. Indeed, there has been a decent amount of repricing of mortgages in the last year with little impact on lending volumes.

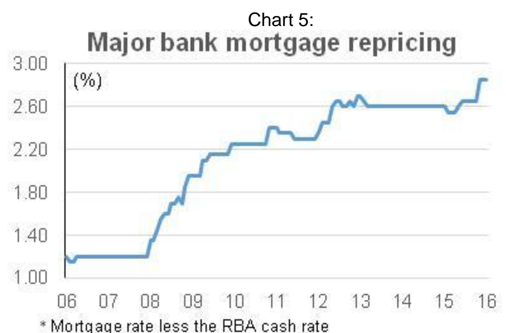
+ Dividend payout ratios are elevated, but a resilient domestic economy, adequate capital levels and subdued credit trends should support the current level of dividends. In fact dividend yields have risen to between 6 and 8% before franking for the major banks – a much better return than from depositing your money with the bank.

Chart 4:



Source: Bloomberg

Chart 5:



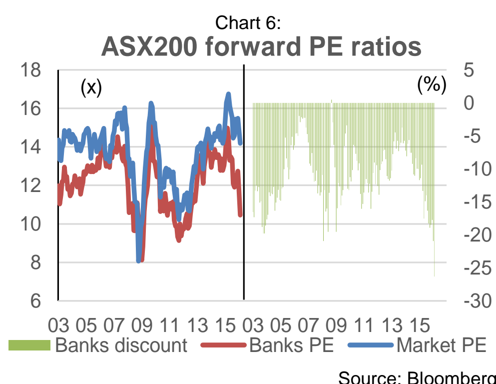
Source: Bloomberg

Of course, investing in bank stocks comes with risks:

+ Regulatory changes required the banks to increase capital in 2015 through capital raisings and asset sales, and this was a drag on market performance. While regulations could change again, it is likely that capital raisings are done for now. The major banks will continue to lift capital through further asset sales and through retained profits.
+ The banks have a highly concentrated exposure to mortgages. We are not overly worried about this given that the RBA is likely to keep interest rates low to backstop growth.
+ There are concerns around the banks' exposure to resources. However, the banks have been very active in managing these exposures, and they only represent a few percent of their corporate lending books.
+ Wholesale funding costs have risen. However, the impact on the overall cost of funding is less today because deposits have become more important as a source of funding.

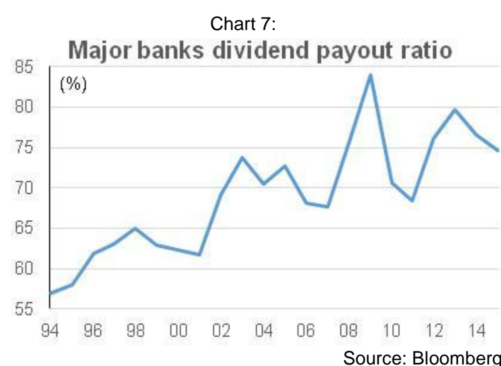
While there are some near-term risks to bank earnings we think they are fully captured in valuations. The banks look attractive on a PE basis both relative to their own history and relative to the broader market. Meanwhile, the banks offer a very attractive dividend yield which is an attractive attribute in the low growth environment. The ability to grow dividends is fairly low as payout ratios are elevated, but current dividends look sustainable as shown in Charts 6 and 7.

Chart 6:



Source: Bloomberg

Chart 7:



Source: Bloomberg

For more information on Australian banks and your investments, please contact BT Financial Group.

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