**Australian Banks - How Low can BDD's go?**

ANZ, National Australia Bank (NAB) and Westpac (WBC) have recently reported their first half results for 2014, with the Commonwealth Bank (CBA) providing the market with a 3rd quarter update.

Each of the results was largely differentiated on each bank’s mix of business type and geographical exposure. Banks focussed on core domestic banking to both retail and business customers generally outperformed those with higher exposures to international and institutional banking.

As highlighted in our previous review of bank earnings 6 months ago, reductions in impairments (“bad & doubtful debts”) continues to drive sector profits! Many analysts estimate that over the long-term, impairments should average between 0.30 - 0.40% of total loans. Yet the latest bank results showed impairments were running at a tiny 0.12 - 0.21%! Impairments have drifted lower over the last few years benefitting from Australia’s very low interest rates and relatively low unemployment. According to the latest Treasury estimates, unemployment is predicted to rise (modestly) towards 6.25% and it is our concern that coupled with slight increases in interest rates over 2015, we could well see a normalisation in impairment levels. This would be a meaningful headwind for continued bank profit growth, dividend growth and consequently, valuations.

While ANZ continues with its Asian growth strategy – successfully growing Asia-Pacific profits to 25% of group earnings - it is concurrently increasing the bank’s exposure to the currently highly competitive international and institutional banking (IIB) environment. This saw ANZ’s margins modestly fall. Despite this, ANZ managed to grow profits by 9% (adjusted for currency movements) thanks to its increasing exposure to the higher growth Asian region. While the market appears concerned about headwinds within its IIB division – ANZ trades at a slight discount to peers - we remain comfortable that the bank’s exposure to Asia will provide a more than adequate offset.

WBC reported its first result following the acquisition of Lloyd’s (UK) Australian business, managing to generate a solid pre-provision earnings growth of 5%. Thanks to its sector-leading capital position, WBC was able to increase dividends broadly in line with earnings growth. The highlight however, was a further 22% reduction in impairments to levels not seen since 1997! Any normalisation of impairments back towards long-term average levels would be a meaningful headwind for profit growth for WBC.
CBA has consistently traded at premium valuation to its peers. The bank’s trading update again reaffirmed this premium with solid underlying trends and further improvements in asset (loan) quality. While we look forward to another set of strong full year results from the bank in August, we remain mindful its high valuation.

As has been the case for many years, NAB provided the most disappointing bank result. The bank’s expense growth continued to exceed revenue growth having a detrimental impact on underlying growth. Indeed, had it not been for the sector-wide trend of falling impairments, NAB would have struggled to generate any profit growth (it delivered sub-5% growth)! Its leading domestic business bank is now struggling, gains in its retail (mortgage) business have slowed and the bank was once again forced to top-up provisions for conduct-related charges against its UK operations. With the CEO retiring shortly, we remain concerned the bank will go through a further period of limbo and strategic uncertainty.

Finally, it’s worth mentioning the regulatory changes announced by APRA over the period regarding the banks’ minimum capital requirements. APRA has now formally defined each of the 4 major Australian banks as “domestically systemically important banks” (or D-SIBs). As part of the changing global banking regulations (Basel III) coming into effect from January 2016, all D-SIBs banks must hold additional capital. While holding such additional capital is to the detriment of bank returns, its purpose is to try to avoid a bank’s collapse during a period of financial system stress. To be clear, all 4 major Australian banks already hold some of the highest levels of capital in the global banking industry. This increased capital requirement may however crimp the banks’ abilities to increase dividend at the same (or higher) rates as profits, at least for the near-term. Alternatively, the bank may look to issue new shares (via their dividend reinvestment plans) in order to meet the new minimum capital levels.