

# Schroders

# Taking Stock

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## Australian banks – still looking for stress relief?

By Andrew Fleming, Senior Portfolio Manager

Recent weeks have seen credit spreads rallying back through 2007 levels and the highest level of debt and equity issuance by global financials ever, suggesting that we are now in the tailwinds of the global financial crisis. Extreme business models have been busted open, not to return until the primal whispers of human greed and personal incentives again overwhelm the combined forces of institutional memory and common sense. Hitherto stable bank business models have been toppled as the inherent instability spurned from excessive financial leverage was laid bare as a reminder for all stakeholders – shareholders, lenders, customers, regulators and governments. Governments have entered the fourth stage of what one major bank recently described to us as the four step IMF financial system rescue playbook – rescue the banking system (facilitating any required consolidation), provide massive liquidity, and fiscal stimulus, and then finally regulate the financial system (including extracting a social dividend).

### The social dividend

Whilst the US and European banking systems have absorbed “once in three generations” style credit losses and illiquidity events, the Australian system has to date only had to deal with the latter affliction, given the dip in GDP growth has been negligible relative to the declines seen in other markets. However, even dislocated funding markets required Australian government intervention, with sovereign guarantees mimicking those established in other regions. In the third quarter of last year, amidst a range of other measures, both the US and the UK introduced wholesale funding guarantees for home banks they regulated. In October, the Australian Government announced that it would guarantee wholesale bank funding, and also deposits for home banks regulated through its agencies. Such guarantees have not been provided with benevolence. As Prime Minister Rudd stated, “... the major banks will continue to need to step up to the plate. Remember that these banks were the beneficiaries of two separate guarantees...” Indeed, Governments around the world are now asking to be paid for “saving the system”; a social dividend is beginning to be extracted from the banking system.

Any shaping of the likelihood, form and cost of a social dividend being extracted from the Australian banking system must be informed by a view on how imperilled the global financial system was through the last quarter of 2008. Today, LIBOR, TED spreads<sup>1</sup> and other measures of financial system stability and confidence are back to 2007 levels and financial markets are hailing “The King is dead. Long live the King” (refer Chart 1).

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<sup>1</sup> The **TED spread** is the difference between the interest rates on interbank loans and short-term U.S. government debt (“T-bills”).



Source: Schroders

### A letter from New York...

This is a world away from the picture of imminent financial Armageddon that confronted the world just five months ago, as painted in a letter sent a month ago by the State of New York Attorney General, Andrew Cuomo, to the four overseers of the Troubled Asset Relief program (“TARP”).

In that letter, Cuomo reveals that Ken Lewis, the CEO of the Bank of America, informed then-Treasury Secretary Henry Paulson in mid December, 2008, that Bank of America was considering invoking a material adverse change (“MAC”) clause and rescinding the merger agreement with Merrill Lynch, because of escalating losses at Merrill Lynch. These losses had seen the projected fourth quarter loss for Merrill move from US\$9 billion to US\$12 billion in just six days at that time. The quarterly loss ultimately exceeded US\$15 billion.

Paulson asked Lewis to immediately come to Washington to discuss the matter, where Federal Reserve Chairman Ben Bernanke joined the meeting. A week and several more meetings later on 21 December 2008, Cuomo reported that “... Lewis informed Secretary Paulson that Bank of America still wanted to exit the merger agreement. According to Lewis, Secretary Paulson then advised Lewis that, if Bank of America invoked the MAC clause, its management and board would be replaced ... Senator Paulson largely corroborated Lewis’s account ... (and) informed us that he made the threat at the request of Chairman Bernanke. After the threat, the conversation between Secretary Paulson and Lewis turned to receiving additional government assistance in light of the staggering Merrill Lynch losses ...”

Bank of America Board minutes from the following day list the four key factors arising from Lewis’s discussions with Paulson and Bernanke, the most important being that “... first and foremost, the Treasury and Fed are unified in their view that the failure of the Corporation to complete the acquisition of Merrill Lynch would result in systemic risk to the financial system in America and would have adverse consequences for the Corporation ...”.

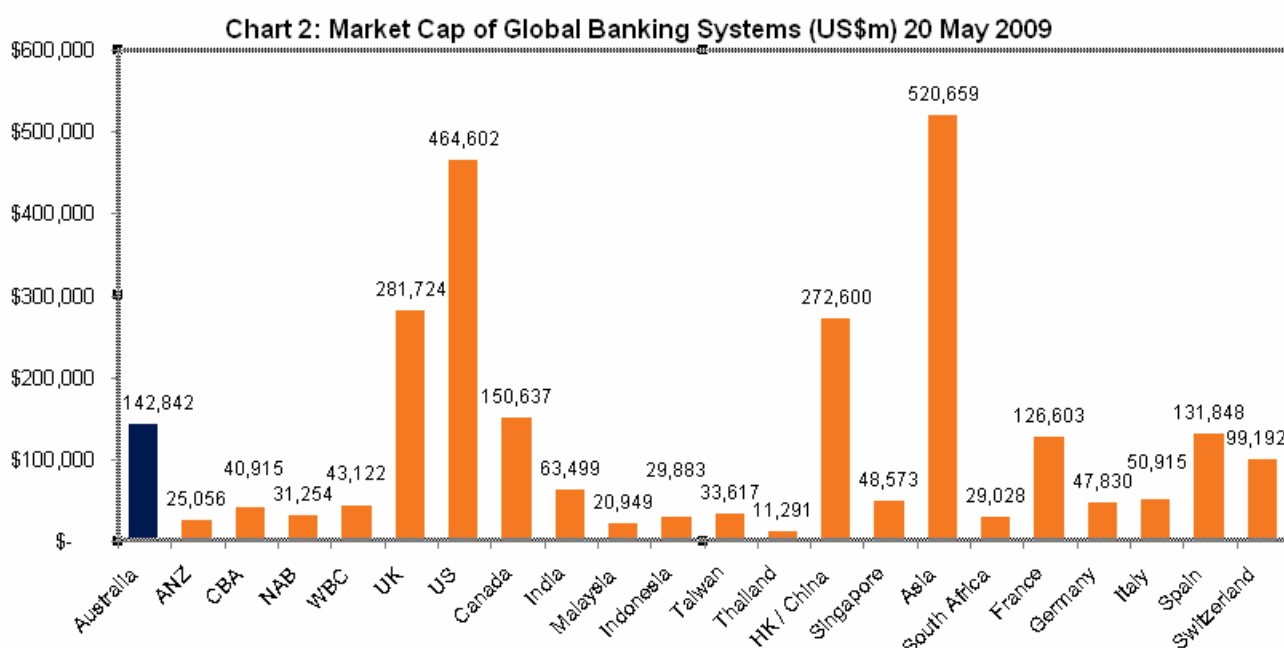
Cuomo’s letter hence erases any residual doubts as to how fearful the authorities in the world’s largest economy were at Christmas last year that the world financial system was in imminent danger of collapse. Of course, the interconnected nature of financial markets means that this instability would

immediately have transmitted globally. Given that 25% of their financing is foreign, the Australian banks would not have escaped the fallout.

Another staggering disclosure in Cuomo’s letter was that Bank of America shareholders were not informed of Merrill Lynch’s losses, the consideration of invoking the MAC clause, nor the government’s commitment to provide additional TARP funding to accommodate completion of the merger. Why? Lewis testified that the question of disclosure was not up to him and that his decision not to disclose was based on direction from Paulson and Bernanke. He said “I was instructed that ‘We don’t want a public disclosure’”. Andrew Cuomo’s decision several weeks ago to publish his letter to the four TARP overseers ensures that this is one want that will now never be satisfied. Meanwhile, George Orwell is rolling in his grave. Did anything akin to this happen in Australia, even in a much milder form, at the time the government guarantees were announced with such unseemly haste last year?

### Test results

All of the above also means that, understandably, the results of the stress tests for US banks have been met with mixed reactions. Market scepticism is reflected in the current market capitalisation of the US banking system at US\$465bn which is just three times that of Australian banks, despite servicing an economy more than 15 times larger (refer Chart 2). The reasons for scepticism were recently neatly summarised by our credit colleagues Harold Thomas and Roger Doig (Are banks emerging from the woods? May 2009), who wrote “... the tests have come in for criticism for being un-stressful. Probably the weakest part of the test was its very low hurdles, both the Tier 1 ratio of 6% and the Tier 1 common ratio of 4%, which required none of the banks (excluding auto-financing firm GMAC) to raise capital in the private market, as pre-existing funds from the TARP (Troubled Asset Relief Program) were sufficient for all banks to convert to cover any shortfalls. ...”.

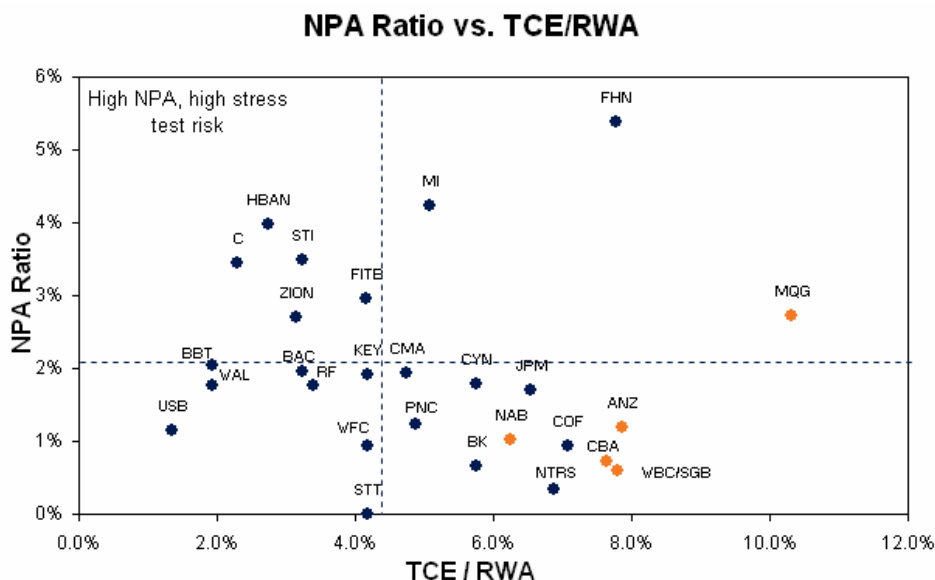


Source: Macquarie Equities

Overall, the stress tests revealed that 10 of the 19 largest banks in America needed to raise US\$75 billion in new capital (or about ¼ of the equity of the major Australian banks). Of this total, one institution stands alone, representing almost half of the capital call for the system and multiples more than the next least capitalised bank – Bank of America. It can easily be seen why US Federal authorities acted as they did last December! And whilst our colleagues and others have questioned the stress test assumptions, the results still provided staggering outcomes. Loss estimates for the

stress tested banks (which account for 2/3 of bank assets and more than 1/2 of bank loans in the US) are up to US\$600bn through 2010, bringing cumulative losses since the GFC began to US\$950 bn. Loss rates at this level reach 9.1%, just above Great Depression levels and dwarfing typical systemic loss rates in the US of between 1% and 2%. In 1992, system losses in Australia did not even reach 3% ! As the Chart 3 below shows, the stress tests revealed that the difference in both the level of losses and capitalisation in the Australian system relative to that in the US is akin to that between a Maybach Landaulet and a 1975 Valiant Charger.

Chart 3



Source: Goldman Sachs JB Were

### A new found optimism for credit?

However, if the overall market valuation of capital reflects some scepticism, the ability to refinance both equity and debt in the past week has reflected new found enthusiasm. The task is now largely seen as done, to the point where our credit colleagues nominate crowding out in sovereign debt markets and de-leveraging of the system as the two major risks they are now confronted with as credit investors in bank paper. The drivers of the credit crisis – credit and capital – which reached crescendo just months ago, are now so passé !

There were good reasons for the fragile market confidence in the banking system in the US, but the market has swiftly moved through recent weeks in discounting a different set of risks and opportunities for financial institutions. This will no doubt ebb and flow – the introduction of Quantitative Easing in Q1 no doubt assisted US bank profitability through that quarter, which has presaged the recapitalisation process undertaken in conjunction with the release of the stress test results, and foreclosures have again started to increase following the end of the temporary ban on foreclosures by Fannie Mae and Freddie Mac. Both of these factors assisted in balancing confidence in the financial system, and the world at large – US consumer confidence increased at its fastest rate in six years last month. The fourth stage of what one major bank has described to us as the IMF playbook for financial system recovery – recue the banking system, then provide massive liquidity, and a large fiscal stimulus, all bookended by regulation of the financial system, and the imposition of a social dividend – has hence come into play. The US government has started to impose its own social dividend measures, with new laws governing credit card fees and charges passed last week. High levels of exception fees, in particular, were targeted with this legislation. The UK also recently enacted legislation targeted at switching costs by stipulating that that the bank from which the customer is switching to send the bank the customer is switching to, all direct debit and other pertinent personal details.

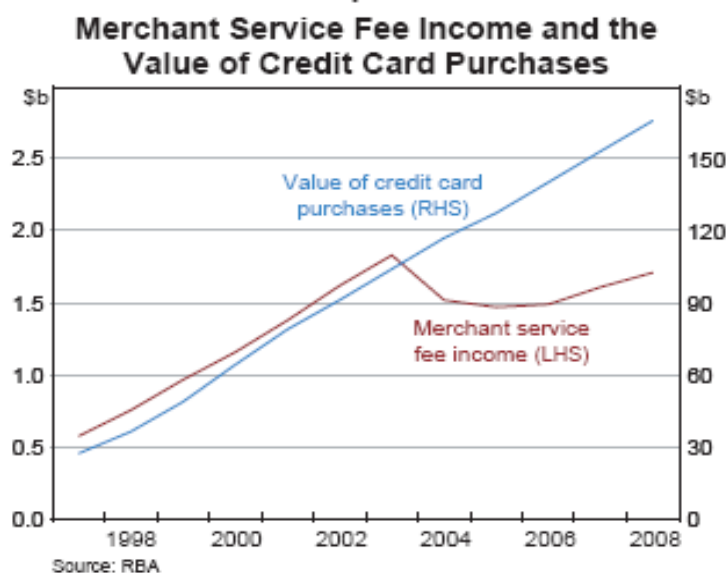
## Implications for Australian banks

One of the looming risks for the Australian system which hitherto has received little attention is replicating the US and UK legislation, and the prospect of a social dividend being sought from the banking system. The current Australian Federal Government has shown with its National Broadband Network announcement in the Telecommunications arena that it is prepared to enact policy which can encourage significant industry structure shifts.

Having extended assistance to the Australian banking system, with guarantees and the emergence of the “RuddBank” proposal, the Government may now look to extract a return for that credit. This social dividend from the banking industry in Australia could take several forms, across revenue, cost and capital measures. Already, the major banks have agreed to provide payment for relief on mortgage payments for up to 12 months for the newly unemployed. CBA has also acted unilaterally in reducing the base salaries of senior executives, and undertook to place “offshoring” initiatives on hold for three years. Apart from offshoring and compensation initiatives, it is clear that the current capital requirements for the banking system, based upon the now discredited pro-cyclical Basle 2 model, will also be lifted.

Other areas where the social dividend may be applied to transfer existing profit streams from the major banks in Australia to the community are emerging. In particular, this week’s Senate Inquiry into bank fees and charges recommended the Reserve Bank collect detailed data on banks’ exception fees for the first time, within its annual survey of banking fees in Australia (released 21 May, 2009). Australian banking fees grew by 8% in 2008, and 7% over the five years to 2007, with 4% growth in the business sector overwhelmed by 11% growth in the personal sector. Interestingly, the Reserve Bank notes that the only area where fees did not increase through that time was in merchant service fees, where absolute fee levels remain below the levels of 2003, when the RBA introduced credit card interchange fee reforms (refer Chart 4).

Chart 4



An exception fee is charged by a bank when a customer breaches the terms of a banking product, typically by making a late payment, overdrawing a deposit account or exceeding a credit limit. In 2008, exception fees totalled \$1.2 billion, around 10 per cent of banks’ total fee income. Around 83 per cent of exception fees were levied on households, mainly on their deposit and credit card accounts. It is difficult for banks to articulate the costs involved which justify such high levels of exception fees being charged. Given the Senate has requested the Reserve Bank to quantify the

fees, the Reserve Bank has noted the success it has enjoyed in moderating fee growth in areas it has previously reformed. Globally, governments are extracting a social dividend in response to their intervention in indigenous banking systems and the Australian Government believes that a social dividend may be appropriate to reflect the assistance it provided the local banking system. It may be that further Government focus upon exception fees can be expected as part of extracting the social dividend in Australia.

### Where to from here?

Reflecting their symbiotic and geared relationship with the economies they serve, the past year has been a tumultuous period for banks throughout the Western world. The oeuvre of credit losses and illiquidity has largely played out in the northern hemisphere, at times leaving the world perilously on the brink of financial Armageddon. Whilst such a scenario seems to have been avoided, Australian banks, whilst well funded, continue to brace investors for another year of credit losses, albeit mild relative to those experienced elsewhere. Secular pricing power for banks has improved markedly as a result of these changes, which has seen the sector perform well through the past year in Australia, in both an operational and market sense. However, we believe that the increasing momentum behind the imposition of a social dividend, together with deleveraging in Australia and elsewhere, may now stymie the return on equity able to be generated by the major Australian banks relative to the bountiful experience of the past decade.

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