



Our banks still as safe as houses

The big five may emerge stronger when the sub-prime crisis is finally over

Tim Blue

SAFE as houses sums up our banks; in fact they are specially built to look that way, as if they can beat off just about anything.

In the past 10 days, they have done exactly that, shrugging aside a tsunami that has sent trembles through the high and mighty of the banking world.

Or are they perfectly safe?

As several big US investment banks shook to their core, it was a rumour from an old-fashioned building society in the north of England that blew hardest against our banks.

A squall hit Adelaide Bank, forcing the Reserve Bank to step in. Nerves were quickly calmed, but it left a big ding in Adelaide Bank shares — down more than \$2, or 12 per cent, this week — and more than a few wondering how safe it is to invest in banks.

Should an investor be staying away from the banks? It's a 50-50 call: the big banks look fine and may well pick up business in the long run, though you may want to hold off for a few months.

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Paul Zwi, CentricWealth

any material damage,” CentricWealth head of equity research Paul Zwi says.

“There may be some negative surprise that comes out of left field, but I don't expect the Big Four will miss a beat due to the US sub-prime mortgage problems.”

ABN AMRO analyst Jarrod Martin says: “In our view, the cyclical down side of the recent credit crunch will develop into a benefit for the major banks. “Our call is to go overweight on the sector.”

Yet there's a view that says to wait, put by fund manager Roger Montgomery of Clime Capital.

“Now is a good time to accumulate cash and take advantage of an irrational underestimation of risk by share market participants,” Montgomery says. “What's the rush to buy a bank?”

Here's the dilemma: banks have big assets and small equity on their balance sheets.

You only need a small problem on the asset side to have a big impact on the equity side.

And that's not to say the shares won't still go up — the stock market often does crazy things.

Banks have three sides to their business: wholesale banking to companies, wealth management for investors and transaction banking for everyone.

One thing in common is a desire to buy cheap and sell dear, and since it is hard to sell high, the cheaper they buy is the key to profit. Big banks have a huge advantage with the pools of cheap money sitting in cheque accounts that cost them next to nothing.

ANZ bank, for example, gets about 52 per cent of its funding from customer deposits.

Smaller banks are forced to turn to other supplies of money, even borrowing from the big banks in the wholesale markets or offering you a big rate on short-term deposits to get you in the door.

Wholesale deposits are simple to get. Adelaide Bank makes great use of them — in two years doubling the sum used from \$2.5 billion in December 2005 to \$5.7 billion in June this year.

At the same time, its retail deposits went up only 11 per cent to \$11.2 billion from \$10.1 billion.

The upshot is a much smaller opportunity to make profits — the net interest margin shrank to 1.01 per cent from 1.16 per cent in the past financial year.

Other metrics tend to suffer too: its return on assets fell to 0.35 per cent from 0.40 per cent. Its Big Four mates aim for about a 1 per cent return on average assets.

No one is saying it's time to drop Adelaide Bank, in fact the opposite.

“We do not see any serious fundamental implications arising for Adelaide Bank and expect its merger partner Bendigo Bank to outperform as a result of the marriage,” Credit Suisse analyst James Ellis says.

Take a look at the bigger picture: it's weird, or in the words of bankers, irrational. Credit markets are not all working properly yet the stock market is back towards all-time highs.

“The stock market has recovered all of its losses since the sub-prime issue hit equities and yet the credit markets — the very markets that triggered the contagion — remain depressed,” Clime's Montgomery says. “We see a mispricing of risk in the fact that of the 400 companies we track, just half a dozen are trading below our estimate of intrinsic value.

“Of those, two are banks.”

Before ploughing in to buy bank stocks, an investor needs to feel comfortable with the liturgy of lurking unease:

The US rate cut is a sign of major US problems, not the beginning of a recovery. Its debt markets are still refusing to roll over a billion dollars of loans by mortgage financiers.

The proportion of US mortgages whose rates will reset at much higher levels in the next 12 months is unprecedented.

The imminent redemption of billions from international hedge funds to be met by September 30, and the tsunami of repricing of sub-prime mortgages from honeymoon or teaser rates to market rates, and more, in the next three months.

The macroeconomic impact of this may prove to be minor, but the risk of an adverse surprise is significant.

The risk of a US financial institution collapsing in the next 12 months is high and in turn this could trigger a financial market meltdown.

Here at home, a JP Morgan/Fujitsu survey has found that 600,000 households are likely to experience mild mortgage stress by the end of this year and 113,000 will experience severe stress and a



significant risk of default.

Another survey says the average mortgage is \$300,000, meaning that there is \$34 billion at risk of default this year.

“I heard one of my fund-management peers quoted in the press saying he’s moving to defensive stocks while he works out what’s going on. Think about the absurdity of that,” Montgomery says. As the Monty Python song goes, always look on the bright side of life. Simon Guzowski, a senior equities analyst at Wise Owl, points out that in the event of a financial market meltdown, China and India will still need raw commodities, as their growth exceeds that of the US.

“Together they now account for 36 per cent of the world’s population, and we are uniquely positioned to supply them,” Guzowski says. “As to turbulence in financial markets, central banks

are actively fighting a credit squeeze — they will do what it takes to avoid recession.”

It may also happen that nervous investors will recognise the strength of Australian banks and swarm towards them, to produce an up-tick in share price.

“In fact the credit crisis could do for banks what September 11 did for insurance,” Guzowski says. “We could see more rational pricing, lesser competition and bigger profits.”

So, if you must buy a bank, what’s it to be?

Montgomery says: “Remembering that our view is that there is no rush, our valuation model indicates ANZ is the cheapest, followed by Westpac.”

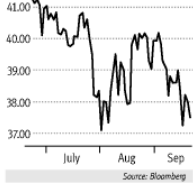
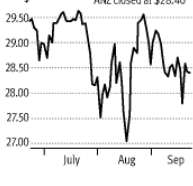
At Credit-Suisse, the order of preference among the large commercial banks is National Australia, then ANZ, Westpac, St George and the Commonwealth.

ABN AMRO’s Jarrod Martin ranks Westpac his top pick, followed by the Commonwealth. Centric’s Zwi sees the Big Four as “certainly a suitable investment” for long-term equity investors.

“Current valuations are fair, with 2008 price-to-earnings ratios of averaging around 13.5 times and dividend yields attractive at 5.2 per cent,” he says. “Relative to industrials, the Big Four look cheap. The funding pressures that everyone is focused on will probably normalise within six months.

“Of the Big Four, we favour CBA and Westpac. Long term, all four of the big banks have delivered terrific returns — just look at the compound growth in their dividends over the last 10 years — and while the momentum may slow, I don’t see it reversing any time soon.”

HOW THEY FARED



Source: Bloomberg



On the run: Australian banks look far more sound than their British cousins