Bank Dividends

- There's lots of commentary about banks eliminating or deferring dividends.
- Bad debts come and go, but Australian bank profitability goes on forever.
- Directors, by themselves, are not going to cease paying dividends.
- Banks' use of Australian retail investors to fund their AT1 capital has saved them around $9b since the GFC. Directors won't want to stop this.
- APRA would be increasing the "confidence" risk, if they prioritise the retention of relatively small amounts of dividends and distributions over continued availability of capital.

So, what has happened?

In early April, APRA wrote to their regulatees advising them that they expected institutions to consider deferring dividends and if they wished to pay a dividend, they needed to stress test the business and then discuss the outcomes with them. There had been some commentary previously that dividends would be reduced, however, the APRA letter brought out a raft of commentary whereby analysts forecast dividends might cease. At the same time some European regulators were also talking about banks and insurers ceasing dividends. For hybrid investors, the situation becomes relevant because if dividends on ordinary shares are paid, the banks have to pay hybrid distributions. However, if the banks cease paying dividends on ordinary shares, there is some prospect distributions on hybrids might also cease.

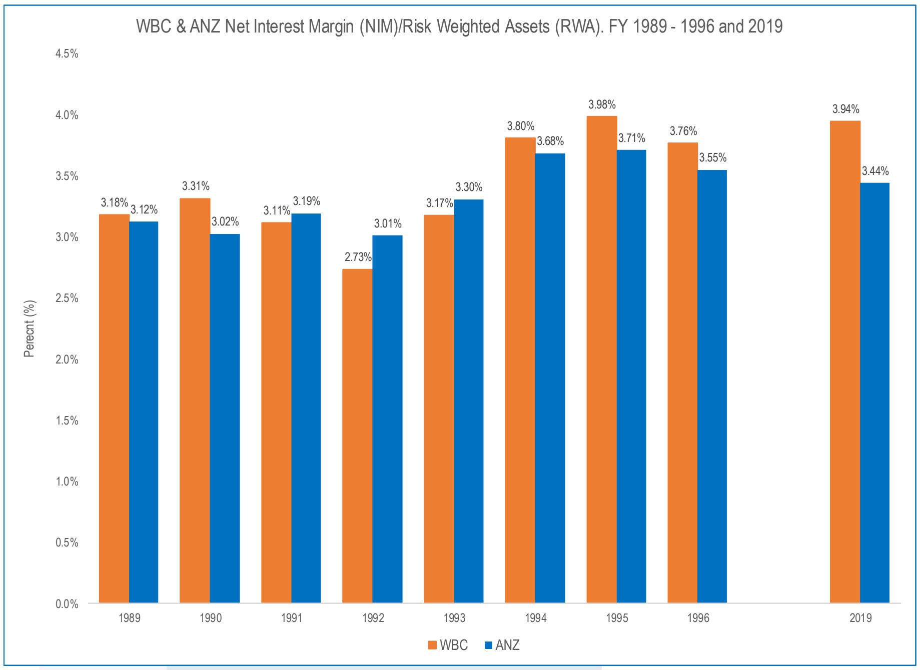
Banks : pretty simple businesses

Banks are pretty simple businesses; US Savings and Loans (think building societies) were described as 3:6:3 businesses; borrow at 3%, lend at 6% and go to the golf course at 3. Banks might be bigger, but not much more complicated in strategy. The aim is simply to generate an appropriate Return on Equity (RoE) to shareholders. Banks use a small amount of capital and they leverage it up by borrowing short term (i.e term deposits) and lending it out. That type of income is called the Net Interest Margin or NIM. The banks (of course) charge fees, incur expenses (and the addition of all 3 gives you the Pre Loss Provision Profit) and allowing for bad debts gives you Profit before tax. The real trick is to determine who you lend to. If you lend to higher risk entities, such as commercial property, you need more capital and you need to charge more (higher NIM) to earn an appropriate return. The easy way to compare returns is by risk standardising the assets, which is where the concept of Risk Adjusted Assets started. If commercial property loans are twice as risky as residential mortgage lending, doubling the denominator allows you compare profitability (return/equity). The 2 most important ratios for a bank are the NIM and Pre Loss Provision profits. You know over a cycle that you will get bad debts and a healthy level of pre provision profits results in an acceptable Return on Equity over the cycle, notwithstanding the 3 years of bad debts every decade.

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level 5, 30 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348
Email: info@eiml.com.au

Bank profitability goes on forever.

The charts below show 2 key measures of bank profitability for ANZ and WBC for the 1991 recession period (and a comparison to 2019). The 1991 period is a really interesting comparator for the current period because 2 of the big 4 banks (ANZ and WBC) did some really silly things in the late 1980's with the consequence that they had big bad debt problems for 3 years in the early 90's. ANZ and WBC bad debt charges in 1992 were equal to 45% and 40% respectively of their capital base with 1990-92 total bad debts equal to around 80% of their capital base. At the same time dividends were cut by between 60% - 75%, but they still paid dividends. The charts below show NIM/Risk Weighted Assets and Pre Provision Profits (PPP)/Risk Weighted Assets (RWA). ANZ is represented by blue and WBC orange.



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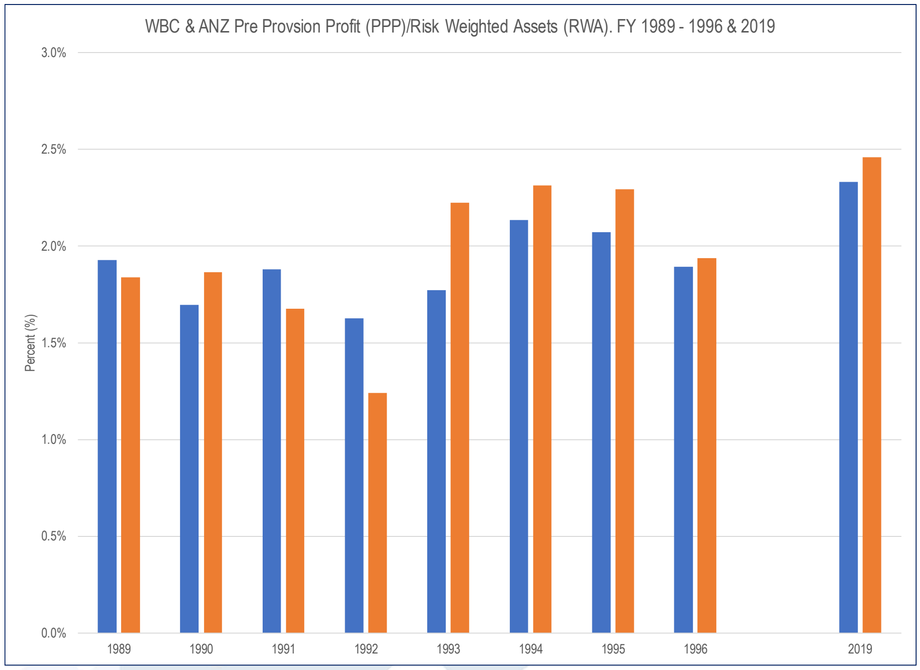

So what does this tell us?

- Banks used to, and still do, make lots of money. Even at the bottom of the recession, their interest line was largely unchanged and it's not materially different now. The steady NIM/RWA line is well above other banking systems and is an indication of the effectiveness of the "four-opoly" eliminating competition.
- The capital generating ability of banks is astounding. The improvement since the early 90's is mostly attributable to lower expenses, but if banks get a period with low credit losses (and not paying tax while they use tax losses from the big default years), they can generate >2% Tier 1 capital per annum.

Capital machines: Why Banks paid dividends during the 90's

We suspect banks are capital machines. We can only find data back to the early 60's, but at least since then the "four-opoly" have always paid a dividend. Clearly, they considered the issue in the early 90's but took the view that even though the bad debts were astounding, the ability to generate capital meant that 2 years of normal bad debts saw the capital restored to pre-crisis levels. This turned out to be the case with both the ANZ & WBC materially increasing their capital ratios by 1995. This was also the case during the post GFC period. It's arguable, if you could guarantee this kind of capital generation, that it's impossible for a bank to be insolvent.

So, what do bank directors do this time?

We think the base case now is that banks continue to pay dividends (for the reasons mentioned above).

- Bank directors will not want to be the first director of a Big 4 Australian bank in 60 years to not pay a dividend.

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- They can be confident that a dividend is affordable, given the underlying profitability of the entity.
- Even if ordinary dividends are deferred, we think there is no chance hybrid dividends will be stopped by directors. The continued access to the investor base is too important. Australian retail investors have provided almost all the AT1 capital since the GFC and the ability to pay out otherwise unusable franking credits has reduced the cash costs. We estimate it has saved the majors between $7b and $10b since the GFC. In addition, Australian retail investors were buying AT1 hybrids during the immediate post GFC when almost nobody else was providing bank capital.

And what do APRA do?

We think the base case is that APRA allows banks to pay dividends. APRA has been extremely supportive of bank capital availability to date. They allowed NAB and MQG to pull their issues (presumably because investors might get narky and not provide capital in the future) and let CGF defer the replacement of their May reset hybrid. We think the requirement for the banks to conduct stress test before declaring (or not declaring) a dividend payment is consistent with APRA's new requirement for annual stress testing. The last round of stress tests, which occurred in 2017, used variables of a GDP declining by 4%, unemployment rising to 11% and house prices falling by 35%. Banks suffered a non catastrophic fall in Tier 1 capital for 3 years followed by a return to profitability. If the same stress test is applied today, we would expect the results to be similar and there would be no impediment to dividends continuing to be paid.

Maintaining confidence in the financial system is paramount

One aspect which would be at the absolute front of mind for APRA is to maintain confidence in the financial system. 60% of the liabilities are at call deposits or short-term deposits. As the GFC showed us (Northern Rock), little banks falling over can generate potential problems for bigger banks and that leads to a systemic financial crisis and 25%+ falls in GDP. So, while there may be some arguments to retaining capital within the system, it is more important to ensure that banks have continued access to capital and deposits. It would be a brave and reckless regulator who takes a hard line on the former at the expense of the latter. We think APRA will emphasise the latter until it is evident that cutting all dividends and distributions is necessary to save the banking system.

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