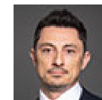
Aussie Banks: Tougher Times Ahead

December 2021



Nicholas Vidale
Financials Investment Analyst

KEY INSIGHTS

- COVID reversed a negative environment for the banks and the sector has performed strongly. We are cautious the path ahead is a recommencement of the Net Interest Margins compression cycle.
- We would caution investors from applying the simple approach of "higher rates equals higher profits", as we see numerous headwinds to that outcome.
- Longer term, however we are monitoring tech disruption and possible negative impacts for the industry, however believe innovation could spell opportunity for the "banks of the future".

COVID was unexpected, as was Australian banks' stellar outperformance from the March 2020 lows. These same banks underperformed the Australian market by close to 30% in the preceding three years[1], plagued with issues arising from the Financial Services Royal Commission and anti-money laundering.

The initial news of vaccine efficacy in November 2020 was a pivotal moment for "back to normal" expectations and a key catalyst for banks outperforming. A successful vaccine meant that the risk of a further deterioration in global growth had diminished. With a pathway out of COVID and the positive implications it had for growth, the risk of interest rates going negative reduced, and the risk of impairment charges surging to the point of banks needing to recapitalise also diminished. While many expected economic collapse, the reality was:

- Unprecedented government stimulus;
- An acceleration in growth of household disposable income;
- The RBA cutting official cash rates;
- Introduction of the Term Funding Facility (facilitating record low borrowing rates); and
- Record net immigration as offshore Australian's returned home.

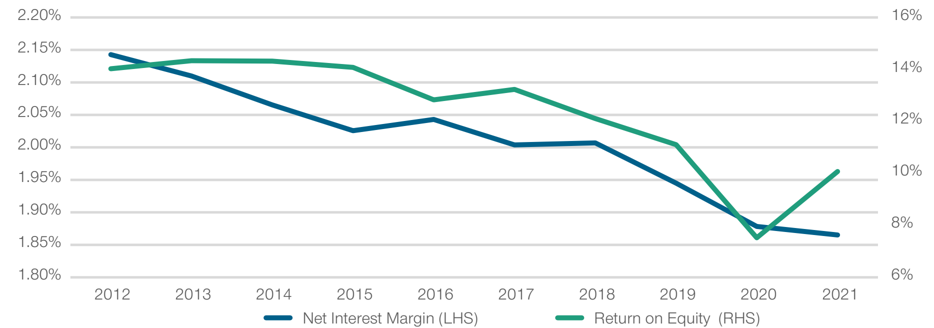
These factors led to a strong environment for both consumption and asset prices. At a macro level, banks were therefore beneficiaries of huge fiscal/monetary stimulus and net migration.

The simple assumption of lower interest rates, lower profits didn't hold true during COVID. Although falling interest rates have typically been bad for banks' net interest margins (the main driver of Return on Equity for banks), during COVID the cost of funding fell faster

[1] 31 Dec 16 – 31 Dec 19

Australian Listed Banks - NIM and ROE (%)

(Fig. 1)



Source: T. Rowe Price, Company Data, as at 30 November 2021.

than lending interest rates, and banks were able to slow the pace of net interest margin decline. This improved the outlook for sector returns relative to expectations. Net interest margin expansion (NIM), combined with an unexpectedly strong macro economy, saw earnings growth for banks surge, and these upgrades drove extended share price outperformance. With bank balance sheet quality also improving in the better macro environment, capital management then followed, with all four major banks engaging in some form of capital management activity in 2021, which is expected to continue in 2022.

As good as it gets...NIM compression cycle to recommence

Falling funding costs and customers migrating term deposits to at-call deposits led to net interest margin expansion through COVID. We believe the benefits are equivalent to a sugar-hit and will be temporary in nature. Funding costs are now reaching a floor while the competitive environment in asset lending remains intense, driven largely by competition in mortgages. Lending rates will start to decline faster than funding rates, or they won't keep up with the increase in funding costs, and this will restart the net interest margin compression cycle the sector has experienced for the past decade.

Higher rates may not equal higher profits this cycle

The outlook for official RBA interest rates has increased post COVID as there is broad recognition that the virus is now manageable and economic growth continues to be higher than expected. Although rising interest rates is typically a positive for banks as they are able to reprice borrowing rates more than deposit rates, there are several variables which make the upside to interest rates potentially less attractive than in previous cycles:

I. Surge in fixed rate lending

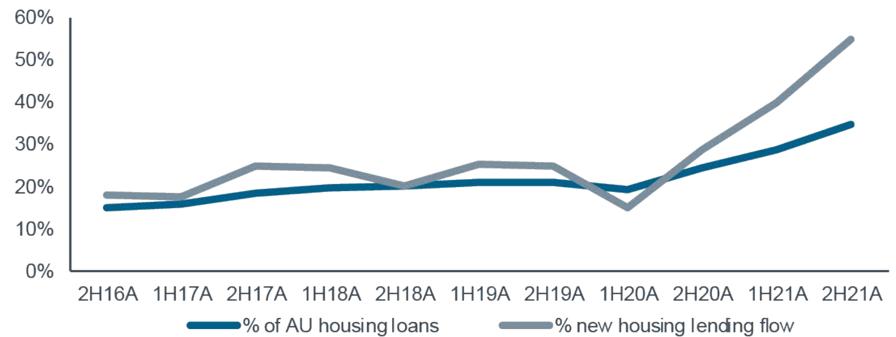
Through COVID, fixed rate mortgages have gone from 15% to 55% of new mortgage lending for the major banks, and this has seen the overall share of fixed-rate mortgages increase from 20% to 35% of major bank mortgage lending. Fixed rate loans do not have the same sensitivity to rising cash rates that variable rate loans have (as they cannot re-price when the RBA changes the cash rate).

II. Competitive lending landscape

Potentially one of the biggest headwinds as fixed rate mortgages are due to be refinanced. We expect retail competition to intensify in the next 2 years as banks look to prevent customer churn at loan resets, and this means the front-back book pricing dynamic could in fact deteriorate rather than stabilise. This leads us to be cautious on the upside for banks from rising interest rates.

Major Banks - Australian Fixed Rate Mortgage Exposure

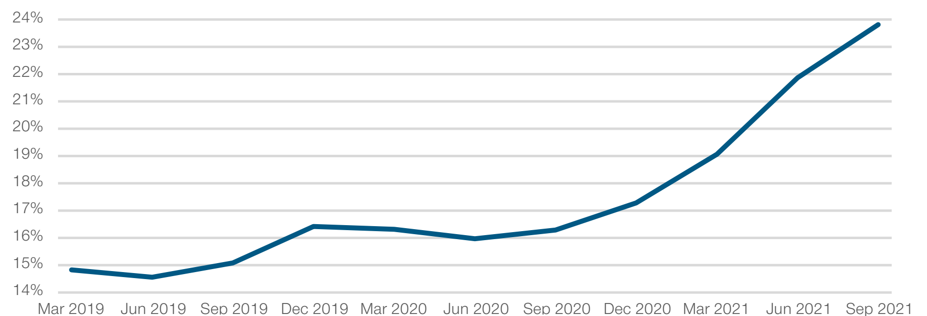
(Fig. 2)



Source: T. Rowe Price, Company Data, as at 30 November 2021.

Australian Approved Deposit Institutions New Lending – Debt to Income > 6x

(Fig. 3)



Source: APRA, as at 30 September 2021.

III. Deterioration in credit conditions

Over the last 2 years, new mortgage loans by households, where borrowing is over 6x debt to income, have increased from less-than-15% share of new lending, to almost a quarter of new lending. This may come under pressure in a period of rising interest rates.

IV. Inflation's impact on household debt servicing

If interest rate increases lag inflation and fail to tame living costs, we see a risk of wages not keeping pace with the rising cost of living, ultimately impacting household disposable incomes and debt servicing capacity.

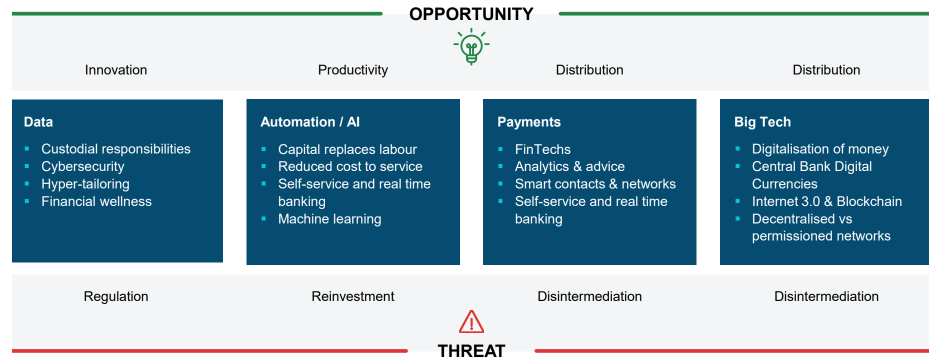
All the above could have flow on effects to mortgage growth, possible bad debts and a negative feedback loop to consumption. Ultimately this would be negative for the banks.

Tech disruption presents both risk and opportunity for the bank of the future

There are technological developments taking place such as blockchain, cryptocurrency and Decentralised Finance (DeFi), which have the ability to threaten the business models of banks. At this stage, permissionless financial systems are very unlikely to ever be a feature of a sovereign financial system. Regulators will always require a responsible entity, and this means at best, we see private blockchains with permissioned networks. Although the amount of capital being invested in DeFi continues to increase, no business model has yet been able to solve the blockchain trilemma, which is the trade-off that occurs between security, programmability, and speed.

Bank of the Future – Opportunities and Threats

(Fig. 4)



Source: T. Rowe Price, as at 30 November 2021.

It is not necessarily the case that DeFi will completely disintermediate banks. As most DeFi business models employ governance models determined by protocols, the banks being regulated and trusted counterparties, with boards that are accountable to many stakeholders, could see them positioned as successful protocol governance managers in DeFi projects. Banks, as trusted custodians of financial data and assets, could see new opportunities emerge as technology developments take place. The bank of the future could look very different to today, where the user interface is a combination of many different product offerings. Some banks may choose to directly invest in and control these product offerings to be closer to the consumer, whereas some banks may choose just to be the provider of infrastructure behind consumer offerings, enabling competition and consumer choice within banking in Australia. We are in the very early stages of real potential change, and will monitor closely what this means for future industry make-up and returns.

Summary

While COVID reversed a negative environment for the banks and the sector has as a result performed very strongly, we are cautious that the tailwinds are peaking, and the path ahead is a recommencement of the NIM compression cycle. We would caution investors from applying the simple approach of "higher rates equals higher profits", as we see numerous headwinds to that outcome. As we think longer term, we are monitoring tech disruption and possible negative impacts for the industry, but also considering how innovation could spell an opportunity for "banks of the future". We will be keeping our eyes open to which banks are willing to invest and who can position themselves as trusted custodians of data. As we look to 2022 however, we are seeing increasing headwinds therefore resulting in a cautious view on the sector and remain underweight.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T.RowePrice®

Important Information

This material is being furnished for general informational marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date noted on the material and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request.

It is not intended for distribution to retail investors in any jurisdiction.

Australia — Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

New Zealand — Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

© 2021 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/ or apart, trademarks of T. Rowe Price Group, Inc.

APAC-PAN-2787
202112- 1947874