Where we have a minor rant about why banks trade off, long term survival and returns, for short term EPS.

- The Reserve Bank of New Zealand (RBNZ) recently announced that they proposed to raise the equity levels of New Zealand (NZ) banks.
- The first reaction by management at the Big 4 Australian banks was that they would consider divesting their NZ banks because their return on equity (RoE) targets would be unattainable.
- Because of their enormous leverage, long term RoE for banks and insurers is determined firstly by diversification and secondly by profitability. The big 4 banks are already undiversified and aiming to become dangerously undiversified.
- It is a real governance fail if management follows this course.
- Who is responsible for this governance fail?

More Capital? Aussies out?

In late February the RBNZ announced that they proposed to raise the CET1 equity levels of NZ banks from 10.5% to 16%, which equates to around $14b NZD additional capital. This was soon followed up by commentary from the Australian banks that they would have to divest their NZ operations because they couldn't generate the same RoE after the capital increases.

Big four **banks** ponder ditching troublesome Kiwi subsidiaries
The Australian - 12 Mar 2019

Why diversification is important

If you run a highly leveraged financial institution (such as a bank or insurer), the most important factor in long term survival is diversification. Because of the inherent leverage, moderate gross losses can wipe out equity. The level of shareholder funds won't save you and underlying profitability is irrelevant in a high impact event. Profitability only becomes important in the immediate aftermath of the event as it enables quick recapitalisation. So, if you are the board of a bank or insurer you need to make the distinction between short and long term profitability as running a non-diversified but highly profitable structure will occasionally kill you. For example, the 2011 Brisbane floods cost around $2.4b. Total annual household and commercial insurance premiums for all of Queensland were around $2.6b in 2011 and the total amount of shareholder funds/equity that would be allocated to Queensland Household and Commercial insurance business would be around $0.9b. So, any insurer who insured just Queensland households and business in 2011 would no longer be in existence. However, due to reinsurance and diversification (ie total insurance premiums for Australia in 2011 were $45b), no insurer went broke and profitability was only marginally affected. For a banking perspective ANZ's experience in the 1991 recession is illuminating. Prior to the recession ANZ had 4 separate divisions and by 1989 it made around $700m p.a.:

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The table below shows the profit contributions and our estimate of how much capital was allocated to each business.

	Profit ($m)	Capital Allocated ($m) (est)
Australian Retail/Housing	150 (c20%)	220
Australian Commercial	300 (c40%)	2,200
New Zealand	90 (c15%)	150
International	170 (c25%)	920

What happens in a recession?

At the start of the 1990's ANZ's business was dominated by business lending both in terms of profit and capital allocation. That exposure was almost fatal in the recession. We estimate that in 1990, the Australian Commercial Business lost around $250m (mainly the result of $300 - $400m of bad debts which offset the income that year). This was followed by losses of c$300m in 1991 and c$1,200m in 1992. All in all, the Commercial business lost around $1.7b during the recession. If the Commercial business was a standalone entity, it would have been 'goneski' by end 1992 as it chewed through most of the c$2.2b capital allocated to the business. However, the other businesses were sufficiently large and uncorrelated and continued to be profitable, so the bank made profits in 1990 and 1991 before making a loss in 1992. The 1992 loss of $572m was around 12% of shareholders' funds (i.e) appalling but not catastrophic. And because ANZ was sufficiently diversified, it was not mortally damaged, and the underlying profitability allowed easy recapitalisation. The share price increased from the mid $4s in 1991 to over $6 in 1995. Give ANZ a big tick for diversification.

Less diversification more housing, higher RoE

The past 30 years have seen creeping de-diversification. Currently ANZ is around 55% housing, 25% corporate and 20% NZ, with international exposure being jettisoned both in the 90s (Grindlays) and the 2010s (ex RBS business). And if the mooted proposal to divest NZ results (after the sale of wealth management in 2017) occurs, we're left with a bank that is around 70% Australian mortgages and 30% commercial. On one hand that is great, as lending on Australian mortgages is very profitable with a probable RoE of >20% because lending on prime housing in Australia (and the rest of the world) has largely been credit risk free. We understand that view and have tried for the past decade to find a bank which has gone bust from doing prime mortgage lending. But that doesn't mean it can't happen. To illustrate the appalling attitude of banks, imagine that you were the IAG board and decided that because Sydney hasn't ever had an earthquake and you were generating high RoE on that business, that you would double up, either by reducing re-insurance or selling off other parts of the business and writing more Sydney insurance. That would never be considered.

So, who is to blame for this negligent

You can't really blame management; there are massive Agency issues. Management is not around long enough to solve many problems and they've been hard wired to maximise short term EPS. Nobody even bothers to blame fund managers; they are incentivised by their clients to buy cheap and sell expensive and there aren't many fund managers who wouldn't sell a

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short term-ism?

bank that would trade off lower short term EPS at the expense of resilience. Boards should be blamed; they've become as obsessed as bank management on short term EPS growth and have been duchessed into validating opaque and oversized salaries for bank management that are heavily focussed on short term performance. However, we think the end owners have to ultimately take responsibility. Increasingly these are the Industry Funds, which own about 10% of the Australian Equity market. If the ALP franking credit proposal is implemented, we'll see large numbers of SMSF holders make the move from SMSF funds (which won't benefit from surplus franking credits) to Industry Funds (which will continue to distribute franking credits) and, their size may increase to 15%. Some will say that the Industry Funds are not homogenous, but we think if you took all their consultants, asset allocation, investment performance, benefits and put them on a plain sheet of paper, you wouldn't be able to tell the difference. In any case, mergers will increase the concentration. However, to date we haven't seen Industry Funds do much other than support Remuneration Reports (Australian Super voted against c10% of Renumeration Reports in Q4 2018, and against the re-election of 2 directors), let alone actively manage their underlying interests.

Power without responsibility?

We think Industry Funds are in an interesting position. They are now in a position of large and growing power and to date there is no evidence of bad capital or poor investment decisions. They've done really well. However, they are fighting against attempts to minimise their agency issues (they still can't agree on independent boards) and we think we can see the very first signs of pre-hubris emerging. We cast our minds back to the Jurassic 1970's and 80's, which was the previous height of influence by financial mutuals. It was amusing (in hindsight) that a sign of an institution that was either big enough or "smart" enough was to buy a coal mine and an Official Dealer (remembering it's after the 1970's oil crisis and, you know, direct investments are easy; you just employed a mining engineer to look after it. And, of course, we know about interest rates). 10 years later, there was written down coal mine in some corner of the institution's balance sheet after the oil price fell or the longwall miner collapsed or whatever, and the Official Dealer was a faint and costly memory. We think that hubris will increase with the current drive towards increasing direct investments and internalisation. But as with the previous episode of history of Australian Mutuals, it's a long ride up before taking the elevator shaft down.

2 points of interest about Industry Super Funds

- We're intrigued by the ALP policy to remove franking credits rebates from Pension Fund mode SMSF funds. The ostensible justification is the increasing cost/leakage which results in the Australian tax Office (ATO) writing out $10b of cheques each year. However, the obvious solution for SMSF pensioners is to move their SMSF to an Industry Fund which, in general, pay enough tax to be able to offer their new ex SMSF clients the benefit of excess franking credits. If I was a CEO of an Industry Super Fund, I'd tweak my platform to allow the SMSF to invest in exactly the same assets (blue chip shares, cash and Platinum/Magellan and some property trusts). The SMSF is no

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worse off, the ATO is in exactly the same leakage position as it was before the policy and the Industry Funds are better off. If the ALP was serious about tax leakage, rather than just assisting Industry Funds, it would amend the tax legislation to ensure that Funds that co-mingle their tax obligations (both Industry and non-Industry) are required to separate the tax activities of their 15% and 0% funds.

- We love financial mutuals. They generally treat the customer better and can be longer term thinkers than shareholder financials. However, the history of financial mutuals in Australia is one of 100 years of slow growth, followed by 20 years of rapid decline. When the writer started in the investment industry, pretty much the whole industry was dominated by Australian mutuals (think, National Mutual, AMP, CML, MLC etc) and English insurers (which in the days before faxes and cheap phone calls operated with pretty much the same culture; chauffeurs, senior exec G&T's at 5pm etc etc). However, we can't think of one significant (ex Industry Funds, ex Health Funds) mutual left in Australia. The decline is partly due to the inherent agency problems, as mutuals tend to be eventually captured by their management and boards. But the rapid decline was assisted by hubris which resulted in bad capital and investment decisions and boards and management that became self serving. We wonder how much of the sclerotic state of Australian industry pre the Hawke/Keating reforms was due to the large amount of capital controlled by mutuals and the influence of their inter linked boards?

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