

Banks Flying in the Face of Big Headwinds

Investors call them headwinds – the negative forces that hinder companies from reporting strong profit growth and despite posting record earnings last month, the major Australian banks are facing these intensifying headwinds with increasing regularity. The most prevalent headwinds Australian banking is facing are macro issues, over which institutions themselves have little real control.

Regulatory Capital & Basel III

The implementation of Basel III is intended to improve banks' ability to absorb large scale economic and financial stress by forcing the banks to hold more capital and higher-quality assets on their balance sheets. Future revenue for the banking sector is under stress. Bank investors are unlikely to see rates of return on equity return to pre-GFC 20 percent-plus levels. ANZ's Mike Smith has been the most vocal of the big four domestic banks in his critiquing of Basel III and APRA's fast-tracking of its implementation, seeing Australian banks being placed at competitive disadvantage globally.

Europe

A further headwind facing Australian banks and their future performance is the debt crisis currently sweeping Europe at the moment. Both CBA's Ralph Norris and Westpac's Gail Kelly have expressed grave concern over the fragile situation with CBA's Mr Norris going so far as to warn of an impending second Global Financial Crisis (GFC). With European banks currently looking to sell parts of their Australian loan

books in order to repatriate capital, domestic banks will be confronting additional funding challenges.

Lack of credit demand

Contagion out of Europe may prove to be only a part of the storm for the banks as a lack of credit appetite settles in amongst Australian business and consumer borrowers for the long haul; indeed East is forecasting sub-2 percent credit growth for at least the next 18 months. NAB's CEO Cameron Clyne has identified this credit squeeze as 'increasingly real' with far reaching impacts. Mike Smith has also highlighted the current operating environment as 'more difficult' with cautious consumer and business borrowing, behaviour that could last for some time.

Cost of wholesale funding

Credit crunch conditions are returning globally, threatening to choke off funding for banks and pushing wholesale borrowing costs back to the same level they were in 2008. All the major banks are preparing for constrained domestic margins during 2012 with a strong focus on cost containment. Cameron Clyne has highlighted the twin challenges facing the banks of not only sourcing money but of then deciding how much they are willing to pay for it.

Where to from here?

While these headwinds are macro in nature, Australia's major banks will look to micro solutions, with sluggish income and revenue in the coming year forcing them to look at even tougher cost cutting measures, in particular labour retrenchments, off-shoring and out sourcing. The coming few years represent an important turning point in both domestic and global banking, can our banks not only make it through to the other side but exceed, by being both prudent and reactive?

And can they do so with their dignity and customers trust intact?

