

**FIDENS PARTNERS**

CONSULTING | STRATEGIC FINANCE | CAPITAL



**Fidens** (Latin) : *confident, without fear, courageous*

**ACCA**

Regain control of your banking relationship

23 Oct 2012

# Our banks....

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SunTze's Art of War says:

***“Know others, know self, hundred battles without fear”***

So,

What is the business of banking?

How are our banks performing?

How do they manage their performance?

What “levers” do they pull to ensure performance?

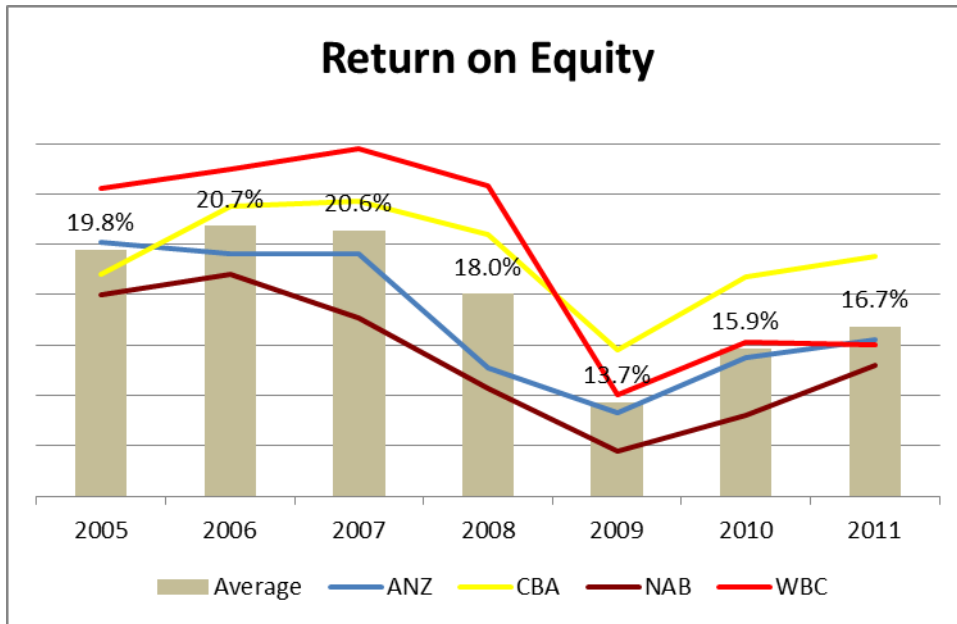
Some key stats:

- Four majors make up \$290bn Mkt Cap
- 30% of ASX 100
- All financial shares make up 46% of ASX100

**Banking is a business.**

**Like all businesses, they need to add value to shareholders**

# This leads to the importance of ROE

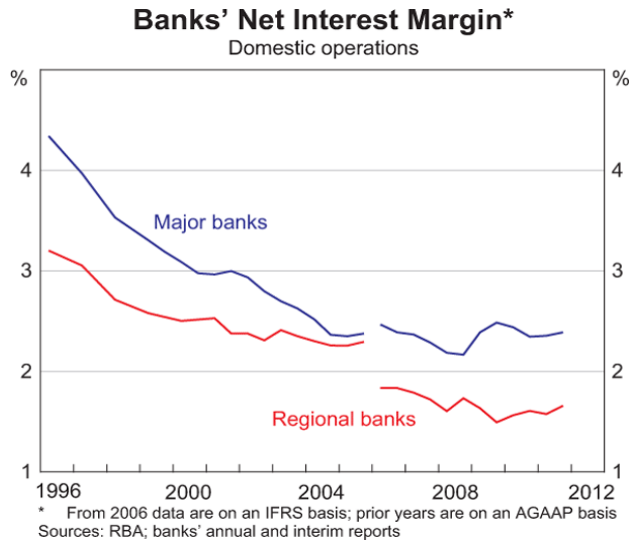


Data source: Comsec

- Despite all the reported super profit, our banks have under-performed since 2008.
- CBA, the ROE leader at 19.5%, is only 31<sup>st</sup> highest among ASX100.
- Considering the balance sheet of banks a leverage business by nature, their ROE performance is not impressive at all.

**Banks will pull every levers they can to improve ROE**

# Profitability

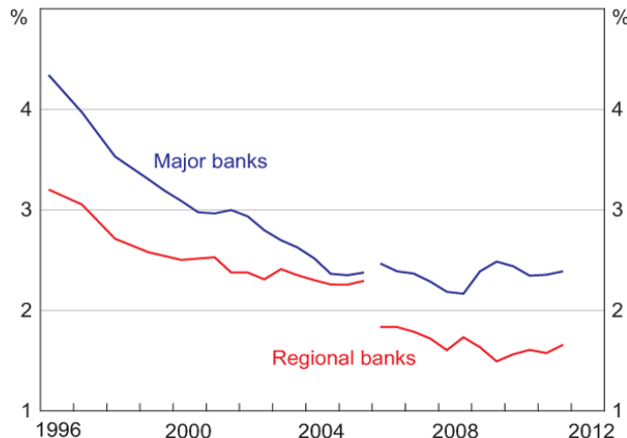


- Net Interest Margin (NIM) – one of the best measurement of bank's profitability
- Downward trend for the past 16 years
- A slight hike in 2008 due to industry wide repricing

# Profitability

**Banks' Net Interest Margin\***

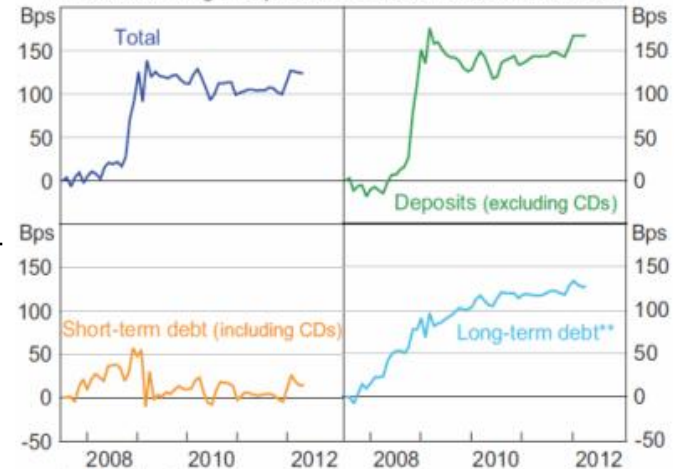
Domestic operations



\* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis  
Sources: RBA; banks' annual and interim reports

**Major Banks' Funding Costs\***

Cumulative change in spreads to the cash rate since June 2007

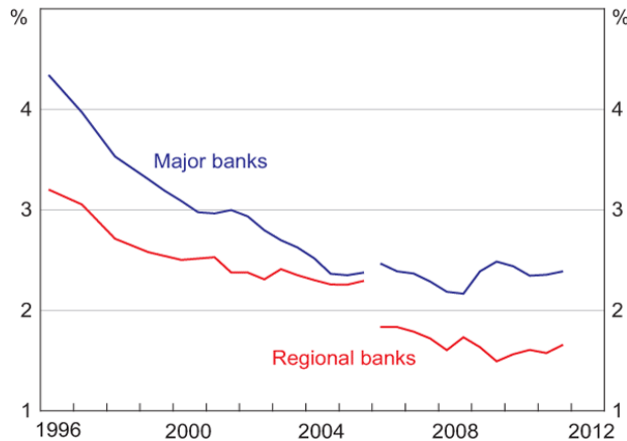


\* RBA estimates  
\*\* Weighted-average spread to cash rate and CGS for long-term variable rate and fixed-rate debt, respectively. Includes foreign currency hedging costs.  
Sources: Bloomberg; RBA; UBS AG, Australia Branch

- Historically, banks rely on wholesale funding market (60% of total funding) which becomes very volatile
- Banks used to raise capital at 15bps overseas. In Aug12, NAB raised at 220bps 10 yrs unsecured & CBA at 325bps sub-debt
- Overall funding cost (Banks' Cost of Goods Sold) increased from 20bps to now 140bps

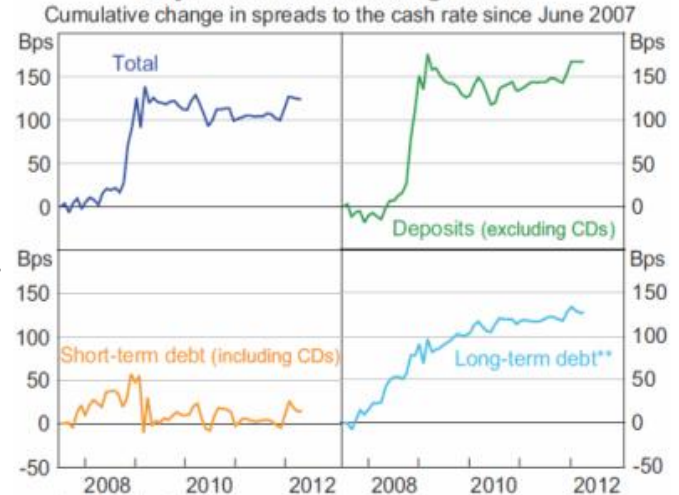
# Profitability

**Banks' Net Interest Margin\***  
Domestic operations



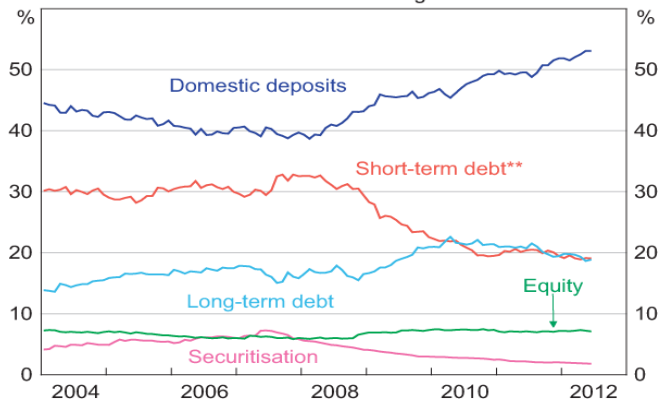
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**Major Banks' Funding Costs\***



\* RBA estimates  
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Sources: Bloomberg; RBA; UBS AG, Australia Branch

**Funding Composition of Banks in Australia\***  
Per cent of funding



\* Adjusted for movements in foreign exchange rates  
\*\* Includes deposits and intragroup funding from non-residents  
Sources: APRA; RBA; Standard & Poor's

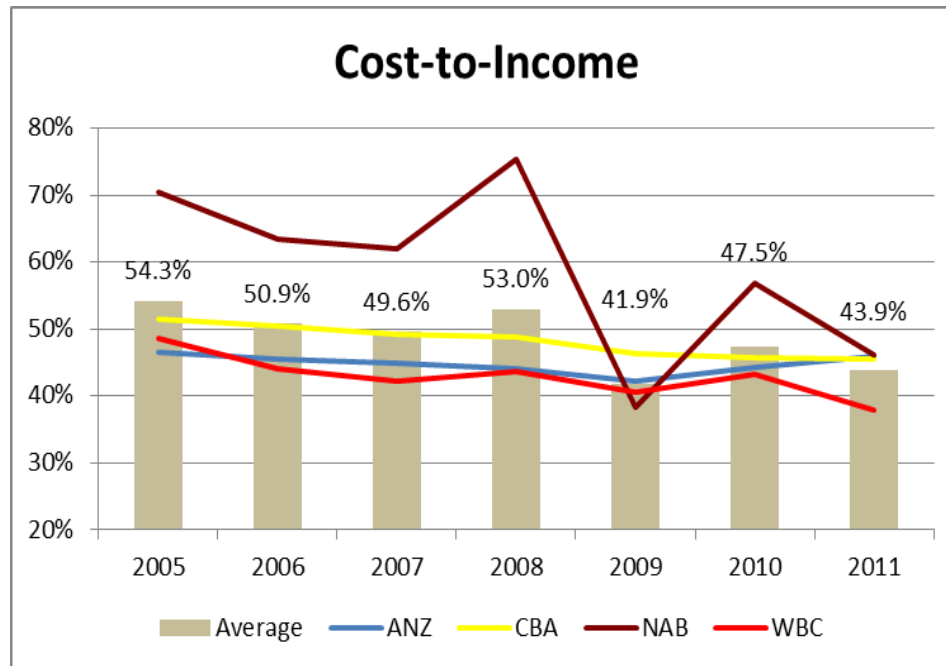
- Banks changed funding strategy
- Increase local deposit and less on wholesale market (now, 40%)
- Pass on Liquidity Premium (LP)
- Pricing quotes now:
  - BBSY + LP + Margin or COF + Margin where COF = BBSY + LP

# Practical tips

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1. **Scrutinise funding base rate – compare like-to-like**

# Profitability



- Banks have been very successful to reduce Cost-to-Income (C.I) ratio from 55% to 44% by using technology & outsourcing
- But too fast and too much: A reduction of 10.5% in C.I ratio (2011 vs. 2005) is about \$6.5bn in cost in today's term

~ Memory lapse syndrome ~

**Banks lose memory of their customers and disregard relationship history**



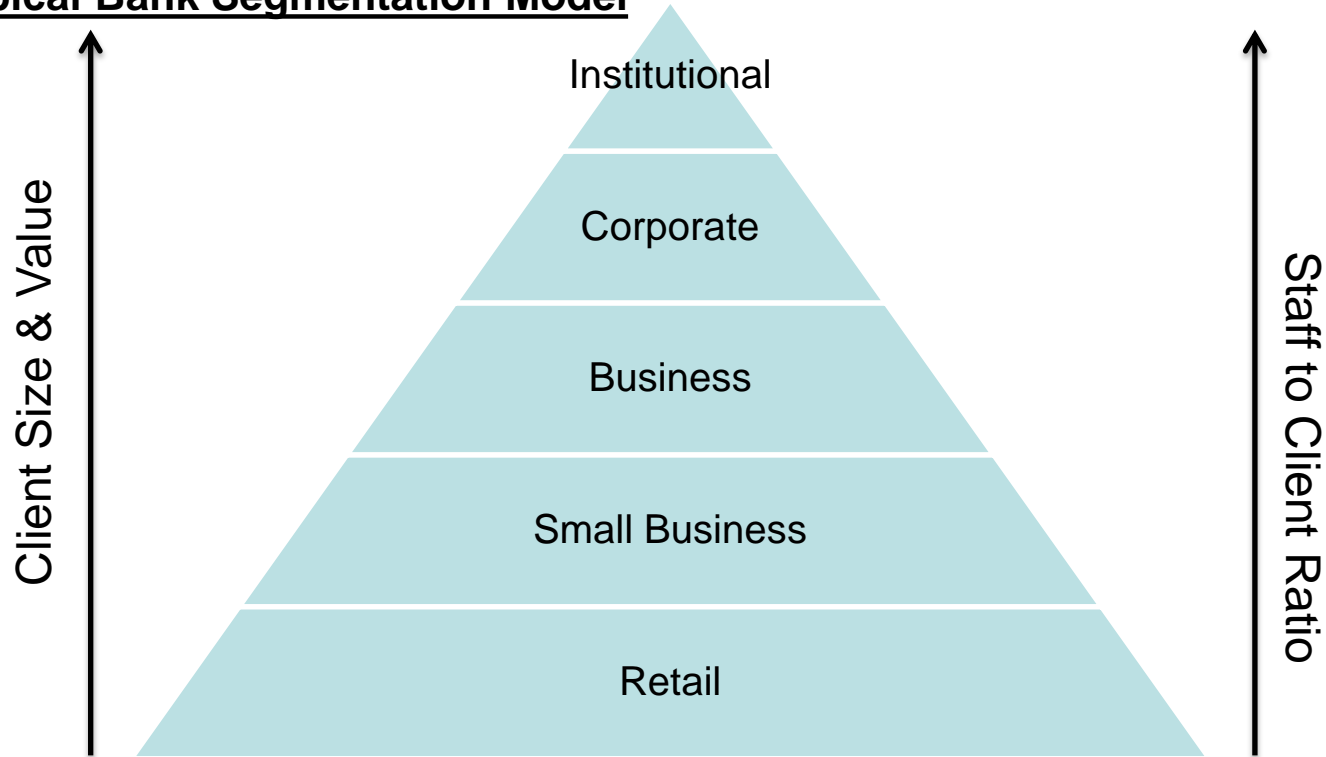
# Practical tips

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1. Scrutinise funding base rate – compare like-to-like
- 2. Retain your relationship history and educate your banker frequently**

# Profitability

## A Typical Bank Segmentation Model



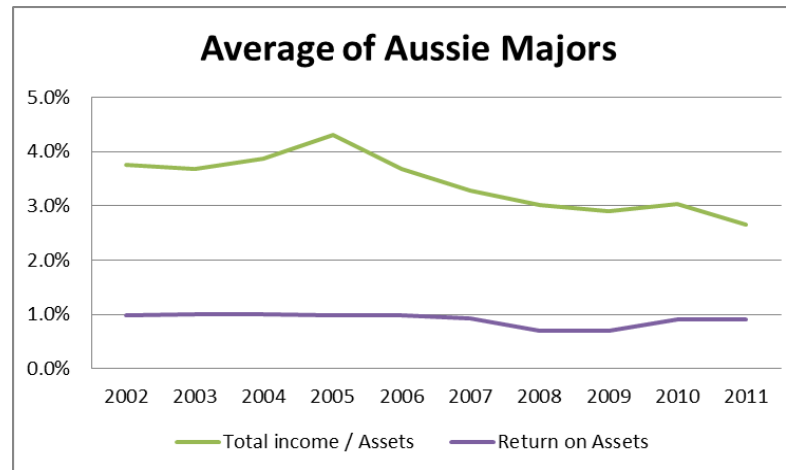
- The size and complexity of your business determine where your account sits in the bank client segmentation
- The value of your account determines which manager looks after you

# Practical tips

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2. Retain your relationship history and educate your banker frequently
3. **Get their best relationship team to manage your account**

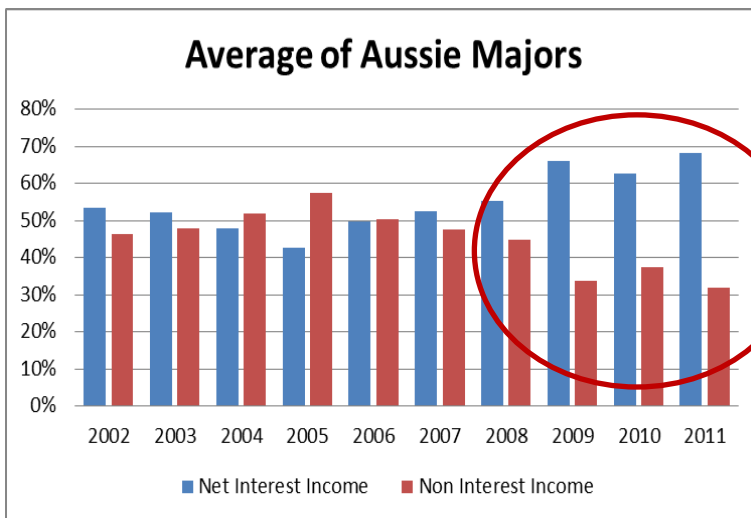
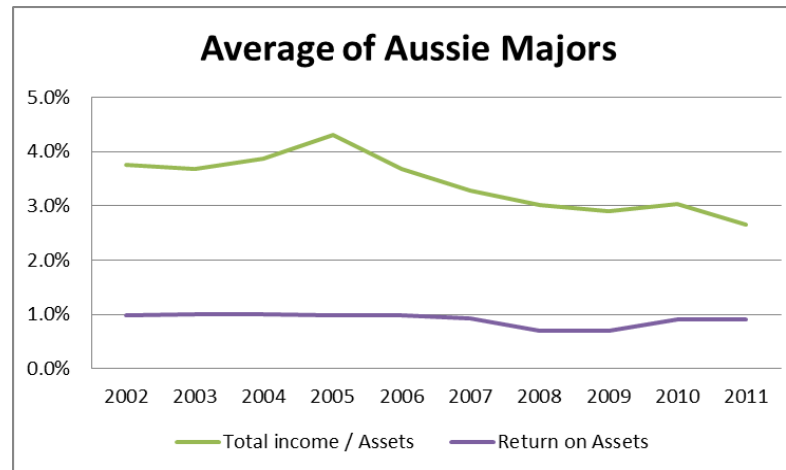
# Operating Efficiency



- ROA (risk adjusted) is relatively constant between 0.8-1%
- Income to Asset is on a downward trend
- Why?

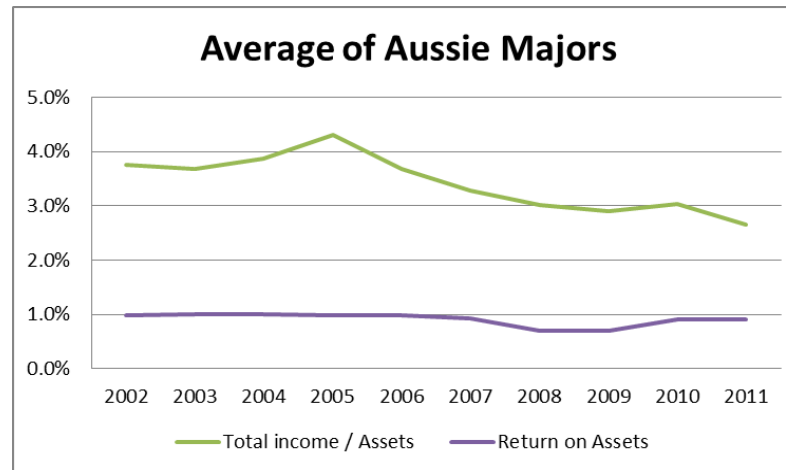
# Operating Efficiency

## Income



- Divergence of Interest vs. Non Interest income
- Non interest income proportion dropped since 2008 because:
  - Market-wide loan repricing
  - Acquisition of St George & Bankwest

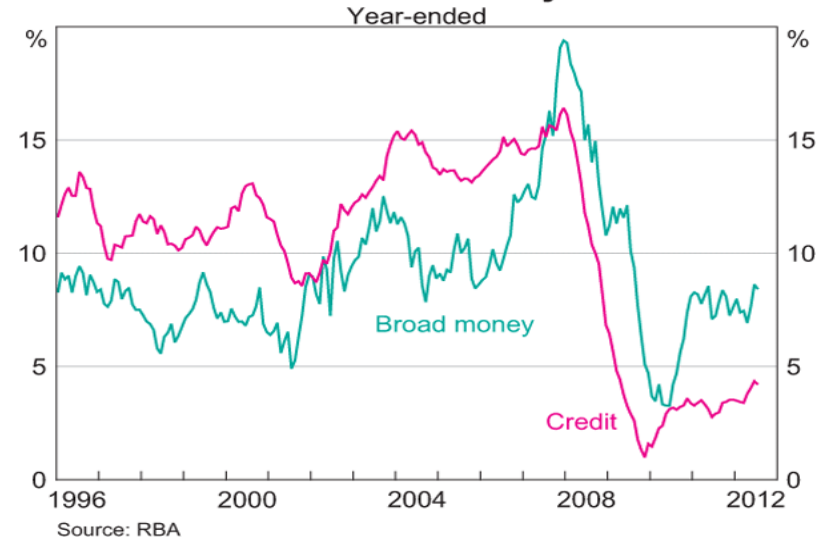
# Operating Efficiency



## Assets

- Benign credit growth
- Growth of income must outpace growth of assets
  - Little incentive to reprice down current loan (complacency)
  - Won't chase after low yield assets
  - Focus on lifting non-interest income for every \$1 lent out

## **Credit and Broad Money Growth**



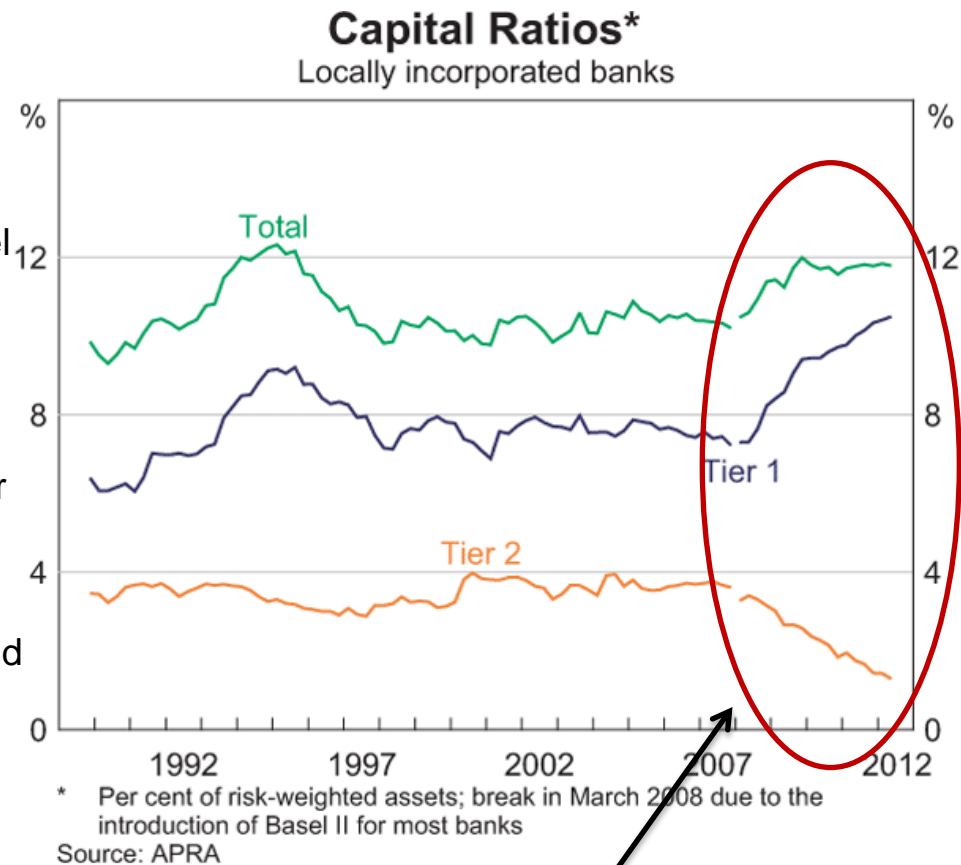
# Practical tips

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1. Scrutinise funding base rate – compare like-to-like
2. Retain your relationship history and educate your banker frequently
3. Get their best relationship team to manage your account
4. **Know your total banking wallet beyond just debt facility**
5. **Be pro-active on managing the “price” you pay**

# Leverage

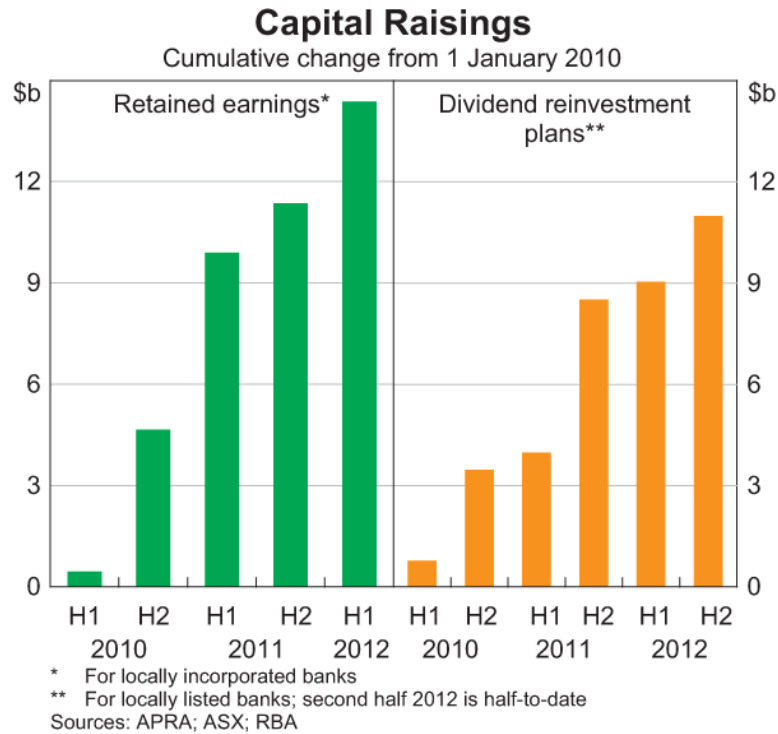
- Banks' ability to leverage is heavily regulated by APRA
- The higher the risk-adjusted-assets, the more capital banks have to set aside.
- Banks in 2013 will start to comply to Basel III – a new capital regulatory framework and to be fully complied by 2015
- Key points of Basel III
  - Lift the requirement for equity in Tier 1 capital
  - Tighten quality of equity to only common equity, retained earning and other income
  - Increase the requirement of holding liquid assets such as highly rated short term paper



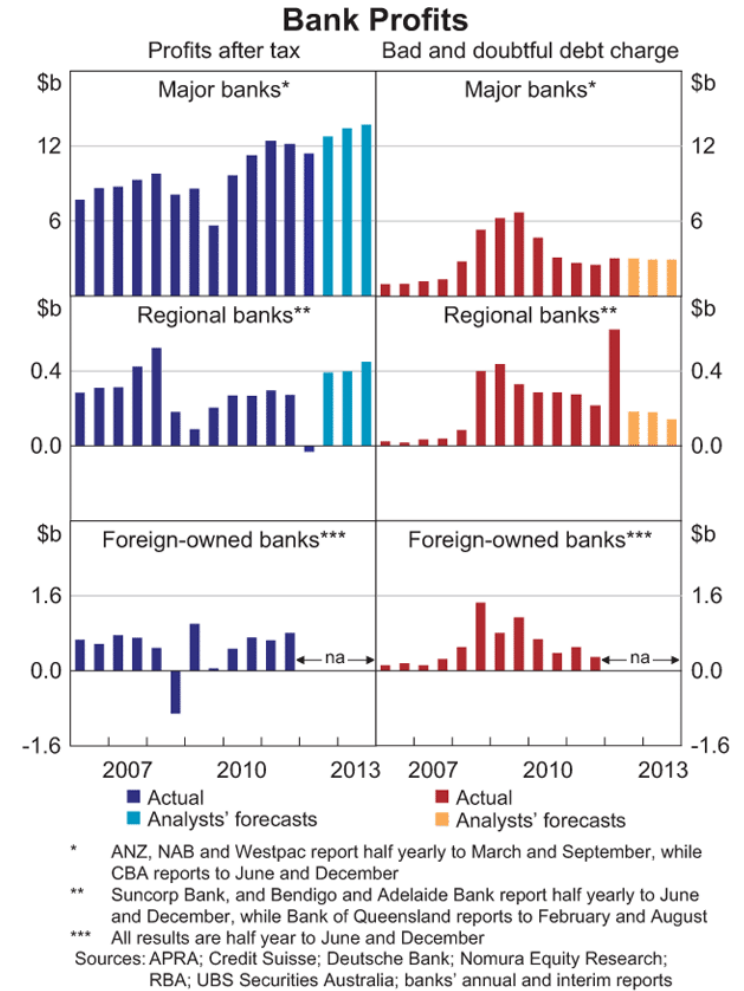
**Banks have started preparing for Basel III**



# Leverage



- The requirement to increase equity in Tier1 capital reduces the ability to leverage and thus decrease returns
- The riskier the assets, the higher the capital requirement, thus the lower the return



**It is getting more expensive to run a banking business**

# Practical tips

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1. Scrutinise funding base rate – compare like-to-like
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4. Know your total banking wallet beyond just debt facility
5. Be pro-active on managing the “price” you pay
6. **Dress your company to be a high quality credit**

# Practical tips

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1. Scrutinise funding base rate – compare like-to-like
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5. Be pro-active on managing the “price” you pay
6. Dress your company to be of high quality credit

***The last one:***

***This is unfortunate reality... no use to complain... learn to adapt***

# Apply to practice (Real case)

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## Company (Fictitious name)

Gourmet Food is a proud Australian family-owned company that specialises in providing gourmet food products to the Australian market. Among the 1,000 well-known brands it imports and distributes are Great Water, Yummy Pasta, Best Butter, and Choc Cheese.

## Banking relationship

Same bank since inception (25 yrs ago). Never changed or attempted to change banks

## What happened

- The bank decided the company was too highly geared
- Tightened covenants
- Issue a breach letter for late quarterly reporting
- When the company asked for more expansion funding, its bank asked them to seek elsewhere.

# Apply to practice (continued)

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## Findings

- X Inappropriate facility structure – funded by term debt and expensive overdraft;
- X Covenant structure did not help client grow
- X A lot of hidden variables in the pricing structure
- X All-in margins were higher than market
- X Plenty of errors in facility agreement

# Apply to practice (continued)

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## Findings

- X Inappropriate facility structure – funded by term debt and expensive overdraft;
- X Covenant structure did not help client grow
- X A lot of hidden variables in the pricing structure
- X All-in margins were higher than market
- X Plenty of errors in facility agreement

## What did we do

- ✓ Internal shadow credit assessment including security cover, facility structure, covenants.
- ✓ Estimated our total banking wallet to know our “worth” to them
- ✓ Drafted credit story for marketing to banks
- ✓ Invited other banks to tender

# Practical tips

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1. Scrutinise funding base rate – compare like-to-like ✓
2. Retain your relationship history and educate your banker frequently ✓
3. Get their best relationship team to manage your account ✓
4. Know your total banking wallet beyond just debt facility ✓
5. Be pro-active on managing the “price” you pay ✓
6. Dress your company to be a high quality credit ✓

# Apply to practice (continued)


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## Results

- Increased the facility size by 25% (\$26m)
- Released directors' personal guarantees and mortgage on his home
- Structured facility to enhance growth
- Transparent pricing structure – no hidden variables, only BBSY + margins
- Streamlined reporting – save on management time
- Significantly reduced pricing
- All up annual saving of circa. \$300k for the next 3 years

**The deal was won by the existing bank who was over-joyed to have maintained a valuable client**





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