Slower Credit Growth: A Benefit for Bank Capital Positions?

The slow down in credit and monetary growth to below 5 and 10 per cent p.a. respectively since the start of 2010 has been bad news for bank employees and of concern for economic growth prospects.

But there is a brighter side. Provided that banks can retain earnings rates (accounting return on equity) of around 15 per cent, they should have little trouble in maintaining or even increasing equity capital ratios without needing to approach the capital market for new equity.

The arithmetic needed to substantiate this statement is a little complex, but the basic point can be simply made. Some part of bank profits (around 30 per cent for the majors) is retained, and increases shareholders funds. The remainder is distributed as dividends, but around 40 per cent of that comes back via dividend reinvestment schemes.

Thus, almost 60 per cent of profits (30 per cent directly and 40 per cent of the 70 per cent distributed as dividends) ends up as an increase in bank equity. If return on equity is 15 per cent, the growth rate of equity from these internal sources is around 9 per cent p.a. (60 per cent of 15 per cent). If bank assets grow at less than 9 per cent p.a., the equity/assets ratio would increase.

With Basel III capital requirements placing more emphasis on (and higher requirements for) common equity, that is potentially good news for Australian banks. Although with equity/assets ratios around 5 per cent (and tier 1 capital at around 10 per cent of risk weighted assets), they are already well placed to meet Basel III requirements.

But it is not all good news for bank management. Growth and increased size objectives seem to be hard-wired into the brains of (not just bank) management and boards. Slow credit growth is thus not an attractive option (although consequent reduction in the need to tap international capital markets for debt funding in these trying times is a plus).

To meet growth objectives then, acquisitions (either domestic or offshore, banking or other financial services) may look more attractive – particularly while valuation ratios remain below the heady heights of the pre GFC days. And while further expansion into other financial service areas, such as wealth management, is an option – current regulatory trends look to be impeding those growth prospects.

And there are two more pieces of the puzzle which need to be considered. Can banks achieve 15 per cent return on equity at growth rates of around (say) 9 per cent p.a.? Will shareholders be content with that rate of return or will bank share prices suffer as a result?

Taking the latter question first, current market/book ratios for banks are around 1.5, suggesting that investors believe that banks can generate a higher return on the equity funds available to them to use than that required by shareholders. Does this mean that a

15 per cent accounting return on equity exceeds the shareholder required rate of return (and that such a profit rate is necessary to prevent bank share prices regressing?

Quite possibly! The accounting return on equity is an after-company-tax rate of return, and the dividends provided to shareholders as part of their return include valuable imputation credits. While there is much debate about the average value of franking credits, they are certainly fully valued by domestic investors such as superannuation funds.

Using a theory such as the Capital Asset Pricing Model, it could be expected that investors in bank shares require a ball park rate of return (including franking credits) of around 12 per cent. (This ball park estimate is based on a risk free rate of 6 per cent, a market risk premium of 6 per cent and a beta for bank stocks of around 1).

Thus a 15 per cent accounting return on equity (which excludes franking credits) looks sufficient to meet investor expectations and maintain share prices (although precise calculations are more complex – and this should certainly not be taken as investment advice!).

But can banks maintain a return on equity of 15 per cent in a low growth scenario? With the current buffeting from international conditions and a raft of costly regulation weighing upon them, that is a question to be answered on another day!

Kevin Davis
Research Director, Australian Centre for Financial Studies
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