

Australian Bank Capital is Higher Than it Appears

Already Basel III compliant before the January 2013 start date. Capital could be returned to shareholders

The latest global bank prudential rules, known as Basel III, came into effect on 1 January 2013 and are wide-ranging, tougher and more contentious than predecessor Basel II. The higher capital requirements are designed to reduce risk and increase a bank's ability to absorb losses, in theory making the global banking system safer and less likely to suffer a repeat of the 2008 financial crisis. However, the significant increase in complexity, flexibility in interpretation and difficulty of enforceability bring into question the effectiveness of the new rules. More worrying is the poor adoption rate, with only a handful of the more than 100 countries that agreed to implement the new rules meeting the 1 January 2013 start. Yet, Basel III pro-forma common equity ratios for the four Australian narrow-moat, major banks already exceed new tougher global capital standards. Despite the 12-month share price rally in Australian major banks, we continue to see good value in Australia and New Zealand Banking Group ASX:ANZ and National Australia Bank ASX:NAB. Westpac Banking Corporation ASX:WBC trades at a smaller discount to our fair value estimate, but remains attractive due to a high, fully-franked yield and the prospect of a capital return in the medium term.

Key Takeaways

- ▶ Australian major banks are well-capitalised and compare favourably with global peers based on 'fully-harmonised' Basel III common equity ratios.
- ▶ We are increasingly confident in our major bank earnings and dividend forecasts for fiscal 2013 with economic conditions in Australia holding relatively steady despite well-publicised headwinds and uncertainty. Strong profitability and capital cushions at Australian major banks support a sustainable stream of fully-franked dividends.
- ▶ Surplus capital is set to increase over the next 12 to 18 months, providing capital management opportunities such as special dividends or share buybacks. Sharply higher bad debts would prevent capital returns, but this is not our base case.
- ▶ We expect Westpac will be the first major bank to start returning surplus capital to shareholders due to its lower-risk loan book, strong capital generation ability and sector-leading Basel III common equity ratio of 10.6%.
- ▶ One-year total shareholder returns (capital growth plus dividends) to 3 January 2013 for the major banks are: WBC +39%, Commonwealth Bank of Australia ASX:CBA +35%, ANZ +30% and NAB +14%.

Common equity ratios exceed new global capital standards

The Australian Prudential Regulation Authority (APRA) maintained its traditionally conservative stance in both timing and content, with Australian banks required to be fully Basel III capital compliant by 1 January 2013, ignoring the more generous three-year phase-in period stipulated by the Switzerland-based international bank standard setter known as the Basel Committee on Banking Supervision (the Basel Committee).

APRA is the prudential regulator of Australia's financial services industry and has always applied much tougher capital requirements on Australia's banks than those prescribed by the Basel Committee. APRA's implementation of the Basel III rules is no different. We argue Basel III incorporates a range of 'blunt' prudential remedies aimed at avoiding a repeat of the global financial crisis (GFC) and the consequent rout of global banking systems and economies. Only a handful of developed economies escaped a financial system meltdown with Australia, Canada, Singapore and New Zealand prominent. In addition to less economic stress, we argue firm and effective bank supervision, combined with responsible internal risk management were key reasons for strong stock price and earnings performances compared with the much larger and more 'sophisticated' financial systems in the United States, the United Kingdom and Europe.



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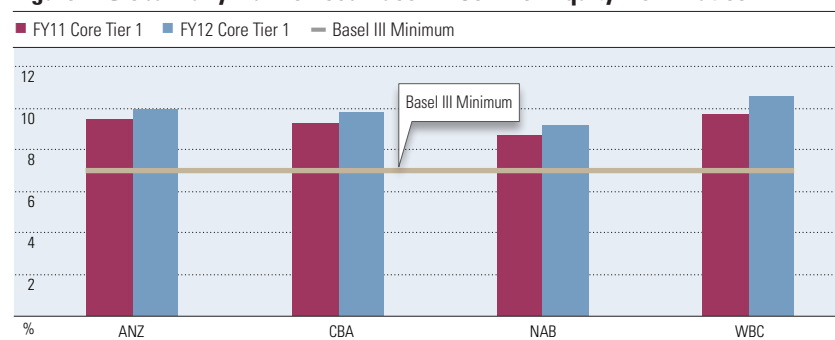
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Table 1: Morningstar Recommendations and Valuation Metrics as at 22 January 2013

Company	Code	Morningstar Recommendation	Market Cap \$m	Share Price \$	Price/Fair Value	Consider Buying \$	Fair Value Estimate \$	Consider Selling \$	Economic Moat	Uncertainty Rating	Year 1 EPS	Year 2 EPS	Forward P/E	Forward Dividend Yield %
ANZ Bank	ANZ	Accumulate	70,483	25.69	0.83	22.00	31.00	42.00	Narrow	Medium	2.36	2.43	10.89	6.1
Commonwealth Bank	CBA	Hold	100,091	62.20	1.04	42.00	60.00	81.00	Narrow	Medium	4.63	4.85	13.43	5.4
National Aust. Bank	NAB	Accumulate	62,888	26.85	0.87	22.00	31.00	42.00	Narrow	Medium	2.53	2.70	10.60	7.5
Westpac Bank	WBC	Accumulate	82,187	26.48	0.88	21.00	30.00	40.00	Narrow	Medium	2.23	2.35	11.87	6.6
Bendigo Adelaide Bank	BEN	Hold	3,634	9.03	1.00	6.30	9.00	12.10	None	Medium	0.87	0.94	10.34	6.9
Bank of Queensland	BOQ	Reduce	2,500	7.99	1.14	4.90	7.00	9.40	None	Medium	0.65	0.72	12.24	6.9
Macquarie Group	MQG	Hold	12,553	37.01	1.12	23.00	33.00	44.00	None	Medium	2.57	3.22	14.43	4.2
Category Average					0.98									6.6

Source: Morningstar

Figure 1: Global Fully-Harmonised Basel III Common Equity Tier 1 Ratios

Source: Morningstar

Table 2: Global Selected Peer Comparison of Basel III pro forma Equity Ratios

Company	Common Equity Ratio
Svenska Handelsbanken	15.7%
Swedbank	15.4%
SEB	13.3%
DnB NOR	11.0%
Nordea	11.0%
Westpac	10.6%
Dankse Bank	10.6%
Standard Chartered	10.5%
ANZ	10.0%
CBA	9.8%
BBVA	9.3%
Intesa Sanpaola	9.3%
Unicredit	9.3%
NAB	9.3%
Raiffeisen Bank	9.3%
Morgan Stanley	9.2%

Source: Westpac 2012 Results Presentation. Based on latest reporting data as at 26 October 2012.

Since establishment in 1998, APRA has consistently and successfully applied tough capital and prudential rules on Australian banks. The Australian economy benefits from APRA's effective supervision, with the strong relative and absolute performance of the banks clear and compelling evidence of APRA's successful role. Despite the four-year GFC-induced stress test, Australia's financial system is not under any significant pressure. In contrast, economic, political and social turmoil are in plentiful supply in countries where banking systems collapsed or nearly collapsed. Equity investors in some northern hemisphere financial institutions were effectively wiped out as governments bailed out banks and insurance companies.

Not all bank regulators have implemented the new Basel III capital standards, with the U.S. and European regulators ignoring the 1 January 2013 deadline and deferring the start date. Ironically, the U.S. and European banks were hit hardest by the GFC.

Australian banks are well-capitalised and compare favourably with global peers

APRA applies a stricter interpretation of the Basel III capital standards than required by the Basel Committee. Consequently, common equity capital ratios reported by Australian banks appear lower when compared with international banks. The difference between common equity capital ratios measured under

APRA's conservative methodology and the globalised fully-harmonised rules is approximately 2%.

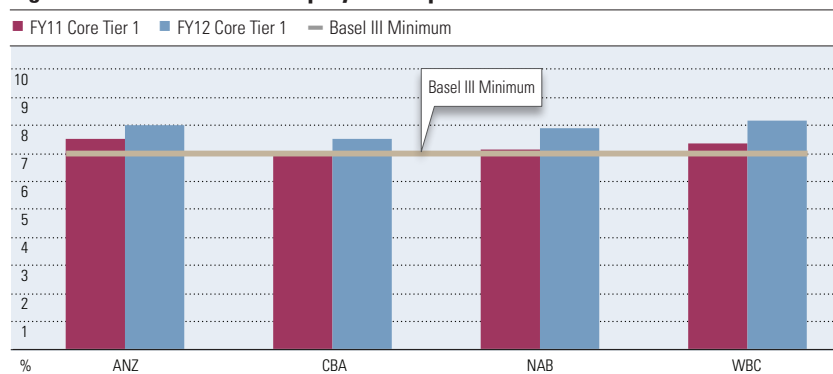
The major Australian banks report pro-forma Basel III Common Equity Tier 1 (CET1) ratios around 8% based on APRA's conservative definition, but on average are a more impressive 10% under the fully-harmonised global Basel Committee rules. CET1s around 10% put the Australian majors towards the top of global peers, broadly in line with Standard Chartered, Danske Bank and Morgan Stanley.

Three specific reconciling items explain most of the difference between the two methodologies.

1. APRA does not allow concessional treatment when determining the capital requirements of deferred tax assets, investments in non-consolidated subsidiaries and equity investments. APRA requires a 100% deduction from common equity for these items. Under Basel III, bank supervisors have the option to apply concessional thresholds when determining the capital requirement.
2. APRA requires a high loss given default (LGD) of 20% on mortgage risk weights whereas Basel III sets a minimum LGD of 10%.
3. APRA applies a risk-weighted asset requirement to interest rate risk in the banking book (IRRBB). This is not required under Basel III.

There are other minor differences that round out the reconciliation between APRA's methodology and Basel III requirements. As an example, we reconcile Westpac's 30 September 2012 APRA calculated CET1 ratio with the Basel Committee's standard requirements:

Westpac Common Equity Ratio per APRA Basel III Rules	8.16%
Add: Non allowance of concessional thresholds	+1.34%
Add: Difference in mortgage risk weights	+0.67%
Add: Risk weighted asset requirement applied to IRRBB	+0.29%
Add: Other minor differences	+0.17%
Fully-harmonised Basel III ratio per Basel Committee Rules	10.63%

Figure 2: Basel III Common Equity Ratios per APRA's Conservative Rules

Source: Morningstar

ANZ and NAB offer the most value compared to our fair value estimates

We've been bullish on Australian banks for quite a while, but share prices for Australia's major banks have risen sharply over the past 12 months and most are now trading closer to our fair value estimates. Australian major banks have minimal exposure to European sovereign debt and instead focus heavily on traditional commercial and savings bank lending and deposit taking. Reducing risk-weighted assets and more efficient use of internal capital are key priorities which will result in lower capital usage and higher capital ratios. One-year total shareholder returns (capital growth plus dividends) to 3 January 2013 for the major banks are WBC +39%, CBA +35%, ANZ +30% and NAB +14%. At this stage, we see greatest value in ANZ and NAB, with these Melbourne-based banks trading at discounts to fair value around 17% and 13% respectively. Strong share price performances from WBC and CBA have reduced their relative attractiveness with CBA trading at a 4% premium to our fair value estimate and WBC now 12% below.

Given this backdrop, ANZ is our top-ranked bank due to its strong earnings profile and differentiated growth strategy. Westpac is ranked second, following its standout 2012 performance, and we expect further improvement in key earnings metrics in 2013 and 2014. We were positive on CBA for some time, but the strong share price performance triggered a downgrade in our recommendation in September. We continue to like CBA and value its low-risk profile, stable earnings growth, conservative balance sheet settings and leading IT capability. Despite

trading at a premium, CBA is still potentially attractive for income investors, as the global clamour for yield has reduced the alternatives. However, Australia's largest bank by market value is now fairly valued on an absolute basis and relatively expensive compared with ANZ and Westpac.

Surplus capital likely to be returned to shareholders

In the current low credit growth environment, we expect the four major banks to generate approximately 50 to 75 basis points (bps) in internal capital each year, providing a growing surplus for capital management initiatives. We are increasingly confident the major banks will generate surplus capital as early as late 2013, but more likely 2014. The major risk to our surplus capital thesis is a significant deterioration in loan quality and a consequent increase in bad debts, but we do not rate this outcome highly. WBC will likely be the first of the major banks to accumulate sufficient surplus capital and will need to undertake capital management initiatives to maintain its new 15% minimum return on equity (ROE) target. Without a return of capital, the bank's 15.5% ROE as at September 2012 will likely decline below the new minimum target within the next 12 to 18 months. The outlook for surplus capital doesn't apply to the regional banks due to lower capital ratios and lower profitability. We applaud the increasing importance of efficient internal capital allocation across the industry and, importantly, the greater focus on measuring return on internal capital. We expect better internal capital allocation will lift shareholder returns over time.

APRA begins consultations with the four major banks and Macquarie Group ASX:MQG in 2013 to consider the Basel III additional capital required under the domestic systemically important financial institutions rules. Any new requirements would phase in from January 2016. APRA may require additional capital, but more likely the impost will be achieved by more banking supervision. Increasing capital by itself is a blunt instrument and could ultimately constrain lending. Higher capital levels do not necessarily lead to safer banks. Capable management, tight risk management, sufficient liquidity and effective supervision are more important in the survival of a bank than just capital. ■■■