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Assessing the virus and fundamentals for Australia's big 4 banks

- **The earnings announcements of large US banks have provided a glimpse of what's in store for the upcoming reporting season for banks under our coverage.**
- **With economic dislocation continuing throughout the globe, the relative success of virus containment measures by different governments along with underlying fundamentals will be a predictor of the ultimate impact on bank credit profiles from COVID-19.**
- **We see Australia's big 4 banks as somewhat better positioned considering these factors along with pro-active regulatory oversight. That said, while we expect enduring fundamentals to prevail over the temporal event of COVID-19, the question remains at what cost.**

Flattening the curve

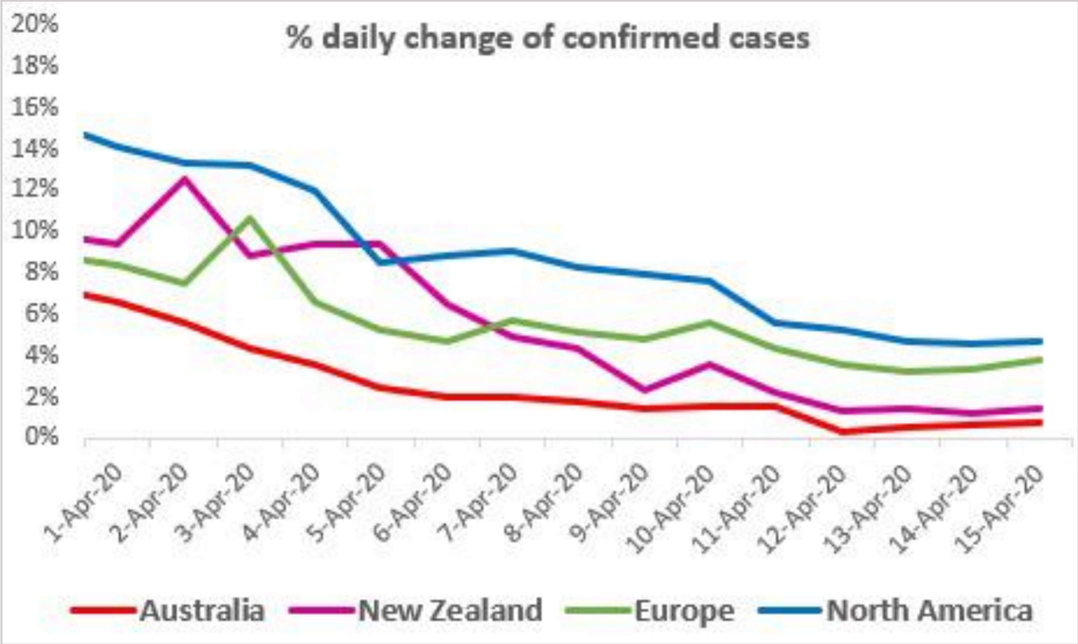
With large US banks JPMorgan Chase & Co, Wells Fargo & Co., Bank of America Corp., Citigroup Inc. and Morgan Stanley reporting earnings this week, we are beginning to get a grasp of how results can look for the Financial Institutions under our coverage. Different business compositions aside, earnings in general were materially weaker due to a significant build up in provisions for loan losses that were the highest amounts since around the Great Financial Crisis at the start of the last decade. Provision recognition for the challenging operating environment overshadowed strong performance in each bank's trading division from the market volatility and a relatively benign operating environment in January and February 2020.

We expect the results make up for Financial Institutions under our coverage to be largely the same with a normal start to 2020 somewhat cushioning management's preparation for an extraordinary rest of 2020 that will necessitate a large build up in reserves to cushion. Earnings will be materially lower as moderate revenue impacts will be overshadowed by a rise in provisions for credit losses. While provisions for credit losses may be lower in 2Q2020 results against the preceding quarter, earnings will nevertheless be materially impacted in our view from a fall in operating income from lower interest rates, likely deferral of interest income for stressed borrowers and reduced net commission and fee income.

While various government support measures and mechanisms have been employed to support distressed sectors of various shut-down economies with Financial Institutions as the conduit (either by passing through government funding plans or using their own balance sheet and low cost funding from the government) and different governments have allowed for a relaxation in recognition of non-performing loans, it appears that the devil is in the detail with some of these mechanisms. As much as government stimulus programs seek to protect as many businesses as possible during the lockdown phase, it appears that not all may be able to see their way through this period and non-performing loans will undoubtedly rise.

How far non-performing loans rise and how low earnings fall for Financial Institutions in our view depends very much on the success of containment measures for COVID-19 and the ability of economies to normalize. Our macro-economic research colleague at OCBC Treasury Research has been routinely sharing the progress of the virus in his COVID-19 monitor and while total confirmed cases continue to rise globally, the success of containment measures has varied.

Figure 1: Daily Change (%) of confirmed cases



Source: OCBC

Using Worldometer data and putting aside potential discrepancies in reporting standards, a somewhat simplistic relative ranking of countries in terms of total cases and tests per 1 million in population shows the relative success against COVID-19 a little more clearly. China was excluded from the list as it has not disclosed any official testing data. With a higher score indicating a better perceived performance, it appears Hong Kong, Australia and New Zealand are outperforming other countries in our coverage of Financial Institutions. Conversely, France fares poorly in terms of its efforts to contain the virus followed by the Netherlands, and the USA.

Table 1: Reported Global Coronavirus cases

Country	Total Cases*	Relative Rank	Tests*	Relative Rank	Score^
Hong Kong	136	11	15,509	12	23
Australia	254	9	14,902	11	20
New Zealand	291	8	14,549	10	18
Germany	1,608	5	20,629	13	18
Singapore	632	7	12,423	9	16
Thailand	38	13	1,440	3	16
Indonesia	20	14	132	2	16
Switzerland	3,043	1	22,993	14	15
Malaysia	157	10	2,694	4	14
UK	1,457	6	5,876	6	12
USA	1,947	3	9,845	8	11
Netherlands	1,643	4	8,220	7	11
France	2,265	2	5,114	5	7

Source: https://www.worldometers.info/coronavirus/
** per 1 million population; ^ summation of relative rank for both factors*

Australia has been successful in flattening the curve, largely as a result of strict social distancing and painful shutdowns of the economy. While the economic damage is expected to result in

Australia's first recession in nearly 30 years and unemployment climbing towards around 10%, Chief Medical Officer of Australia Brendan Murphy recently stated that Australia's detection rates are one of the best in the world (estimated detection of around 92% of all symptomatic cases) while the basic reproductive number (the average number of people a single case infects in a population with some immunity and/or public health strategies such as social distancing, quarantine and non-essential closures) was less than one as at 29 March 2020, indicating that the virus is on the decline. This has put the economy in a better position to restart, although the government continues to tread cautiously, only considering a lifting of current restrictions in around a month. Still, the Federal Government is now pressing state leaders to consider re-opening schools while Health Minister Greg Hunt indicated that talks would begin this week on how to relax current public health strategies.

New Zealand faces a similar dynamic, having also successfully flattened the curve of COVID-19 through tough lock-down measures implemented three weeks ago. It is now in a position where the government can meaningfully discuss how to restart the economy, although similar to their Australian counterparts, the New Zealand government is wary of losing the gains achieved since the lock-down began. Still, New Zealand's Deputy Prime Minister Winston Peters has indicated that New Zealand is on track to exit its four week lockdown on April 22 while Prime Minister Jacinda Arden has stated that the government will decide on April 20 if New Zealand moves one step below lockdown to Alert Level 3 and what the country could look like in that instance. According to Ms. Arden, most movement restrictions would be retained but certain parts of the economy would be allowed to re-open subject to strict health and safety and physical distancing rules.

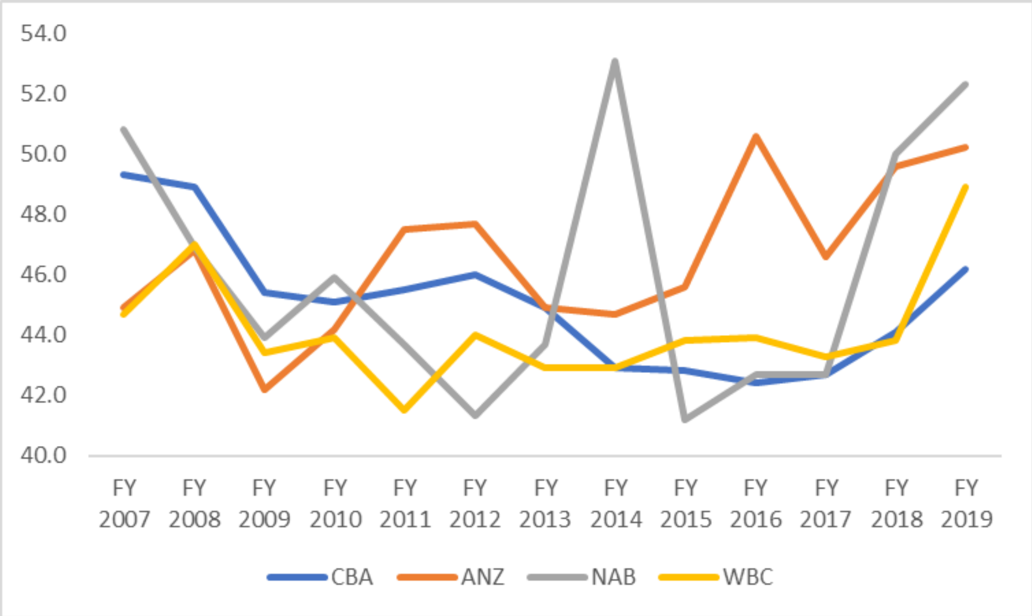
What this means for the Australian banks under our coverage is that there is some hope the temporal impacts of COVID-19 may be less damaging on their fundamentals compared to peers. There remains significant uncertainty on how long the temporal impact may be and when these extra-ordinary times will normalize. Still, the progress in addressing the virus spread thus far may provide an objective indication of how close normalization can be, notwithstanding that this still remains in the control of respective governments who are weighing up the benefits of restarting their economies with the threat of a secondary wave of new infections. With Australia and New Zealand taking conservative stances despite their relative success, there seems increasing consensus that starting of economies can only be done carefully and slowly in stages. Aspects of social distancing are likely to remain for some time, making any economic recovery a long and arduous process.

Flattening the impact?

Against this backdrop, we continue to focus on the importance of underlying fundamentals as a buffer against the temporal events of COVID-19. Broadly speaking, we see fundamentals for Financial Institutions driven by both temporal influences (the macro environment, asset quality and earnings) and enduring influences (business mix, market position, strategic positioning, funding and liquidity profile) that both combine into the strength of a Financial Institutions capital buffers. In our view, we think on balance that for the Australian Financial Institutions under our coverage, these enduring influences can offset the temporal influences in the short to medium term. Market positions for each of Australia's big four banks remain entrenched and in total comprise around three quarters of the banking system. Despite the impact to reputations from the Royal Commission into misconduct in the Banking Industry and rising competition from new online entrants, respective market positions have endured. Further, the Australian Prudential Regulation Authority has stopped issuing new banking licenses for at least the next six months given current economic conditions. We expect consumers will also seek the security of well-established players in the financial services sector to ride out the storm.

We do also expect however that there will be damage to the financial profile of Financial Institutions. Earnings will deteriorate noticeably, firstly from the build-up in provisions for loan losses and secondly from a fall in operating income due to (a) lower interest rates; (b) the deferral of interest income for stressed borrowers; and (c) the reduction in economic activity from lockdown measures that will impact net commission and fee income. Operating expenses will not reduce in line despite Financial Institutions' ongoing focus on cost containment and efficiency given a high level of fixed costs as well as the recent rising expenditure on compliance and digitalisation and the likely current increase in expenditure on technology to facilitate work from home capabilities.

Figure 2: Various bank efficiency ratios

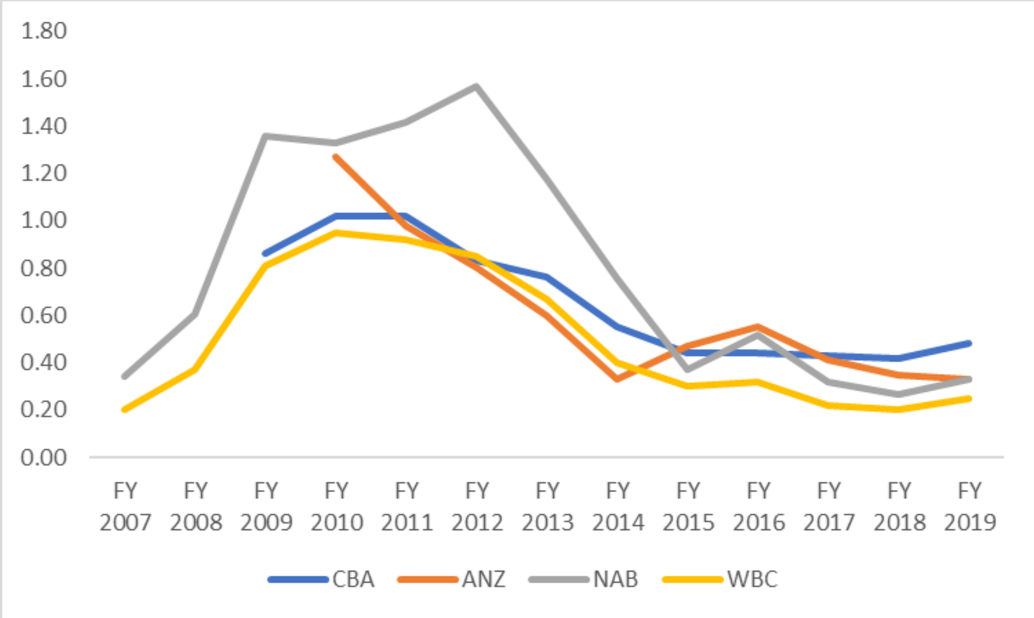


Source: Bloomberg

Commonwealth Bank of Australia ("CBA") | Issuer Profile: Positive (2); National Australia Bank Ltd ("NAB") | Issuer Profile: Positive (2); Westpac Banking Corp ("Westpac") | Issuer Profile: Positive (2); Australia & New Zealand Banking Group Ltd ("ANZ") | Issuer Profile: Positive (2)

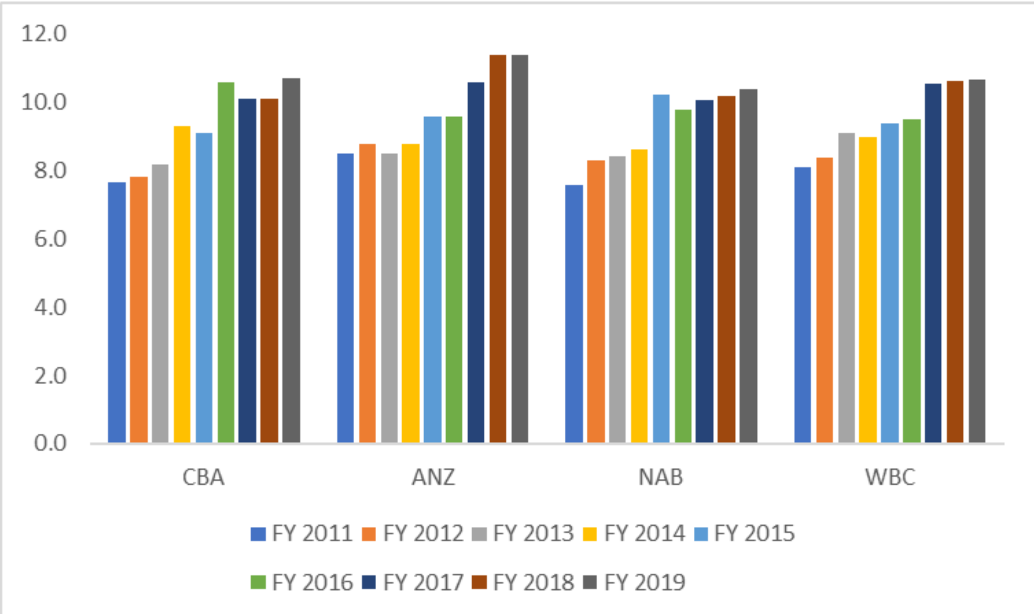
Providing a buffer to some extent for the temporal challenges of the operating environment to earnings is the progressive strengthening of some financial ratios prior to the onset of COVID-19. This was a consequence of the banks' solid market positions, a constructive operating environment, and a progressive strategic refocusing back to their core competencies in the domestic market. Non-performing loan ratios have reduced as balance sheet quality has improved while common equity tier 1 capital ratios have built up solid buffers since the Global Financial Crisis. This recognizes each bank's business franchises as well as pro-active regulatory oversight from the Australian Prudential Regulation Authority ("APRA") which has sought to strengthen the minimum loss-absorbing and recapitalisation capacity of Australian Banks. The Reserve Bank of New Zealand ("RBNZ") similarly provides strong oversight, releasing its final decision on the proposal to raise minimum regulatory capital requirements for New Zealand banks in early December 2019, seeking under their "Capital Review" proposal to almost double minimum CET1/Tier1/CAR requirements for New Zealand's largest four banks. In its decision, RBNZ opined that the benefits of ensuring a higher loss absorbing capacity for its banking system and increased financial stability for the economy outweighed any potential impact to economic growth through a reduction in credit availability by the banks or a rise in the cost of credit to the financial system.

Figure 3: Various bank non-performing loan ratios



Source: Bloomberg
Commonwealth Bank of Australia ("CBA") | Issuer Profile: Positive (2); National Australia Bank Ltd ("NAB") | Issuer Profile: Positive (2); Westpac Banking Corp ("Westpac") | Issuer Profile: Positive (2); Australia & New Zealand Banking Group Ltd ("ANZ") | Issuer Profile: Positive (2)

Figure 4: Various bank CET1 ratios



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Commonwealth Bank of Australia ("CBA") | Issuer Profile: Positive (2); National Australia Bank Ltd ("NAB") | Issuer Profile: Positive (2); Westpac Banking Corp ("Westpac") | Issuer Profile: Positive (2); Australia & New Zealand Banking Group Ltd ("ANZ") | Issuer Profile: Positive (2)

Presence of strong regulatory oversight continues to be credit supportive in our view, recognizing the banks' systemic importance and indicating a level of government support in times of need. This is notwithstanding the expectation that the government could have a reduced capacity to support Australia's banks as the economy heads towards a recession and the government implements stimulus measures totalling AUD320bn. With APRA seeing Australia's big four banks as part of the solution to softening the economic blow from COVID-19, co-ordination and co-operation has increased in recent times. The government is coordinating with the big four banks to ensure rate cuts are passed onto affected borrowers, the Reserve Bank of Australia has provided a three year AUD90bn fixed rate lending facility at 25bps for banks to provide funding (banks can initially use up to 3% of their outstanding credit to domestic households and companies with additional funding available if banks increase lending to businesses) while APRA has deferred the scheduled implementation of Basel III reforms by one year and relaxed its minimum 10.5% CET1 capital ratio benchmark for 'unquestionably strong' capital ratios as long as the ratio remains above the minimum 8.0% requirement. Both actions are meant to provide 'additional operating capacity for banks and supervisors' to deal with COVID-19 impacts and ensure financial sector stability. Based on most recent full year or half year results, this should release lending capacity equal to around AUD550bn in credit risk weighted assets across Australia's big four banks. As a consequence of legacy as well as current systemic importance and support, the liquidity and funding position for Australia's big four remains solid despite some reliance on wholesale funding.

Fundamentals should prevail, but at what cost?

While we expect enduring fundamentals to prevail over the temporal event of COVID-19, the question remains at what cost. This is because the situation remains fluid with the uncertain duration of COVID-19. The longer the duration, the more the impact on existing fundamentals. To this end, the combination of the build-up of capital since the Global Financial Crisis, governments' economic stimulus measures and pro-active regulatory oversight should provide a floor to Australian bank credit profiles. Combined with the positive progress so far in containing the spread of COVID-19, we think the opportunity to return to some level of normality is relatively better in Australia and New Zealand. That said, there will be an inevitable mark on the economy and credit profiles of Australia's big four banks, the size of which we will only know in the passage of time.

Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Please note that Bond Recommendations are dependent on a bond's price, underlying risk free rates and an implied credit spread that reflects the strength of the issuer's credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.

Explanation of Bond Recommendation

Overweight ("OW") – The bond represents **better relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Neutral ("N") – The represents **fair relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Underweight ("UW") – The represents **weaker relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

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