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Banking royal commission: Strip AMP apart and unwind byzantine banks

A key flaw in David Murray's otherwise fine Financial System Inquiry was it failed to address the hazards of vertical integration. **Louise Kennerley**

by **Christopher Joye**

Arguably the apogee of the "vertical integration" of Australia's financial system, which this column has aggressively railed against for years, came in early 2014 when the banks (and AMP) convinced the Coalition to roll back the Future of Financial Advice (FoFA) laws. They did so to allow them to pay bonuses to financial advisers pushing in-house products under the most sensitive "personal" advice – as opposed to "general" advice – services.

The Coalition's misguided FoFA changes almost passed through the Senate, which at the last minute rejected them thanks to advocacy by this column and others like it. After the banks and AMP lost the FoFA war, most realised they would never be able to fully harness the planners they had acquired as sales channels. The vision of having the in-house planner push their financial supermarket's platform, deposits, loans, super fund and in-house managed funds, which the internal super fund would allocate to, was dashed.

Confident planners likewise recognised they would be better off positioning themselves as true independents where they had the freedom and flexibility to select the solutions that were, in fact, in the best interests of their clients.

There has since been a mass exodus of planners out of the financial oligarchy and a slow unwinding of the vertical integration process, with most banks looking to dispose of their fund managers, advisers, life companies and wealth businesses.

AMP's business model, which is irreversibly predicated on vertical integration, looks fundamentally broken and should be stripped apart and sold off in pieces to maximise the sum of its parts. The CEO's sudden resignation on Friday is but the first domino to fall.

A key flaw in David Murray's otherwise fine Financial System Inquiry was that it failed to address the hazards of vertical integration and conflicted remuneration. The royal commission and Productivity Commission have nevertheless picked up this baton, and will belatedly bequeath us with a much more "narrow" banking system,

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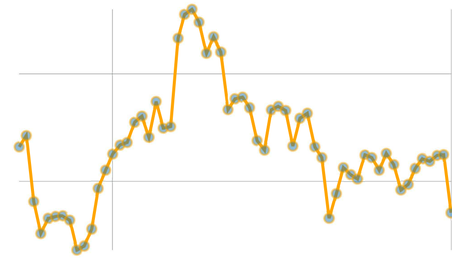
focused on simpler savings and loans, which we've needed for years. It is precisely the inherent complexity of our big banks that has made them so difficult to properly supervise.



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Skinnier returns

While our banks will ultimately have lower credit risks, they will also produce skinnier returns for shareholders. (AMP may cease to exist altogether.) This is one reason why the major banks' market capitalisation multiples of their book values, which in the case of CBA and Westpac rose to a world-beating 3 times, were completely unsustainable.

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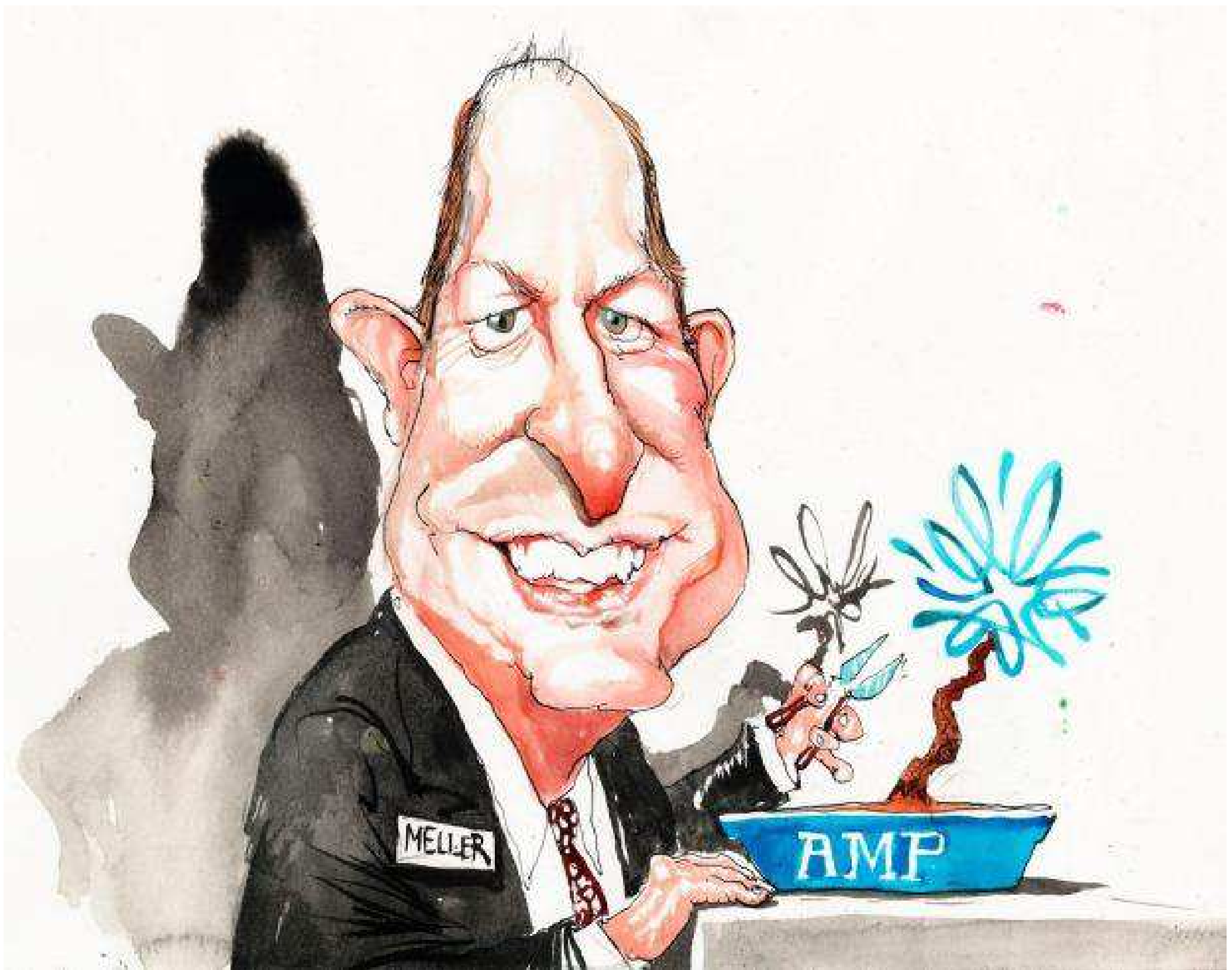
Since 2015 I've explained that as regulatory change and heightened competition forced the majors' returns on equity to approach their circa 10 per cent cost of equity, their price-to-book value multiples must, by definition, approach one. CBA, Westpac and NAB's price-to-book value multiples have since plummeted to 1.6 times today, while ANZ's multiple has fallen to just 1.3 times.



AMP's business mode looks fundamentally broken and should be stripped apart and sold off in pieces. Craig Meller is the first domino to fall. **David Rowe**

The royal commission has also lifted the lid on the admirably intrusive nature of APRA's surveillance of lending standards. This identified shortcomings in the banks' internal controls notwithstanding Australia has among the smallest mortgage default rates in the world (despite interest rates that have been elevated relative to overseas peers).

Counter-intuitively, this surveillance also documented the conservatism of smaller lenders like the Bank of Queensland, which comes out of APRA's review looking positively parsimonious relative to its bigger bank brethren. And yet historically, regional banks have reported mortgage default rates that have been loftier than the major banks. So what gives?

My hypothesis is that this has been an artefact of adverse selection driven by the regulatory dysfunction we first identified in April 2013, which permitted the major banks to leverage their home loan books more than 70 times while regionals were capped at less than half this number.

For very low-risk borrowers with modest loan-to-value ratios (LVRs), the majors' competitive advantage was actually far greater. Whereas regional banks were stuck applying their minimum 35 per cent risk weights against these products, the majors' risk weights could fall below 10 per cent. (The leverage ratio is simply the risk weight multiplied by the banks' equity ratio.)

The royal commission has also lifted the lid on the admirably intrusive nature of APRA's surveillance of lending standards. **Louise Kennerley**

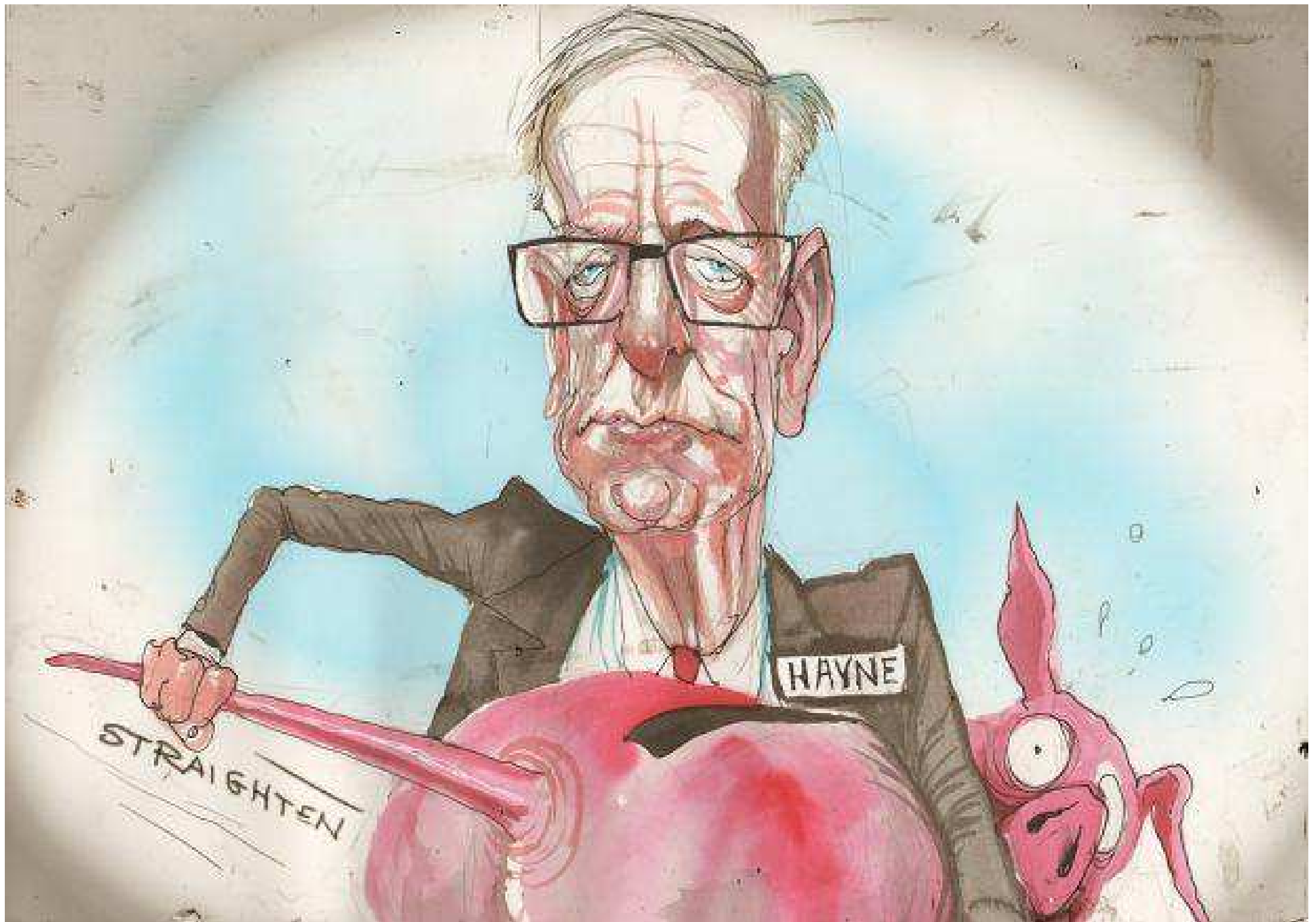
Ultra-cheap rates

In September 2014, Westpac reported it had more than $260 billion of home loans with average risk weights of between 4 per cent and 8 per cent, implying they were leveraged between 147 times and 294 times. The majors could, therefore, charge ultra-cheap rates and still earn extraordinary returns, which allowed them to dominate the low-risk (and low-arrears) sectors, shunting regionals into higher LVR categories with correspondingly higher risks. Thankfully APRA has come to understand these problems and is seeking to minimise them.

The credit assessment flaws APRA unearthed also afflict the loans that underpin residential mortgage-backed securities (RMBS), which is an increasingly popular asset class. This week CBA's fixed-income research team published a note highlighting that mortgage pre-payment

speeds – or the proportion of borrowers ahead of their scheduled payments – "are falling rapidly".

This has been fuelled by several factors including: rate increases on interest-only loans as APRA forced banks to reduce their origination of these products; falling home sales (a key trigger for prepayments); tighter lending standards that restrict a borrower's ability to refinance into a new loan; and the ongoing decline in Aussie house prices, which makes it harder to roll into another product as LVRs climb.



The royal commission and Productivity Commission will belatedly bequeath us with a much more "narrow" banking system, focused on simpler savings and loans, which we've needed for years. **David Rowe**

"With household debt-to-income at a record level, borrowers' ability to make pre-payments are likely to be stretched, especially if and when mortgage rates start to increase," CBA's researchers opine. "We expect unscheduled principal payments to continue to fall...[given] spare cash just isn't as plentiful."

This is important for RMBS, which are valued on a static assumption regarding borrowers' conditional prepayment rates (CPRs). As CPRs fall to near-decade lows, the weighted average life (WAL) of RMBS pools will rise beyond what investors assumed. The RBA has shown that

this sensitivity between WALs and CPRs also increases as one move downs into more subordinated RMBS tranches.

A decrease in CPRs also increases required risk premiums. This means that the $40 billion plus of RMBS that investors have blindly bought in recent years should be worth less for a given reduction in CPRs, which is another reason why we have exited the sector.

In the future non-banks will have profound advantages over their more heavily-regulated rivals. In this context it was pleasing to see Metrics Credit Partners raise $730 million via its listed trust (ASX: MXT). Metrics offers investors access to a new asset class – the unlisted and unrated corporate direct loan sector that has traditionally been dominated by banks. Backed by super funds and now retail investors, Metrics is a non-bank that finances businesses across Australia. It has an advantage over conventional banks insofar as it is not subject to the same regulatory rules, which can constrain activities.

MXT is diversified across around 71 corporate loans with an average maturity of less than three years, three-quarters of which are assessed by Metrics to be "investment-grade" (the remaining loans are sub-investment grade). It is distributing attractive annual income of 4.75 per cent. If you can get comfortable with Metrics' credit assessment process, this product can play a diversification role.

The author is a portfolio manager with Coolabah Capital Investments, which invests in fixed-income securities including those discussed by this column.

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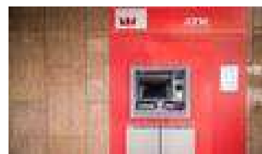

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