FINANCIAL REVIEW

HD **Great bank mysteries**

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Notwithstanding humans' innate desire to believe in basic answers to complex problems, solutions are often intricate. The secret to unravelling the most intractable puzzles is to pose simple yet penetrating questions that reveal underlying inconsistencies. Allow me to present a few examples investors of all stripes should consider.

Why isn't anyone asking what National Australia Bank is doing pouring its scarce **equity** capital – which the government will probably require it to increase in the years ahead – into a British **commercial property** business, given its heinous track record of burning **billions** of dollars in precisely this space?

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The irony of the situation could not be more acute. A couple of days after NAB said it was planning to punt shareholder cash on a highly pro-cyclical British **commercial property** fund manager, it disclosed another $605 **million** write-down of existing UK assets, which will contribute to a rare fall in full-year profits.

Only three months ago, NAB was forced to sell $1.1 **billion** of "distressed" **commercial property** loans from its beleaguered UK banking subsidiary, Clydesdale Bank, whose **commercial property** borrowers have been defaulting on their debts. NAB reportedly had to transfer $6.3 **billion** of Clydesdale's bad real **estate** loans to its Australian balance sheet, which it is now selling down.

This episode suggests Australian bankers have few comparative advantages in British financial services, which makes perfect intuitive sense. Yet, for some reason, NAB is allowed to mindlessly repeat its errors.

For years I've asked similar questions about ANZ's "super-regional strategy", which targets generating 30 per cent of its total profits from loans to companies and individuals in Asian markets, including Indonesia, Malaysia, **Hong Kong**, Taiwan, Singapore, India, the Philippines, Burma, Vietnam, and **China**.

These are foreign states with radically different languages, political systems and business cultures, and conflicting approaches to the regulation of banking, **property** rights, the rule of law and human rights. We all understand **China** is our largest trading partner and key export market for **iron ore** and **coal**, which Australia does have a comparative advantage in producing.Idiosyncratic risks

The question is what overriding **commercial** "edge" do Aussie bankers have doing business inside Asian nations? There is absolutely merit in facilitating cross-border trade with our import and export partners. Yet it is also reasonable to suppose our bankers will struggle to compete against local players with superior political and social capital, and knowledge of the unique credit risks that characterise overseas borrowers.

Invert the issue. How many foreign institutions have taken material market share away from the majors, which today control more than 80 per cent of Australia's core savings and loans sectors? The answer is none. Many have tried and failed, with only ING Direct and Rabobank surviving as marginal participants.

Analysts say far from being a high-reward opportunity, ANZ's risky Asian **operations** generate only 10 per cent returns, compared with 15 per cent to 16 per cent annual gains on its Australian activities.

A further issue for ANZ is that if 30 per cent of its profits come from Asia by 2017 and another 20 per cent originate in New Zealand, how can it continue to pay fully franked dividends to Aussie shareholders?

It is possible ANZ will ultimately be compelled to abandon its Asian adventures, as it did with its last foray into India (when it bought and **sold** Grindlays Bank). History teaches us the major banks tend to discard offshore subsidiaries when returns inevitably disappoint and management works out they cannot outwit (or properly supervise) the locals. But then a future CEO thinks he's brighter than his predecessors, and repeats the mistakes.

The more fundamental concern is that ANZ will expose its Australian shareholders, like NAB has done with its ill-conceived UK bets, to the uncertainty inherent in Asian credits that have idiosyncratic catastrophe risks. One only needs to reflect on the riots in **Hong Kong**, the combustible brinkmanship between **China** and Japan or the frequency of terrorist incidents in Indonesia to appreciate the instability these markets introduce into ANZ's business model.All-pervasive power

Here's a third puzzle. After several high-profile mis-selling crises over the past decade, you would think someone at these institutions would have asked the question: is it really a smart idea for us to **buy** (or legally align) most of Australia's independent financial planners, which have an obligation to act in their clients' best interests, and then seek to conflict them by paying sales bonuses for flogging our products?

Surely somebody could have figured out treating financial advisers as just another sales channel like branches would risk polluting both the planners' and the banks' brands? Apparently not.

This brings me to my final question: does it make sense to give four banks unpriced taxpayer subsidies that allow them to raise funding more cost-effectively than anyone else; regulation that enables them to hold less capital than their peers; and, finally, let them exploit the ensuing market power to consolidate other industries?

This "vertical integration" is now the heart of the modern major bank enterprise. You start by using your cost-of-capital edge, which is a function of your size (and thus begets more scale), to dominate conventional savings and loans. Whenever chance affords, you gobble up competitors to bulk up more (think St George, BankWest, Aussie, RAMs, Wizard, Challenger's lending **operations**, etc), peddling the line "too much competition undermines financial stability". You then co-opt regulators into letting you hold more leverage than peers, which means your economic advantage is unassailable.

Having expanded as far as you can within the main financial system, which you have effectively become (and cannot therefore grow more rapidly than), you use your world-beating profits to power into other industries. So you acquire most of the fund managers. You build or **buy** investment banks and **equity** and debt capital broking businesses for retail and institutional customers. You internalise financial planners to boost your branch networks.

And you create superannuation products that your now all-pervasive distribution networks' footprints can push to help you control the retirement income system.Investors' only hope

With your foot on the throat of every link in the financial value chain, you can cross-subsidise and price both new threats and existing competitors out of markets while also stealthily restricting third parties' access to your own clients. Your "administration platforms", which are like electronic walled gardens that connect customers and advisers with, in theory, all publicly available financial solutions (no third-line forcing here!), naturally have "approved product lists", which take years (if ever) for innovative new entrants and competitors to be accepted into. In this way, you limit choice and customer mobility under the rubric of risk management.

This python-like approach has been previously proven with deposits and loans. The banks control the so-called "payments system", which has to date prevented real-time transfers of our savings between institutions. Very convenient. And they have rationally resisted creating common electronic connections between institutions that would facilitate real-time switching of credit cards, personal loans, **residential** mortgages and the associated customer data.

The "universal bank" today clips the ticket everywhere you turn: on the customer's financial advice, the products the adviser recommends (including the savings, loans, insurance, super, and the shares and managed funds the super is allocated across) and the administration of all of the above.

It is the financial equivalent to Woolworths, where the banks also own the farmers, the food and beverage suppliers, and the product manufacturers. Or a pharmaceutical **company** that owns the doctors (and can pay them to spruik medicines).

Investors' only hope is that Treasurer Joe Hockey's financial system inquiry, run by David Murray and a band of former bankers who have not publicly disclosed their conflicts, ask and address these questions.

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