Bashing the banks could bash you

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Be wary of bank bashing. Source: Getty Images

NEXT Tuesday, the Reserve Bank will almost certainly cut its official interest rate.

If it does, the banks will just as certainly cut their lending rates by less than the RBA's 25 points.

All hell will break loose in the media. Heck, look what happened in December when all the banks did cut by the full 25 points. It's not hard to imagine the increased media decibel level when this time, they don't.

True, much of the frothing in December was driven by the fact they didn't cut immediately.

The perceived 'success' of the coalition of media and outraged politicians led by the treasurer Wayne Swan, in forcing the wavering banks to end up "doing the right thing" will just fuel the coming frenzy.

Indeed media and almost all the public will be of one mind. The banks are greedy; they are ripping you/us off; or at the very least, they could 'afford' to forego some profit.

I suggest that in some not insignificant part, much of the public outrage is driven by a fundamental misunderstanding of the RBA's 'official cash rate,' and so what happens when it 'cuts it.' Or increases it.

This misunderstanding operates on two levels. The first is that word 'official.'

It will be seen by many as a government mandated order. Simplified, interest rates are being 'officially declared' to come down by 25 points. So when they don't, the banks are defying authority.

The second, bigger, misunderstanding, is a belief that the RBA is cutting the rate it charges banks for their money by 25 points. So that when they don't cut their lending rates by 25 points, they are pocketing some of that. They are profiteering.

Without getting too complicated - for those interested, a full explanation of what the cash rate is and how it operates, is on the RBA's website - except in certain very special circumstances not relevant to this discussion, the RBA doesn't lend the banks money and certainly not 'at' the cash rate.

What the cash rate does is influence the level of all other short-term rates in our financial system.

In more normal times, there was a pretty seamless flow-through of the cash rate changes to all other rates. But not now in this turbulent global context.

That's exactly what the banks are trying to say; and they are telling the truth. The RBA Governor, Glenn

Stevens, no spokesman for the banks, has said as much.

If what he's said has been somewhat muted, and neither treasurer nor the media have had any particular interest in amplifying his comments.

Stevens will almost certainly be saying it again, when he next gives evidence to the politicians about the state of the economy. Perhaps he will increase the volume himself.

Let's be very clear. The banks - and bankers - are no corporate manifestations of Mother Teresa. But they play an absolutely critical role that spans every aspect of our lives.

What's much worse than a greedy bank is a shaky bank; what's worse than an overpaid banker - and yes, they are overpaid at the senior executive level - is a non-existent banker.

This points to the bigger and more serious issue in all this.

Bashing the banks, and 'succeeding' in curbing their profits, is the first and rather big step to compromising the absolutely vital - and casually taken for granted every day - confidence in both the overall financial system and the individual banking entities.

Let's start with those humungous profits; I'll use the numbers of the biggest bank, the Commonwealth, for illustration.

Last year the CBA made a profit of $6.7 billion. That might look big - it's certainly bigger by any measure, of the profits of almost all the Irish, Italian, British, American, etc, etc, banks. But that doesn't say much.

It's enough to buy around 13,500 half-million dollar homes. To me, that doesn't sound quite so big. That's not that many homes, and it'd be gone.

A more interesting comparison is that the total profit of all four big banks, the CBA, Westpac, the ANZ and NAB, last year added up to just a little bit more than the profit of BHP Billiton.

OK, you might respond; that's a good case for the resources super-profits tax. But looked at in the other direction, again, that's not that big a number for what is almost our entire financial system. Employing hundreds of thousands of people and lending more than $1500 billion.

In the case of the CBA, it had total loans out of $576 billion. So the $6.7 billion profit was a profit of not much more than 1c on every dollar of those loans. It does not take many loans to go bad to wipe out that very thin margin.

The CBA seems to be super-profitable. Last year it earned nearly 20 per on its capital base. That's much more than the 10-12 per cent of other non-financial companies.

But there's a very, very big difference. Banks are very highly geared. In the case of the CBA, its total assets of $668 billion rested on a capital base of $37 billion.

The other $631 billion is (broadly) borrowed. If each loan lost not much more than 5 per cent, the capital would be entirely wiped out. That's the risk of gearing.

The upside, as any business student - and indeed anyone who's negatively geared a property - knows, is that gearing can dramatically increase your return.

With gearing of 18 times its capital, the CBA 'should' make a return, much, much higher than 20 per cent. Those 'normal' companies making 10-12 per cent would be mostly geared at less than just one times capital.

That the CBA doesn't make a profit of, say, 100 per cent of its capital, to reflect the higher risk of its very high gearing, is part of the complex 'social contract' of the place of banks in our economy and our society. Helped also, by competition.

Banks are traded the ability to highly gear, so that more funds are generated for lending to business and homeowners. In return, they make an implicit, and to some extent explicit, commitment on profit levels and prudence in their business practices.

The absolutely critical binding glue for the social contract is confidence in the individual banks and the system. So promiscuously putting that at risk - as a number of treasurers from Paul Keating to now Swan, have done – is appalling and very, very dangerous. Especially in today's context of global fear and loathing.

It's going to be a long and challenging year. Is it also going to be a year of unremitting, very stupid and dangerous bank bashing, that would ultimately hurt us?

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