FINANCIAL REVIEW

Return on equity for Canadian banks is higher than Australia's big four

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"The best example of a comparable developed market is Canada," said CBA's Ian Narev on Tuesday. *Andrew Meares*

by **Vesna Poljak**

Australia's bank bosses fronting the parliamentary inquiry have sought to play down the returns they earn by drawing a parallel with banks in Canada, another commodity economy similar in structure.

In this respect, the big four chief executives are correct. But in reality, comparisons with Canada flatter Australian banks, in the eyes of some investors.

That's why global investors are lining up short positions betting that share prices of Canada's big five banks will fall. Beyond having a similarly hot housing market and a national reliance on commodity prices, Canada's prudential regulation and lending standards are arguably weaker than Australia's, and Canadian banks are believed to be underdone on capital levels whereas the big four raised $20 billion last year. There is also uncertainty about the extent of derivatives exposures among Canada's banks.

Watermark Funds Management has added short positions against some Canadian banks to its portfolio, amid significant interest in the trade. Marc Cohodes, a high-profile retired hedge fund manager-turned-private investor, has also generated headlines for his bearish views.

"We're actually short the Canadian banks at the moment because they look like they're at where Australian banks were a few years ago, before the financial system inquiry and APRA's changes to capital requirements," said Omkar Joshi from Watermark, who also argues Canada's government-insured mortgages disincentives prudent lending.

"Canadian banks' RoEs are pretty similar to Australia but their RoAs (return on assets) are lower than Australia. Australian banks have been de-risking but have not materially de-leveraged. The short interest in the Canadian banks is fairly high."

The average return on equity is 13.8 per cent for an Australian bank compared with 14.8 per cent for a Canadian bank. The Reserve Bank of Australia has signalled that Australian bank return on equity is falling, a forecast that the big four banks do not dispute.

GFC survivors

Mr Joshi estimates that leverage ratios in Canada are 20-times versus 16-times in Australia. "Both countries survived the GFC mainly because of the commodities boom aiding their economies. But APRA doesn't credit itself entirely with getting us through the GFC whereas in Canada the regulator's patting themselves on the back for the outcome," Mr Joshi said.

Indeed, the survival of Canada's financial institutions through 2008 and 2009 is a source of pride, given how poorly Wall Street banks in the United States fared.

"The Canadian banks had a tough time in the late 1980s, early 1990s, which saw the failure of some smaller Canadian banks exposed to domestic housing and commercial real estate. This resulted in stricter regulation being put in place prior to the GFC and consequently no Canadian taxpayer-funded bailouts during the GFC," said Hugh Dive, a fund manager at Aurora.

"In terms of market concentration the Canadian banks have a deeper involvement [in] wealth management and more importantly into the capital markets than the Australian banks, which explains their slightly higher RoE."

Structurally, Canada's financial system is also "fairly closed" to foreign lenders with the five big banks lending mainly domestically, Mr Dive said.

Other global investors prefer US banks. Garry Laurence, from Perpetual, does not own any Canadian lenders. "It's probably a function of the Canadian economy being a little bit weak over the past few years because of weaker energy and material prices, and also just valuations of the Canadian banks don't look appealing," he said.

He is an investor in Wells Fargo, ING, and Julius Baer. Return on equity for US banks is lower, but "the RoEs are depressed because of interest rates being so low. The benefit to the US banks is that RoEs will rise as interest rates rise," he said.

On Tuesday, Commonwealth Bank of Australia boss Ian Narev told Canberra: "The best example of a comparable developed market is Canada."