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The banks at risk of an Aldi moment - sell!

Tim Farrelly | farrelly's | 14 September 2016

An absolute barrage of reasons are being thrown up as to why not to buy Australia's major banks – most of which sound impressive until you do the maths, but then they just don't stack up as reasons not to buy.

The latest idea is that the banks face the risk of an Aldi moment – the risk that our extraordinarily profitable banks may have their margins taken away by a well resourced disrupter. This risk is, of course, absolutely real. But should we not own banks, as a result?

Consider that proposition for just a moment. It implies that we should not own any business that is capable of being disrupted. In other words, we should never own any business.

Leaving that extraordinary notion behind, look at the risk of disruption to the banks' mortgage lending businesses, a large driver of profits. The banks earn very high Return on Equity (ROE) on their mortgage lending businesses, making the area an obvious target for a disrupter. But how easy would it be to disrupt?

We need to look at the underlying economics. Firstly, the major banks offer new loans at interest rates of around 4%. To gain significant market share, a disrupter would probably have to offer a home loan interest rate of, say, 3.6%. On top of that, a disrupter would incur costs of administering the loan portfolio of, say, 0.8%, if they can match the banks operating costs. This is no small ask given the immense scale of Australia's major banks. But let's assume that a disrupter can do it. To just break even, a disrupter needs to fund this new enterprise at a cost of lower than 2.8% per annum. What investor would provide funds to the disrupter at this rate? Certainly not a wholesale investor. So the disrupter would need to attract retail deposits by offering a rate well under 2.8% – not impossible, but very, very hard.

The major banks' risks and strengths lie in their existing book of business. Under attack, they could choose to cede new business to a disrupter. If they can maintain current loans at current margins, the major banks would still make excellent returns. If a disrupter can unpick the major banks' existing loan books, then the banks would have real issues. But all of this is very hard to do. For many families, the home loan is the biggest single expense. A home loan is just a home loan – it should be the ultimate price sensitive product. But, yet, after years of low cost competition, the banks still maintain healthy margins.

Just because an Aldi moment for the banks is not particularly likely is not to say that it is impossible. No business is immune from competitive disruption. So assume that a disrupter is successful and that the major banks' high returns are competed away. ROEs of around 15%

are reduced over time to, say, 9%. Is it a disaster? Not really. Returns over the next decade would fall from an expected 12% per annum to around 7.5% per annum – which is not so shabby in a low return world. Once again, those avoiding the major banks are also avoiding doing the maths.

The idea that we should spurn investment in the major banks because of the potential for disruption? It's nuts. And you can clearly see it's nuts.

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