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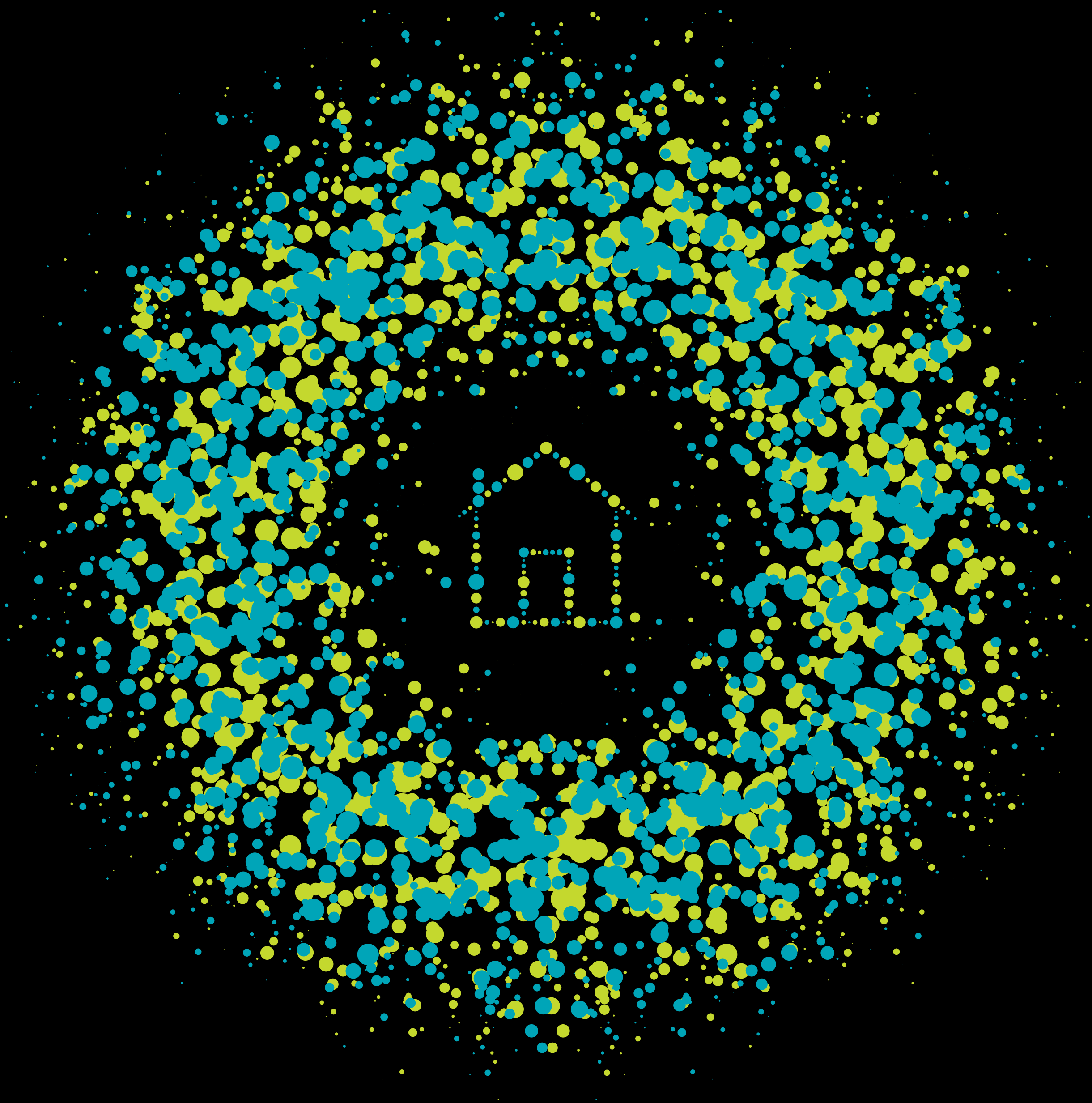


Finding focus in a complex market

Mortgage Report 2017

12th Annual Deloitte Australian Mortgage Report

Funding: Explaining the gap

Deloitte Financial Services Advisory Partners Heather Baister and Graham Mott *consider why pricing of mortgages is more of an art than we realise and the criticality of educating all Australians on the funding balance.*

In 2016 bank funding costs were under a spotlight to an extent never seen before. The CEOs of major banks were quizzed by the House of Representatives Economic Committee and there was a passionate debate as to the role of banks in society.

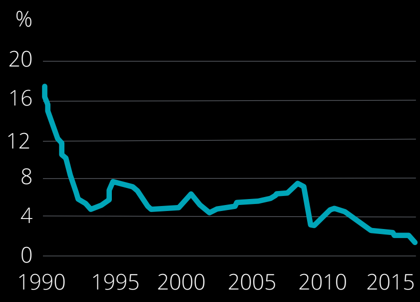
One of the key areas banks were eager to clarify was their funding and in particular, the link to the cash rate. While most Australians may struggle to understand why a change in the cash rate does not correlate to an exact change in mortgage rates, pricing of mortgages is far more of an art than most of the public are aware.

The RBA cut interest rates twice in 2016, by 25bps each time. This was prompted by weak inflation results and predictions, and a desire to return inflation to target over time. Much media commentary was focused on the extent to which these cuts were passed on to the end consumer. Many banks used the cuts, as an opportunity to rebalance their net interest margins (NIM), given the global focus on capital and the continuous need for book growth.

In response to the August 2016 rate review, the banks passed on part of the cut, to mortgage borrowers and to depositors. This move was publicly criticised when, after a relatively short period of time, deposit rates were scaled back. B anks need to be alert to attributing any reduced cuts to aiding depositors in the future. Depositors are integral to bank funding strategies. Given the wider international regulatory environment for banks with its emphasis on liquidity and stability, there remains a continued focus on reliable deposit funding. Domestic deposits across the Australian market, have remained relatively stable for the last two years at around 58-59% of bank funding, with the majors' proportion of deposit funded trending slightly higher.

Deposit management continues to focus on product mix, including the impact of the growth of offset accounts, which continue to grow by 10%+.

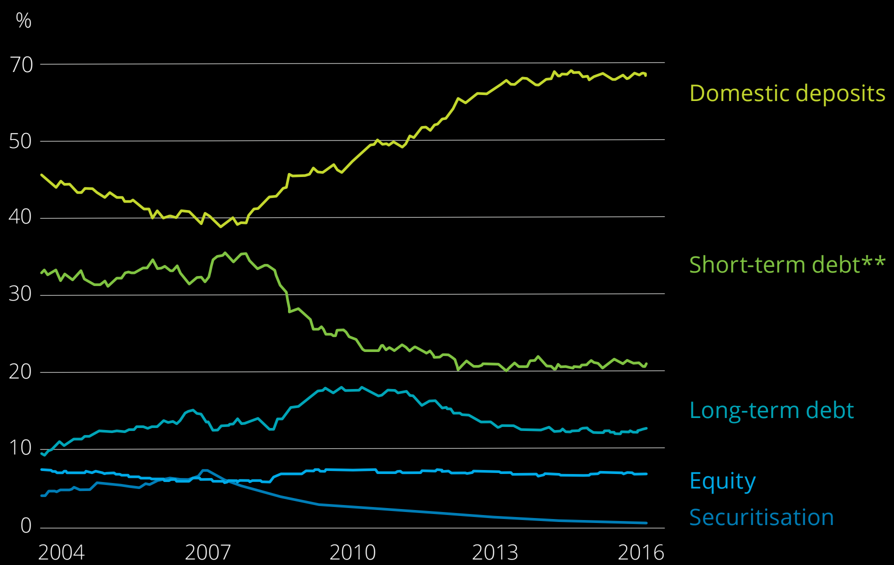
Reserve Bank Australia Cash Rate



Source: Reserve Bank Australia

Funding Composition of Australian Banks*

Share of total funding



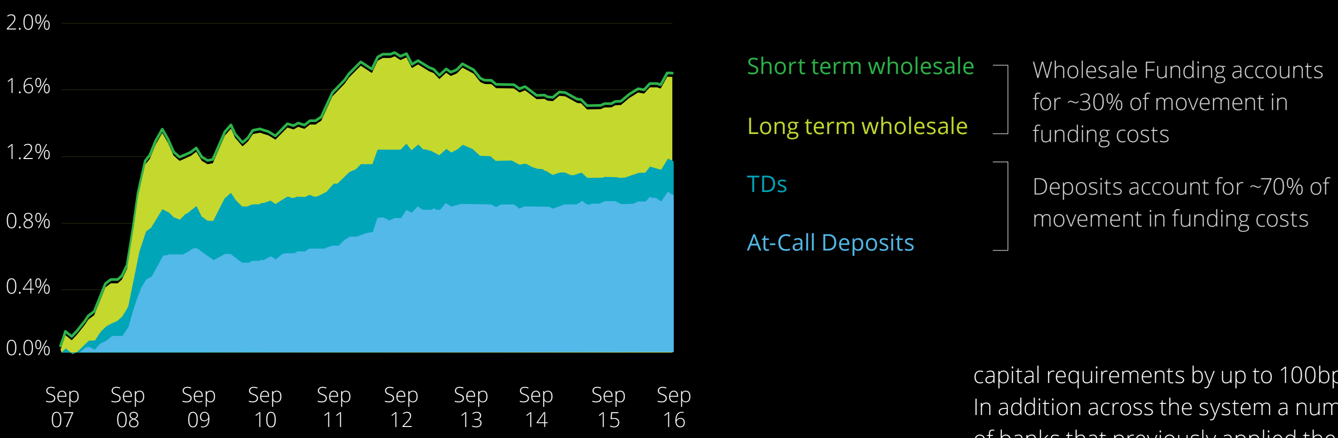
* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

** Includes deposits and intragroup funding from non-residents

Source: http://www.rba.gov.au/publications/submissions/bank-fees-and-margins/handout-standing-committee-on-economics-2016-09-22

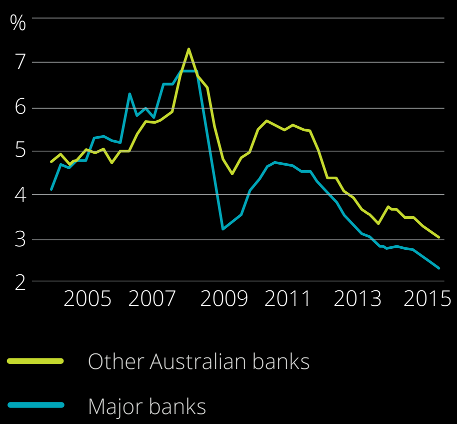
Weighted difference in home loan funding costs to official cash rate

Increase in funding costs relative to official RBA cash rate driven mainly by increased competition for deposits



Source: ANZ Bank [1]

Weighted average funding costs (per cent) for the major and other Australian banks



Source: RBA, Developments in Banks' Funding Costs and Lending rates

Not an island

International events can also impact the cost of funds. The economic turmoil in Europe in recent years effectively froze portions of the debt markets.

The rise of Trump during 2016 also caused disruption in funding markets while participants waited to see long term impacts. Approximately 70% of the banks overall wholesale funding is from international investors, and therefore it is important to have a constant eye on events overseas.

These offshore funding sources are vital for major banks that need greater access to markets and a range of investors, and are key contributors to understanding the gap between funding costs and cash rates.

Another key area which cannot be ignored when understanding the complexity of banks' funding, is the impact and continued focus on capital by our own regulators and those globally.

As APRA and the 2015 'Murray' Report into banks has specified; banks need to be 'unquestionably strong'. The major banks benefit from a perceived 'too big to fail' advantage over mid-tier banks, which impacts their funding costs, an advantage estimated by the RBA as far back as in 2013 to be worth $3.7billion.

However this advantage should diminish as capital holding requirements increase under Basel's intentions to reduce the variability between IRB banks, and those applying the standardised model. APRA implemented higher risk weights on Australian mortgages measured under the IRB approach on 1 July 2016, which is estimated to have increased the bank's capital requirements by up to 100bps. In addition across the system a number of banks that previously applied the standardised model have applied to APRA to move to IRB which will reduce the extent of the gap between majors and some next tier lenders.

At 10% of risk weighted assets, the major banks' CET1 ratios are well above the regulatory requirement, even after the high risk weights took effect.[2]

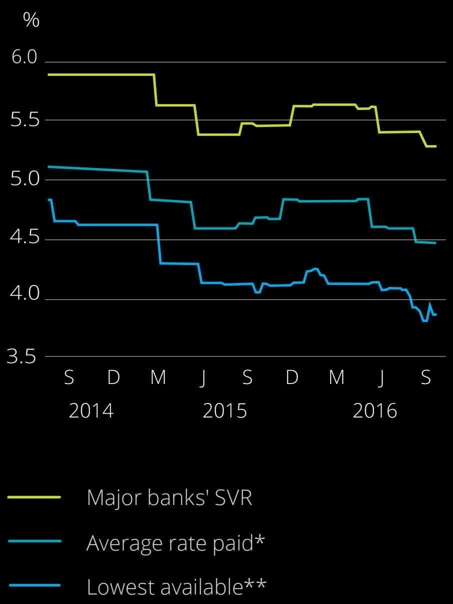
The major banks have been issuing additional capital throughout 2016 which has strengthened their international standing. An APRA international capital comparison released in 2016 showed that as at December 2015, the major banks had moved into the top quartile of international banks. However the trend for increased capital issuance has and will continue internationally. Therefore if the majors wish to remain in the top quartile, to demonstrate that they are 'unquestionably strong', they will need to keep increasing their capital ratios.

Impact on mortgages

The contribution of mortgages to the profitability of the major banks is still highly significant, despite the increased capital requirements. The retail banking arm, powered by mortgages, is by far the largest contributor to underlying profitability, and to the return on equity (ROE) by which all the large banks are measured.

1. Investor Discussion roadshow pack November 2016
2. RBA Financial Stability Review October 2016

Variable Housing Interest Rates



* RBA estimate for existing stock of mortgages
** Indicator based on selected lenders' lowest available advertised standard variable rates

Sources: ABS, APRA, Canstar, Perpetual, RBA

According to APRA during 2016 the ROE across the Australian banking market fell 23% compared with 2015. This would explain why banks absolutely have to focus on funding and capital management in 2017 and beyond. Because of this, we also expect that funding will still get primarily diverted to 'safe' mortgages over other, more capital intensive, asset classes with less predictable returns.

ROE was also impacted by the higher capital levels noted above, alongside a decline in interest rates that has impacted income for many lenders. Australian banks with their recent ROEs of 10%-15% are still high by international standards. However they are lower than shareholders and investors in Australia have been used to. The pressure to maintain ROE is acute, and it will drive decisions about rate movements and repricing the front books in particular.

This is why Australian banks need to protect their NIM in order to sustain ROE. Already this year the average rate for borrowers dropped below 4.5% for the first time in years, with an increasing discount between the benchmark Standard Variable Rates (SVRs) and advertised rates.

We note that only a small proportion of borrowers will actually be able to attract the headline-grabbing sub 4% rates, but significant discounts to SVRs are still available to most borrowers or refinancers.

These discounts only affect new borrowers and refinancers, as the back books are not repriced accordingly. (See page 24 for discussion on some of the challenges regarding pricing front vs. back books).

While APRA's activities have challenged bank profitability through increased capital demands, its investor lending oversight has resulted in banks raising rates to manage growth within prudential restraints. As a side effect this has increased investor lending NIMs, albeit not sufficiently to offset the increased capital costs.

Pressure on NIM, and wanting to avoid the political and social pressures of 'unwarranted' out of cycle rises, has led some banks to re-focus on their fee arrangements and product suites, to support the bottom line.

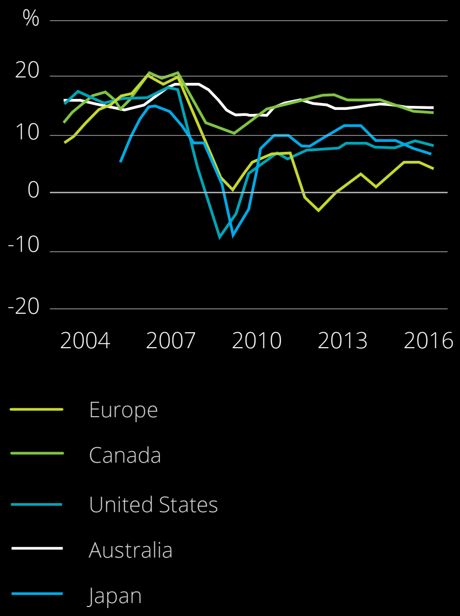
Other Funding Options

Securitisation continues to be a small portion of the overall Australian funding market, predominately used by non-bank lenders with an approximate share of the RMBS market of 25% compared with 5% pre-GFC. This is partly due to pricing on RMBS deals remaining challenging. While they have reduced from the spike at the end of 2015 into early 2016, these are still higher than equivalent issuances two years ago.

Direct link of cash rate to mortgage rates

- One solution, offered for the first time in Australia in 2016 to 'solve' for the misunderstanding between cash and mortgage rates, is the 'tracker mortgage'. This is a mortgage where the rates offered to customers are directly linked to movements in underlying cash rates.
- Proponents of tracker mortgages say they provide consumer certainty, comparability, competition and enhances understanding of what is behind the rates.
- Historically they have been very popular in Europe, however there are some significant concerns from some members of the banking community about their suitability in times of liquidity stress. This reflects the inability of banks to raise funding to match the duration of the mortgage.
- In addition, the 'disconnect' between cash rates and wholesale market rates can be significant, and prove a real threat to ongoing viability in non-liquid markets.
- As a result of these funding and liquidity risks, the tracker mortgages will need to be priced higher than other products offered by the bank. Accordingly our view is that tracker mortgages may be appropriate for a small cohort of customers, for a limited short term period which matches available funding (for example three years), and offered as a part of a suite of products.

Large Banks' Return on Equity
After tax and minority interests



* Number of banks: Australia (4), Europe (52), Japan (4), Canada (6) and United States (18); adjusted for significant mergers and acquisitions, reporting periods vary across jurisdictions

- The major Australian banks' return on equity has averaged around 15 percent over the past decade.
- It is similar to the return on equity for large Canadian banks, but higher than in United States, Japan and Europe

Sources: Bloomberg; RBA; S&P Global Market Intelligence

Senior unsecured debt is also treated more favourably than RMBS for NSFR purposes, making securitisation a relatively expensive funding tool for large banks.

Self securitisations continue to be a key tool however for ADIs, with APRA encouraging smaller ADIs and mutuals to establish such transactions so they can access the Committed Liquidity Facility from the RBA.

We expect that the market in 2017 will not change significantly for RMBS or ABS asset classes, however now that APS 120 *Securitisation* has been finalised, there will be some returnees to the market, now that much of the uncertainty is resolved.

Looking ahead

As we look forward, another question regarding the costs of funds, and therefore a potential wider gap between cash rates and consumer mortgage prices, is the focus on the sovereign rating.

If Australia loses its AAA sovereign rating, this will inevitably flow on to a downgrade of the Australian banks which are currently all rated AA to A. The impact of this has been estimated as increasing funding costs by between 10 bps to 20 bps[3].

This would flow through to the underlying borrower, on top of the continued costs of regulatory capital and liquidity, and further exacerbate the gap between the headline cash rates and the actual cost to consumer.

The more the industry can do now to educate consumers, the media and politicians, as to the balance of considerations from both local and international perspectives, including the need for strong banking institutions within society, the easier it will be to focus the debate on other pressing issues within the industry.

3. https://www.nationalaustraliabank.com/nabglobal/en/blog/2016/09/201609_AustraliaRating

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