Australia and New Zealand Banking Group Limited

Response to Questions on Notice following 5 October 2016 House of Representatives Economics Committee Hearing

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Question

Mr CONROY: Mr Elliott, can you tell me—and I am not asking for specific product lines—in your credit card part of your business what your return on equity is over, say, 10 years?
Mr Elliott: I think you went through this yesterday with another bank. It is difficult for us to disclose that without giving away competitive information. The reality is that returns on the cards business are higher than average. That is undoubtedly true. They have been reducing at a fairly healthy rate, at a fairly fast rate. Over the last 10 years they have come down a lot. That is to do with the fact that there are increases in terms of the cost of running the programs and there is the increasing cost of the rewards programs, which is one of the prime drivers that attracts people to that product, and so the returns have absolutely come down. Are they close to the cost of equity? No. They are still above our group average.
Mr CONROY: Well above? Are we talking 30 or 40 per cent?
Mr Elliott: Our group average ROE is 12 per cent. We reported at our first half 9.5 per cent ROE, so, yes, they are above our group average but are coming down.
Mr CONROY: Well above?
Mr Elliott: They are well above and they are coming down. The cards business is not a growing business.
Mr CONROY: Will you disclose to this committee—I am not asking for individual products; I am asking at the general product level—your returns on equity over the last 10 years for your credit card business, your personal loan segment and your housing loans segment?
Mr Elliott: We are happy to make some disclosures around that with some caveats. Partly the reason there is resistance around that is having been a former chief financial officer I know that ROE is not as an exact science as it might sound. Part of the reason for that is in this simple example. We run a branch network. It costs a lot of money. In order to calculate the ROE on cards versus personal loans versus mortgages I have to allocate the cost of that branch network to those products. How exactly you do that is an art not a science, so you can get very misleading answers by looking at it. But, in general, we are happy to give you the broad returns and trends on those products.

Response to Questions in Writing following 5 October 2016 House of Representatives Economics Committee Hearing

Question asked by

Mr Bandt

Question

In relation to return on equity:
What is the return on equity (ROE) on mortgages?
What is the return on equity (ROE) on credit cards?
What percentage of the ANZ's overall ROE is attributed to home loan business?

Answer

Mr Elliott undertook to provide information on broad returns and trends, noting that there is considerable variation and uncertainty about how Return on Equity (ROE) is measured.

Measurement issues

ROE is the Return on Assets (ROA) multiplied by leverage (the ratio of assets to equity).

- ROA is net income divided by assets.
- Net income is a combination of net interest margin, operating efficiency, credit loss rates, and an allocation of overhead and common costs.

A product level ROE calculation involves assumptions about each element of the definition. Key issues are:

- Product level equity is usually estimated by banking analysts based on regulatory capital requirements. Banks do not actually hold 'equity' in dedicated accounts against particular product groups. Rather, banks are required by regulators to hold an overall amount of capital based on the aggregated capital requirements for all products they offer.

  Additionally, to remain 'unquestionably strong' from a capital perspective, banks may hold more capital than the amount determined through those aggregated capital requirements.

- ANZ like other full service banks provides a bundle of services to customers – customers value the convenience and utility of the bundle of services. In operational terms, banks also use infrastructure and services like branches and security systems to support many products. Banks do not sell services nor operate on the basis of standalone product 'silos'. As a consequence:

  - Measuring a standalone product ROE involves many assumptions about which costs are counted and how. ROE and ROA will be misleadingly high if the full costs of the business are not counted. For example, if the measurement of net income only includes directly attributable product costs (eg product marketing), but not costs that are common across a number of products (eg brand marketing, branch costs, common IT systems). If costs are narrowly defined, ROEs will at best be partial indicators.

    Common and overhead costs are very significant in 'network' industries, such as banking, where common infrastructure such as branches, call centres and information technology serve many products. Assumptions about how to allocate overhead and common costs are not straightforward since there will be no direct relationship between a single product and these costs.

    Bundling of products supported by common infrastructure will often be the most efficient means of producing services. Full service banks are competing with single product businesses (such as a standalone provider of consumer mortgages). Through competition, the most efficient form of provision to meet different needs would be expected to emerge.

  - Standalone ROE can be misleading for lower risk products. Less capital can be held against a lower risk product while maintaining a prudent approach. Specifically, Australian home mortgages often appear high return because they are relatively low risk and both regulators and banks will require a relatively low level of capital held against the product. A more appropriate measure of profitability would be ROA (1.1% in H1 2016 for ANZ Australia division).

  - The treatment of fixed assets will also affect how ROE is measured. For example, fixed assets can be measured on a depreciated historic basis, replacement or future requirements basis. Consistent with regulatory practice generally, it is arguable that a forward looking methodology should be employed rather than historic view if policy makers sought to assess appropriate cost structures.

- Credit loss rates should be assessed 'through the cycle' rather than at a point in time. Prudent banking requires that pricing takes into account losses that arise in adverse as well as benign economic periods. Small increases in losses will have a substantial financial impacts given that the margin on assets is around 1%.

- ROE does not take into account the market value of the business. Internally generated goodwill or brand value cannot be recognised under accounting standards but nonetheless have real economic value. If recognised, they would result in economic returns on equity that are substantially lower (~5-7%) than the accounting-based returns on equity.

Analyst estimates

Reflecting the issues noted above, there are many differing analyst estimates of product ROEs. As analysts rely on publicly available information, they will generally calculate a simple product ROE based on estimated margins and capital allocations, rather than taking into consideration detailed cost allocations:

- In October 2016, JPMorgan published a report on Australian mortgages ("Australian Mortgage Industry Report") that estimated that the ROE on major bank originated mortgages was around 25%. It noted that non-mortgage ROEs were currently likely to be around 10% as a result of competition and increased regulatory requirements.

- In June 2016, Macquarie ("Australian Banks") estimated that major banks ROE returns on new mortgages were between 12% (most recent) and 31% (historic) depending on the nature of the lending.

- In December 2015, CLSA ("Australian Banks") estimated the ROEs on owner-occupier mortgages were between 35% and 49%, and for investor mortgages between 47% and 64%.

ANZ comments

ANZ has seen ROEs come down consistently across all product classes reflecting strong competition and the financial impacts of regulation (for example, the requirement to hold more capital, interchange reforms).

Slides provided to the Committee on 5 October showed:

- ROE at the ANZ Group level had decreased from 20.9% in FY2007 to 12.2% in 1H2016.

- Over the period from 2005 to 2015, better customer pricing reduced returns by the equivalent of 5.1% ROE and regulatory requirements to hold more capital had reduced returns by the equivalent of 8% ROE.

- Efficiency improvements have allowed ANZ to recover around 8% ROE of this decline.

The returns on equity for key consumer products have fallen by approximately 3 to 4% since the introduction of Basel 2 in 2008. We consider that the JP Morgan October 2016 estimate of mortgage ROE is overstated by ~5%. We suggest that the cost allocations used in this accounting-based estimate understandably may have been broad and based on available statutory reporting.

The ROA for home mortgages sits around ~0.65%. A relatively higher standalone mortgage ROE is the result of relatively high leverage, for which shareholders will reasonably expect to be appropriately compensated.

The returns on equity for credit cards are coming close to those of home lending while personal loans returns on equity are modestly higher given the higher inherent risk in that product. These unsecured products have high through-the-cycle loss rates.