House of Representatives Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Review of the Australian Prudential Regulation Authority Annual Report 2022

02 June 2023

Division/Agency: Australian Prudential Regulation Authority
Question No: APRA-ED01QON
Topic: **Net Interest Margins and Return-on-Equity**
Reference: Spoken (Hansard Page 19)
Member: Daniel Mulino

Question:

CHAIR: As I mentioned, the measures we've been tending to look at, which is very much guided by what the experts look at, is market share of the big players, and entry/exit mark-ups. My next question was going to be about the net interest margin and return to equity. You're understandably consciously wanting a system where the big players are stable and, as you say, you're the safety regulator. Obviously from a competition perspective you don't want to see net interest margins or return to equity getting to levels that are inappropriately high as a result of market power. Where do you see net interest margins both at the moment and over the cycle, if you will, and how do we compare to similar economies?
Mr Lonsdale: I will have to come back to you if you're interested in the last part of the question on similar economies. I don't have that with me. NIMs have been under pressure of late. We don't forecast NIMs. In a sense they're a by-product of what the banks are doing, but it is an important indicator of their profitability, if you like, which we are interested in, and how they're operating, where they're operating and competition. We don't have a particular house view on where that's going, only to observe that it has reduced more recently.
CHAIR: Does it move quite a bit cyclically?
Mr Lonsdale: If you give me a moment, I can see if I have got that information. I'll come back to you on that.
CHAIR: I will put that on notice.
Mr Lonsdale: We'll certainly have that information, the time series.
Ms Roberts: I think it would be good to come back to you on that. Just anecdotally, there was a period recently where the banks, probably all of them, felt as though they were writing business below their cost of funding. It was a very hot market, as we've seen in the refinance numbers. Some of them have pulled back from that a little bit to obviously protect their margins. In terms of magnitude of variation over time, little changes have big impacts to banks' bottom lines. You won't see big swings, but I think we'll get you a time series and that'll help your analysis.
Mr Lonsdale: That would be good. I've got data just to 2019—at 1.72 for the NIM; now it's at 1.64. So, some tightening, but we certainly can go back further and we'll come back.
CHAIR: Yes, that would be useful. As I mentioned, it would be great if you could give us anything you've got on international comparisons. You mentioned return to equity. I'd be interested again in your analysis on return to equity, but also to the extent that you disaggregate that return to equity on, say, residential mortgages versus riskier loans in the business sector, for example. Is that something you disaggregate and look at over time?
Mr Lonsdale: We'll come back to you on disaggregation. On return to equity, the high-level factoid would be that, if you go back a decade, you were talking about return to equity of around 14 or so. If you're looking at it now it is significantly less than that. So, 11.3 is the number I've got as at March '23. But for most of the last two or three years it was in the tens. So, it's a significant reduction. What has contributed to that? Competition is a factor. I think another factor has been, as I mentioned before, there's been a very significant increase over the last decade in regulation, and some of that is borne globally and came out of the global financial crisis through the Basel capital reforms, LAC and REM. There's a whole list of 'too big to fail' reforms that came out. Some of it is Australian grown government regulation and others are regulation from the regulators themselves, most of it with the outcome of strengthening stability and safety in the system, which I think in Australia has certainly been the case.
CHAIR: It would be useful to get that information. It does take me back to that 2018 PC report where one of the observations was that the financial services sector in general and banks in particular are complicated businesses and figuring out their risk adjusted returns can be difficult. I think it used the phrase 'opaque'. That's a challenge when you're trying to make observations about the level of competition in a sector. It's not a simple set of businesses to interpret.
Ms Roberts: When you look at the return on equity in particular, a lot of things come into it—cost-income ratios, pricing, which varies for all of the banks. The banks do have various business models and distribution strategies. All of that would play into their overarching return on equity. Mr Lonsdale mentioned that those numbers have come down over time. Economies of scale is also important to the banks. From our perspective,

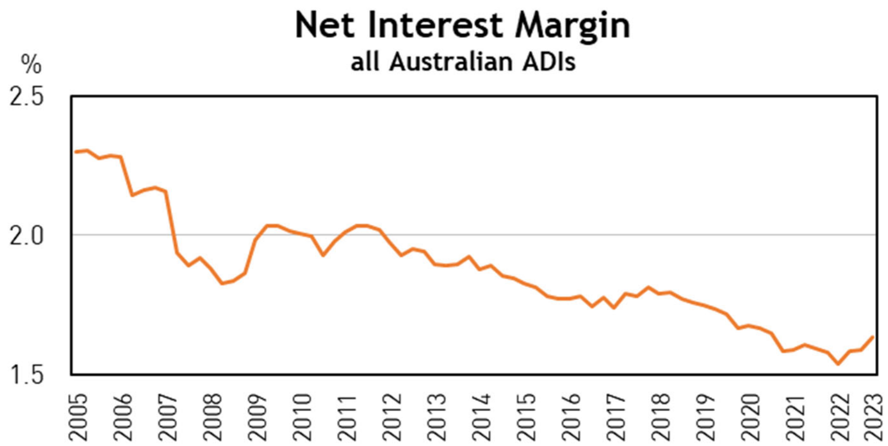
what we look at is really the risk weighted assets and what they look like and not necessarily directly the return on that. But it is challenging.

Dr Carmody: When you look at that question of trying to attribute a return on equity to different products or subsectors of a bank's portfolio, while it's relatively straightforward for a bank to attribute the income generated product by product, if you want to look at an overall return on equity you've got to then attribute costs and capital. As Ms Roberts referred to, often costs can be hard to attribute because you've got shared services that maybe cross multiple products. Investment in cyber resilience, for example, might be something you've got to make decisions to attribute. Although minimum capital requirements will be set asset class by asset class, banks will then determine an overall buffer that they'll maintain for their actual capital levels over and above regulatory minimum. Again, there's a decision you have to make, a judgement you have to make, as to how you attribute that. I know in practice banks have a range of approaches as to how they do that attribution themselves. There's not really any standard or sort of ultimately correct way. It does become quite hard to attribute return on equity to a disaggregated level. As Ms Roberts said, that's why often a proxy is looking at things like return as a percentage of risk weighted assets as an example; that's a bit more straightforward.

Answer:

Trend

The trend of average **net interest margin (NIM)** of Australian ADIs is below.[1]



Data source: unpublished APRA data collected from ADIs

The data indicates that:

- the average NIM of Australian ADIs has been narrowing over the past 2 decades, which reflects a combination of increased competition, from within the sector and from non-ADIs, and the declining trend of interest rates over the period; and
- the average NIM has widened since Jun-22 as interest rates have increased.

The average NIM of banks in New Zealand has also been narrowing over the same period.[2] The average NIM of New Zealand banks began to widen in late 2021 following RBNZ cash rate increases. The average NIM of Canadian Banks has also been narrowing over the past decade.[3]

[1] Net interest margin is calculated as net interest income divided by average interest earning assets. The classification of its various components may differ across ADIs.

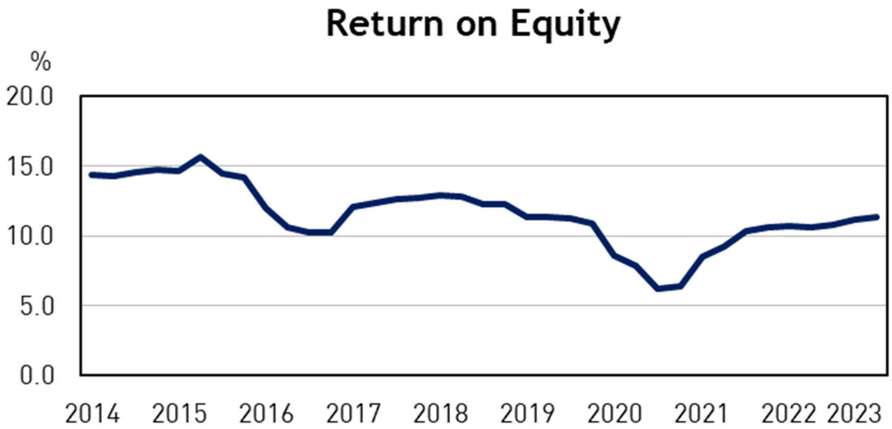
[2] New Zealand banking NIM extracted from ‘Banks: Summary income statement and related ratios (S20)’ published by RBNZ.

[3] Candian Banking NIM extracted from data published by World Bank, code ‘GFDD.EI.01’.

Cyclicality
Research by the Reserve Bank of Australia in 2021 suggested that NIMs may have a modest positive correlation to policy rates in the short term because interest rates on some liabilities (e.g. term deposits) may not adjust as quickly as interest rates on assets (e.g. mortgages). There is not a clear relationship over the long-run.[4]

Return on equity (ROE) is a measure of how efficiently shareholder capital is being used to generate profit. ROE is a commonly used metric to assess banks' profitability. The metric is a wide-ranging one which incorporates many inputs including incomes, expenses, and certain balance sheet components. APRA does not collect data to calculate ROE on a disaggregated basis that would allow for accurate product-level ROE analysis.

ROE for Australian banks has broadly declined since 2010. It reached a low point of around 6.2 per cent in 2020-2021 as a result of pandemic related provision increases. There has been an improvement in profitability over the past two years as those provisions were released.



Data source: APRA quarterly ADI performance statistics publication

[4] RBA paper "Low Interest Rates and Bank Profitability – The International Experience So Far", Jun-21, Mark Hack and Sam Nicholls. ADIs' overall profitability is also influenced by factors such as provisions and losses.