Inquiry into the post-GFC banking sector

May 2012

ANZ Submission to the
Senate Economics References Committee

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EXECUTIVE SUMMARY

ANZ is pleased to provide a submission to the Senate Economics References Committee Inquiry into the post-GFC banking sector.

The banking industry has been subject to extensive review in recent years including three previous parliamentary inquiries into banking competition and small business access to finance. Each of these inquiries has examined the effects of the global financial crisis (GFC) on Australia in one way or another.

The financial sector has also been subject to extensive regulatory change across prudential and consumer regulation. In addition, the Government has put in place a package of measures intended to support competition in banking. These regulatory changes have been aimed at addressing many of the concerns which arose during and after the GFC.

It is important to note that, while the GFC in Australia is considered “over”, the effects of sustained increased funding costs in particular, are still being felt. The ongoing sovereign debt crisis in Europe can be seen as a second phase to the GFC. As a result, the global economic environment remains highly volatile. The European debt crisis, a potential slowdown in China and concerns of a renewed global downturn continue to affect market confidence. These factors have understandably led financial institutions to be more cautious in their assessment of risk.

The official cash rate set by the Reserve Bank of Australia (RBA) has is *one* element affecting banks’ cost of funds and hence lending rates. The adjustments made in ANZ’s lending rates since January 2008 have differed from the RBA cash rate moves, largely reflecting a pass through of increased overall funding costs. The major components of bank funding that have increased relative to the RBA cash rate include:

- Greater competition for customer deposits which is increasing the cost of deposits (and benefiting depositors through higher returns on their savings);
- An increase in wholesale funding costs due to a repricing of risk on wholesale debt markets; and
- A change in the funding mix towards longer-term wholesale debt and deposits as more stable sources of funding.

It is important for the long term health of the Australian economy that lending generates adequate return on the capital employed in the industry. Without adequate returns, lenders would be unable to attract the capital required to support the growth in credit necessary to finance economic growth.

Some attention is drawn to the absolute level of bank profits. To assess whether these profits are appropriate, dollar amounts need to be measured against capital employed and risks associated with earning these profits. On the key measure of profitability, Return on Equity, bank profits are not excessive and are in line with other large companies in other industries. It should also be recognised that a reasonable level of profits is required to ensure:

- That confidence in the financial system is maintained in periods of economic downturn by ensuring that banks are able to absorb higher bad debt expenses without incurring losses
- There are sufficient amounts that can be retained to fund the regulatory capital required to fund increased lending and support economic growth.

THE GLOBAL FINANCIAL CRISIS AND BEYOND

When the US banking system experienced instability, particularly after the collapse of Lehman Brothers in September 2008, this was quickly transmitted to other banking markets around the world, including Australia.

One reason for the severity of the crisis was the excessive on and off-balance sheet leverage of banking sectors in some countries, with many banks holding insufficient liquidity buffers. These weaknesses spread rapidly to the rest of the financial system and the economy as a whole, resulting in a massive contraction of liquidity and credit availability. Ultimately, in many countries the public sector had to step in, exposing taxpayers to large losses.[1]

The Australian financial system weathered the storm better than most. Australian banks did not have high exposures to the types of securities in which many US lenders had incurred substantial losses and lending standards in Australia had not eased to the extent they had in United States. We also benefited from strong growth and demand for resources in our key trading partners in Asia.

Nevertheless, the three main components of the GFC – a 'drying up' of liquidity, an upward repricing of risk and a requirement for more capital – had a significant impact on Australian banks' ability to source funds.

Immediately following the onset of the financial crisis, the cost of funds on global wholesale funding markets increased dramatically as investors became reluctant to lend and supply dried up. After the collapse of Lehman Brothers, wholesale funding markets were effectively closed to Australian financial institutions and most institutions globally for around six weeks. There were also legitimate concerns that fear of contagion would lead to a "run" on banks globally.

There was also a repricing of risk which has affected the cost of borrowing globally. As noted by RBA Governor, Glenn Stevens, this was unavoidable:

> *I think it is probably reasonable to conclude that, given that we know that risk generally around the world was underpriced for at least a few years prior to the events of 2007 and 2008, there was always going to be, even in a highly competitive market, some repricing of risks.*[2]

While in Australia the GFC is considered over, in other developed countries it has had a long tail, with ongoing fragile economies in Europe and North America. Government intervention in Europe and the US has lead to a sharp increase in government debt. This included efforts to stabilise the financial sector and boost the economy in these countries through two rounds of quantitative easing in the US and efforts through the long term refinancing operations (LTRO) in Europe.

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1 *Basel III: A global regulatory framework for more resilient banks and banking systems – revised version June 2011*: www.bis.org/publ/bcbs189.htm

2 House of Representatives Standing Committee on Economics, p 17

From late 2011, the European Central Bank (ECB) has injected substantial funds into the economy via its LTRO. A key driver was the need to finance European banks' significant debt rollovers due in 2012. This was done in an attempt to shore up confidence in the European banks and remove immediate financial risk from the European economy. While these moves provided more stability to the financial system, significant risks remain which continue to fuel uncertainty. In particular, the Greek and French elections have indicated a shift away from a commitment to reforms which are needed to rein in public sector finances. This has contributed to greater volatility across European and world markets.

Europe will continue to negotiate its way through the difficult political and economic environment for some time and we expect this to cause ongoing instability on global markets. This will affect market confidence and the cost and availability of funding. As an example of the impact, global funding markets closed again for a short period at the end of 2011.

REGULATORY RESPONSES TO THE GFC

The last three years has seen a substantial program of regulatory change in financial services. While some regulatory changes have been in direct response to the GFC, other initiatives have been introduced to support competition and efficiency in banking. Each reform is a major implementation project for banks in its own right and timelines for implementation have been tight.

GOVERNMENT GUARANTEES

Actions taken by governments around the world in response to the severe disruption in global financial markets included instituting guarantees to domestic depositors in order to shore up confidence. Governments also provided support for financial institutions to gain access to wholesale borrowing, including guarantees on debt issuance so they could continue to lend to their customers.

On 12 October 2008, the Australian Government announced that it would provide similar guarantees and put in place guarantees on wholesale funding and domestic depositors. The wholesale funding guarantee facilitated access to global funding markets for Australian banks. While banks in Australia would have survived without the scheme, they would have found it difficult to maintain an adequate supply of affordable credit in the economy.

Reflecting the sound position of the Australian banks, and the market access rationale for the guarantee, no Australian financial institution has needed financial support from the guarantees. The Government has not "bailed out" any Australian financial institution as has occurred in many other developed countries. Nevertheless, the measures were particularly important to increase confidence in smaller institutions which were at risk of being affected by a "flight to quality".

In Australia the emergency situation passed quickly and banks only made use of the wholesale funding guarantee for around six months. In early 2010, the Government withdrew the scheme in an orderly fashion. The guarantee scheme will generate around $5.5 billion of revenue for the Government by the time all guaranteed debt expires in 2015. Australia is one of the few countries in the world where the government was a net recipient of funds from the banking system as a result of the GFC.

The Government also implemented a Financial Claims Scheme. The Scheme guarantees deposits held in Australian Authorised Deposit Institutions (ADIs) up to $250,000 per depositor per institution and is administered by the Australian Prudential Regulation Authority (APRA). In the event of the failure of an ADI, APRA would seek to recover what money it can from the failed institution. Any shortfall would be made up by a levy on the rest of the industry, ensuring taxpayers do not carry the risk of a bank failure and depositors do not bear any upfront cost given the low likelihood that any bank will need to access the Scheme.

PRUDENTIAL REQUIREMENTS

In December 2010, the Basel Committee on Banking Supervision released a package of reforms to raise the level and quality of regulatory capital in the global banking system (Basel III). The reforms address the lessons learnt from the GFC with the objective:

> *…to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy.*[3]

Basel III provides a revised set of standards for *capital* and *liquidity* to address these lessons. On capital, the key elements are:

- more and better-quality capital required to meet the basic minimum;
- a capital conservation buffer that sets rules for managing capital above the minimum;
- a time-varying countercyclical buffer, aimed at mitigating the effects of the credit cycle; and
- an unweighted capital ratio (or 'leverage ratio') to act as a backstop to all of that.
- a liquidity coverage ratio, which requires banks to hold enough liquid assets to meet a 30-day stress scenario; and
- a net stable funding ratio, which requires banks' long-term assets to be matched by stable sources of funding.

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[3] *Basel III: A global regulatory framework for more resilient banks and banking systems – revised version June 2011*: www.bis.org/publ/bcbs189.htm

In September 2011, APRA released its discussion paper on its proposed treatment of the Basel III capital reforms. APRA proposed approach will adopt some variations to the Basel III rules which serve to understate ANZ's key capital strength on a global comparison.

The ANZ and the Australian Bankers' Association submissions to APRA argued that Basel III represented a global compromise which had many shortcomings, and that it would create further distortions if not implemented in a globally consistent fashion. These suggestions have not been adopted in APRA's draft standard released in April 2012.

A global approach is needed in regards to the definition of Capital/Capital Deductions and the determination of Risk Weighted Assets. This would have significantly assisted investors in being able to make effective comparisons of banks and would have better highlighted the strength of the Australian banking sector. Consistent measurement of Capital would not impinge upon APRA's ability to ensure Australian Banks were appropriately capitalised.

Initial proposals on liquidity from the Basel Committee appeared problematic for Australia because it would have required banks to hold large amounts of liquidity in sovereign debt. This would be difficult in Australia due to the low levels of Government debt. To overcome this problem, the Australian Government successfully negotiated in the G20 and Basel Committee for special arrangements for countries like Australia. The proposed committed liquidity facility (CLF) is a good solution to this problem and we commend the Australian Government on the positive outcome.

The industry has raised a few issues with regard to the proposed approach to liquidity in Australia. In particular:

- with cash outflow assumptions and calibration of the Liquidity Coverage Ratio (LCR);
- requesting further clarity on APRA's approach to managing transition to a committed liquidity facility (CLF) and on the treatment of self securitisation under the Net Stable Funding Ratio (NSFR); and
- emphasising the need for consultation on appropriate timeframes for public disclosure and reporting to APRA.

While there are still some issues that need to be resolved, ANZ is well placed to meet capital and liquidity targets for Basel III implementation. ANZ currently holds 60 per cent more regulatory capital than it did before the GFC. However, the more capital we are required to hold against a loan the greater the cost of lending. This cost is ultimately borne by consumers.

CONSUMER PROTECTION

In July 2008, the Council of Australian Governments (COAG) agreed that the Australian Government would assume responsibility for regulating all consumer credit products with the

Australian Securities and Investment Commission (ASIC) as the sole regulator. A two phased implementation plan was put in place.

Phase one came into effect on 1 July 2010 and established a national licensing regime for providers of consumer credit and credit-related brokering services and advice; required licensees to observe a number of general conduct requirements including responsible lending practices; and mandated membership of an external dispute resolution (EDR) scheme. It also extended the scope of regulated credit products to include consumer mortgages over residential investment properties, and regulated margin lending and trustee corporations.

Treasury has released draft legislation for consultation as part of phase two of the reforms. In phase two, among other issues, the Government is considering the need for:

- Regulation in the provision of small business credit including access to hardship assistance and external dispute resolution schemes;
- Enhancements to the regulation of reverse mortgages;
- Extending the hardship applications under the National Credit Code;
- Regulation of investment lending, other than purposes already regulated, where the family home is at risk;
- arrangements regarding the caps on the maximum cost payable in respect of both small amount credit contracts and all other credit contracts; and

Treasury is consulting separately on possible measures aimed at reducing the dependency of consumers on payday lending (high-cost short-term small amount loans).

BANKING COMPETITION

In December 2010, the Australian Government announced a package of changes to promote competition in the banking industry. The changes comprised three streams:

1. “empowering consumers to get a better deal” – including a ban on exit fees on new home loans, easier switching and responsible lending reforms for credit cards;
2. “supporting smaller lenders to compete with big banks” – including continuing the Financial Claims Scheme as a permanent feature of the financial system, a third tranche of support for the residential mortgage-backed securities (RMBS) market and accelerated development of bullet RMBS market for smaller lenders; and

3. “securing the long-term safety and sustainability of the financial system” – including allowing banks, credit unions and building societies to issue covered bonds and developing a corporate bond market.[4]

In our submission to the Senate Economics References Committee inquiry into competition within the Australian banking sector in December 2010, ANZ expressed support for practical measures to promote competition and consumer choice without unnecessary burden on banks and their customers. ANZ believes that the Government took a relatively balanced approach with its package.

Switching

ANZ acknowledges that switching cannot be done without some effort, but we believe the barriers to switching are more perceived than real and assistance to customers who wish to switch is available.

ANZ first introduced our switching service for customers in 2006 which enabled new customers to generate letters to companies with which they have regular payments. Since then the Government announced an Account Switching Package in 2008 to help reduce unnecessary barriers to customers changing providers. The package included a listing and switching service that required banks to provide their customers with accurate information on all direct debits and credits to their account over the last 13 months. ANZ’s listing service has been available since 10 March 2008 and is provided without charge.

The Government has requested the banks to implement a new ‘tick and flick’ switching service by 1 July 2012 in an effort to remove the burden on customers to change the details of automatic debit and credit transactions. The process will allow customers to sign one form switching financial institutions, to authorise their new provider to arrange the transfer of all automatic transactions linked to the customer’s account.

ANZ supports this initiative and is working with the Australian Payments Clearing Association (APCA) on implementing the new ‘tick and flick’ switching service.

Alternative funding sources

ANZ welcomed the Government’s approach to developing alternative funding sources. As will be discussed later, Australian banks are heavily reliant on wholesale funding because domestic saving in Australia is insufficient – given the diversion of funds to mandatory superannuation - to fund investment opportunities and bank lending. Australia has run a current account deficit for most of the past 150 years and banks provide the conduit for tapping foreign savings to allow investment opportunities in Australia to be realised and effectively fund this deficit. All Australian banks are reliant to a greater or lesser extent on raising funds on global markets.

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[4] http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/091.htm&pageID=003&min=wms&Year=2010&DocType=0

It is often said this is necessary because Australians save less than other developed economies. However, RBA Deputy Governor Ric Battellino has recently noted that:

> *Australia uses foreign capital not because its national savings ratio is low, but because its investment ratio is high by the standards of developed economies. In the past decade, for example, the national savings rate in Australia has averaged 22 per cent, much the same as in Europe and well above the figure of 15 per cent in the US and UK. Over the same period, the investment ratio in Australia averaged 27 per cent, whereas in most developed economies it has averaged around 20 per cent*

Diversifying the range of tools banks can use to fund the gap that arises between savings and investment will help to mitigate the effects of disruptions on global funding markets. The Government has made some positive steps in this area.

For instance, since November 2011, banks, credit unions and building societies have been able to issue covered bonds. Covered bonds offer institutional investors more security than bank bonds which in effect should provide the incentive to lend to financial institutions for less than some other forms of funding. This reform has helped the industry to diversify funding sources and also assisted banks to meet the new Basel III liquidity standard.

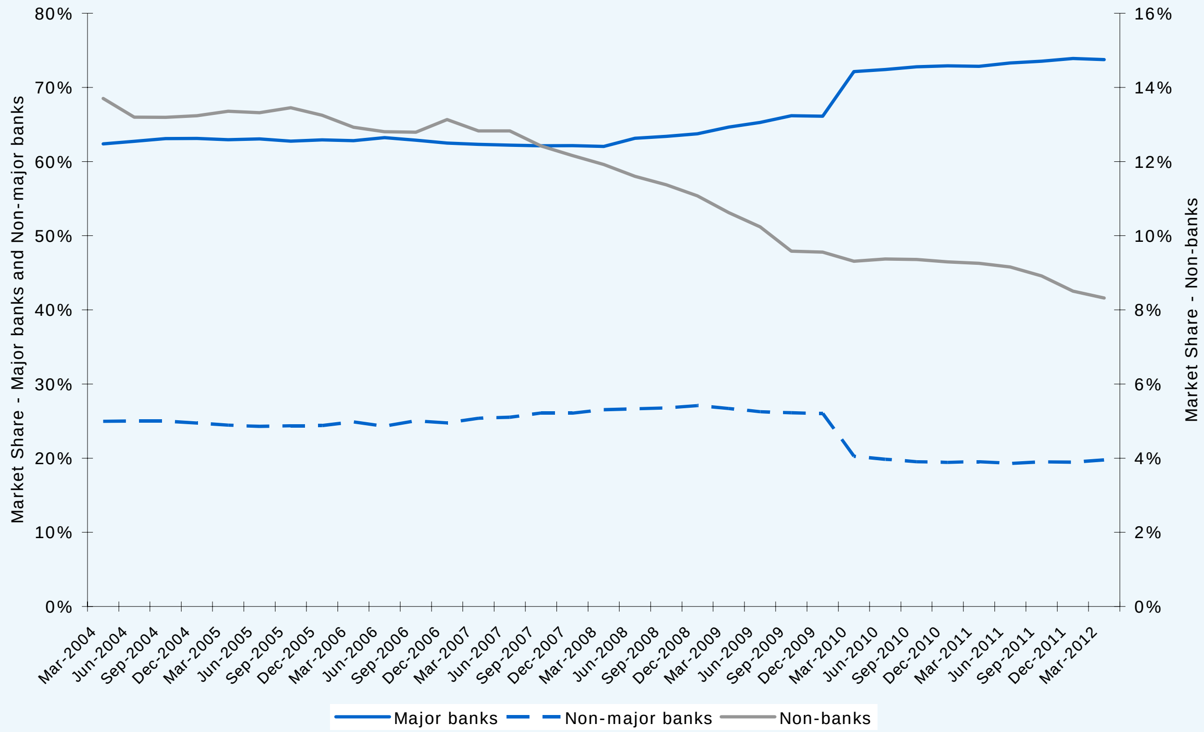
In November 2011, ANZ announced its intention to offer covered bonds from time to time, establishing a US$20 billion covered bond program with the first issuance completed in that month. While covered bonds will not fully resolve the pressure on the cost of funds, they do provide an opportunity for ANZ to diversify the funding base and further reduce the reliance on senior unsecured debt in offshore markets. They also allow ANZ to lengthen our funding profile with more longer-term 5-10 year debt.

COMPETITION IN THE BANKING SECTOR

Since the GFC, there has been some consolidation in the Australian banking sector. The chart below shows the effect of the GFC on the market shares of total lending for different types of participants in the market.

As can be seen from the chart, non-major banks and non-banks (including finance companies, credit unions, building societies and other non-bank lenders) were maintaining a steady market share up until late 2007. However, the chart shows that, from then, the market share of non-banks and non-major banks began to decrease.

Chart 1: Market Share of Major Banks, Non-Major Banks and Non-Banks 2004-2012



Source: Derived from data in the APRA Monthly Banking Statistics and RBA Lending Aggregates[5]

Since 2007, major Australian banks have acquired other lenders in the market, in particular Bankwest and St George (the effect of this is clear in the chart in late 2008). Securitisation as a method of funding failed as a direct result of the GFC, leading to the acquisition by banks of some non-bank lenders such as RAMS and Wizard. Some non-bank lenders have exited the market completely or are not writing new loans, including finance companies GMAC and Bluestone.

Some of this competition was from players whose business models were not sustainable and did not reflect the full cost of providing financial services throughout the economic cycle. Competition in Australia is often compared to offshore countries whose financial models were

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[5] Available at http://www.apra.gov.au/adi/Publications/Pages/monthly-banking-statistics.aspx and www.rba.gov.au/statistics/tables/xls/d02hist.xls

also proven to be unsustainable. Liquidity and credit risks were not being properly recognised and built into prices which ultimately resulted in the failure of those businesses.

Notwithstanding this consolidation there are still a large number of players in key consumer markets. For example, in the mortgage market, there are still over 100 providers of mortgages in the Australian market offering standard variable rates of between 5.83 per cent and 7.66 per cent.[6] This is a significantly greater number of providers than most other industries.

Over the last few years, competition in the deposit market has been intense. In the wake of the financial crisis, banks have been competing to attract deposits as a stable source of funding. This saw the 90-day term deposit rate offered by ANZ increasing from around the RBA official cash rate in 2007 to be around 100 basis points (i.e. 1.0 per cent) above the cash rate today. Depositors, particularly typical users of term deposits such as self funded retirees, have benefited from this competition.

FUNDING COSTS

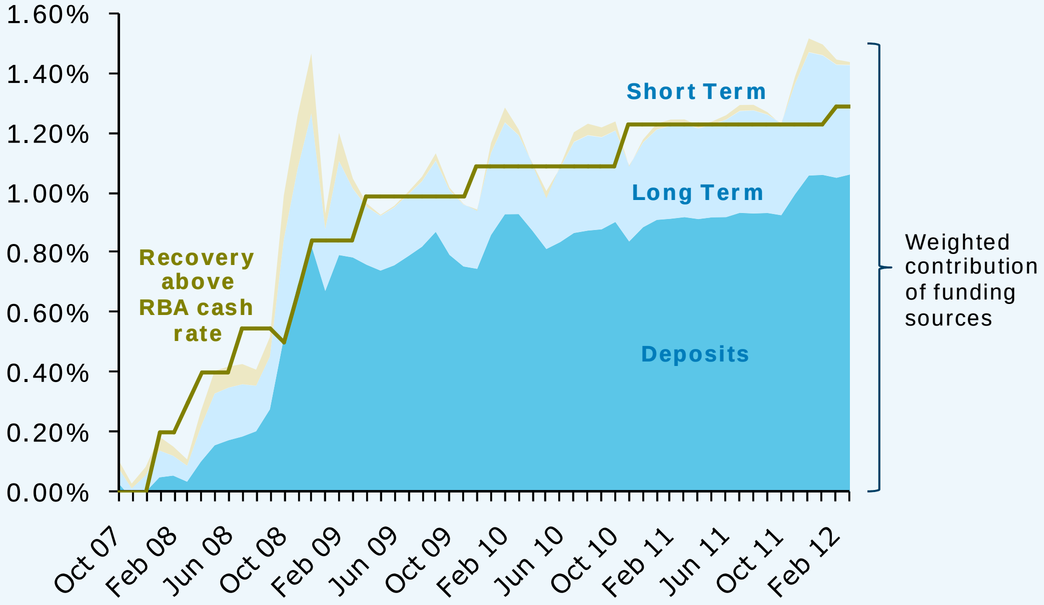
Banks raise funds to lend to customers from two main sources – customer deposits and in wholesale markets from domestic and international investors. The cost of raising funds from wholesale markets and customers' deposits are key drivers of the price of credit products. Since 2007, the cost of both of these components of banks' funding has risen relative to the RBA's official cash rate. Three main factors have driven an increase in ANZ's funding costs over recent years:

1. The increase in the cost of customer deposits due to greater competition between deposit-takers;
2. The increase in term wholesale funding costs from 20 bps above the 90-day Bank Bill Swap Rate (BBSW) in 2007 to an average of 165 bps above BBSW today; and
3. The change in the mix of funding with an increase in customer deposits and longer-dated term wholesale funding.

Chart 2 below shows the contribution of each source of funding to changes in the overall cost of funds since the GFC. It also shows the movement in ANZ's standard variable mortgage rate relative to the cash rate, which has increased in line with changes in funding costs.

6 Data sourced from mozo.com.au on 21 May 2010

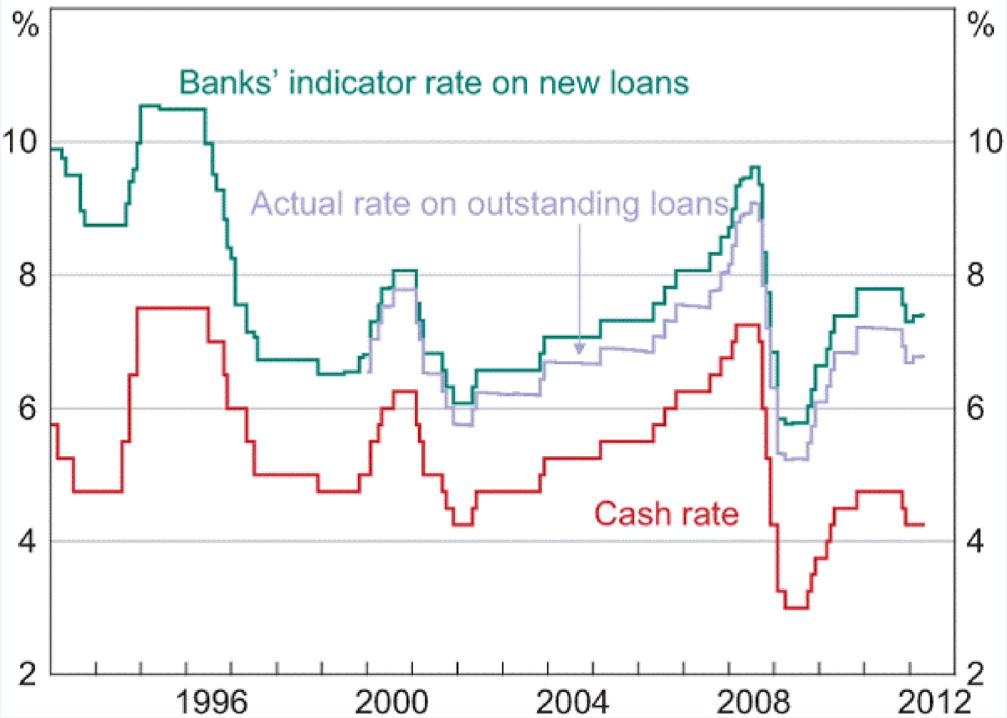
Chart 2: Change in cost of funds over the RBA Cash Rate since the Global Financial Crisis[1]



[1] Represents the average change in cost of funding relative to the cash rate over the 12 month period ending September 2007

However, notwithstanding these pressures, the absolute cost of funding has declined as official interest rates have come down. Chart 3 shows household lending rates over the period from 1992 to now. As can be seen current household lending rates are close to record lows over this period and only slightly above the lowest level during the GFC. These low interest rates provide an important stimulus to households and the economy.

Chart 3: Household lending rates



Source: RBA

CUSTOMER DEPOSITS

Customer deposits are the primary sources of funding for lending. As noted above, competition for deposits has increased significantly since the onset of the GFC as all banks have sought to rely more on this as a relatively stable source of funding.

This increase in competition for deposits has driven up the price which banks are willing to pay for deposits (the interest rate). In 2007 the rate offered by ANZ on a 90-day term deposit was very similar to the RBA cash rate. Today, it is around 100 basis points above the cash rate. As shown in Chart 2 above the increase in the cost of deposits has been the key driver of funding cost increases for the banks.

WHOLESALE FUNDING COSTS

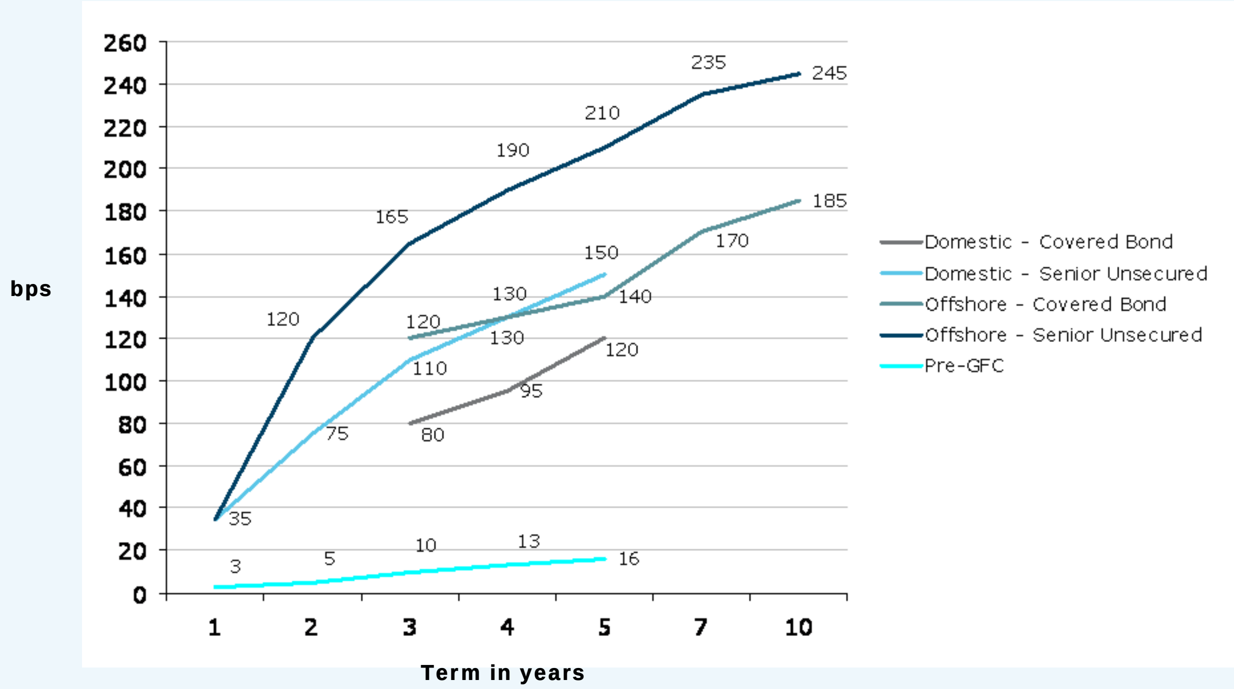
Following the collapse of Lehman Brothers, wholesale funding markets closed for around six weeks and the cost of wholesale funding increased dramatically. Since then, costs have remained elevated relative to the cash rate and markets closed again for a short period at the end of 2011 due to uncertainty in Europe.

The chart below shows the costs at which ANZ can raise term funding today and pre-GFC. Before the GFC, the average cost of five-year term funding was around 16 bps above BBSW. Today, the cost of five-year term funding is between 120 and 210 bps above BBSW (see chart 4).

This has contributed to an increase in ANZ's funding costs since 2007 relative to the RBA cash rate. In the six month period from 1 October 2011 to 31 March 2012, the average cost of ANZ's $75 billion stock of term wholesale funding increased every month, except in December 2011 when credit markets froze because of the European sovereign debt crisis and wholesale markets were closed globally.

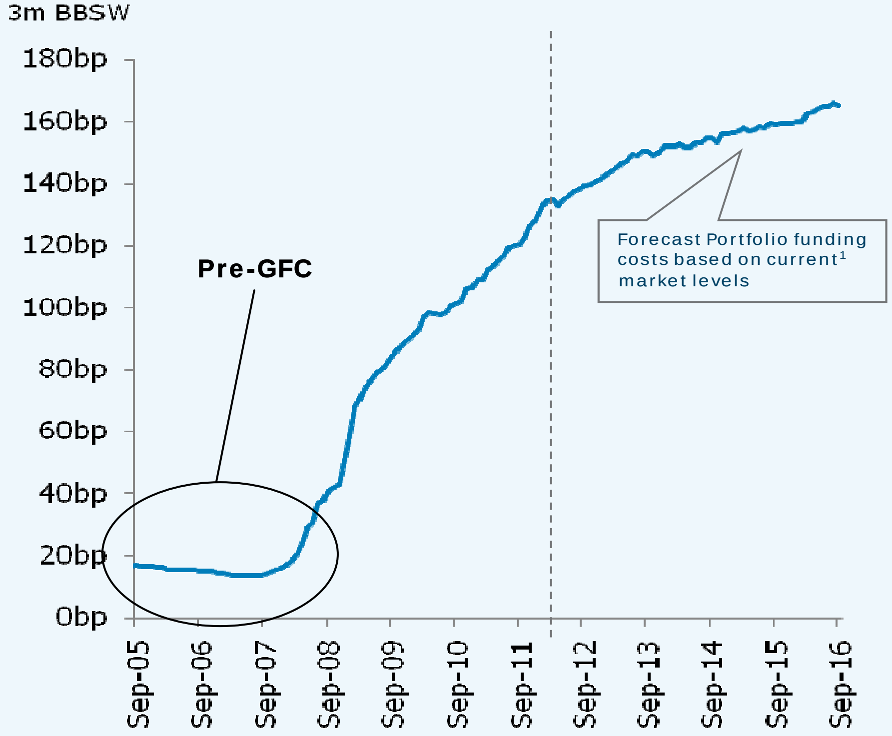
Even if the cost of wholesale funding did not rise further, the average cost of ANZ's wholesale funding portfolio would continue to rise gradually as cheaper pre-GFC debt expires and is refinanced with more expensive debt at today's prices. For example, as less expensive funding (costing on average 72 bps above BBSW) matured and was replaced with more expensive funding (on average 165 above BBSW), ANZ's average cost for term wholesale funding increased by 15 bps from 116 bps above BBSW to 131 bps. We expect this effect to continue to put pressure on lending margins as the remaining pre-GFC debt expires and is replaced.

Chart 4: Indicative Term Funding Costs (basis points above 3 month BBSW)



Wholesale funding costs will be affected by ongoing developments in the world economy. As chart 5 shows, ANZ expects the upward trend in wholesale funding costs to continue in 2012 with term debt new issuance costs likely to average 170 bps above BBSW for the 2012 financial year. It also shows the period of funding cost stability in the lead up to the GFC which lead to bank funding costs largely tracking the RBA cash rate over that period.

Chart 5: Forecast portfolio funding costs based on market levels as at 31 March 2012



Source: ANZ

[1] as at March 2012

FUNDING MIX

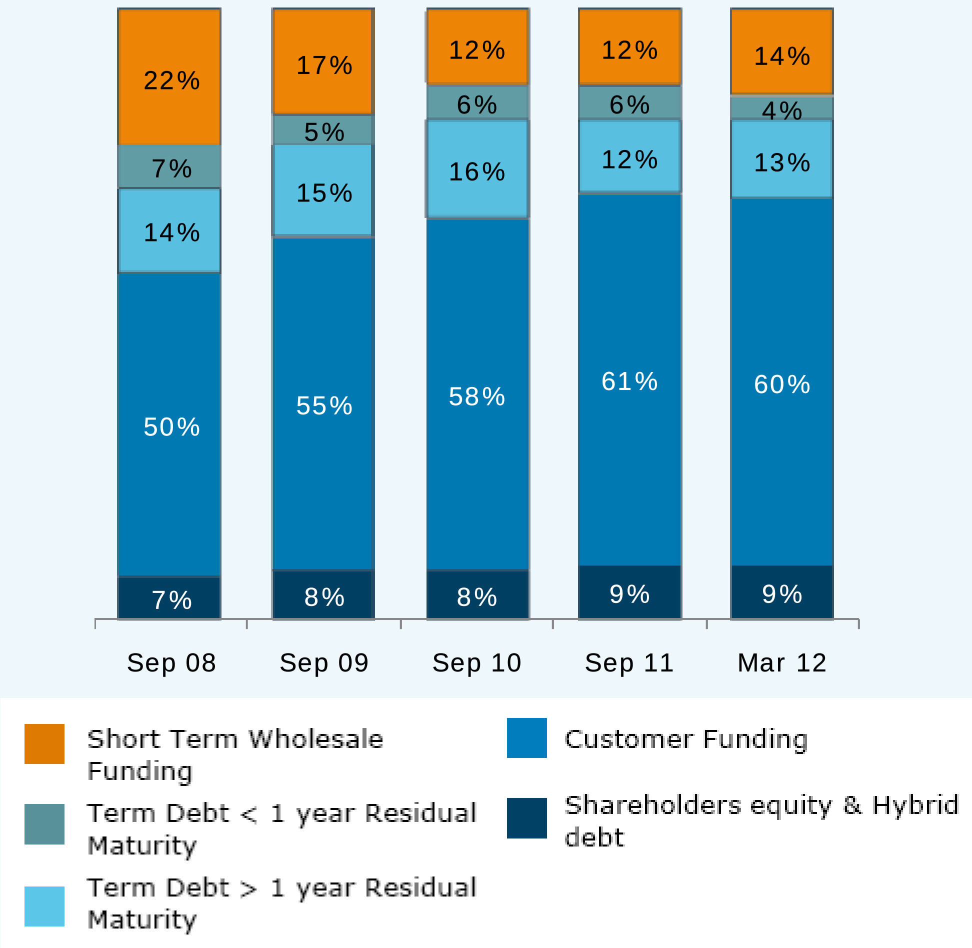
In addition to increases in the relative costs of individual sources of funding, a change in the funding mix is also contributing to higher costs. APRA has been encouraging banks to increase more stable term funding and reduce reliance on cheaper short-term wholesale funding. It is also part of ANZ's strategy of helping maintain its AA rating which assists in accessing funds.

Between 2008 and 2012 there has been a marked decline in short-term wholesale funding from 22 per cent in September 2008 to 14 per cent in March 2012 (see chart 5). Over this time, ANZ has increased the proportion of its funding from more stable sources such as customer deposits and long-term wholesale debt. These funding sources give greater certainty in a volatile environment.

As chart 6 shows, on the whole ANZ has moved to reduce reliance on wholesale funding and has increased funding sourced from customer deposits from 50 per cent in 2008 to 60 per cent in 2012.

With longer-term debt (wholesale and customer deposits) more expensive than shorter-term debt, the increase in these forms of funding is contributing to an increase in overall funding costs.

Chart 6: Composition of ANZ's Group Funding Sep 2008-Mar 2012



Source: ANZ

IMPACT ON LENDING

ANZ'S INTEREST RATE POLICY

In January 2012, ANZ began reviewing its variable home loan and small business interest rates on the second Friday of each month, with any changes to take effect on the following Friday.

In the past, Australian banks generally have announced interest rate changes following the RBA announcement of its cash rate on the first Tuesday of each month. Since January 2008, ANZ has changed its mortgage and small business lending rates beyond movements in the RBA cash rate.

ANZ's approach of reviewing rates monthly enables all the relevant factors to be taken into account when reviewing our rates. The five key criteria on which ANZ bases its decisions are:

1. **Ensuring attractive returns for depositors:** ANZ is committed to providing customers with competitive returns and absolute security for their savings.
2. **The cost of wholesale funding:** This covers the interest ANZ pays on funds we borrow from wholesale money markets. The cost of funds has become more volatile and expensive since the GFC and has been elevated in recent months as a result of the European debt crisis.
3. **Our competitive position:** ANZ is determined to remain competitive by attracting customers, winning business and managing our costs.
4. **The impact of economic conditions on our customers:** ANZ is committed to lending responsibly and giving consideration to the financial health of our customers, the economy and the banking system in Australia.
5. **Regulatory requirements:** ANZ works within a strong prudential and regulatory environment. For example, we must hold capital reserves and levels of liquidity to operate safely and securely for customers.

While initially overall ANZ's net interest margin increased slightly following the GFC, it has since fallen as a result of increasing competition for deposits (and therefore higher deposit rates) and higher funding costs (see chart 6). From the first half of 2011 to the same period 2012, ANZ net interest margin (excl. global markets) fell by almost 6 basis points to 2.4%. Reflecting the difficult operating environment in Australia, the impact on our Australian business was larger with net interest margins falling 13 basis points.

If ANZ had not increased its lending rates relative to the RBA cash rate since January 2008, the rising cost of funds from wholesale markets and customers' deposits would mean the margin on mortgages was negative. This would make mortgage lending unsustainable.

RETAIL CUSTOMERS

A highly volatile global economic environment has subdued market confidence and led to a downward shift in Australian house prices in most capital cities in the past 18 months.

This trend coupled with financial market uncertainty and funding cost increases following the GFC, have led to a more cautious assessment of risk amongst lenders. For instance, ANZ maintains a maximum 90% loan to value ratio (LVR) for new customers and is the only major bank that is not lending to 95% LVR for new-to-bank customers.

In its targeted review of the collateral management and foreclosure management procedures of authorised deposit-taking institutions (ADIs), APRA highlighted that:

> *a lack of regular valuations of collateral … can expose an ADI to a greater risk of loss on its lending portfolios (residential and commercial property) from significant changes in the value of property.* [7]

APRA believes it's important to have more specific 'triggers' in lending policies as part of risk management procedures, to ensure that real estate held as security is revalued when there is a material change in the market value of real estate within an area or region.[8]

As part of prudent risk management ANZ regularly monitors the property market and identifies areas which are at higher risk of falls in value. This analysis in itself would not trigger a property revaluation but is used in our assessment of the level of LVR we would be willing to sustain for new lending or additional lending in a given area. For residential loans, key stages of a mortgage contract may trigger the need for a valuation:

- When the customer applies for the loan;
- When customers request additional lending against an existing security;
- When a customer wants a security released or swapped; and
- When customers go into default and the property may have to be sold.

While the number of mortgage customers who are delinquent by 90 days or more has risen since the GFC (see chart 7), delinquencies have fallen in the past year and mortgage losses have remained low and fairly stable. Despite softening in property values across the market, credit quality in ANZ's mortgage book continues to improve with 4.4% of the total mortgages portfolio above LVR 90% today, compared to 6.6% in September 2008. Notwithstanding this improvement in credit quality, we are seeing localised weakness in some areas, for example tourism centres in Queensland where the local economy has been affected by the high exchange rate.

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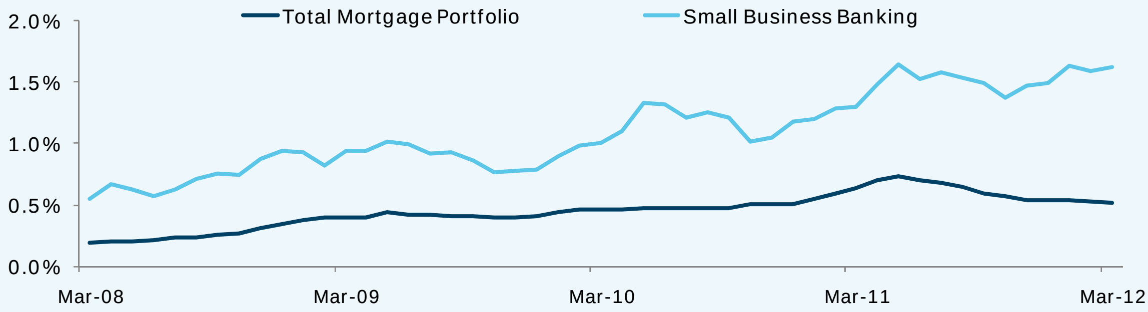
[7] *The management of collateral and foreclosures,* APRA Insight, Issue two 2011

[8] *The management of collateral and foreclosures,* APRA Insight, Issue two 2011

Chart 7: 90+ day delinquencies for total mortgage portfolio and small business banking portfolio



Source: ANZ

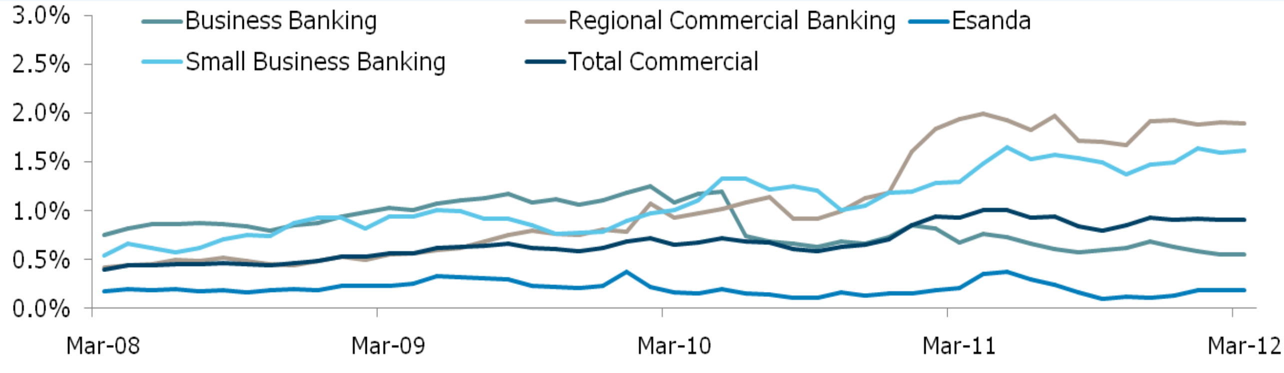
SMALL BUSINESS CUSTOMERS

During the uncertain economic conditions, which have existed since late 2008, ANZ continued to lend to viable small businesses. As growth in the economy slowed:

- finance application numbers fell in small business;
- following the withdrawal of our higher risk “low doc” product in late 2008, approval rates reduced marginally and have remained solid at over 80% on average since then; and
- total lending in our Small Business Banking segment (business with lending of $1m or less) has continued to grow solidly at around 10 per cent per annum.

We have also seen a decrease in the quality of our small business lending portfolio because more customers are behind in their repayments. Chart 8 shows that delinquencies of 90 days or more for all lending in ANZ’s Commercial Banking have increased since the GFC. Commercial Banking provides deposit and lending products to small and medium sized enterprises. This increase is mostly attributable to increases in delinquencies of 90 days or more for small business banking and regional commercial banking (including agribusiness and the regional small business sector). While there are ongoing concerns about some segments of the SME sector (e.g. retail), the overall delinquency rate is low and within expectations.

Chart 8: 90+ day delinquencies for ANZ Commercial Banking portfolio



Source: ANZ

Concerns are often expressed about the difference in interest rates for lending to residential mortgage customers compared with small business lending, including where that lending is secured by a residential property.

Interest rates set by the banks must take account of the risk of lending money. In accordance with APRA's prudential standards, that risk is determined primarily by two factors:

- **Probability of default** – How likely a customer is to be unable to repay their loan. Small business customers have a higher probability of defaulting than Mortgage/Retail customers; and
- **Loss given default** – The amount the bank can recover if a customer defaults on a loan. A significant proportion of small business loans are unsecured, therefore the bank generally will be able to recover less than other forms of lending with higher security (e.g. mortgages).

The probability of default and loss given default for small business customers when compared to mortgage customers is higher. For example, Chart 7 shows that while 90+ day delinquencies for both mortgages and small business have risen since the GFC, small business delinquencies have increased at a greater rate and the difference between the two has widened.

ASSISTING CUSTOMERS IN FINANCIAL DIFFICULTY

We understand that the economic environment following the GFC has been difficult for some customers. ANZ is committed to working with customers who are experiencing financial difficulty to try and help them get back on track.

Customer Connect is ANZ’s hardship team and its members trained to identify and assist customers in hardship; we also work closely with the financial counselling community to assist us in better understanding customers in hardship. Customers who suffer a sudden or unexpected change to their personal circumstances, but who reasonably expect they can meet their repayment obligations if ANZ provides some assistance, can apply for hardship assistance.

When a customer applies for, or requests, hardship assistance ANZ Customer Connect will:

- assess the customer’s request, giving genuine consideration to their circumstances;
- look at the customer’s financial position;
- ask some questions about how the customer’s circumstances have changed;
- look at how the customer expects to be able to resume their standard repayments down the track; and
- look at the customer’s products to see what might be feasible and suitable.

Assistance measures offered to customers depend on the customer’s individual circumstances, financial position and loan type, but may include:

- a short term extension of the loan to reduce the amount of each ongoing repayment;
- deferring some repayment or a short period of reduced repayments with arrears capitalised into the balance of the loan;
- refinancing a loan; or
- reduced credit card repayments for a short period of time (with the credit card being closed so the customer doesn’t get into further debt).

If a review of a customer’s circumstances and financial position indicates they can afford to service their loan or credit card and meet their ongoing repayments then a request for assistance may be declined.

If a customer’s situation has permanently changed, or they’re experiencing long term financial difficulties, then a change in their loan contract may not necessarily be in their best interests as it may just postpone inevitable default under their credit contract.

In these circumstances, other options such as property sale may need to be considered and ANZ recommends customers seek financial advice, either from a financial planner or from an independent community-based Financial Counsellor.

Special circumstances

There are times when retail and small business customers may be affected by special circumstances or natural disasters such as bushfires or floods. For example, As part of our assistance package during the 2010 Queensland flood crisis, ANZ offered to:

- suspend repayments on all loans for three months;
- waive fees associated with restructuring business loans considered necessary due to storm impacts;
- waive early withdrawal costs for term deposits;
- consider temporary adjustments to customer lending limits including credit cards to assist them to cope financially with unexpected costs arising from the storms; and
- waive fees associated with replacement of damaged business EFTPOS/credit card terminals.

ANZ also actively contacted customers in affected areas to ensure they were getting the assistance they needed.

Similarly, ANZ has actively supported regional commercial customers during times of difficulty. For example, following the Australian Government's suspension of all live cattle exports to Indonesia on 7 June 2011, ANZ provided assistance for its regional commercial and farming customers affected by the ban and the period of uncertainty that followed. Regional commercial customers were encouraged to contact their relationship manager to discuss their circumstances and assistance options such as:

- deferring business loan repayments (with interest capitalised);
- waiving fees associated with restructuring business loans considered necessary; and
- waiving fees associated with accessing business term deposits early.

BANK PROFITS

Australia's four major banks are large businesses: all four are in the top-five listed companies in Australia by market capitalisation. The dollar amount of profits made by the four major banks is a reflection of the size of the companies and the amount of capital employed. They are not unusually profitable when compared with other industries.

The accepted way to compare profitability across industries and companies is the Return on Equity (ROE). ROE measures the profit a company generates relative to the capital that shareholders have invested in the company.

In the 2010/11 financial year, ANZ made a profit of $5.6 billion representing an ROE of 15.3 per cent (on a statutory basis). That is not particularly different to other industries and it is considerably lower than the ROE before the GFC. ANZ's ROE is similar to the healthcare sector (14.4 per cent) and consumer staples including supermarkets (13 per cent) and is lower than telecommunications (26 per cent) and the resources sector (28 per cent).

This point was also expressed by Glenn Stevens, RBA Governor, during the RBA's appearance before the House Standing Committee on Economics on 24 February 2012:

> *Our assessment is that, if you look at the rates of return on equity in our banks over a lengthy period of time, say 20 years, they are good but they are actually broadly in line with the listed company sector in general in Australia. I do not think it is obvious from that comparison that they are in some sense excessively profitable.*[9]

These ROEs also reflect (reasonably in our view) the risk the market attaches to investing in these industry sectors. The market sets the level of ROE expected from sectors in the economy and if returns are below these investor expectations (domestic or international) then investor appetite for that sector will diminish.

Notwithstanding these comparisons, it is important that Australia's banking sector is strong, safe and profitable. The good rating held by Australia's four major banks enables them to continue to raise funds offshore at reasonable rates. Any deterioration in the strength of ANZ may put at risk its rating. A lower credit rating would raise the cost at which we could fund our lending as wholesale markets demand higher rates to compensate for higher risk – a cost that would necessarily be passed through to customers.

It should also be recognised that a reasonable level of profit is required to ensure:

- That confidence in the financial system is maintained in periods of economic downturn when losses on bad debts will inevitably increase by ensuring banks do not make losses; and
- There are sufficient amounts that can be retained to fund the regulatory capital required to fund increased lending and support economic growth.

APRA requires banks to hold substantial amounts of capital to back their lending, with the amount required dependent on the risk of the loan. The capital is sourced principally from retained earnings, that is, profit retained after dividends have been paid to shareholders. Banks need to be profitable to fund the capital required to allow them to continue to lend.

We have seen during the GFC that strong banks are fundamental to the health of the economy. In Australia, the Government has not needed to bailout any banks as has occurred in many other countries. In countries where this has occurred it has resulted in greatly increased public debt with the attendant problems that has created.

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[9] House of Representatives Standing Committee on Economics, *Reserve Bank of Australia annual report 2011*, Official Committee Hansard, Friday, 24 February 2012, p.3.

Banks in many developed countries have had to reduce their lending to survive the difficult economic times. The difficulties many developed countries are having in reinvigorating economic growth can in part be attributed to their relatively weaker banking systems and a shortage of credit supply. In contrast, Australia's banks have remained profitable and been able to continue lending to both consumers and businesses through the GFC and continue to do so. This has underpinned a stable economy and employment in Australia during the financial crisis.

CONCLUSION

The period since the GFC has been characterised by ongoing instability around the globe, particularly in Europe. Australia has so far escaped the worst effects of the economic difficulties in Europe. Nevertheless, the level of uncertainty is having an impact on the Australian economy through higher funding costs and lower business and consumer confidence.

The Australian banking sector is effective, safe, efficient and well-managed. It has supported the economy through the most difficult financial conditions in over 80 years. ANZ is being managed in a way that reflects the very significant economic and political uncertainties that exist in the global economy. ANZ is continuing to minimise reliance on short term wholesale funding, raising funds from more stable sources such as customer deposits and longer term wholesale funding.

Wholesale funding costs are elevated relative to the cash rate in comparison to before the GFC as global investors demand a higher risk premium from financial institutions. Deposits are also more expensive as financial institutions reduce their reliance on wholesale funding and compete to attract deposits. These increases in our input costs are being reflected in the price of credit products.

In this difficult environment it is important that we lend prudently and responsibly support our customers in financial difficulty. At the same time, we seek to deliver an acceptable return for our depositors and shareholders and maintain ANZ as a strong global bank to support growth in the Australian economy.

While seeking to manage these challenges, the banking sector has been subject to three parliamentary inquiries into aspects of the banking sector and extensive regulatory reform including the Government's package of reforms to promote competition in the banking sector. These regulatory reforms have addressed many of the concerns which arose during and after the GFC. A period of regulatory stability would enable the industry to bed down these reforms, which are still being implemented, and allow their impact to be assessed