AUSTRALIAN BANKERS' ASSOCIATION INC.

Fact sheet

Bank Profits – Frequently Asked Questions

Introduction

The importance of a profitable banking system has never been as apparent as in the current economic environment when global conditions remain uncertain due to the continuing impacts of the Global Financial Crisis (GFC). A solid and reliable banking system provides economic security for Australia at a time when countries overseas are still dealing with high unemployment, poor business conditions, negative economic outlooks and depressed consumer sentiment. Australia's healthy banks continue to keep our savings safe and continue to make loans which keep the economy moving.

Each year, as banks report their financial results, there is a great deal of commentary regarding banks' annual profit. With the aim of improving the quality of the debate, the Australian Bankers' Association (ABA) has produced this fact sheet about banks' profits. The fact sheet covers what profit is, why it is important, and why reported profits appear large. It begins with answering basic questions about the nature of banking and ends with an assessment of whether bank profits are too high.

What is the role of a bank?

Banks are part of the financial services sector. The fundamental role of the financial services sector is to facilitate the transfer of money from (1) people and businesses who have spare savings, to (2) people and businesses that need money to invest. The technical term to describe this is 'intermediation' – the role of 'intermediating' between savers and investors.

This process is also undertaken by a range of other institutions such as credit unions, building societies, fund managers, and superannuation trusts. A similar process is also undertaken by insurance companies; they gather premiums (savings) from policy holders and then use the money to buy securities (i.e. make loans).

Chart 1 shows the categories of financial service providers who are involved in transferring money between savers and investors and the relative size of each, as measured by their share of total financial assets.

Note this graph shows only 'institution types' involved in the transfer of savings to investors, yet much of the transfer process is undertaken outside banks and other institutions. For example, stock and bond markets provide a means by which companies and governments can raise money from savers.

In effect, as a lender of money to companies, banks compete against share and bond markets. This competition ensures banks do not over-price their services. Companies always have the option of securing money from sources other than banks, particularly large companies.

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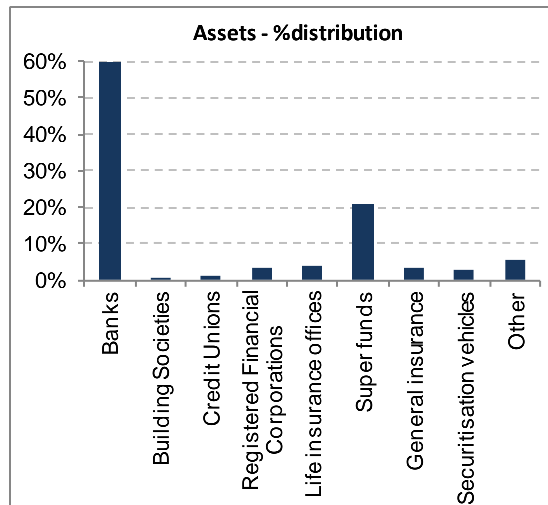
Chart 1



Source: RBA

Intermediating money between savers and investors is a vital function in any country. Without a process whereby savers can safely lend money to borrowers, it is much harder for a country's businesses and entrepreneurs to invest and improve the productive base of the economy. Investment in businesses, houses and other assets raises living standards.

Banks are a central part of this process, particularly in providing finance to small and medium-sized businesses.

Most small businesses are not large enough to wear the costs of issuing shares or bonds directly to the public, so most of their external financing comes from banks.

In addition to their primary role of intermediating funds between savers and investors, banks also offer a wide range of other services. These include the provision of facilities to make convenient and safe payments; investment advice; funds management; insurance; and general business advice.

It is from all of these activities that banks earn their revenue, and ultimately, their profits.

What are bank profits?

Bank profits are simply an accounting record of how a bank has performed over a given period of time, typically a twelve-month period.

There is a simple and well recognised formula to determine and report profit. At its most basic level, a business's profit is represented by the formula:

Profit = Revenue minus Costs

This formula applies for all businesses and banks are no exception. When critics claim that banks make 'excess profits', what they are claiming, in essence, is that the bank's revenue is well in excess of its costs[1]. Understanding how banks make revenue and what costs they incur is critical to properly understanding any given bank result and understanding the context of that result.

Nearly all banks in Australia are commercial businesses that are listed on the Australian Stock Exchange (ASX) or an international stock exchange. As such, they are required to report their operating results on a regular basis. This information gives investors valuable insight into the bank's fundamental capacity to generate earnings and, hence, an indication of the bank's underlying value.

[1] An equivalent but more abstract concept is the idea that 'excess profit' is the result of a bank's operating costs being too low relative to its revenue.

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With this information, investors can make more informed decisions on whether to buy or sell bank stock. Similarly, performance data gives other stakeholders important information. For example, a central concern of depositors (who provide around 60% of total funding for Australia's banking sector) is whether the institution holding their money is likely to repay it. From the financial statements, depositors will have confidence that their money is safe while also having information which might assist them in choosing the institution with which they want to do business.

Another example relates to institutions which purchase the debt issued by our banks, bond holders (who provide the remaining funding of Australia's banking sector). These stakeholders use financial statements to gain confidence in the ability of the bank to repay the debt.

Where does bank revenue come from?

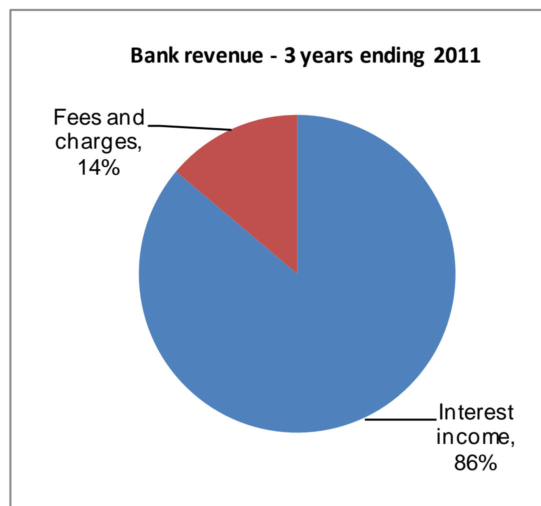
Like any other business, bank revenue comes from their customers. As indicated above, banks are involved in sourcing depositor savings and then channelling those funds to borrowers. This gives banks two broad customer groups – depositors and borrowers.

From these customers, two categories of revenue are derived: (a) interest received, and (b) fees and charges for services provided.

Banks charge borrowers interest on outstanding loans and they charge both borrowers and depositors for account-related services, such as monthly account fees which cover costs such as providing the banks' extensive networks of branches, ATMs, call centres and Internet banking platforms, as well as regulatory compliance costs.

(Readers should be aware that this section of the paper considers only the gross interest received by banks. It is important to remember that while banks make a significant amount of income from interest received, banks also pay out a large amount of interest to depositors and bond holders. The gross revenue data present in this paper does not remove any interest paid out.)

Chart 2



Source: Bank Annual Reports

Chart 2 shows that the majority of bank revenue (around 86%) comes from interest on money lent to businesses, home borrowers, and consumers (for other purposes). The remainder 14% comes from fees and charges.

Of this 14%, the majority is sourced from business customers, not households. Indeed, the fees and charges from households have fallen markedly in recent years as banks have slashed a range of fees.

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The Reserve Bank's "Bank Fees 2012 Report" shows that banks have cut $1.15 billion of fee revenue from households over the two years ending June 2011, significantly reducing their cost of banking.

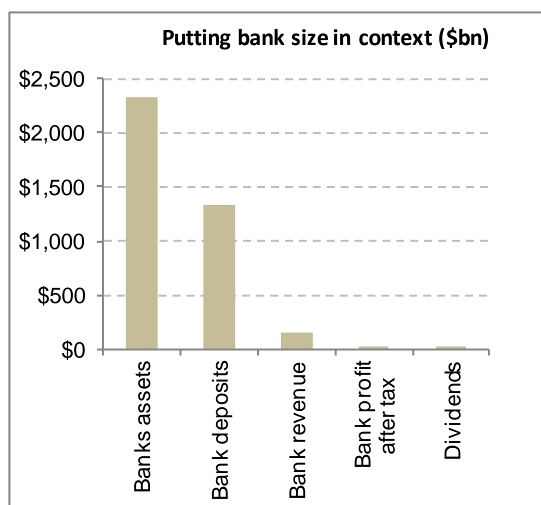
Why do banks make so much revenue?

Over 2011, total bank revenue was $156 billion, roughly 12% of Australia's Gross Domestic Product (GDP). While this is large relative to Australia's GDP, it needs to be seen in the context of the size of banks and the degree to which they are integrated into the economy. For example, as of mid-2012, bank assets - mostly as loans to households and businesses[2] - stand at $2.3 trillion dollars, almost double Australia's GDP.

Bank revenue appears large for the simple reason that the banking sector is large. The task of transforming savings into investment now constitutes the largest business sector in Australia, even larger than mining and manufacturing. Bank stocks constitute around 27% of the ASX/S&P 200 and the major banks are all represented in Australia's ten largest companies by market capitalisation.

This point is further highlighted by comparing the size of a bank's balance sheet with well-known benchmarks.

Chart 3



Source: APRA Monthly Banking Statistics/Bank Annual Reports

Given the size of bank balance sheets, it is not surprising they produce large amounts of revenue.

But when viewed against the size of the asset base, bank revenue is reasonably low. This fact is drawn out in Chart 3.

Bank revenue is only about 6.7% of total bank assets. Profits represent just 1.0% of total bank assets.

And when comparing dividends paid to shareholders against bank assets, it works out to be around half of one per cent.

As can be seen from the chart above, dividends are very small by comparison.

Low-income households

One particularly damaging myth about banking is the criticism that banks profit through high charges for services to Australia's lowest income earners. This is persistently argued by critics, but there is no statistical evidence for it and typically critics rely upon assertion or unsubstantiated anecdotes.

[2] Assets also include placements and securities held on balance sheet.

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Around every five years, the Australian Bureau of Statistics (ABS) releases detailed data[3] on the expenditure patterns of Australia's households. The data is valuable for analysing the spending behaviour of households with differing income levels. Households are classified into five income groups from the lowest to the highest incomes.

Data for the 2009-10 financial year were released in August 2011. In reference to banking services, the data clearly shows that low-income households are not the main source of bank revenue. For example:

- It costs households in the lowest income group about $1.04 per week to operate bank accounts such as transaction accounts and savings accounts. This compares to $5.65 per week for high income households.
- Because low-income households typically have fewer mortgages, of lower value, they pay, on average, around $17 per week on home loan interest, compared to $164 per week for the highest income group.
- Low-income households pay $1.81 per week on credit card interest, whereas high-income households pay $7.94 per week.

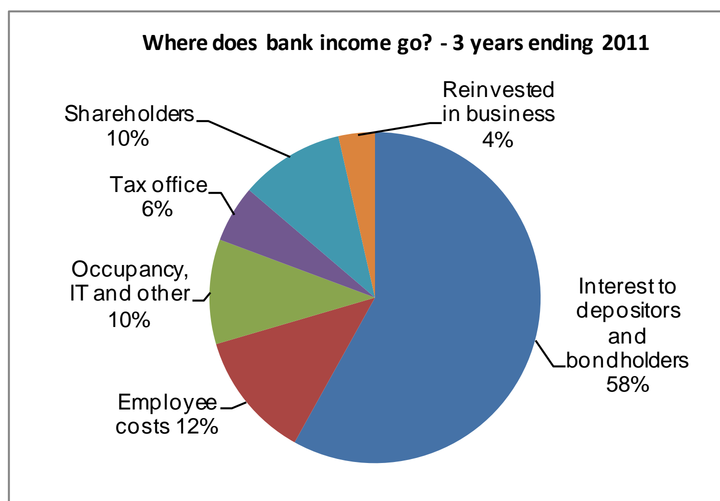
The data shows bank revenue from households is predominantly sourced from high-income households and not low-income households. The cost of banking for low income earners is very low and most banks offer free or low cost accounts to many low income customers.

What do banks do with their revenue?

As detailed above, the formula for bank profit is Revenue minus Costs. While banks derived revenue of around $156 billion last year, only a small portion (10%) of this goes to shareholders. The rest of the money is distributed to the various stakeholders of the banks for services they provide to the bank.

By far the largest receivers of bank revenue are depositors and bond holders, those people and businesses that – in effect - lend money to the bank: the savers.

Chart 4



Source: Bank Annual Reports

As can be seen from Chart 4, 58% of bank revenue was distributed to depositors (and bondholders) in the form of interest payments.

The next largest receivers of bank revenue are bank employees, receiving 12%.

[3] Household Expenditure Survey (HES).

Shareholders, who are often assumed to be the main beneficiaries, receive only 10% of total bank revenue.

What happens to bank profits?

In much of the commentary regarding bank profits, it is often implied that banks distribute all their profit to shareholders. In fact, shareholders only receive in direct payments about half of all before-tax profit.

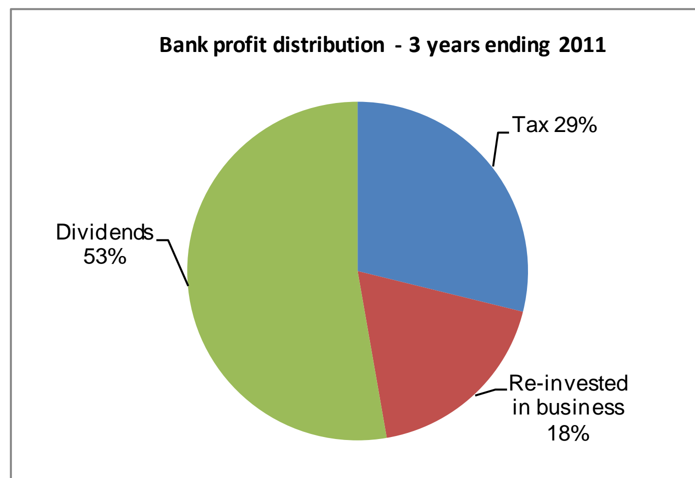
The Australian Government received 29% of bank profits through taxes over the 3 years ending 2011. Indeed, banks contribute more corporate tax than any other industry in Australia.

In the last 5 years, banks have paid over $35 billion dollars in tax, plus an additional $3.0 billion for the government's bank funding guarantee.[4]

The remainder of bank profits are used for reinvesting in the business. Technically this is known as 'retained earnings'.

In 2011, the main retail banks made a combined before-tax profit of $32.4 billion. A breakdown of this profit distribution is shown in Chart 5.

Chart 5



Who are shareholders?

It is often implied that bank shareholders are wealthy and that bank profit is just cementing their already healthy bank accounts.

Yet, the reality is quite different. The great majority of bank shares are held by households either directly or indirectly through their superannuation funds and retirement savings.

As of June 2012, 58% of bank shares can be attributed to Australian households. About 24% of bank shares are held by offshore residents, 10% of shares are held by Australian businesses, specialist investment companies, trusts and 8% by Government.

[4] Over the duration of the Government Guarantee, it is estimated that banks will pay around $5 billion in premiums to the Federal Government.

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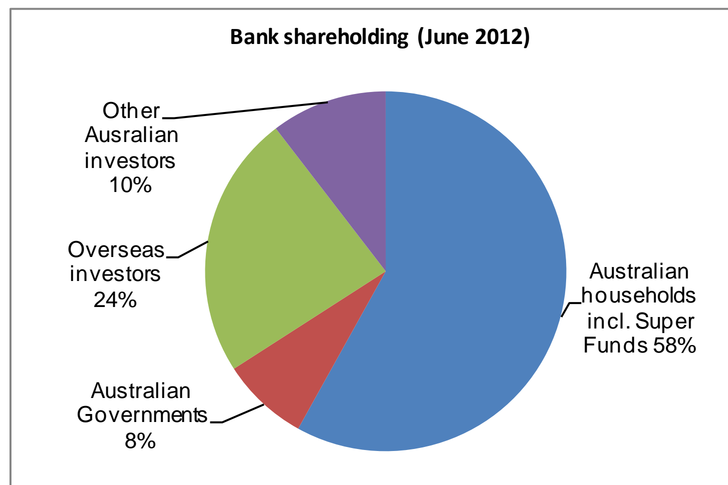
Chart 6



Source: ABS Financial Accounts

Bank shares are a mainstay of superannuation investment given the stability of earnings and relatively high dividends.

It is almost inconceivable that a person with a superannuation account - in a balanced portfolio - would not hold bank shares and earn dividends towards their superannuation and financial security in retirement.

Are banks too profitable?

Probably the most contentious and debated area of banking is regarding the level of profits they make each year.

While most people seem to understand the value in banks making profits, certainly when seen in light of unprofitable banks, there is a degree of concern over the size of these profits. A question arises - what level of profit equates to a healthy bank?

There is a short answer: for any given level of risk, the more profitable a bank, the healthier it will be.

Theoretically, excess profit can indicate high risk taking, but most banks around the world, including Australia's, are prudentially regulated under the international capital framework (known as the Basel Capital Accord) and this means a bank's risk profile must be managed with an appropriate level of reserves and capital. Under the rules, the greater risks faced by the bank, the higher the capital needed.

For any given level of risk, the higher the bank's profit, the more resilient the bank. This point is illustrated with a simple example.

A simple example of why bank profits are essential

Table 1 compares the profitability of two banks. As can be seen, both Bank A and Bank B are identical in every respect except the level of operating costs. Revenue is 100 for each bank, but Bank B's operating costs are 5 higher. The difference in operating costs results in a difference in underlying profit because Profit = Revenue minus Costs.

In the example, both banks are making an 'underlying' profit, but Bank B is much more vulnerable to an economic downturn or some other factor causing a spike in loan defaults. As can be seen in Table 1, if both banks are hit with bad debts of 6, then Bank B will make an overall loss of 1, whereas Bank A will continue to return a profit.

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While this is a simple example, it captures the essential link between bank profits and stability. Bank failures[5] are extremely disruptive events, typically causing damage to the real economy and unemployment.

Table 1: Stylised example of the importance of profits in absorbing losses

Profit/loss	Bank A	Bank B
Operating Revenue	100	100
Operating Costs	90	95
Underlying Profit	**10**	**5**
Bad Debts	6	6
Overall Profit (adjusted for bad debts)	**4**	**-1**

A further point can be made from the simple example above. Bank A has greater underlying profitability than Bank B, not because it has greater revenue (both have 100), but from the fact that Bank A has lower operating costs (90 versus 95).

This shows that financial strength can be driven by managing costs as well as revenue generation, a point often missed in debate over restructuring, outsourcing etc. When banks seek to cut costs, they are simultaneously building resilience, assuming no offsetting decline in revenue.

Indeed, making an institution more efficient by reducing the amount of resources used and therefore cutting costs, not only strengthens the bank, it contributes to economy-wide productivity and sustained economic growth.[6]

Benchmarks

Another way to approach the question of whether banks make too much profit is to look at relevant benchmarks. A bank is both a 'listed corporation' and a 'bank', so these two characteristics provide obvious starting points for profit comparisons.

When comparing profitability, there is a technical issue over which definition of profit is most suitable for comparison. Profit can be defined in terms of pure dollar numbers, such as a profit of $5 billion over the financial year. This can further be narrowed to define it as 'before-tax' or 'after-tax'. The before-tax figure has the advantage of revealing the fundamental capacity of a bank to generate earnings whereas 'after-tax' profit can reflect changes to government tax rates and rules.

Another option is to compare bank profit as a ratio of some benchmark. Common choices include GDP, total assets, total liabilities, or shareholders' equity. A ratio of bank profit to shareholders' equity, known as Return on Equity (ROE), is particularly good when comparing Australian banks against other listed

[5] It should be noted that an accounting loss will not necessarily lead to the insolvency of the bank. Insolvency is defined as a situation where a business' assets are less than its liabilities. An accounting loss can be absorbed by capital. However, in practice, a bank loss, in the absence of explicit government support, is likely to shatter confidence and lead to a liquidity problem ultimately resulting in insolvency.

[6] Economic theory establishes that there are only two ways for an economy to produce more output i.e. grow. Firstly, more resources can be used, such as more labour input (longer hours or more workers), more land and/or more capital machinery. The second means of growth is by using existing resources more efficiently, that is, increased productivity. To use a very simple example, if a lighting business can produce a light bulb with one employed worker rather than two, then the business will be producing the same output with less labour resources. This benefits the economy because one worker is freed from that task of producing light bulbs, and can be deployed in other productive activity such as bricklaying. Assuming there are limits to the amount of resources available for production, the best long-term solution to growth is greater efficiency and productivity, not more resource input.

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companies. This measure removes the influence of gearing ratios and highlights the fundamental benefit of operations to the shareholders.

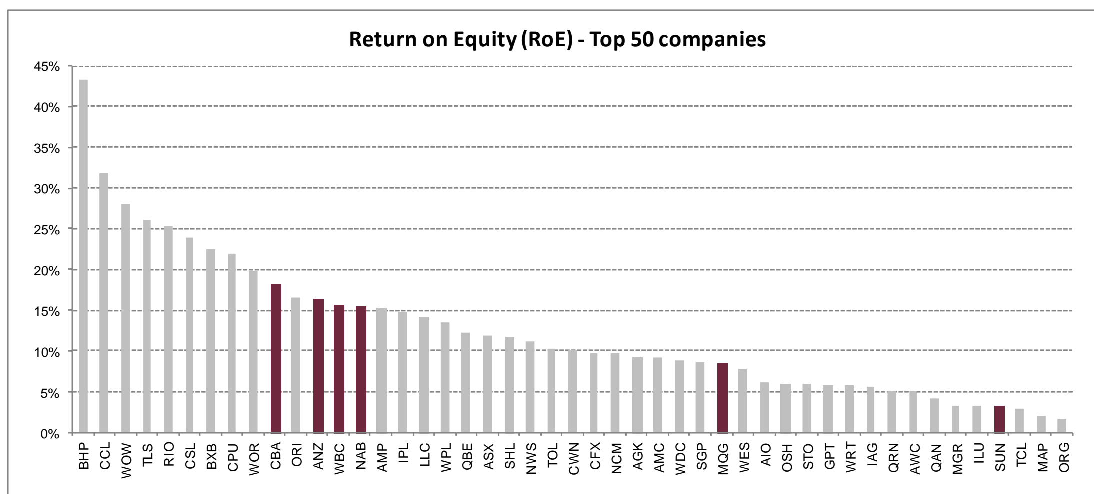
Benchmark 1: Comparing bank profit to other businesses

The ASX requires disclosure of detailed information on the assets, liabilities and other performance indicators of companies with shares listed on its exchange. This provides robust comparative data.

Looking at the profitability measure of ROE, it appears the major banks are around the average of comparable businesses. This can be seen in Chart 7 which shows the ROE for the top 50 companies on the ASX sorted from highest to lowest.

Chart 7 shows three distinct ROE groupings: those businesses with ROEs above 20%; those with ROEs between 10%-20%; and those with ROEs below 10%. All of the major banks fall into the middle category.

Chart 7



Source: Commonwealth Bank of Australia

Since Chart 7 only examines ROE of the largest 50 companies, a more informative result can be seen from Chart 8 which lists companies in order of overall profitability (as measured by ROE). This shows that only two banks (CBA and ANZ) make the list. For the top 50 profit earning companies, the vast majority are making ROEs well in excess of 20%, considerably higher than even our most profitable bank.

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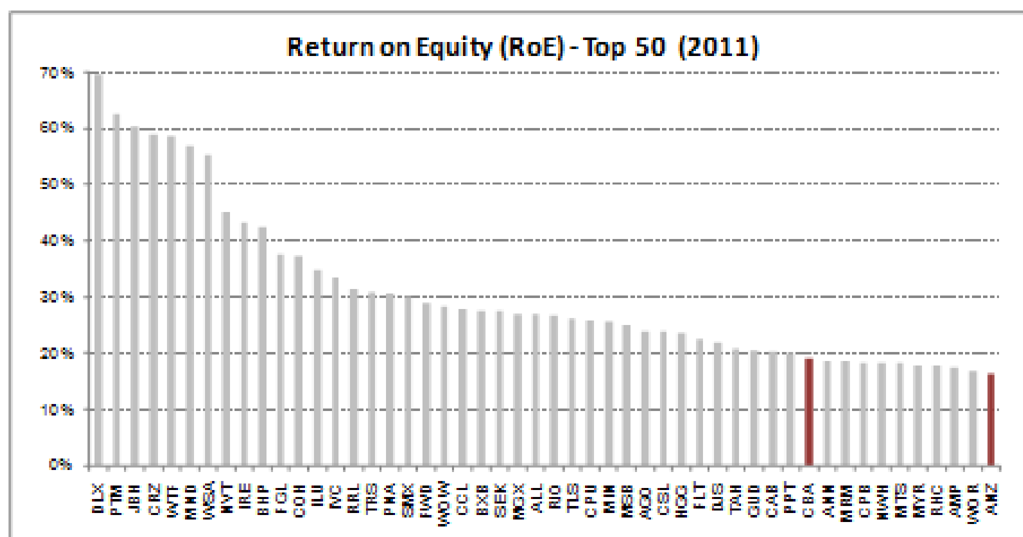
Chart 8



Source: Commonwealth Bank of Australia

Based on ROE - a commonly used profitability measure - it cannot be claimed that Australian banks are making excess profits in comparison to other large listed companies.

Benchmark 2: Comparing Australian banks with banks in other countries

Another useful benchmarking approach is to compare our banks with overseas banks.

Comparing profitability of banks between countries, however, is notoriously difficult, as small differences in accounting, taxation and prudential regulations can distort the accuracy of comparisons.

Given these difficulties, the ABA has not attempted to derive comparisons from original data but has relied upon some produced series from the Bank of International Settlements' (BIS). BIS Annual Reports show comparative profit data (based on the profit measure of Return on Assets (ROA) for major banks in 13 industrialised countries.

ROA is a reasonable benchmark for comparing banking systems across countries although it should not be used to compare banks and non-financial institutions, given differences in leverage.

Summary data is included in Table 2. This shows Australian banks have proven to be profitable compared to banking systems of all countries listed.

Over the ten years to 2011, the average ROA for Australia was 1.33%, compared to US banks at 1.32%.

In 2011, Australia's largest banks recorded the highest ROA (1.19%) of the selected countries surveyed.

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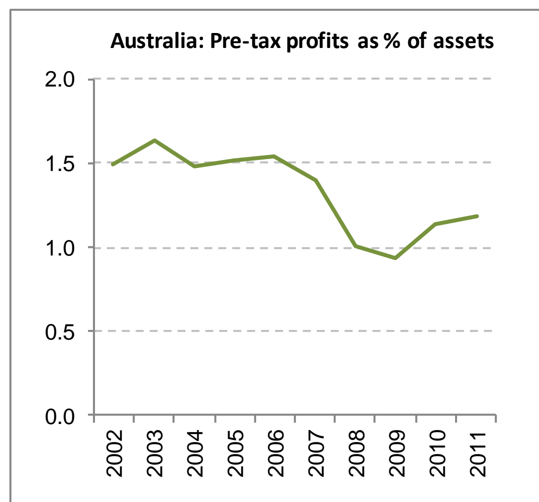
Table 2 – Comparison of profits by selected country

Pre-tax profits as % of assets	10-year to 2011 Avg	Pre-GFC Avg
Australia	1.33	1.53
Austria	0.73	0.84
Canada	0.95	1.03
France	0.46	0.65
Germany	0.10	0.19
Italy	0.53	0.92
Japan	0.26	0.20
Netherland	0.26	0.54
Spain	1.10	1.21
Sweden	0.74	0.87
Switzerland	0.26	0.55
UK	0.63	1.00
US	1.32	1.91

Source: Bank of International Settlements (BIS)

Even though Australia has performed well in comparison to other countries in terms of ROA, the data show that since the height of the GFC, since late 2008, the ROA for Australia has been considerably less than pre-GFC.

Chart 9



Source: BIS

Some analysts have examined different data and concluded that Australian banks are around average in terms of international profit comparisons, particularly once bad debts are factored into the analysis. While the ABA has not been able to rigorously verify this, anecdotally it appears that even by taking non-performing loans into consideration, Australia's banks are towards the higher end of the profitability spectrum.

In one sense, this is no surprise. Bank profitability correlates to overall economic growth. Strong GDP growth manifests in higher levels of confidence and a greater willingness for households and businesses to borrow money and use financial services.

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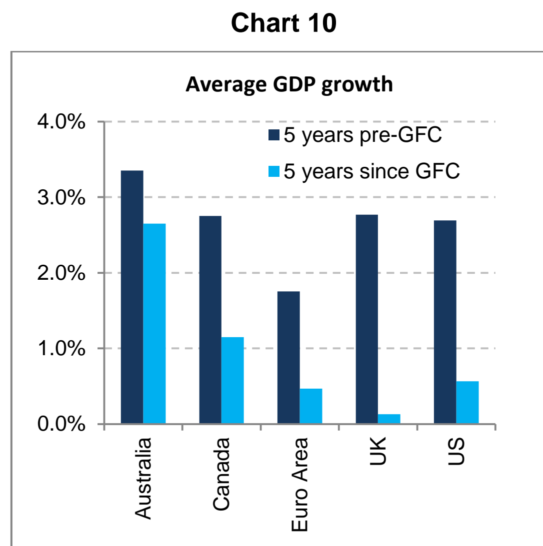
Chart 10 shows that Australia's GDP performance has been significantly higher, on average, than for other western economies over the past five and ten years, a key reason why banks have shown consistently higher profitability than banks in other countries.

Chart 10



Source: IMF

Australia has experienced 21 years of sustained economic growth[7], a record shared by few other countries. Bank profits have benefitted from this period of growth and stability and it would be expected that the performance of the banking sector would mirror the performance of the economy.

Benchmark 3: Competition

Another way to assess profits is to consider whether the banking industry exhibits competitive characteristics. The idea here is that the community can be confident that banks are not too profitable if there is sufficient competition.

On this basis, there appears to be good reasons to be confident. Over the last four years, the Government has undertaken many inquiries into banking that have looked at competition issues and has also undertaken two formal competition assessments in respect of mergers between institutions.

Bank margins have only been lower during the period in the lead up to the GFC, when some have argued that banks under-priced risk.

None of these assessments have concluded that there is any significant problem in banking competition in Australia.[8]

Chart 10, tells the essential story in terms of bank competition.

The net interest margin is, in effect, the price of banking. When it declines, it indicates greater competitive pressure. Chart 11 shows a clear decline in banks' net interest margins from the late 1990s.[9]

[7] Note the commonly used definition of 'recession' is that of two consecutive quarters of negative GDP. Australia has not experienced recession since 1991.

[8] It should be noted that a number of the ABA's smaller retail banks have a concern over the competitive landscape i.e. that it is harder for smaller institutions to compete in today's market than it was pre-GFC. This reflects the changes which the GFC has made to the economics of different business models. However, from the consumer perspective, competition is strong.

[9] The declining margin shown in Graph 10 is even more dramatic when considered in light of the fact that significant margin decline also occurred in the five years preceding the time period depicted in the graph.

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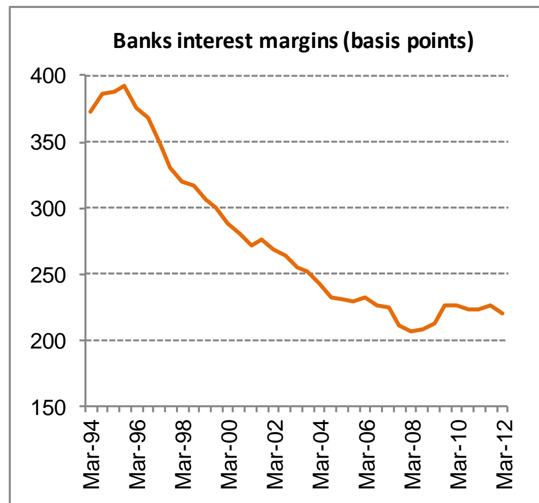
While the net interest margin ticked up in wake of the GFC, as banks adjusted pricing to the more risky and uncertain environment, since then, as conditions have stabilised, competition is once again driving down margins.

Chart 11



Source: UBS Warburg

Housing finance market

The main evidence put forward to claim banking is uncompetitive is the high level of housing loan market share of the major four banks.

This ignores a number of realities. As a result of the GFC, many non-bank housing loan providers exited the housing finance market because these non-bank providers were entirely or very heavily reliant on securitisation, which was proven to be an unsustainable business model. The major banks, in particular, were relied upon to fill the void, so that people wishing to buy homes could still get finance.

Second, the GFC was a turning point in that the difference between the cost of funding for highly-rated institutions, and the cost for lower-rated institutions, increased markedly (i.e. the funding cost differential between the major banks and other lenders widened). Expressed in another way, while AA- rated institutions have always sourced funding more cheaply than lower-rated institutions, this differential was exacerbated by the GFC.

An example of the differential in funding costs during the GFC was the difference in the premiums charged by the Government for the use of the wholesale funding guarantee.

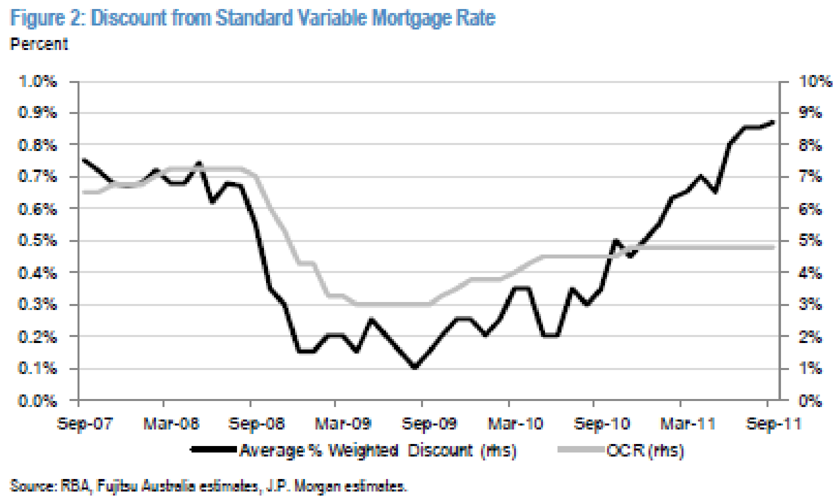
Competition has also intensified as demand for home loans and other forms of borrowing have eased considerably through the GFC. Banks and other lenders now compete for fewer customers, driving stronger competition.

Recently, leading J.P. Morgan banking analyst Scott Manning described the housing finance market as *'competitive as it can get prior to diluting group returns'*[10].

In other words, if interest margins on housing mortgages were to drop much further, the loans would become unprofitable. The J.P. Morgan research note includes a graph (reproduced below) which shows that banks are 'discounting' housing loans by more than they were before the GFC, even though the market shares of the major banks have increased significantly since the GFC.

[10] Australian Banking Sector, J.P. Morgan, Australian Equity Research, 16 September 2011.

Chart 12



Any other questions?

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