The Australia Institute

Research that matters.

The profit in home lending

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About TAI

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Our philosophy

As we begin the 21st century, new dilemmas confront our society and our planet. Unprecedented levels of consumption co-exist with extreme poverty. Through new technology we are more connected than we have ever been, yet civic engagement is declining. Environmental neglect continues despite heightened ecological awareness. A better balance is urgently needed.

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Our purpose—'Research that matters'

The Institute aims to foster informed debate about our culture, our economy and our environment and bring greater accountability to the democratic process. Our goal is to gather, interpret and communicate evidence in order to both diagnose the problems we face and propose new solutions to tackle them.

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Method

The purpose of this brief is to estimate the profit earned on mortgages by the ANZ Bank, the Commonwealth Bank of Australia, the National Australia Bank and the Westpac Banking Corporation known as big four banks.

The method here is to estimate the average profit margin on bank home loans and then to apply that to the amounts people are borrowing at the moment. The estimates here are based on the data presented in Table 1 which in turn are based on statistics published by the Australian Prudential Regulation Authority.

The first two rows of data in Table 1 show the banks' balance sheet items, total assets and housing loans. Both are averages of the four quarters ending in December 2011.

The following four rows of data are operating items for the full four quarters ending in December 2011. They include the

- interest income banks earn on housing loans,
- total interest expenses,
- total operating expenses, and
- the charge for bad and doubtful debt.

The next five rows of data are based on calculations by The Australia Institute. The average interest rate on housing loans is the amount charged by banks in 2011 as a proportion of housing loans and then expressed as a percentage return on the housing loans.

To obtain average interest expense, interest expenses have been allocated over all assets and then pro rata allocated to housing loans. Normally interest expenses would be thought of as applying to banks' liabilities. However, banks earn an income on their assets (loans to individuals, homeowners, businesses and governments) and in trying to determine the interest expenses backing housing loans we need to allocate them over the asset portfolio.

Like interest expenses, other bank costs have had to be allocated across the bank businesses in a similar way. It is assumed here that non-interest expenses are allocated pro rata across the banks' businesses. Likewise the charge for bad and doubtful debt is allocated pro rata. Both are expressed as a margin or percentage charge on housing loans. The pro rata allocation of the charge for bad and doubtful debts may be too high given that home loans tend to be insured and that they tend to be much better risks than other lending. The conservative bias this lends our results is acknowledged.

Finally the profit margin is presented as a percentage of the housing loans and calculated by taking the interest rate on housing and deducting the interest expense, the expense margin and the bad and doubtful debt margin.

Table 1: Banks' home loan profitability, 2011

	Big four banks	All banks	Smaller banks
Balance sheet items			
total assets ($ million)	2,603,393	3,325,695	722,302
housing loans ($ million)	1,102,348	1,254,649	152,301
Operating items			
interest income: housing loans ($ million)	72,510	83,044	10,534
total interest expense ($ million)	91,462	122,242	30,780
total operating expenses ($ million)	32,808	43,205	10,397
charge for bad and doubtful debt ($ million)	5,162	6,604	1,442
Rates per dollar of housing loan			
average interest rate on housing loans %	6.58	6.62	6.92
average interest expense allocated over all assets %	3.51	3.68	4.26
expense margin %	1.26	1.30	1.44
bad and doubtful debt margin	0.20	0.20	0.20
After tax profit margin %	**1.61**	**1.45**	**1.02**

Source: APRA (2012) Statistics: Quarterly bank performance, December 2011, 15 May.

The results here show that the big four banks earned profit margins of 1.61 per cent of the value of their housing loans, while smaller banks earned profit margins of 1.02 per cent of their housing loans.

The banking industry might claim that the cost of raising funds for housing loans is somehow different to the cost of raising funds for other purposes. Certainly it is difficult to allocate a particular bank cost to a particular part of the bank's business. But the situation is analogous to asking which part of the tree trunk holds up which set of branches. It does not seem meaningful to try and differentially allocate more or less expensive sources of funds to particular lending activities so we apply the average interest expense.

Our estimate is conservative as the allocation of non-interest expenses to housing uses the pro rata approach and probably exaggerates the non-interest costs of administering home loans. Those costs tend to be high at the initial stage of a home mortgage, the signing up stage, and perhaps the discharge point, but are likely to be very small in between. Moreover, some if not all of these costs are recovered through establishment fees and the like. The latter have not been factored in to the profit margin fees reported below.

Again, our estimate is conservative because we have not included the fees banks charge on housing loans. According the Reserve Bank of Australia bank fees on housing loans were $1,240 million in 2011[1] or 0.10 per cent of housing loans. In principle that could be added to the interest charge to obtain the full profit figure. However, bank fees are heavily loaded in favour of establishment fees but include on-going loan servicing fees. In addition they apply as fixed rates that do not vary with the size of the loan. On top of that there is no breakdown by type of fee, nor allocation between the big four and other banks. It is therefore not possible to allocate the fee income and include it in Table 1.

By deducting expenses but not adding fees the results are necessarily a conservative estimate of the true profit margin on housing loans.

Implications for home buyers

The average value of new housing finance commitments for owner-occupied housing was $293,000 in the twelve months to June 2012.[2] Applying the 1.61 per cent profit margin to that loan means that the average big four bank would be making a profit of $4,705.91 per annum. On those figures a household in Australia that has taken out the average new loan would be paying $90.50 per week in profit to the bank. If that household pays a monthly mortgage repayment then $392.16 a month is the banks' profit.

Over the life of the loan the value of the outstanding principle will decline and so the annual profit on the loan will gradually decline. The typical loan in Australia is for 25 years and requires monthly repayments. Hence, over the life of that loan the profit would be $74,450.27.[3]

As emphasised above, our estimates are conservative as the fees banks charge on housing loans have not been included in these calculations. Nevertheless, the findings here suggest that the burden of bank profits fall very heavily on homebuyers.

Australia's big four banks are extremely profitable by world standards and by the standards of other companies in Australia. Those excessive profits are clear in the $4,705.91 profit extracted from the average new mortgage.

1 Reserve Bank of Australia, Statistical tables at http://www.rba.gov.au/statistics/index.html

2 ABS (2012) Housing finance, Australia, Cat no 5609.0, 8 August.

3 This estimate is based on the total interest cost as calculated in the ANZ home loan calculator. The profit is estimated by using the ratio of the profit margin estimated in Table 1 to the average interest rate on housing. That ratio is applied to the value of the interest cost over the life of the loan.