RESPONDING TO THE LOW INTEREST RATE ENVIRONMENT IN AUSTRALIA
EXECUTIVE SUMMARY

Australia has entered into a record low interest rate environment and there is a high probability that interest rates will remain low for a prolonged period of time. This is leading to a net interest margin compression for banks, which could result in their profits reducing by up to 15 percent. Responses from European and US banks who have experienced similar constraint environments provide useful lessons for Australian banks. We see five core levers that banks can pull, to adapt to this low interest rate environment:

- **REPRICE LENDING AND DEPOSITS**
  by differentiating pricing by segment/product based on detailed analysis of price sensitivities

- **REDEFINE FEE INCOME STRATEGY**
  by differentiating according to price sensitivities and customer value

- **OPTIMISE BALANCE SHEET HOLISTICALLY ON A RISK AND RETURN BASIS**
  including optimizing wholesale funding composition and duration, liquidity, capital, and asset and liability management (ALM) positions

- **REVISIT COST TRANSFORMATION INITIATIVES**
  and establish sustainable cost management

- **UPDATE BUSINESS MIX/ASSET ALLOCATION**
  including promoting investment products to limit the outflow of funding as customers search for higher returns

Each of these levers needs to be well thought through, and implementing them will likely require upgrades to existing tools and approaches. Learnings from banks overseas suggest that those with a centrally coordinated approach with decisiveness will prevail.
AUSTRALIA HAS ENTERED A RECORD LOW INTEREST RATE ENVIRONMENT, WITH THE EXPECTATION OF IT BEING PROLONGED, LIKE THAT OBSERVED IN OTHER ADVANCED ECONOMIES

The Reserve Bank of Australia (RBA) cash rate is at a historical low of 100 basis points (bps). This is following two interest rate cuts in consecutive months that have been driven by the weakening economy and subdued inflation pressure¹. As indicated by the implied yield curve of the ASX cash rate futures, the market is expecting further interest rate cuts, which could bring the RBA cash rate to 75bps by the end of 2019, and there is a possibility that interest rate will drop to 50bps by Q3 2020. While this environment is unprecedented for Australia, many other economies have experienced similar conditions, with banks having to manage within a similarly constrained interest rate environment.

As we look forward, we see three possible macroeconomic scenarios for Australia:

1. Steady recovery
2. Europe scenario
3. Japan-lost decade scenario

Each of these scenarios impact banks’ profits differently (See Exhibit 2). With persistent downside risks to the global economy combined with subdued inflation², we believe the most likely scenario is B, where interest rates will remain low for a prolonged period, leading to a potential negative profit impact of 3-15 percent.

The potential impact of the low interest rates on banks’ profits will differ depending on the composition of their portfolios and the characteristics of the banks themselves. As such, the key drivers of net interest margins (NIMs) need be carefully analysed on a bank-by-bank basis to determine the appropriate mitigating actions.

¹ Quote from speech by Philip Lowe, Governor of the RBA: Today’s reduction in the Cash Rate, June 4, 2019.
² Quote from statement by Philip Lowe, Governor of the RBA: Monetary Policy Decision, July 2, 2019.
Exhibit 1: Interest rates across major economies

Source: Oxford Economics

Exhibit 2: Potential macroeconomic scenarios and impact on profit

<table>
<thead>
<tr>
<th>SCENARIO</th>
<th>MACROECONOMIC DESCRIPTION</th>
<th>GENERAL EFFECTS ON BANKS</th>
<th>PROFIT IMPACT¹</th>
</tr>
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<tbody>
<tr>
<td>1. STEADY IMPROVEMENT</td>
<td>• Inflation and growth remain positive</td>
<td>• Slow increase in profitability</td>
<td>STABLE/INCREASING PROFITS</td>
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<td></td>
<td>• Interest rates begin rising slowly over time</td>
<td>• Strong growth in lending as consumer confidence and affordability pick up with economic growth</td>
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<td></td>
<td>• Limited NPLs due to stable or growing wages</td>
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<td>• Conflicting effects on deposits as it becomes more attractive with rising rates vs. rising propensity to spend</td>
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<td>2. EUROPE SCENARIO</td>
<td>• Inflation remains subdued</td>
<td>• Pressure on NIM as market expects low interest rates to last in absence of growth (resulting in flatter yield curves)</td>
<td>LOW–MEDIUM 3–15% profit reduction</td>
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<td></td>
<td>• Economy is stagnant and unemployment remains high</td>
<td>• Low demand for credit given weak economic environment</td>
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<td></td>
<td>• Extended period of low interest rates</td>
<td>• Growing NPLs driven by stagnating or falling wages</td>
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<td></td>
<td></td>
<td>• Relatively stable deposit volumes but with business mix increasingly shifting from term deposits to instant access</td>
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<td>3. JAPAN-LOST DECADE Scenario</td>
<td>• Deflation</td>
<td>• Pressure on bank earnings ultimately impacting solvency (especially for smaller/regional players)</td>
<td>HIGH 15–30% profit reduction</td>
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<td></td>
<td>• Deteriorating economy and rising unemployment</td>
<td>• Low credit volumes due to bank deleveraging and low demand (lack of growth)</td>
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</tr>
<tr>
<td></td>
<td>• Extended period of low interest rates</td>
<td>• High NPLs driven by stagnating or falling wages</td>
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<td></td>
<td></td>
<td>• Outflow of funds from saving deposits seeking higher yields in international opportunities or alternative assets</td>
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¹ Profit impact estimated based on banks’ historical NIMs
THE LOW INTEREST RATE ENVIRONMENT IS COMPRESSING BANKS’ NIMS DRIVEN BY A NUMBER OF FACTORS

Banks will need to understand the trade-offs associated with each factor in order to determine appropriate mitigating actions:

Increased pressure to fully pass-through interest rates cuts into lending rates: Treasury analysis shows that interest rate cuts have not been passed in full to variable mortgage rates 70 percent of the time that RBA has cut interest rates since the Global Financial Crisis (GFC). However, in this heightened political and regulatory environment driven by the Royal Commission ¹, pressure from the Treasurer and the Governor of the RBA to fully pass-through rate cuts are elevating. Nevertheless, the level of reduction in lending rates is likely to be differentiated by several factors, including bank strategy, client segment, product type, fixed versus floating, and front versus back-book considerations.

Limited room to further reduce deposit rates to offset the reduction in lending rates: Banks’ funding is composed primarily of at-call deposits, term deposits, and wholesale funding. Despite major banks’ term deposit rates falling by an average of ~35bps (with a range of ~10bps to ~60bps) in the few months leading up to the interest rate cuts, the total reduction in deposit rates is likely to be restrained due to a material portion being at-call or non-interest bearing. The overall funding cost is also driven by wholesale funding reflected in the Bank Bill Swap Rates, which is influenced by factors such as the offshore money markets.

Flight of deposits to other assets, leading to a shift in the funding composition and growing credit-deposit gap: Banks’ deposits have grown as a proportion of total bank funding from 48 percent in 2008 to 60 percent in 2014, and have been relatively stable since then.² This has contributed to the overall funding cost falling. However, as deposit rates further decline, banks’ customers could look to substitute deposits with higher-yielding assets. This is likely to result in an outflow of funds and exacerbate the growing credit-to-deposit gap of banks, particularly as many banks have divested their wealth and asset management businesses due to recent scrutiny of misconduct in wealth distribution.

Flattening of yield curves leading to reduced ALM profit margins: Banks have traditionally profited via maturity transformation, that is, by borrowing funds in the short-term at a low rate and making long-term loans and investments at a higher rate. The reduction in the difference between short-term and long-term rates, or the flattening of yield curves due to the lowering of RBA cash rates, is thus likely to reduce banks’ ALM profit margins in the longer term. As the 10-year Australian government bond yield has fallen to an all-time low, banks’ ALM profit has collapsed (See Exhibit 3).

Heightened balance sheet risks as customers switch from variable to fixed lending products and from term deposits to at-call deposits: The lowering of interest rates is likely to lead to the growth of fixed rate lending or other longer-term products which contain embedded ALM risk. Fixed rate lending currently contributes to 20 percent of total mortgages in Australia. However, this could shift materially as observed in some European markets (for example, Spain and the UK). On the liabilities side, as observed in many European markets, a shift in household deposits from term deposits towards at-call savings accounts is likely to occur given the falling interest rates, which will lead to less stable funding.

¹ Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry
² RBA March 2019 bulletin – Developments in Banks’ Funding Costs and Lending Rates.
The average NIM of major banks in Australia has already fallen from 2.27 percent in 2010 to 2 percent in 2018 (a drop of 12 percent), driven by the lowering of interest rates and flattening of the yield curve among other factors (see Exhibit 4). This could potentially fall further by ~15 percent over the medium term as observed in other advanced economies. Banks need to act now and establish a clear action plan to mitigate the potential material negative impact of low rates on profitability.

While much of the focus is on how major banks navigate through this new environment, the regional and smaller banks are likely to be more impacted. Their starting points of lower customer bases, being “price takers” on both sides of the balance sheet, and much higher costs-to-income ratios will place even more strain on their balance sheet performance. Establishing a strategic response will, therefore, be even more important and could lead to market consolidation.

Beyond the impact on profitability, the low interest rate environment is also likely to present challenges including funding and liquidity constraints, conduct and mis-selling risks as banks look to reprice or develop new products, as well as operational and system impact (in some markets, the systems were unable to cope with rates being lowered to zero or negative). These risks and challenges will also need to be carefully managed.
TO ADAPT TO THIS LOW INTEREST RATE ENVIRONMENT, WE RECOMMEND FIVE LEVERS FOR BANKS TO CONSIDER

Amid this backdrop and in recognition of the challenges the industry faces, banks need to act now in a coordinated and holistic way. They should start with modeling and stress-testing potential P&L impact by applying various macroeconomic and strategic levers. Banks should also prioritise initiatives based on the outcome of the impact assessment and other trade-off decisions, and establish a central team with involvement from across the business, treasury, finance, and risk teams.

The following are a non-exhaustive list of levers that all banks should consider:

Exhibit 5: Evolution of major Australian banks’ NIMs, %

Source: S&P Market Intelligence
REPRICE LENDING AND DEPOSITS
by differentiating pricing by segment/product based on detailed analysis of price sensitivities

REDEFINE FEE INCOME
by differentiating according to price sensitivities and customer value

OPTIMISE BALANCE SHEET HOLISTICALLY ON A RISK AND RETURN BASIS
including optimising wholesale funding, liquidity, capital and ALM positions

REVISIT COST TRANSFORMATION INITIATIVES
and establish sustainable cost management

UPDATE BUSINESS MIX/ASSET ALLOCATION
including promoting investment products to limit the outflow of funding as customers search for higher returns

REPRICE LENDING AND DEPOSITS

The ability to effectively reprice lending and deposits is crucial to minimise the adverse effects of low interest rates. So far, banks have made efforts to offset losses on margins by selective repricing or adjusting pass-through rates. However, these are not likely to be sustainable in this new low-rate environment.

Deposits make up the majority of the liabilities, with corresponding impact on both P&L and balance sheet risk. As such, there is a pressing need to identify deposit repricing opportunities. Banks should first perform tactical analysis of how to reprice deposits to cover current and future increases in interest expense and consider differentiating pass-through rates by segment and product type. They should also consider upgrading deposit behavior analysis capabilities and perform in-depth analysis of the deposit book using rich customer-level data, in order to better understand their price sensitivities, establish relevant segments, and adjust pricing accordingly.
Exhibit 4: Observed responses from banks oversee

<table>
<thead>
<tr>
<th>TYPE OF RESPONSE</th>
<th>MARKETS OBSERVED</th>
<th>DESCRIPTION</th>
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<tbody>
<tr>
<td>REPRICE DEPOSITS</td>
<td>USA, EU</td>
<td>Banks have begun disincentivising large deposits and exploring tiering</td>
</tr>
<tr>
<td></td>
<td>UK</td>
<td>There is also innovation towards structured deposits, e.g. low risk derivative interest, dual currency short term notes to provide additional returns</td>
</tr>
<tr>
<td>REPRICE LENDING</td>
<td>Australia, UK, USA</td>
<td>Banks have been re-pricing/ differentiating pass-through rates in light of margin pressure</td>
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<tr>
<td></td>
<td>UK, Switzerland, Denmark</td>
<td>Increase in mortgage prices were observed in the UK, Denmark and Switzerland as banks sought to restore their margins from &quot;elevated funding&quot; costs and/or recapture losses made on retail deposits</td>
</tr>
<tr>
<td></td>
<td>USA</td>
<td>In the US, banks have proactively established minimum rates on lending products</td>
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As with deposits, we recommend banks to explore various lending repricing options in light of margin pressure and consider differentiating pass-through rates by segment and product type. Separately, banks should perform in-depth analysis of changes in offer take-up rate across various price levels to fully understand the price elasticity of their current customer base in order to differentiate lending prices.

REDEFINE FEE INCOME STRATEGY

In a low interest rate environment, banks typically rely on non-interest income to maintain profit margins. In Europe, we have observed that banking players in almost all markets have been raising fees in response to low interest rates. Examples include increased current account fee, credit card fees, late payments charges, ATM fees (domestic versus international), FX fees on credit card transactions, and fees for premium services such as advisory.

However, the degree to which banks can increase fees to make a profit is also influenced by the economic and political environment, which is particularly challenging in Australia due to the Royal Commission. We recommend that banks in Australia perform detailed analyses of their existing fees structures, quantify the value that customers place on specific product features and fully understand their price elasticities in order to differentiate fees between customers (for example, lower fees to attract or retain certain customers and optimise in certain services or customer segments). Aside from increasing charges on existing products, which is likely to be challenging in the current political environment, banks could consider enhancing or introducing alternative products, including monetising through the provision of third-party marketing and/or introduction of reward programmes.
OPTIMISE BALANCE SHEET HOLISTICALLY ON A RISK AND RETURN BASIS

The low interest rate environment has a material impact on banks’ NIMs and interest rate risks. Therefore, banks should review their existing ALM frameworks to understand whether the key interest rate risks are being well managed:

• Repricing risk – the risk that assets and liabilities of different maturities might have different sensitivities to changes in interest rates
• Yield-curve risk – the risk that changes in the shape of the yield curve can affect banks’ assets and liabilities differently
• Basis risk – differences in the base rates used to price banks’ various assets and liabilities, and potentially disparate moves in the base rates
• Options risk – the impact of interest rate changes on bank customers’ behavior (for example, early withdrawal of funds, flight of deposits to higher yielding assets)

More broadly, banks should further optimise their balance sheets by taking a more holistic view that can make a material difference to both risk and returns. We recommend that banks analyse the risk-return trade-offs and develop specific optimisation strategies. Potential considerations include:

• Optimising wholesale funding (including composition of wholesale versus deposits and duration versus risks)
• Liquidity buffer (including size and composition)
• Capital
• ALM position (trade-off between managing for NIMs and short-term P&Ls)

To manage optimisation over the longer-term, we recommend that banks develop more sophisticated capabilities, including granular balance sheet forecasting and stress testing tools to better understand drivers and levers, option analysis tools, and improved ALM analysis. We also believe that optimising the balance sheet as a whole in this low interest rate environment will require material changes to the existing operating model. In particular, there needs to be a rebalance between risk-averse “service centre” approach and risk-taking with the aim of achieving risk-reward optimisation.

REVISIT COST INITIATIVES AND ESTABLISH SUSTAINABLE COST MANAGEMENT

Many banks across the major economies have focused on cost reduction since the GFC, which has been re-emphasised in recent years. A range of cost reduction measures have been observed. They include:

• Tactical cost take-out (for example, staff reduction, lowering third party spending)
• Increase in levels of automation across major processes
• Structural changes (for example, outsourcing, divestments of lower profitability businesses)
However, banks have typically executed top-down cost reduction mandates, and in light of the low interest rate environment, revenues are not likely to keep pace. Thus, current cost reductions may not be sufficient to maintain profitability. We recommend that banks establish a sustainable cost management program including the following key components:

- **Cost compass** – set the direction and smart targets for the bank by applying industry foresight, strategic lens, and peer analytics
- **Cost intelligence** – establish a comprehensive view of costs, which includes not just the absolute levels of costs but also cost drivers, characteristics, and associated values, on which to make rational decisions
- **Hypothesis-led cost strategy** – consider the key trade-offs and define the roadmap and financials for sustainable cost management
- **Execution at pace** – tools and techniques to deliver commitments through the business cycle

**UPDATE BUSINESS MIX/ASSET ALLOCATION**

We recommend banks explore various options to update their business mix across savings/investment and lending products in light of lower returns. To limit the potential outflow of funds as clients search for higher yields while reducing the negative interest income, banks could consider offering alternative products to savings deposits such as fund investment vehicles or structured deposits.

There are economic advantages for banks in offering these products while allowing customers to customise their risk-return preferences. However, the associated customer conduct and mis-selling risks would then need to be carefully managed. Furthermore, banks could investigate updating their lending portfolio mixes and find pockets of risk-reward, as well as explore alternative lending models such as peer-to-peer lending as an additional revenue stream.

Each of these levers needs to be well thought out and banks will have to take a disruptive view. Banks will also likely need to bring together expertise not always present inside their organisations in developing the tools and approaches necessary to tackle the challenge brought by the low interest rate environment. Learnings from banks overseas suggest that those with a centrally coordinated approach and willingness to be decisive will prevail.