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Asia Pacific/Australia
**Equity Research**
Multinational Banks

# Bank Mortgage Pricing

SECTOR REVIEW

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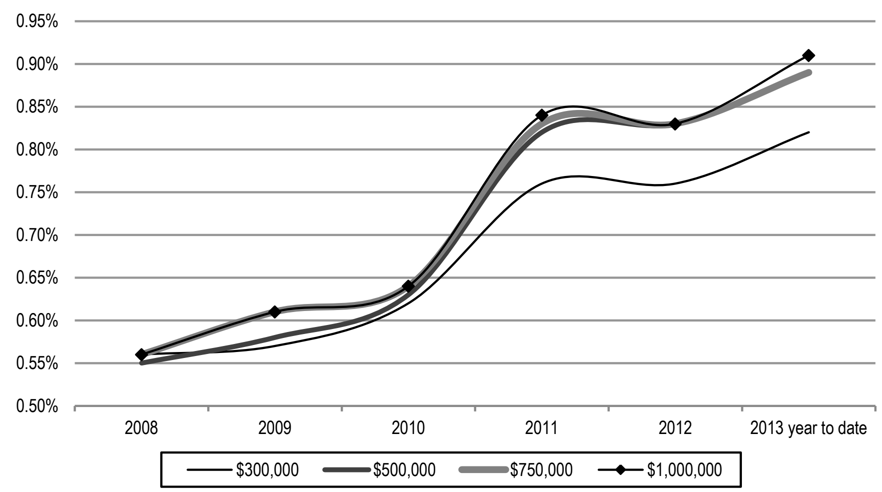
## Effective rate discounting redux

Figure 1: **Discounts rising through time, particularly for larger-sized loans**
*Average of major bank brand standard variable mortgage rate discounts by loan size*




*Source: Company data, 1300HomeLoan, Credit Suisse estimates*

- Since 2008 mortgage discounts have increased for all loan sizes, but since 2011 discounting has disproportionately increased for larger-sized loans (i.e., loans of $500,000+ in size). In 2013 to date, discounts on $1mn-sized mortgages (0.91%) have increased even more again than for small-sized loan amounts. In turn, dispersion on mortgage pricing, by loan size, has gone from being negligible in 2008 (0.01%) to reasonably significant in 2013 (0.09%). Amongst the majors, CBA has most clearly been differentially pricing more aggressively for larger-sized loans. In turn, this suggests that the risk for WBC is that stemming its own market share losses might require not only capitulation on “back-book” re-pricing, but also grading effective rates to progressively enhance the price appeal for larger loan sizes (like CBA has done).
- Using again proprietary data (the Australian Lenders’ Index from mortgage broker 1300HomeLoan), we have extended our previous work on effective mortgage rates to examine the additional dimension of mortgage size.
- Our major bank order of preference: ANZ (NEUTRAL), NAB (NEUTRAL), CBA (UNDERPERFORM), WBC (UNDERPERFORM).

# Effective rate discounting redux

We have revisited our recent work on bank mortgage pricing by adding the additional dimension of mortgage size, again using proprietary data (namely, the Australian Lenders' Index from independent mortgage broker 1300HomeLoan). Refer further: *"Bank Mortgage Pricing: Drilling down into mortgage discounting with proprietary data"* (17 June 2013). Some of our key conclusions from that previous report were:

- Whereas **CBA** appears to have successfully stemmed three years of mortgage market share erosion, this has come at the expense of both discounting the front book (deeper package discounts) as well as the back book (more attractive headline rates). In turn, we expect this has / will place some pressure on **CBA's** near-term net interest margin;

- Whilst still maintaining a relatively high carded rate (13bp premium to the cheapest major bank mortgages), **WBC** has significantly increased its package discounting in 2013 in an overall mortgage pricing strategy that appears to be heavily reliant on "front book" pricing initiatives to stem mortgage market share losses (but at the same time seeking to preserve the premium yield being earned on the mortgage "back book"). In turn, we see a risk that **WBC** is forced to capitulate on its premium carded rate pricing stance (re-pricing the "back book") in order to successfully stem market share losses, noting that both front and back book re-pricing initiatives were necessary to stem **CBA's** market share losses. Accordingly, such a scenario would likely place pressure on **WBC's** net interest margin (particularly from FY14E); and

- **ANZ** appears to have managed the margin / market share trade-off overall better than it peers, ostensibly through adopting a similar pricing approach to **NAB**: namely, implementing attractive carded rates (the visibility of carded rates are high to prospective customers) by preserving margins through being disciplined on package discounts.

# Adding an additional dimension: loan size

Whereas our previous work was based on $300,000 owner occupied mortgages, we have now added an additional dimension through loan size, looking at pricing (carded and effective rates) for larger-sized loans (namely, $500,000, $750,000 and $1,000,000). Our purpose here is to see whether "market share aspirants" in the mortgage market differentially price / more heavily discount for larger sized loans (on the basis that larger loan sizes are prima facie more valuable from the perspective of building market share relative to smaller sized loans).

Our key observations from this data are as follows:

- Through time discounts have increased for all loan sizes, but since 2011 discounting has disproportionately increased for all categories of larger sized loans (i.e. loans of $500,000+ in size). In 2013 to date, discounts on $1mn mortgages (0.91%) have increased even more again than small sized loan amounts. In 2008, discounts for all loan sizes showed little dispersion (0.01%) whereas in 2013 to date, this has increased (to 0.09%).

- In terms of price competitiveness by loan size, **CBA's** effective mortgage rate is the most competitive for both loans of $300,000 in size and $1mn in size (but not in-between) suggesting a "barbell" pricing strategy, whereby **CBA** protects the smaller-sized loans (which are closer to average loan sizes / more common) and also pursues the "jumbo" mortgage (which allows for market share to be more readily gained).

- The follow on from this is that, whilst all banks offer larger discounts for larger-sized loans (i.e., $500,000+), **CBA** is the only bank that price discriminates increasingly for larger and larger loan sizes (which is illustrated in the following table).

**Figure 2: CBA is the most active in discounting based on loan size in July 2013**
*Current carded rates, effective rates and discounts (July 2013)*

| | ANZ | CBA | NAB | WBC | St George | Homeside |
|---|---|---|---|---|---|---|
| Carded rate (i.e., advertised) | 6.13% | 6.15% | 6.13% | 6.26% | 6.24% | 6.16% |
| Effective rate – $300,000 | 5.43% | 5.30% | 5.33% | 5.36% | 5.34% | 5.30% |
| Effective rate – $500,000 | 5.33% | 5.25% | 5.28% | 5.26% | 5.24% | 5.19% |
| Effective rate – $750,000 | 5.33% | 5.20% | 5.28% | 5.26% | 5.24% | 5.19% |
| Effective rate – $1,000,000 | 5.33% | 5.15% | 5.28% | 5.26% | 5.24% | 5.19% |
| Discount – $300,000 | 0.70% | 0.85% | 0.80% | 0.90% | 0.90% | 0.86% |
| Discount – $500,000 | 0.80% | 0.90% | 0.85% | 1.00% | 1.00% | 0.97% |
| Discount – $750,000 | 0.80% | 0.95% | 0.85% | 1.00% | 1.00% | 0.97% |
| Discount – $1,000,000 | 0.80% | 1.00% | 0.85% | 1.00% | 1.00% | 0.97% |

*Source: Company data, 1300HomeLoan, Credit Suisse estimates*

- **NAB's** Homeside brand offers the most competitive effective for the loan sizes in the $300,000, $500,000 and $750,000 loan size categories, but not in the $1mn loan size. This suggests from **NAB** a broker-led strategy on mortgage market share, but less price focus on jumbo $1mn loan sizes (a market where we suspect **NAB** is already quite well represented given its traditional retail banking franchise strength).
- After a step-up in loan discounts in 2011, since 2012 **ANZ** has progressively reduced mortgage discounts across all loan sizes. **CBA** also stepped-up discounts in 2011, which were partially wound back in 2012 only to be reinstated in 2013 (even more so in the $300,000 and $1mn loan category sizes). For **NAB**, stable and consistent levels of discounting 2009-2012 across all loan size categories was followed by larger discounts being introduced in 2013 across all loan sizes. Since 2011, **WBC** has increased its discounts quite uniformly across all loan sizes from $500,000 but with little price differentiation amongst different loan sizes.

**Figure 3: ANZ's discounts peaked in 2011…**
*Annual average of SVR rate discounts by loan size—ANZ*

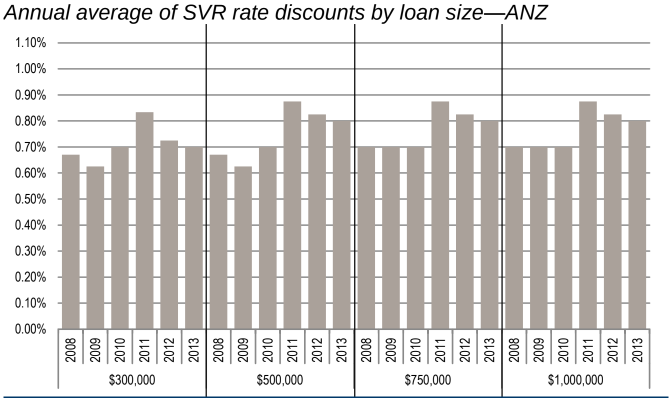



**Figure 4: …but CBA continues to maintain high discounts**
*Annual average of SVR rate discounts by loan size—CBA*

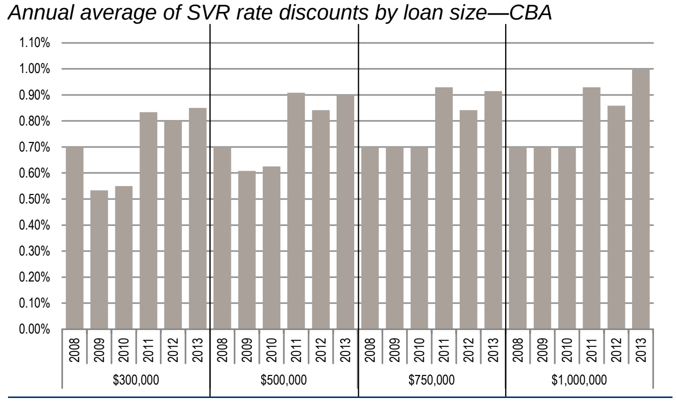



**Figure 5: NAB discounts largely stable until 2013…**
*Annual average of SVR rate discounts by loan size—NAB*

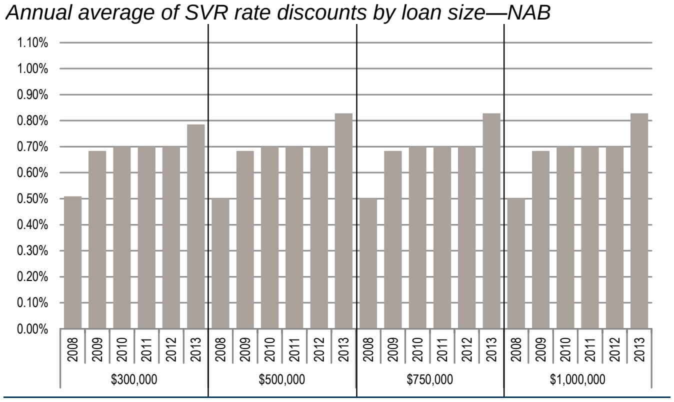
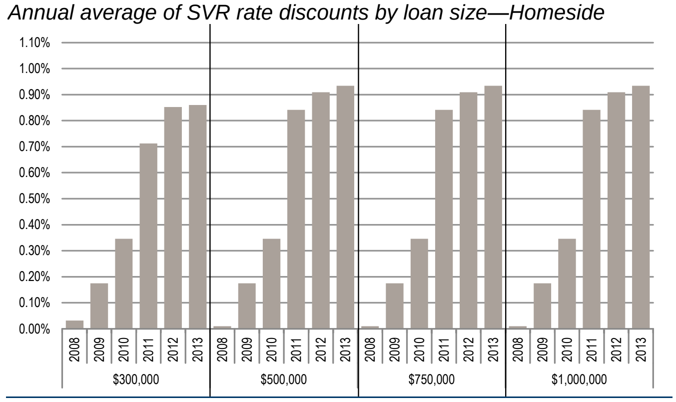



**Figure 6: …but Homeside discounts rapidly increasing**
*Annual average of SVR rate discounts by loan size—Homeside*




*Source for all charts: Company data, 1300HomeLoan, Credit Suisse estimates*

**Figure 7: WBC increasing discounts for larger loans…**
*Annual average of SVR rate discounts by loan size—WBC*

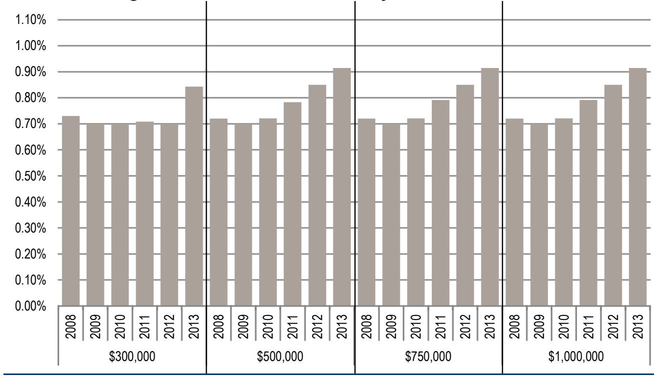
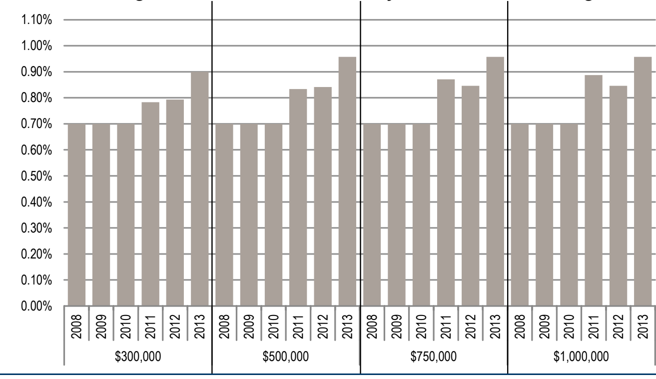



**Figure 8: …with St George also increasing discounts**
*Annual average of SVR rate discounts by loan size—St George*




*Source for both charts: Company data, 1300HomeLoan, Credit Suisse estimates*

**Figure 9: ANZ's gaining share despite higher rates**
*ANZ housing share vs. effective mortgage SVR spread to peer avg.*

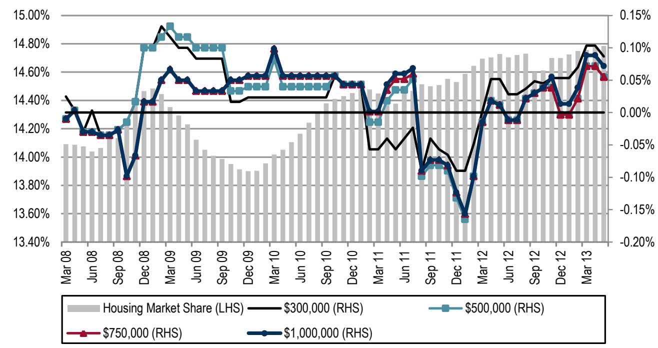



**Figure 10: CBA most clearly price differentiating now**
*CBA housing share vs. effective mortgage SVR spread to peer avg.*

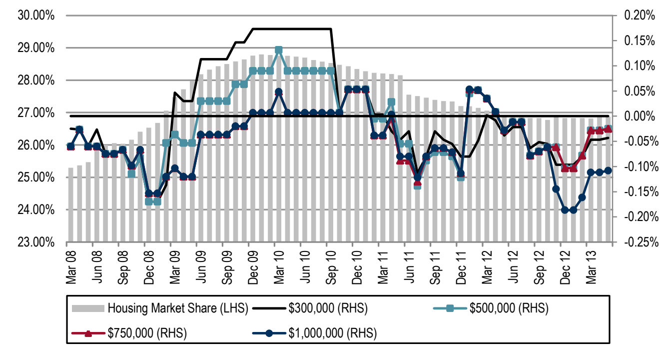



**Figure 11: NAB most price competitive for smaller loans**
*NAB housing share vs. effective mortgage SVR spread to peer avg.*

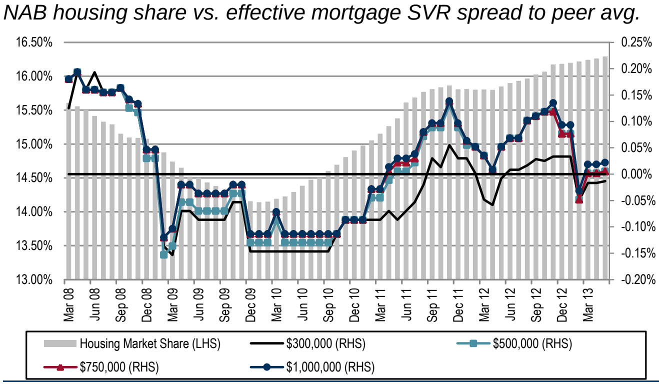



**Figure 12: Homeside competitive for all loan sizes**
*Homeside housing share vs. effective SVR spread to peer avg.*

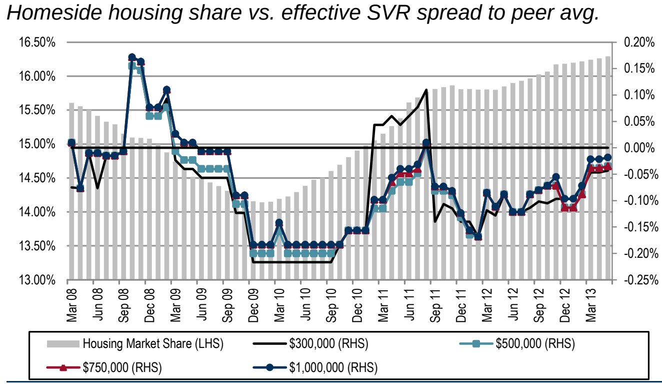



**Figure 13: WBC price differentiating now (a little)…**
*WBC housing share vs. effective mortgage SVR spread to peer avg.*

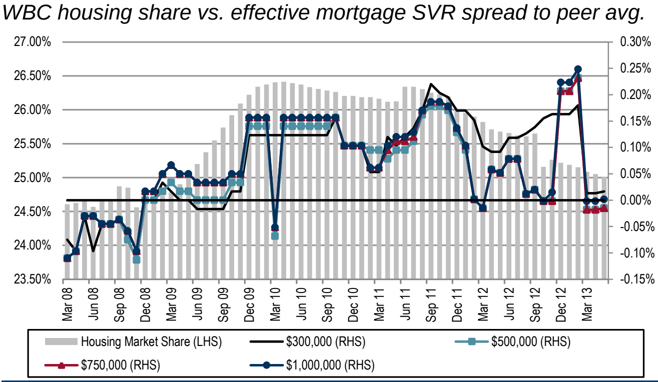
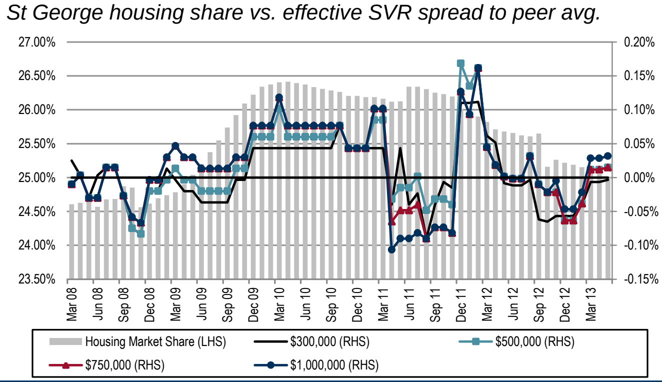



**Figure 14: …as is St George**
*St George housing share vs. effective SVR spread to peer avg.*




*Source for all charts: APRA* Monthly Banking Statistics, *1300HomeLoan, Credit Suisse estimates*

**Figure 15: WBC's SVR premium recently lower…**
*Effective SVR spreads to peer avg. effective SVR—$300,000*

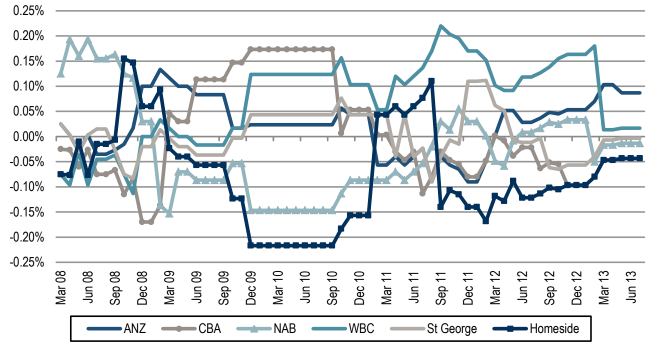



**Figure 16: …and also for $500,000 loans**
*Effective SVR spreads to peer avg. effective SVR—$500,000*

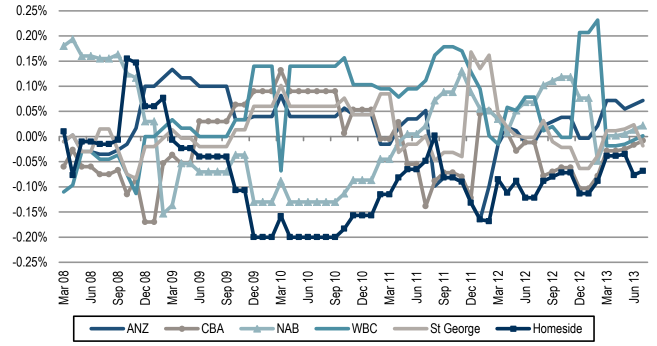



**Figure 17: CBA and Homeside rates recently similar…**
*Effective SVR spreads to peer avg. effective SVR – $750,000*

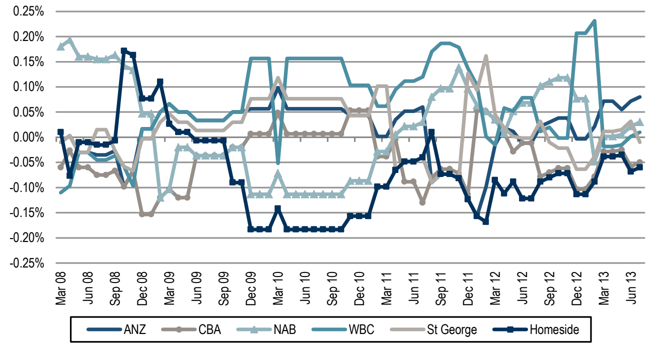
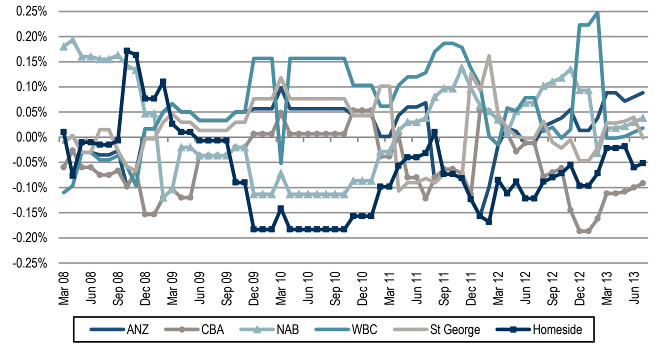



**Figure 18: …but with CBA the cheapest for $1mn loans**
*Effective SVR spreads to peer avg. effective SVR – $1,000,000*




*Source for all charts: 1300HomeLoan, Credit Suisse estimates*

**Figure 19: ANZ discounts broadly similar across loans**

*ANZ carded mortgage spread to peer average vs. discount*

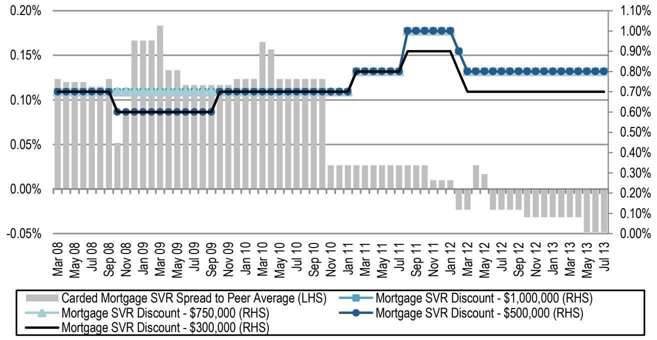



**Figure 20: CBA actively varying mortgage discounts**

*CBA carded mortgage spread to peer average vs. discount*

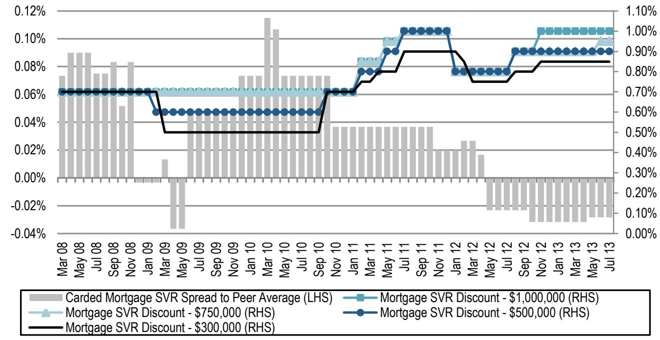



**Figure 21: NAB has had almost no variation in discounts**

*NAB carded mortgage spread to peer average vs. discount*

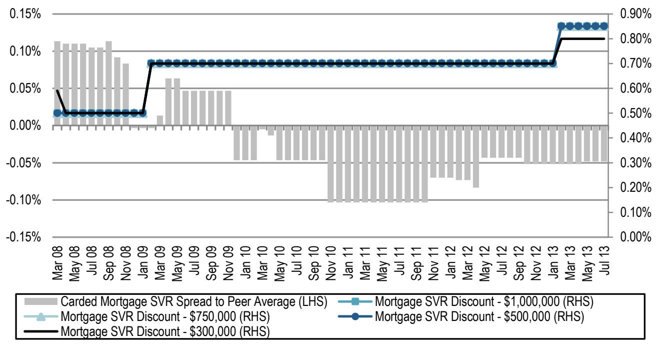



**Figure 22: Homeside recently started variable discounting**

*Homeside carded mortgage spread to peer average vs. discount*

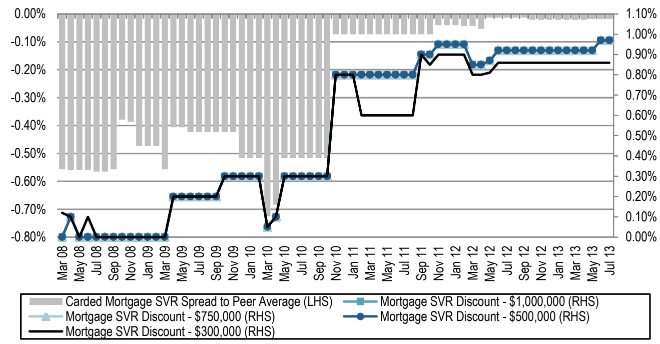



**Figure 23: WBC's discounts stable but recently higher**

*WBC carded mortgage spread to peer average vs. discount*

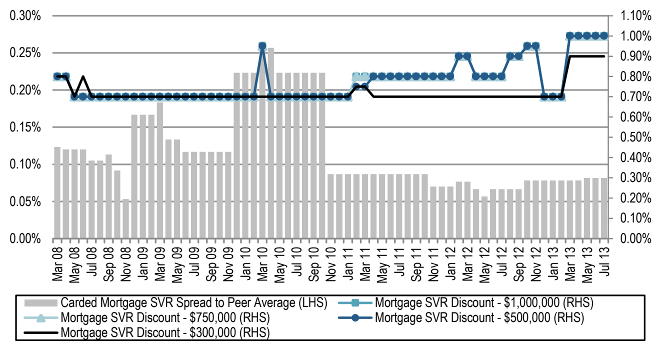
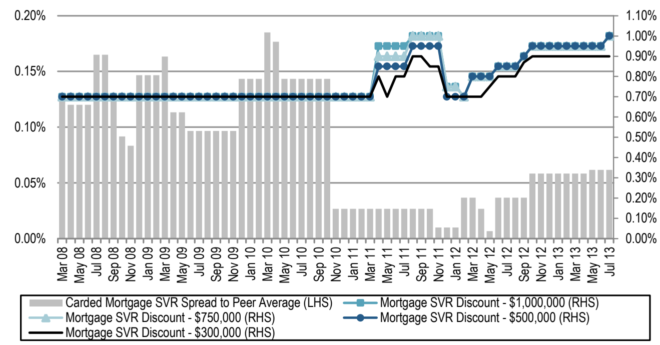



**Figure 24: St George discounts with little variations**

*St George carded mortgage spread to peer average vs. discount*




*Source for all charts: Company data, 1300HomeLoan, Credit Suisse estimates*

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## Companies Mentioned *(Price as of 29-Jul-2013)*

**ANZ Banking Group** (ANZ.AX, A$29.64, NEUTRAL, TP A$31.5)
**Commonwealth Bank Australia** (CBA.AX, A$73.86, UNDERPERFORM, TP A$71.0)
**National Australia Bank** (NAB.AX, A$31.16, NEUTRAL, TP A$34.0)
**Westpac** (WBC.AX, A$30.82, UNDERPERFORM, TP A$31.0)

# Disclosure Appendix

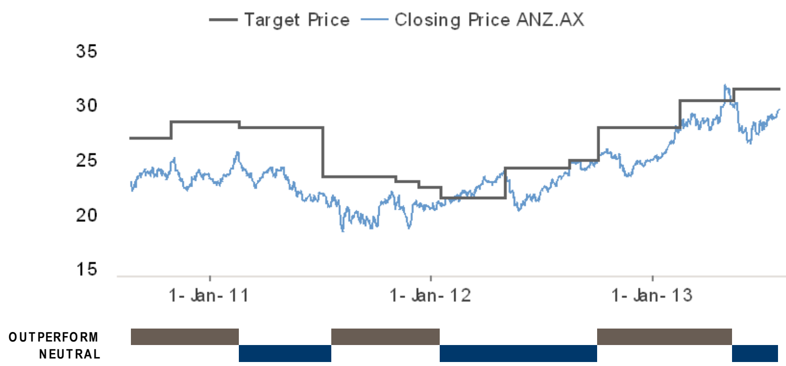
## Important Global Disclosures

Jarrod Martin and James Ellis, each certify, with respect to the companies or securities that the individual analyzes, that (1) the views expressed in this report accurately reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

### 3-Year Price and Rating History for ANZ Banking Group (ANZ.AX)

| ANZ.AX Date | Closing Price (A$) | Target Price (A$) | Rating |
|---|---|---|---|
| 23-Aug-10 | 22.95 | 27.00 | O |
| 29-Oct-10 | 24.81 | 28.50 | |
| 18-Feb-11 | 24.89 | 28.00 | N |
| 06-Jul-11 | 21.85 | 23.50 | |
| 21-Jul-11 | 21.26 | 23.50 | O |
| 03-Nov-11 | 20.49 | 23.00 | |
| 12-Dec-11 | 20.95 | 22.50 | |
| 17-Jan-12 | 21.05 | 21.50 | N |
| 02-May-12 | 23.80 | 24.25 | |
| 17-Aug-12 | 24.61 | 25.00 | |
| 04-Oct-12 | 25.30 | 28.00 | O |
| 15-Feb-13 | 27.77 | 30.50 | |
| 15-May-13 | 29.98 | 31.50 | N |

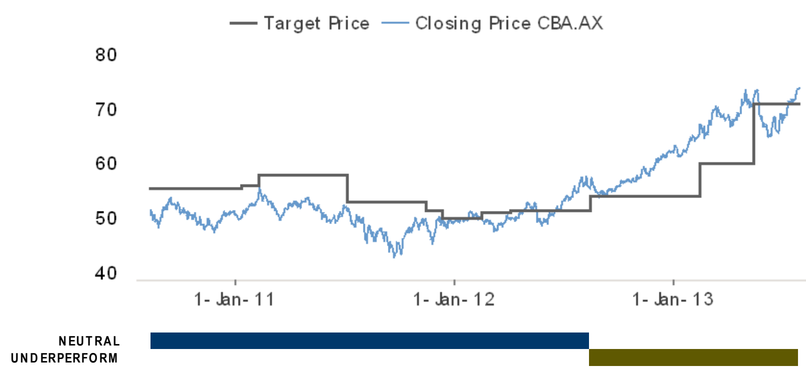
** Asterisk signifies initiation or assumption of coverage.*




### 3-Year Price and Rating History for Commonwealth Bank Australia (CBA.AX)

| CBA.AX Date | Closing Price (A$) | Target Price (A$) | Rating |
|---|---|---|---|
| 12-Aug-10 | 50.70 | 55.50 | N |
| 11-Jan-11 | 50.30 | 56.00 | |
| 09-Feb-11 | 55.07 | 58.00 | |
| 06-Jul-11 | 51.47 | 53.00 | |
| 15-Nov-11 | 49.15 | 51.50 | |
| 12-Dec-11 | 49.83 | 50.00 | |
| 15-Feb-12 | 50.23 | 51.00 | |
| 03-Apr-12 | 50.04 | 51.50 | |
| 15-Aug-12 | 56.05 | 54.00 | U |
| 13-Feb-13 | 67.11 | 60.00 | |
| 15-May-13 | 72.65 | 71.00 | |

** Asterisk signifies initiation or assumption of coverage.*



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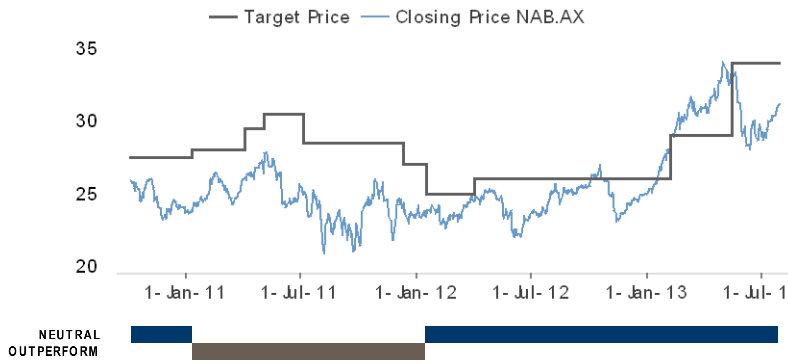
## 3-Year Price and Rating History for National Australia Bank (NAB.AX)

| NAB.AX Date | Closing Price (A$) | Target Price (A$) | Rating |
|---|---|---|---|
| 06-Oct-10 | 25.88 | 27.50 | N |
| 11-Jan-11 | 23.89 | 28.00 | O |
| 05-Apr-11 | 26.06 | 29.50 | |
| 05-May-11 | 27.01 | 30.50 | |
| 06-Jul-11 | 24.96 | 28.50 | |
| 12-Dec-11 | 24.36 | 27.00 | |
| 17-Jan-12 | 23.80 | 25.00 | N |
| 03-Apr-12 | 24.61 | 26.00 | |
| 07-Feb-13 | 28.63 | 29.00 | |
| 15-May-13 | 33.07 | 34.00 | |

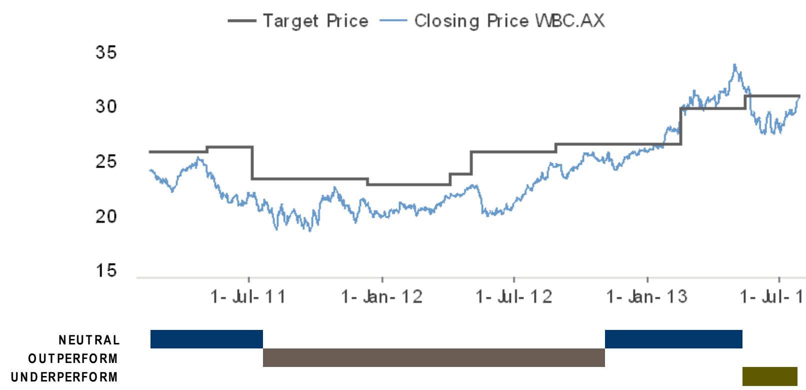
** Asterisk signifies initiation or assumption of coverage.*




## 3-Year Price and Rating History for Westpac (WBC.AX)

| WBC.AX Date | Closing Price (A$) | Target Price (A$) | Rating |
|---|---|---|---|
| 15-Feb-11 | 24.16 | 25.84 | N |
| 04-May-11 | 23.97 | 26.34 | |
| 06-Jul-11 | 21.76 | 23.36 | |
| 21-Jul-11 | 21.01 | 23.36 | O |
| 12-Dec-11 | 21.16 | 22.86 | |
| 03-Apr-12 | 21.69 | 23.86 | |
| 03-May-12 | 22.77 | 25.84 | |
| 27-Aug-12 | 24.53 | 26.59 | |
| 05-Nov-12 | 25.20 | 26.59 | N |
| 15-Feb-13 | 28.98 | 29.82 | |
| 15-May-13 | 31.67 | 31.00 | U |

** Asterisk signifies initiation or assumption of coverage.*

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**Outperform (O) :** The stock's total return is expected to outperform the relevant benchmark*over the next 12 months.

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**Underperform (U) :** The stock's total return is expected to underperform the relevant benchmark* over the next 12 months.

**Relevant benchmark by region: As of 10th December 2012, Japanese ratings are based on a stock's total return relative to the analyst's coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. As of 2nd October 2012, U.S. and Canadian as well as European ratings are based on a stock's total return relative to the analyst's coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. For Latin American and non-Japan Asia stocks, ratings are based on a stock's total return relative to the average total return of the relevant country or regional benchmark; Australia, New Zealand are, and prior to 2nd October 2012 U.S. and Canadian ratings were based on (1) a stock's absolute total return potential to its current share price and (2) the relative attractiveness of a stock's total return potential within an analyst's coverage universe. For Australian and New Zealand stocks, 12-month rolling yield is incorporated in the absolute total return calculation and a 15% and a 7.5% threshold replace the 10-15% level in the Outperform and Underperform stock rating definitions, respectively. The 15% and 7.5% thresholds replace the +10-15% and -10-15% levels in the Neutral stock rating definition, respectively. Prior to 10th December 2012, Japanese ratings were based on a stock's total return relative to the average total return of the relevant country or regional benchmark.*

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**Market Weight :** The analyst's expectation for the sector's fundamentals and/or valuation is neutral over the next 12 months.

**Underweight :** The analyst's expectation for the sector's fundamentals and/or valuation is cautious over the next 12 months.

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## Global Ratings Distribution

| Rating | Versus universe (%) | Of which banking clients (%) |
|---|---|---|
| Outperform/Buy* | 42% | (53% banking clients) |
| Neutral/Hold* | 40% | (50% banking clients) |
| Underperform/Sell* | 15% | (39% banking clients) |
| Restricted | 2% | |

**For purposes of the NYSE and NASD ratings distribution disclosure requirements, our stock ratings of Outperform, Neutral, an d Underperform most closely correspond to Buy, Hold, and Sell, respectively; however, the meanings are not the same, as our stock ratings are determined on a relative basis. (Please refer to definitions above.) An investor's decision to buy or sell a security should be based on investment objectives, current holdin gs, and other individual factors.*

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**Price Target: (12 months) for ANZ Banking Group (ANZ.AX)**

**Method:** Our target price of $31.50 is based on a valuation of ANZ using our $2.64 rolling 24-month forward cash earnings per share estimate and a combination of: (1) 51% historical bond yield / earnings yield relationship (50% weighting), (2) 87% historical price / earnings multiple relative to the S&P/ASX 200 ex-banks (25% weighting), and (3) 95% price / earnings multiple relative to the S&P/ASX 200 banks (25% weighting).

**Risk:** The risks to our $31.50 ANZ target price include acquisition risk, margin compression from higher wholesale fundng costs and competition in the deposit market combined with continued political pressure on banks limiting their ability to pass through the higher funding costs, the potential for further loan loss provisioning emerging in the SME and consumer lending books and the regulatory outlook (capital / liquidity / provisioning).

**Price Target: (12 months) for Commonwealth Bank Australia (CBA.AX)**

**Method:** Our target price of $71.00 is based on a valuation of CBA using our $5.07 rolling 24-month forward cash earnings per share estimate and a combination of: (1) 56% historical bond yield / earnings yield relationship (50% weighting), (2) 99% historical price / earnings multiple relative to the S&P/ASX 200 ex-banks (25% weighting), and (3) 107% relative to the banks index (25% weighting).

**Risk:** The risks to our $71.00 CBA target price include margin compression from higher wholesale funding costs and competition in the deposit market combined with continued political pressure on banks limiting their ability to pass though the higher funding costs, the potential for further loan loss provisioning emerging in the SME and consumer lending books and the regulatory outlook (capital / liquidity / provisioning).

**Price Target: (12 months) for National Australia Bank (NAB.AX)**

**Method:** Our target price of $34.00 is based on a valuation of NAB using our $2.87 rolling 24-month forward cash earnings per share estimate and a combination of: (1) 50% historical bond yield / earnings yield relationship (50% weighting), (2) 85% historical price / earnings multiple relative to the S&P/ASX 200 ex-banks (25% weighting), and (3) 92% relative to the banks index (25% weighting).

**Risk:** The risks to our $34.00 NAB target price include: acquisition risk (UK banking assets), execution risks from restructuring all parts of the business, a management team that is still relatively unproven, and the condtion of the UK economy.

**Price Target: (12 months) for Westpac (WBC.AX)**

**Method:** Our target price of $31.00 is based on a valuation of WBC using our $2.40 rolling 24-month forward cash earnings per share estimate and a combination of: (1) 53% historical bond yield / earnings yield relationship (50% weighting), (2) 92% historical price / earnings multiple relative to the S&P/ASX 200 ex-banks (25% weighting), and (3) 100% relative to the banks index (25% weighting).

**Risk:** The critical risks associated with our forecasts and valuation, and hence $31.00 target price for WBC, are the revival of business credit growth, the potential for further deceleration in housing credit growth, mortgage asset quality / house prices and the regulatory uncertainty regarding new capital and liquidity requirements.

Please refer to the firm's disclosure website at www.credit-suisse.com/researchdisclosures for the definitions of abbreviations typically used in the target price method and risk sections.

*See the Companies Mentioned section for full company names*

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