Building a better working world

Australian major banks' full year results 2017

Solid performance. But who will win the execution race?

Overview

ANZ, NAB and Westpac's full year reporting periods ended on 30 September 2017. CBA's full year reporting period ended on 30 June 2017.

Unless otherwise specified, references to the banks in this publication refer to the 'big four' Australian banks: ANZ, CBA, NAB and Westpac.

Underlying cash earnings: $31.5 billion	**Increase of 6.3% (total of all four banks)**
Average return on equity: 13.93%	**Increase of 15 basis points**
Net interest margin: 2.01%	**Decrease of 4.5 basis points**
Bad debt expense:	**Decrease of 22.5%**

Note: *Figures throughout this report are calculated on the prior corresponding period unless otherwise stated.*

Australia's major banks have delivered another solid financial performance for the 2017 full year. Results were shaped by:

- Sustained earnings momentum – from housing lending growth, low credit losses and cost management measures
- Profitability pressures – with net interest margin declining across the banks
- Strong capital and asset quality – with most banks adding to their capital ratios and improvement in asset quality
- Digital innovation – with new technologies enabling banks to drive new efficiencies and customer experience

The banks have demonstrated they can maintain profits against a challenging backdrop. However, they must now show they can successfully execute on the digital, customer and regulatory compliance agenda for long-term sustainable performance. As the banks continue to reshape their businesses for future performance, four priorities will be critical:

1. Implementing strategies for sustainable and profitable growth, with a focus on embedding the right customer experience fundamentals
2. Optimising the balance sheet and using technology to improve service and reduce cost
3. Managing risk and regulatory compliance
4. Rebuilding trust

Executing well in each of these areas will require the banks to manage the tension between the competing demands of growing the business and keeping the bank, and customers, safe. Advanced technology will be a key enabler, allowing the banks to continuously evolve in response to a rapidly changing and digitising world. Building an ecosystem that enables engagement with digital partners to accelerate innovation will also support successful execution.

Trust: can it be restored?

EY research[1] indicates that consumers have diminished trust in banking relationships. Following a string of conduct-related issues, the Government, regulators and the banks are all stepping up efforts to enhance accountability and improve risk cultures.

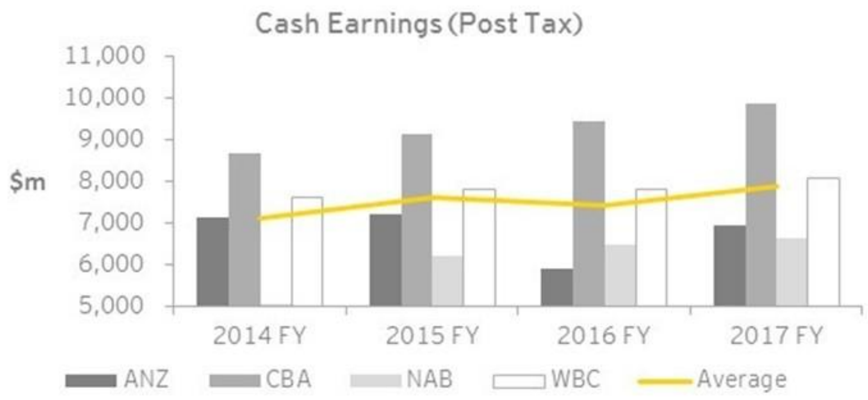
The spotlight on trust keeps getting bigger. It includes: the Banking Executive Accountability Regime to improve bank culture and governance, the House of Representatives Standing Committee on Economics' review of the major banks, ongoing calls for a Royal Commission, and ongoing regulatory audits and inspections by regulators. As a priority, the banks need to focus on developing a customer-centric culture that promotes transparency. At the same time, further investment is required to meet the competing demands of all stakeholders equally - customers, shareholders, regulators and government.

Sustained earnings momentum

Earnings have proved resilient supported by:

- Continued growth in housing credit
- Housing loan repricing
- A benign credit environment.

Housing lending has continued to be a major earnings driver in an era of lower sector revenue growth, sustained by cheap credit and strong demand for housing.



Housing credit

Housing credit growth has remained steady, as the banks balance the need for continued loan book expansion against the investor and interest-only lending restrictions imposed by APRA.

Macro prudential measures and the banks' differential loan repricing and tightened lending requirements appear to be slowing lending perceived to be higher risk. Interest-only loans have declined following the announcement of the lending cap and investor lending is showing signs of moderating. Existing borrowers also continue to change their loan purpose from investor to owner occupier.

In this environment, the banks are likely to find it challenging to maintain housing credit growth, given:

- Their ability to reprice upwards is restricted by intense political scrutiny, with concerns that lenders may have passed on the bank levy to customers and used the caps to support excessive back book repricing.
- The current benefits of repricing are likely to be at least partially eroded by customers switching to lower margin products.
- Differential pricing and stricter lending requirements for higher-risk lending could also see a front book shift to lower cost, lower profit principal and interest lending.

[1] EY, Customer trust: without it, you're just another bank, 2016

- Housing affordability challenges in Melbourne and Sydney.

The transition of borrowers from interest-only to principal-and-interest loans may lead to borrower stress, creating further regulatory and credit challenges.

Business credit

Business credit is yet to show a sustained pick up despite strong business conditions and higher business confidence than last year.

Business lending growth for the banks has been constrained, partly due to the banks' portfolio rebalancing efforts and repricing to strengthen margins. Anecdotally, SMEs remain cautious about investing, suggesting ongoing risk aversion.

Will we see property lending risk shift to shadow banking?

APRA's lending caps could see borrowers seeking alternative financing from the shadow banking sector. Reserve Bank of Australia (RBA) research[2] suggests shadow banking's share of housing credit has only increased slightly, with a possible uptick in lending to property developers as family offices, trusts, super funds and other non-bank lenders search for yield. For example, available data indicates registered financial corporations' share of residential property development loan approvals grew from zero in 2011 to approximately 4% in 2016[3].

The spectre of financial system instability is being raised by the prospect of borrowers turning to finance providers subject to limited regulatory oversight and focused on higher-risk lending. The sector is concerned that the Government's proposed extension of APRA's powers to the non-bank sector to address this risk will restrict lending and increase funding costs.

Profitability pressures

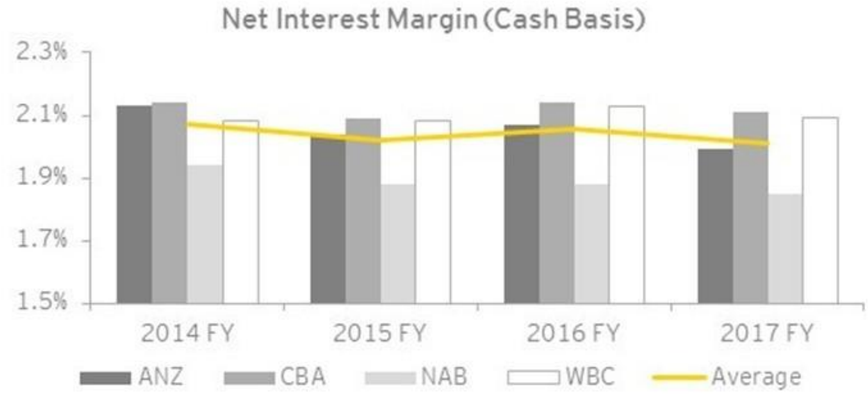
Net interest margin (NIM)

NIM was lower across the banks with asset repricing helping reduce the varying impacts between the banks of:

- The major bank levy (included in the last quarter for banks with 30 September year ends)
- Lower returns on capital
- Competition in business and institutional lending

The banks continue to optimise portfolios to reduce margin compression. Recent home loan repricing should support margins into 2018 but may be diluted by:

- Borrowers switching from higher to lower margin products
- Front book competition
- Regulator and political scrutiny
- Full year impact of the bank levy



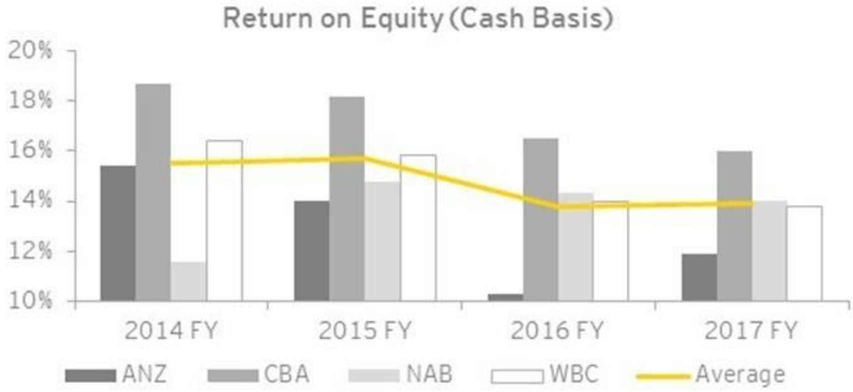
[2] Reserve Bank of Australia, *Shadow bank lending to the residential property market,* Bulletin, September 2017
[3] Ibid

Return on equity (ROE)

ROE was also lower for most of the banks, again demonstrating the challenge to generate sustainable returns in a low growth/high competition environment. Downward pressure on ROE is coming from:

- Higher Tier 1 capital requirements eroding lending returns
- Ongoing re-shaping activities
- Elevated levels of mortgage front book competition
- Competition in the business and institutional segments

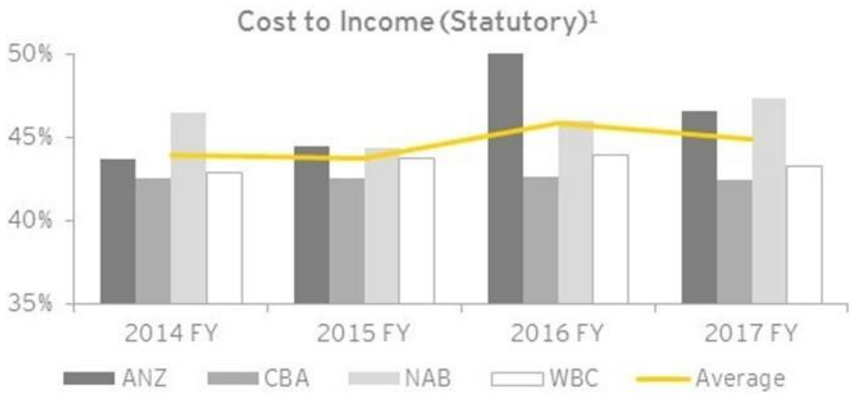
Uncertainty about the growth outlook and the possibility of higher housing risk weights are also adding to the subdued outlook for returns.



Relentless focus on expense management

The banks continue efforts to tighten their cost bases, by refocussing on core business and removing complexity and duplication to streamline processes. Some are also accelerating their productivity programs. Cost to income ratios improved for most of the banks as they work hard to balance the need to invest in innovation and growth programs with managing the cost of change and deployment. As the move to digital gathers pace, banks will continue to target branch network transformation to reduce costs.

Full time equivalent staff numbers declined at most of the banks, with further reductions foreshadowed as the banks continue to invest in productivity and automation initiatives to support profitability.



1. The Cost to Income result is calculated by EY as Operating Expense (Statutory) over Operating Income (Statutory). The Cost to Income reported by the big four banks is typically reported on a cash basis.

Strong capital and asset quality

Greater clarity on capital

Capital levels are strong, with most of the banks adding to their capital ratios via internal capital generation, including optimising risk-weighted assets.

APRA has further defined "unquestionably strong", setting the banks a target of CET 1 ratios of at least 10.5% by 2020. All the banks are expected to reach this target comfortably.

Adjusting mortgage risk weights remains one of the most significant outstanding capital issues for APRA, given the banks' heavy housing lending exposure. Increased weightings for higher-risk investor and interest-only loans are a possible outcome.

Changing wealth model

Changes to the bancassurance model will significantly reshape the Australian banking and wealth sector. Banks have reassessed the sustainability of owning fully integrated life insurance operations from a product manufacturing perspective. Increased regulator focus in response to conduct issues and the need to optimise capital have rendered these businesses significantly less attractive. As a result, the emphasis is shifting to distribution agreements.

Despite strong premium growth, margins have been declining in the life insurance sector due to a sustained rise in loss ratios relative to historical experience. Key issues include the:

- Efficiency of distributing through the branch network.
- Investment spend for improved platforms and digitisation
- Resolution and impact of regulatory issues
- Capital cost.

Recent transactions have highlighted the importance of separation and integration planning to address the growing complexity in managing outsourced manufacturing over 15 to 20-year horizons and the long tail to transition the business[4]. This will require transparent assessment and management of:

- Ongoing distribution costs
- Brand management
- Shared investment in technology
- Regulatory compliance
- Stranded costs.

Asset quality still resilient

Despite some deterioration in consumer portfolio arrears – notably among home loans and consumer finance in Western Australia and Queensland – asset quality remains resilient on the back of:

- Fewer large individual provisions in institutional portfolios
- Improved commodity pricing
- Stronger New Zealand dairy credit conditions.

Heightened risks in the domestic economy point to potential increases in credit losses, particularly given the banks' concentration in housing lending and increased levels of loans in arrears. As the RBA has noted [5], households with lower income, lower net wealth or higher leverage are less likely to have mortgage buffers to help protect them from interest rate, income or house price shocks. Tighter monetary policy could significantly impact households' finance and consumption spending, in turn adversely impacting other sectors such as retail.

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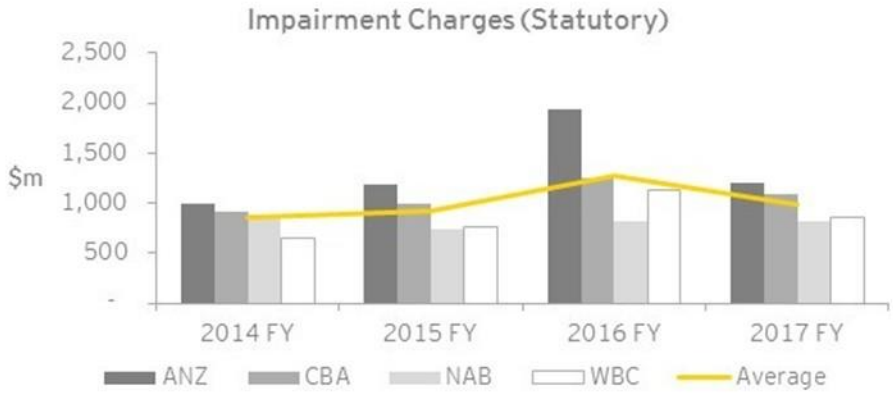
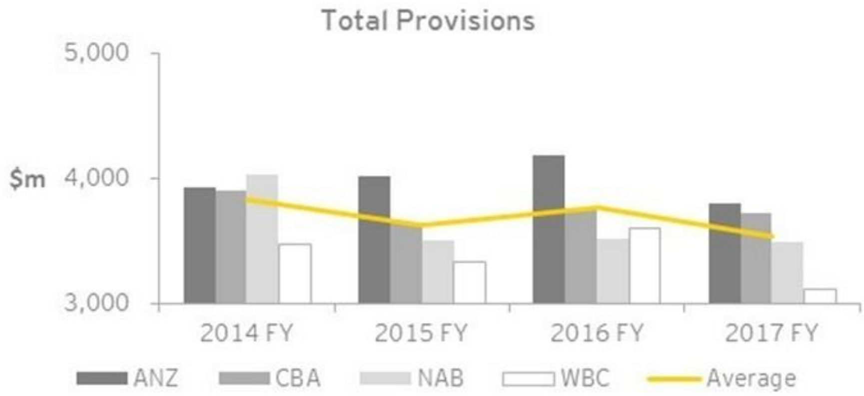
[4] See also: EY, Scaling new heights: M&A integration in financial services, 2017
[5] Reserve Bank of Australia, *Financial Stability Review*, April 2017





The digital innovation agenda

The banks are embracing digital innovation to maintain growth and relevance in a rapidly changing competitive environment. New entrants are starting to erode the traditional banking value chain, from the new 'born digital' FinTechs and digital-only NeoBanks, to the global technology companies moving into payments and loans. The Government's new mandatory comprehensive credit reporting regime aims to improve the ability of these new entrants to compete for customers. Most do not aspire to become full-scale banks, but they do want to disrupt the most profitable bank products like payments and credit.

The extraordinary growth and reach of China's e-commerce ecosystem, which encompasses financial services providers operating outside the traditional banking system, is testimony to the potential disruptive threat of flexible and fast-adapting technology players.

Attracting and retaining the next generation of customers is a key area of investment focus for the banks. They are building customer value ecosystems to provide the right experience and increase customer 'stickiness'. This includes entering into agreements and investments with technology companies and FinTechs to deliver new customer-facing technology such as mobile payments, voice biometrics and chatbots. The banks are also joining forces with each other, with a new digital payments joint venture recently announced between three of the banks and the upcoming launch of the New Payments Platform. Australia's Open Banking regime will likely accelerate the emergence of a customer-centric banking ecosystem.

Some of the most disruptive technologies, such as artificial intelligence, blockchain and robotics, will enable banks to reduce costs and increase efficiencies. We have already seen the banks employ robotics process automation to transform processes and cut costs, and participate in blockchain proofs of concept offering innovation in payments, and financial products and services. These technologies will also disrupt workforces, though the nature and extent of job changes versus job losses remains uncertain.

Open Banking - transformative

The Australian government plans to introduce an Open Banking regime by 2018 to increase competition and encourage innovation in financial services. Open Banking is gaining traction globally as a means to propel digital transformation and unlock choice for financial services consumers.

Open Banking allows consumers to access and use their financial data across institutions. The relationship between banks and consumers is likely to change, reducing existing profit pools but uncovering new opportunities.

Financial services firms should assess the impact of Open Banking and prepare for the technology integration required to seize these opportunities. Treating Open Banking as a regulatory compliance initiative runs the risk of leaving incumbent banks as financial ‘utility’ providers.

For forward-thinking and well-prepared banks, Open Banking offers a new channel to attract, service and offer new services and generate new revenue streams.

Open Banking will be disruptive, and should be considered a key strategic risk. Maintaining trust will be more important than ever. Security, liability, rights to recourse, data integrity and consumer consent will all be amplified, and require new, more frequent and heightened controls.

Leaders can establish themselves as a financial health and wellbeing destination, thereby growing loyalty, engagement and retention. Seizing these opportunities will require rapid innovation, new alliances and substantial technology change. Are you ready to seize the opportunity?

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