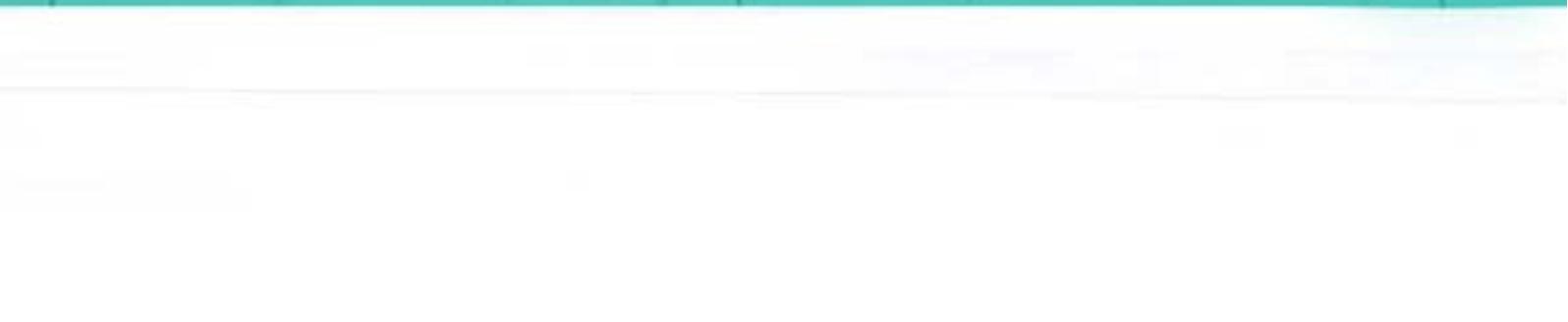




Major Australian Banks

Full Year 2017 Results Analysis



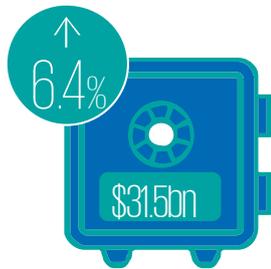


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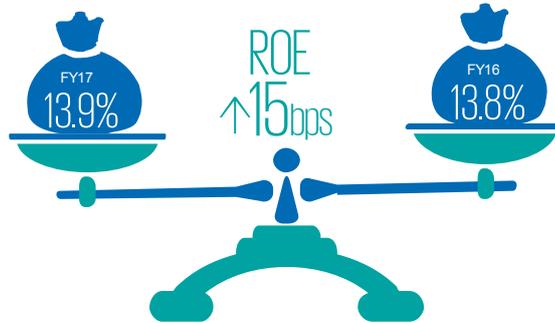


Full Year 2017 Results Snapshot



Cash profit after tax increased by 6.4% on FY16 to \$31.5bn

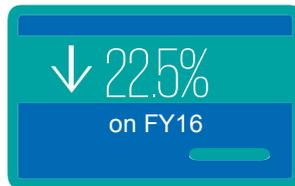
Average ROE up 15bps to 13.9%



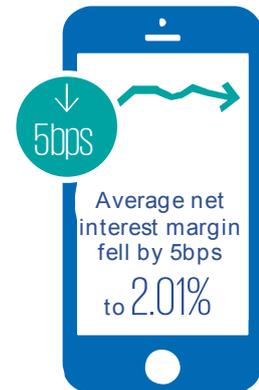
Banks need to balance the trade-offs between risk, capital and earnings growth



Average cost to income ratio decreased by 103bps to 43.4%



Aggregate charge for bad and doubtful debts decreased by \$1,152m (22.5%) to \$4.0bn



Average net interest margin fell by 5bps to 2.01%



Average CET1 capital ratio up by 46bps from FY16 to 10.3% of risk weighted assets



The majors continue to invest in technology, with an aggregate technology spend of \$4.2bn during FY17

Ability to identify opportunities to deliver future earnings growth whilst realising cost savings will be critical

Modest balance sheet momentum

Compared to FY16:



Housing credit



Non-housing credit



Deposits

At a glance

| | ANZ | | CBA ¹ | | NAB | | WBC | |
|--|---------|---------|------------------|---------|---------|---------|---------|---------|
| | FY17 | FY16 | FY17 | FY16 | FY17 | FY16 | FY17 | FY16 |
| Ranking | | | | | | | | |
| By profit before tax | 3 | 4 | 1 | 1 | 4 | 3 | 2 | 2 |
| By total assets | 2 | 2 | 1 | 1 | 4 | 4 | 3 | 3 |
| By total equity | 3 | 3 | 1 | 1 | 4 | 4 | 2 | 2 |
| By market capitalisation | 3 | 3 | 1 | 1 | 4 | 4 | 2 | 2 |
| By CET 1 capital ratio | 1 | 3 | 3 | 1 | 4 | 2 | 2 | 4 |
| Financial Performance – P/L | | | | | | | | |
| Profit before tax (\$ million) – statutory basis | 9,627 | 8,178 | 13,944 | 12,849 | 8,661 | 8,978 | 11,515 | 10,644 |
| Profit after tax (\$ million) – statutory basis ² | 6,406 | 5,709 | 9,928 | 9,223 | 5,285 | 352 | 7,990 | 7,445 |
| Cash profit after tax (\$ million) | 6,938 | 5,889 | 9,881 | 9,445 | 6,642 | 6,483 | 8,062 | 7,822 |
| Performance Measures – P/L | | | | | | | | |
| Net interest margin – cash basis (basis points) | 199 | 207 | 211 | 214 | 185 | 188 | 209 | 213 |
| Cost to income ratio – cash basis (%) | 46.1 | 50.7 | 42.7 | 42.4 | 42.7 | 42.7 | 42.2 | 42.1 |
| Basic earnings per share – statutory basis (cents) | 220.1 | 197.4 | 577.6 | 542.3 | 194.7 | 8.8 | 238.0 | 224.6 |
| Basic earnings per share – cash basis (cents) | 237.1 | 202.6 | 574.4 | 554.8 | 249.3 | 245.1 | 239.7 | 235.5 |
| Return on average equity (%) – cash basis | 11.9 | 10.3 | 16.0 | 16.5 | 14.0 | 14.3 | 13.8 | 14.0 |
| Credit Quality Measures | | | | | | | | |
| Impairment charge (\$ million) (statutory basis) | 1,198 | 1,929 | 1,095 | 1,256 | 824 | 813 | 853 | 1,124 |
| Impaired loans to loans and advances to customers (%) – B/S | 0.41 | 0.55 | 0.43 | 0.44 | 0.70 | 0.85 | 0.22 | 0.32 |
| Collective provision to credit RWA (%) – B/S | 0.79 | 0.82 | 0.73 | 0.82 | 0.86 | 0.85 | 0.76 | 0.76 |
| Financial Position – B/S | | | | | | | | |
| Total assets (\$ million) | 897,326 | 914,869 | 976,374 | 933,001 | 788,325 | 776,710 | 851,875 | 839,202 |
| Total equity (\$ million) | 59,075 | 57,927 | 63,716 | 60,564 | 51,317 | 51,315 | 61,342 | 58,181 |
| Capital Measures – B/S | | | | | | | | |
| Capital Adequacy Ratios (%) | | | | | | | | |
| - Total | 14.8 | 14.3 | 14.2 | 14.3 | 14.6 | 14.1 | 14.8 | 13.1 |
| - Tier 1 | 12.6 | 11.8 | 12.1 | 12.3 | 12.4 | 12.2 | 12.7 | 11.2 |
| - Common Equity Tier 1 | 10.6 | 9.6 | 10.1 | 10.6 | 10.1 | 9.8 | 10.6 | 9.5 |
| Market capitalisation (\$ billion) ³ | 86.9 | 80.9 | 142.9 | 127.3 | 84.3 | 73.8 | 108.3 | 98.7 |

¹ CBA as reported as at 30 June 2017. All other majors as at 30 September 2017.

² Profit after tax attributable to the owners of the bank (on a statutory basis). Statutory profit after tax for NAB in FY16 decreased to \$352 million, due to discontinued operations of CYBG Group and NAB Wealth's life insurance business.

³ Market capitalisation sourced from statutory account or ASX

Executive summary

The financial year 2017 (FY17) results of the Australian major banks (the majors) highlight a solid result in an increasingly challenging operating environment. Combined cash profit increased 6.4% to \$31.5 billion and earnings per share rose 15.6 cents to 325.1 cents on average across the majors. With regulatory capital continuing to increase, return on equity at 13.9% was marginally higher on FY16.

Against a backdrop of subdued economic growth, slowing demand for credit, continued margin pressure and high regulatory and capital costs, the majors have been adept at managing a number of headwinds to deliver a solid result for the full year.



2017 Financial Highlights

\$31,523 million

Combined cash earnings, up 6.4% vs FY16

43.4%

Average cost to income, down 103 bps vs FY16

2.01%

Average net interest margin, down 5 bps vs FY16

0.44%

Loan impairment expense to loans and advances (FY16: 0.54%)

75.2%

Average dividend payout ratio (FY16: 79.3%)

325.1 cents

Average earnings per share (FY16: 309.5 cents)

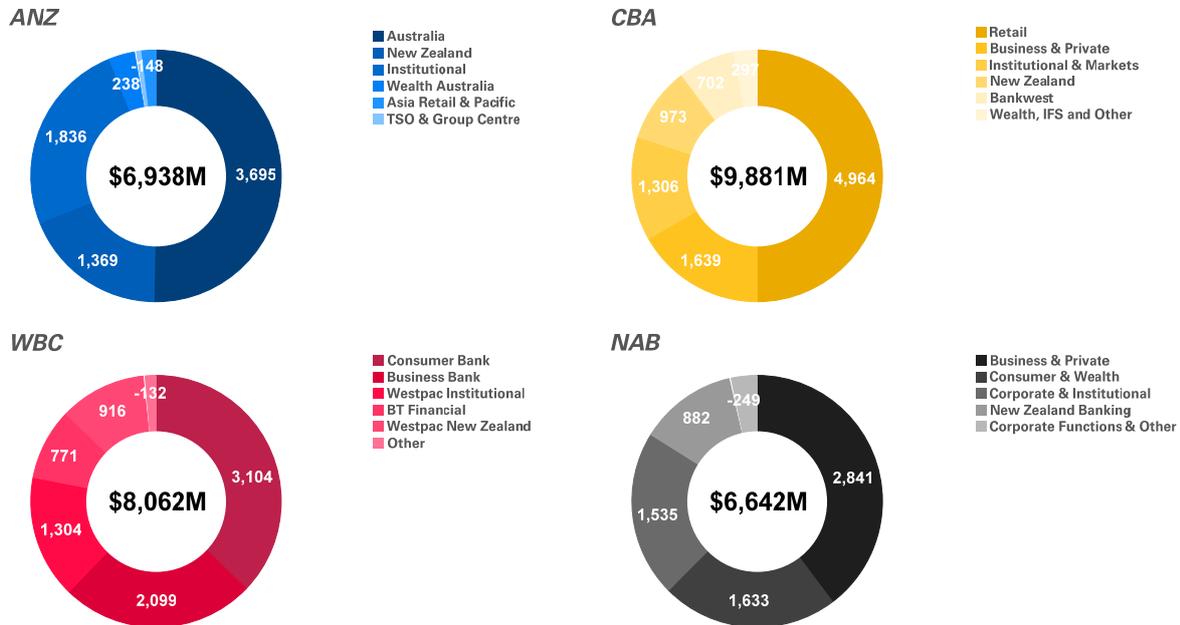
In the face of subdued local market conditions and heightened regulatory pressure, the majors continue to reshape their businesses in response to an increasingly challenging operating environment. Against this backdrop, the majors are seeking to preserve current (and identify future drivers of) earnings growth at the same time as intensifying their cost efficiency efforts. These cost reduction and productivity measures have been deployed across the majors to rebalance their investment and project portfolios towards a greater emphasis on digital capabilities, robotic process automation, machine learning and cognitive computing (to achieve not only cost, but also customer, compliance and revenue outcomes).

Looking at the full year results, the average cost-to-income ratio decreased by 103 basis points across the majors to 43.4 percent, with revenue growth moderating compared to the increase recorded in underlying operating expenses. The rise in expenses can be directly attributed to meeting high and rising regulatory compliance, legal and remediation requirements, as well as restructuring costs and investment in technology.

The number of full time (FTE) employees across the majors decreased 2,498 FTE to 159,028 as the majors look to reshape their

businesses and labour force. This trend is expected to continue, as the composition of their workforce shifts towards a greater balance of digital and contract labour (e.g. freelance specialists) to augment their relatively smaller FTE bases, over the coming years.

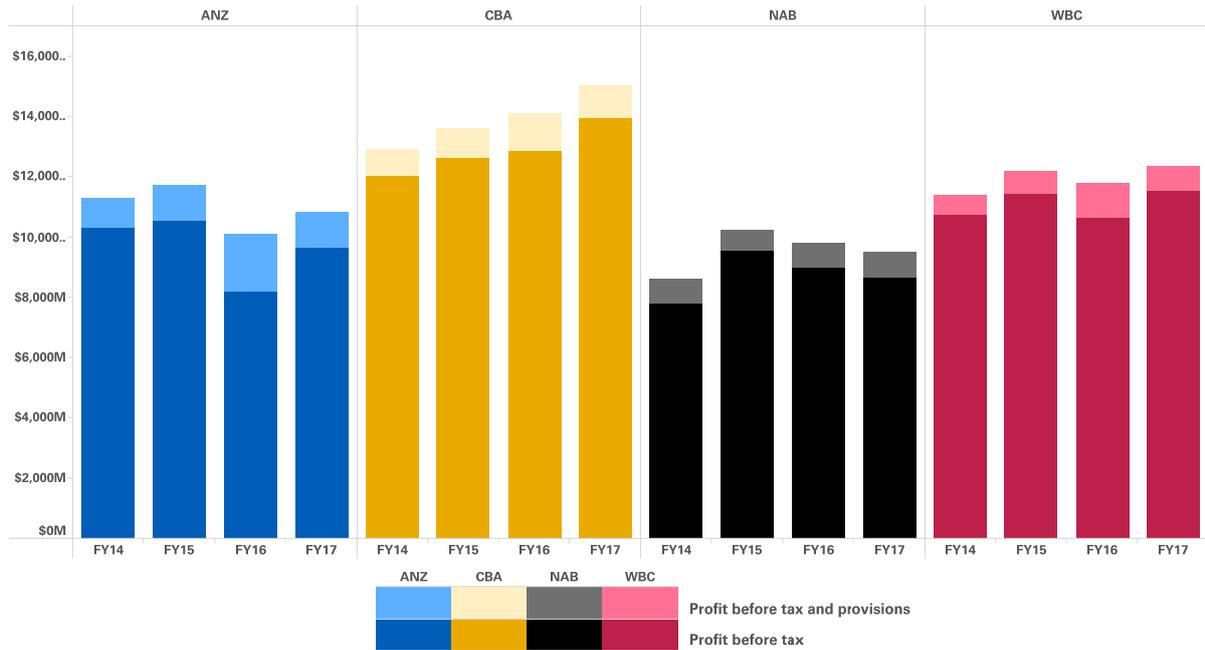
Diagram 1. Cash profit after tax by segment



In addition to this, the majors continue simplifying product offerings in an effort to streamline their operations, remove complexity and achieve cost savings. Ongoing (and in some cases, increasing) regulatory compliance and remediation programs have become a permanent expense burden for the majors. The removal of time-intensive, manual processing activities and the application of automated processing (e.g. through the application of fintech and regtech solutions) are expected to deliver compliance requirements, and deliver an enhanced customer experience while ultimately reducing costs over the medium to long term.

Technology remains a key enabler to the majors' strategic direction, with the majors reporting a combined investment in technology and digital capabilities of \$4.2 billion. This investment in technology and restructuring initiatives is expected to be significant across FY18 and beyond. However, the majors will need to be targeted with their investment in new technologies and balance short-term cost pressures to achieve their intention to transition to lower cost operating models where the benefits are expected to be secured over the medium to longer term. Ultimately, this focus on cost will provide greater capacity to invest in enhancing the customer experience, which will form a critical part of their response to growing competition from fintech firms, as well as the looming threat posed by the technology giants.

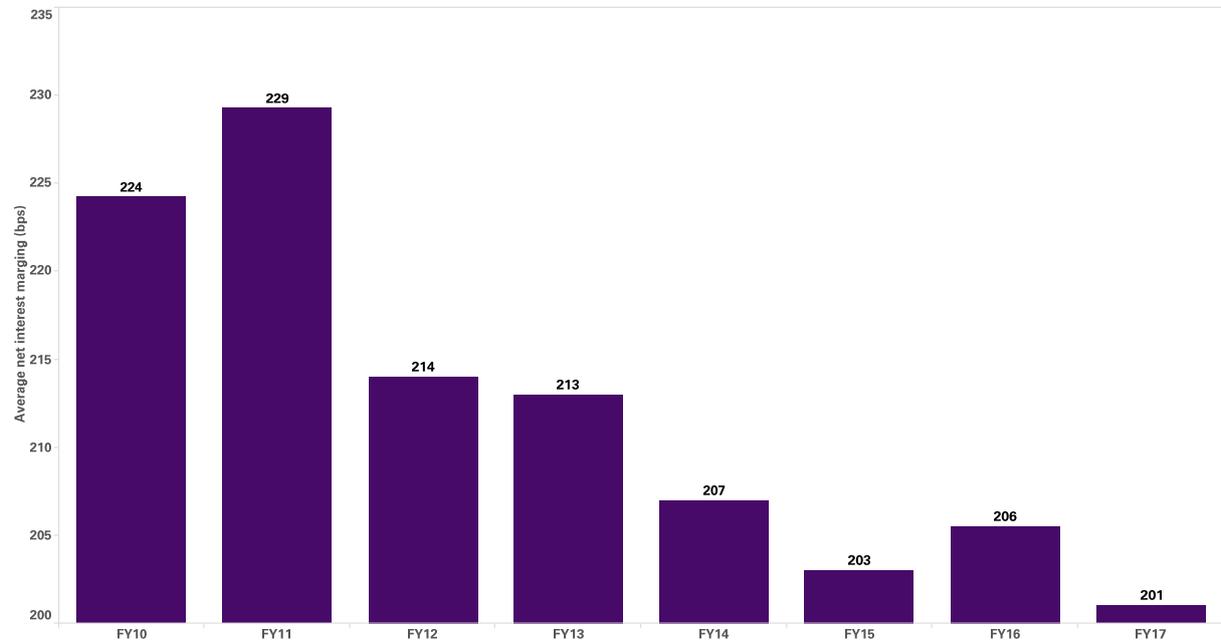
Diagram 2. Profit before tax and provisions vs operating profit before tax (statutory basis)



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Combined net interest income (NII) increased \$1.0 billion to \$61.3 billion on FY16, however with a declining net interest margin (NIM). NIM declined 5 basis points to 2.01%, reflecting a combination of competitive pricing on lending and customer deposits, increased cost of funding, as well as the initial impact following the introduction of the Major Bank Levy in July 2017.

Diagram 3. Average net interest margin

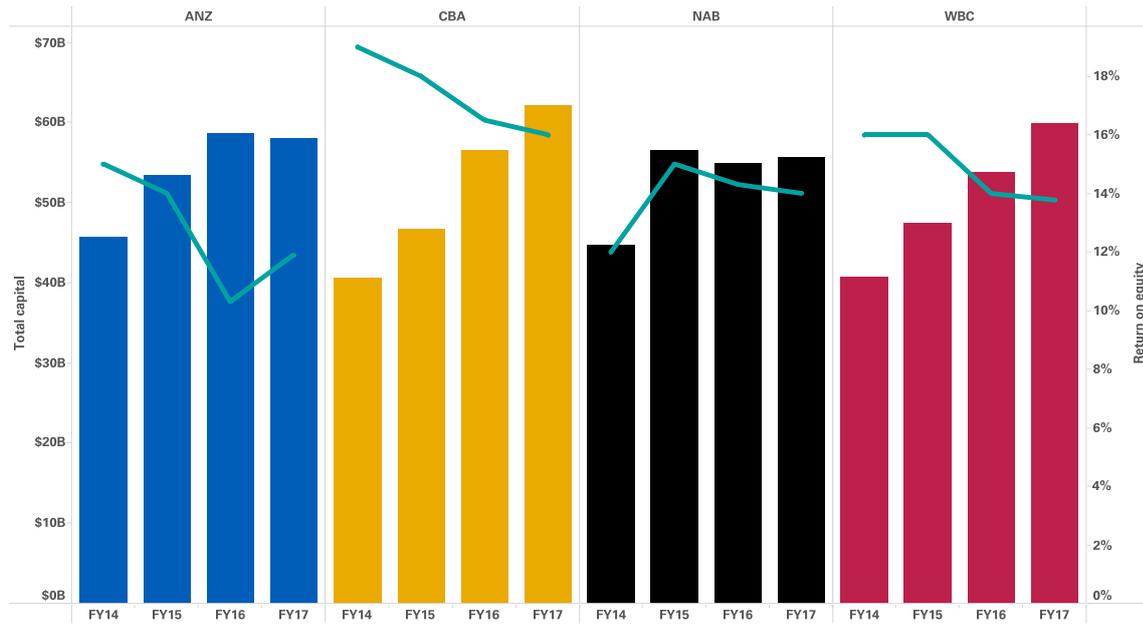


Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

On a positive note for the major banks, loan losses remain low. Impairment expense recognised across the majors was \$4.0 billion, representing 0.44% to total loans and advances, down 10 basis points on FY16.

Notwithstanding the coalescence of a number of headwinds impacting the banking industry, many of which are structural in nature, the major banks are well placed to adapt their businesses to these challenges (and are demonstrating an increasing sense of urgency in doing so).

Diagram 4. Total capital vs return on equity



Return on equity
 Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Fintech and digital: the future of banking

Ian Pollari, Partner, Head of Banking, KPMG Australia & KPMG Global Co-Lead Fintech

'We have to have the mindset of a financial technology (fintech) company'; 'We need to think and act like a 200-year old start-up'; 'If we don't innovate, we're toast'.

These statements from Australian major bank CEOs highlight three strategic implications for the future of the banking industry. Firstly, technology disruption is quickly evolving the competitive landscape, lowering entry barriers for new players and creating new business models. Secondly, investment in digital innovation will be critical in delivering customer experiences that are being redefined by the likes of Uber and Airbnb. And thirdly, partnering with and/or sourcing capability from fintech start-ups and technology companies will form an important part of the response for established financial institutions, as they more aggressively pursue revenue growth, cost efficiency and risk-mitigation opportunities.

Fintech is one of the fastest-growing sectors in the global financial services industry, with total investment rising from US\$100 million in 2008 to more than US\$31 billion in 2016. In Australia, we have seen the number of fintech start-ups increase from less than 100 in 2014 to more than 575 today, with more than US\$670 million invested in the fintech sector today (from US\$50 million in 2012). While this growth has seen the emergence of fintechs that are seeking to directly compete with incumbent banks (the 'carnivores'), with \$30 billion of industry revenue estimated to be at risk of disruption over the next five years, there is an increasing number of fintechs looking to partner with or sell their services to financial institutions (the 'herbivores').

There are benefits for both parties in a collaborative model. Fintechs gain access to a range of important growth levers, such as customers, distribution, data, capital, experience, licences, a trusted brand and an ability to scale much more quickly. Alternatively, incumbents gain access to new ideas, solutions, capability, knowledge and potential investment opportunities, in new players that are typically focused on a specific problem or opportunity, and have significantly lower cost structures. It ultimately allows incumbents to be more agile and faster to market, as well as providing strategic optionality.

There are several factors that are reshaping the banking industry and fuelling the growth of fintech – the accelerating pace of change; the proliferation of mobile devices and digital platforms; falling barriers to entry and greater competition; and a more supportive policy and regulatory environment for fintech innovators, each of which plays an important role. Above all, changing consumer behaviours and attitudes, led by the rising tide of millennials, and a move towards platform-based business models, will be the most fundamental driver of the industry's evolution in the future.

Gen Y already makes up 22 per cent of Australia's population and will form 50 per cent of the workforce in five years; therefore, they will be significant drivers of banking revenue in the not-too-distant future, and their priorities and preferences are distinctive. They rapidly embrace new technology, seek advice from alternative sources (for example, social media) and demand greater levels of personalisation, convenience and immediacy. They are also increasingly less loyal to their financial institutions. In a recent KPMG Australia study, 28 per cent of gen Y professionals surveyed hold financial products with three or more institutions, compared to 11 per cent last year. An enhanced customer experience is key to attracting and retaining this group. These attributes will be important to consider as banks evolve their future products and services to meet these needs.

In an industry traditionally dominated by large players, with historically product-centric operating models such as banking, the emergence of platform-based businesses in and outside of the sector will likely result in a shift in the balance of power towards platform providers and the end customer. Furthermore, as technology infiltrates every aspect of life, retail banks could become largely invisible to consumers, as banking activities become hidden – for example, by virtual assistants, like Amazon's Alexa, which can fulfil daily personal and financial obligations, informed by data gathered from a fully connected way of life. The technologies that enable this scenario are all available today: advanced data analytics, voice authentication, artificial intelligence (AI), connected devices, application programming interface (API) and cloud technology.

In considering their responses, banks remain highly trusted and could develop 'lifestyle layers' to compete in the platform space, orchestrating ecosystems of fintechs and other providers themselves for consumers and small businesses. If banks are not leveraging these capabilities, they face being disintermediated by, and disaggregated behind, devices, services and 'lifestyle platforms' that manage more than financial services.

Clearly, the banking industry is not standing still. Banks, globally and in Australia, are increasingly recognising that investments in and collaboration with fintech start-ups and other technology companies offer a broader range of new ideas and possibilities. According to the Wharton Business School, 'Disruptive innovations need not lead to an incumbent's fall, despite prevailing academic theory arguing otherwise. Start-ups introducing disruptive technologies are more likely to end up licensing to incumbents, forming alliances or merging with market leaders rather than turning into rivals'.

There is no doubt that the banking industry of the future will look very different from what it looks like today. The landscape will be more competitive, more efficient and provide more customer choice. Banks will come under increasing competitive pressure unless they can leverage technology to cut costs, making them closer to leaner fintech operators. Agile incumbents that are efficient distributors or acquirers of leading fintech capability to meet adjacent customer needs have the potential to generate new sources of growth and value for customers.

This article was originally published in Future Banking Australia: Commemorating 200 Years of Banking in Australia.

Net Interest Income

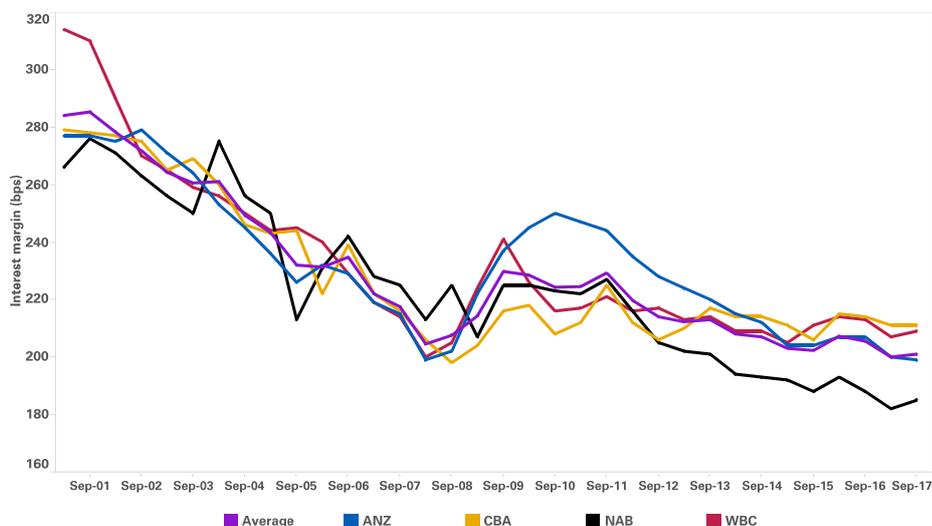
Net interest income increased 1.7% to \$61.3 billion in aggregate across the majors driven by continued growth in interest earning assets. However, net interest margins, the difference between their cost of funds and the price they lend at, fell an average of 5 basis points to 2.01%. We anticipate revenue growth will continue to be a challenge, particularly given the sustained competitive environment between the traditional banking peers and emerging competitors. This combined with slowing asset growth, a low cash rate and increasing regulatory capital requirements is expected to continue to dampen net interest income in the future.

Stagnant wage growth and high levels of underemployment are keeping a lid on economic growth and in turn, demand for credit, with growth moderating to mid-single digits.



| Cash basis | FY17 | FY16 | FY17 Movement % |
|----------------------------|---------------|---------------|--------------------|
| NET INTEREST INCOME | | | |
| ANZ | 14,872 | 15,095 | -1.5% |
| CBA | 17,600 | 16,935 | 3.9% |
| WBC | 15,704 | 15,348 | 2.3% |
| NAB | 13,166 | 12,930 | 1.8% |
| Aggregate | 61,342 | 60,308 | 1.7% |
| NET INTEREST MARGIN | | | |
| ANZ | 199 | 207 | -8 bps |
| CBA | 211 | 214 | -3 bps |
| WBC | 209 | 213 | -4 bps |
| NAB | 185 | 188 | -3 bps |
| Average | 201 | 206 | -5 bps |

Diagram 5. Interest margins



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

The majors have continued to face margin pressure, with heightened competition, higher funding costs, holdings of liquid assets and the prevailing low interest rate environment, not sufficiently offsetting mortgage re-pricing efforts.



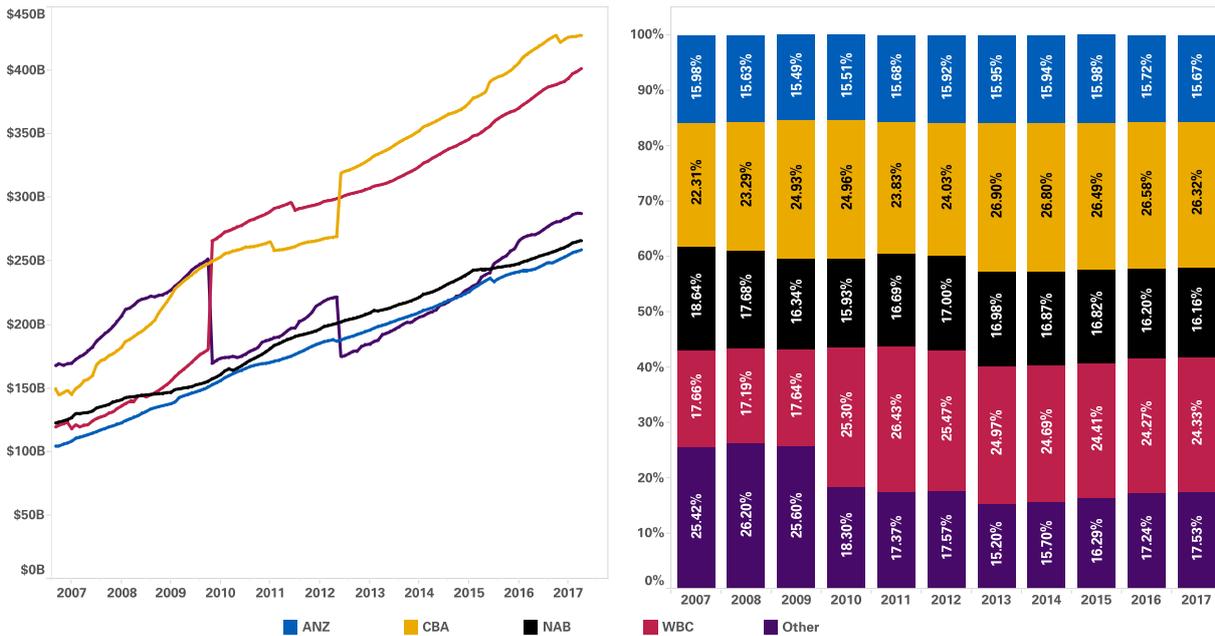
Net interest margin

In the current environment of low interest rates and heightened regulatory requirements, the majors net interest margins continue to decline, mainly affecting housing lending margins. In the first half of the year, competition for customer deposits and the impact of the Major Bank Levy in the final quarter of 2017 combined with lower earnings on capital have offset mortgage repricing efforts.

Repricing has focused on residential mortgages, both investor and owner occupied, in efforts to reduce the decline of interest margins. Looking forward, the introduction of the Bank Levy is expected to place further downward pressure on net interest margin prospectively as it takes full effect in FY18.

Lower interest rates have also impacted on the Markets and Treasury businesses within the majors with existing low interest rates in Australia causing higher spreads, driving higher earnings from market's activities and earnings on capital.

Diagram 6. Loans to households and market share of household loans



Source: APRA Monthly Banking Statistics

Lending asset growth

Stagnant wage growth and high levels of underemployment are constraining economic growth and in turn, demand for credit, with growth moderating to mid-single digits.

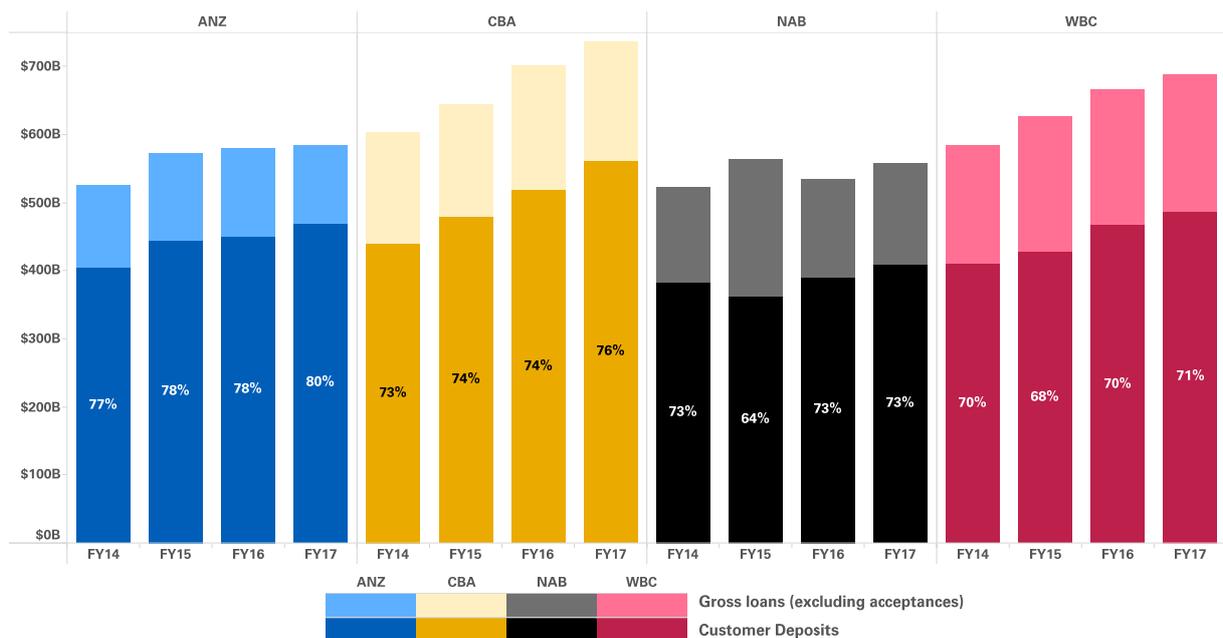
Average interest earning assets across the majors increased 3.9% in FY17, increasing 2.0% in 2H17. This increase has been predominantly driven by mortgage lending, specifically owner-occupier mortgages which significantly outpaced investor mortgages in FY17.

APRA’s increased scrutiny of investor and interest only loans appears to have contributed to the sharp reduction in investor loan approvals. However, this has been offset by an increase of similar magnitude in owner-occupier lending.

Notwithstanding this growth in interest earning assets, mortgage and business lending competition has combined to place pressure on the majors’ interest margins, reducing the effect of repricing mortgage books and rebalancing commercial portfolios. While the interest rate rises on investor and interest only loans helped increase NIM in the second half, over the full year, NIM fell an average of 5 basis points to 2.01%. Competition for deposits, increases in funding costs and the low interest rate environment have further contributed to the continued decline seen in the majors’ net interest margins in FY17.

Given the challenges of balancing competition and repricing efforts, the majors have ceded market share at a modest rate of 29 basis points (95 basis points PCP). The reduction in the majors’ market share is indicative of the continued competitive pressure between the banks to retain market share and their greater focus on profitability (over growth).

Diagram 7. Customer deposits proportionate to total gross loans



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Funding mix

Funding mix had an unfavourable impact on net interest income during the year. Competition for customer deposits and increases in wholesale funding costs due to lengthening the mix and tenor of wholesale funding to address the Net Stable Funding Ratio (NSFR) requirements of Basel III offset the favourable movement in lending volumes and the effect of repricing initiatives.

The major banks have continued to engage in wholesale funding ensuring that the tenor and mix of funding enables them to meet the NSFR of 100% from 1 January 2018. As a result of the shift to wholesale funding, short term debt continues to decrease as a proportional source of funding.

Competition for deposits has made sourcing funds from customers challenging yet the proportion of funding from customer deposits has remained relatively stable.

Asset Quality

Loan losses continue to remain low. Asset quality metrics show that the quality of the majors' lending portfolio's continue to improve with the level of commercial troublesome and impaired assets reducing over the year. Combined loan impairment expense was \$4.0 billion in FY17, down 22.5% year-on-year.

The majors have demonstrated an ability to preserve credit quality in a challenging growth environment. As interest rates inevitably rise, they will need to balance their pursuit of future growth, with profitability and a strong focus on pricing discipline.

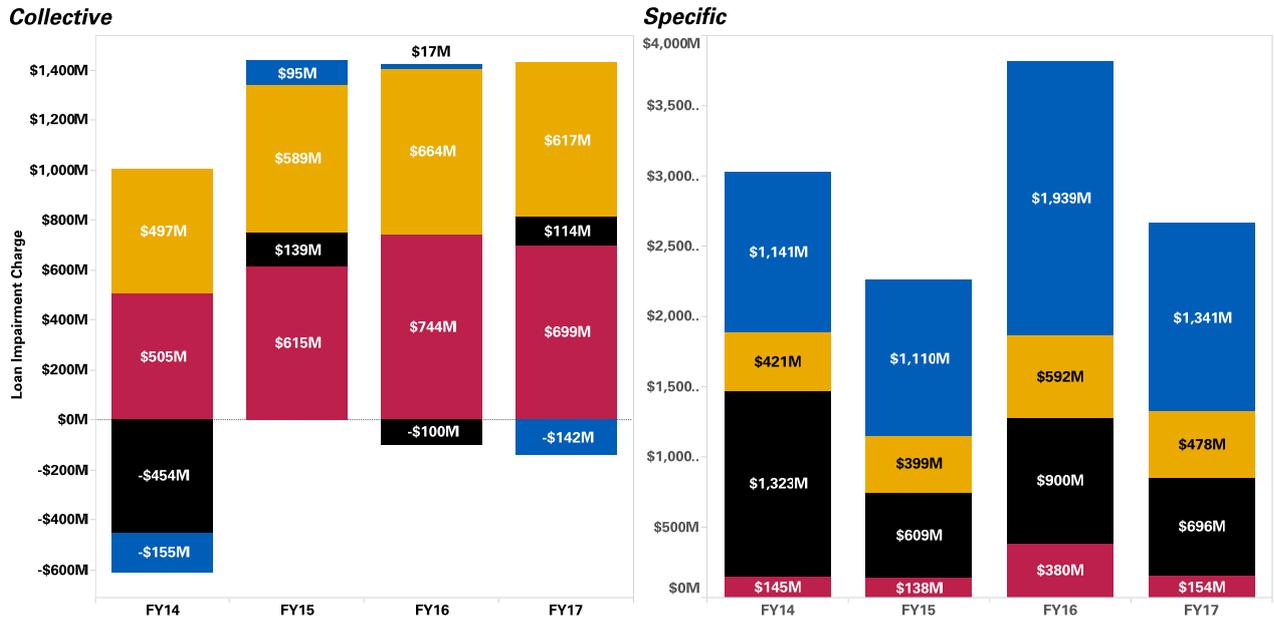


The majors' strong asset position was reflected in a 15.2% decrease of impaired assets to \$11,082 million. The credit environment, with the exception of regional pressures linked to the mining sector, has remained stable in FY17 reflected by a 4bps decrease in loan impairment expense as a proportion of gross lending assets (GLA).

The majors' impairment charges have decreased 22.5% (or \$1,152 million) to an aggregate charge of \$3,970 million. Total provisions for credit losses have decreased 5.6% attributable to reductions in troubled commercial debt, improvements in corporate repayments, and rebalancing of portfolios. Retail mortgages and personal credit impairment provisions offset the decrease due to growth in interest earning assets and pressures felt from weaker market conditions in WA.

The future headwind to the current low losses is the eventual rise in interest rates. Household debt continued to rise, increasing to over 180% of household's disposable income. However, in the current environment, arrears for the home loan and credit card portfolios remain relatively low. As interest rates inevitably rise, the majors will need to balance their pursuit of future volume growth, with profitability and a steady focus on pricing discipline.

Diagram 8. Loan impairment charge



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Non-interest income

Across the majors, the combined non-interest income of \$24.6 billion is up 3.8% on FY16. This positive result was in the face of continued internal scrutiny over their wealth management offerings and consumer pressure on fees and commission structures. Overall, non-interest income benefited from favourable trading conditions, one-off asset sales and valuation adjustments.

The majors recorded net interest income growth, increasing by 1.7% to \$61.3 billion in the year, while non-interest income also increased, by 3.8% to \$24.6 billion, mainly due to improved market conditions and one-off asset disposals.

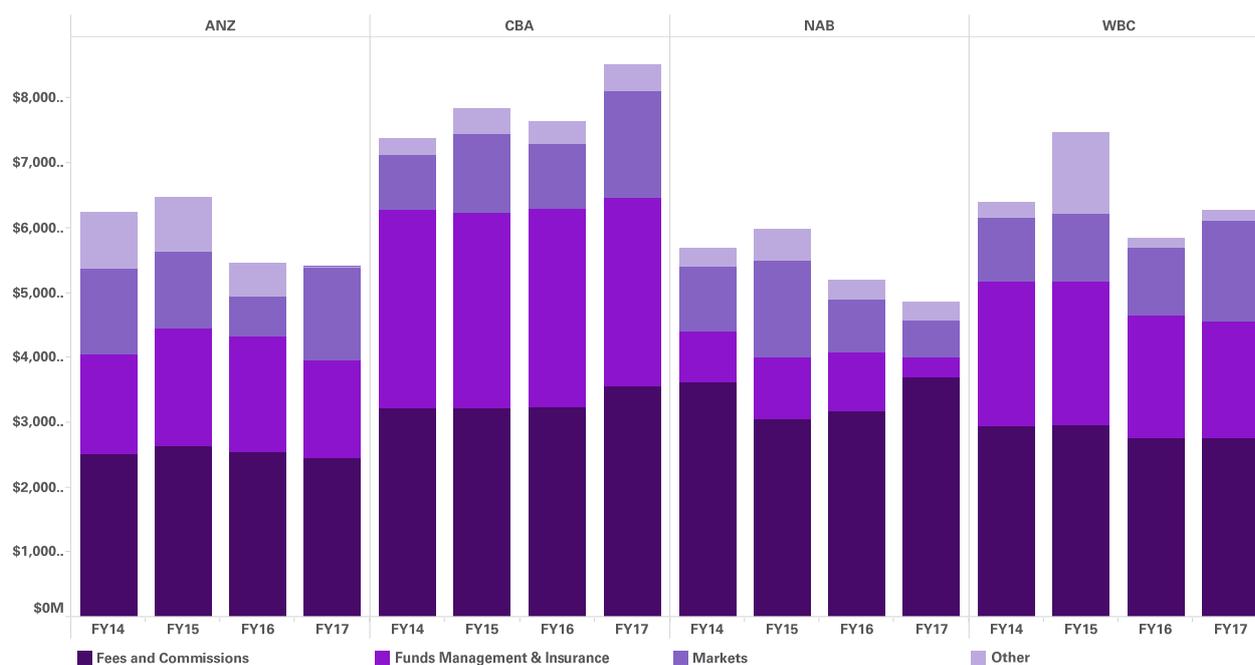


CBA reported a \$593 million increase to \$8,405 million, up 7.6% from prior year. This is primarily from the \$397 million recognised through the sale of its remaining investments in Visa Inc and a 12% increase in commissions received from consumer finance income due to higher purchases, lower loyalty costs and volume of deposit fee income.

ANZ recorded an increase in markets income of \$670 million which was a 31% increase on prior year. This was driven by decreasing spreads which generated positive movements in hedges and higher mark-to-market gains. Excluding a one-off \$237 million charge from the change in derivative valuation (CVA) methodology in the prior year, the underlying increase is \$433 million or 21.3%. This result was offset by decreases in fee and commission income and net funds management and insurance income owing to lower performance and adverse life insurance claims.

NAB similar to ANZ, had an increase in trading income of 31.2% to \$295 million to \$1,240 million, of which \$281 million related to favourable movements in economic hedges. NAB also reported an improved lending fee collection rates during the year, leading to higher fees and commissions received.

In comparison, WBC observed modest movements across non-interest income, with a total decrease of \$36 million, or 1% across the year. Increases across trading income and operating lease rental income were offset by lower fees and commission and wealth and insurance income from higher insurance claims, provisions raised against customer refunds and regulatory changes to interchange fees.

Diagram 9. Breakdown of non-interest income (statutory basis)

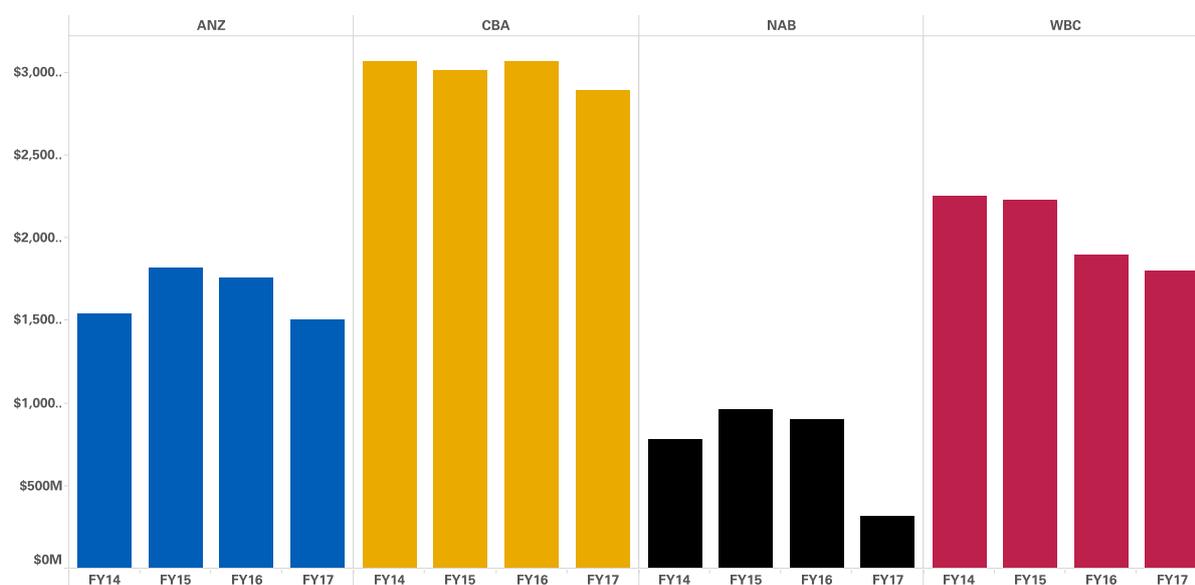
Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Wealth management and insurance

Performance in the wealth management and insurance businesses have diminished across the majors to \$10.0 billion, a decrease of 29.7%, largely driven by the impact of the exit of non-core businesses.

Key drivers to the result include:

- Increased funds under advice (FUA) reflecting strong investment markets across Australia and New Zealand and positive net flows in Australia.
- Increase in average assets under management (AUM).
- Marginal unfavourable impact from the higher Australian dollar.
- Decline in FUA and AUM margins as a result of increased customer remediation costs and change in investment mix.
- Insurance income decreased on prior year driven by higher claims experience and an increase in average inforce premiums.

Diagram 10. Net funds management and insurance income

Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Asset sales

In line with recent trends, the majors continue to selectively retreat from their non-core business offerings, reshape their business portfolio and exit some international markets. The following highlights some of the key transactions announced in FY17:

- In FY17, ANZ sold its stake in Shanghai Rural Commercial Bank, as well as the disposal of the three Asian Retail and Wealth businesses. The bank also recognised a \$114 million gain on sale of 100 Queen Street, Melbourne. In October, ANZ announced the sale of the OnePath Pensions and Investments and Aligned Dealer Group business to IOOF, and the sale of the Group's 40% stake in Metrobank Card Corporation. Completion of the sales are expected in FY19.
- In December 2016, CBA disposed of its remaining shareholding in Visa Inc. for \$439 million, realising an after profit gain of \$278 million. Recently, CBA has announced that it has sold its CommInsure life insurance businesses in Australia and New Zealand to AIA Group, expected to complete in FY19.
- NAB's accelerated strategy includes the divested non-core, low returning businesses including Clydesdale and Great Western banks and life insurance.
- In FY17, WBC continued their divestment of BT Investment Management (BTIM), reducing its ownership stake in BTIM to 10%.



Regulatory change: a permanent fixture

Michael Cunningham, Partner, Audit, Assurance & Risk Consulting,
Financial Services

If bank executives thought this year was busy with the ongoing toil of strengthening their balance sheets, e.g. building capital, liquidity and moderating leverage so as to be 'unquestionably strong', a slew of regulatory changes and challenges on the horizon will see this continue in the foreseeable future.

Given the expected finalisation of Basel III/IV and the Fundamental Review of the Trading Book (FRTB) in 2018, the major banks are faced with a disparate confluence of both local and global regulatory changes. Whilst the major banks' implementation of IFRS 9 is looking well in hand, the implications of the European Union's General Data Protection Regulation (GDPR) and Australia's Notifiable Data Breaches Scheme (NDBS) are expected to be far reaching and problematic in how personal information is managed and protected.

The European Markets in Financial Instruments Directive (MiFID II) is anticipated to have sweeping effects and to significantly impact Australian banks that operate branches or subsidiaries in Europe (and those transacting or trading financial instruments with European firms). The changes affect how applicable Australian businesses access and pay for research, process KYC, data management and record keeping, trade transparency and reporting, as well as best execution. Add in Brexit for our banks with a UK presence and you have a significant suite of regulatory risk projects to complete in a short time.

On the local front, despite the initial outrage and cost of the Major Bank Levy announced in the May 2017 Budget, this is expected to pale into significance compared with the long run impact of the Bank Executive Accountability Regime (BEAR). The BEAR shouldn't be viewed as another 'tick-the-box' compliance exercise. Its success and better accountability depends on how well it can be aligned to business as usual and instilled into the way banks deliver their services and products.

Moreover, Accountable Persons and employees need to be trained and be fully aware of how BEAR impacts them, their role's accountability and responsibility, and how this fits into their organisation's wider accountability map. It's critical that key stakeholders are engaged as early as possible, especially as this is expected to significantly change the ways of working across businesses and functions. Consequently, it's imperative in the early stages to clarify involvement and ownership of the operating model once BEAR is implemented. How a bank, its Board and Accountable Persons approach BEAR and embed it will ultimately say a lot about the culture of the firm, its leadership, and people.

In a relatively modest time frame, Comprehensive Credit Reporting and Open Banking will also revolutionise the provision of banking products and services by breaking down customer inertia on changing banking service suppliers and intensify competition for customers. On a more positive note for the industry, opportunities will unfold as the Open Banking regime extends into other sectors, such as energy and telecommunications (moving towards an open data framework).

In conclusion, if we consider ASIC's conduct risk regulatory responses such as: the Design and Distribution Obligation (DDO) upon financial services providers for financial products, the Responsible Lending investigations, Enforceable Undertakings for FX and the expected ones for BBSW, it appears Australian banks have a full regulatory 'dance card' in 2018. This will strain already tight resources – which are already suffering from prolonged regulatory change fatigue.

Capital

In the wake of continued pressure from APRA around the banking industry's management of capital, key measures of capital, such as the Common Equity Tier 1 (CET1) and Basel III ratios strengthened year on year to an average 46 bps across the majors.

The majors' capital position continued to strengthen, with their average Common Equity Tier 1 (CET1) capital ratio rising by 46 basis points over the full year to an average of 10.3 percent of risk-weighted assets (RWAs), reflecting the impact of increased regulatory capital requirements.



The year-end average CET1 ratio was 10.3% across the majors. Looking ahead, APRA's clarification of the capital requirement of an average CET1 ratio of 10.5% or more for the majors to be "unquestionably strong" means that the majors will need to continue to strengthen their balance sheets to meet the requirement by the expected date of 1 January 2020. The term "unquestionable strong" is expanding from purely a capital perspective to a wider, more comprehensive set of balance sheet metrics. APRA has promised to provide more clarity as to what they actually mean.

Net organic capital generation continues to be the main driver in the increase of the CET1 ratio with an increase in cash net profit after tax of 6.4% across the majors, and a decrease in dividend payout ratios to an average of 75.2% across the majors. Risk weighted assets also continue to decrease year on year across the majors, with the exception of CBA which increased by \$42.4m due to APRA increasing the average risk weight on Australian residential mortgage exposures to at least 25% for ADIs accredited to use the internal ratings based approach to credit risk, effective from FY17.

Capital adequacy metrics

| | ANZ | | CBA | | NAB | | WBC | |
|---|---------|---------|---------|---------|---------|---------|---------|---------|
| | FY17 | FY16 | FY17 | FY16 | FY17 | FY16 | FY17 | FY16 |
| Common Equity tier 1 ratio | 10.6% | 9.6% | 10.1% | 10.6% | 10.1% | 9.8% | 10.6% | 9.5% |
| Tier 1 capital (total) | 12.6% | 11.8% | 12.1% | 12.3% | 12.4% | 12.2% | 12.7% | 11.2% |
| Tier 2 | 2.2% | 2.5% | 2.1% | 2.0% | 2.2% | 2.0% | 2.2% | 1.9% |
| Total regulatory capital ratio | 14.8% | 14.3% | 14.2% | 14.3% | 14.6% | 14.1% | 14.8% | 13.1% |
| Tier 1 capital (\$ million) | 49,324 | 48,285 | 52,684 | 48,533 | 47,417 | 47,336 | 51,175 | 45,785 |
| Total capital (\$ million) | 57,993 | 58,613 | 62,076 | 56,477 | 55,707 | 54,945 | 59,910 | 53,768 |
| Risk weighted assets (\$ million) | 391,113 | 408,582 | 437,063 | 394,667 | 382,114 | 388,445 | 404,235 | 410,053 |
| Credit risk weighted assets (\$ million) | 336,834 | 352,033 | 377,259 | 344,030 | 325,969 | 331,510 | 349,258 | 358,812 |

The majors also maintained healthy buffers against specific Basel III ratios and reported that they are in compliance with the new NSFR requirements which come into effect on 1 January 2018. In addition:

- The Liquidity Coverage Ratio (the amount of high quality liquid assets held that can be used to meet the bank's liquidity needs for a 30 day calendar liquidity stress scenario) is running at an average of 127.7%, compared with the 100% minimum; and
- Leverage Ratio (the amount of Tier 1 capital held divided by average total consolidated assets of the bank) for the majors is at an average of 5.4% versus the currently agreed minimum requirement of 3%.

Digital labour and process automation - extracting value

Chris Foster, Partner, Management Consulting, Financial Services
Daniel Knoll, Partner, Management Consulting, Financial Services
Karen Parkes, Partner, Management Consulting, Financial Services

While many organisations are starting on their automation journey, some are not prepared to maximise the opportunities it offers. By beginning small and with a strong strategy, the potential benefits are greater.

Robotics and process automation have become part of most banks and financial institutions productivity and efficiency agendas. We see few institutions that aren't actively considering these technologies as a way of reducing manual labour on the high transaction, low complexity tasks across key parts of their organisation. So far the benefits realised have been mixed.

Many institutions are utilising process automation as part of their digital strategy, as a viable way of helping to keep their products and services accessible and relevant to their customers. Chat-bots and virtual assistants are becoming more prevalent in Europe but are not without their challenges in terms of user experience and stability.

Whilst most of these institutions are early on their digital labour journey, we are 2 years into the experiment phase and so far many banks have been disappointed by the tangible dollar value that they have been able to realise. Research claims that around 30 percent of admin costs will be saved due to smart machines by as early as 2018, yet few institutions are achieving benefits even close to this now.

So where are they going wrong?

The technology to achieve revolutionary customer and business benefit is available, but what often holds organisations back is the ability to enact the right change. Based on KPMG global experience we have identified six common reasons why:

1. Institutions have looked for opportunities to apply robotics rather than considering how customer experience and profitability could be achieved through various methods of process automation.
2. Point solutions have been implemented rather redesigning entire processes, in turn creating inconsistency and risk.
3. The change program is 'owned' by IT, not by the broader business responsible for delivery to customers.

4. Robots are not plugged into IT release schedules (so when inputs change, robots aren't changed).
5. Solutions are only able to harvest 'fingers and toes' benefits, rather than re-thinking whole groups of activities or processes using process design techniques.
6. Lack of active performance management for automation solutions, so intended benefits are never realised.

From our experience working with international banks and financial institutions, we believe there are a number of essential components to realising value from digital labour/automation:

- 1. Outline the strategic intent of automation** – This should include communicating automation vision and benefits. Institutions which have achieved value from digital labour at scale are communicating the benefits as follows:
 - **Employee satisfaction** – Eliminating mundane, repetitive tasks allows employees to focus on strategic initiatives, thereby impacting the business in a more profound way and experiencing greater job satisfaction.
 - **Scalability** – Robots can scale instantaneously at digital speeds to respond to fluctuating workloads.
 - **Performance** – Allows an institution to respond to customers 24/7, 365 days a year.
 - **Control and regulatory compliance** – The technologies keep the perfect audit trail, documenting every action taken and the outcome.
 - **Quality** – When configured properly there are no mistakes.
 - **Cost efficiency** – Digital labour savings are estimated to be between three and 10 times the cost of implementing.
- 2. Rethink whole processes to deliver better customer outcomes using automation** – Mortgage origination, KYC or on-boarding processes have been automated by some banks by rethinking the entire end-to-end process using several tools to deliver across the value chain. This requires a combination of process architects and solution architects working together, led by the business leader.
- 3. A rapid approach to implementation by selecting the right use-cases and technology** – Successful institutions are driven first by customer needs, and then select the new technology. Those that are less successful look to the new technology first. Consider all possibilities across the process automation continuum including office robots, chat/voice bots, digital assistants, Artificial Intelligence and machine learning, then cognitive technologies.
- 4. Consider the right organisational design and development for a virtual workforce** – This requires role definition and capability development for all roles required to implement the process automation solutions (such as sponsor, designer, architects, analysts, change managers) and the roles and capabilities to then lead the digital labour in BAU (people leaders, sponsors, SMEs).

5. Using automation to achieve competitive advantage requires innovation and agility – Those that have used process automation not just to reduce transactional administrative activities, but to provide a ‘world’s first’ to their customers, have often sourced their ideas from customer insights, drawn from data analytics, and from people within their own business. A visible pipeline of ideas generated from within the business is an effective way of keeping teams engaged and proactive, and ensuring the process automation can achieve enough scale quickly to make a positive impact.

6. A well designed operating model will allow for smart and effective scaling of digital labour technologies and benefits – The digital labour operating model should scale with maturity. This has the following implications:

- Start small with only the basic required processes in place to automate a few processes.
- As digital labour solutions spread through the institution, additional layers and roles should be added or scaled up within the operating model to ensure that the growth occurs in a structured and controlled manner.

7. Management of risk and security is a vital consideration, often missed – Early engagement of Risk functions in the process is essential. Security risks range from the increased impact on cyber security, the risk of human error in programming, managing capacity of space and licencing, to business continuity if something goes wrong. Ensuring an audit trail by linking each robot to a personnel number and people leader is key.

The digital labour journey is a complex undertaking that can add significant risk and complexity to an organisation. The movement towards digital labour is coming faster than most banking industry participants have anticipated and our experience shows that when done right, the benefits are real and significant.

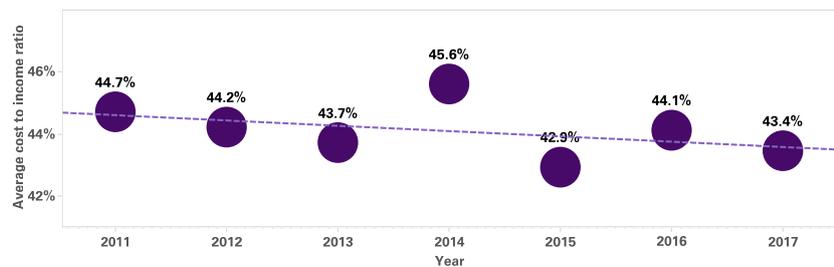
Costs

The retail banking industry, with intensifying competition, regulatory intervention and a low cash rate paints a picture of a challenging growth and margin environment, naturally placing the strategic focus for the majors on cost management. Nonetheless, operating expenses have continued to grow over the past year, with the majors continuing to invest in technology to find efficiencies and to improve the customer experience, offset by personnel expense savings.

The majors will need to be targeted with their investment in new technologies and balance short-term cost pressures to enable them to transition to lower cost operating models where the benefits are expected to be secured over the medium to longer term.

Operating expenses for the majors have decreased by 0.1% in FY17 to \$37.3 billion but the average cost to income ratio on a cash basis is down 1.0% on PCP to 43.4%, reflecting sound management of competing priorities amidst cost and revenue demands. The increase in operating expenses is a common theme across the majors except for ANZ which reported a decrease of operating expenses by \$991 million compared to the prior year. This was on the back of the one-off software capitalisation policy charge of \$556 million in 2016 and restructuring expenses decreasing by \$216 million owing to the large outlay in 2016 for the reset of ANZ's strategy.

Diagram 11. Interest margins



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Savings in operating expenses will continue to be a key focus area for the majors going forward, though challenges to do so exist. NAB announced plans in their annual report to increase investment by \$1.5 billion over the next three years to accelerate their strategy. In doing so, it is expected to increase expenses by 5 to 8% in the upcoming year and remain flat during FY19-FY20.

Technology

The large number of investment priorities for the majors is highlighted through increasing operating expenses as the majors continue to balance meeting the ongoing demands of regulatory compliance whilst optimising their investment in technology. Technology expenditure was focused particularly on the areas of streamlining processes, improving banker and customer experience and managing cyber risks. As discussed above, NAB has already announced plans to continue spending focus on increasing innovation, improving the customer experience through digital channels and automating processes.

Technology expenditure increased year on year by 2.2% to \$6,723 million across the majors though there are significant one-off items included such as a \$393 million one-off acceleration of amortisation on certain software assets at CBA meaning that the underlying increase in technology expenditure at CBA was approximately 4.2%. Similarly, ANZ reported a \$501 million decrease in technology expenditure in FY17 due to a \$556 million software capitalisation charge in 2016. Excluding this, ANZ had increased technology expenditure by 3.4% year on year.

Diagram 12. Capitalised Software



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Personnel

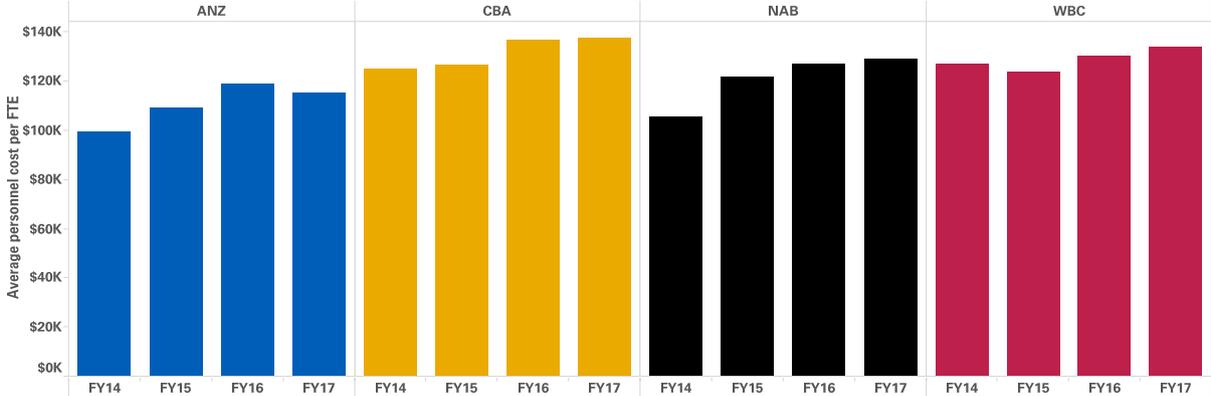
Overall personnel numbers across the majors continue to decline, with a re-orientation towards new digital skills, including robotics and data science being added. As an example of this, NAB has announced it will reduce its FTE by 6,000 over the next three years, while hiring 2,000 new people with digital skills.

Lower average FTEs have driven employee expenses down by 1.3% to an average of \$5.1 billion across the majors.

Looking ahead, the industry will look toward new technologies including robotic process automation, machine learning and cognitive inputting to automate routine, rule based tasks in areas such as fraud detection and loan processing.

In addition, jobs that will continue to remain in demand involve high quality human interaction, creativity and those requiring social intelligence and perception.

Diagram 13. Average personnel costs per FTE



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Return on Equity

Rising regulatory capital requirements and operating expenses will continue to challenge the majors as they strive to maintain shareholder expectations for high returns on equity.

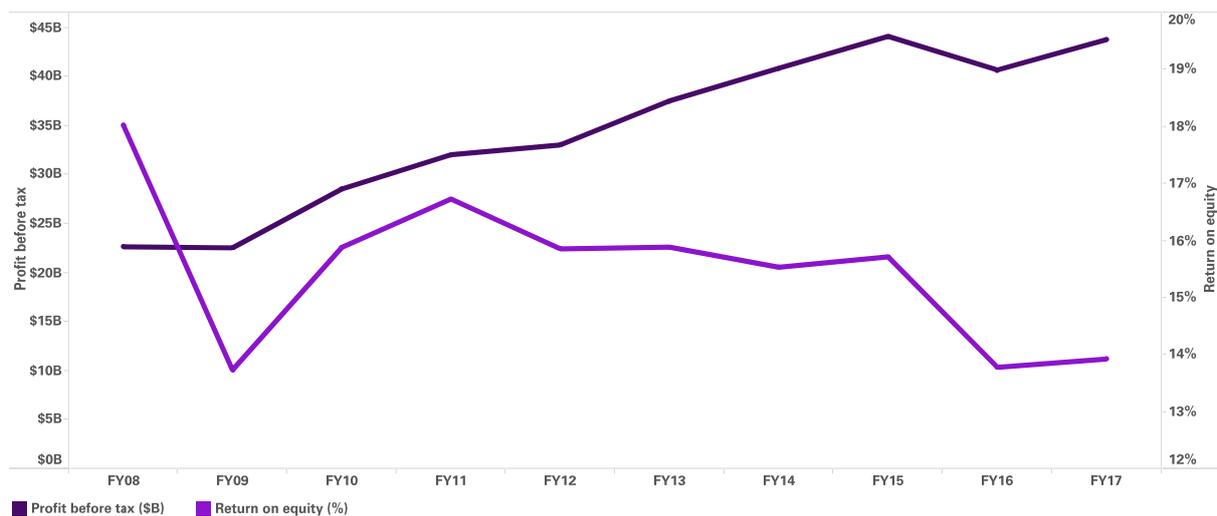
Given a number of structural factors are impacting the banking industry simultaneously, the majors will need to adapt their business mix and product portfolios to give them greater financial and operational leverage to invest in future areas of growth and facilitate a transition to lower cost operating models.

Despite capital raisings undertaken by all the majors during FY16, additional efforts will be required by the majors to meet APRA’s “unquestionably strong” requirement by the expected date of 1 January 2020. This will put further pressures on the majors to achieve strong average cash return on equity (ROE) results which were up 15 basis points to 13.9% during FY17.

ANZ increased its ROE throughout the year, reporting an increase of 160 basis points to 11.9%. CBA, NAB and WBC each posted a reduction in ROE, reporting 16.0%, 14.0% and 13.8% respectively.

Despite increasing cash profit across the majors, the sustainability of ROE continues to prove challenging as the downward trend remains unchanged since 2010 as evident below.

Diagram 14. Profit before tax against return on equity



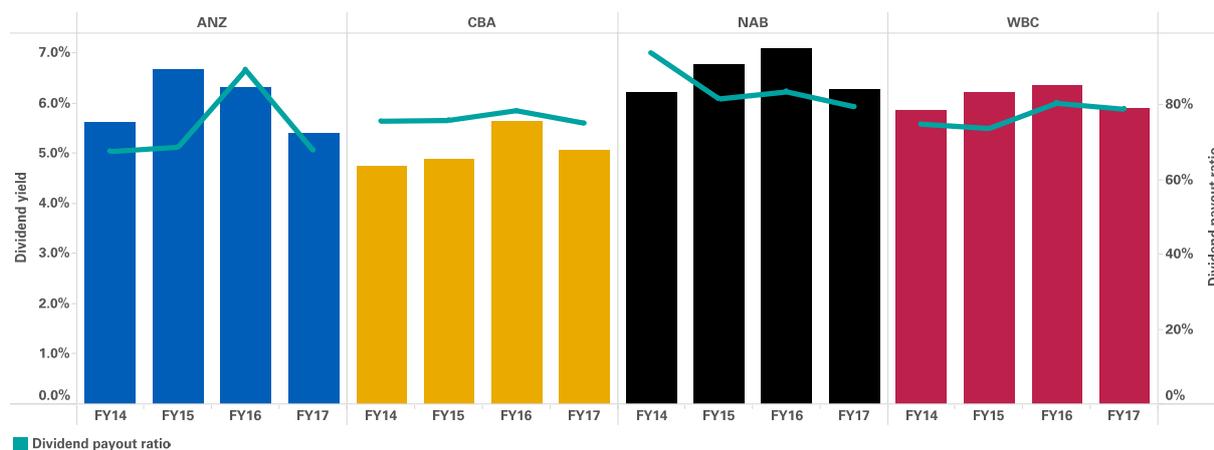
Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Dividends

Across the majors, dividends remained flat year on year except for CBA which paid out 9 cents more per share compared to prior year. The dividend payout ratio was down across the majors, by an average of 4.0% to 75.2%.

In striking a balance between handling prudential pressures and delivering on shareholder expectations, sourcing organic growth opportunities and managing rising costs will continue to factor highly in the majors' decision-making. NAB in particular have announced that they expect to maintain the FY18 dividend at the FY17 level.

Diagram 15. Dividend yield vs payout ratio



Source: KPMG analysis from Bloomberg data



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Contact us

Andrew Yates

National Managing Partner – Audit Assurance & Risk Consulting

+61 2 9335 7545

ajyates@kpmg.com.au

Ian Pollari

National Banking Sector Leader

+61 2 9335 8408

ipollari@kpmg.com.au

kpmg.com/au/majorbanks



www.kpmg.com.au

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