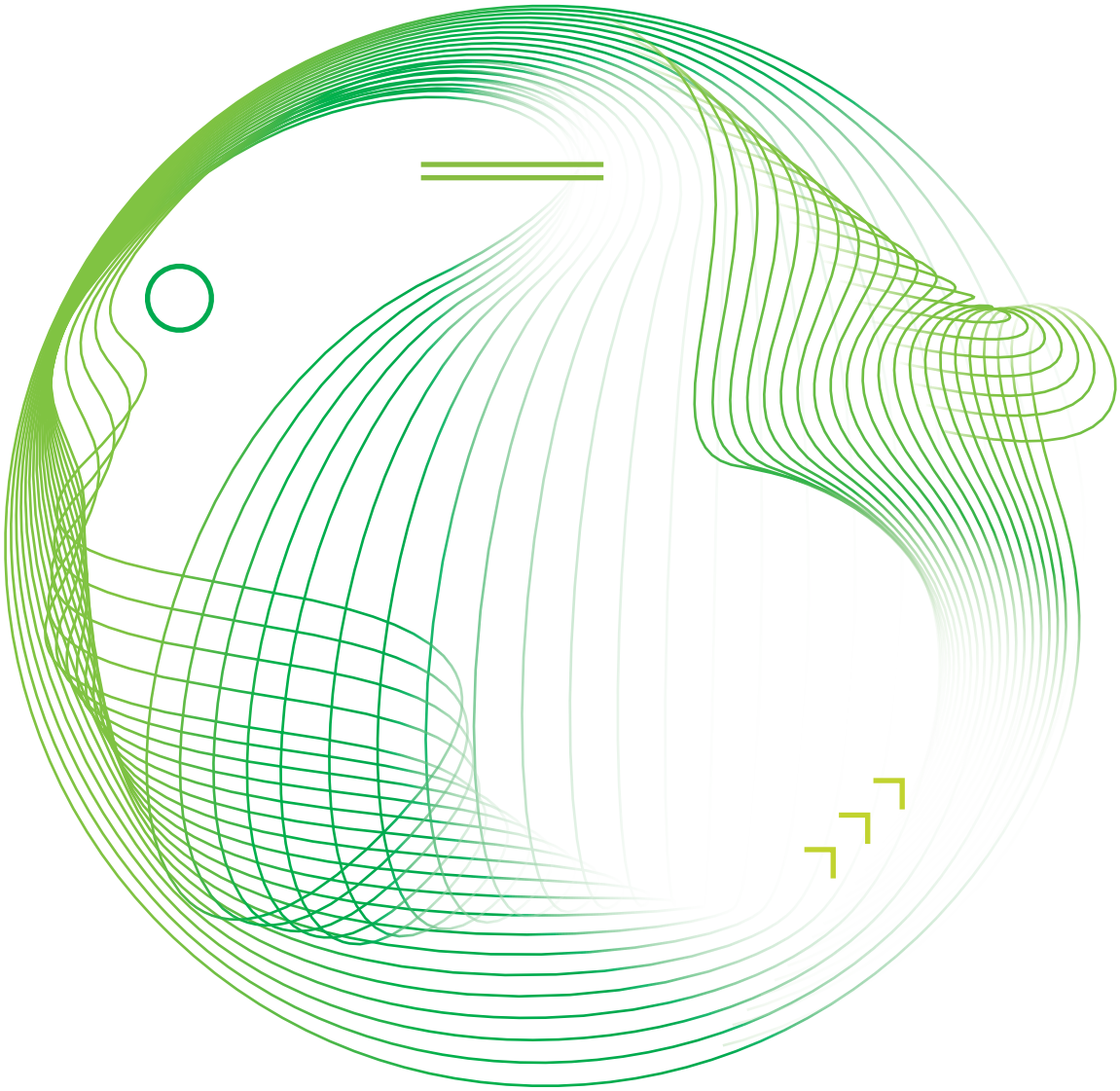
Deloitte.



Road to recovery

Australian major banks FY20 results

November 2020

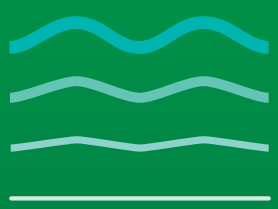
MAKING AN IMPACT THAT MATTERS since 1845

"We could never have forecast 2020, a year that started with devastating bushfires in Australia and unwound with the waves of a pandemic that continues today. While we still cannot predict its course, we remain confident we can deal with its impacts."

Shayne Elliott – CEO, ANZ[1]

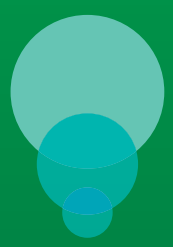
Growth a major challenge

Total income declined by 1.7%



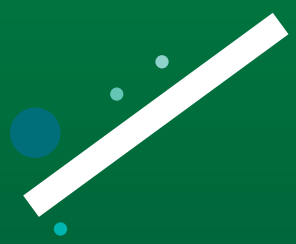
Efficiency is critical

Total expenses increased by 10.3%



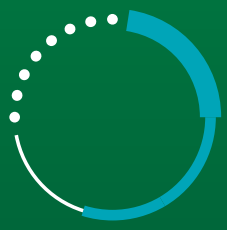
Cash profit declined by

36.6%



Credit risk increasing significantly

(90DPD + GIA) / GLA increased by 19bps



Lending growth has slightly increased

Total average interest earning asset growth 3.7%

'Unquestionably strong' capital into the crisis

Average CET1 above 10.5%

Source: FY2020 results and investor presentation for ANZ, CBA, NAB and WBC: Deloitte analysis, compared to FY2019.

Major banks FY20 results

In the course of just a few months, COVID-19 significantly impacted countries around the world by causing an unprecedented health and economic crisis. While it is far from over, the good news is that the outlook is beginning to look more positive than during the depth of the crisis; but as the IMF states, "While the global economy is coming back, the ascent will likely be long, uneven, and uncertain."[2]

Bad times are followed by good times, sentiment about the future is improving; many economies across the world have started to recover, COVID-19 vaccine trials are underway, and swift and significant fiscal, monetary and regulatory responses have led to a rebound in employment levels; albeit only partially.

The Australian economy is suffering its first recession in almost three decades, business and consumer confidence touched all-time lows earlier this year, shutdowns and border closures have impacted the economy and pushed unemployment into double-digits.

However, light at the end of the tunnel is starting to appear. As Deloitte Access Economics' latest Business Outlook[3] reports "Even with the second wave in Victoria, our nation has outperformed the world on the virus, and that has allowed us to outperform on our economy too. We have held the economy together using Band-Aids. That has worked brilliantly. But those Band-Aids are starting to come off. And the virus remains an unpredictable enemy that could throw further spanners into the works. So although this recession arrived quickly, it will leave slowly".

The IMF's latest World Economic Outlook has downgraded the 2020 outlook for more than three-quarters of countries. However, Australia has recorded the 7th highest upward revision[4].

Green shoots are sprouting in Australia and elsewhere, but the recovery from here will be slow and uncertain. Deloitte Access Economics forecasts that domestic economic activity could grow by $54 billion in 2021, starting to recover some of the $76 billion estimated to be lost through 2020.

The 'Team Australia' spirit exhibited by all levels of government, regulators, community, and the banking industry has been and will be an essential part of the road to recovery.

This spirit has enabled Australia to deliver some of the best health and economic outcomes in the world. COVID-19 forced radical changes in consumer behaviour, moved significant proportions of the economy online and increased the comfort and willingness of customers to engage digitally – in mere weeks.

The banking sector moved swiftly to protect the interests of its employees and customers and we saw many of the hurdles to digital transformation stripped away. COVID-19 has not only proven the role of digital in reaching customers and maintaining operational resilience, but in forcing organisations to act, it has revealed their true capacity for innovation.

As Wayne Byres the Chair of APRA recently noted "Australian banks have navigated the past six or so months quite well. Importantly, at a time of extreme community uncertainty and nervousness, there has been no significant degradation of services provided to customers."[5]

Investments in data analytics and real-time monitoring systems helped the banks, regulators and the government to deliver a swift response to cushion the blow from the pandemic. Many banks granted temporary relief to borrowers impacted by COVID-19. At the peak of the crisis in June, repayments on approximately 500,000 mortgages, and more than 200,000 small business loans were paused. The latest Australian Banking Association data shows almost 45% of deferred mortgages are now back to normal and making regular repayments[6] - a good sign, but given government support measures are temporary and will come to an end early next year, there continues to be uncertainty on the horizon.

While Australia has, so far, been successful in controlling the spread of COVID-19, the lower-for-longer interest rates, higher unemployment, lower business and consumer confidence, and high household debt will significantly impact the banks' top-line growth and cause structural challenges to the longer-term profitability of the sector. The economic recovery from here is expected to be unpredictable and uncertain as many households are still holding back spending.

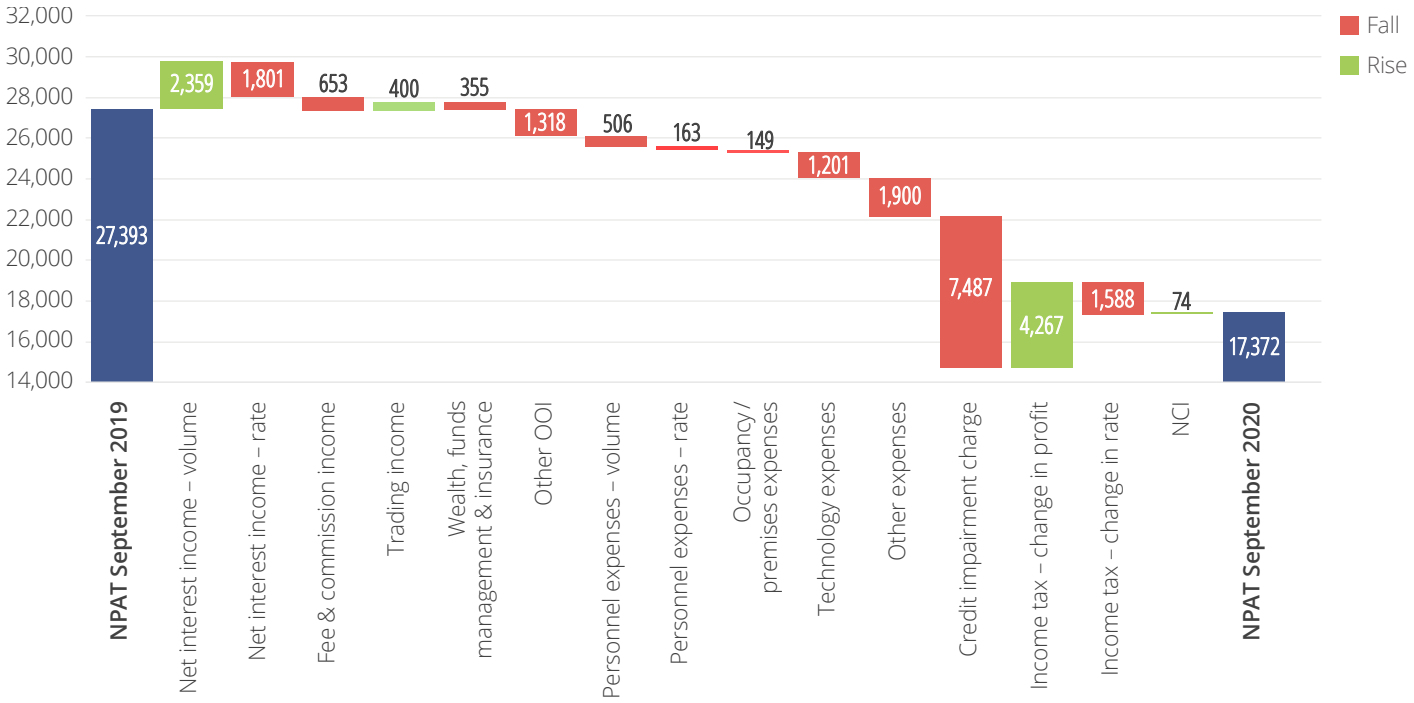
Although the Australian banking sector entered the crisis in a relatively strong funding and capital position, it will continue to face an extended period of low economic and credit growth. As Michelle Bullock, Reserve Bank of Australia (RBA) Assistant Governor, Financial System, recently noted " There is going to be further pressure on banks' profits and capital over the coming year. But with substantial uncertainty about economic outcomes, it is difficult to determine how large the impact might be."[7]

Given the economic backdrop, it is not surprising that the aggregate FY20 cash profit of the major banks declined by $10 billion to $17.4 billion (36.6% down vs FY19) and the bottom line results were impacted by $6 billion of large, notable one-off items.

Even after stripping out these items, underlying cash profit from continuing operations declined by 22.6% highlighting the challenging outlook for the sector.

In this report, we will compare the major banks' FY20 results, their strengths and challenges across the key performance indicators of growth, efficiency, quality & risk, and capital & funding. Our report also highlights the most important questions banking executives will be facing as they deal with these challenges and seize opportunities on the road to recovery.

Net profit - FY20 vs FY19



Source: FY2020 Results and Investor presentations for ANZ, CBA, NAB and Westpac and Deloitte analysis.

The domestic banking industry has experienced significant impacts from the COVID-19 crisis, with potentially more to come. Banks should approach the challenges as also presenting opportunities, and seize this moment to accelerate their digital transformation agendas and continue to rebuild customer trust to thrive in a post-COVID world.

Headwinds

Uncharted territory

COVID-19 has led to structural changes in the behaviour of businesses, workers and consumers. Banks' earnings have come under significant pressure because of higher impairment charges, lower for longer NIMs and higher ongoing spending on compliance, technology and remediation.

Economic conditions make for a challenging outlook

Although Australia has responded to the health crisis better than most, COVID-19 has delivered a significant blow to the country's economic momentum. The backdrop is likely to remain a concern for some time. Travel, hospitality and other service sectors in particular will continue to face considerable challenges further complicating overall employment conditions. Lower population growth is likely to slow the pace of recovery. The structural mortgage growth tailwind that banks have enjoyed for decades is unlikely to re-emerge in the short to medium term.

Tailwinds

A golden opportunity to transform banking for the new normal

COVID-19 has provided an opportunity to accelerate the transformation agenda. This is the time for banks to make long-term structural changes to their cost base, connect deeply with their customers, streamline their processes, and deliver simpler, better and more engaging banking experiences.

Capitalising on the opportunity to continue to rebuild trust

Actions speak louder than words, and banks have been able to amplify the impact of fiscal and monetary policies by proactively extending support to households, small businesses and corporations over the past six months. This has enabled Australian banks to continue to rebuild customer trust. However, banks need to maintain and build on this momentum, as it could provide a significant competitive edge in the 'new normal'.

What is profit?

Statutory Profit. Cash Profit. Cash Profit from Continuing Operations. Underlying Profit. The banks report a number of different profit results.

	ANZ	CBA	NAB	WBC	TOTAL
	$bn	$bn	$bn	$bn	$bn
Statutory Net Profit after Tax	3.58	9.63	2.56	2.29	**18.06**
Statutory Net Profit after Tax from continuing operations	3.68	7.46	3.50	2.29	**16.92**
Cash Net Profit after Tax from continuing operations	3.76	7.30	3.71	2.61	**17.37**
Cash Net Profit after Tax from continuing operations excluding 'one-offs' and notable items (estimate)	5.30	8.15	4.73	5.23	**23.41**
Core Earnings before Tax (excluding large notable items and impairment charges)	10.12	13.72	9.64	10.87	**44.35**

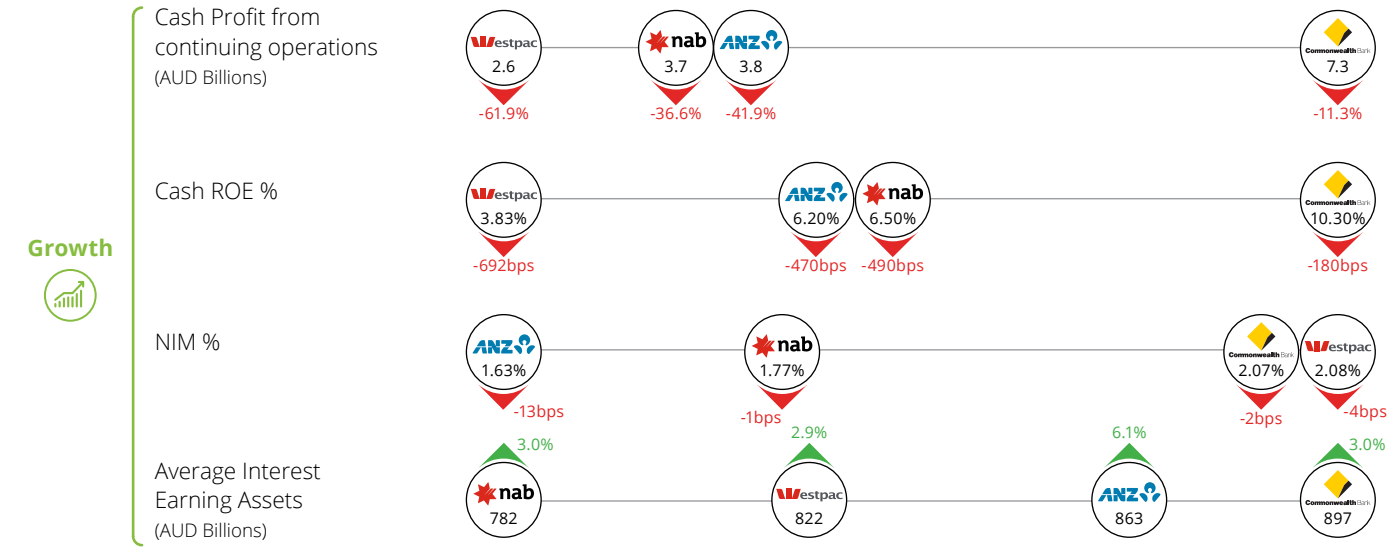
Source: FY2020 Results and Investor presentations for ANZ, CBA, NAB and Westpac and Deloitte analysis.

Growth

"The housing market overall has been an area that has surprised us on the upside ... Overall, housing volumes – in terms of applications and listings coming on the market – are much stronger than you'd expect, or certainly what we had expected. There is some cause for optimism compared to what we were expecting just a month or two ago."

Matt Comyn – CEO, CBA[8]

Major banks: 2020 results



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Source: FY2020 Results and Investor presentations for ANZ, CBA, NAB and Westpac and Deloitte analysis.

Cash profit and total operating income

CBA

The Commonwealth Bank of Australia's (CBA) FY20 results were announced in August this year; the first released by the industry, and providing some insight into the impacts of COVID-19.

Cash profit fell 11.3% as a result of a higher credit impairment charge (up 109.7% vs FY19), which included a $1.5 billion COVID-19 provision and an increase in loan loss rates.

CBA's top-line income was flat (vs 1H 2019), with the increase in net interest income (NIM) of 2.1% offset by a 6.5% reduction in non-interest income (excluding trading income) as a result of lower credit card transaction volumes, lower profits from minority investments, impairment of aircraft in its structured asset finance portfolio and realised losses on the hedge of New Zealand earnings. A 10% growth in trading income partially offset declines in other non-interest income streams.

CBA's home and business lending grew by 4.3% and 4.8% respectively, with home loan volumes growing faster than the system.

ANZ

Australia and New Zealand Banking Group's (ANZ) cash profit from continuing operations was down 42% to $3.8 billion. This was due mainly to significant COVID-19 related impairment provisions, a $881 million write-off of investments in its Asian businesses, a $77 million write-off of goodwill, and a decline in operating income and an increase in operating expenses. ANZ's net interest income decreased by 2%, despite a 6.1% increase in interest earning assets. This was primarily due to a large decrease of 13 basis points in NIM to 1.63%. The increase in interest earning assets was driven by an 8.3% increase in business lending, as well as an increase in non-lending interest earning assets (cash and other liquid assets).

The decline in operating income was also partially offset by an increase in markets other operating Income (46.5%). When large notable items and the credit impairment charge are excluded from core earnings, ANZ's earnings declined slightly to $10.1 billion compared with FY19.

NAB

Due to large notable items related to remediation, National Australia Bank's (NAB) cash earnings declined by 36.6% to $3.71 billion, compared to FY19. NAB's total operating income declined by 1.4% compared to FY19 primarily due to lower trading income and fee and commission income offsetting the increase in net interest income. The decrease in fee income was driven by lower card transaction volumes and COVID-19 fee waivers to support customers. NAB's 21.1% decrease in trading income included a $222 million loss from economic hedges.

Net interest income has increased from FY19 by 2.4% as a result of a 3% increase in interest earning assets. Excluding large notable items, NAB's cash profit still declined significantly by 25.9% compared with FY19.

WESTPAC

Westpac's cash earnings declined significantly by 62% to $2.61 billion compared with FY19, as a result of a significant increase in operating expenses (26.6%) and impairment charges of $3.18 billion. Westpac's operating income remained flat at $20.6 billion as the decline in non-interest income, which included a $260 million life insurance asset impairment, offset the increase in net interest income.

Westpac's 0.8% increase in net interest income was supported by a 2.85% increase in average interest earning assets, which was slightly offset by a 4 basis points decline in NIM. Westpac's Return on Equity (ROE) declined significantly to 3.83% from 10.75% in FY19.

Divisional performance

All the banks split their divisional results slightly differently. CBA's retail banking services division profit increased by 2.3%. After excluding the COVID-19 impairment charge, ANZ's Australian Retail and Commercial divisions declined significantly by 14% and 52% respectivel. This was partially offset by an improvement in the institutional result of 1.4%, owing to higher markets income. NAB's Personal banking division increased cash earnings by 9.5%, as a result of a 12 basis point increase in NIM from home loan repricing and lower funding costs. However, NAB's Business and Private banking divisional cash profit declined due to lower net interest income and merchant acquiring income, as well as an increase in operating expenses. NAB's divisional results above does not include the credit impairment charge related to COVID-19, as it is recognised in its Corporate Function division.

Westpac's consumer bank dropped 11.9% with its business bank and institutional bank results falling by 62.3% and 64.1% respectively. These declines were largely associated with higher impairment charges. Two of Westpac's specialist businesses, insurance and auto and vendor finance had net losses of $480 million and $148 million respectively.

In response to the government's COVID-19 approach 'to protect lives and livelihoods', the banks have assumed a frontline role, cushioning the country through the crisis. By extending unprecedented support to households, small businesses and corporates, banks have been able to continue to rebuild customer trust. They need to seize on this opportunity to further cement their position, as trust is going to provide a significant competitive edge as the financial services ecosystem evolves.

Although the outlook for the economy and by extension the banking sector is comparatively optimistic, the structural mortgage growth tailwind the banks have enjoyed for decades is unlikely to re-emerge in the short to medium term.

Key questions

Questions leaders should consider include:

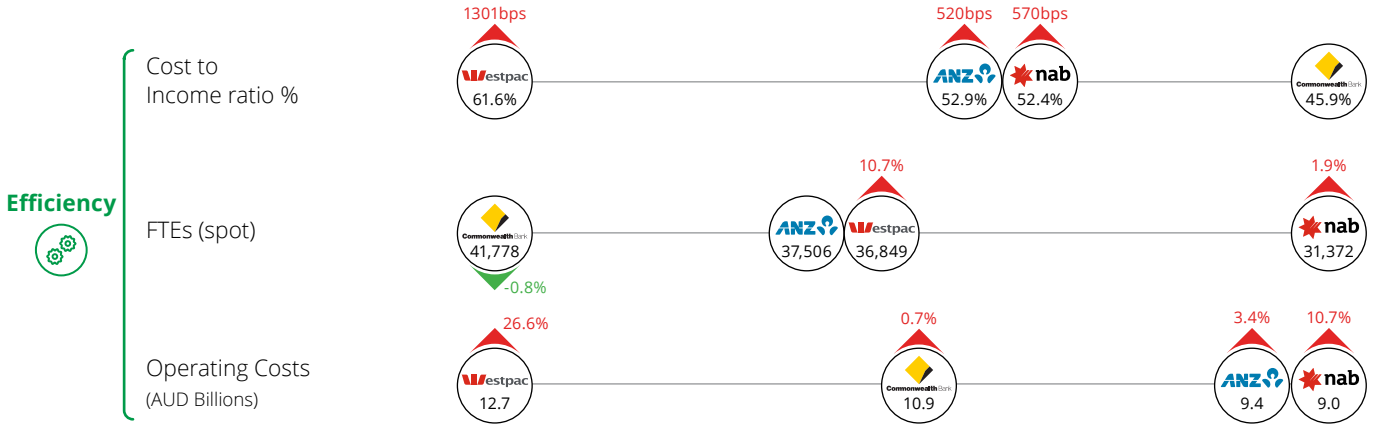
1. How do we balance the economic downturn with lending standard regulatory compliance and the need to continue funding the economy while still growing the business?
2. Are we focused on the right activities to drive strong customer relationships and growth?
3. Do we manage customer transition points, e.g. life events, contract expiry etc., effectively?
4. Do the promises we are making to our customers align with their expectations and our capacity to deliver?
5. Are we effectively using our analytic tools, and are they the right ones?
6. Can we improve our understanding of the drivers of customer pressure, churn and switching?
7. Do we tailor our sales and marketing programs to specific customer segments?
8. Have we adopted strategic pricing programs?
9. What platforms are we using to meet customer needs, and should we refresh our alliances to continuously improve our products and services delivered through these platforms?
10. Are we allocating investment to increase digitisation and making business model updates to enable innovation in new products, new services and new ways of doing things?

Efficiency

"We really see the big opportunities there in two big areas of cost. One is in the broad term of distribution, whether that's our branch network, whether that's our people out on the frontline, et cetera. We see opportunity to digitise and do that much, much more effectively. And the second is around process automation. The reality is that sadly, we are still very heavily manual in a lot of our processes, including things like home loan processing."

Shayne Elliott, CEO, ANZ[9]

Major banks: 2020 results



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Source: FY2020 Results and Investor presentations for ANZ, CBA, NAB and Westpac and Deloitte analysis.

CBA's headline costs and income rose slightly by 0.7% and 0.8% respectively, resulting in positive jaws, but its CTI ratio remained flat compared to FY19 at 45.9%.

NAB reported a 570 basis point increase in its CTI to 52.4% mostly due to higher personnel expenses and software amortisation policy charges of $950 million. NAB's CTI increased by 150 basis points to 44.3% when large notable items are excluded.

ANZ saw an increase of 520 basis points to 52.9%, which includes large notable items on a continuing operations basis.

Westpac's CTI significantly increased by 1301 basis points to 61.6%, primarily due to costs related to the AUSTRAC penalty.

CBA, NAB and ANZ each saw slight increases in underlying operating expenses compared to FY19 of 2.7%, 2% and 1%, respectively. Westpac's underlying expenses increased 6.2% compared with FY19.

ANZ's spot full-time equivalent (FTE) staff numbers decreased slightly, but higher investment spend increased personnel expenses to 2.4%. Technology expenses were up by 18.9% as amortisation costs were accelerated. Other expenses also increased due to customer remediation costs.

CBA's personnel and technology expenses rose by 2.2% and 7.1% respectively compared with FY19, which was partially offset by reductions in occupancy expenses due to the closure of 44 branches and other expenses. CBA FTE numbers declined slightly to 41,778 compared with FY19.

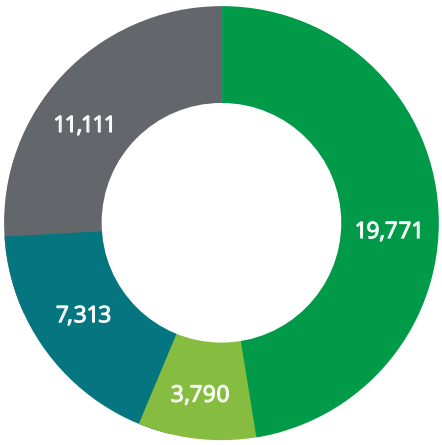
NAB's 11.3% increase in personnel expenses was driven by greater spend associated with technological capabilities and its risk and compliance environment. This investment increased NAB's FTE numbers 1.9% compared with FY19.

Westpac's total operating expenses increased by 26.6% compared with FY19. Excluding notable items, the increase was lower at 6%. Underlying staff expenses increased by 3% primarily due to an increase in FTEs to manage COVID-19 activities as well as risk and compliance activities. Technology expenses increased 14% as a result of write-downs on capitalised software and higher amortisation costs.

Collectively, the major banks' total operating expenses were up significantly to $42 billion, representing a 10.3% increase over the last year because of the increased spending in expanding technological capabilities, regulatory compliance and remediation costs.

2020 Operating expenses (millions)

Total: $42 billion



Personnel Occupancy Technology Other

Source: FY2020 Results and Investor presentations for ANZ, CBA, NAB and Westpac and Deloitte analysis.

Large notable items and discontinued operations

NAB's large notable items included charges related to a capitalised software policy change ($1.06 billion) and customer-related remediation ($648 million). This was partially offset by a $434 million income tax gain.

CBA's underlying profit excluding large notable items declined by 12.1% compared with FY19 (notable items declined by $195 million). This consisted of customer-remediation costs ($454 million) and risk and compliance program costs ($399 million).

The majority of ANZ's large notable items related to the impairment of its Asian associates, Ambank and PT Panin, which cost $815 million. A further $279 million in customer remediation costs were also recognised in FY20.

The Westpac result was significantly affected by notable items in the half year. The bank has set aside $1.44 billion for fines and costs relating to AUSTRAC's proceedings around alleged contraventions of Anti-Money Laundering (AML) and Counter-Terrorism Financing (CTF) obligations. The bank has provided a further $440 million for customer remediation costs and a $614 million write-down of intangibles.

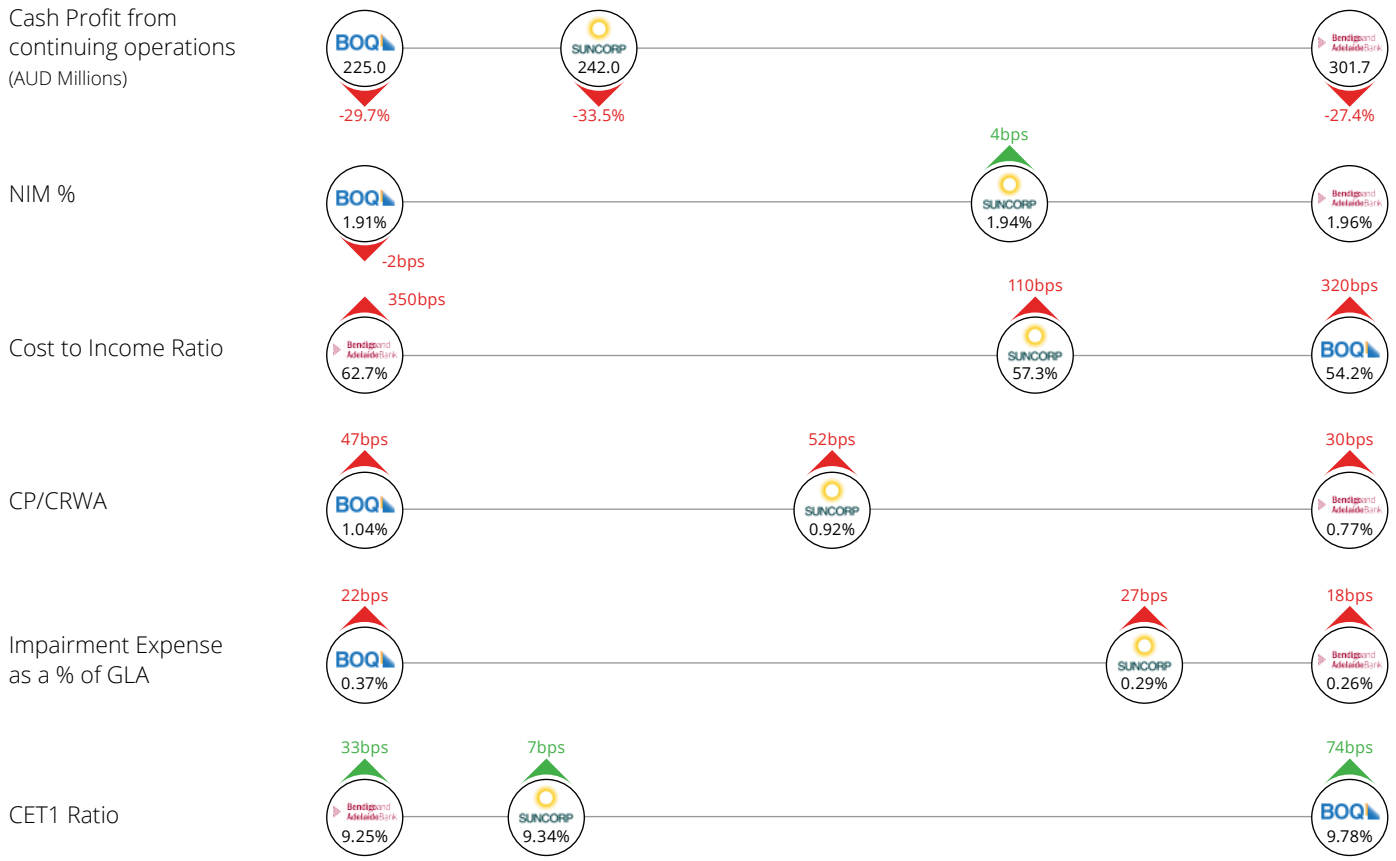
Key questions

Questions COOs, CIOs, CFOs and business units should be asking include:

1. Are we harnessing the transformational power of digital technologies to streamline our cost structures?
2. Can we increase cross-business unit and cross-enterprise collaboration?
3. Can we increase business agility and flexibility?
4. Can we improve our training processes to emphasise customer experience and culture?
5. Can we further rationalise our IT application portfolio?
6. Can we improve our processes for managing systems operation, maintenance and change?
7. Can we consolidate or re-architect data stores?
8. Can we improve IT performance management methods and tools?
9. Can we establish product, service and process innovation as core competencies?
10. Are there options to buy or rent capabilities as well as build?

Impact of COVID-19 on second tier banks

Second tier banks: 2020 results



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Source: FY2020 results and investor presentations for Bank of Queensland, Suncorp Ltd and Bendigo and Adelaide Bank and Deloitte analysis.

Similar to the four major banks, Bendigo and Adelaide Bank, Suncorp (Banking and Wealth division) and Bank of Queensland (BOQ) all experienced declines in their FY20 cash profits. Suncorp's Banking and Wealth division had the largest decline of the second tier banks to $242 million - 33.5% decrease compared to FY19.

Unlike the major banks, however, the NIMs across the three second tier banks have not experienced large declines. BOQ's NIM declined slightly by two basis points to 1.91% while Suncorp's NIM increased by four basis points to 1.94%. Despite Bendigo Bank's NIM remaining flat, its net interest income increased by 2.9% to $1.34 billion as a result of increased lending activity. This income was slightly offset by a decline in fee and commission income.

The second tier banks are facing similar cost pressures to that of the major banks. Bendigo Bank saw the largest increase in its cost-to-income ratio to 62.7%, primarily due to a 9.4% increase in personnel expenses. The large increase is a result of $10.8 million redundancy costs and support for its 7.9% residential lending growth compared to FY19. Despite a 320 basis point increase in BOQ's cost-to-income ratio, it has the best efficiency ratio of the second tier banks (54.2%). Looking across the second tier banks, the increases in cost to income ratios were primarily driven by increases in personnel and technology expenses.

Given the impact of COVID-19, the second tier banks have increased provisions to recognise the potential future impact on their lending assets. Suncorp's impairment expense as a percentage of gross loans and advances was the lowest of the three banks in FY19 at 0.02%, but increased by 27 basis points in FY20. BOQ and Bendigo Bank had increases of 22 basis points and 18 basis points to 0.37% and 0.26% respectively. Despite asset quality deterioration in FY20, impairments as a percentage of GLA remained near historically low levels. Collective provisions as a percentage of credit risk weighted assets increased significantly across the three banks by an average of 43 basis points, with BOQ having the highest ratio at 1.04%.

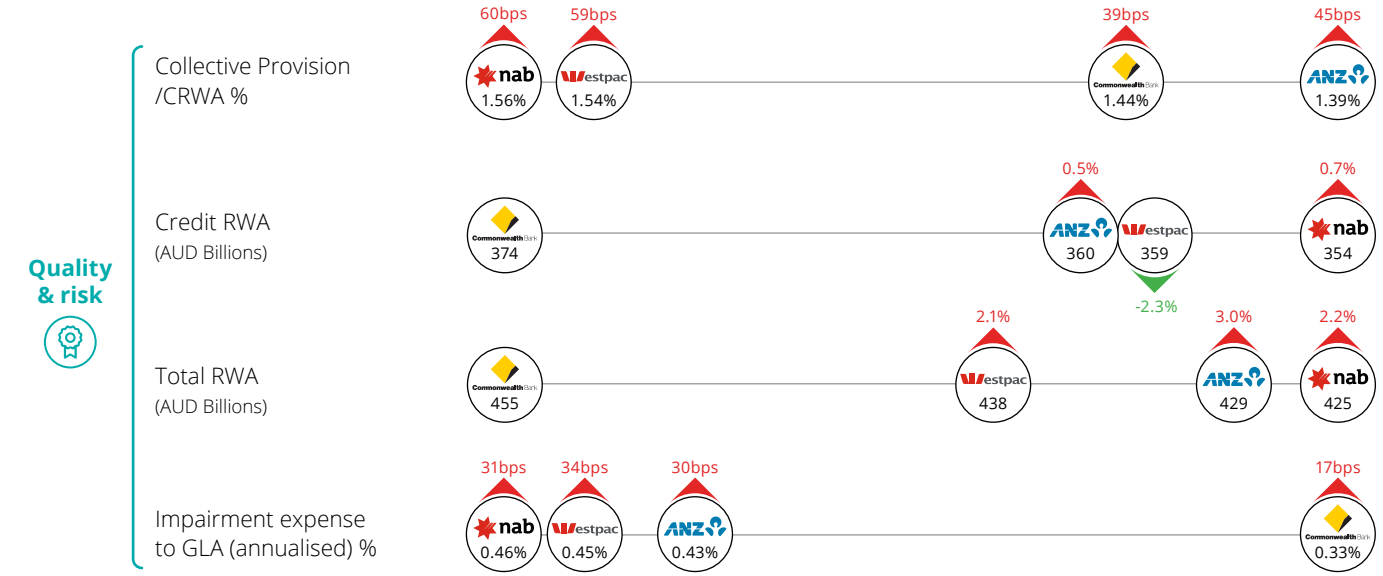
All three banks continue to have sufficient capital during these current economic conditions, with each increasing their CET1 ratio to between 9.25% and 9.78%. Bendigo Bank and BOQ's respective 33 basis points and 74 basis points CET1 ratio increases were supported by capital raisings via institutional placements and share purchase plans.

Quality & risk

"In line with the weaker economy, asset quality deteriorated, although the pace of deterioration was better than our earlier expectations. The other key point is stress remains well below the GFC peak."

Peter King, CEO, Westpac[10]

Major banks: 2020 results



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Source: FY2020 Results and Investor presentations for ANZ, CBA, NAB and Westpac and Deloitte analysis.

The economy has started to recover and the recession appears to be less severe than was expected a few months ago; however there is a lot of uncertainty, and questions remain unanswered around what happens to defaults across the board when these temporary measures are withdrawn. What impact will they have on banks' balance sheets? To what extent will they be offset by easing restrictions in Victoria and more broadly? Risks to the economy, and by extension the banking sector, will remain elevated for quite some time.

The trajectory of the pandemic is hard to predict, but banks are signalling cautious optimism as national and state/territory economies recover more quickly than anticipated but the sector still faces a number of headwinds including:

- Low business confidence (after a slight improvement in September, confidence levels are well below the long-term average)[11]
- Lower for longer interest rates (the RBA has recently reduced the cash rate to all time low of 0.1% and is not expected to raise rates until the actual inflation rate hits the 2-3% target range)[12]
- Significant economic contraction for the first time in nearly three decades, with an unpredictable and uncertain road to recovery
- High household debt to GDP – the second highest among the G20 nations[13]
- Comparatively lower housing demand because of reduced inward migration.

AASB 9 expected credit losses

Westpac's macroeconomic scenario weightings used in the calculation of expected credit losses (ECLs) remain unchanged from 1H20. Given uncertainty surrounding the economic impact of COVID-19, the weightings to the upside, base and downside scenarios are skewed towards the downside scenario, with the weightings being 5%, 55% and 40% respectively. Westpac's economic assumptions includes 2.5% GDP growth in calendar year 2021 and the unemployment rate to fall to 7.5% in December 2021 after peaking at 7.9% in February 2021.

ANZ's macroeconomic weightings and assumptions suggests a slightly more subdued economic outlook, compared to Westpac's outlook. While the weighting to the base scenario remains unchanged from 1H20 at 50%, the weightings allocated to the severe downside and upside scenarios have decreased from 10% to 6.3% and from 12.7% to 10.4%, respectively. The weighting allocated to the downside scenario has increased to 33.3%, compared to 27.3% in 1H20. ANZ also forecasts 1.6% GDP growth and an 8.8% unemployment rate for Australia in calendar year 2021.

CBA's central downturn scenario, which uses the bank's base case assumptions, forecasts a 7.5% unemployment rate at the end of December 2021 and a 6% change in GDP during calendar year 2021.

Similar to the other majors, NAB's macroeconomic weightings towards the base case (60%) and downside (25%) scenarios, reflects a softer outlook. NAB's base case scenario forecasts a 3.1% change in GDP in calendar year 2021 and a 7.6% unemployment rate at the end of December 2021.

The RBA in its latest Financial Stability Review has noted: "Major and mid-sized Australian banks have raised an additional $8 billion in forward-looking provisions since the start of the year, bringing the stock of total provisions to 0.8 per cent of the value of their total loans outstanding."[14]

There is significant uncertainty about the impact the pandemic will have on banks' credit losses, as asset quality is a substantial earnings risk for the major banks for FY21 and beyond. All experienced increased asset impairments for FY20: NAB's total impairment charge was $2.76 billion, 46 basis points of gross loans and acceptances (GLA), which included a provision of $1.8 billion for COVID-19; ANZ's was $2.74 billion (43 basis points of GLA); and Westpac reported $3.18 billion (45 basis points of GLA), largely driven by the provision for COVID-19.

Loan deferrals

The temporary loan repayment relief provided by ADIs to households and SMEs, continues to decline from its peak in May 2020. Westpac had the largest decline in the value of loan deferrals by 41.3% when compared to June 2020. The increase in new or extended deferrals in September 2020, were more than offset by the exited or expired deferrals as the economy starts to recover from the economic impact of COVID-19.

Loan deferral changes

	June 2020 - Total		September 2020 - Total		Change (%)	
	Number of Facilities	Amount ($m)	Number of Facilities	Amount ($m)	Number of Facilities	Amount ($m)
ANZ	129,338	39,880	121,279	35,562	-6.2%	-10.8%
CBA	209,799	66,629	128,994	41,907	-38.5%	-37.1%
NAB	115,780	57,938	88,855	42,898	-23.3%	-26.0%
WBC	259,085	54,691	128,235	32,088	-50.5%	-41.3%

Source: APRA, Temporary loan repayment deferrals due to COVID-19, 30th October 2020

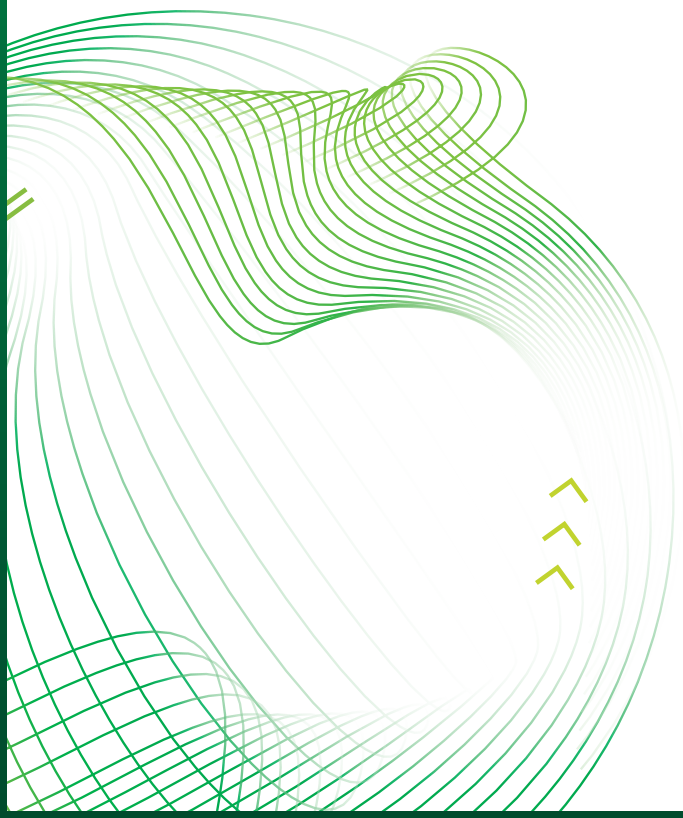
Key questions

Questions CROs and business units should be asking include:

1. Have we reassessed the organisation's risk tolerance in light of the COVID-19 crisis?
2. Have we been and are we continuing to effectively stress test our risk management processes?
3. Do we have a clear cross-enterprise customer view of risk and have we effectively communicated it?
4. Have we effectively added risk assessment into our new products and services?
5. Is our data collection, aggregation, use and reporting robust?
6. Is operational risk effectively incorporated into our key controls enabling us to rapidly and effectively respond to shifting business needs, risk exposures, regulatory change and community expectations?
7. Are we continuing to monitor and supervise third parties to mitigate risk, particularly with a view to the changed supply chains?
8. Do we effectively measure our performance in meeting the promises we make to our customers?
9. Do we have the right capabilities in our risk and compliance teams?

Collections is dead, long live collections

Collections and recoveries functions have for decades delivered the mission they've been tasked with, to collect and recover bad debts and protect shareholders from financial loss. Most banks have adjusted to cope with the increased expectations that now come with managing customers experiencing financial hardship, but the last 18 months have clearly shown that this is no longer enough. From collections to assistance, recoveries to solutions, hardship to supporting many forms of vulnerability, it's not enough to simply change the vocabulary of collections. The mission, people, processes and technology within this critical and strategic banking capability need to evolve and scale to be future-fit.



The past

Against the backdrop of decades of uninterrupted economic growth, the once sleepy 'down-the-corridor', 'back-office' collections function, chasing contacts and promise-to-pays, was rudely awakened by the Royal Commission into Misconduct in the Banking, Superannuation and Services Industry questioning the treatment of the vulnerable and those in hardship. The bushfire crisis posed further questions on new categories of vulnerability and community expectation for banks to support rather than simply seek to collect. Finally, COVID-19 shattered old-style predictive models and segmentation rules, as banks abandoned collecting and instead sought to focus solely on assisting the customer and the wider economy, with mass loan deferrals.

The present

Recent years have been incredibly challenging for collections operational management and agents. They have found themselves at the forefront of their bank's operational responses to each of these significant challenges—made even more difficult by long-term underinvestment. The lack of investment dollars has been a consequence of collections' position at the end of the value chain, with perceived distance from the customer and being viewed as a cost centre, are other likely factors. The recent spate of crises has in fact highlighted the importance of collections and, for many banks, the need to elevate and invest in this critical capability. The collections function, in fact, sits at the crucial banking epicentre of customer experience, product, credit risk, compliance, operations and technology. It has also become abundantly obvious that it can provide invaluable insights on customers and, for some, make it the bank's second marketing function, and in fact a profit centre.

The future

With increases observed in credit risk across the industry, bad debt still requires management. Depending on the enterprise appetite, bad debt will need to be balanced alongside the opportunities for improved efficiency, through enabling digital channels, and for the continued rebuilding of trust, by offering a range of support to customers where it is needed.

So, what are some of the factors to consider when assessing whether a bank's collections function is sitting in the past or is match fit for today and future fit for tomorrow?

The past	The future	Contention
Pre-delinquency and missed payments	Early engagement	The importance and value of focussing on the customer's circumstances by leveraging enterprise data to identify customer behaviours that may indicate changing circumstances requiring support, before payments are missed and basic collections contacts are attempted.
Powerdialler, letter or SMS	Omni-channel digitally enabled	No more war-dialling or sending SMSs. It is about enabling the best digital channel for the customer and maximising first contact resolution for customers with known or emerging vulnerability, connecting them with an appropriate specialist and, in severe cases, ensuring the customer 'tells their story once'.
Promise to pay	Solution toolbox	It is no longer about being first to get to a customer and establish a payment arrangement. It is about having a 'toolbox' of financial and, increasingly, non-financial solutions, with agents trained to use and clearly communicate them, to drive fair and consistent customer outcomes.
Cents on the dollar	Customer data, insight and feedback loops	The best way to balance bad debts, provide support and offer assistance to customers experiencing difficult circumstances is to understand the customer through data and insight, leveraging both internal and external data sources, with feedback loops and controls to enable iteration.

Key questions

Key collections questions executives (COO, CRO, CTO) should consider include:

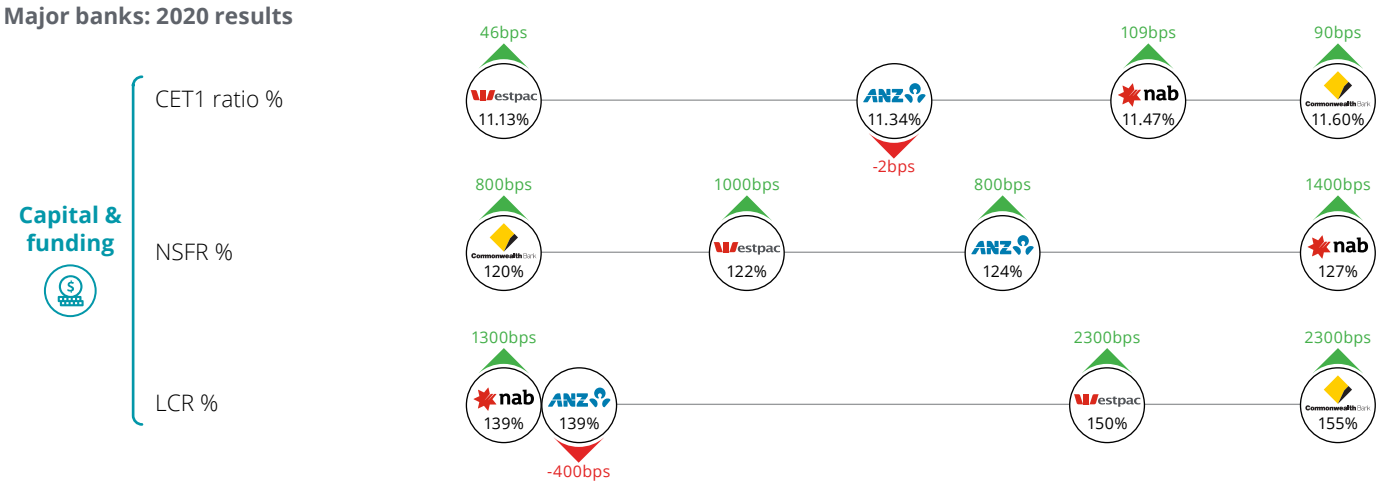
1. Is the mission of your function aligned with your enterprise strategy, ensuring that help is provided to as many customers as possible, while protecting the bank?
2. Does the governance and oversight of your function allow for the management of tension between brand, customer, conduct and compliance, operational and financial outcomes?
3. Is there an appropriate enterprise response to multiple dimensions of vulnerability (financial, short-term/ long-term health, domestic violence, etc.) and is this either orchestrated or consistently delivered through your function?
4. Do you have the necessary suite of forbearance tools, financial and non-financial, well understood by both agents and the broader bank network, to enable flexible support to customers through a channel of their choice?
5. Do you have appropriate customer outcomes testing in place to drive fairer and consistent customer outcomes? Are you able to leverage it at pace to identify and address emerging issues or hotspots and translate this into training and continuous improvement?
6. Has your recent investment slate been appropriately allocated to this critical strategic capability?

Capital & funding

"Our banks remain soundly capitalised and highly liquid. APRA's stress testing of the banking sector indicates the industry is well-placed to withstand any major economic headwinds ahead: even when faced with severely adverse scenarios, our analysis indicates the banking industry would remain well above minimum capital requirements."

Wayne Byres, APRA Chair[15]

Major banks: 2020 results



Note: Banks' comparative positioning here is based on approximation. Cash Profit and Operating Costs have been stated on a continuing operations basis including large notable items.

Indicates increase/decrease in numbers with respect to the previous corresponding period.
No arrow indicates no change from the previous corresponding period.

Source: FY2020 Results and Investor presentations for ANZ, CBA, NAB and Westpac and Deloitte analysis.

Capital

APRA's 'unquestionably strong' Common Equity Tier 1 (CET1) benchmark of 10.5% has so far proven effective to cushion the major banks through the current uncertainty due to COVID-19. All four major banks' CET1 ratios are well above the 10.5% benchmark – at 11.60%, 11.34% , 11.13%, 11,47% for CBA, ANZ, WBC, and NAB, despite provisions made for the impact of COVID-19.

Most major banks took APRA's advice on deferring or cutting dividend distributions[16]. CBA, which paid its interim dividend in full ($2.00 per share), has decided to follow APRA's advice to cut its final dividend (to 98 cents per share). Westpac, which deferred its interim dividend, has decided to pay 31 cents per share for its final dividend. On average, the four major banks cash base dividend payout ratio (DPR) is at 53.71% for their FY20 final dividend, excluding CBA that pays 70.82%. The remaining three banks are in line with APRA's updated guidance to retain at least half of their earnings, which was released on 29 July.

New Zealand's central bank's (RBNZ) mandate to stop distributing dividends, which was in place starting 2 April, has not impacted the major banks' capital. Even with 27% of ANZ's FY20 cash profit coming from its New Zealand subsidiary, there seem to be no noticeable impacts.

APRA[17] advised that any rebuild of capital buffers will be conducted in a gradual manner. The Basel III capital reforms have been postponed to 2023, and RBNZ[18] regulatory reforms were postponed by 12 months. Nonetheless the banks need to be prepared for RBNZ's total capital requirements increasing from a minimum of 10.5% to 18% and CET1 increasing from 7% to 13.5% with a transition period of seven years[19].

Most banks' CET1 ratios have been flat, or even increased, mostly due to strong increases in cash earnings. For Westpac, notable items, which included the AUSTRAC charge of $1.3 billion[20], have decreased its CET1 ratio by 28 basis points (this, however, is fully offset by an increase in cash earnings).

Total risk weighted assets (RWA) have increased across the four banks, with the biggest percentage increase coming from interest rate risk in the banking book (IRRBB). CBA, NAB and ANZ showed an increase relating to traded market risk and interest rate risk due to increased volatility in the market. Credit risk on the other hand, showed a rather flat or slight decrease in RWA, despite the impact of COVID-19 on credit quality. This is mainly due to APRA's concession to allow banks to ignore payment deferrals, and therefore arrears for RWA purposes, until early 2021.

Westpac on the other hand, shows an increase in Operational Risk and IRRBB RWA. The Operational Risk RWA increase of $6.3 billion came from the $500 million capital overlay imposed by APRA with regards to AUSTRAC's statement of claim.

Funding

In its October monetary policy decision statement[21], the RBA confirmed there is a very high level of liquidity in the Australian financial system, and borrowing costs are at record lows. Balances with the RBA (Exchange Settlement Accounts) reached up to $90 billion, increasing 30 times more than before the pandemic[22]. This was caused by the preference of holding cash during this troubled time, and also the RBA's initiatives of purchasing government bonds and its term funding facility (TFF) initiative, which substantially increased liquidity.

The RBA's TFF, which was first established in March 2020, has provided $81 billion of low-cost funding to Authorised Deposit-taking Institutions (ADIs) to October 2020. From the expansion of this TFF rolled out in September 2020, a further $120 billion of low-cost funding can be advanced to ADIs.[20]

The reported LCR of CBA and Westpac has reflected some impact on the expected boost of the LCR numerator from TFF and deposit growth, excluding ANZ, which shows a decrease in LCR due to a 20% increase in stressed scenario cash outflow. On average, the four banks have shown LCR of 146% and NSFR of 123% - all of which are significantly above the regulatory requirements of 100% for both LCR and NSFR.

The major banks' funding structures have shifted from wholesale funding to more customer deposits and TFF funding. This is seen most clearly at CBA, with an 11% increase, and ANZ with an 8% increase in customer deposits. Overall, funding structures are now even more weighted to customer deposits, with 74% of CBA's, 65% of Westpac's, 61% of ANZ's and 57% of NAB's funding coming from customer deposits.

NAB drew down the full TFF Initial allowance amount of $14.3 billion, Westpac also drew down $17.9 billion and ANZ $12 billion of TFF facility provided by the RBA, as at 30 September. From its result in June, CBA had reported a draw down of $1.5 billion of its $19.1 billion initial allowance.

Key questions

Questions CFOs and business units should be asking include:

1. Do we understand the impact that regulatory changes in provisioning will have on business strategy?
2. Have we communicated this to business units?
3. Do we understand how sensitive profitability is to changes in funding costs, interest rates and competitive pressures on asset re-pricing?
4. Have we assessed the impact of proposed changes to RWAs on our product portfolio?
5. Do we have a broad diversification of funding sources, and should we consider refreshing our deposit strategy, in light of the current environment?

Last word

"We're not predicting the future, but we are prepared for inevitable change, volatility and uncertainty. Our culture, strong balance sheet, operational flexibility, engaged workforce and our experienced team will see ANZ emerge as a better, more relevant post-COVID bank."

Shayne Elliott, CEO, ANZ[23]

Despite all the uncertainty what hasn't changed is that the banking system in Australia remains strong, stable and well capitalised. As we move towards recovery, the sector is likely to see further challenges but it also has significant opportunities.

The global pandemic has been a moment that matters for Australians and the banks have been there to cushion the impact. Looking ahead, banks should build on this momentum and continue to maintain and rebuild customer trust.

The global pandemic has not only proved the role of digital in reaching customers and maintaining operational resilience, but it has forced organisations to act, revealing their true capacity for innovation. COVID-19 has been not only a digital accelerant, but a catalyst to consider the value organisations want to provide in the future.

By connecting deeply with their customers and delivering simpler, better and more engaging experiences and at the same time making changes to their cost base and streamlining processes, banks will have the right foundation to thrive through this challenge and beyond.

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