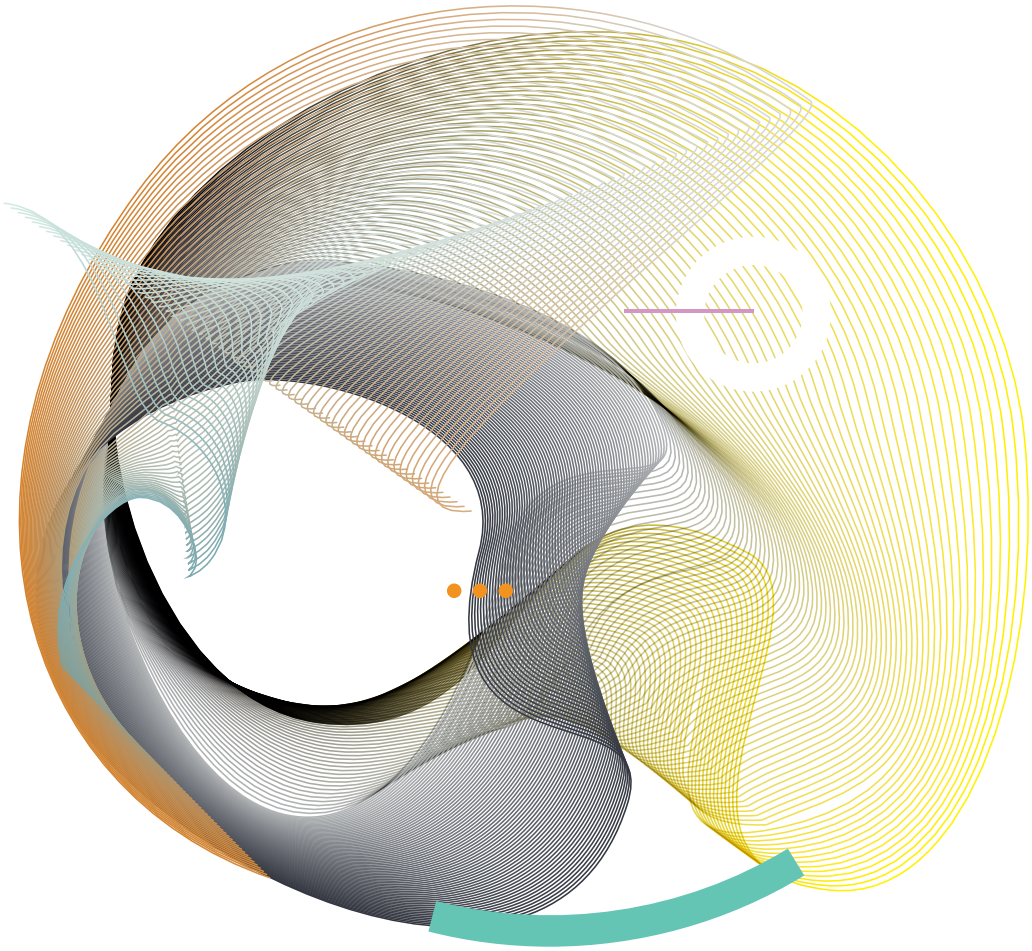
Deloitte.



Managing growth into the headwinds

Australia's major bank results 1H

May 2019

"If you want to build trust then really, today, it is about your social licence and making sure your business is not too far away from what society expects. Otherwise, basically, you won't have a business, because you won't have customers, you won't have employees, and you probably won't have investors."

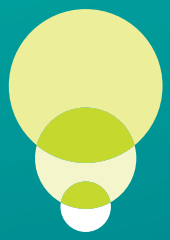
Greg Medcraft, immediate past chair, Australian Securities Investment Commission (ASIC), now director of the Directorate of Financial & Enterprise Affairs, Organisation for Economic Co-operation and Development (OECD) Paris AFR, 12 April 2019.

Growth was a challenge

Total income declined by 4%

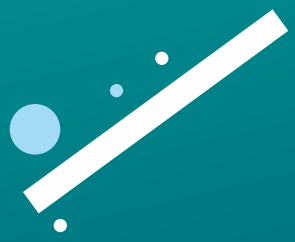
Efficiency is critical

Total expenses declined by 2.6%



Cash profit declined by

4.1%



Credit risk increasing

(90DPD+GIA)/GLA increased by 8bps

Lending growth has increased

Total average interest earning assets 3.7%

On track to meet APRA's 'unquestionably strong'

CET1 target of 10.5%

Source: Deloitte Managing growth into the Headwinds – Australian major banks half year results 2019.

Major banks: 1H 2019 results

Large scale remediation programs, intensifying regulation, risk management and the Hayne Royal Commission into Misconduct into Banking, Superannuation and Financial Services – these were the 'four 'Rs' that describe the common themes from the 1H-2019 results of Australia's major banks[i].

Ahead there is an accelerated focus on productivity, a continued focus on the 'core' and simplification, including continued disposals, in the challenging environment of a synchronised global slowdown[ii].

The 2019 first half results highlight the challenge banks face with aggregate cash profit of the major banks declining $611 million (vs. 1H 2018) to $14.49 billion.

The bottom line results were impacted by $1.26 billion of large, notable one-off items.

The final costs of the biggest bill for the majors – remediation – will not be known until all the data is gathered, consolidated and settled. The bank-to -bank comparison is difficult to make (given the complexity and the variables involved), but the total bill is $5.6bn since November 2017 and is expected to grow to more than $6bn.[iii]

The banks are now facing an extended period of low economic and credit growth with declining NIMs and deteriorating asset quality. In this era of anaemic revenue growth, the majors are increasingly looking for ways to reduce absolute costs by simplifying their business models and moving towards a utility style model of 'efficiently' seeking deposits and making loans.

Our analysis shows that Cost to Income ratios for the majors (except WBC) has improved to 44.6% from 46.42% (1H 2018). For WBC, the Cost to Income ratio deteriorated by ~8% on account of large notable items.

Traditional drivers of super high profits (high leverage, low bad debts and high pricing power) are losing their momentum.

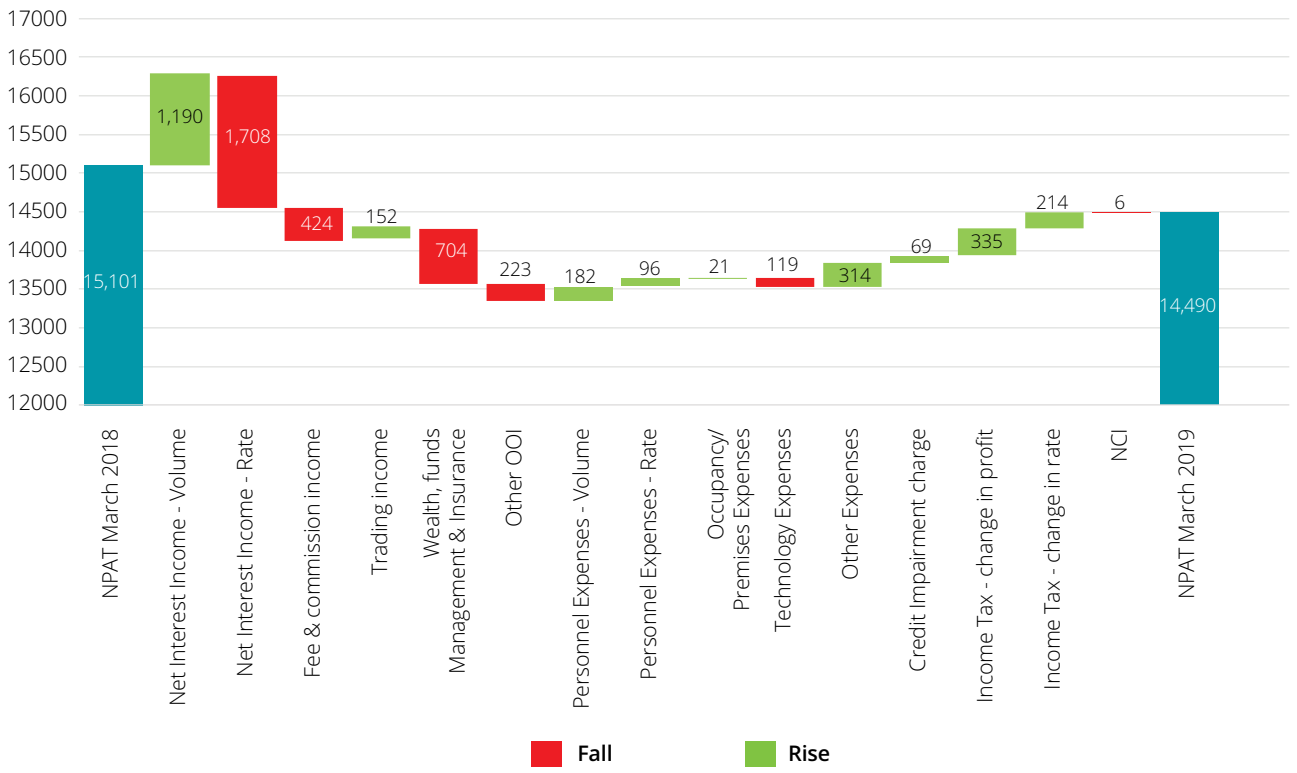
With the intensifying regulatory scrutiny of 'why not litigate?', a clearer social license, and explicit community expectations, the possibility of a return to the heydays of a 'profits-first' yesteryear is remote.

Decreasing risk appetite has also triggered a series of completed or planned divestments (viz. life insurance at NAB, CBA and ANZ; and wealth to different degree at all four major banks) which can extend to further areas such as general insurance.

All these headwinds are also in the context of both ASIC's Chairman James Shipton and Deputy Chair Daniel Crennan QC clear call to action that 'Now is the time to put fairness first', and a 'Fair, Strong and Efficient' financial system requires meaningful change that requires leaders 'leaning into the future' to take responsibility for Environmental, Social and Governance (ESG) matters.

Regulators have also made it clear that banks can't sell their historic issues, and will be held responsible for the past, which has placed a number of planned disposals on hold (see more later).

Aggregate cash profit of major banks – 1H 2019



Source: 2019 Half Year Results and Investor Presentations for ANZ, CBA, NAB and WBC; Deloitte analysis.

Current challenges in Australia's domestic banking environment

Intensive regulatory and community scrutiny Heightened community expectations, a clear social licence and policy uncertainty are big risks in the short to medium term. The Hayne Royal Commission outlined what went wrong – now to ensure it never happens again.

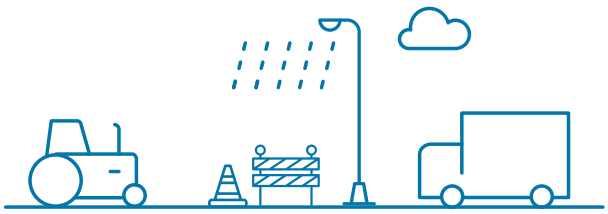
Managing and responding to the **evolving customer expectations** driven by new technology and business models.

Changing competitive dynamics Open banking and the increasing threat of competition from the unconventional players – TechFins, Neobanks and Foreign banks.

Trust in the banking industry and the broader financial services industry is under intense pressure and has probably touched its 'all-time' lows. The banks have a lot of hard work to do to restore the customer and community trust.

Asset quality has been benign for several years, but given the household sector debt and the broader residential market headwinds, it is likely to revert to more normal levels in the short to medium term.

Modest revenue growth and reduced pricing power Weaker housing and SME loan prospects, loss of earning potential from non-core asset sales. Differential pricing strategy for front book vs. back book may have to change.



Compliance and remediation Spend on Risk and Compliance constitutes more than 33% of the total investment spend. Large-scale remediation programs, emboldened regulators with a 'why not litigate' strategy, will mean ongoing investment in Risk & Compliance.

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	3.17	4.60	2.69	3.17	**13.64**
Statutory Net Profit after Tax from continuing operations	3.24	4.58	2.90	3.17	**13.90**
Cash Net Profit after Tax from continuing operations	3.56	4.68	2.95	3.30	**14.49**
Cash Net Profit after Tax from continuing operations excluding 'one-offs' and notable items (estimate)	3.48	4.95	3.28	4.05	**15.75**

Source: 2019 Half Year Results and Investor Presentations for ANZ, CBA, NAB and WBC; Deloitte analysis.

Balancing corporate culture, trust and social licence, structural shifts in the banking industry and shareholder returns

As the four majors continue to address the issues raised by the Royal Commission, they all acknowledge the nexus between misconduct and institutional culture. Determined to fix doing not 'what we could, but what we should do,' to align with the expectations of the community, the banks have remapped their paths to trust.

When announcing its half yearly results, CBA Chief Executive Matt Comyn said: "We will continue to take action to address issues, earn trust and be a better bank for our customers, as we strengthen risk management, invest in core business growth, and deliver long-term sustainable returns for shareholders." Adding that the bank's transformation 'to be a simpler, better bank is well underway'.

All four majors have accepted that their search for yield cannot be allowed to push risk to a point where it deviates so far from what society expects.

The sector is remodelling its businesses, and does so in the added knowledge that policy makers believe that competition is one of the lynchpins to good conduct – a place where people treat their customers fairly.

All these adjustments need to be done in the context of today's subdued earnings given the majors have collectively lost ~$50bn of their market value since the establishment of the Royal Commission on 14th Dec 2017, vastly underperforming the ASX200 index[iv] (refer to the TSR chart on the following page).

These changes also come at a time when rapidly evolving customer expectations, changes in technology and increasing regulatory forces are creating a new operating environment for retail banks.

TSR chart

The Australian Banking Index* has underperformed the broader market over the last year

* Datastream defined ASX 200 Banking Index. Source: Refinitiv Datastream.

Emerging shifts

Declining payments profitability: growing fee pressures on payment transactions, margin erosion from new competitors, and increased operating costs to support real-time payments.

Open Banking: democratising access to data, increasing accessibility of banking data will enable new business models, competitors and products.

Falling barriers to bank entry: changes in technology are lowering the cost to enter retail banking, with new entrants focused on customer engagement and avoiding regulation.

To be successful in this changing environment, banks will require a new approach. The bank of the future will have a more focused strategy supported by foundational capabilities.

In retail banking this will result in the cost-income ratio for profitability increasing in importance, with a focus on measuring, understanding and optimising the cost to sell, and the cost to serve.

This will require a more granular understanding of customer profitability both at a point in time and how it changes over a customer's lifetime.

Banks will need to measure the profit and loss around customer journey's rather than products. These changes could see credit contextually priced at a relationship and transaction level, rather than a product level.

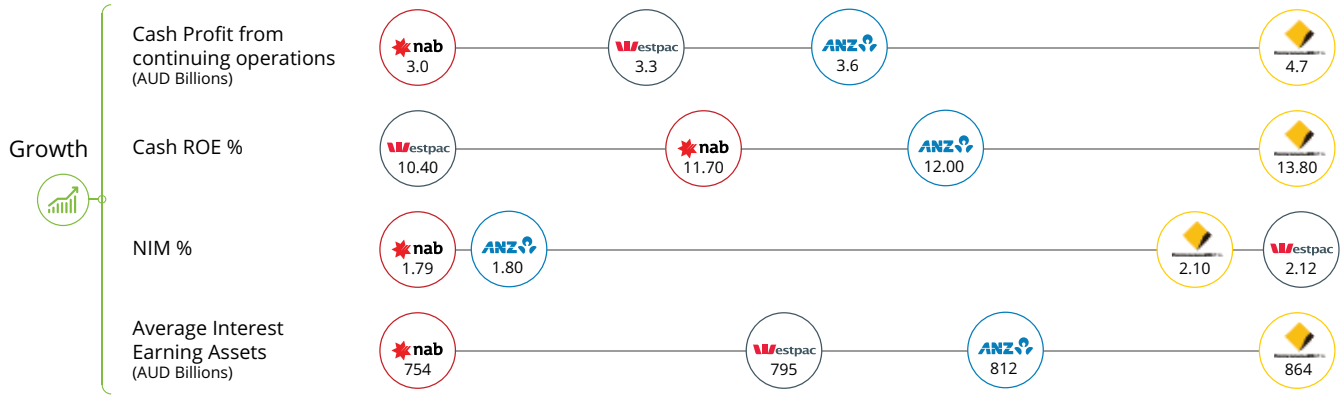
Meeting emerging shifts in retail

Today	Tomorrow	
Synchronous manufacturing and distribution	Platform based delivery breaking link between manufacture and distribution	**Banking will facilitate or be embedded in broader customer journeys**
Product-first sales and marketing	Data-drive customisation	**Best of breed open product shelf enables relationship ownership**
Cross-sell and cross subsidisation	Competition will be product-by-product, service-by-service and experience-by-experience	**Distribution channels focus on fulfilling customers' needs**
Transaction account is the driver of customer relationships	Central interface owners is the driver of customer relationships	**Digital interfaces the primary port of call for customers**
Economies of scale drive capability quality	Economies of scope based on assembly of differentiated capabilities	**Capabilities are continuously assembled by buying, renting and building**

Growth

It has been a challenging half year reporting season for all four banks. While overall results for the banks appeared largely flat, the detail shows varied underlying divisional performance. All banks experienced weakness in their retail businesses, offset by growth in business and institutional banking and their New Zealand operations.

Major Banks: 1H 2019 results



Banks' comparative positioning here is based on approximation.
Source: 1H 2019 results and investor presentations for ANZ, CBA, NAB and WBC: Deloitte Analysis.

Cash profit and total operating income

CBA recorded a 2% increase in cash profit from continuing operations, mostly driven by reductions in total expenses and lower income tax expense. Top line income fell by 2% against the corresponding half, with some growth in loan volumes more than offset by lower net interest margins (down 4bps) due to home loan discounting and switching, as well as higher BBSW. CBA grew its home lending volumes the fastest of all the banks, however this was offset by a reduction in institutional lending. Other income declined 3% with reductions in fee income and trading income.

ANZ also experienced a 2% increase in its half year cash profit result, despite a decline in total income of 1%. Declines in operating expenses, impairment charges and income tax expense all contributed to the improved result. ANZ's net interest income declined by 1% despite growth in interest earning assets of 6%. NIM declined considerably by 13bps. Other operating income declined by 3% caused by falls in fee and commission income and income from the insurance business, offset by improvements in markets income.

NAB's cash earnings from continuing operations improved by over 7% compared with the March 2018 half, despite a decline in total income of 2.4%. The main driver for the improved result was the large restructuring expense in the March 2018 half of $755m which did not recur. Otherwise, there were increases in operating expenses, remediation costs, impairment charges and income tax expense.

NAB's total operating income decline was all due to customer remediation income reversals of $344m, offset by a 4.2% increase in other operating income, mostly due to gains on economic hedges. Net interest income was flat with a 4% increase in interest earning assets, offset by an 8bps reduction in NIM.

WBC's cash earnings suffered a significant drop of 22% compared with March 2018, driven by a 10% drop in total operating income and a 7% increase in operating expenses. This was buffered somewhat by a 25% drop in impairment charges. The drop in total operating income was due to declines in net interest income of $116m and non-interest income of $208m (excluding notable items). Further hits from remediation related income reversals of $812m (disclosed as large notable items) also contributed to the large operating income decline.

Net interest income fell mostly due to a 16bps drop in NIM with interest earning assets growing by 4%. Non-interest income (excluding large notable items relating to remediation) fell by 8%, with bank fee and wealth management and insurance income all down on the previous half year periods. Markets income also declined 9%.

Divisional performance

All the banks split their divisional results slightly differently, however overall the Australia retail banking divisions of all the major banks suffered declines in cash profit for the half, reflecting the challenging trading conditions and general slowdown in growth. CBA's retail banking services division declined by 10% and ANZ's Australia division results dropped by 13%, offset by a significant 32% improvement in the Institutional result. NAB suffered a 20.6% drop in the Consumer Banking and Wealth division, offset by an 11% improvement in New Zealand.

WBC's consumer bank dropped 11% with its business bank and institutional bank result falling by 6% and 2% respectively. BT Financial Group suffered the worst decline, falling from a $406m profit to a $305m loss owing to remediation related provisions. Excluding remediation losses, the result still declined by 22%.

Royal Commission and BEAR

The fall out from the Royal Commission, with ASIC's Chairman James Shipton proposing prison penalties be increased to 15 years, and civil penalties to $1.05 million for individuals and $500 million for organisations, along with banks' transition to the Banking Executive Accountability Regime (BEAR), all appear to have put the brakes on system lending growth.

The 'Fear of BEAR' (see our **The Heart of Accountability Why BEAR becomes FEAR**), has slowed lending as bankers become more risk-averse and make more enquiries before extending credit.

As Westpac's Chief Executive Consumer Banking said at the AFR Banking & Wealth Summit in April: "Bankers are scared of making a mistake".[v]

As a sector the Big Four have also been losing market share to Tier 2 and non-bank players.

The regulatory drag on growth

The banks' results presentations detail the regulatory changes to home loan origination processes from 2015 to 2019. All have enhanced their lending processes recently in response to concerns raised during the Royal Commission. This was a key driver for a slowdown in housing lending growth for the half as the changes resulted in reduced customer borrowing capacity and in general more rigour and detail required for applications.

ANZ recorded a 1% decrease in housing lending this half, compared with the others recording growth, however all were slower than the system. CBA managed the regulatory change best out of the big four growing almost in line with system for the half year.

All the majors began the process of selling and spinning off their 'non-core operations' last year as they embraced 'simplifying and streamlining' their operations, starting with life insurance disposals and wealth divestments and demergers. However, they have had to slow down some of these divestment and demerger operations to prioritise dealing with regulation, legacy, and legal costs, as well as both political and strategic uncertainty following the Royal Commission.

This is considered to be a pause rather than a reversal, with salaried planners and general insurance both potential areas to be caught up in simplification.

The key question for the sector is where will the majors find growth?

For the past 27 recession-free years, the bulk of that growth has come from residential mortgages, which according to the latest APRA numbers accounted for around 62% of the Australian banks' combined lending portfolio[vi].

This sector, to date a sinecure stalwart for the banks, is now at the tail end of its lending super cycle. This, together with unprecedented regulatory-driven costs and evolving competition from the non-bank lenders, neo banks and foreign banks, indicates a challenging near term outlook.

The focus on Innovation which began in earnest post GFC with investments in platforms, online banking, Apps, Artificial Intelligence (AI), cognitive technologies, payments, chatbots and the digital and strategic requirements for improved speed, accuracy, customer experience and sustainable outcomes will need to ramp up.

Key questions

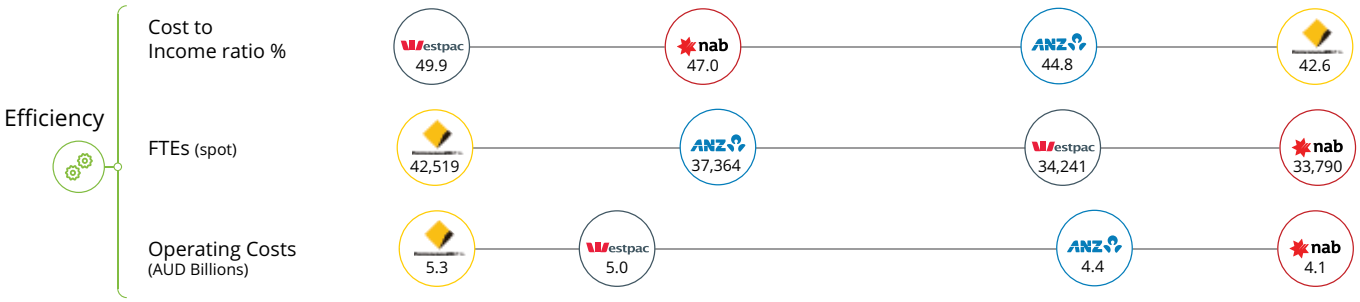
With open banking starting from 1 July 2019, banks will need to continue to invest in connecting with customers, and leveraging data and analytics to retain and grow profitable customer relationships. CMOs should be asking:

1. How do we balance regulatory compliance with lending standards, and the need to continue funding the economy and growing the business?
2. Are we focused on the right activities to drive strong customer relationships and growth?
3. Do we effectively manage customer transition points e.g. life events, contract expiry etc.?
4. Do we clearly know the promises we are making and our capability to keep them – are they the right promises?
5. Do they align with our customers' expectations?
6. Do we have the right analytic tools and are we effectively using them?
7. Can we improve our understanding of drivers of customer churn and switching?
8. Do we tailor our sales and marketing programs to specific customer segments?
9. Have we adopted strategic pricing programs?
10. Could we better meet customers' needs through alliances and with products and services delivered through a platform?

Efficiency

Given the subdued revenue growth and the challenging operating outlook, the majors have had to focus on efficiency.

Major banks – 1H 2019 results



Banks' comparative positioning here is based on approximation.
Source: 1H 2019 results and investor presentations for ANZ, CBA, NAB and WBC - Deloitte Analysis.

Underlying cost to income ratios (excluding large notable items) have improved for all banks (except WBC) compared to both the corresponding and most recent half year period. CBA's underlying costs rose slightly, however income grew faster. Both NAB and ANZ saw overall reductions in underlying operating expenses compared to prior half year periods. WBC's cost to income ratio was up to 43.7% excluding the effect of large notable items, mostly due to lower total income.

ANZ's total Full Time Equivalent (FTE) decreased slightly, however personnel expenses remained flat. Technology expenses were down 30%, mostly due to lower amortisation, after a large accelerated amortisation charge in the most recent half. Other expenses declined due to lower marketing and consulting spend.

CBA's personnel and technology expenses rose slightly compared with the prior corresponding half, offset by reductions in occupancy and other expenses. CBA's FTE numbers were up 3% over 1H-18, but flat compared to the most recent half.

NAB's underlying costs have increased by 1.7% compared to the corresponding half, with increased investment in technology, compliance and control costs, offset by reductions in personnel and occupancy expenses. Total expenses reduced 2% compared to the 2nd half last year through better cost control. NAB's FTE numbers were largely flat.

WBC's total operating expenses increased 7% compared with March 2018. Excluding notable items, the increase was lower at 2%. Underlying staff expenses decreased slightly due to a 3% decrease in FTEs. At the same time occupancy expenses increased slightly and technology expenses were also marginally higher. The bank noted some productivity gains from branch closures and property consolidation.

Removing costs is much harder than adding them. However, as part of their efficiency drive and the simplification agenda, the banks have focused on reducing their absolute cost base.

Collectively the major banks' total operating expenses were down to $18.87bn, representing a 2.6% decrease compared with March 2018 and 4.3% compared with September 2018.

Large notable items and discontinued operations

Included in CBA's half year result were net losses of around $400m from large notable expenses, including expenses for risk and compliance uplifts, and customer remediation.

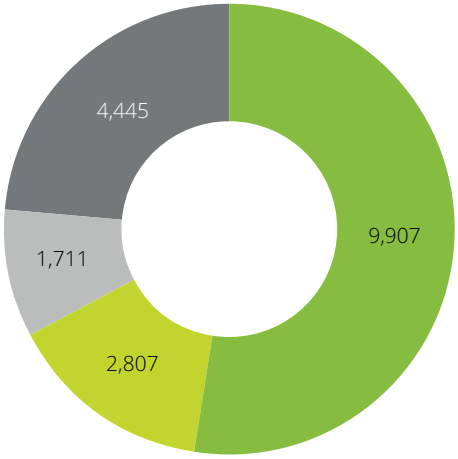
ANZ recorded a net $86m profit from large notable items, with gains on sale from divestments of $201m offset by Royal Commission ($79m post tax) and restructuring costs. A further $53m (post tax) of customer remediation costs related to discontinued operations (the sale of the OnePath businesses to IOOF and Zurich).

NAB recorded losses from discontinued operations of $200m for customer related remediation associated with the life insurance business sale to Nippon life, with the remaining $325m (post tax) relating to customer remediation in the wealth, financial planning and banking business as part of continuing operations.

The WBC result was significantly affected by notable items in the half year. Customer remediation costs negatively impacted profit by $617m (post tax), whereas costs relating to restructuring the wealth business hurt results by a further $136m.

The current cost and resource squeeze however, is taking place in the context of the considerable work Australian banks have done on efficiency over the last two decades. The majors have successfully delivered positive jaws – the gap between income growth and cost growth – since 2009. As a result their cost-to-income ratios sit at around 42% to 49%, significantly lower than their American and European peers (60–63%)[vii]. Nevertheless, there are opportunities to trim the absolute cost base further to deliver sustainable long term returns.

1H 2019 Operating expenses
$18.9 billion



Personnel Technology Occupancy Other

Source: 1H 2019 results and investor presentations for ANZ, CBA, NAB and WBC; Deloitte Analysis.

Remediation costs

The remediation spend and the related timeframes are one of the major headwinds to the banks results. The majors have announced (expensed and provisions) approximately $5.6bn for customer refunds and remediation since 2017. And although difficult to estimate, this cost is likely to increase substantially. Further provisions were set aside this half for costs arising from past misconduct, possible breaches of responsible lending laws and misselling banking and insurance products, in the face of ASIC's 'why not litigate?' mantra and APRA's new enforcement approach.

In an era of low revenue growth, banks will need to continue to simplify their business models, drive out inefficiency and optimise the cost to serve or sell to customers. They will continue to focus on productivity and dedicated 'cost-out' programs, combined with transformative technologies such as AI, RPA and large-scale automation.

In addition, banks are reducing management layers, the number of products and IT applications, eliminating redundant processes as they re-focus on the 'core'.

Key questions

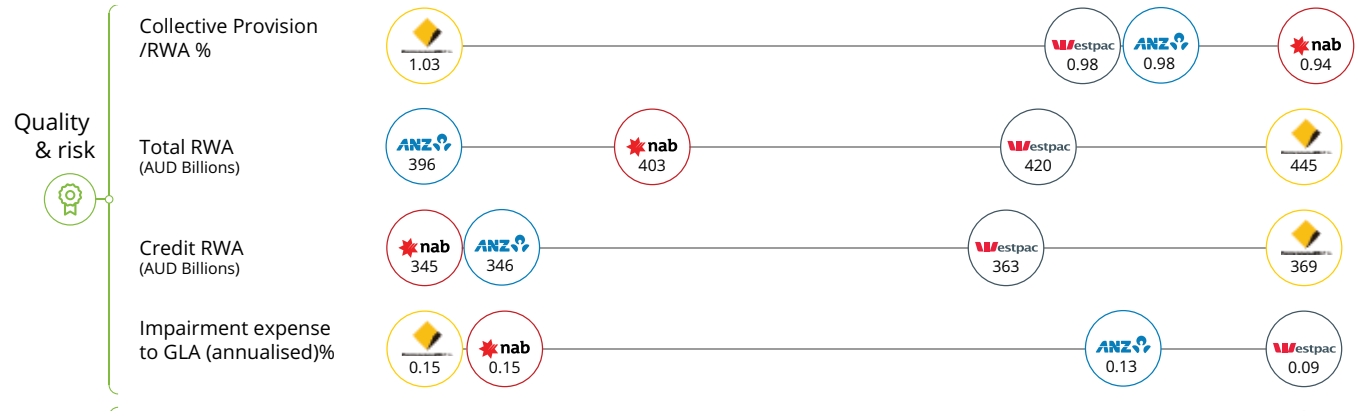
Questions COOs, CIOs, CFOs and business units should be asking include:

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. Do we have the right skills and capability to deliver our strategy?
5. Can we improve our training processes to emphasise customer experience and culture?
6. Can we further rationalise our IT application portfolio?
7. Can we improve our processes for managing systems operation, maintenance & change?
8. Can we consolidate or re-architect data stores?
9. Can we improve IT performance management methods and tools?
10. Can we establish product, service and process innovation as core competencies?
11. Are there options to buy or rent capabilities as well as build?

Quality & risk

Asset quality has remained stable across the majors with credit impairment still low. All four banks are now reporting their provisions under the revised AASB 9 Accounting Standard, with banks increasing their provisioning coverage significantly. Collective provisions as a percentage of credit risk weighted assets has increased by around 25bps.

Major banks – 1H 2019 results



Banks' comparative positioning here is based on approximation.
Source: 1H 2019 results and investor presentations for ANZ, CBA, NAB and WBC - Deloitte Analysis.

Impairment expense has remained low; however, it did increase for all four banks compared with previous periods. This reflects higher arrears and 90+ day delinquencies showing some early signs of deterioration.

The 1H-2019 results highlight the challenges for the Australian retail banking sector with asset quality emerging as a potential issue as mortgage arrears continue to rise across the board. ANZ reported that 5% of its portfolio was in negative equity and home loan delinquencies (particularly 30 days past due) have risen from 1.8% of the portfolio in Sept 2018 to 2.25% for 1H -19. NAB reported an increase of 18bps in its 90 days past due delinquencies and WBC also saw a deterioration in its 90+ days past due loans. The banks' asset quality is showing some signs of stress, as the (90DPD+GIA)/GLA ratio has increased by 8 basis points compared to the half ending March 2018.

After a period of strong house price growth the housing sector is facing a challenging outlook with house prices in Sydney and Melbourne falling at their fastest rate.[viii]

The headwinds the banks are facing include:

- High levels of household debt to GDP[ix]
- High levels of household debt to household disposable income[x]
- Falling Australian house prices[xi]
- Declining housing loan[xii]
- Low consumer confidence.[xiii]

Together with tightening credit conditions these headwinds are likely to affect credit quality negatively. The risks to the downside are mounting and could impact the asset quality for the banking sector, which has been benign for several years.

In its latest Financial Stability Review the RBA noted: "Risks to the household sector have increased over the past six months given weak housing market conditions. Housing prices have fallen significantly in Sydney and Melbourne after the earlier large run-up in prices, while in Perth and other mining exposed regions, prices have been declining for several years. Indicators of financial stress remain low outside the mining-exposed regions. However, the value of housing loans in arrears has drifted up from very low levels.[xiv]

Operational Risk

Given the Royal Commission's focus on misconduct, banks have continued to address operational issues and earn back trust.

Significant culture change is required to meet the regulators determination to use the 'full extent of its new powers' to ensure there is 'meaningful change to meet the goals of a fair, strong and efficient financial system'.

As APRA's Wayne Byres said, there needs to be more investment in operational resilience and more needs to be done to build cultural resilience, 'a multi-dimensional problem requires a multi-dimensional solution'.[xv]

For instance, accountability regimes like BEAR, are at their heart about cultural change. BEAR pivots around making sure organisations and their most senior people prevent, detect, and properly fix problems. It is about establishing and documenting what accountabilities Directors and the most senior executives face. This requires setting standards of conduct, and being held to account through remuneration and reputational consequences. In addition to acting honestly and with integrity, and taking due care and diligence, it also requires being open, co-operative and constructive with APRA (and soon ASIC), and taking steps to protect the organisation's prudential standing and prudential reputation.

While the remuneration aspects of BEAR – the deferral of part of variable pay – has gathered particular attention, this is in reality the least important aspect of what is really driving cultural change. The reality is no-one wants to fail, or to be seen to have failed.

Boards and executives are being held to community, and not just legal, standards.

Key questions

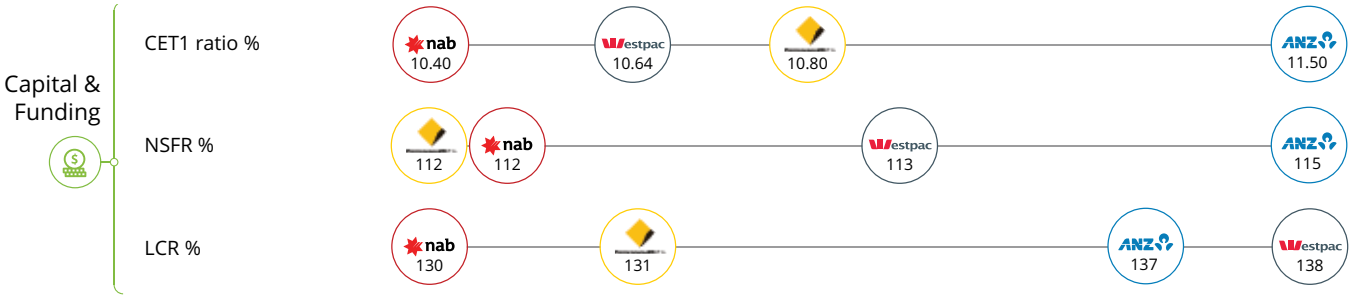
Questions CROs and business units should be asking include:

1. Have we clearly communicated the organisation's risk tolerance?
2. Have we created a cross-enterprise customer view of risk?
3. Have we effectively incorporated stress testing into our risk management processes?
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 evaluating variance and performance management?
7. Do we monitor and supervise third parties to mitigate risk?
8. Do we effectively measure our performance in meeting the promise we make customers?
9. Are our risk management processes accurate, reasonable and have integrity?
10. Do we have the right capabilities in our risk and compliance teams?
11. Can we effectively manage significant and emerging risks, and regulatory obligations?

Capital & funding

The four major banks either meet, or are on track to meet the 'unquestionably strong' CET1 target of 10.5% by January 2020.

Major banks – 1H 2019 results



Banks' comparative positioning here is based on approximation.
Source: 1H 2019 Investor presentations for ANZ, CBA, NAB and WBC; Deloitte Analysis.

As the RBA's latest Financial Stability Review, noted: 'In the decade since the onset of the financial crisis, significant changes in regulations and in financial institutions' own policies and practices have made them more resilient. Banks now have much higher levels of capital, more liquid assets and more stable funding structures'. Stress tests of the banks indicate that they have sufficient capital to withstand double-digit unemployment rates and housing price falls exceeding 30 per cent"[xvi]

However, the new RBNZ capital proposals, large scale remediation programs, weaker capital generation from retail banking operations, large notable one-off expenses and the broader macro headwinds are proving challenging. NAB, for example has reduced its interim dividend from 99 cents per share to 83 cents per share and have declared a dividend reinvestment plan to raise an additional $1.8bn, to enable the bank to meet APRA's 'unquestionably strong' capital benchmark of 10.5% and prepare for potential higher RBNZ capital requirements.

Total Risk-Weighted Assets (RWA) barely changed overall since the last reporting period. NAB showed an increase to Operational Risk RWA, offset by a reduction in IRRBB RWA, while CBA managed to decrease RWA's overall by reducing credit and market risk exposure (traded and IRRBB) in the Institutional and Markets business. WBC's RWA's decreased with a significant $6bn reduction in IRRBB RWA the main driver.

Funding:
Total deposit funding increased only marginally, in line with slower lending growth. NAB and CBA grew their liability base mostly with increases in deposits, while ANZ and WBC relied more on wholesale funding.

Retail and corporate customer deposits comprise about~60% of total funding for the banks. Given the recent low inflation outcome, and a slight uptick in the unemployment numbers, the market expectations of an interest rate cut from the RBA has evolved over the last few weeks.[xvii]

If the RBA cuts interest rates this year, the four majors would be under political and community pressure to pass on the reduced interest rates to their lending customers. At the same time it will be difficult to offset that with reduced interest rates on deposits given the fact that rates on certain deposits are already at or near zero and pricing competition on term deposits. This could hamper the funding flow from retail deposits as well as result in further reduction in NIM.

On top of this, the banks estimate future funding requirements under APRA's new Loss Absorbing Capacity (TLAC) rules will be in the order of $60-80bn collectively. As APRA is proposing Tier 2 as the primary instrument this will result in a significant increase in funding costs. The rules are proposed to apply from 2023.

Key questions

Questions CFOs and business units should be asking include:

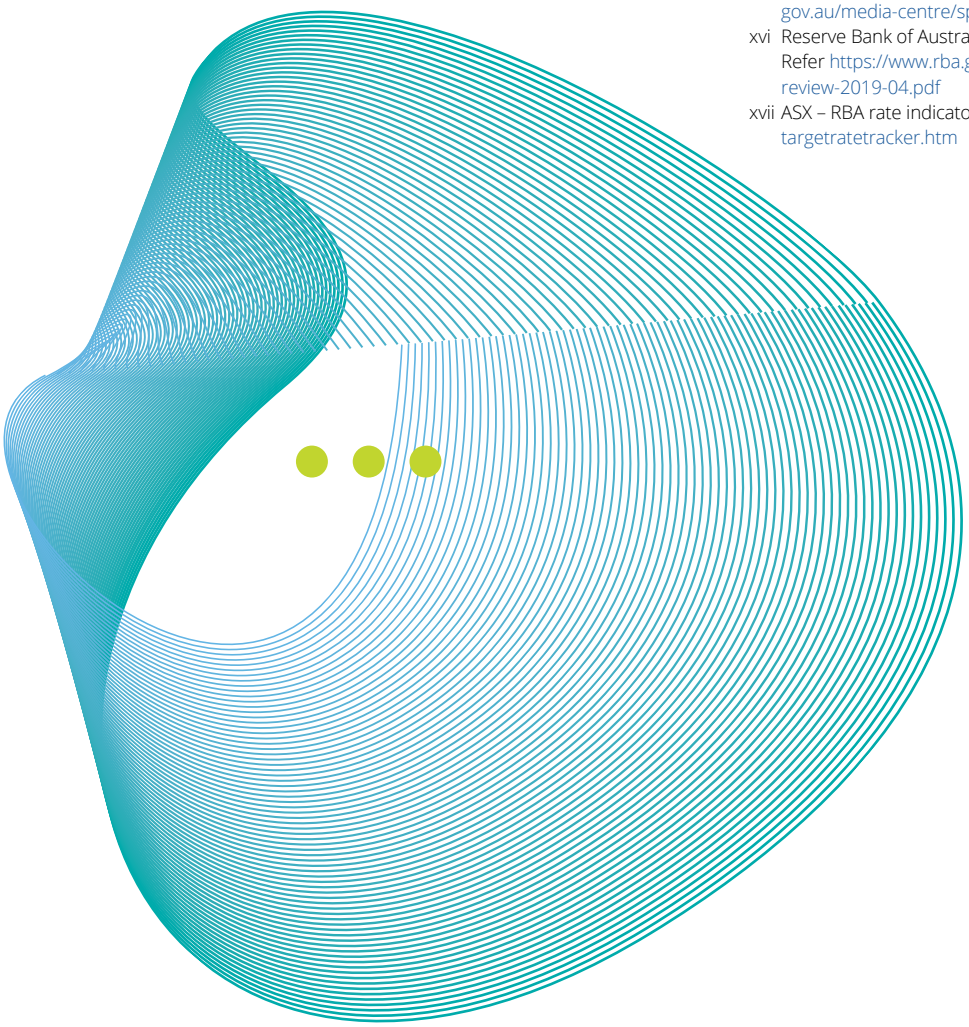
1. Do we understand the impact that capital and funding (e.g. TLAC) regulatory changes will have on our business and strategy?
2. Do we understand how sensitive profitability is to changes in funding costs, interest rates and competitive pressures on asset and deposit re-pricing?
3. Have we communicated this to business units?

Last Word

The story of the results for the first half of 2019 shows that the big four Australian banks are under siege from all sides. The environment is one of low growth, declining NIM, regulatory change, remediation programs, increasing capital requirements, trust issues and the threat of new entrants and digital disruption.

The current focus of the banking sector is to execute on all of these programs with a high degree of urgency and complete their remediation requirements, as well as their digitisation and simplification transformation.

This is the backdrop that informs our four considerations of the **growth**, **efficiency**, **quality** and **capital** of these results, where we compare the majors with each other and pose a series of questions aimed at assisting in navigating the way ahead.



Endnotes

i Half year ending 31st Dec 2018 for CBA; 31st March 2019 for ANZ, NAB and WBC.

ii The Brookings-Financial Times Tiger Index- April update indicates that that major advanced and emerging market economies are all losing growth momentum. 'World economy lurches from uneven recovery to synchronized slowdown'. Refer – https://www.brookings.edu/research/april-2019-update-to-tiger-world-economy-lurches-from-uneven-recovery-to-synchronized-slowdown/

iii Big bank compo bill may top $10bn – The Australian – 20th April 2019

iv Refinitiv Datastream defined sectors – 2nd May 2019

v James Frost – Micro-regulation and fearful bankers are crimping credit – The Australian Financial Review – 26th March 2019; Refer https://www.afr.com/business/banking-and-finance/micro-regulation-and-fearful-bankers-are-crimping-credit-20190326-p517ks

vi APRA, Monthly Banking Statistics, Feb 2019 – Table 2 – Loans and advances on Australian books of individual banks.

vii Westpac FY18 Investor presentation – page 66

viii Corelogic – 'Most Capital Cities Have Now Seen Values Fall Below Their Peak As The Housing Downturn Becomes More Widespread' – March 2019; Refer https://www.corelogic.com.au/news/most-capital-cities-have-now-seen-values-fall-below-their-peak-housing-downturn-becomes-more

ix 120.5% at Q3 2018. Refer https://tradingeconomics.com/australia/households-debt-to-gdp

x Refer https://www.rba.gov.au/chart-pack/household-sector.html

xi Down 5.1% yoy to Q1 2019. Refer https://tradingeconomics.com/australia/housing-index and https://www.rba.gov.au/chart-pack/household-sector.html

xii Refer https://www.rba.gov.au/chart-pack/household-sector.html

xiii Refer https://tradingeconomics.com/australia/consumer-confidence

xiv RBA's Financial Stability Review – April 2019 – page 26

xv Byres, Wayne, Building resilience in three dimensions, Australian Financial Review Banking and Wealth Summit, 27 March 2019. Refer https://www.apra.gov.au/media-centre/speeches/building-resilience-three-dimensions

xvi Reserve Bank of Australia, Financial Stability Review, April 2019 – page 3. Refer https://www.rba.gov.au/publications/fsr/2019/apr/pdf/financial-stability-review-2019-04.pdf

xvii ASX – RBA rate indicator – May 2019 – https://www.asx.com.au/prices/targetratetracker.htm

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