Challenges, choices and complexities
Australian major banks
FY2019 results
November 2019
“Bank profitability is under threat, ROE has halved over the past 15 years. NIMs have halved over that period. We are now much closer to our cost of equity. The ability to hold the machine together as it is ... is unsustainable. I think the idea that these universal, mass-market banks are going to continue to thrive, I don’t agree that’s the case. I am not saying there’s going to be none, but I don’t believe that this is sustainable in the future.”

Shayne Elliott  CEO, ANZ

<table>
<thead>
<tr>
<th></th>
<th>Total average interest earning assets</th>
<th>CET1 target of</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth was a challenge</td>
<td>3.7%</td>
<td>10.5%</td>
</tr>
<tr>
<td>Efficiency is critical</td>
<td>Total expenses increased by 0.8%</td>
<td></td>
</tr>
<tr>
<td>Cash profit declined by</td>
<td>7.8%</td>
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</tr>
</tbody>
</table>

Credit risk increasing 14bps

Lending growth has slowed 3.3%

On track to meet APRA’s ‘unquestionably strong’ CET1 target of 10.5%

Source: FY2019 results and investor presentations for ANZ, CBA, NAB and WBC. Deloitte analysis.
Major banks: FY2019 results

A typical Australian banking reporting season a few years ago was characterised by high retail banking Return on Equity (ROE), positive jaws, lower bad debts, and above system mortgage growth.

Solid GDP growth, high immigration intake, and a resilient job market have provided a favourable backdrop to the Australian banking industry for many years. But the tide has turned.

The FY19 annual reporting season highlighted the headwinds of uncertain economic conditions locally and globally, flattening global and domestic growth, net interest margin compression, elevated remediation costs, and a turning asset quality cycle.

Together with continued pressure in the wake of the Hayne Royal Commission, a Productivity Commission inquiry into competition in the financial system, and the ACCC’s mortgage pricing inquiry over the last 18 months, the outlook for the sector is complex and challenging.

What the majors can control is cost. And each CEO has been actively doing so. What isn’t easy, is to do so while delivering top flight service, redesigning processes, and investing in compliance and technology.

On top of this, banks have had to implement APRA’s Banking Executive Accountability Regime (BEAR) effective from 1 July 2018.

With intensive competitive pressures from international banks and non-traditional players; ‘zero bound’ interest and deposit rates; higher capital requirements for NZ businesses; continued large remediation programs, and the permanent increase in regulatory and compliance costs, choices are having to be made.

Simplicity, productivity, transparency, and value are the name of the game. The good news is that this is not just beginning. This work has been going on in some instances for at least four years. The big question is which bank will cross the ‘perception’ finish line first?

So it is not surprising that the major’s aggregate FY19 cash profit declined by $2.3 billion to $26.9 billion. (down by 7.8% vs last year) and the bottom line results were impacted by $4 billion of large, notable items.

Even after stripping out these items, underlying cash profit from continuing operations declined by 2.6% highlighting the challenges facing the banks.

The cash ROEs of the majors have declined significantly and are now approaching their cost of capital.

### Aggregate cash profit of major banks – FY2019

| Source: FY2019 Results and Investor Presentations for ANZ, CBA, NAB and WBC, Deloitte analysis. |
Managing the challenges, choices and complexities

Australian banks are facing unprecedented challenges forcing choices to cut through the complexity.

**Lower for longer interest rates**
In Australia and globally, rates are now close to zero suppressing the NIMs and ROEs, and potentially fuelling asset bubbles and impacting the stability and profitability of the financial system. The sector should prepare itself for a ‘zero rate’ world characterised by elusive revenue growth, declining profit margins resulting in significant implications for Australian households and businesses.

**Underlying economic conditions**
With tightening credit conditions, low productivity and weakening consumer and business confidence, Australia is experiencing loss in economic momentum. The banking sector mirrors the state of the economy and is facing an extended period of low credit growth.

**Intensive regulatory scrutiny and intervention**
Intense regulatory and political scrutiny is likely to be the ‘new normal’ for the Australian banking sector in the foreseeable future. Proactive enforcement regime of the emboldened regulators is likely to hinder the process of rebuilding trust with the community and customers.

**Non Financial Risks**
Broader societal and community expectations are demanding significant leadership attention and resources. Organisational culture, trust, fairness and accountability have become part of the national conversation.

**Rising Shareholder activism**
Boards and ELTs are under increasing shareholder pressure over strategic direction, remuneration, culture and governance issues. Given the growing trust deficit, Boards will find it challenging to balance the interests of employees, ELT, shareholders, customers and the wider community.

**Permanent increase in cost of doing business**
Higher capital requirements, elevated risk & compliance costs, and rising remediation costs have increased the cost of doing business for the majors. The gap between ROE and Cost of Equity has substantially reduced over the last 5 years. Given the world of disruption is evolving rapidly, the majors would need to make substantial investment in technology to stay ahead of the disrupters.

**Changing competitive dynamics**
The majors are facing intensive competitive pressure from international banks and non-traditional players in business lending, residential lending and the payments space. Open banking regime could substantially impact banks’ primary relationship with their customers.
## What is profit?

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

<table>
<thead>
<tr>
<th></th>
<th>ANZ</th>
<th>CBA</th>
<th>NAB</th>
<th>WBC</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statutory Net Profit after Tax</td>
<td>5.95</td>
<td>8.57</td>
<td>4.80</td>
<td>6.78</td>
<td>26.11</td>
</tr>
<tr>
<td>Statutory Net Profit after Tax from continuing operations</td>
<td>6.30</td>
<td>8.36</td>
<td>5.09</td>
<td>6.78</td>
<td>26.53</td>
</tr>
<tr>
<td>Cash Net Profit after Tax from continuing operations</td>
<td>6.47</td>
<td>8.49</td>
<td>5.10</td>
<td>6.85</td>
<td>26.91</td>
</tr>
<tr>
<td>Cash Net Profit after Tax from continuing operations excluding 'one-offs' and notable items (estimate)</td>
<td>6.77</td>
<td>9.62</td>
<td>6.55</td>
<td>7.98</td>
<td>30.91</td>
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Source: 2019 Full Year Results and Investor Presentations for ANZ, CBA, NAB and WBC; Deloitte analysis.
Challenges, choices and complexities | Australian major banks FY2019 results

Growth

FY19 has been a challenging year for the majors, with NIM declining and growth slowing. Fee income has also taken a hit. ROE’s are now approaching the cost of equity. Remediation and restructuring provisions continue to weigh on bank results and may do so for some time to come. Banks are focusing on efficiency and productivity savings to offset this, which is no mean feat given the need to serve customers well and improve in the areas of risk and compliance. At the same time banks need to invest in the future with new players providing fierce competition.

Major Banks: FY2019 results

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<tr>
<td>Cash Profit from continuing operations (AUD Billions)</td>
<td>5.1</td>
<td>6.5</td>
<td>6.8</td>
</tr>
<tr>
<td>Cash ROE %</td>
<td>9.90</td>
<td>10.75</td>
<td>10.90</td>
</tr>
<tr>
<td>NIM %</td>
<td>1.75</td>
<td>1.78</td>
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Cash profit and total operating income

CBA recorded a fall of 4.7% in its cash profit for FY19 as a result of higher operating expenses, (up 2.5% vs 2018), which included higher remediation charges, increased investment in risk and compliance and fee removals. Topline income fell by 2% (vs 2018) as a result of fee changes to benefit customers ($275m in FY19 and expected to be ~$415m in FY20) and reduced interest income (driven by decline in FY19 NIM by 5bps).

CBA’s home and business lending grew by 4%. Its home loan volumes grew faster than system growth, which was offset by a reduction in institutional lending (down 12% vs 2018).

Other banking income declined by 2.8% primarily because of a reduction in fee income and reclassification of institutional lending fees under new revenue accounting standard AASB 15.

ANZ’s cash profit from continuing operations was $6.47bn (flat vs last year) despite a decline in total operating income of 2%. ANZ’s net interest income declined by 1% despite growth in interest earning assets of 5%. NIM declined by 11bps. Other operating income declined by $163m (3%) because of the impact of net divestments, reduction in fee and commission income and reduction in income from the lenders mortgage insurance business. The decline was partially offset by improvements in markets income.

NAB’s cash earnings from continuing operations declined by 10.6% compared to FY2018 as a result of 4.2% decline in total income. NAB’s total operating income declined because of higher remediation charges of $1.2bn. Net interest income increased by 0.6% with a 4.4% increase in interest earning assets, offset by an 7bps reduction in NIM.
WESTPAC

Westpac's FY19 cash profit declined by 15.1% to $6.85bn, caused by both income declines and increases in total expenses (a.k.a. negative jaws). The main contributing factor was additional customer remediation provisions of $958m (after tax). Excluding the effect of large notable items, underlying cash profit declined by 4% caused by a decline in NIM by 10bps, offsetting a 3% increase in lending volumes. Total operating income declined by 3% because of a significant decline in non-interest income (excluding notable items) of 12% with net interest income remaining flat for the year. The decline in non-interest income (excluding large notable items) was caused by a 6% decline in net fee income and a 23% decline in wealth management and insurance income. The average interest earning assets grew by 3%.

Divisional performance

Continuing the trend of the first half results, overall the Australia retail banking divisions of all the major banks suffered declines in cash profit for the full year, reflecting tightening credit conditions, rising competition, and a general economic slowdown. All the majors, except CBA experienced below system mortgage lending growth.

CBA’s Retail Banking Services division declined by 10% and ANZ’s Australia Retail & Commercial division results dropped by 10%, offset by a significant 11% improvement in the Institutional result. NAB suffered a 11.2% drop in the Consumer Banking and Wealth division, offset by an 8.1% improvement in New Zealand.

WBC’s Consumer bank dropped 6% with its Business bank and Institutional bank result falling by 2% and 7% respectively. BT Financial Group was integrated into Consumer and Business divisions with Private Wealth, Platforms, Investments and Superannuation businesses going into the Business division and the Insurance business going into the Consumer division.

The banking industry is a spread business; the industry doesn’t perform well in an environment of declining interest rates and a downward sloping yield curve. The collapse in long-term bond yields is bad news for the sector that earns a margin by borrowing short-term and lending longer-term.

Escalated trade-tensions between the US and China, coupled with heightened global risks and currency wars means that further monetary policy easing by the RBA is not a question of ‘if’ but ‘when.’

The cash rate cuts are negative for banking NIMs and revenue, and in this environment, offsets are hard to find; pricing power is reduced, credit growth is anaemic, savings from productivity and efficiency initiatives need to be reinvested into the business, and bad debts are showing signs of increasing from historic low levels.

As the majors ‘simplify and streamline’ their operations, the residential mortgage market is becoming a key battleground!

Unfortunately, for the majors, not only is credit growth anaemic, but their share of the pie is also falling. For example, ANZ reported that its mortgage portfolio in its Australian Retail division has shrunk by $7bn in FY2019.

The majors have been ceding market share to the challenger banks, led by the three foreign banks (ING, HSBC, and Citi) and domestic banks (Macquarie, ME bank, AMP and the mutual ADIs). Neobanks such as Xinja, 86400, Volt Bank etc have aggressive growth plans, they are targeting a niche customer base by building unique products and could increase the competition in the mortgages space.

Key questions

With open banking starting from Feb 2020, 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?
In order to give customers choice, convenience and confidence, open banking will be introduced in Australia from February 2020. To better understand how consumers will react, Deloitte surveyed more than 2000 banking customers.

We asked which organisations people trust with their money and their information, what they value, and why. We explored how willing people are to share their information, and how often they had changed their banking product providers in the last three years. And what had triggered their decision to switch and what would entice them to do so in the next 12 months.

All of these factors will play a large role in the success of banks in an open banking eco-system.

The ‘Big Five’ findings from the survey are:

1. **Trustworthiness is key**
   - Australians tend to distrust most organisations
   - People do trust traditional banks to keep their money safe (prudential trust)
   - They also trust traditional banks to keep information about them and their financial transactions secure (information trust)
   - But people don’t trust that banks have their best interests at heart (relationship trust).

2. **Privacy, security, transparency**
   - 65% said trust was essential when deciding whether to provide personal information
   - Transparency over how customer information is used and shared is critical
   - Organisations need to clearly communicate why customers should share their data - the value created for the customer
   - People are three times more likely to share their data with ‘an accredited third party’.

3. **Engage – gathering information**
   - Most people do not actively seek information about other offerings, but half of Millennial’s (Gen Y) and post-Millennials (Gen Z) do
   - Most of those that gather information, do not end up changing their provider
   - But when data recipients are accredited, people’s willingness to share data triples.

4. **Switching: Retention is cheaper than acquisition**
   - Most people are satisfied with the current provider of their banking products
   - 76% of people have had their banking relationship for over five years
   - Behavioural biases can stop people gathering information or switching providers
   - Switchers are more likely to be better educated and have a higher income
   - Switchers are more likely to be tech-savvy and millennials (Gen Y)
   - For most products, switching is not seen as difficult – mortgages are the exception
   - Once someone has switched, they realise it’s not as difficult as they might have thought
   - 33% of people still experience pain points, particularly for mortgage lending.

5. **It’s all about value**
   - 20% of people intend to change the provider of a banking product in the next 12 months
   - What’s important to people differs across banking products and generations
   - Better value is most important
   - Other product features and services also influence customers’ choices, like the ability to consolidate finances, better customer service, and more convenient banking.

With open banking now just around the corner, it is important for all organisations to change their focus from just compliance with the CDR legislation, to propositions that deliver value for customers.

To attract a customer, having a point of difference is critical. In the UK, account aggregation, personal financial management, and SME financial management propositions have been the initial areas of focus.

Greater data sharing facilitates such new offerings, and increases the potential for real-time credit decision making. However the lack of financial and data literacy in Australia is probably one of the key impediments to consumers realising benefits from open banking.

**Next steps:**

1. **Ensure they can meet their compliance obligations** under the Consumer Data Right legislation, rules and standards – both as a data holder and as a data recipient.

2. **Understand operationally** what processes and controls need to change e.g. credit assessment and pricing, data governance, data analytics, responsible lending and conduct, financial crime, and more.

3. **Understand strategically** how open banking and the emerging open data economy may impact the organisation’s strategy, and its products and services, and target customers and the eco-system in which the organisation operates.
Challenges, choices and complexities | Australian major banks FY2019 results

Given the subdued revenue growth and the challenging operating outlook the majors have had to focus on efficiency, and have delivered almost $1.3bn in productivity savings.

**Major banks – FY2019 results**

<table>
<thead>
<tr>
<th>Banks</th>
<th>Cost to Income ratio %</th>
<th>FTEs (spot)</th>
<th>Operating Costs (AUD Billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NAB</td>
<td>52.3</td>
<td>2,551</td>
<td>175.3</td>
</tr>
<tr>
<td>ANZ</td>
<td>48.6</td>
<td>3,588</td>
<td>150.0</td>
</tr>
<tr>
<td>WBC</td>
<td>47.7</td>
<td>2,431</td>
<td>151.0</td>
</tr>
<tr>
<td>CBA</td>
<td>46.2</td>
<td>2,301</td>
<td>173.3</td>
</tr>
</tbody>
</table>

With the sluggish economic growth and rising competitive pressures from the digital players (that are challenging incumbents both in customer acquisition and the share of wallet), the sector is grappling with thinning margins, turning asset quality cycle, and the permanent increase in the cost of doing business.

Large scale remediation programs, elevated risk and compliance costs have led to deterioration of all the banks’ cost-to-income ratio.

**CBA’s** headline costs rose by 2.4% (excluding large notable items) and income declined by 2.2% (reporting negative jaws).

**ANZ’s** underlying operating expenses remained flat with its total operating cost base at $8.6bn.

**WBC’s** cost to income ratio was up to 43.9% excluding the effect of large notable items, mostly due to lower total income.

**ANZ’s** total Full Time Equivalent (FTE) staff members decreased slightly, however personnel expenses increased by 2%. Technology expenses were down 7%, mostly due to accelerated amortisation charges in FY18. Other expenses increased by 2%.

**CBA’s** personnel and technology expenses rose 3% and 8% respectively compared with FY18, which was offset by reductions in occupancy (4%) and other expenses (1%). CBA’s FTE numbers were up 1% over FY18.

**NAB’s** underlying costs have increased by 0.4% compared to FY2018, with increased investment in technology, compliance and control costs, offset by reductions in personnel and occupancy expenses. Total expenses increased by 0.2% compared to FY2018.

NAB’s FTE (spot) numbers increased by 3.3% compared with previous year. Excluding notable items, the cost base remained flat. The personnel expenses decreased by $150m primarily due to a 5% decrease in FTE from productivity initiatives. Occupancy expenses increased by 2% and technology expenses increased by 7% due to higher amortisation of software assets. Other expenses decreased by $22m excluding large notable items.

Collectively the major banks’ total operating expenses went up to $39.4bn, representing a 0.8% increase against FY2018.

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

Indicates increase/decrease in numbers with respect to the previous corresponding period and otherwise for the ‘Efficiency’ and ‘Quality and risk’ sections. No arrow indicates no change from the previous corresponding period.

Source: FY2019 results and investor presentations for ANZ, CBA, NAB and WBC - Deloitte Analysis.
Large notable items and discontinued operations

CBA’s FY19 result was heavily impacted by large notable expenses of $1.1bn, which included customer remediation spend of $918m and $358m on risk & compliance programs. This was partially offset by professional indemnity insurance recovery amount of $145m relating to the AUSTRAC civil penalty.

ANZ recorded a net loss of $302m from large notable items. This loss was primarily driven by higher customer remediation charges of $475m, which was partially offset by gains from divestments.

NAB’s FY19 results were impacted by large notable items of $1.45bn, which included customer related remediation spend of $1.57bn, accelerated software amortisation of $494m. This was partly offset by $617m income tax benefit.

The WBC result was also significantly affected by large notable items of $1.1bn in FY19. Customer remediation costs negatively impacted the profit by $958m (post tax), whereas costs relating to restructuring the wealth business hurt results by a further $172m (post tax).

Remediation

The majors announced $6.8bn for customer refunds and remediation since 2017, this cost is likely to increase. Market analysts estimate the total remediation bill for the sector to be north of $8bn by 2020 and expect remediation to be a ‘lingering issue for the sector’\(^2\), which could also extend to the traditional areas of business and consumer banking.

Cost Out and Productivity

In an era of anaemic revenue growth, the majors are increasingly looking for ways to reduce costs by simplifying their business models and exploiting efficiencies. The divestments of non-core assets, streamlining of the branch operations and domestic distribution network\(^5\), and digitisation/automation of processes are all helping the banks to reduce complexity and achieve absolute cost reduction. CBA, for example, delivered productivity savings of $190m for FY19, NAB $480m, ANZ $259m and WBC $405m. Having said that, there are opportunities to further trim the cost base and deliver sustainable returns.

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?
Challenges, choices and complexities

Cost management remains a global and Asia Pacific imperative, but failure rates are up. A Deloitte survey of findings of 332 APAC companies representing 83% of the APAC economies on strategic cost transformation, show that in the next 24 months, all Asia Pacific countries plan to undertake cost improvement initiatives (70%).

On average, about two thirds of APAC respondents have overall cost targets above 10%, while a quarter are targeting cost reductions above 20% including Australia where 35% of Australian companies have targets above 20%, significantly higher than APAC and an increase from the previous survey (2017).

Past and expected future revenue growth, both at 87%, show a very positive outlook and are slightly higher than both global average.

However Australia (85%), Hong Kong (83%) and Singapore (87%) have higher failure rates than the rest of APAC countries – higher than the US (82%), APAC (80%), and globally (81%).

Reliability and functionality of information systems, the top internal risk globally (26%) and in the US (34%), is the top internal risk only for Australia (30%).

Product profitability, the second highest strategic priority in APAC overall (73%), is the top strategic priority only for Australia (78%).

The top three drivers of cost initiatives, both in the future in APAC and the past 24 months were competition (70%), international growth opportunities (69%) and investment in growth areas (67%).

The rise of digital technologies and innovations is also contributing to a shift in how APAC companies we surveyed approach cost management. The ‘save-to-grow’ mindset from 2017 is steadily evolving into a ‘save-to-transform’ mindset, where investments in digital enablement and transformational technologies play a prominent role.

### Strategic cost transformation

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### Investment in growth areas and increased international growth opportunities

Both increase over the next 24 months in APAC (+4%).

**A. Implementation challenges** are among the top three barriers across all APAC countries, especially in India (86%) and Australia (78%)

**B. Weak/unclear business case**, the third highest-ranked barrier in APAC, is especially high in China (76%) and India (86%)

**C. Erosion of savings due to infeasible target setting** is the lowest-ranked barrier in China (58%), Japan (40%) and Hong Kong (30%); however, it is the top barrier in India (86%) and New Zealand (70%).

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**Strategic cost transformation**

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**Digital and technology solutions applied to cost management in banking**

### Cloud leads the pack, except in Asia Pacific.

In banking, the most widely implemented technology covered by the survey is cloud. However, implementation levels vary widely by technology and region.

- **45%** Cloud
- **37%** Business Intelligence
- **37%** Cognitive

### Most technology implementations meet or exceed expectations.

88%

Percentage of banking respondents who had their expectations met or exceeded when implementing each of the technologies covered by the survey.

### High levels of technology implementation are expected

The technologies expected to be most actively implemented over the next 24 months in banking are automation and cognitive; the technology expected to be least actively implemented is cloud, most likely because current implementation levels for cloud are already very high.

- **64%** Automation
- **60%** Cognitive
- **49%** Cloud

### Reasons for applying digital technologies.

The top reason for applying cloud is to tighten data security and improve business control. The top reason for applying both RPA and cognitive/AI is to reduce costs and increase productivity.

### Digital leaders make a difference.

+275%

On average banks with a designated digital leader achieve much higher levels of technology implementation, although the impact varies by region and technology.
Asset quality has remained stable across the majors with credit impairment still low. However, there are signs of deterioration with some of the banks reporting increases in delinquencies. 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 have increased by around 20–25bps.

Banks’ comparative positioning here is based on approximation. Cash Profit and Operating Costs has been stated on a continuing operations basis including large notable items. Indicate increase/decrease in numbers with respect to the previous corresponding period and otherwise for the ‘Efficiency’ and ‘Quality and risk’ sections. No arrow indicates no change from the previous corresponding period.

Source: FY2019 results and investor presentations for ANZ, CBA, NAB and WBC - Deloitte Analysis.

In its latest Financial Stability Review the RBA noted: “Overall, households continue to have a sizeable stock of mortgage prepayments that could be used if they encounter difficulties servicing their loans. The total stock of prepayments (the sum of balances in offset accounts and redraw facilities) is around 16 per cent of gross housing credit, or 2½ years of required mortgage repayments at current interest rates.” ANZ, for example reported that 76% of home loans accounts are ahead in terms of loan repayments and 27% of borrowers are more than two years ahead of repayments schedule.

Operational Risk

In May 2019, APRA released its report analysing the self assessments carried out by 36 Financial services players into governance, culture and accountability. As a result, in July this year, APRA imposed higher capital requirements of $500m each for ANZ, NAB and WBC ‘reflecting higher operational risk identified in their risk governance self-assessments;’ CBA already had $1bn of additional capital imposed by APRA last year. APRA noted that “there is a need to strengthen non-financial risk management, ensure accountabilities are clear, cascaded and enforced, address long-standing weaknesses and enhance risk culture”.

Quality & risk

Asset quality has remained stable across the majors with credit impairment still low. Collective provisions as a percentage of credit risk weighted assets has increased by around 19bps vs FY2018. Impairment expense has remained low, although arrears and 90+ day delinquencies are showing signs of deterioration.

The banks’ asset quality is showing some signs of stress, as the (90DPD+GIA)/GLA ratio has increased by 14 basis points as compared to FY18.
Challenges, choices and complexities

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?
Business Outlook: Oz muddles through global uncertainty

The cash rate is at a record low because inflation is stubbornly low. That's why the Reserve Bank of Australia has doubled down on the accelerator, cutting the cash rate to a record low of 0.75% October.

And doing so for both cyclical (a slower economy) and structural reasons (inflation is harder to get moving than it used to be).

Lower interest rates should help to boost economic activity. But business investment hasn't yet budged, and there is a risk that record low interest rates are counter-productive by spooking business and consumer confidence.

However, because Australia enjoys a solid rate of population growth, it's not easy to tip our economy into recession. Neither the drought nor the housing downturn are here to stay, and there's already stimulus via cuts to taxes and to interest rates, plus a lower $A.

The most likely outlook is that Australia's economic growth does lift through 2019–20.

Although global growth is still slowing and the trade wars are worsening, the largest single driver of the slowdown is no longer the push and shove over trade.

Rather, families and businesses have lost confidence in the ability of political leaders to govern wisely.

Amid that rising uncertainty, business in particular has wound back the money they spend today to help them sell more in the future. The resultant pullback in investment plans is a global phenomenon. And it is now the largest driver of the downturn.

Risks are rising

Worse still, risks are still rising. Brexit, Kashmir, Hong Kong, Iran and the Saudis ... the rolcall of possible flashpoints is growing ever longer. Yet, as we often stress, headlines and economies are two different things. Although more could go wrong than already has – the risks of that are rising – to date the global economy has been dominated more by the risk of things going wrong than actual poor outcomes.

So we shouldn't overstate the weakness in the current path of global growth. It's below trend, but not markedly. The world may be run by dictators and dumbos, but to date the damage that has caused has been well contained.

Australia has been a big winner from the world slowdown. Yep, winner. China is fighting its slowdown with stimulus, which has led to a pay rise for Oz via higher iron ore and coal prices.

Rather, the pain in our economy has been homegrown, coming from the double whammy of a deflating housing boom (leaving consumers cautious) and a nasty drought (flattening farmers).

The bad news is that, although global events have so far helped our economy rather than hurt it, that could change fast. The geopolitical landscape is littered with risks to an extent not seen in decades.

But neither the drought nor the housing downturn are here to stay, and there's already stimulus via cuts to taxes and to interest rates, plus a lower $A.

So, absent a spanner in the works from a global threat, Australia should keep muddling through the aftermath of a housing bubble and a drought.

Growth won't be flash, but it should slowly lift. Yet that recovery looks unlikely to develop sufficient momentum to see wages accelerate or to see unemployment fall much over the coming year. That will disappoint many, including the Reserve Bank.

Central banks are cutting interest rates and markets are slicing longer term borrowing costs. But rates are falling for two reasons, not one.

The reason that everyone understands is that the world's economies have slowed. The second reason is the one most people miss (or misunderstand): rates are also falling because these days the world's growth shows up more in jobs than in wages, so inflation is harder to get moving than it used to be.

A housing let off for the east coast states

It will take time for rising housing prices to be reflected in rising housing sales turnover. However it's a temporary fix for a nation that is in need of structural reforms. 'Twas ever thus.

The rebound in Sydney's housing prices (currently rising by $3,000 a week) is welcome, but it's also bad news. It will help NSW by boosting retail (soon) and housing construction (in a little while).

But down the track the return towards diabolical rates of housing affordability will bite into NSW's economic and population growth.

Victoria has slowed, but it has stronger defences than any other state, including nation-leading population gains, surging public infrastructure, and rebounding property prices (even if the latter are a double-edged sword).

That has put a floor under state growth, which should lift from here (and stay ahead of Australia's).
Challenges, choices and complexities | Australian major banks FY2019 results

Capital & funding

Major banks – FY2019 results

### Capital

- All four banks (except NAB) have CET1 capital levels above APRA’s ‘unquestionably strong’ benchmark of 10.5%. However, getting there hasn’t been without its challenges. **NAB** has cut its full year dividend to get closer to the target, and **Westpac** has disappointed shareholders with a dividend cut and planned capital raising.

- The key drivers for these capital management actions have been weaker organic capital generation through lower earnings, large remediation provisions significantly impacting profits, as well as additional capital requirements from the RBNZ, together with changes to APS111, and APS222 Related Entities from APRA.

- **ANZ** in particular has suffered from these changes as it is one of the smaller banks in Australia, however it is clear number 1 in New Zealand. So while ANZ does have surplus capital it may need it to meet its targets.

- Total Risk-Weighted Assets (RWA) have increased by 3%. ANZ and NAB both had 7% growth in their RWA, which was supported by growth in their Credit Risk Weighted Assets (CRWA) and Operational Risk Weighted Assets. This was partially offset by iRRBB (Interest Rate Risk in Banking Book) RWA. CBA’s total RWA declined by 1.3% due to the significant decrease in iRRBB RWA. WBC’s Total RWA increased by 0.8%, with all RWA gains almost offset by a 96% decline in iRRBB RWA.

### Funding

- The customer deposit funding for all the majors has increased by 2.8% as compared to FY18. Overall customer deposits still comprise about 60% of total funding, with a large proportion paying less than 25 bps. It’s easy to see why rate cuts are squeezing margins.

- All banks comfortably meet both liquidity targets of LCR and NSFR, however they will have to deal with the new ‘Total Loss Absorbing Capacity’ (TLAC) rules which will require major banks to increase Total Capital by 3% of RWA by 1 January 2024. This will result in increased funding costs, but is designed to make the banks safer.

### Key questions

Questions CFOs and business units should be asking include:

1. Do we understand the impact that regulatory changes in capital, liquidity and provisioning will have on our 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 asset risk weighting on our product portfolio?
5. Do we have a broad diversification of funding sources?
There is no doubt that the banking industry is facing an ‘Uber’ moment. The majors are not as nimble and agile as the Neobanks, Fintechs, and ‘Techfins’. They are not as encumbered by legacy systems.

That said, as announced by Westpac’s CEO Brian Hartzer, his bank’s investment in a new banking platform to enable it to respond to a ‘once-in-a-generation transition’ of the financial services sector to attract Millennials and partner with non-banks, all the majors are considering their digital options.

The new operating environment for the banks, particularly post the Hayne Royal Commission, is characterised by a permanent increase in the cost of doing business, ‘unquestionably strong’ capital levels, and requires a greater investment in technology and operating systems to capture the opportunities in an ecosystem era.

The sector is preparing itself for a radically different future, with a strong focus on productivity, sustainability, substantial investment in technology, and exceptional customer-centricity, to enable it to lead in the world of ‘bank platfromification’!

These are challenging times for it; the sector knows it must lift its game. To this end the sector has been and is in the process of managing its complexities and challenges, to make the choices that will enable it to be leaner, more innovative, and balance the needs of all its stakeholders.
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