

Perspectives

October 2008

Major banks analysis

Sound results in unprecedented times

This October 2008 review is the third half-yearly review we have published since the collapse of the US sub-prime market in July 2007. In each period, the storm around us has intensified; indeed it is now clear that international financial markets have not seen such dislocation since the Great Depression. It is equally clear that Australia's major banks have risen to the challenge and helped reinforce their reputation as being among the best general commercial banks in the world. Of course they have not emerged completely without blemish, but certainly with their collective reputation enhanced in overall terms, not diminished.

It is an equal mark of the time that the Australian Government, mindful of the trend around the world, has offered guarantees for deposits and wholesale bank borrowings for three and five years respectively. It is certainly a dramatic departure from the doctrine of 'constructive ambiguity' – that is, an emphasis on implicit and situation-specific supervisory responses rather than explicit and unbending commitments – which has been the hallmark of the supervisory tradition in Australia since at least the formation of the Reserve Bank of Australia in 1959. We expect that the implications of this dramatic change will continue to play out for many years.

While the four largest Australian banks are still standing strong, there have been a number of significant changes in the next tier of banks, as foreshadowed in our previous review. BankWest has been purchased by the Commonwealth Bank; all regulatory approvals for the merger between Westpac and St George have been obtained and there is every expectation that the merger will proceed; and at least one other domestic bank is said to be actively looking for a new owner. In addition, we have started to see further consolidation across building societies and credit unions. It is still too early to judge the full competitive implications of these changes, particularly in the context of the Government guarantees.

Regardless, there can be no doubt the current environment requires all banks to focus on efficiency and cost control as a priority to offset sluggish credit growth and increases in bad debt expense. As always, those who can achieve this objective through genuine process improvement, and so achieve efficiencies without weakening service quality or distribution reach, will emerge in the best position. We expect that the trend towards offshoring will accelerate and be an important element of the banks' response to this challenge. In addition, a number of banks have announced core systems replacements which provide the potential for step-

change improvement in customer service and bank efficiency. It will also be particularly interesting to watch how those institutions undertaking significant merger integrations balance the requirements of the integration with the process improvement and efficiency requirements of the broader organisation.

The annual results show that, given the environment, and despite a couple of high profile hiccups, the performance of the five majors has been sound. In aggregate, their combined underlying cash earnings reduced in FY08 by 3.0%.

As explained further in the review, net interest income was a highlight, up 12.2% as a result of loan growth offset by margin contraction of 11 bps. The wealth businesses came under strain in the second half given the steep falls in investment markets and funds inflows, but still delivered revenue growth of 5.4% for the year. Despite wage pressures and increasing inflation, cost increases were restricted to 5.1%. However, the predicted increase in credit losses hurt the banks, up 174% in FY08.

Looking forward, the main uncertainty is the extent to which the so-called "real economy" will slow and so the extent to which this will act as a brake on the banks, both through lower lending demand and through higher bad debt expense. The risk of further substantial step-ups in bad debts remains the single largest uncertainty for the banks.

In this context, we expect the banks to continue to put a heavy emphasis on their capital position as well as reducing costs. No doubt though, they will be mindful to retain a strong focus on the customer. And as we emerge from the turmoil, it will be important to compare their growth initiatives and seemingly diverging strategies, including their offshore plays.

The PwC Banking Gauge predicts that the major banks' FY09 cash earnings will be up 8.5% on FY08. We should note, however, that the range of forecasts across the analysts comprising the PwC Banking Gauge is quite wide. Uncertainty and volatility are likely to remain for some time.

Part of the uncertainty surrounds the unfolding indirect consequences of recent Government announcements. Additionally, as the financial system stabilises, the Government's attention will likely turn to competition and we may see further initiatives in this area. The landscape has shifted profoundly; and it hasn't stopped moving.



Michael Codling

Banking and Capital Markets Leader
Tel: +61 (2) 8266 3034
Email: michael.codling@au.pwc.com

Note: the PwC Banking Gauge is a consensus view across the five banks and across five of Australia's leading banking analysts – Ben Zucker (Macquarie Equities), Brian Johnson (JPMorgan), James Ellis (Credit Suisse), Jonathan Mott (UBS) and Matthew Davison (Merrill Lynch).

Government Measures

The disruption in credit markets caused by the defaults on a large number of debt instruments, the failure of a number of large financial institutions elsewhere, and the knock-on impact on the global economy has precipitated extraordinary regulatory responses around the globe. Page 6 gives a summary of some of the key international and domestic milestones over the last 18 months.

In Australia, regulatory responses to the crisis have been ongoing during the past six months, but reached a crescendo in October. Prior to October, key responses had included the widening of securities acceptable to the Reserve Bank for its open market operations, the first easing of monetary policy since December 2001, the decision by ASIC to limit short-selling in securities markets for four weeks, and the Government's decision to purchase \$4 billion of RMBS to support residential lending by non-bank lenders.

October saw a dramatic lift in the nature of responses from the official family, reflecting the worsening of the international credit environment, including:

- the Reserve Bank reduced official cash rates by 1%, the first reduction of this magnitude since 1992;
- the Government announced that bank deposits would be Government-guaranteed for three years, under a combination of fee and fee-free arrangements;
- the Government announced that it would guarantee wholesale borrowings by banks for five years on a fee basis;
- the intended purchase of RMBS would be extended to \$8 billion;
- the Government announced a \$10.4 billion economic stimulus package;
- the limit on short-selling in financial institutions' shares was extended to 27 January 2009.

It is still too early to judge all the implications and repercussions of these changes. As the recent debate over the extension of the guarantee beyond bank deposits reminds us, there is the scope for a range of unintended consequences.

In considering the major banks' results for the past year we need to be mindful of the extraordinary events which have led to these unprecedented regulatory changes.



Net Interest Income

One of the key aspects of the full-year results has been the overall strength of net interest income, which has risen by 12.2% over FY07, compared to an increase of 9.1% in the previous twelve months.

This result reflected two main factors. First, loan growth had been strong in FY07 and that provided "carry in" interest income momentum into FY08. Moreover, this strong loan growth continued well into FY08; in fact it was only towards the end of FY08 that loan volumes, particularly to business, began to slow sharply. Gross loans rose by 14% in FY08, only fractionally less than the 15.3% recorded in FY07.

Second, banks have been disciplined in managing the spread between lending rates and borrowing rates and so been able to limit the downside impact on their net interest margins. In order to understand this, it is worth reviewing the three main sources of funding for banks – customer deposits, short-term money markets, and long-term debt markets.

Customer Deposits

Customer deposits make up the cornerstone of the majors' funding requirements, providing relatively cheap and stable funds. Through the liquidity squeeze of this past year, pricing competition became especially intense as banks chased deposits. On average, customer deposits now represent 55% of their funding requirements.

One impact of the market turmoil has been a flight to quality to bank deposits as consumers and businesses value the safe haven provided by banks. While this trend has been evident since last year, it gathered particular pace in the September quarter as the market uncertainty rose dramatically. It has been given a further boost in recent weeks by the Government's decision to guarantee bank deposits.

There is some anecdotal evidence that the banks have been able to reduce deposit rates in recent weeks in response to the surge in volume. It will be interesting to see if this trend continues once market conditions settle given that one implication of the Government guarantee is that there may be less opportunity for banks to distinguish themselves on credit rating. In this environment, it may be that pricing competition for deposits becomes more intense, which in turn would benefit those banks which are the most efficient and so can prosper on lower interest margins.

Short-Term Money Markets

Short-term money markets provide the next largest source of funding for the banks, and account for between 20% and 30% of the banks' total funding. The instruments include bank bills, promissory notes, and certificates of deposit and provide flexible funding for day-to-day balance sheet management

such as funding new lending. Indeed this is a major market to facilitate lending by banks to each other and so is very sensitive to perceptions of bank creditworthiness.

In normal conditions, the short-term money market provides cheaper funds than long-term borrowings because of the shorter tenure of these instruments (less than 1 year), with risk margins of say 5–10bp between the 90 day OIS (Overnight Index Swaps Rate) and BBSW historically. Over the past six months, spreads have risen as high as 95bp; the first major spike occurred in March 2008 to around 80bp due to the collapse of the US investment bank Bear Stearns and associated concerns about contagion to other banks, and then again to 95bp in September associated with the collapse of Lehman Brothers. At the time of writing, spreads have eased back to 40–50bps, reflecting a number of factors including the calming effect of the Government measures.

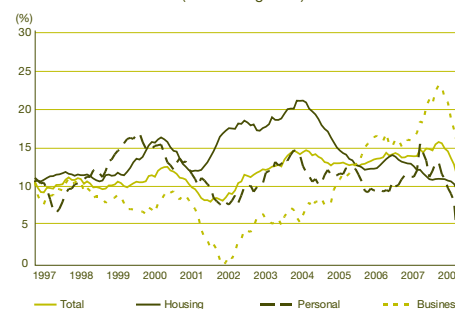
Long-Term Debt Markets

Long-term debt markets provide the final component of bank funding, with the major banks securing around 15% of their requirements through these markets. Like all credit markets they have been impacted by the market turmoil and associated concerns about the creditworthiness of banks. Margins paid by the Australian majors have risen from pre-July 2007 levels of less than 20bps to around 80bps – 100bps today. However, the Australian majors' strong balance sheets and reputation has served them very well in these markets; the AA ratings enjoyed by the four Australian majors are shared with only 14 other banks around the world.

Lending

The banks' lending portfolios continued to contribute strongly to net interest income. However, total system credit growth slowed throughout the year to 10.5%pa*, from 16%pa* last year. Business lending has seen the most dramatic change going from 22%pa* last September to 13.6%pa* this year, with much of this occurring in the second half as the external conditions started to bite.

Domestic Credit Growth (Annual % growth)



Housing showed slightly different trends. Growth has been moderating for some time and was only down 2%pa to 9.4%pa* at August 2008. A key question will be whether this level of system growth is sustainable in the new environment. At the same time,

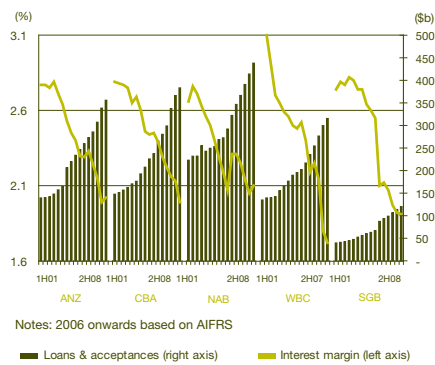
* Growth rates are based on RBA 12 month rolling rates per table D01, the latest data is for August 2008

the major banks have been successfully growing market share – up from 64.4%* at September 2007 to 66.3%* at August 2008 – as competitors such as NBFIs were marginalised by the credit crisis. Undoubtedly this trend will have continued and probably accelerated since the latest official statistics were released.

Net Interest Margin

In recent years Australian bankers have come to expect that competitive and other pressures would see net interest margins reduce by roughly 10 basis points per annum. Given the unprecedented turbulence of the past year it is noteworthy that this rough rule of thumb should turn out to be relevant in FY08, with the weighted average net interest margin declining from 2.19% to 2.08%.

Interest margins and loans & acceptances



The point though is that the pressures behind this decline are quite different to previous years – competition driven by the NBFIs and foreign banks has given way to changes in funding and liquidity costs and a changed competitive landscape. For instance:

- the need for banks to hold elevated volumes of liquid assets as a safety buffer has reduced average NIM by 5 basis points;
- the credit crisis has pushed up the cost of credit and this higher cost of wholesale funds, net of repricing initiatives, has reduced average NIM by 7 basis points;
- because the real surge in consumer deposits only came in the final quarter, the banks actually increased their dependence on more expensive wholesale funding relative to consumer deposits during the year, which reduced margins by 2 basis points;
- “AIFRS volatility” added 3 basis points to NIM. This relates to the banks’ increased use of relatively cheaper offshore funding, which they then hedge for foreign currency risk. This lower funding cost increases NIM but such hedges do not meet the AIFRS definition for hedge accounting. As a result, the gain in NIM is offset by losses on these foreign currency contracts being reported through other operating income.

As we look ahead, we wonder whether the rule of thumb will continue to apply. Perhaps not, if competition in the near-term is less intense, if liquid assets can be released, and if spreads on wholesale funding reduce?

* Market shares are calculated by PwC based RBA/APRA data

Economic Outlook

Global

As at 31 October 2008, the global economic outlook is most uncertain and changing daily. The average growth in GDP across the globe for FY09 is slowing with the October IMF World Economic Outlook report forecasting global average growth of 3%. But averages hide the sizable diversity in growth rates between countries. Much hinges on China and India, the world’s 3rd and 12th largest economies respectively. If they can adapt to reduce their dependence on the USA, and to a lesser extent Europe, they should still grow by around 7–9% to drag up the global average. Concurrently a number of other economies are suffering significant downturns such as the UK, Italy, USA, Japan, New Zealand, France, Germany, Singapore and South Korea.

Some key economic trends which complicate the global outlook include:

- The financial contagion effect across many banks – primarily in the USA but also through the Eurozone – and continuing uncertainty as to the full extent of sub-prime related losses and their destination.
- Wall Street to Main St: this downturn is somewhat different, being driven by problems in the financial sector resulting in a tightening of credit, rather than contractions in either household spending or business investment. This downturn has now quickly spread across the USA and is impacting most industries. However, some harder hit sectors include residential construction, automotive, tourism and property. The big question is whether the \$US700 billion bank bailout and other bank ‘nationalisations’ will be effective in resuscitating new lending activity?
- A softening in commodity prices and oil as business and consumers reduce their production/consumption and adopt more efficient technologies.
- The rapid swings in several currencies, particularly the rising USD and Yen, and the plummeting \$A – these swings will alter trade competitiveness and export flows.
- Surging inflation with a wide variety of countries from most of the Eurozone, to South Africa, India, China and Brazil all having a CPI well above target levels. The big question is whether the downturn in GDP in these countries will be sufficient to ease price growth?

The major unresolved question for determining the global economic outcome for FY09 is to what extent the economies of China, India and Europe become tainted by the USA downturn. If they show agility in developing new export markets and growing their domestic economies we should record modest

global growth but if the contagion worsens a protracted global downturn appears the potential outcome.

Australia

Overall, the outlook for the Australian economy has deteriorated since the first quarter of FY09 as confirmed by the RBA’s historic 100bp rate cut on 7 October and the Federal Government \$10.4 billion stimulus package announced on 14 October. Hence we now expect a rockier landing from this downturn with some sectors being in ‘a world of pain’ until 2010.

Some key features of the Australian economic outlook include:

- Slowing GDP growth from 2.7% in FY08 to low 2%, and possibly less, in FY09. Australian GDP has been cushioned by our extended commodities boom – but if commodity prices continue to fall and if China stutters, with subsequent reductions in orders for Australian commodities, our risk of recession is far higher. Overall, relative to many other nations, Australia still has good scope to further apply fiscal policy and interest rate levers to try to achieve a softer landing to this downturn.
- Elevated levels of CPI expected to ease as petrol prices soften and consumer confidence levels remain low.
- The weakening Australian property market with more suburbs and market segments experiencing declines. However, our property prices are traditionally sticky on the downside, most cities have housing demand exceeding new supply, and the recent Federal stimulus package contained an increase in new home owner grants that could buoy demand.
- A slow rise in unemployment towards 5 – 6% across the south-eastern states.

Having said this, every time the economic outlook has been reconsidered in recent months the forecasts have deteriorated, and the above forecasts certainly have further potential downside risk. The key question remains: where is the bottom?



Scott Lennon

Senior Partner, PwC Economics
Tel: +61 (2) 8266 2765
Email: scott.lennon@au.pwc.com

Other Operating Income

In recent years other operating income has been a reliable source of considerable revenue growth. This has proved not to be the case in FY08, with other operating income growing less than 1% in FY08, well down on the previous year's growth of 10.8%. A substantial fall in trading income, and slower growth in wealth management income were the main factors behind this. Banking fees and commissions grew more quickly in the current year, up by 9% in FY08 compared to 4% in FY07.

Wealth Management

Revenue from the banks' wealth management businesses grew 6.6%, however, underlying cash earnings (income less operating expenses and tax) increased by 12% (FY07 13%), which is a creditable result given the difficult market conditions – for instance, the ASX 300 dropped 28% in the nine months to 30 September 2008. Market conditions have of course deteriorated further since that time.

Market data to June 2008 show that funds under management (FUM) contracted 11% between December 2007 and June 2008, reflecting lower asset prices and the 80% reduction in net inflows (sales less redemptions) in the year to June 2008. The funds under administration (FUA) market, which largely comprises the administration platforms, showed a market fall of 10% and a drop in annual inflows of 25%. Interestingly, the major banks appear to be faring better than some competitors with their market share* of total FUM gaining 60bps, and of FUA gaining 40bps, in the six months to June 08. These gains are significantly influenced by success in attracting wholesale funds.

However, with the overall value of investment markets down, these gains in market share may be small comfort. The Australian investment industry has entered a new phase. Negative returns are an industry-wide phenomenon with investors having received annual statements with negative returns for the first time in many years. PwC's Investment Management CEO Survey 2008 published in August confirmed that by far the biggest issues facing CEOs and investors alike are falling asset prices and investment performance.

The Government's bank deposits guarantee appears to be yet another blow to an industry that is already facing major challenges. Most diversified fund managers offer funds investing in fixed income and cash products which compete against bank deposits for funds. The Government guarantee is being blamed for a severe run on certain of these funds, causing managers to freeze redemptions. At the time of writing the industry is calling for a more level playing field and the Government is considering various options.

With everything that has happened, some fund managers are flagging large scale cost cutting.

However, the bank-owned wealth managers are undoubtedly buoyed to some degree by the reputation and balance sheet strength of their parent banks, a factor that would perhaps have been considered a hindrance only a short while ago.

Meanwhile the Government's recently announced comprehensive review of superannuation and tax policy will soon be under way. While formal terms are yet to be announced, reports suggest the review will cover operations, structure and costs of the compulsory superannuation industry with a view to reducing the fees ultimately paid by investors. With superannuation being a significant driver of funds into the banks' wealth managers, any structural changes to fees will have a lasting impact on their ability to generate profits. Managers will however also be hoping that the Government's commitment to delivering product rationalisation legislation arrives soon to provide some relief against the significant costs locked into maintaining out of date legacy products. One thing is for sure, once the markets settle down the landscape will be very different.

Bank Fees

Bank fees comprise two main categories – lending fees (30% of the total) and other fees and commissions (70%). Reflecting the relative strength in lending by the major banks for much of the year, lending fees grew by 9.1%, in line with the previous year. Other fees and commissions rose at a similar rate of 8.7%.

However momentum is unlikely to be retained. The latter part of 2008 has seen a slowdown in both consumer and business credit growth, which in turn is expected to reduce lending fee income. All sectors, including credit cards are being affected as consumers rein in their spending and the banks restrict business access to funds during the current crisis.

At the big end of town, fees from transactions as well as lending have dried up, with the volume of Australian capital raisings declining 35% in the year to September 2008 and the number of M&A transactions being well down on previous years.

Historically, the banks have looked to increasing fee rates as a way to offset slower revenue growth during downturns. This will be a very interesting area to watch over the next year, particularly given the increased regulatory focus on banks which is inevitable following the market turmoil.

For its part the Government stated a view on this matter very clearly it's Green Paper on Financial Services and Credit Reforms when outlining its proposals for mortgage products – “the Government does not intend regulating fees on the bases that regulation of bank fees and charges discourages new investment and innovation, increases compliance costs for the industry and may actually lead to an increase in prices for consumers. The Government considers a competitive market to be a more effective mechanism for driving down fees and

charges.” The Green Paper was released in June 2008, and of course much has happened since then. We suspect that the Government will have ample opportunity to express its views on these matters over the next twelve months!

Trading Income

Trading income was substantially lower in FY08, falling by some 43% compared with growth of 11% in the previous year. However, the FY08 results include some significant one-off losses associated with structured credit intermediation trades and the hedging of securitisation conduit risk. On our estimates, income from the banks' core trading operations improved modestly over the year, reflecting the trading opportunities thrown up by the more volatile market conditions.

Efficiency

On the face of it, the major banks put in a respectable performance on costs and efficiency in FY08, with total costs rising by 5.1%. This was not out of kilter with the overall increase in income of 7.7%, enabling an improvement in the aggregate cost-income ratio of 47.3% in FY08, compared to 48.5% FY07.

Headline expense to income ratios

	FY 08	FY07	FY06
ANZ	47.4%	44.9%	45.6%
CBA	48.9%	49.3%	50.6%
NAB	46.9%	50.8%	54.5%
SGB	38.7%	42.5%	44.0%
WBC	43.9%	45.0%	46.6%

The main driver again was salary costs, which rose 6.5% over the prior year. This was not surprising given the tight labour market conditions prevailing when the previous year's salary decisions were taken, and the fact that average FTE numbers rose by 3.4% over the year, mainly in frontline roles.

It needs to be noted that, in aggregate, the banks have also set aside more than \$1 billion of restructuring/core systems replacement costs which are excluded from their cash-based results. As foreshadowed previously, some of the banks are using the float proceeds from Visa International for these purposes.

In the new environment, costs are back at the top of the agenda. Success, however, will not be easy. A key question is how quickly they can get pay-off from ongoing major spending commitments on systems. The broader challenge will be to obtain efficiencies without reducing customer service standards, increasing operational risk, or otherwise jeopardising future revenue streams. This is especially important in those institutions which are integrating merged entities, where the risk of customer defection is particularly acute.

*Market size and market share estimates are calculated by PwC based on Morningstar data.

Whether implementing new systems or bedding in an acquisition, project risk is a very significant and often under-estimated risk. In an environment where there is no “rising tide” to cushion poor execution, implementation quality will be a key determinant of organisational success.

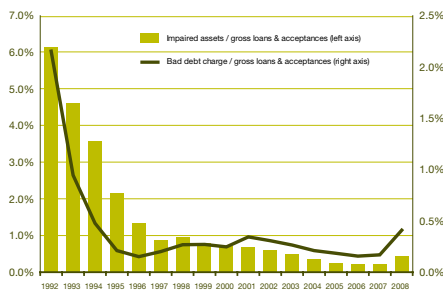
Asset Quality

Reflecting the deterioration in economic conditions, the banks’ combined bad debt charges have risen markedly, some 174% over FY07 (with 2H being 54% higher than 1H FY08). Including some charges taken below the cash earnings line, the increase in FY08 was 183%. This represents 41bps of total loans, a statistic we haven’t seen since 1994.

The increase was driven partly by a substantial increase in individual provisions on a small number of highly geared companies affected by the debt market turmoil, plus provisions raised in relation to one bank’s securitisation conduit assets. Collective provisions were also up significantly, including variously described overlays in response to the economic downturn.

Consistent with these trends, we have seen an increase in impaired assets, up by 137% during FY08 to represent 43bps of total loans. This is a similar level to that experienced in the early part of this decade and still significantly below the levels throughout most of the 1990s.

Impaired assets and bad debt expense



Notes: 2006 onwards based on AIFRS

At the same time we are also seeing marked increases in past-due loans. During FY08, loans which are “past due 90 days or more with adequate security” have increased 29% in aggregate.

Given our expectation that both the international and domestic economies will continue to slow over the foreseeable future, it must be expected that these trends will continue. The good news is that, overall, business balance sheets have been managed in a relatively prudent manner since the last serious recession, and the authorities have clearly signalled their intention to use monetary and fiscal levers to stimulate economic activity. In contrast, household balance sheets are much more highly geared than 15 years ago, so this will most likely be a dampener on economic activity as households adjust to the new environment. Understanding these trends requires us to delve into the different sectors.

Household Lending

Lending to households is predominantly via mortgages secured by residential property (roughly 85% of all household borrowing, and 57% of the banks’ total loans). In addition, households borrow through personal loans 10% and credit cards 5% which are generally unsecured. From the banks’ perspective, the most important factor is serviceability – can the borrowers meet their ongoing commitments?

For the household sector overall, this depends primarily on employment and interest rates. Employment provides borrowers with cash flow (wages) to repay their debt; history shows that employment is the key driver of a household’s ability to service debt. It is important to remember that unemployment is coming off 30 year lows, and while it is forecast to rise from 4.3% to potentially 6% over the next year, this is still low by historic levels and so provides hope that household financial stress will not translate into widespread failure to service loans. This is further buoyed by the prospect that housing interest rates have begun to decline. On the other hand, banks are very mindful that household debt is at record levels.

In those cases where a borrower is unable to service the debt, the bank’s position depends critically on the extent and quality of security held. As noted above, most lending to households is secured by residential property and to date house prices in Australia have held up relatively well, in contrast to many overseas markets especially the US and the UK. This reflects the fact that there has been relatively little forced selling of homes to date in Australia, and so long as employment holds up reasonably well, we expect this to continue. There will of course be variations in different markets; for instance, regional coastal areas which have a large “second (holiday) home” component may come under stress, while the Reserve Bank has highlighted stresses in the western suburbs of Sydney.

In short, the continuing sound quality of the banks’ household lending book depends primarily on the path of unemployment and then on the path of house prices. A major deterioration in either would have a marked flow-on effect for the banks.

Business Lending

Serviceability in business lending is driven by different factors. In general businesses need to generate profits to service and repay debt. So far, reported business profitability has held up reasonably well reflecting the steady, if not spectacular, growth of the economy in recent times. The question of course is how the further slowing of the economy will impact on business profitability, although lower interest rates and the falling Aussie dollar will serve as partial offsets.

In addition to profits, a company’s ability to service debt depends on its overall debt load (most commonly measured in terms of gearing ratio). In general, non-financial businesses (perhaps other than some infrastructure and utility companies) are going into these difficult economic times with strong balance sheets and relatively low levels of gearing. Although available data are limited, it seems that, in aggregate, gearing ratios are currently roughly in line with the average of the last 15 years. Unlike the experience of the late 1980s, this credit cycle has not been reflected in a dramatic increase in gearing by business.

The last factor that impacts the ability to service debt is the interest rate paid by the business. Both reference-rate spreads and creditworthiness spreads have increased dramatically since July 2007 and consequently businesses have experienced a significant increase in the cost of debt since June 2007, although the recent easing of monetary policy is providing some domestic reprieve.

Having painted a relatively stable picture, there are some genuine fears. If the recent steps taken to unfreeze the lending pipes do not work, and credit rationing by the banks continues, there could be some real stress amongst corporates. Further, if the economy does take a serious turn for the worse, credit losses will undoubtedly spike.

Safe to say, we are living in times of unprecedented uncertainty and you’d be brave to make too many predictions. We refer you to the PwC Banking Gauge on the front page!



Some key events of the past 18 months

Feb-Mar 2007	<ul style="list-style-type: none"> Signs of problems with US sub-prime housing assets start to emerge in bank 1st quarter earnings announcements, following a sharp rise in arrears and delinquencies, as teaser rates mature to standard rates, interest rates rise generally, and US house prices fall. 	<p>HSBC sets aside US\$10.56b for losses on US home loans</p>	<ul style="list-style-type: none"> IMF predicts that the credit crunch will be broader, deeper and more protracted, indicating total losses will reach US\$1trillion. 	<p>UBS seeks USD15.5b of capital.</p>
Mar-Jun 2007	<ul style="list-style-type: none"> Special Purpose Vehicles start to default on interest payments as underlying mortgage borrower defaults rise, forcing a number of loan originators to halt operations. 	<p>New Century Financial files for Chapter 11</p>	<ul style="list-style-type: none"> Short-term money market spreads settle at 40–50bps (up from 10–15bps before credit crunch). Longer-term debt markets continue to function, providing funds for quality borrowers, albeit at higher spreads. Banks step up capital raising efforts and equity markets appear to settle. 	<p>Barclays raises GBP4.5b and the Qatar Investment Authority invests a further GBP1.7b in the bank</p>
Jul 2007	<ul style="list-style-type: none"> Rating agencies re-rate billions of dollars of CDOs, which results in massive portfolio revaluations and a loss of confidence in the debt markets. 	<p>Moody's and S&P downgrade USD \$17b of subprime CDOs</p>	<ul style="list-style-type: none"> Banks continue to identify new losses. US Treasury provides guarantees to Fannie Mae and Freddie Mac. Commodity prices soar as oil hits record US\$147 a barrel and A\$ reaches post float high of US98.49c 	<p>HBOS announces a 72% decline in profits for 1H08</p>
Aug 2007	<ul style="list-style-type: none"> Credit markets freeze and spreads reach highs not seen for several decades. Hardest hit are the securitisation market and highly leveraged financial institutions. Talk of US\$700b–\$900b of losses on US subprime mortgages starts to emerge. Central banks pump funds to provide liquidity. 	<p>RAMS – market conditions disrupt operations and the franchise is sold to WBC. A number of hedge funds start to fail – eg Bear Stearns and Basis Capital</p>	<ul style="list-style-type: none"> OECD forecasts recessions for UK and some European countries. 	<p>Belgium, Luxemburg & Dutch Governments bail out Fortis Group & Dexia.</p>
Sept 2007	<ul style="list-style-type: none"> Notwithstanding the collapse of Northern Rock, interest spreads start to stabilise, albeit at levels higher than those seen for many years. Confidence grows that things will start to settle down. Central banks, including Reserve Bank of Australia, expand eligible securities for open market operations to include some RMBS and ABCP to ensure liquidity in the markets. 	<p>Northern Rock – the first run on a UK bank in 150 years sees queues outside the branches as worried depositors withdraw funds</p>	<ul style="list-style-type: none"> In what may be seen in time as the seminal event, Lehman Bros files for bankruptcy having posted a US\$3.9b 2nd quarter loss and failing to strike a rescue deal. Merrill Lynch quickly seals a deal with Bank of America to avoid a similar fate. The Federal Reserve also provides a lifeline to insurer AIG of US\$85b, with strict conditions attached. This rises to US\$123b a month later. The only two remaining Wall St banks, Goldman Sachs and Morgan Stanley, apply for commercial bank status so that they can raise deposits. 	<p>HBOS is sold to Lloyds TSB for GBP12b to avoid bankruptcy. UK Government moves to nationalise Bradford & Bingley, with its profitable franchise being sold to Santander and to guarantee bank deposits up to GBP50k.</p>
Oct/Nov 2007	<ul style="list-style-type: none"> Third quarter earnings announcements highlight problems in US banks. A number of sovereign wealth funds take equity positions in US and European banks. Apart from selected financial services stocks, the equity markets appear generally unaffected by events in the debt markets. 	<p>UBS announces \$3.4b of losses and Citigroup announces \$9b of losses primarily related to US sub-prime.</p>	<ul style="list-style-type: none"> Washington Mutual is sold to JP Morgan; Wachovia to Wells Fargo; HBOS to Lloyds TSB; a host of other banks are effectively nationalised. Credit spreads reach near historic highs as liquidity dries up. Global losses mount – US\$520b, but forecast of US\$1trillion still stands. Regulators temporarily ban short selling. Governments buy toxic assets to free up the markets: <ul style="list-style-type: none"> US Government negotiates with US Congress for \$700b bailout package to buy toxic assets. UK Government purchases GBP150b toxic assets from Northern Rock and B&B 	<p>Irish Government guarantees all bank deposits for 2 years. Iceland nationalises Glitnir, their 3rd largest bank.</p>
Dec 2007	<ul style="list-style-type: none"> Highly leveraged institutions start to experience difficulties as rollover funding is unavailable in the stalled debt market. Losses reported by global banks reach US\$400b. Monoline insurers start to suffer with rating agencies downgrading their debt. 	<p>Centro alarms Australian markets as difficulties emerge in rolling over \$3.9b of short-term debt.</p>	<ul style="list-style-type: none"> Data indicates US and a number of European economies are heading towards recession. Seven US and European central banks simultaneously cut interest rates. In Australia the Reserve Bank drops interest rates by 1% and further expands domestic market liquidity facilities. Governments step up their response to the crisis: <ul style="list-style-type: none"> US Congress finally passes US\$700b rescue package to buy toxic assets and invest in ailing banks Australian Government provides deposit and funding guarantees, and announces a \$10.4b economic stimulus package. UK and European Governments inject capital into their banks by taking equity stakes and buying toxic assets to revive bank balance sheets 	<p>Lloyds TSB/HBOS merger and RBS benefit from Government cash injection in return for equity. UBS receives US\$5.3b in capital</p>
Jan 2008	<ul style="list-style-type: none"> Equity markets fall as contagion from the debt markets finally starts to have an impact and the long bull run comes to end. In Australia, margin calls start to mount, with a number of high-profile directors exposed by heavy debt loads which had been used to acquire stock. 	<p>Issues over securities lending at ANZ emerge and both ANZ and NAB announce increased provisions for 1H08. Macquarie and Babcock & Brown stock suffer heavy falls</p>	<ul style="list-style-type: none"> These measures provide no relief yet to global stock markets, with the ASX 300 being 40% below its level of a year ago. 	<p>Credit Suisse raises US\$8.8b from Qatar Investment Authority. Iceland Government takes control of Landsbanki, the country's 2nd largest bank.</p>
Feb 2008	<ul style="list-style-type: none"> More problems start to emerge through margin lending and equity finance. It is clear that certain market players are short selling highly-leveraged stocks. Australian banks start to flag higher debt provisions. 	<p>Issues over securities lending at ANZ emerge and both ANZ and NAB announce increased provisions for 1H08. Macquarie and Babcock & Brown stock suffer heavy falls</p>		
Mar 2008	<ul style="list-style-type: none"> US Federal Reserve brokers a deal for JP Morgan to buy Bear Stearns for US\$240m, supported by \$300b of central bank loans. Short-term money spreads blow out again. Equity markets are down 15% in 3 months. 	<p>Northern Rock is nationalised in March 2008</p>		

Key banking statistics – Full year 2008

	ANZ			CBA			NAB			SGB			WBC		
	12mths Sep-08	12mths Sep-07	12mths Sep-06	12mths Jun-08	12mths Jun-07	12mths Jun-06	12mths Sep-08	12mths Sep-07	12mths Sep-06	12mths Sep-08	12mths Sep-07	12mths Sep-06	12mths Sep-08	12mths Sep-07	12mths Sep-06
Balance sheet															
Total assets	471,024	392,773	334,640	487,572	440,157	369,103	656,799	574,220	484,785	147,380	125,800	107,002	439,548	377,653	299,578
Risk weighted assets (v)	275,434	275,018	240,219	205,501	272,609	216,438	343,511	355,226	318,323	75,162	63,226	52,982	195,505	228,077	193,417
Total loans and acceptances (Gross)	355,980	307,384	273,166	383,502	337,339	280,282	438,303	390,984	346,689	120,399	106,552	93,723	315,490	276,746	235,684
Asset quality & provisioning															
Gross impaired assets	2,673	702	698	683	421	326	2,149	1,094	904	191	139	83	1,177	540	521
Net impaired assets	1,998	432	412	316	222	155	1,504	787	720	146	105	52	642	274	264
Gross impaired assets as a % of loans and acceptances	0.75%	0.23%	0.26%	0.18%	0.12%	0.12%	0.49%	0.28%	0.26%	0.16%	0.13%	0.09%	0.37%	0.20%	0.22%
Individually assessed provisions	675	270	286	367	199	171	645	307	184	45	34	31	413	148	164
Individually assessed provisions % of impaired assets	25.3%	38.5%	41.0%	53.7%	47.3%	52.5%	30.0%	28.1%	20.4%	23.6%	24.5%	37.3%	35.1%	27.4%	31.5%
Collective provisions	2,821	1,992	1,940	1,378	1,057	1,070	2,318	1,800	1,838	370	291	268	1,761	1,410	1,194
Collective provisions % of non housing loans & acceptances	1.57%	1.33%	1.46%	0.82%	0.79%	0.95%	0.97%	0.88%	1.05%	0.82%	0.78%	0.86%	1.02%	1.14%	1.16%
Total provisions	3,496	2,262	2,226	1,745	1,256	1,241	2,963	2,107	2,022	415	325	299	2,174	1,558	1,358
% of risk weighted assets (v)	1.27%	0.82%	0.93%	0.85%	0.46%	0.57%	0.86%	0.59%	0.64%	0.55%	0.51%	0.56%	1.11%	0.68%	0.70%
% of loans & acceptances	0.98%	0.74%	0.81%	0.46%	0.37%	0.44%	0.68%	0.54%	0.58%	0.34%	0.31%	0.32%	0.69%	0.56%	0.58%
Profit & loss analysis (i)															
Net interest income	7,850	7,302	6,943	7,907	7,036	6,514	11,142	9,765	8,777	2,473	2,193	2,015	7,223	6,313	5,642
Other operating income	3,645	3,720	3,146	6,452	6,013	5,322	5,210	5,704	5,465	1,143	1,045	898	3,894	3,773	3,456
Total expenses	5,444	4,953	4,605	7,021	6,427	5,994	8,214	8,327	8,148	1,386	1,390	1,290	4,876	4,543	4,295
Core earnings	6,051	6,069	5,484	7,338	6,622	5,842	8,138	7,142	6,094	2,230	1,848	1,623	6,241	5,543	4,803
Bad debt expense	1,948	522	407	930	434	398	2,489	790	605	291	178	144	931	482	375
Profit before tax	4,103	5,547	5,077	6,408	6,188	5,444	5,649	6,352	5,489	1,939	1,670	1,479	5,310	5,061	4,428
Income tax expense	1,066	1,616	1,486	1,631	1,730	1,576	1,408	1,722	1,563	561	505	446	1,511	1,487	1,295
Minority interest	8	7	4	31	27	31	(1)	0	13	1	2	1	73	67	54
Cash earnings after tax before significant items (underlying profit) (ii)	3,029	3,924	3,587	4,746	4,431	3,837	4,242	4,630	3,913	1,377	1,163	1,034	3,726	3,507	3,079
Operating profit after tax and outside equity interests (iii)	3,319	4,180	3,688	4,791	4,470	3,928	4,536	4,578	4,392	1,205	1,190	1,037	3,859	3,451	3,071
Key data															
Other operating income (% of total income)	31.7%	33.8%	31.2%	44.9%	46.1%	45.0%	31.9%	36.9%	38.4%	31.6%	32.3%	30.8%	35.0%	37.4%	38.0%
Interest spread	1.58%	1.72%	1.86%	1.68%	1.75%	1.90%	1.69%	1.79%	1.88%	1.66%	1.81%	1.93%	1.76%	1.85%	1.92%
Interest margin	2.01%	2.19%	2.31%	2.02%	2.08%	2.22%	2.20%	2.28%	2.31%	1.91%	2.01%	2.11%	2.07%	2.19%	2.29%
Expense/income ratio (headline ratio cash basis)	47.4%	44.9%	45.6%	48.9%	49.3%	47.7%	46.9%	50.8%	54.5%	38.7%	42.5%	44.0%	43.9%	45.0%	46.6%
Total number of full time equivalent staff	36,925	34,353	32,256	39,621	37,873	36,664	39,729	38,822	38,419	8,420	8,722	8,598	28,302	28,018	27,224
Operating costs per employee (dollars)	147,434	144,180	142,764	177,204	169,699	163,485	206,751	214,492	212,083	164,608	159,367	152,862	172,285	162,146	157,765
Return on average equity % (cash basis)	13.2%	19.6%	20.1%	20.4%	21.7%	21.3%	14.3%	17.1%	15.9%	21.5%	23.2%	22.9%	22.3%	23.8%	23.0%
Capital ratios (v)															
Tier 1	7.70%	6.70%	6.80%	8.17%	7.14%	7.56%	7.35%	6.67%	7.35%	6.60%	6.70%	6.90%	7.80%	6.50%	6.90%
Tier 2 (Net of deductions)	3.40%	3.40%	3.80%	3.41%	2.62%	2.10%	3.58%	3.32%	3.46%	3.80%	3.50%	3.90%	3.00%	3.00%	2.70%
Total	11.10%	10.10%	10.60%	11.58%	9.76%	9.66%	10.93%	9.99%	10.81%	10.40%	10.20%	10.80%	10.80%	9.50%	9.60%

All figures in AUD million unless otherwise indicated

- i In arriving at "underlying profit", income and expenses exclude significant items and certain non cash items. Significant items include the impact of accounting changes, gains on disposal of businesses and other items reported by the banks. Some components of income and expenses have been reclassified to improve comparability between banks.
- ii NAB underlying cash earnings after tax before significant items are shown before distributions to holders of National Securities – September 08 \$312 million, Sept 07 \$283 million, Sept 06 \$254 million

- iii Statutory result as reported by the banks, unadjusted
- iv 2007 and 2006 comparatives have been updated where information is available
- v 2008 figures for ANZ, CBA, NAB and WBC are based on Basel II. All other figures are based on Basel I.

Five major's combined performance – \$A million – underlying cash earnings

	FY 08	FY07	FY06	FY08/07
Net interest income	36,595	32,609	29,891	12.2%
Other operating income	20,344	20,255	18,287	0.4%
Total income	56,939	52,864	48,178	7.7%
Operating expense	26,941	25,640	24,332	5.1%
Core earnings	29,998	27,224	23,846	10.2%
Bad debt expense	6,589	2,406	1,929	173.9%
Tax expense	6,177	7,060	6,366	(12.5%)
Outside equity interests	112	103	101	8.7%
Underlying cash earnings after tax before significant itmes	17,120	17,655	15,451	(3.0%)

pwc.com/au/mba

Sydney

Michael Codling
Banking and Capital Markets Leader
michael.codling@au.pwc.com

Melbourne

Mark Laurie
mark.laurie@au.pwc.com

Brisbane

Graham Sorensen
graham.sorensen@au.pwc.com

Adelaide

Kim Cheater
kim.cheater@au.pwc.com

Perth

Andrew Edwards
andrew.edwards@au.pwc.com

New Zealand

Warwick Hunt
warwick.hunt@nz.pwc.com

For further information or copies of this report please contact

Michelle Tickle
+61 (2) 8266 1133
michelle.tickle@au.pwc.com
www.pwc.com/au/mba

Disclaimer:

These notes are not intended to be comprehensive. Readers are advised that before acting on any matter arising in these notes, they should discuss the situation with a PricewaterhouseCoopers specialist partner.

© 2008 PricewaterhouseCoopers. All rights reserved. "PricewaterhouseCoopers" refers to PricewaterhouseCoopers, a partnership formed in Australia or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.



This document is printed on ecoStar, which is an environmentally responsible 100% recycled paper made from 100% post-consumer waste that is FSC CoC certified and bleached chlorine free (PCF). The mill operates under the ISO 14001 Environmental Management System which guarantees continuous improvement and is PEFC certified for traceability.