

Banking on change



\$14.8bn

Half-year underlying cash earnings

16.2%

Return on equity, up 50bps

2.08%

Margins, close to all time low

Banking on change

The major banks half year underlying cash earnings of \$14.8 billion is yet another record and reinforces their broad-based contribution to the Australian economy, a theme common to each of their submissions to the Financial System Inquiry.

The \$14.8 billion result represents an increase of 5.8 per cent compared to the prior half (hoh) and 10.1 per cent compared to the prior comparable period (pcp). Total revenue was \$40.2 billion, up 5.7 per cent on a year ago. Improvement in lending volumes and non-interest income were sufficient to offset a reduction in net interest margins and an uptick in cost growth.

The global scene

One driver of these results has been continued improvement in global financial conditions, which has benefited the Australian banks through reduced wholesale credit spreads for bank bonds, which are currently around their lowest level since 2009.

The relative stability of global financial conditions over the past six months has also seen regulators in a number of jurisdictions begin to lay the foundations for a return to more normal arrangements. Perhaps the most notable of these is the gradual scaling back of 'quantitative easing' arrangements in the US, with monthly bond purchases now running at \$45 billion per month, compared to \$85 billion in late 2013. We have also seen the first tentative steps in some countries of retightening monetary policy, including New Zealand where the official cash rate has risen from 2.5 per cent to 3 per cent since March. Other countries which have also tightened include South Africa, India, and Turkey. In Australia, the easing bias has been softened to a more neutral tone. Nonetheless, global interest rates look set to remain low for an extended period.

The Australian Prudential Regulatory Authority (APRA) has also announced additional measures to increase core capital requirements – an extra 1 per cent core capital buffer for the four major banks to reflect their systemic importance to the domestic banking system, and revisions to the treatment of non-recourse debt in wealth management subsidiaries. Both changes have been well-flagged and are consistent with a prudential regulator keen to see some insurance cover set aside for the next down-cycle.

Dynamics of the banks' Australian balance sheet

Low interest rates continue to have a positive impact on demand for credit in Australia, particularly for investment home loans. Total growth in housing loans is closing in on 6 per cent per annum, well above the historic trough of 4 per cent a year or so ago.

We continue to believe that we are not seeing a generalised boom in house prices, but there is considerable variation between locations. For example, the recent construction surge in Melbourne and other parts of Victoria (now coming to an end), has left supply and demand in better balance, while Sydney has been slower to ramp up construction in light of supply shortfalls.

Growth in business loans remains more subdued but, like housing, has lifted from the lows of twelve months ago. Over the past year business credit has grown by 2.6 per cent compared to 1.7 per cent over the previous year. There is some anecdotal evidence this will pick up further, together with continuation of recent trends for larger corporates to borrow directly via bond issues.

In all, total bank loans and advances have grown by 6.8 per cent over the year to March, compared to 5.2 per cent a year ago.

While bank lending has accelerated, deposit growth has slowed. Core bank deposits grew by 7.3 per cent in the year to March, compared to 9.9 per cent in the year to March 2013.

With growth rates for bank lending and bank deposits now roughly similar, the dollar increase in lending will start to exceed the dollar increase in bank deposits (total lending being 40 per cent bigger than total deposits) requiring the banks to look to non-deposit sources of funding via wholesale markets. Those markets seem quite comfortable with that prospect at present. Reflecting that trend, the ratio of core deposits to bank lending has edged back to 70.3 per cent as at March, compared to the post-GFC peak of 71.3 per cent, reached in December 2013.

Four majors' combined performance

Cash earnings – A\$ million

	1H14	2H13	1H13	1H14 vs 2H13	1H14 vs 1H13
Net interest income	27,728	26,884	26,151	3.1%	6.0%
Other operating income	12,434	11,745	11,828	5.9%	5.1%
Total income	40,162	38,629	37,979	4.0%	5.7%
Operating expense	17,558	16,905	16,327	(3.9%)	(7.5%)
Core earnings	22,604	21,724	21,652	4.1%	4.4%
Bad debt expense	1,854	2,315	2,745	19.9%	32.5%
Tax expense	5,901	5,377	5,424	(9.7%)	(8.8%)
Outside equity interests	54	53	49	(1.9%)	(10.2%)
Cash earnings	14,795	13,979	13,434	5.8%	10.1%
Statutory results	14,066	13,669	12,321	2.9%	14.2%

Major banks performance

Against the backdrop of fairly benign economic conditions, the banks have performed well:

- Increased revenues from asset growth in housing and margin compression as asset price competition is only partially offset by declining funding costs. Net interest margins have contracted 19 bps over the last two and a half years.
- Stronger performances from offshore operations, in New Zealand as the economy takes off, and Asia, where the banks are beginning to achieve critical mass delivering improved efficiencies and returns on investment.
- Profits from wealth management operations have improved up 10.3 per cent over the year, reflecting the relatively stable equity markets and improved life office claims experience and lapse rates.
- Bad debt expenses are at the low end of normal. Reflecting improving business conditions and no deterioration in the quality of the housing book.
- Expenses are beginning to climb due to rising salaries and technology costs.

Outlook

The major banks have a tone of cautious optimism in their most recent outlook statements, and it is hard not to agree with that as the most appropriate view. As always, there are risks and uncertainties in the global economy, but with the US stable-to-stronger and China stable-to-weaker the broad factors seem well balanced, especially as global markets seem content to take developments in their stride at present. Likewise, the adjustment in Australia from mining investment to other sources of demand proceeds, and the tenor in the business and financial community is of adjusting to a period of lower growth. The Federal Budget, due in a few days' time, is unlikely to upset that consensus materially.

For the banks, the business challenges continue to be realigning their businesses to the requirements of the digital economy, while responding to increasing regulatory requirements and community expectations, and at the same time meeting the well-established market expectations of ongoing growth in profit.

One notable shift over the past six months which will continue to play out for some time is the greater focus by each of the banks on their payments capabilities. In part, progress domestically on the new 'real-time payments' infrastructure is concentrating everyone's attention on payments. More generally, continued globalisation, increasing technical sophistication, and rising affluence is fueling global consumer and business demand for convenient, integrated payments solutions. Cyber security issues are concentrating attention as well. To be successful, banks need to solve for innovation, flexibility and speed to market. However this is undeliverable without a resilient payment platform. In the high volume, low value retail space, without a resilient payments platform, banks will struggle to compete with offerings from the technology giants, including Paypal, Google, Amazon and Apple. Equally, in the lower volume, high value corporate market, those banks that can deliver on the promise of a resilient platform will steal the march on those that compete only on price.

The deliberations of the Financial System Inquiry will also take an increasing share of market attention in coming months, with the interim report expected in July and the final report due in November. We outline some of our thoughts around the impacts of the Financial System Inquiry in more detail later in this report.

So what does this mean for bank profitability? The PwC Banking Gauge – a consensus view across four leading banking analysts - predicts that the four major banks will deliver cash earnings growth of 8.3 per cent in FY14, 4.1 per cent in FY15 and 5 per cent in FY16.

Note: PwC Banking gauge is a consensus view across four banks with four of Australia's leading analysts – Brian Johnson (CLSA), James Ellis (Credit Suisse), Jonathan Mott (UBS), and Scott Manning (JP Morgan).

One notable shift over the past six months which will continue to play out for some time is the greater focus by each of the banks on their payments capabilities.

A time to inquire – An update on the Financial System Inquiry

Developments in the Financial System Inquiry since November 2013 have largely proceeded as we anticipated at that time, with very broad Terms of Reference, finalised in December 2013. Over 270 submissions have been made to the Inquiry from all industries and sectors. The core focus of the Inquiry remains how best the financial system can contribute to maintaining Australia's strong economic growth record in coming decades. However, the attention placed on technology trends by the Wallis Committee has continued to feature heavily.

On 1 May, David Murray, the Inquiry Chairman, confirmed that he expects to issue an interim report in July, and flagged three areas of particular interest:

Moral hazard – the expectation that government will stand behind the financial system to prevent or minimise loss;

Funding – potential consequences of current system settings for the flow of funds in the financial sector and the economy, and;

Drivers of change – regional and demographic change, but especially technology and innovation.

He also emphasised the challenging trade-offs involved in these issues, especially in relation to risk, quoting, with approval, the RBA's comment:

“the role of the financial sector is not to remove risk entirely... The socially optimal amount of risk is almost certainly not the minimum feasible level, given the importance of risk-taking to innovation and entrepreneurship”.

The core focus of the Inquiry remains how best the financial system can contribute to maintaining Australia's strong economic growth record in coming decades.

This last point particularly resonates with PwC's submission as, having considered developments, theory and trends, we argued that:

“Australia needs to tread a balanced path in financial services to reward risk-taking and innovation – the driving forces of economic growth – while ensuring systemic risk in the financial system is kept within appropriate bounds. We need to resist the sense that government can or should be eliminating risk. Overly complex regulation can have the perverse effect of compounding rather than reducing risk. Therefore, ongoing simplification of the regulatory burden must remain our focus. Taking the aforementioned into consideration it is also important to recognise that innate to governments is the role they play mitigating against the inherent uncertainty of the future while providing benefits for the economy. For instance, maintaining a back-stop role in relation to the banking system overall or delivering genuine economic benefits through the strength of their balance sheets.

The global banking sector is about to undergo a live experiment in adapting to substantially increased requirements for liquidity (from January 2015) and funding (from January 2018). For its part, Australia needs to take extreme care to not place too great a focus on excessive leverage and mismatch risk, and not enough on encouraging new sources of economic activity and growth. Potentially, reducing mismatch and liquidity risk will provide the banking system room to increase risk elsewhere in the financial system – provided it is well understood and balanced by commensurate reward expectations”.

Technology and innovation as drivers of change

Since the late 1960s when information technology was first applied on a systemic basis in the Australian financial system, technology has become one of the most persistent and pervasive trends in the system, with critical benefits flowing to customers and shareholders. The economy as a whole has enjoyed significant spin-off benefits as technology skills nurtured in the finance sector have migrated to other sectors. The question is not whether the impact of technology on the Australian economy and the financial system will accelerate in coming decades, but rather how far-reaching these impacts will be.

In a world where speed to market and agility are going to be key in differentiating those who will be able to innovate from those who will be left behind, we need to ensure a robust system that allows for failure and risk-taking as part of the growth cycle. Information, and its increasingly rapid dissemination, and technology are continuing to empower customers and drive their purchase preferences.

Technology itself is evolving rapidly, creating the ability for innovators, disruptors and incumbents to analyse significant amounts of structured and unstructured data in real time. This in turn enables organisations to gain greater insights into the behaviour and needs of their customers.

Enabling organisations to utilise available technology, encourages innovation and creation of products and services that match the needs of tomorrow's consumer, inspiring trust and generating increased value for our the banking sector and the financial system as a whole.

Technology and innovation have been highlighted as key drivers of change against the backdrop of our broader discussion of the philosophy and objectives of the financial system. In addition, we considered three areas in some detail – superannuation, bank funding, and taxation.

Superannuation

The superannuation industry has experienced much change over the past 10 years, particularly in relation to increased regulation and industry consolidation. It plays a key role in generating and harnessing savings to sustain growth and living standards, and contributing to inter-generational equity. Whilst the superannuation industry is essentially operating effectively, there are a number of areas that could be changed to increase its efficiency, stability and sustainable growth. These include: streamlining the regulatory environment and addressing costs; improving governance; improving fund effectiveness through widening the investment pool, extending tax rollover relief, removing barriers to annuities and the restriction of lump sums.

The question is not whether the impact of technology on the Australian economy and the financial system will accelerate in coming decades, but rather how far-reaching these impacts will be.

Funding

Like superannuation, the banking industry plays an integral role in allocating capital, including credit, across the economy. However, the GFC highlighted the extent of vulnerability arising from banks placing too heavy a reliance on short duration wholesale debt to fund longer-term assets. Despite changes to funding and risk policies, the question still remains whether Australia's current funding arrangements are sufficient to fund the investment required for economic growth. The target of eight per cent annual credit growth, which has been suggested as being required to bring the economy up to trend economic growth, would test the current funding model for banks.

The recommendations found in our submission are aimed at mitigating this potential funding gap, to encourage deposit growth and source additional wholesale funds from the domestic bond market.

Taxation

The complexity and uncompetitive nature of the Australian taxation system contributes to both the distortion of the financial system's allocation of capital and capital flows. It is critical that the Inquiry considers not only tax impediments to an efficient and effective allocation of capital but those that would attract/promote greater capital flows into and out of Australia. However, this issue can only be effectively addressed within the broader context of wide-ranging tax reform. Therefore, our recommendations address both taxation issues within the financial system specifically and also related and contingent issues within the taxation system more broadly. They include the changes in approach to the taxation of property and overhauling the imputation system.

As we remarked last November, the recommendations of the 1981 Campbell Inquiry into banking have been so enduring precisely because it clearly anticipated where the world was headed and made the case for Australia to move in line with these trends. Will this inquiry continue on its current path towards future-focused change versus short term gains? Current indications are pointing to it being just as far sighted, but the challenge remains.

“Australia needs to tread a balanced path in financial services to reward risk-taking and innovation – the driving forces of economic growth – while ensuring systemic risk in the financial system is kept within appropriate bounds.”

PwC's full submission to the Inquiry is available at www.pwc.com.au/fsi

Net interest income

**Credit growth
4.4 per cent per
annum to March
2014, gradually
picking up pace.**

**The main driver
is investor
housing, up
7.9 per cent over
the year.**

Credit growth

Total intermediated credit now stands at \$2.2 trillion, with banks continuing to account for 85 per cent of this total.

Household credit

Housing credit grew by 5.9 per cent in the year to March 2014, up from 4.4 per cent in the previous year. Housing credit now accounts for 60 per cent of total credit, the highest it has been since deregulation.

Investor housing has been particularly strong. Over the past six months, investor loan outstandings have risen at an annualised rate of 8.6 per cent, well above the 4.8 per cent annualised growth in the six months to March 2013 and the highest since mid-2010. By contrast, the equivalent growth in owner-occupier loans was 4.5 per cent in the latest six months, not much higher than the 4.2 per cent of a year ago.

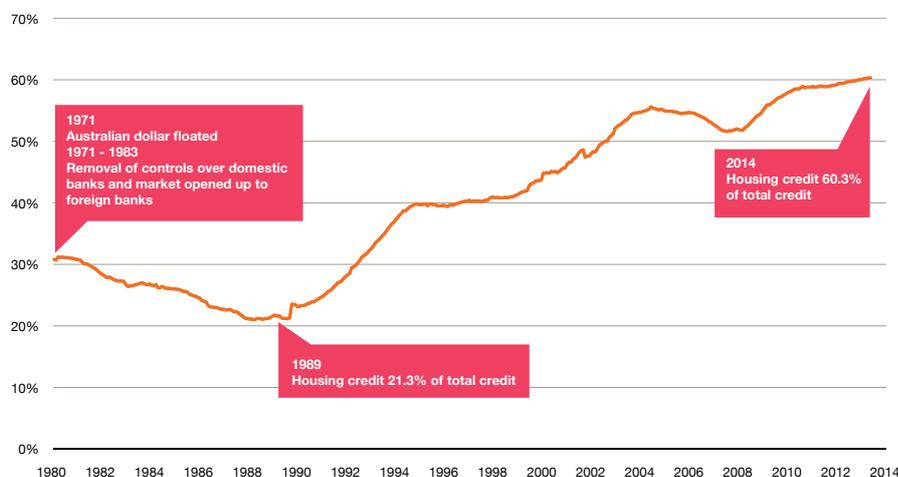
We believe this stronger growth in investor home loans is more in the nature of 'catch-up' after a period of subdued growth relative to owner-occupier loans rather than anything else. Investor loans are currently 33 per cent of home loans compared to a peak of 34 per cent in the mid-2000s. Some specific markets are being influenced by offshore demand and by demand from self-managed super funds but these are not exerting undue national influence.

Nonetheless, recent media coverage of rising house prices is clearly influencing expectations with a recent Melbourne Institute - Westpac Consumer Sentiment Survey indicating consumers believe that real estate is currently the wisest place to save, ahead of deposits, paying down debt and equities, although the same survey also noted that the time to buy a house has passed its peak, possibly reflecting the impact of recent price increases on their perception of value for money.

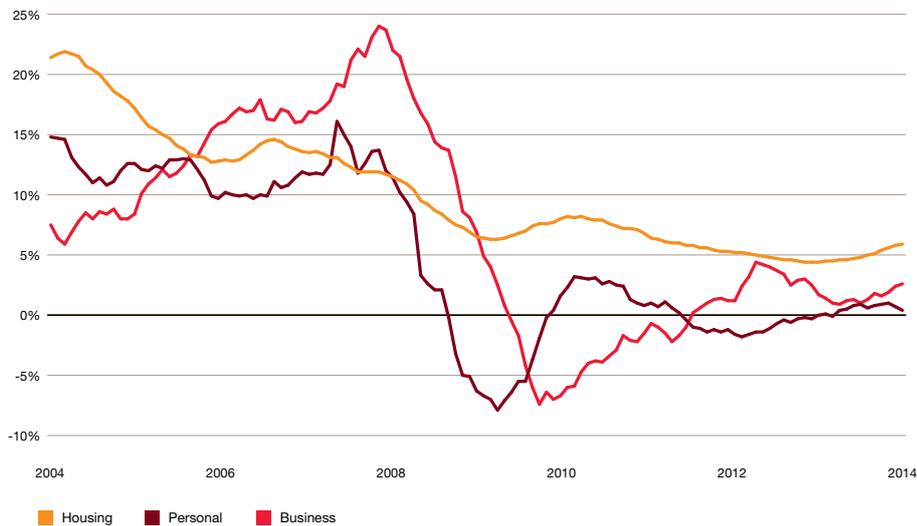
The major banks' market share of housing credit, at 77.7 per cent, has slipped backwards marginally (63 bps) since September 2013, with other banks and non-banks gaining some ground.

Personal lending continues to bounce around a very flat trend. It grew by 0.4 per cent per annum in the twelve months to March 2014, after being flat in the preceding period.

Total housing credit as a proportion of total credit



Domestic Credit Growth (Annual per cent growth)



Business credit

Business credit grew 2.6 per cent per annum to March 2014, a little higher than the 1.7 per cent of a year ago. The overall picture remains one of a business sector which is not highly geared but which continues to be cautious about borrowing for investment purposes. For larger corporates issuing bonds directly into the market remains an attractive option. This trend is consistent with overseas markets such as the US and UK which have both seen debt market funding growing more rapidly than intermediated business credit.

The major banks market share of business credit shrank 26 bps compared with September 2013 largely due to one particular foreign bank making significant gains.

Businesses have stopped deleveraging, but demand for credit remains weak at 2.6 per cent per annum.

Bank deposit growth slowed from 9.9 per cent to 7.3 per cent per annum.

Both household deposit and business deposit growth have picked up.

Growth in deposits from superfunds has slowed significantly.

Deposit growth

Bank deposits growth has slowed significantly, growing by 7.3 per cent in the year to March 2014, compared to 9.9 per cent in the year to March 2013. Within this, there were quite divergent trends between household deposits, business deposits, and superfund deposits.

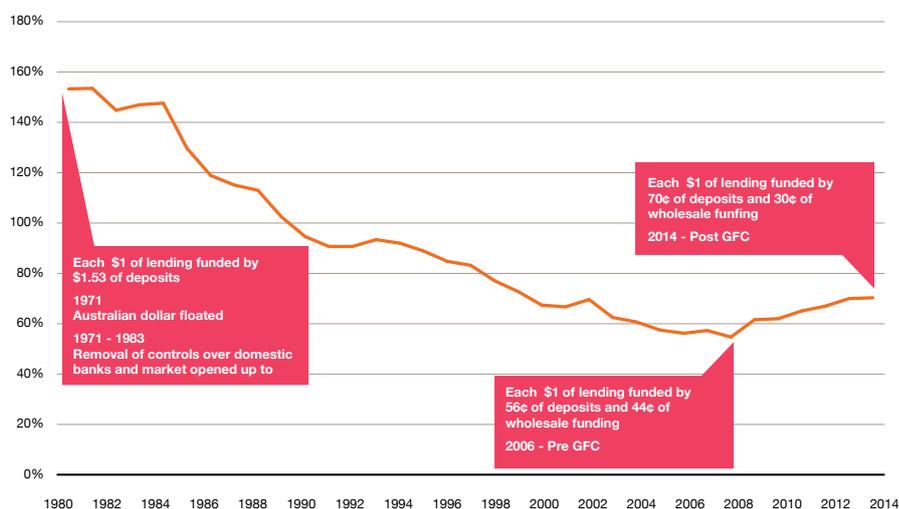
Household deposit growth was marginally stronger 9.6 per cent in the year to March 2014, compared to 8.9 per cent a year earlier. Business deposits grew by 3.6 per cent per annum to March 2014, up from 3 per cent in the year to March 2013, suggesting some improvements in cash-flow and ongoing caution about investment in business assets.

By contrast, growth in deposits from superannuation funds, a third source of deposits,

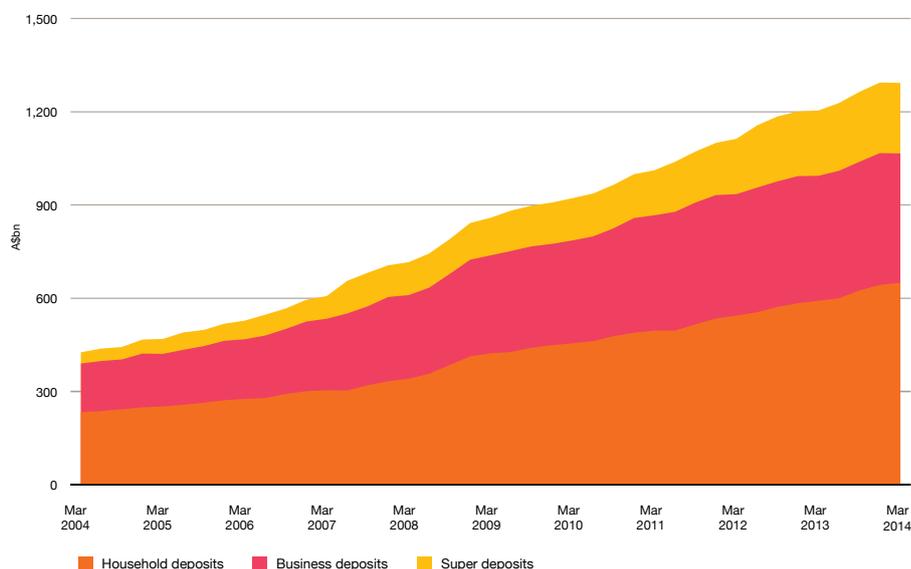
seems to have slowed from double-digit growth to single digits. The latest available data is for December 2013 which shows growth of 9 per cent over that year, compared to 24 per cent in the preceding twelve months and indeed an average growth of 12 per cent per annum for the five years up to December 2012. Given improved equity market performance and declining cash rates it is not that surprising to see slower growth of superfund deposits. Nonetheless, they have been a recent mainstay of growth in bank deposits and so this could be an important development.

There could be further headwinds for superfund deposits as changes to the Corporations Law, due to come into effect from June 2014, aim to make it easier for retail investors, such as SMSFs, to access the bond market and hence redirect funds away from bank deposits.

Core bank deposits as a proportion of bank loans and advances



Composition of bank deposits (A\$bn)



Combined net interest margin



Net interest margins

The banks' combined net interest margin fell 5 bps over the past six months to 2.08 per cent, not far off the all-time low of 2.05 per cent reached in 2008. Growth in lending volumes offset this, enabling the banks to deliver growth in net interest income of 3.1 per cent hoh (6 per cent pcg).

The decline in margins was driven by:

- competition for lending, as banks shaved prices for loans and as consumers locked in fixed rate loans, particularly in New Zealand where official interest rates have risen. Together, these two factors reduced the net interest margin by 5bps hoh,
- the negative impact of holding higher levels of liquid assets as banks grow their mortgage books and transition to Basel III further reduced the margin by 1bp and,
- a slight reduction in funding costs, which is a combination of some easing in the competition for term deposits, lower costs of new wholesale debt issues, and lower hedging costs. Together, these three factors had a positive impact on margins to the extent of 1bp hoh.

Looking ahead, we believe margins are likely to fall further, even allowing for the benefits of lower wholesale funding. Primarily, this is because we expect demand for new borrowing will remain subdued, heightening price competition from lenders. Given funding needs, price competition for deposits has not run its course either. We see no reason why net interest margins will not touch fresh lows in due course.

Margins fell 5 bps to 2.08 per cent, close to the all-time low of 2.05 per cent in 2008, with further falls likely as banks increase competition for business.

Other operating income

5.9% hoh

Banks delivered stable growth across the board in other operating income which grew 5.9% hoh and 5.1% pcp.

Improved investment markets and higher FUM resulted in a 8.4% hoh increase in income from investment management and funds administration activities.

8.4% hoh

Insurance income also improved 6.3% hoh, due to growth in retail in-force life insurance premiums coupled with lower life insurance claims and lapse rates.

6.3% hoh

4.8% pcp

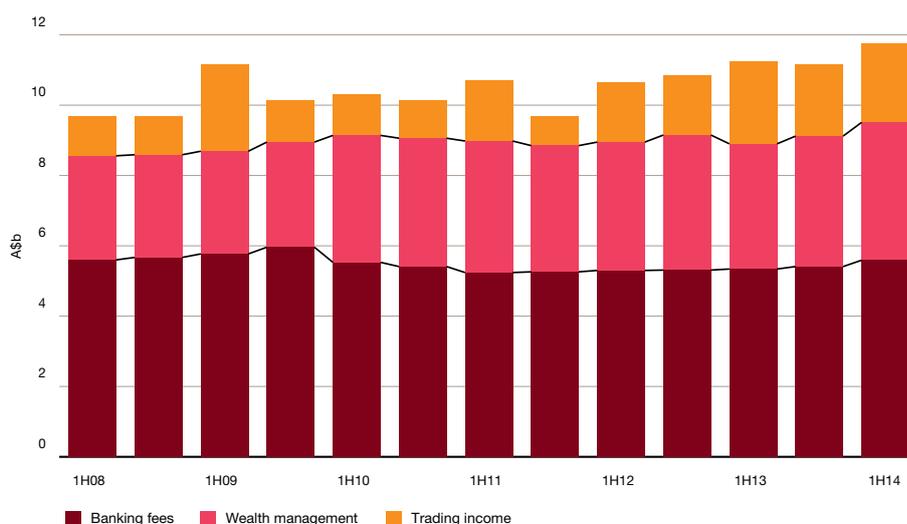
Headwinds that have been impacting bank fees and commissions for some years seem to be finally abating as these grew steadily at 3.4% hoh and 4.8% pcp.

\$2.2 billion

Trading income at \$2.2 billion now represents 18% of other operating income, up from 10% four years ago. This grew 11% hoh off the back of increased customer demand for foreign exchange and risk management products.

11% hoh

Analysis of other operating income



Expenses

Combined expense-to-income ratio



3.9% hoh

The banks are finding it harder to keep a lid on expenses which grew 3.9% hoh and 7.5% pcp.

The expense to income ratio remains at 43.7% for the half year with revenue growth compensating for expense growth.

43.7%

172,000

The major banks staff numbers have remained steady at 172,000 for the last 2 years, whereas employee costs have increased 4.9% hoh and 6.7% pcp reflecting higher salaries.

4.9%

\$8.5 billion

Capitalised software balances of \$8.5 billion, are at their highest level ever. Amortisation of this balance is a contributing factor to the 4.5% hoh (9.6% pcp) increase in IT expenses.

Asset quality

20% hoh

In aggregate bad debt expenses fell 20% hoh and 33% pcp, as fewer problem loans emerge. We don't expect to see it fall much further.

The benefits of lower interest rates are very evident in asset quality, while the banks have held to their lending quality criteria. Business gearing in general remains conservative. The wildcard remains the eventual impact of higher interest rates on the household sector, given household debt to income ratio remains at its' historical high of 150%.

\$2.5 billion hoh

Gross impaired assets reduced by \$2.5 billion hoh or 13%, as business failure rates decline and economic conditions show signs of improvement.

150%

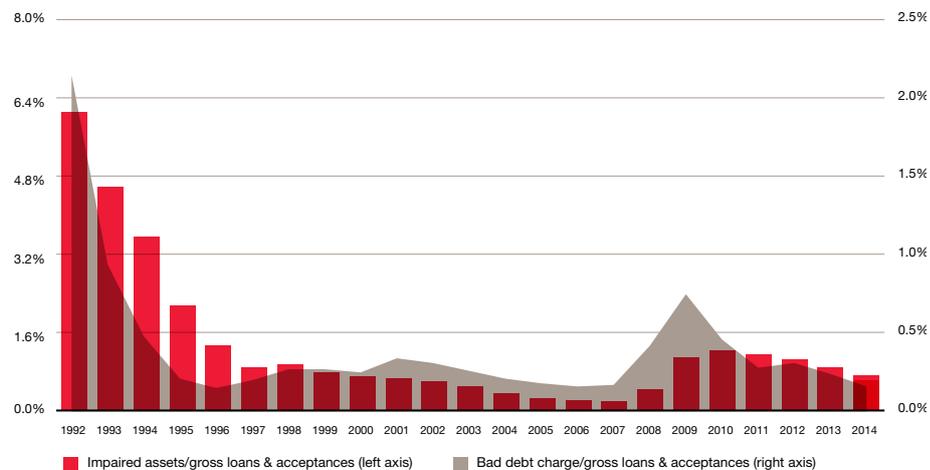
7% hoh

Delinquencies rose 7% hoh, reflecting growth in home lending and the ageing treatment of hardship facilities.

Total provisions, at 0.8% of loans and acceptances, are edging down closer to the pre GFC levels.

0.8%

Impaired assets and bad debt expense



Connecting with customers

Highly engaged customers are twice as profitable as other customers

The rules of the game have changed for banks. The pre-GFC days of 10 per cent plus credit growth are over, and banks are now competing more aggressively for share of customer wallet. In this new environment, banks that excel at customer engagement will win.

Achieving true customer engagement requires significant investment and focus, but ultimately delivers substantial returns. One global bank has found in its commercial banking business that highly engaged customers generate 50 per cent more revenues and are twice as profitable as other customers.

There are three key stages involved in achieving customer engagement:

1. Measure and monitor customer engagement
2. Identify and fix customer pain points
3. Co-create and personalise customer experiences

Most Australian banks are at stage one, typically monitoring high-level customer satisfaction or Net Promoter® Score (NPS®)* metrics, benchmarking themselves against competitors and linking those metrics to executive KPIs. However, as our case study highlights, going beyond high level metrics to implement a sophisticated Customer Engagement Measurement (CEM) program that measures actual drivers of customer behaviour leads to more profitable outcomes for the bank.

Understanding the drivers of customer decision making is key. PwC's retail banking customer experience radar, a comprehensive customer experience survey in the United States, found that bank fees and charges are the number one driver of customers' purchase decisions. However,

in a homogeneous pricing environment such as the Australian banking sector, staff are the key point of differentiation, with 60 per cent of memorable experiences involving bank staff. Four times as many positive memorable experiences are due to bank staff than good rates or low fees. Furthermore, 50 per cent of recommendations by customers are due to good service experiences, not discounts or free products. It is clear that bank staff play a critical role in driving customer engagement.

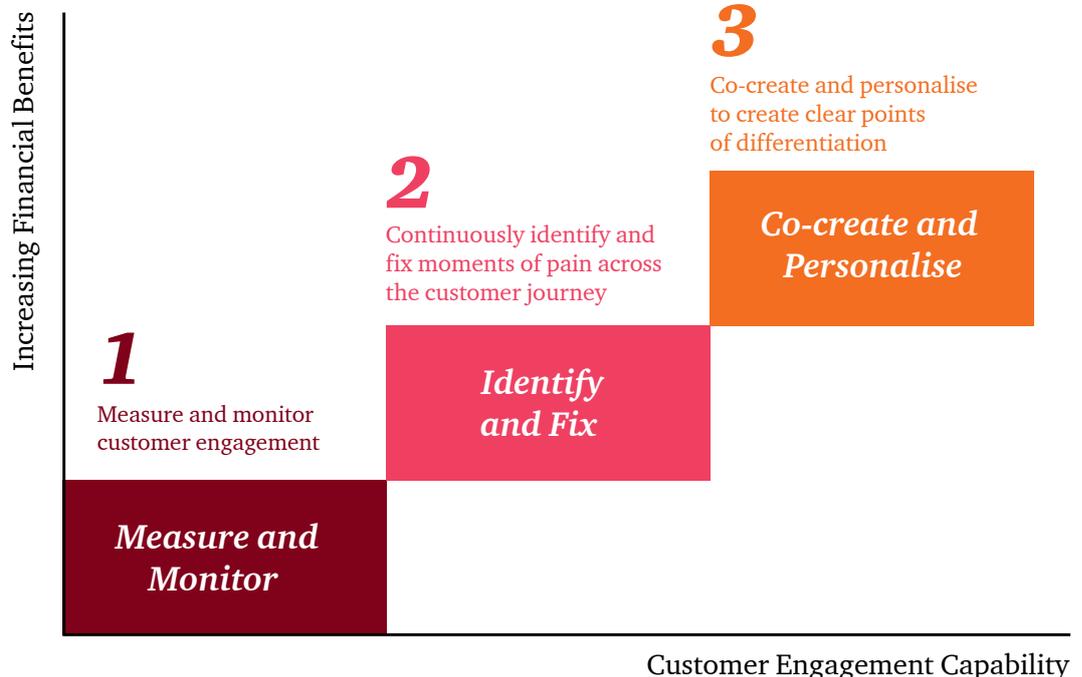
Most banks are yet to progress to the next step of leveraging CEM data and insights to systematically identify and fix customer pain points.

Our research found that over 40 per cent of bad banking experiences are due to bank errors and slow service.

Given two out of five customers shift business to another bank after a bad experience, fixing customer pain points is critical.

One Australian bank that has taken this step has implemented a real-time customer feedback program for its mortgage business. The bank asks customers for feedback at key points along the customer journey, enabling the bank to quickly identify customers who are at risk of attrition, and deploy informed and empowered staff to respond accordingly. This also enables the bank to implement a continuous improvement program to identify and fix the root causes of negative customer experiences. With the average Australian mortgage worth \$350,000, the payback for each retained customer is significant.

Benefits staircase



Fixing customer moments of pain is a given, but alone isn't enough to create highly engaged customers. With the explosion of the digital economy, banks need to be relevant and engaged with their digitally enabled, 'always on' customers.

30 per cent of surveyed global banking executives cite improving customer experience as the most important factor driving their digital channel strategy for the next two years, according to Eyes Wide Shut, PwC's recent digital banking report.

Banks must create meaningful 'wow' experiences that exceed the expectations of customers by being bold, innovative and agile. Achieving this requires banks to take the final step of co-creating personalised experiences with their customers.

Barclaycard Ring MasterCard is a crowd-sourced solution that is generating customer engagement by drawing on card members to design product features and benefits. Members can vote online any time Barclaycard suggests raising fees, changing the interest rate or altering the card's terms and conditions. They can also influence marketing ideas and website enhancements through online forums. The card's Giveback program gives members a percentage of the product's estimated profits, which they have the option of keeping or donating to charity. This is driving positive customer engagement with the product. Barclaycard has reported a 25 per cent increase in retention and 50 per cent reduction in customer complaints compared to other card

products. In the words of one member, "I actually get a good feeling when I pull the card out of my wallet".

It is unrealistic to try to differentiate at every point along the customer journey. Banks need to use analytics to predict what features will drive customer engagement and then invest accordingly. In doing so they need to adopt a challenger mindset of investing in those key points differentiation for customers.

Creating truly engaged customers is an imperative for Australian banks. Successful design and execution of a customer engagement program requires commitment to a long-term investment, but this can return disproportionate financial outcomes when you can deliver an experience that your competitors can't replicate.

In establishing a successful customer engagement program ask yourself:

- Who owns the customer in my organisation?
- Can we identify our customers' drivers of behaviour – and are we able to differentiate those drivers for specific customer segments?
- Are our existing customer measurement programs allowing us to shift beyond 'measuring and monitoring' customer satisfaction and advocacy, to generate differentiated customer experiences and disproportionate financial outcomes?
- Are we fully harnessing our employees to drive customer engagement?
- Are we leveraging our digital assets to co-create personalised products and services and 'wow' experiences for customers?

Case Study: Commercial bank customer engagement success

One global bank implemented a comprehensive Customer Engagement Measurement (CEM) program and identified that highly engaged commercial banking customers generated 50 per cent higher revenue and 100 per cent more profit than other customers.

The bank's CEM program goes beyond high level customer engagement metrics, to capture the underlying drivers of customer behaviour and engagement. The bank found these drivers differed by customer segment and over time. During the recent financial crisis trust was the key driver of customer behaviour, but more recently this has changed to value.

The sophistication of this bank's CEM program has enabled it to shift beyond simply measuring

and monitoring a customer score to identify actions and initiatives that drive customer engagement, attract and retain customers and grow wallet share.

The bank found that banker relationships drive over 50 per cent of customer engagement scores. More specifically, the customers who felt that their relationship manager understood their business and provided value-creating solutions generated 15 per cent more revenues for the bank. In response, the bank implemented a customer engagement improvement program. The outcomes of this program for one major customer resulted in 33 per cent uplift in share of wallet and a 65 per cent increase in bank revenues.

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Key banking statistics – Half year 2014

	ANZ			CBA			NAB (iii)			WBC		
	6 mths Mar-14	6 mths Sep-13	6 mths Mar-13	6 mths Dec-13	6 mths Jun-13	6 mths Dec-12	6 mths Mar-14	6 mths Sep-13	6 mths Mar-13	6 mths Mar-14	6 mths Sep-13	6 mths Mar-13
Balance sheet												
Total assets	737,815	702,995	672,630	782,301	753,857	722,183	846,014	809,870	763,828	729,375	701,097	681,878
Risk weighted assets	360,740	339,265	322,582	334,197	329,158	314,942	367,224	362,078	351,391	322,498	307,372	307,976
Gross loans and acceptances	512,430	486,931	457,577	591,775	568,821	549,216	534,172	522,079	500,881	568,057	539,806	524,985
Asset quality & provisioning												
Gross impaired assets	3,620	4,264	4,685	3,939	4,330	4,480	5,614	6,347	6,102	2,893	3,600	4,281
Net impaired assets	2,150	2,797	3,142	2,400	2,571	2,522	3,660	4,317	4,092	1,550	2,046	2,558
Gross impaired assets as a % of gross loans and acceptances	0.71%	0.88%	1.02%	0.67%	0.76%	0.82%	1.05%	1.22%	1.22%	0.51%	0.67%	0.82%
Individually assessed provisions	1,470	1,467	1,543	1,416	1,628	1,845	1,954	2,030	2,010	1,139	1,364	1,505
Individually assessed provisions as a % of impaired assets	40.6%	34.4%	32.9%	35.9%	37.6%	41.2%	34.8%	32.0%	32.9%	39.4%	37.9%	35.2%
Collective provisions	2,843	2,887	2,769	2,870	2,858	2,858	2,739	2,783	2,841	2,652	2,585	2,694
Collective provisions as a % of non housing loans & acceptances	1.15%	1.24%	1.26%	1.40%	1.46%	1.50%	1.17%	1.20%	1.26%	1.37%	1.46%	1.56%
Total provisions	4,313	4,354	4,312	4,286	4,486	4,703	4,693	4,813	4,851	3,791	3,949	4,199
Total provision as a % of gross loans & acceptances	0.84%	0.89%	0.94%	0.72%	0.79%	0.86%	0.88%	0.92%	0.97%	0.67%	0.73%	0.80%
Profit & loss analysis (i)												
Net Interest Income	6,764	6,536	6,236	7,444	7,082	6,862	6,843	6,799	6,608	6,677	6,467	6,445
Other operating income	2,904	2,763	2,856	3,704	3,450	3,427	2,644	2,521	2,635	3,182	3,011	2,910
Total operating expenses	4,286	4,213	4,044	4,751	4,543	4,467	4,456	4,214	3,992	4,065	3,935	3,824
Core earnings	5,382	5,086	5,048	6,397	5,989	5,822	5,031	5,106	5,251	5,794	5,543	5,531
Bad debt expense	528	598	599	457	466	616	528	842	1,092	341	409	438
Profit before tax	4,854	4,488	4,449	5,940	5,523	5,206	4,503	4,264	4,159	5,453	5,134	5,093
Income tax expense	1,333	1,170	1,265	1,662	1,505	1,448	1,263	1,163	1,162	1,643	1,539	1,549
Minority Interest	6	5	5	10	8	8	0	0	0	38	40	36
Cash earnings after tax before significant items	3,515	3,313	3,179	4,268	4,010	3,750	3,240	3,101	2,997	3,772	3,555	3,508
Statutory results (ii)	3,381	3,329	2,937	4,207	3,987	3,631	2,856	2,889	2,466	3,622	3,464	3,287
Key data												
Other operating income as a % of total income	30.0%	29.7%	31.4%	33.2%	32.8%	33.3%	27.9%	27.0%	28.5%	32.3%	31.8%	31.1%
Interest Spread	1.92%	1.95%	1.98%	1.97%	1.95%	1.86%	1.65%	1.70%	1.67%	1.91%	1.90%	1.94%
Interest margin	2.15%	2.19%	2.25%	2.14%	2.17%	2.10%	1.94%	2.02%	2.03%	2.11%	2.12%	2.19%
Expense/income ratio (as reported)	44.3%	45.3%	44.5%	42.9%	43.4%	43.8%	45.4%	43.5%	41.6%	41.2%	41.5%	40.9%
Total number of full time equivalent staff	48,857	48,865	48,871	44,007	44,969	44,363	42,719	42,164	42,668	36,494	35,597	36,000
Operating costs per employee (dollars) - annualised	175,426	173,546	164,424	215,050	202,332	198,152	211,015	198,105	185,644	226,072	219,196	212,633
Return on average equity (as reported)	15.5%	15.1%	15.5%	18.7%	18.6%	17.9%	14.6%	14.3%	14.6%	16.5%	15.8%	16.1%
Return on average assets (cash basis)	0.96%	0.95%	0.97%	1.12%	1.09%	1.04%	0.76%	0.75%	0.76%	1.04%	1.02%	1.04%
Capital ratios												
Common equity	8.3%	8.5%	8.2%	8.5%	8.2%	8.1%	8.6%	8.4%	8.2%	8.8%	9.1%	8.7%
Tier 1	10.3%	10.4%	9.8%	10.6%	10.3%	10.2%	10.8%	10.4%	10.2%	10.3%	10.7%	10.8%
Tier 2 (net of deductions)	1.8%	1.8%	1.9%	0.8%	0.9%	1.0%	1.4%	1.4%	1.5%	1.8%	1.6%	1.7%
Total	12.1%	12.2%	11.7%	11.4%	11.2%	11.2%	12.2%	11.8%	11.7%	12.1%	12.3%	12.5%
Lending and Funding Ratios												
Gross loans & acceptances as a % of total assets	69.5%	69.3%	68.0%	75.6%	75.5%	76.0%	63.1%	64.5%	65.6%	77.9%	77.0%	77.0%
Housing loans as a % of gross loans & acceptances	51.7%	52.0%	52.1%	65.4%	65.5%	65.4%	56.3%	55.4%	54.8%	66.0%	67.2%	67.1%
Deposits (exclude CDs) as a % of gross loans & acceptances	82.6%	81.1%	81.7%	72.0%	71.2%	70.3%	71.3%	70.1%	68.3%	68.5%	70.9%	68.5%
Deposits (exclude CDs) as a % of total liabilities	61.3%	60.1%	59.3%	58.0%	57.2%	56.8%	47.7%	47.9%	47.6%	57.1%	58.5%	56.7%

All figures in AUD million unless otherwise indicated

(i) In arriving at cash earnings, income and expenses exclude significant items and certain non cash items. Non cash items include the impact of hedge accounting, revaluation of treasury shares and other items reported by the banks. Significant items include restructuring and transformation costs and other items reported by the banks. Some components of income and expenses have been reclassified to improve comparability between banks.

(ii) Statutory result as reported by the banks, unadjusted.

(iii) NAB's cash earnings after tax before significant items are shown before distributions to holders to National Securities; - 1H14 (\$90) million, 2H13 (\$94) million and 1H13 (\$94) million.