PRICEWATERHOUSECOOPERS

Perspectives

Major banks analysis

May 2007

Majors in strong profit-making holding pattern

Australia's five major banks have delivered another set of record half-year profits with a combined 16.1% increase in underlying cash earnings over the prior corresponding period. Buoyed by a resilient economy, the excellent results were underpinned by solid performances in traditional banking and by good wealth management income.

It was business as usual in the core banking areas with a 9.2% increase in net interest income over 1H06. This was achieved despite intense competition – particularly from large foreign banks like HBOS, HSBC and RBS – which nibbled away some of the banks' market share and was largely responsible for an average 3 basis point reduction in margins over the past six months.

Banking fee income increased 6.7% on 1H06, mostly due to volume growth but also some pricing initiatives. Interestingly we have seen some price reductions this period. With consumers increasingly value-conscious, less brand-loyal and better informed, pressure on retail banking fees is likely to continue.

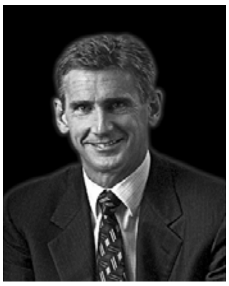
The performance of the banks' wealth management businesses was particularly strong, with cash earnings up 22% on average. This was driven by both strong inflows and favourable investment returns. In the 6 months to December 2006, funds under management increased 10% and funds under administration 15%.

The banks are generally very well positioned for future growth from their wealth plays. Investor confidence remains high. The banks have expanded their distribution channels and product offerings. This quarter we're going to see record inflow due to the one-off opportunity to make up to $1 million of after-tax contributions before 1 July. And the ongoing compulsory superannuation environment and demographic shifts make their wealth plays an important competitive advantage for the banks. Making the most of them will depend on how well they execute their customer centric strategies.

Five majors' combined performance – A$ million – underlying cash earnings

	1H07	2H06	1H06	1H07/ 2H06	1H07/ 1H06
Net interest income	16,046	15,194	14,688	5.6%	9.2%
Other operating income	10,490	9,352	9,247	12.2%	13.4%
Operating income	26,536	24,546	23,935	8.1%	10.9%
Operating expenses	12,085	11,851	11,574	2.0%	4.4%
Core earnings	14,451	12,695	12,361	13.8%	16.9%
Bad debt expense	1,150	997	932	15.4%	23.4%
Tax expense	3,871	3,121	3,622	24.0%	6.9%
Outside equity interests	714	535	302	33.5%	236.4%
Underlying cash earnings after tax before significant items	8,716	8,042	7,505	8.4%	16.1%

Total expenses rose 4.4% on 1H06 (2.0% on 2H06). This was partly attributable to the banks investing in convenience (eg more branches, more ATMs) and in improving the quality of service (eg more front-line staff). The banks have been focussed on widening what is becoming commonly referred to as the 'jaws' – the gap between revenue growth and expense growth. Their current success is demonstrated by the fact that the banks' expense-to-income ratios have further improved.



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Majors in strong profit-making holding pattern (Continued)

Investing for future growth remains a key challenge. With competition remaining fierce and customers having an increasing propensity to shop around, deciding which investments will widen the 'jaws' is not getting any easier.

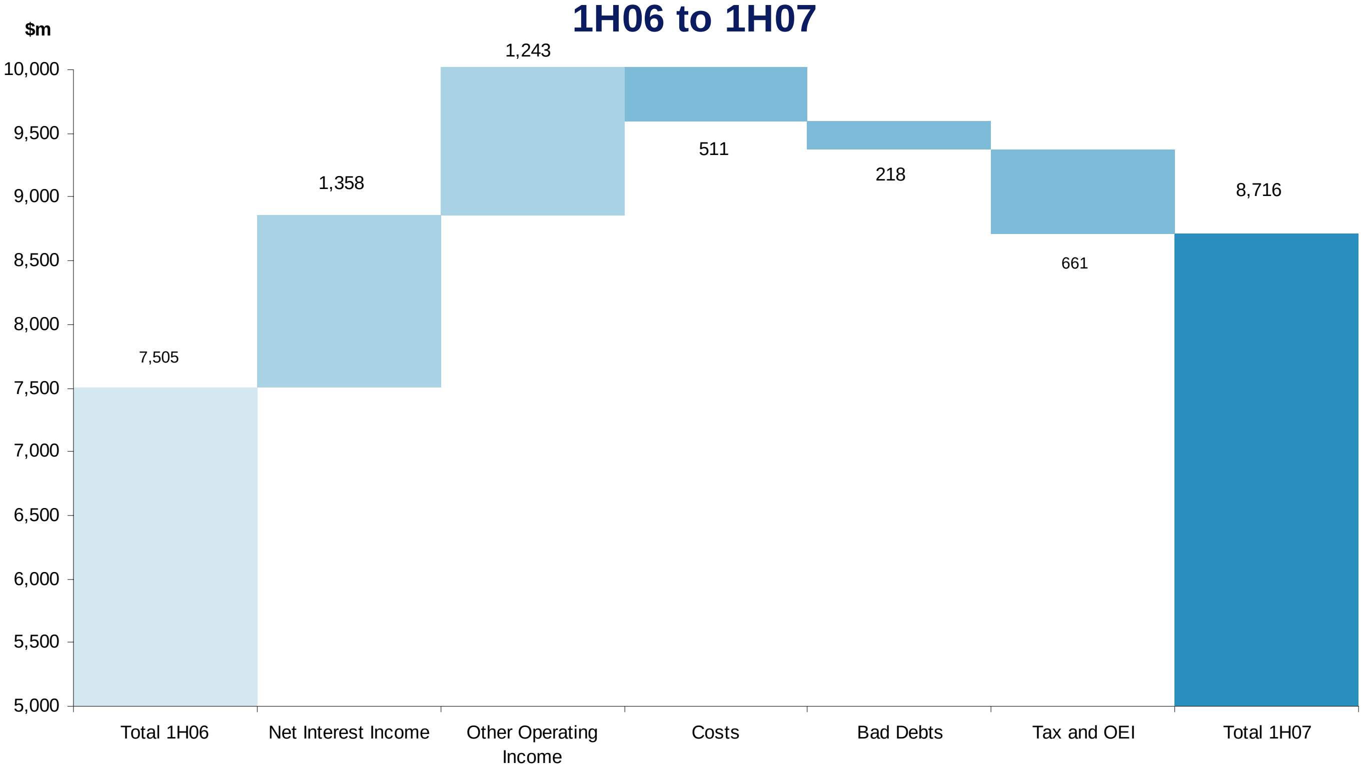
Bad debt charges were up 23%, representing 20bps on average loans and advances for the period (compared to 18bps for 1H06). While the credit cycle has turned a touch, as expected, it is not setting off any alarm bells. Impaired assets remain at historic lows, and while consumer arrears levels have ticked up, the unemployment levels are at 31-year lows.

But it needs to be watched carefully. The banks have generally moved up the risk curve somewhat in recent times and have also relaxed some credit standards. So if the cycle does turn more sharply than anticipated, there could be some pain from 'covenant-light' business loans and the unsecured and high-LVR retail loans.

The RBA and Treasury expect the current period of economic expansion – now into its 16th year – to continue, albeit at a slower pace primarily because of labour shortages. In such an environment the banks will be hard-pressed to deliver remarkable earnings growth. The PwC Banking Gauge indicates that the major banks' underlying cash earnings will grow 9.5% (annualised) in 2H07, and 10.6% in FY08. So, still comfortably in a holding pattern of profit-making at a solid pace of growth.

Note: the PwC Banking Gauge is a consensus view across the five major banks and across three of Australia's leading banking analysts – Andrew Hokin (Macquarie), Brian Johnson (JPMorgan) and Jeff Emmanuel (UBS).

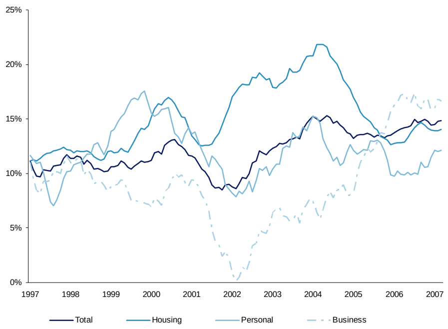
Major Banks – Movement in underlying cash earnings 1H06 to 1H07



Net interest income

The banks delivered solid growth in net interest income of 9.2% for the half-year over the prior corresponding period, in the face of intense competition and a weak NSW housing market. The result reflected strong volume growth – just below system – offset by margin compression (3 basis points in the past 6 months).

Domestic Credit Growth (Annual % growth)



Source: RBA data

The backdrop has been a robust domestic economy. The RBA's Assistant Governor (Economics) commented in March that "The Australian economy has had a lengthy period of expansion. By past standards, we have had reasonably stable growth and low inflation, and the economy has moved closer to full capacity". The steady economic growth, along with a prolonged period of low 'absolute' interest rates, has enabled the continued systems growth in all lending portfolios.

The majors remain highly dependent on the housing market with home loans now representing 55% of their total loans and acceptances, having increased from 40% at September 2000. Despite the recent interest rate rises (which are still being absorbed by borrowers) housing system credit growth stayed firmly above 14% pa over the six months, well above its 12.7% pa low in December 2005. The majors grew their home lending books by 11.5%pa over the period, but their market share dropped in aggregate by 63bps, to 64% at March 2007. Well heeled foreign banks such as ING and HBOS (BankWest) were the winners of market share.

Brokers continue to be a major influence. According to a recent JPMorgan and Fujitsu Consulting report, nearly 40% of the major banks' total housing loans outstanding have been originated by mortgage brokers, up from just under 20% five years ago.

In their report, JP Morgan and Fujitsu Consulting outlined how this trend has been eroding the banks' profitability through reduced margins and increased third party commission payments. It has also impacted the competitive pricing of non-broker originated loans. However, the proportion of broker originated loans has stabilised over the past year. The report notes that success with the banks' branch reinvigoration programmes will be an important element in regaining distribution strength and ultimately pricing power.

At a macro level, home lending growth looks set to continue: interest rates are still low and on hold (at least for the near term), household incomes are increasing and house prices remain in positive territory according to the ABS house price index which showed a 8.3% increase over the December 2005 quarter, albeit driven by WA and NT.

Personal lending is following a similar pattern to home lending. Systems credit growth over the period remained relatively stable at around 12% pa suggesting that people are not yet feeling the 'pinch' after last year's interest rate rises. The major banks' market share of credit cards fell 52bps to 66.1%, reflecting the attack on this market by foreign banks, like HSBC, and non-bank lenders with zero balance transfer offers and low rate cards. Most of the majors have responded with low rate cards which has been good for volumes but reduced margins notably. Competition is only set to get tougher with more potential entrants circling, and the possibility that some of the large retailer groups will expand their card offerings.

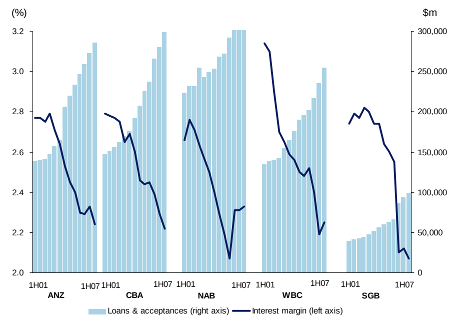
Business credit systems growth at 16.6% pa has strengthened slightly and continues to reflect the low interest rates and the business' need for both working capital and investment to expand as the economy continues to operate at near full capacity. However, the major banks' market share declined by 135bpts over the period to 49.5%. There are two parts to this story. At the corporate/institutional end the majors lost out to some of the global giants, like RBS, who took the lion's share of the large private equity deals. At the middle market/SME end, competition has also been fierce but the majors have fought particularly hard to retain or grow their footprint.

On the liability side, household deposits continued to grow at 12.6% pa over the period. Some of the growth in this sector would have been due to rising interest rates making bank deposits more attractive and the equity market jitters during the 1Q07. Deposit growth is also a key target for the branch reinvigoration programmes. However, the major banks lost 26bps in market share in the period, due to the continued rise in popularity of high-yielding at-call on-line deposit accounts offered by the foreign banks such as HBOS (BankWest).

As predicted, the margin crunch continued over the period, a trend we are likely to see continue for some time to come. In aggregate the 3bps margin decline during 1H07 comprised:

- competition continues as the major contributor at -4bps, driven by foreign entrants and non-bank originators offering lower rate products
- funding mix -1bps, reflecting the increased cost of funding asset growth via the wholesale market
- positive deposit spreads +2bps, partly as passing on interest rate rises lagged the asset repricing
- other contributing factors across the banks balanced to zero.

Interest margins and loans and acceptances



Notes: Historical data based on previous AGAAP. 2006 and 2007 based on AIFRS.
Margins as reported by the banks ie no attempt to normalise the margins above for the impact of AIFRS or large non-

Other operating income

Other operating income was up 13.4% on 1H06 (12.2% on 2H06) and now represents 39% of total income, up from 38% in 1H06. There has been growth in all components: Wealth Management Income - 24%; Banking Fees - 7% and Trading Income – 8%.

If the Wealth Management returns are normalised for expenses and tax, the cash earnings were up 22% on 1H06. This excellent result was driven by strong net fund inflows and continued buoyant equity markets. The majors' funds under management grew by 10% (market share constant at 39%) and funds under administration grew by 15% (market share also constant at 61%) over the 6 months to December 2006.

The funds management businesses have high growth potential, given Australia's compulsory superannuation regime and related tax breaks, and shifting customer demographics and improving living standards. Little wonder that the banks have generally expanded their distribution channels and product offerings. They have an important competitive advantage, and making the most of them will depend on how well they execute their customer-centric strategies. As with the traditional banking markets, competition from both existing funds management players and new entrants will be fierce.

Banking fee income which accounts for 50% of other operating income was up 6.7% on 1H06, reflecting growth in both lending fees (8.1% on 1H06) and non-lending fees and commissions (5.9% on 1H06). Fee income is generated from activities ranging from retail account keeping fees, mortgage packaging fees, credit card annual fees and cheque dishonour fees, to corporate transactional services, structured finance and advisory fees, specialised funds management fees and origination fees. It has been a key focus for the banks to grow these income streams as net interest margins have declined.

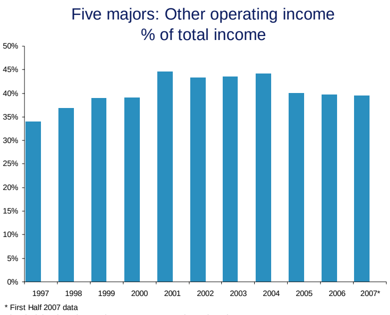
Retail banking fees have increased primarily due to volume growth in loans and in the number of transaction accounts. Pricing initiatives on a variety of loan and deposit products and on electronic banking transactions have also contributed. However, we have also seen some fee reductions, partly in response to competition, and in some cases in response to negative consumer reaction.

Retail banks need to deliver on three things – convenience (ie easy to do business with), service (ie good customer experience) and value. Value has become an increasingly important differentiator in Australia. Intermediaries and brokers have made their presence felt and Australian consumers are now even more price-conscious and less brand-loyal. This has been compounded by the additional transparency around fees.

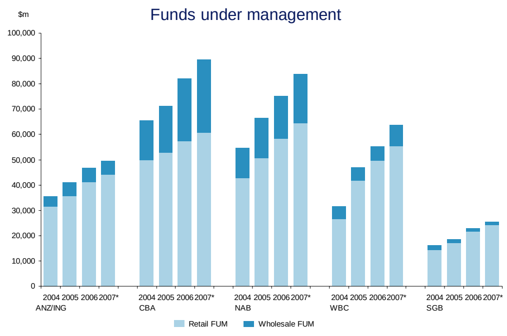
Recent studies have suggested that Australian retail banking fees are higher than international peers. In addition, in April the Office of Fair Trading in the UK launched a market study into personal current accounts. The intent is to ensure UK banks treat consumers fairly, and that active and informed consumers drive competition among banks. The signs are that there could be ongoing pressure in Australia on certain retail banking fees.

Fees from large corporates and institutions also increased in the period, particularly as all the majors sought to participate in the current debt and fixed interest market boom. The banks increased fees from debt origination, structured finance and M&A activities; plus fees from specialised funds management, as investors (eg superannuation funds) looked for enhanced yields from infrastructure funds and the like.

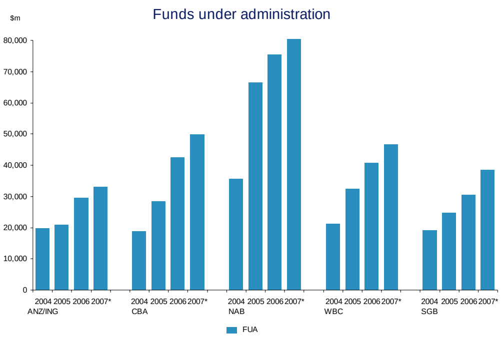
It is interesting to compare the recent UK experience. UK trading banks failed in investment banking in the 80s and early 90s, and have since largely steered clear of trading equities or advising on mergers and acquisitions (areas traditionally dominated by large Wall Street houses). More recently though, banks like Barclays and RBS have used corporate lending relationships to offer a broader array of products, from underwriting bond issues to hedging commodity exposures. Now their investment banking arms generate 30-40% of their pre-tax profits.



* First Half 2007 data
Historical data based on previous AGAAP. 2006 and 2007 based on AIFRS.



Source:ASSIRT Market Share Reports as at June. * December 2006 data used for 2007.



Source: ASSIRT Market Share report June 2006. * December 2006 data used for 2007.

Efficiency

Total expenses rose 4.4% on 1H06 (2.0% on 2H06). This was partly attributable to the banks investing in convenience (eg more branches, more ATMs) and in improving the quality of service (eg more front-line staff).

The banks have been focussed on widening what is becoming commonly referred to as the ‘jaws’ – the gap between revenue growth and expense growth. Their current success is demonstrated by the fact that the banks’ expense-to-income ratios have further improved.

Staff costs, which account for approximately 56% of total costs, were up 8.9% on 1H06 (7.2% on 2H06). The staff cost increases can be attributed to:

- general wage increases of around 4%; as inflation and near full economic capacity put pressure on the labour markets
- changes in staffing mix as the banks increased the number of relatively higher-cost customer-serving employees whilst pursuing productivity gains in support functions.

Looking at other costs:

- premises costs rose 2.5% due primarily to the opening of new branches
- IT/computer costs shrank 3.3%, in the absence of further significant systems/technology investment
- other costs remained generally static.

A key challenge for the banks continues to be making the ‘right’ investment decisions. A number of banks, for example, have embarked on programmes aimed at reinvigorating their distribution capability by expanding their footprint and sales staff along with a renewed focus on customer service. With competition remaining fierce and customers having an increasing propensity to shop around, it is difficult to judge the investment points at which the ‘jaws’ will widen or close.

One thing is for sure: productivity gains in the back office and support functions will continue to be sought, and offshoring may have to feature more prominently.

Reported expense-to-income ratios

	1H07	2H06	1H06
ANZ	44.3%	45.5%	45.8%
CBA	45.6%	47.4%	48.1%
NAB	50.3%	51.5%	55.6%
SGB	42.6%	43.5%	44.5%
WBC	45.3%	46.9%	46.1%

Asset quality

The banks’ cash earnings have been impacted this period by bad debt charges which were 23% higher than in 1H06. The charge represents 20bps on average loans and advances, up from 18bps for 1H06. So the charge is trending up, but still far less than ‘normal’ long-term levels.

We are seeing something of a divide between the consumer and business/corporate portfolios. Impaired assets, which largely reflect what is happening in the business and corporate sectors, declined slightly over the period – due to a lower number of new impaired loans – from what was already a historically low base. Conversely the consumer portfolios – primarily housing, credit cards and personal lending – are showing signs of creeping credit issues. Accounts 90 past due ticked up again over this latest period.

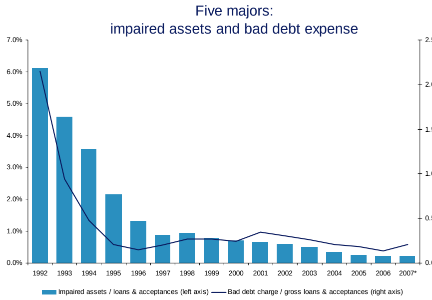
With credit growth cooling somewhat from the heady days of early 2004, and moreover given the intense competition, the majors have sought incremental revenue growth by moving up the risk curve somewhat. In the consumer lending market this has included more low-doc loans, higher LVR and no-deposit loans, and personal lending scores adjusted so as to include more people and higher limits.

Recently all eyes have been watching the events unfolding in the US housing market where more than 30 sub-prime lenders have collapsed in the past 6-months. We see it as highly unlikely that a similar situation will develop here as the key factors such as prolonged rising interest rates (17 hikes in two years) and falling house prices are not as prevalent here. Furthermore, the housing market and products are structurally very different. The sub-prime market in the US now represents 15% of the total residential mortgage market, whereas it represents less than 2% of the Australian market; 75% of all mortgage debt is securitised in the US, whereas 75% of the Australian mortgage market is held by regulated institutions; the US products have been far more aggressively pitched, for example, with teaser rates and 70% of the sub-prime loans having adjustable rate features.

That said, we did have 3 interest rate rises last year, which when coupled with some lowering in credit standards and the differing economic conditions across the states and indeed within various states is causing some issues to emerge, such as rising foreclosures in parts of NSW. Consumer credit losses will undoubtedly rise in the short term, but with unemployment at 31-year lows and not expected to increase soon, the upswing is not expected to be severe.

Asset quality for the business and corporate sectors looks generally sound. Global and local economic growth continues and S&P ratings data for corporate debt shows more upgrades than downgrades in the quarter to December 2006. The recent round of profit announcements reinforced the message that businesses are doing well.

However, we may not have seen the full impact of the interest rate rises, higher oil/fuel prices, and the strong Australian dollar. If there is a dip in the credit environment which has been benign for so long, then the ‘covenant-light’ corporate and business loans may be exposed and some pain felt.



* 2007 Half year Data

Key banking statistics – Half-year 2007

	ANZ			CBA			NAB			SGB			WBC		
	6 mths Mar 07	6 mths Sept 06	6 mths Mar 06	6 mths Dec 06	6 mths Jun 06	6 mths Dec 05	6 mths Mar 07	6 mths Sept 06	6 mths Mar 06	6 mths Mar 07	6 mths Sept 06	6 mths Mar 06	6 mths Mar 07	6 mths Sept 06	6 mths Mar 06
Balance sheet															
Total assets	351,724	334,640	322,181	397,261	369,103	351,193	508,835	484,785	459,213	111,980	107,002	100,045	328,200	299,578	291,879
Risk weighted assets	250,485	240,219	230,653	234,569	216,438	202,667	330,457	318,323	301,824	57,117	52,982	50,955	211,984	193,417	181,823
Total loans & acceptances (Gross)	285,667	273,073	259,435	299,085	280,282	265,630	366,502	346,689	322,418	99,046	93,723	87,336	254,553	235,684	216,851
Asset quality & provisioning															
Gross impaired assets	749	698	802	338	326	396	1,071	1,057	984	95	86	80	458	433	470
Net impaired assets	447	412	486	167	155	217	876	873	730	59	52	45	282	256	225
Gross impaired assets as a % of loans & acceptances	0.26%	0.26%	0.31%	0.11%	0.12%	0.15%	0.29%	0.30%	0.31%	0.10%	0.09%	0.09%	0.18%	0.18%	0.22%
Individually assessed provisions	302	286	316	171	171	179	195	184	254	39	31	36	162	164	231
Individual provisions % of impaired assets	40.3%	41.0%	39.4%	50.6%	52.5%	45.2%	18.2%	17.4%	25.9%	41.1%	36.1%	45.0%	35.4%	37.9%	49.2%
Collective provisions	1,981	1,940	1,903	1,040	1,046	1,041	1,918	1,838	1,746	283	268	261	1,325	1,194	1,058
Collective provisions % of non housing loans & acceptances	1.45%	1.46%	1.50%	0.85%	0.92%	0.98%	1.02%	1.05%	1.09%	0.84%	0.86%	0.95%	1.18%	1.16%	1.15%
Total provisions	2,283	2,226	2,219	1,211	1,217	1,220	2,113	2,022	2,000	322	299	297	1,487	1,358	1,289
% of risk weighted assets	0.91%	0.93%	0.96%	0.52%	0.56%	0.60%	0.64%	0.64%	0.66%	0.56%	0.56%	0.58%	0.70%	0.71%	0.71%
% of loans & acceptances	0.80%	0.82%	0.86%	0.40%	0.43%	0.46%	0.58%	0.58%	0.62%	0.33%	0.32%	0.34%	0.58%	0.58%	0.59%
Profit & loss analysis(i)															
Net Interest Income	3,611	3,575	3,368	3,485	3,259	3,255	4,783	4,527	4,241	1,078	1,051	964	3,089	2,782	2,860
Other Operating Income	1,770	1,583	1,562	2,953	2,775	2,546	3,469	2,760	2,978	527	479	460	1,771	1,755	1,701
Total operating expenses	2,386	2,346	2,259	3,144	3,027	2,967	3,643	3,652	3,580	683	666	633	2,229	2,160	2,135
Core earnings	2,995	2,812	2,671	3,294	3,007	2,834	4,609	3,635	3,639	922	864	791	2,631	2,377	2,426
Bad debt expense	240	183	224	195	210	188	390	335	270	93	79	65	232	190	185
Profit before tax	2,755	2,629	2,447	3,099	2,797	2,646	4,219	3,300	3,369	829	785	726	2,399	2,187	2,241
Income tax expense	817	770	715	876	817	753	1,243	701	1,226	248	243	223	687	590	705
Outside equity interests	2	3	1	13	13	18	665	490	259	0	0	(1)	34	29	25
Cash earnings after tax before significant items (underlying profit)(ii)	1,936	1,856	1,731	2,210	1,967	1,875	2,311	2,109	1,884	581	542	504	1,678	1,568	1,511
Operating profit after tax and outside equity interests(iii)	2,102	1,877	1,811	2,191	1,929	1,999	2,136	2,398	1,994	585	557	511	1,641	1,602	1,469
Key data															
Other operating income (% of total income)	32.9%	30.7%	31.7%	45.9%	46.0%	43.9%	42.0%	37.9%	41.3%	32.8%	31.3%	32.9%	36.4%	38.7%	37.3%
% Interest spread	1.74%	1.89%	1.84%	1.86%	1.95%	2.02%	1.85%	1.93%	1.82%	1.86%	1.92%	1.93%	1.90%	1.82%	2.03%
% Interest margin	2.24%	2.33%	2.29%	2.22%	2.29%	2.39%	2.33%	2.31%	2.31%	2.07%	2.12%	2.10%	2.25%	2.19%	2.40%
Banking expense/income ratio	44.3%	45.5%	45.8%	45.6%	47.4%	48.1%	50.3%	51.5%	55.6%	42.6%	43.5%	44.5%	45.3%	46.9%	46.1%
Total number of full time equivalent staff	33,183	32,256	31,063	37,216	36,664	34,918	39,048	38,433	39,298	8,727	8,598	8,640	27,312	27,224	26,932
Operating costs per employee (dollars)	71,904	72,731	70,340	84,345	82,779	85,744	93,295	95,023	91,099	78,263	77,460	73,264	81,612	79,342	79,274
Cash return on average equity %	19.70%	20.20%	20.00%	22.30%	20.80%	21.70%	17.50%	17.50%	16.30%	23.24%	23.03%	22.69%	23.60%	23.10%	23.00%
Capital ratios															
Tier 1	6.70%	6.80%	6.80%	7.06%	7.56%	7.54%	7.33%	7.35%	8.05%	7.20%	6.90%	6.80%	6.50%	6.90%	6.80%
Tier 2 (Net of deductions)	3.60%	3.80%	3.60%	2.72%	2.10%	2.27%	3.18%	3.46%	2.68%	3.30%	3.90%	3.60%	2.90%	2.70%	2.90%
Total	10.30%	10.60%	10.40%	9.78%	9.66%	9.81%	10.51%	10.81%	10.73%	10.50%	10.80%	10.40%	9.40%	9.60%	9.70%

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 cash earnings after tax before significant items (underlying profit) are shown before distributions payments to holders of National Income Securities – March 07 $137 million (September 06 $127m, March 06 $127 million).

(iii) Statutory result as reported by the banks, unadjusted

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