Major Banks Analysis

Facing in to the future

Australia's four major banks' results, while strong, have declined for the first time since the Global Financial Crisis. There are however signs of focus and action as they prepare themselves for a new, less certain, banking environment.

Over the period 2009-2015, the major banks' cash earnings rose from $17 billion (bn) to $30.6bn (after restatements), fuelled in particular by sustained system credit growth, ever-improving bad debt performance and balanced pricing decisions in a stable, but evolving, societal and regulatory context.

Looking deeper at the results, momentum in these traditional drivers has slowed and appears unlikely to reignite soon. With this in mind, and considering an unprecedented degree of government and societal focus, it is clear to see why the majors are taking tangible steps to reposition themselves to 'win' in the future.

Strong, but slowing

Cash earnings for the year were $29.8bn, a decrease of 2.6% year on year (yoy) and a modest 1.5% increase on the first half (hoh). The headline results vary significantly across banks and were impacted by a number of 'specified items' as ANZ in particular made some significant strategic decisions at an in-year cost of $1bn.

After adjusting for these and other significant 'one-off' items, most of which were in the first half, cash earnings rose a modest 1.1% yoy but, importantly, declined 0.9% hoh.

Return on Equity (RoE) was 13.75% for the year, down 127 basis points (bps) and 13.66% for the half (down 12bps hoh) and the lowest since 2009. Adjusting for one-off items, RoE fell 118bps yoy and 29bps hoh, driven by both a $18.1bn increase in average shareholders equity during the period and the decline in earnings momentum.

Given the regulatory outlook for further increases in capital and funding costs (including Basel Committee announcements on the global direction of capital levels) and with a tough earnings outlook, it seems likely that RoEs will experience further pressure.

While credit growth over the 12 months has been solid (5.4% p.a.), this masks a significant slow-down in the second half. For instance, in the six months to September 2015 bank loans and advances grew at an annualised rate of 9.1%; whereas the equivalent measure for the last six months is 6.5%. The comparatively strong growth in owner-occupied housing in late 2015/early 2016 has slowed considerably, with current growth rates now roughly half of the earlier numbers. Business credit growth shows a similar picture with annualised growth in the six months to September 2016 at 1.5%, compared to 3.7% in the six months to March 2016. This slowing demand for credit is a key factor explaining industry concerns about the immediate outlook for profit growth from core operations.

Given the competitive pressures operating in the sector, the reduction in combined net interest margin to 2.02% (-1bp yoy, -4bp hoh) has been relatively benign. However it is clear that this result was achieved with some fundamental repricing of lending categories in order to offset higher funding costs both for wholesale and retail funding. This repricing of lending has definitely been one of the factors which have served to increase public scrutiny on the banks, suggesting that such repricing to preserve margins may not be able to be undertaken indefinitely.

While all the banks highlighted compliance with the 100% Net Stable Funding Ratio minimum, APRA has yet to finalise what 'unquestionably strong' represents in the context of funding and so any potential buffer requirements may create further need to obtain longer term funding, with the resultant impact on margin.

2.6% — **Cash earnings for the year fell 2.6% yoy to $29.8bn.** This represents the first decline in earnings since the GFC. Half-on-half earnings rose 1.5%.

127bps — **Return on equity fell yoy from 15.02% to 13.75%, a reduction of 127 basis points (bps).** After adjusting for 'one-off' items, RoE fell 118bps.

24bps — **The combined Common Equity Tier 1 ratio increased 24bps to 9.85% yoy.** The banks generated and issued $13.1bn of CET1 during the year and more is expected.

2.02% — **Net interest margin decreased by 1bp yoy to 2.02% and 4bps to 2.00% for the half.** The benefits of asset repricing have been offset by funding costs as the majors prepare for NSFR in a more volatile funding market.

39% — **Bad debt expense rose by $1.5bn (39%) yoy and $88m (3.5%) hoh driven by specific exposures particularly connected to the resources sector.** Underlying asset quality metrics remain relatively stable, again suggesting BDE may provide a headwind in the future.

109bps — **Expense-to-income ratio at 44.3% increased 109bps yoy but fell 114bs hoh.** After adjusting for 'one-off' items, expense-to-income decreased 40bps yoy.

"The challenge ahead and its acknowledgment by the banks is clear from the significant steps they are already taking to ready their businesses for the new environment"

As we expected from the half, bad debt expense (BDE) increased a significant $1.5bn or 39% yoy to $5.1bn. Almost all of this movement relates to specific 'names' or sectors as the banks monitor the resource/mining areas in particular. Portfolio credit performance remains stable, though we note two of the banks highlighted potential stress in retail portfolios in the outlook - again suggesting that there remains little upside in the impairment story.

Cost management continues to rise on the major banks' agendas and each bank has chosen their own approach. After adjustment for one-off items in the year, at 42.87%, expense-to-income decreased yoy 40bps and 2bps hoh, however the story by bank varies.

True 'efficiency' is increasingly complex to understand as the majors change, and there are signs of this challenge in the results.

How the banks consider investment spend as a result of accelerating change and obsolescence is one example. On average, 51% of the $4.5bn investment spend in the year was directly expensed rather than capitalised, compared to 36% a year earlier - an additional $600m of in-year expense. Technological change, innovation and responding to regulation are increasingly becoming running costs rather than capital investment for the banks. Efficiently delivering these changes so that benefits can be realised quickly may be a defining feature of success in the future.

By way of further illustration, rising risk and compliance costs ($1.3bn, up 13.8% yoy) remain 30% of investment spend and a drag on underlying productivity improvements for many of the banks.

Staff costs remain 56% of total expenses, with average total full time global employees (FTE) decreasing 1.2% yoy. One bank reported a 5% reduction in average headcount yoy, while others highlighted less significant reductions, in part explained through a variety of investment initiatives, implementation of business changes and the rising risk and compliance obligations above.

Changing the cost profile of these large institutions is challenging and may take some time to work its way through.

Without action from the banks, the above all points to a very challenging outlook, not least because at the same time they are considering these business issues, a very public discussion is taking place around something more fundamental and entirely connected - the role that banks should play in a rapidly changing and increasingly empowered society.

Already changing

The challenge ahead and its acknowledgement by the banks is clear from the significant steps they are already taking to ready their businesses for the new environment.

To release additional capital and simplify their businesses, the banks have sold or restructured operations with significant financial impacts in the last two years- most notably NAB's listing of its overseas banking subsidiaries and sale of its life insurance business, Westpac's partial sale of interests in BTIM, and ANZ's sale of the Esanda business, impairment of some offshore investments and foreshadowed potential sales of Asian and Wealth businesses.

This theme of 'focus' indicates a clear prioritisation of higher-return and lower-capital, domestic banking activities - where the majors believe they can 'win'. Given global uncertainty and competition, the short-term benefits of this focus are clear. How this focus is applied in practice to longer term opportunities such as Asia will be of particular interest, given the significance of the region to Australia's economic future.

Technological change has also been evident in the banks' decisions, recognising that the payback periods on investments are dramatically shortening. Three of the banks have explicitly revised their assumptions for software useful lives and cost capitalisation policies as a result since 2012 - with $0.9bn of assets written off or amortisation accelerated.

And on matters of regulation and conduct, changes are also evident – with the majors initiating action, with unprecedented levels of cooperation, to respond to concerns over their treatment of customers and perceived self-interest. The 6-point plan being developed under the Australian Bankers Association (ABA), with independent oversight, is the clearest indication of this and is being closely watched as a result.

Tougher changes to come

In summary, the majors banks are faced with a lower credit growth outlook, capital and regulatory constraints, a dramatic pace of social change and technological investment and arguably the most intense socio-political scrutiny the sector has experienced since the government proposals to nationalise the banking industry in the late 1940s.

In our view, responses to these challenges are inherently interconnected and go to the heart of the value banks must provide if they are to escape the "commodity trap". Six months ago, we contended that the future of banking should see banks become simpler, smaller and more deeply connected with their customers.[1] Many of the changes that we have already seen align to these concepts and, we believe, there is more to come.

The Australian banks have been working hard to shape a new environment where customers can expect a different, more thoughtful and connected experience - with technology and engaged staff as the key enablers.

The banks are large, diverse organisations with long histories - Westpac for example turns 200 in 2017 - and so it is not surprising that these changes are complex. But customers expect it all to be easier. Creating a more resonant offering may require fewer (rather than more) products, contact points and messages and will involve reframing organisational norms that are deeply embedded and very tightly held.

And it may not be necessary for the banks to 'make' such a high proportion of what they sell. We have already seen ANZ's announcement that it will be reconsidering its role as a manufacturer of wealth management products. This does not mean that all banks will, or should, follow suit. But as they look to become more connected and tailored to the myriad needs of a customer, they may need to release direct ownership of parts of the value chain.

And with 17% or $6.2bn of expense (excluding employees) in 2016 related to technology, we expect the banks to take more and more partnership approaches to innovation, infrastructure and distribution - reducing the organisational footprint to create more flexibility and access the very best of others' developments. In pursuing their own approach to FinTech and innovation, each of the banks has the chance to invite others to help them change, while protecting the core of what they do and stand for as a brand.

Outlook – purpose and trust

Taking all of this together, the notion of 'purpose' for the major banks has never been so relevant – transcending the commercial and societal context. The majors are already busy reassessing, simplifying and refocusing on what makes them truly unique, where they are most relevant to customers and, therefore, where they will generate the most value. We have already seen the nature of the decisions that have been taken to date in response.

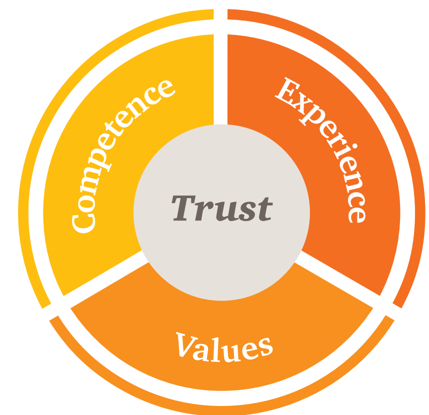
However effective these changes may prove to be, the banks have acknowledged that 'trust' will always be at the heart of the relationship between banks and society and that there is a lot more they can do to rebuild and reinforce it.

Our "Hot Topic" perspective takes a deeper look at the trust dynamic in Australian banking and the drivers of trust - Competence, Experience and Values.

Recognising bank actions to date, and that there are no quick fixes, we suggest some practical steps that can be considered to assist in rebuilding trust.

Of course, the challenges for the banks are not confined to rebuilding trust. In our view the next period will also be dominated by the following challenges:

- relatively **weak growth** in demand for credit, with **ongoing pressure** to access stable funding;
- competitive pressures on both sides of the balance sheet, inevitably requiring very **tight margin management**;
- assessing the implications of the forthcoming Basel Committee pronouncements on **capital requirements** and the final steps to achieve **"unquestionably strong"** capital and stable funding;
- hence the imperative to **reduce costs** can only accelerate, and a **reset to return and dividend expectations** by investors;
- an increasingly complicated cost agenda driven by the need to skew **investments to digital-ready capabilities**, with uncertain paybacks and useful durations; and
- further debate on the value of **non-core assets**.



> "...trust will always be at the heart of the relationship between banks and society"

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[1] Escaping the commodity trap: the future of banking in Australia, available at www.strategyand.pwc.com