Emerging strong - on shifting sands

Profits rebound to pre-pandemic levels and banks remain in great shape. Shifting sands set the stage for further transformation.

Banking Matters | Major Banks Analysis Full Year
November 2021

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Earnings and returns

Cash earnings

+53.7% yoy

-5.4% hoh

$26.8b

CE rose, driven primarily by credit write-backs, and reduced, albeit persistent, notable charges. This was offset slightly by a $1b reduction in non-interest income and $1.4b increase in operating expenses (ex notables).

Return on equity

+316bps yoy

-80bps hoh

9.9%

Up with the dramatic increase in CE yoy, but down hoh on higher capital levels held and lower CE in 2H21. RoE will normalise, to an extent, with the distribution of excess capital in the form of resumed pre-pandemic dividend levels and share buybacks.

Asset quality

Credit impairment

-$12.0b yoy

-$0.6b hoh

$0.8b benefit

Improved economic outlook resulted in a net credit benefit, bolstering results. Cessation of the majority of loan deferrals and the impact of recent lockdowns yet to show material impact on credit quality.

Credit provisions

-12.6% yoy

-7.8% hoh

$20.4b

Down due to additional releases of prior-year provisions as the credit environment and outlook improved. Credit provisioning levels remain elevated and substantially higher than the $16.4b level seen as recently as 2019.

Notable items

Remediation

$1.49b

-55.1% yoy

-11.9% hoh

Remediation charges continue to fall as legacy issues are addressed and in the absence of material new items. A substantial reduction from $3.3b and $4.4b seen in FY20 and FY19, respectively.

Reshaping the business

$1.9b

-43.2% yoy

+80.2% hoh

Driven in most part by two banks which wrote down goodwill, capitalised software and other assets in FY21. Charges have reduced from prior years as business rationalisation processes draw to a conclusion.

Revenues

Net interest margin

-3bps yoy

-3bps hoh

1.86%

Down due to liquids, competition and mix. Deposit funding and favourable wholesale funding rates (due to the RBA's Term Funding Facility) mitigated margin pressures. Net interest income was $63.5b, down $105m yoy.

Non-interest income (ex notables)

-5.8% yoy

-3.9% hoh

$16.1b

Structural decline in this revenue stream continued in FY21 and fell below $8b in 2H for the first time in over a decade. Yoy decrease primarily driven by reduced trading income due to lack of the markets volatility seen in FY20.

Expenses

Operating expenses (ex notables)

$38.2b

+3.7% yoy

+4.8% hoh

Technological and productivity savings outweighed by marked increase in personnel costs to improve risk management/ compliance and support customers through COVID. Headcount rose 9,438 spot (6.4% yoy), 6,333 ave. (4.3% yoy).

Expense-to-income (ex notables)

48.0%

+246bps yoy

+245bps hoh

Expense-to-income excluding notable items rose to 48%, the highest in more than a decade. Expenses were up whilst non-interest income fell yoy. Net interest income was broadly flat as the impact of increased average interest earning assets was roughly offset by reduced net interest margin in FY21.

Balance sheet

Lending growth

+3.8%

+402bps yoy

+304bps hoh

Discernible improvement yoy. Some majors were hampered by loan processes and unable to capitalise on domestic system credit growth (6.5% for home loans and 4.6% for business loans yoy), ceding mortgage share to the non-majors.

Common equity tier 1

12.7%

+129bps yoy

+23bps hoh

Increased profitability, reduced dividend payment (from announced FY20 profit) and improved credit conditions each increased CET1. Capital surplus reduced through share buybacks ($2b completed in FY21 and a further $11.5b committed for FY22).

Figures above are in respect of continuing operations and include the impact of notable items unless otherwise stated. Comparative analysis is against results as reported in FY20 (yoy) or a comparison of the first half FY21 (hoh).

Overview

Earnings rebounded, up 53.7% yoy to $26.8b in FY21 consistent with pre-pandemic levels as economic confidence continued to build with vaccination progress and reopenings. As uncertainty reduced, credit expenses fell by $12b (a net write-back of $0.8b) and notable expenses, which dominated bank results since 2018, fell significantly. This was despite a rise in operating expenses (excluding notables) as the banks added more than 6,000 additional people during the year to support growth, improve risk management and deal with COVID-related changes to demand. Non-interest income fell $1b for the year, continuing a consistent trend over many years. The strong result and elevated levels of capital held meant the banks were able to commit to return $32.2b of capital ($18.7b in dividends and $13.5b through share buy backs) and deliver a return on equity (RoE) of 9.9%.

The banks' reputation continues to benefit from their record of economic support to customers during the crisis. They have also delivered a significant amount of remediation, restructuring and simplification work during the unprecedented circumstances of the crisis. In short, **they are in very good shape, perhaps their best in a generation**, and can look ahead to an economic environment full of optimism and opportunity. There are many reasons for optimism about the outlook for growth, economic environment and breadth of opportunity.

However at the same time, the combination of long-term headwinds in core business performance, intensifying (and broadening) competition and accelerating changes in the external environment means the transformation can not stop there. **Sands are shifting** in ways we haven't seen in a long time, and it is worthwhile to think about them in terms of five interconnected 'fields of play' which we believe will determine the evolution of the industry and in which long-term advantage will be established. We call them F2AST, and they reflect PwC's framework for delivering sustained outcomes in many different industries:[1]

- **F**inancial results and environment
- **F**racturing world
- **A**tmosphere (climate)
- **S**ocial change
- **T**echnological disruption

It's obvious that banks have a lot to do, and the market won't wait. For the most part, banks appear hard at work on all the priorities you would expect. In the coming months and years, we will be paying attention to the way the major banks strike the **balance between rigour and speed** in four specific areas: people, technology, value proposition and societal leadership.

In each of these areas, there are two imperatives to balance. On the one hand, they must bring a level of ambition and haste appropriate to the speed of change, vigour of competition and scale of emerging strategic opportunity. On the other hand, they must ensure they deliver with enough rigour and care to ensure they do not reintroduce the very issues they have worked so hard these past years to put behind them.

We explain each of these points in the four sections below:

- Earnings rebound
- Banks in very good shape, perhaps their best in a generation
- Shifting sands - F2AST
- Balance between rigour and speed

1. See "Why sustained outcomes are essential for future success", PwC, August 2021.

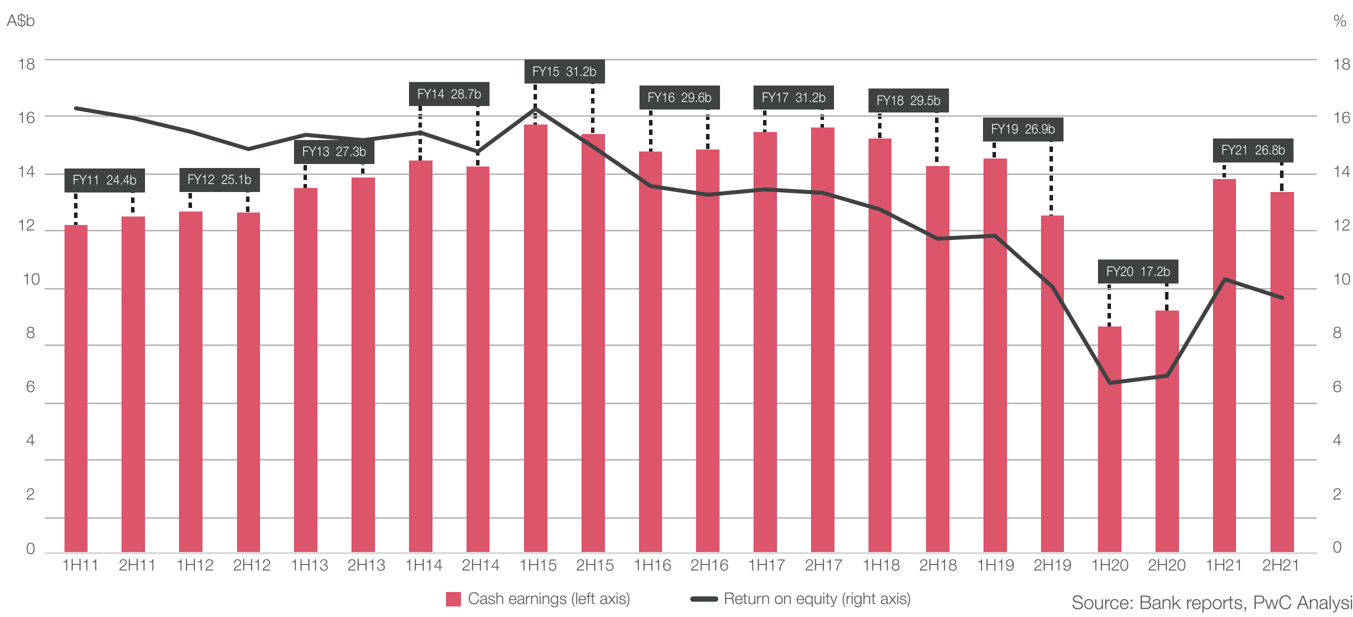
1. Earnings rebound

The economic recovery that started in late FY21 is still underway, and bank full year cash earnings (CE) reflect the economic outlook, strength of their balance sheets, reputation and progress on transforming their core franchise. The results, however, were driven by sizable reductions in credit expense and a marked fall in notable charges which in FY21 overshadowed the impact of less favourable longer term trends. Excluding credit expense, notables and tax, 'underlying profit' (UP) fell for the fourth year in a row, reflecting both the deliberate simplification of their business and a continuation of trends in the core banking businesses which have been building for a decade. These include declining NIM, market share, non-interest income, and a stubborn cost base.

Earnings recovered to $26.8b for year; the best since 2018, thanks to significant reductions in credit expense/provisions and a large decline in notable items.

Cash earnings at $26.8b represented an almost 60% increase on FY20. Two primary factors drove the rebound in the results. The first was a marked decline of $3.3b (pre-tax) in notable items from prior year as costs associated with strategic rationalisation of businesses and efforts to remediate issues of the past begin to taper. Notable items in FY21 still remain sizeable at $3.4b but were in most part driven by two majors which took large impairments in capitalised software, goodwill and leases in the period. It remains to be seen if notable items persist at this level in future periods but we believe, for now at least, that we are beginning to see the tail end of remediation costs.

Figure 1: Recovery of earnings to highest level since 1H19, though return on equity (ROE) remains at ~10%

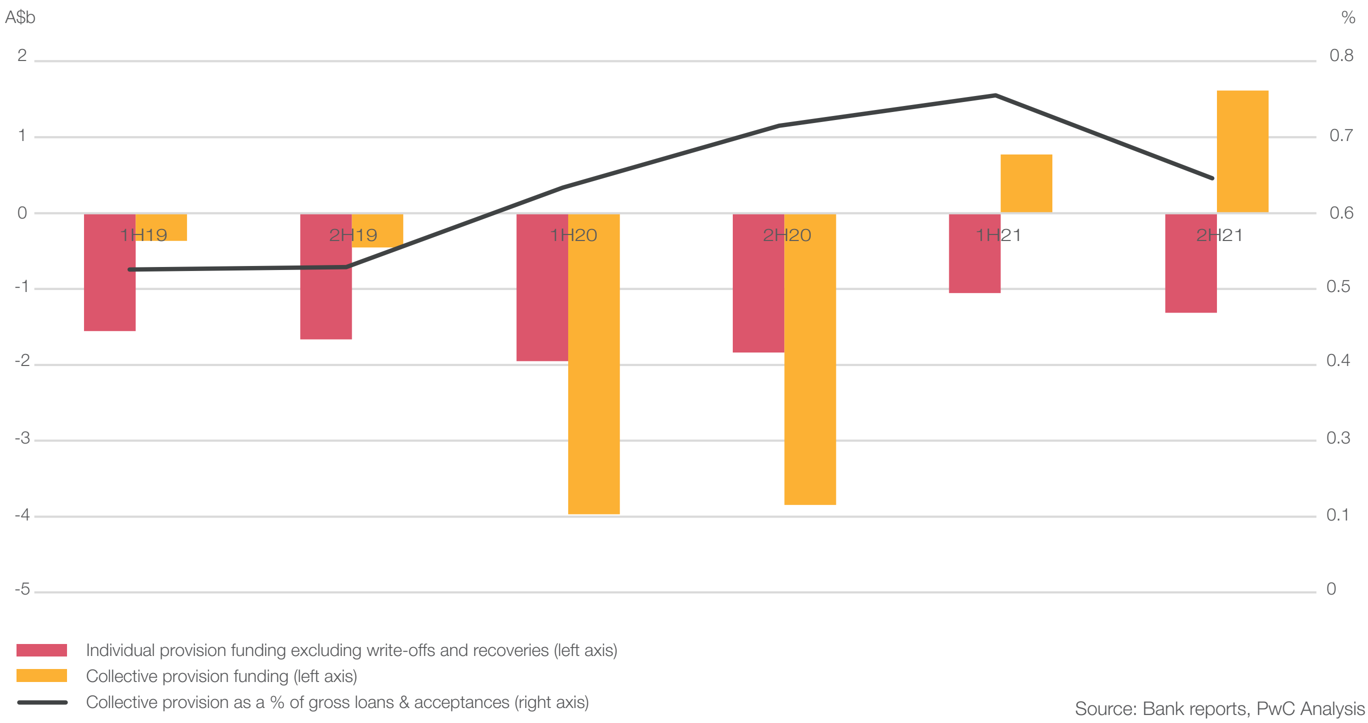


Source: Bank reports, PwC Analysis

A second feature of the FY21 results was a net swing in credit expenses of $12b, with a credit impairment benefit (net-write back) of $0.8b due to a more optimistic economic outlook from a year ago and an extremely benign credit environment. This compared to credit impairment expense of $11.2b in FY20, when the majors fortified their credit provisions in anticipation of potential COVID related credit losses which, thankfully, to date have not emerged; primarily due to fiscal and monetary stimulus. This further compared to a pre-pandemic credit impairment expense level of $3.7b in FY19.

Overall provision levels still remain elevated compared to pre-pandemic levels; total provisions are currently 0.73% of gross loans and advances compared to the 0.61% in FY19. Some risk remains, not least in relation to the time period for losses to emerge given the extent of support provided by the government, possible asymmetry of recovery across sectors and the success of reopenings over the longer term. However, should circumstances continue to improve as they have done in FY21, there may be further adjustments to provisions made.

Figure 2: Significant releases of credit provisions in FY21 but provisioning levels still higher than pre-COVID



Source: Bank reports, PwC Analysis

Further highlights of the results are as follows:

01 **Cash earnings rose to $26.8b** up from $17.4b a year ago and consistent with pre-pandemic levels. RoE has also recovered in more recent halves but, partly due to elevated capital levels held, is just shy of the double digits which were the new norm in almost any other half prior to 2019.

02 **A credit impairment benefit of $0.8b** in FY21, representing a $12b improvement relative to the $11.2b impairment expense in FY20. This was driven by the combination of lower provisioning levels (total provisions as % of gross loans and advances fell from 0.87% to 0.73% yoy) and lower impaired asset levels (0.31% as a % of gross loans and advances vs. 0.4% in FY20).

03 **Credit provisions reduced to $20.4b** from $23.3b in FY20. Overall provisioning levels are still above trend. If provisioning coverage levels were to fall to pre-pandemic levels of 0.61% of gross loans and advances, this would result in a total provision amount of ~$17b indicating a potential upside to future earnings of ~$3.4b.

04 **Notable items fell to $3.4b** for the year down from $6.6b. Consequently, these weighed less on the results compared to a year ago as legacy issues were addressed and efforts to reshape businesses progressed. Notable items for FY21 were driven by regulatory and service remediation, as well as write-downs on businesses, goodwill and capitalised technology.

05 **Net interest margin (NIM) decreased to 1.86%,** another record low and down 3bps from a year ago, primarily as a result of increased holdings of low margin liquids assets, increased pricing competition and a change in portfolio mix towards lower margin products by customers. Increased proportion of deposit funding and favourable wholesale funding rates (largely due to the RBA's Term Funding Facility) helped mitigate the impact of margin pressures.

06 **Non-interest income decreased to $16.1b** excluding notables, continuing its steady decline from the $17b reported in FY20 to its lowest level in over a decade. The yoy decrease was driven by reduced trading income due to the drop in market volatility from FY20. Fee income also fell due to the removal of fees, reduced card usage and lower institutional credit utilisation. Non-interest income as a share of total income has now fallen to just above 20% for the first time.

07 **Expense-to-income excluding notable items rose to 48%** the highest level in at least a decade as income fell marginally and costs rose. Savings from technology and productivity investments were outweighed by marked increases in headcount required to improve risk management and compliance processes as well as support customers through COVID.

08 **Lending grew by 3.8%**, which was far less than domestic system growth of 6.5% and 4.6% for home and business loans respectively. Share loss in mortgages has been especially pronounced, with both non-banks and non-majors growing faster than the majors.

09 **Common equity Tier 1 (CET1) rose again to 12.7%** on the back of increased profitability, reduced dividend payments (from conservative FY20 dividend declarations) and improved credit conditions. This reflects almost $44bn CET1 capital in 'excess' of the banks' 10.5% requirement (though this is before $11.5bn in share buybacks and FY21 dividends completing in FY22). We expect CET1 to normalise with resumed dividends and the announced share buybacks.

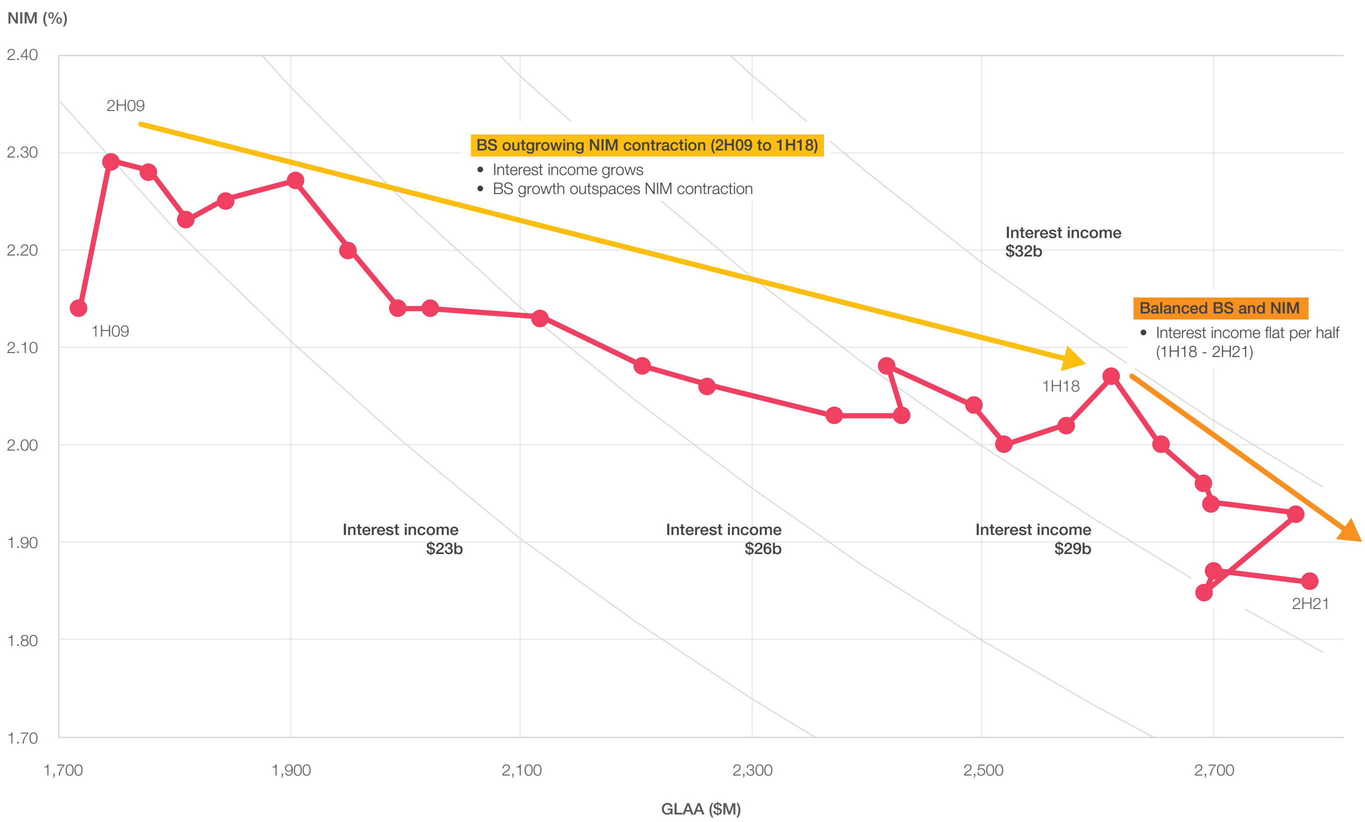
10 **Deposits grew $159b** in the year thanks to government stimulus and Quantitative Easing, growth of 7.2%. These higher deposits, along with the Term Funding Facility, helped reduce funding costs in the year and may further in the outlook.

Long-term headwinds evident in results

Net interest income, the engine of revenue growth, is stalling

Notwithstanding the rebound in CE, the results highlighted longer term challenges in the banks' underlying economics. Net interest income, for example, retreated in 2H20 and again in FY21, as balance sheet growth was insufficient to compensate for falling net-interest margin (NIM). While the story for individual banks differs significantly this year, this reflects 12 years of falling net-interest margin (NIM) as competition has intensified and market rates have fallen. Until last year, banks were able to offset this change with a growing balance sheet but since then, losses in aggregate market share, overall subdued credit growth, combined with the margin impacts of low central bank rates, product mix and significant additional liquid assets have meant NII has fallen or barely risen.

Figure 3: Secular decline in NIM presenting sustained constraint on interest income



Source: Bank reports, PwC Analysis

For mortgages in particular, bottlenecks in application processes at some banks were unable to cope with the volume of demand in the past two years. This prevented them from capitalising on stronger credit growth during the year. As a result, the majors overall lost share.

Looking ahead, there is reason to expect a rising and steepening yield curve will be, all else equal, NIM-accretive for the majors, especially given the elevated levels of system deposits which we expect will linger for some time.

However, depending on what happens to inflation (see below), it is also possible that 'real' NIM is lower, not higher, in the years to come.

In any case, whatever happens to the yield curve, it will not address challenges in application throughput, competition and portfolio shifts away from higher-margin products, so we expect to see pressure on NIM continue.

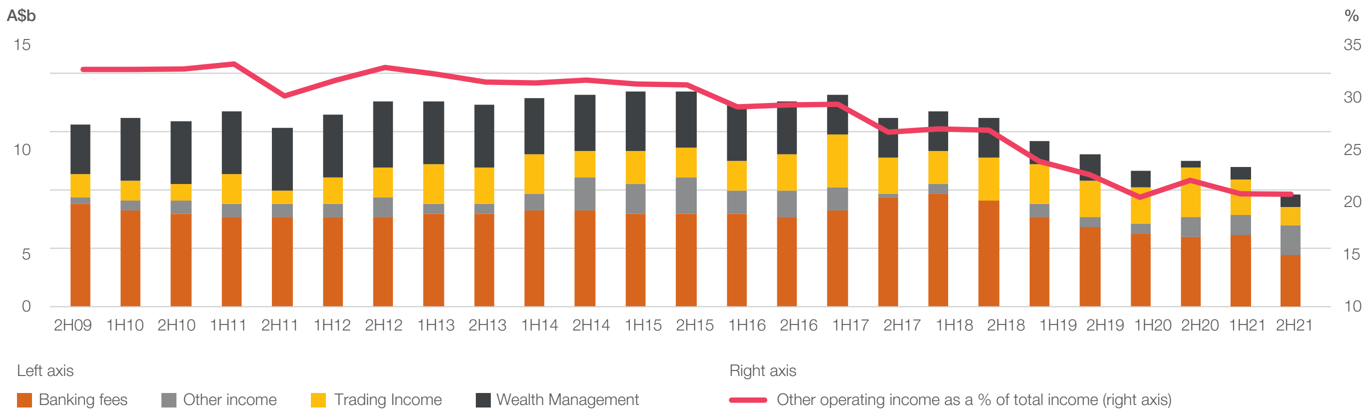
Diversification benefit of non-interest income diminished through simplification

Non-interest income as a proportion of total income continues to fall, coming in at around 20% for FY21, compared to over 30% during the 2010s and the lowest level for a decade. Much of this is driven by divestments in non-banking businesses, of course, but the banks have also experienced a steady decline in banking fee income due to the removal of product fees and declining card and ATM usage.

While much of this decline could be deemed deliberate given the simplification steps described above, as the name suggests, non-interest income is a valuable ballast to earnings during low rate phases of the economic cycle, tends to have scale benefits and is generally less capital intensive. More broadly, the non-interest income opportunity reflects a broader strategic imperative to service a wider spectrum of customer needs, becoming more integrated in their financial lives, without rebuilding complexity into the business by veering away from the core.

There are several recent examples of steps taken by the banks that indicate, with simplification progressed, the appetite to invest and partner to approach this opportunity has returned.

Figure 4: Non-interest income continues decline as a proportion of total income



Source: Bank reports, PwC Analysis

Costs reduction initiatives not yet delivering reduced costs

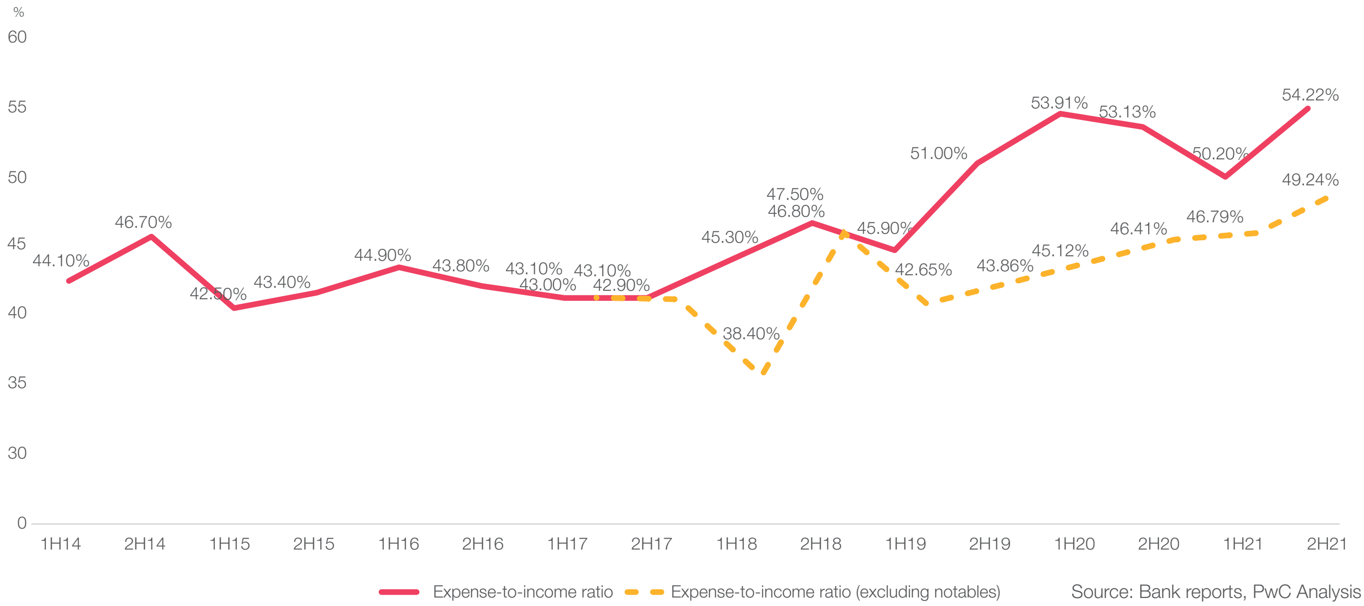
Given the narrowing of traditional margins observed above and a highly competitive outlook, the cost of running the banks and investing in the future have become a critical factor in results. Three of the majors have committed to cost 'targets' (or 'guidance') that they expect to be achieved through the completion of business disposals, simplification, technology migrations (over time) as well as the realisation and full exploitation of broader productivity investments which are underway.

However changes of this nature take time and so far efficiencies gained have been largely outweighed by other cost increases and particularly headcount increases; notably, the costs of dealing with the pandemic, enhancement of risk management and compliance oversight, as well as the inevitable doubling-up of expenses when legacy systems and processes must be maintained while new ones come online.

Notwithstanding significant efforts to reduce 'ongoing' operating costs, total expenses excluding notable items, at $38.2b, were 3.7% higher in FY21 than the preceding year. Average FTE rose by over 6,000 to c. 152,000 today as the banks recruited to support customers during COVID, invest for growth (including supporting operational problems described above) and improve risk management. The expense-to-income ratio (excluding notable items) rose as a result to 48%, its highest level in more than a decade.

Given the extent of investment that may be required to respond to the factors of change described later in this report, the uneven profile of cost benefits from transformation and simplification and the (debated) potential for inflationary pressures, we expect the cost profile to be a critical and challenging focus in the years ahead.

Figure 5: Expense-to-income ratios are back to record highs



Source: Bank reports, PwC Analysis

2. Banks in very good shape, perhaps best in a generation

Notwithstanding the challenges noted above, there are many achievements and opportunities for the banks to be happy and optimistic about. For one, the major banks - at least at this time - are in very good shape, perhaps their best in a generation. They have important achievements behind them in areas as diverse as: customer and compliance remediation; strengthening balance sheets (capital and provisions); divestments; selective acquisitions; and investment in people, skills and technology. All this was carried out in an operating environment full of unprecedented logistical and other challenges. Looking ahead, the outlook for the economic and financial environment is extremely favourable. We review some of these achievements, and our views on the outlooks, below.

Internal reinvestment and restructuring

Banks spent much of FY20 strengthening their balance sheets against both expected and unexpected losses. We estimate the majors retain almost $44b capital in excess of that required for their 10.5% CET1 target (not counting dividends and $11.5b share buybacks taking place in FY22).

Provisions ($20.4b) are down from FY20 but are still greater than any prior level since 2009 (notwithstanding increased provision coverage due to the adoption of AASB9 in 2019), with actual losses not transpiring in line with the heightened FY20 expectations.

As for reputational capital, the industry is enjoying something of a reappraisal in the public discourse. Thanks to their readiness to support customers and the economy during the COVID-19 pandemic, and to redress customer grievances with intent, banks are simply not the focus of the negative attention they've received for such a long time. They've avoided significant adverse headlines, and record-low borrowing rates probably haven't hurt either.

External readiness for rebound and growth

It's not just the banks that are in good shape. It's much of the global economy, including Australia. We should of course exercise extreme caution in forecasting the future impacts of the pandemic, including how credit losses, particularly businesses, could emerge over the longer term horizon- but for now the signs are positive. Although workforce participation remains subdued by physical constraints (from lockdown to shortages), the 4.6% unemployment rate suggests those who are in the labour force are finding work and working.

Consumer attitudes have changed during the pandemic and we expect working from home and online shopping to continue. The approximately $337b in additional deposits accumulated since FY19 is a substantial sum, ready to be spent on (long-foregone) consumption and entertainment, especially as we head into summer. In fact, although consumer confidence has fallen from its April peak when the Delta variant emerged in Australia, it has remained at elevated levels all year and can be expected to rise again as lockdowns are lifted.

Some of this is, of course, due to supply. With borders closed, for instance, it's harder to find talent, and so job adverts stay up longer. But anecdotal evidence suggests that there is genuine and widely held optimism right now. The good news is that the opening of borders will stimulate the job market in terms of both supply and demand.

Finally, on top of all this, the UN expects that $1-2T per year in incremental capital and funding is needed, at least through to 2030, to meet net-zero commitments[2]. From housing to infrastructure, clean energy to green manufacturing, there are huge opportunities for growth.

2. See UN Climate Action Report.

3. Sands that are shifting - F2AST

At the same time, combined with the long-term headwinds above, intensifying competition and accelerating changes in the external environment means that the transformation successes described above must continue and can not stop there. The strategic foundations are shifting in ways we haven't seen in a long time.

To make sense of the broad scope and implications of these varied factors, we think about them in terms of five interconnected factors which will determine both the evolution of the industry and the 'fields of play' in which to establish transformational business outcomes and long-term advantage - we call them F2AST[3] and they are relevant far beyond just banking or financial services:

01. Financial results and environment
02. Fracturing world
03. Atmosphere and climate
04. Social polarisation
05. Technological disruption

3. See "Why sustained outcomes are essential for future success", PwC, August 2021.

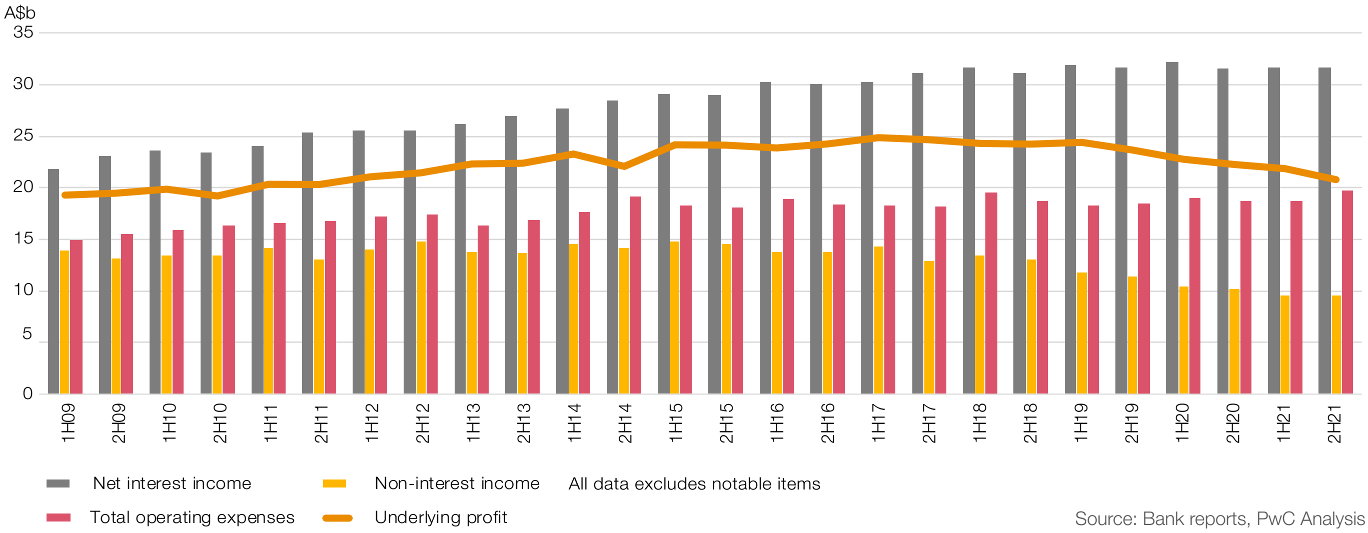
01 Financial results and environment

Notwithstanding the health of the overall environment, the financial foundations of the business are challenged by a number of factors, the most significant of which include: the gradual reduction in core earnings; newly-emerging competition; and a potential end to this era of low inflation and falling rates.

Slowing core earnings

Although steady, on an underlying basis, core bank results have been slowly reducing in part through deliberate simplification and in part due to long-term trends discussed in Section 1. In fact, since peaking at $24.2bn in 1H17, underlying profit (earnings before notable expenses, credit and tax) has reduced to $20.1b in 2H21. This is illustrated in Figure 6.

Figure 6: UP has been in decline since 2017

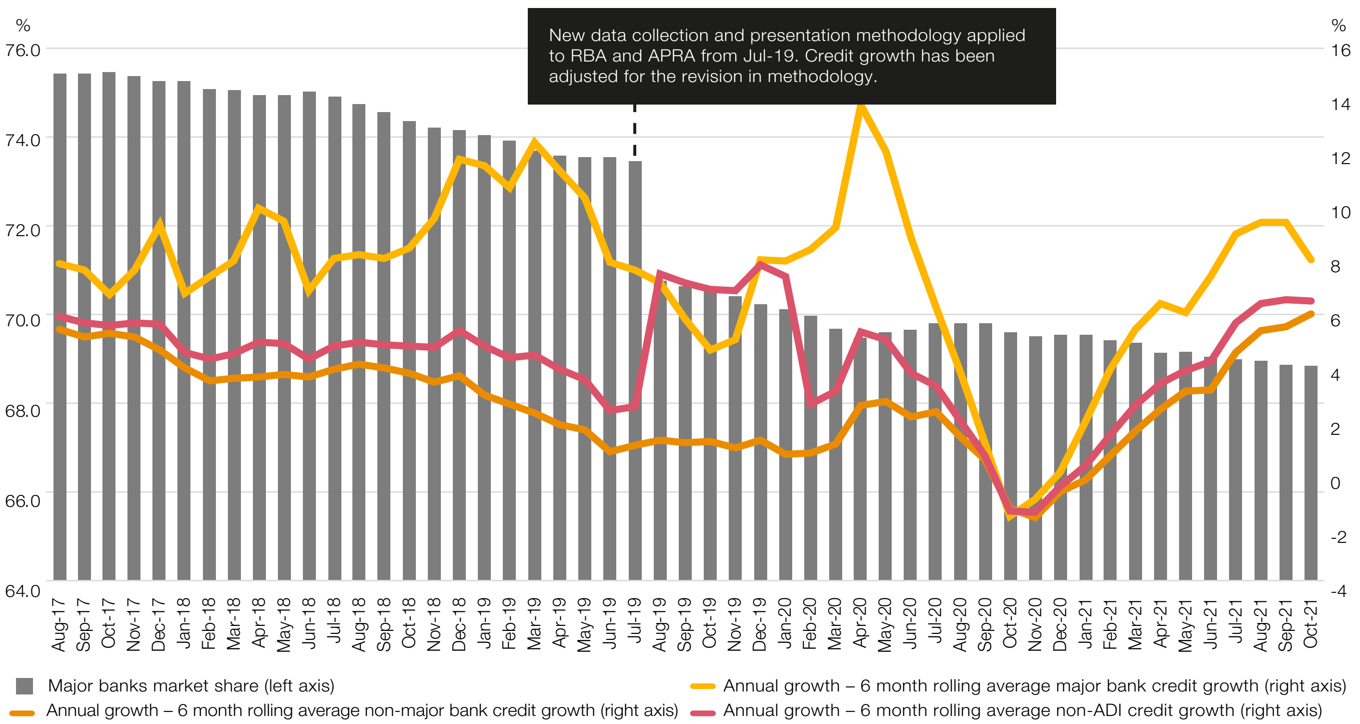


Source: Bank reports, PwC Analysis

This is driven by the trends in expenses, interest income, margins and non-interest income discussed in Section 1.

Those trends have been amplified by the slow erosion of market share, especially in mortgages, a market in which the majors took significant share in the dislocation following the GFC. More recently however, at an aggregate level (not for all majors) they have steadily been losing share to both non-major banks and non banks alike. This is illustrated in Figure 7.

Figure 7: Eroding share is impacting interest income despite system growth



Source: Bank reports, RBA, APRA, PwC Analysis

In fact, though the majors' share of mortgages remains dominant at 75%, in the past 18 months they accounted for only 56% of new net growth, although in business lending they have held their own.

Newly-emerging competition

Share of the banking 'wallet' is being taken by new kinds of competitors, including fintechs, non-bank lenders (including BNPL), as well as non-major banks who are demonstrating especially consistent focus, discipline and strategic intent.

Last week, Australia saw a significant bank IPO, a recent startup that is now, with a $2.5b market capitalisation, is an ASX200 listed company. Digital-only lenders are bringing compelling offers to mortgage and business borrowers. They are winning both market share and awards for service and innovation. Finally, based on current trends, one non-major is on track to overtake a major in market capitalization terms sometime in FY22. It's not an apples-to-apples comparison: this institution is truly global and its business spans much more than banking. Nevertheless, if this happens, it would be the first time since deregulation that the 'Big 4' banks were not also the four most valuable financial institutions in Australia.[4]

The two largest online payments providers are actively acquiring and growing in traditional banking domains (illustrated, most dramatically, with last winter's acquisition of Australia's largest buy now, pay later (BNPL) provider, the largest acquisition in Australian history). Again, in terms of market capitalisation and ability to deploy resources and technology at scale, these providers are at least comparable (and arguably larger) than even the largest major bank.

Whilst vigorous competition is nothing new in banking, it has been a long time since the majors faced competition quite like this. In light of the rapid evolution of new players and dynamics in crypto, DeFi and other services, the competitive landscape for banking in Australia in the next few years may be dramatically different to anything we have seen in a very long time.

Potential end to era of low inflation and rates

All this is taking place in the face of profound questions about the very nature of the monetary system and financial regime. Will it continue to be characterised by low rates and inflation, balanced by elevated asset values, returns and debt? These are the key features of what one might call the 'long wave' which began in the early 1980s, and they have had profound consequences for the nature of banking and the global financial system, the sources of value and advantage, and wealth. In short, if the recent inflationary signals are signs of things to come - then a lot of very deeply-held beliefs about the future of this business will need revising; or will they?

Obviously, we don't know. For now, we agree with the 'inflation dove' consensus in Australia (which, after last week, clearly includes the Reserve Bank) that most of the inflation we see around the world has very clear explanations, and they are almost all found in things which are transitory: supply-chain disruption, 'catch-up' demand, fiscal stimulus, pandemic-induced changes to consumption, and many others. No doubt these will all dissipate as global economies return to 'normal' (whatever that may be).

However, just because a spark is transitory doesn't prevent the fire from catching and having a life of its own. Almost every major economic and geopolitical transition was triggered by things which were, at the time, transitory. This includes not only the break out of inflation in the 1970s, but also the period of low inflation which followed.

Around the world, thanks to the combination of demographic changes and rising expectations of the workforce in places like China and India, labour supply is no longer in surplus relative to demand (and capital) the way it was in the past.

More recently, the effectiveness of government stimulus has led to a 'rediscovery' of Keynesian economics, including so-called 'MMT', much of which indeed involves nothing more than the translation of Keynesian ideas into a post-Bretton-Woods environment.

On the supply side, producer pricing power is clearly not dead, with markets tolerating 4-5% price increases across a broad set of goods and services in almost every currency. Finally, regarding monetary policy, it remains extremely unclear whether central banks have the capacity or will to restrain rising inflation should it become embedded in expectations.

Our view is that a scenario of sustained (10-20 years) inflation, along with periods of negative real rates, is a possibility that at least warrants contemplation, and banks need to think about how they would respond. It would have enormous implications for the distribution of value (e.g. negative for lending and proprietary risk taking, positive for fees and services), and will affect excess returns, opportunities for growth, and, of course, risk.

4. Note that it was originally 'six pillars', with the four majors and two largest insurance / wealth-mgt companies representing the foundation of Australian financial services.

02 Fracturing world

Globally, the certainties of trade, international relationships and political dynamics of previous decades have given way to a far more fractured world of competing, and sometimes hostile, powers, economic models and ideologies, notwithstanding important efforts at building global cooperation in areas including financial regulation, tax, human rights, labour and the environment.

As providers of services to international customers (be they individual or businesses) and financiers and facilitators of cross-border trade and investment, Australia's major banks have a critical role in helping their customers navigate this effectively and manage the risks inherent in these complex dynamics - and indeed to manage their own role and risks.

Thanks to certain trends which do not appear to be abating, it will likely continue to get harder to deal with multilateral challenges like these, before it gets easier. We expect to continue to see examples of this fact and its implications in the banks' and their customers' businesses and operations, particularly given the relevance of international alignment and cooperation as the world transitions towards zero carbon.

03 Atmosphere and climate

The decarbonisation of global economies as they transition to net zero could present the most clear and sizeable opportunity for the major banks, given the eye-watering significance of change, investment and risk that it presents to Australia.

Perhaps one of the most notable differences between Glasgow and previous COPs[5] is how much of the discourse has centred on the 'real economy' impacts of decarbonisation and the related commitments.

In the years ahead, these gatherings may even supplant Davos as the paramount gathering of the world's leaders, decision makers and other stakeholders, just as Davos replaced the annual WTO gatherings for that status in the '00s. There is a symbolism in that. For one, it is symbolic of the direction of change in the economy, financial markets and banking. The 'existential imperative' for humanity must inevitably become an existential priority for the industry responsible for the allocation of credit and capital. For the world, that is expected to require $1-2T in incremental energy and infrastructure investment every year to 2030, and likely beyond, according to the UN Climate Action report.

Obviously this is both a moral and commercial opportunity for banks - but it's a threat as well. As any banker who's ever worried about their place on a league table knows, there is a certain winner-take-all dynamic in many areas of finance, especially when new. An institution able to establish an early lead can quickly consolidate their position as deals and mandates attract attention, attention attracts clients and talent, who then go on and do more deals.

The majors are well-positioned, but they are not the only ones. Banks, funds and private wealth around the world, including in Australian non-majors are deeply assessing and have significant growth agendas centred on financing the transition to net zero. It's not just about ESG risk and showcase deals; it's the basis of their growth strategy for the decade to come.

04 Social polarisation

Society itself is changing in ways that reinforces the challenges described above for the banks' core franchise, but also presents new opportunities for growth, distinction and impact.

At this time, there are three great sources of polarisation with which bankers will need to grapple in the next 12 months, and likely for years to come: the divergent way different Australians are experiencing the economic recovery; the cost of housing and implications for equality; and the so-called 'Great Resignation' and future of work.

Divergent (K-shaped) recovery

We don't hear much about the 'K-shaped' recovery these days. With credit conditions so mild, and losses so low, it's easy to forget that for many businesses and households, the economy is still in crisis. In a recent survey, over 25% of businesses said their revenues were up more than 40% on pre-pandemic levels – twice as many as last year. At the same time, 20% reported revenues down 20%, again double the number last year. In short, both 'legs' of the K are growing apart, and for all the positive headline data, we continue to see stress in areas like commercial property, hospitality, tourism and entertainment.

Nevertheless, so far at least, borrowers aren't defaulting. How much of this is due to government support, bank support, stored-up capital and/or, most importantly, hope, remains to be seen. We suspect, however, that many of these are relationships which will require ongoing counsel, oversight and support for years to come.

5. The Conference of the Parties, or 'COP', is the governing body responsible for oversight of any global convention in international law. For obvious reasons, the COP for the UN Framework Convention on Climate Change is the most famous today, all though there are 'COPS' for every major convention. Glasgow was the 26th such annual convention, and is therefore known colloquially as 'COP26'. COP27 will take place in Sharm El Sheikh.

Housing, equality and the Jane Austen economy

Another issue banks will have to grapple with for at least a generation is the extraordinary growth in the cost of housing and household debt relative to wages over the past three decades. Mortgage lending growth during this period ran well-ahead of nominal GDP.

During that time the share of households not owning their own home has risen from 23 to 33 percent.[6] For those not lucky enough to have access to family wealth, even if highly-skilled and professionally employed, participating in Australia's now $9T housing market appears increasingly out of reach. Economists are increasingly talking about a return of a 'Jane Austen' economy divided between those who own property and those who never shall.

Bankers understand that this is unsustainable, with a number of major-bank CEOs saying so publicly. Accordingly, macro prudential measures such as last month's increase in minimum serviceability buffers were broadly welcome by the industry, and we suspect, barring an early rate rise in 2022, there will be more such measures to come.[7]

Great resignation and future of work

Finally, banks are confronting the reality of reopening of workplaces, the gradual return of many people back into the office, and into a changing world of work. Obviously the immediate priority is ensuring the safety of returning employees, inclusiveness of actions and noting that the virus is still circulating.

At the same time, many are finding that lockdowns and work-from-home (WFH) have given them an opportunity to reflect on their own aspirations, values, priorities, worth and power. Some are leaving, and those who stay expect to be able to renegotiate the terms of their employment. Banks, as recruiters and employers of some of the most highly-skilled Australians, need to be on the front-foot in this discussion, proactively working to not just get their people back to the office, but to ensure they remain engaged with purpose and enabled to thrive in the environment ahead.

05 Technological disruption

The fifth area needing sustained outcomes on shifting sands is of course, disruptive technology. Banks are working hard on digitisation, cloud migration and automation. At the moment, innovation is especially active in payments. In August a buy-now-pay-later (BNPL) provider that successfully embedded its app into the point of sale for many online retailers with a special focus on millennials was the target of the largest buyout in Australian history. Its acquirer, a leading provider of merchant payment solutions, is a bank in its home country.

The next big frontiers for technological advancement, or disruption, involve such things as open banking, artificial intelligence, digital money, IoT and the so-called 'semantic web' (or Web3.0) and how it helps enable decentralised finance. In our view, the interplay between transaction analytics, open data, payments and digital currencies represents perhaps the most prospective area for innovation in the next few years.

6. Australian Institute of Housing and Welfare, Home Ownership and Housing Tenure Snapshot, 30 June 2021
7. RBA guidance remains that a rate rise before 2023 is off the table. However, swap rates suggests the market doesn't believe it.

4. Balance between rigour and speed

It's obvious that banks have a lot to do. The majors are working hard on many fronts: technology simplification and transformation; new services; customer intimacy; uplifting culture; risk management practices and controls; compliance; customer outcomes; productivity; and of course, ESG. The scope of work is broad and, broadly speaking, similar across most institutions. The key points of differentiation will be execution, speed and, most importantly, rigour.

Banks are complex things. It's not just because of legacy systems and processes. It's due to the very nature of who they are: institutions that sit at the heart of capitalism, intermediating between so many (often) competing stakeholders, interests and objectives. Transforming such an enterprise, while simultaneously satisfying such a wide range of operational, regulatory, legal, and commercial requirements has never been easy.

There is no bank not working hard on all of this now. The big question, of course, is whether they will move fast enough – and carefully enough – and how much of the opportunity will be seized by others while they struggle with this balance.

In the coming months and years, we will be paying attention to the balance of ambition, pace and carefulness the all the areas above, with special focus on what they do in areas which we categorise, for the sake of discussion, into the following headings:

People

Technology

Value proposition

Societal leadership

We describe each of these below.

People: getting people back to work safely, and keeping them there

We start with 'people' because it is here where the most immediate imperatives lie. Very simply, people are coming 'back' to work. As mentioned in Section 3, the transition back to 'normal' (whatever that looks like) must be managed effectively and safely. Many will also likely use the reopening as an opportunity to reconsider their life and career aspirations and the future employee value proposition (EVP).

Although we are not (so far) seeing evidence of an emerging 'Great Resignation' in Australia of a scale comparable to what has happened in other markets, we do expect retention to be a challenge for banks in areas such as analytics, technology, design, and leadership, where demand for talent is especially high, and this will be exacerbated the longer borders remain closed.

Accordingly, we will be paying special attention to statistics about turnover, satisfaction, and planned versus actual full-time equivalent, especially for the aforementioned specialisations.

Technology and digitisation: infrastructure, analytics, automation

While the technology discussion in Section 3 is about 'disruption', the majority of the current agenda is perhaps more every day but no less significant: continuous improvements to digital solutions for customer journeys, better use of analytics and artificial intelligence, decommissioning old systems. The fact that this now might feel like blocking and tackling says something about how far the banks have come.

We will be paying attention to the ongoing disclosures such as share of applications, data, and customer transactions held in the cloud as one useful measure of progress, since most contemporary applications are designed to be hosted there.

But perhaps more importantly, customers' lived experience in the last 18 months have dramatically increased comfort with digital-first or digital-only solutions. Likewise, the share of transactions and customer interactions that are digital-first merit special focus (and we expect this to grow steadily over time). These metrics must be carefully matched with progress on measures of operational risk (both forward- and backward-looking).

Finally, while customer satisfaction and feedback is always important, it is worth ensuring that the questions and metrics appropriately distinguish between digital, non-digital, and hybrid experiences.

Value proposition: especially non-interest income streams

The new trajectory of top-line revenue provides an opportunity for the industry to ask a fundamental question: How does it create value, and how does it get paid?

For three decades the basic model has been:

- Earn interest income off the balance sheet whose growth is driven by Australian mortgage lending
- Charge fees for critical services, and
- Offer a wide range of other - often quite expensive - services for free as a means of attracting customers and keeping them. These include internet banking, branch support, call centres, and many others.

As mentioned above, the value of this model is diminishing. What can be done?

The first priority, obviously, is to find a more long-term sustainable source of balance sheet growth. As we've discussed, we believe that business and institutional credit and capital provision, especially for energy, infrastructure, housing and net zero transition represents enormous opportunities for growth.

The second is to find new sources of non-interest income. Simply raising existing fees or charging customers for services they may not value (or worse, which a bank's own processes make impossible to avoid) is obviously not a solution. Better pricing can certainly help,[8] but it's not a silver bullet.

What is really needed and is arguably underway is a stream of new products and services customers will want to pay for. Obviously, that's easier said than done, particularly to avoid creating new complexity - and is a function not only of investment and intent, but also of risk appetite, culture and tolerance for failure.

In the years ahead, we will be paying attention to the way banks talk about their strategy, ideas and ambition in areas such as platforms, outsourced services, embedded finance, micropayments and partnerships. We will be especially looking for examples of customer problems being solved in unique and differentiating ways, and whether they might pay for that.

[8] See PwC Hot Topic: The Price is Right: what should we pay?, June 2018.

Societal leadership: differentiated positioning on F2AST fields of play

Finally, we will look to see which banks stake out clear positions of leadership in the interconnected F2AST fields of play. Obviously, with COP26 just ending, atmosphere and climate is most topical, and this is a natural opportunity for the majors. In the last year we've seen significant activity in terms of lending commitments, ESG and green bonds, derivatives, carbon trading platforms, and other initiatives, but this is just the beginning. Many markets are not yet deep or sophisticated enough to enable, say, fulsome hedging and pricing of an institution's climate and ESG risks, but the pace of change is dramatic.

After all, there are real risks to manage. Most obviously, it is essential that public statements about climate (or any ESG issue, for that matter) are consistent with other things the bank is doing. Given the size and breadth of these institutions, that is never easy.

The second is to remember that as important as net-zero may be, it is not the only opportunity for major bank leadership. Housing affordability, as mentioned above, is an area where banks have an enormous contribution to make. Funding for much-needed social and affordable housing comes from the banks. The industry is also a stakeholder in the societal conversation about land use, urban architecture, permits and regulation of development and construction. These are all critical drivers of the quality and quantity of future housing supply. Finally, and most importantly, it is bank lending which determines the 'money supply' for housing, and by extension, all else equal, its price.

There are many areas just like this where banks can exercise societal leadership. See our half-year report[9] for more, including our discussion of the changing world of work, Australia's place in the world, and the broader challenges of changing social norms and expectations about fairness, equality and justice.

9 See Window of Opportunity, MBA 1H21, May 2021, PwC.

Optimistic about potential opportunity

Profits have rebounded dramatically. The industry has managed an unprecedented set of challenges, and so finds itself in very good shape, perhaps its best in a generation – financially, operationally and reputationally.

Banks are operating in an environment which is as favourable as it has been in a long time. There is a backlog of consumption and economic activity ready to be unleashed, as well as a slew of challenges and opportunities, which markets all over the world seem ready to address. It's not a bad confluence of circumstances.

At the same time, a combination of long-term headwinds in core business earnings, intensifying competition and accelerating changes in the environment are shifting the sands and setting the stage for the next phase in bank transformation.

Five interconnected factors, which we call F2AST, will determine the evolution of the industry and also the 'fields of play' in which transformational, sustainable business outcomes and advantage will be established.

For the banks, while capacity to innovate and change exists, disciplined execution will be key. As will the ability to strike a balance between careful rigour and ambitious pace. It's a balance that is, unfortunately, easier for us to describe than the reality of delivery.

	ANZ			CBA			NAB			WBC		
	FY21	FY20	FY19	FY21	FY20	FY19	FY21	FY20	FY19	FY21	FY20	FY19
Earnings and Returns												
Cash earnings	6,198	3,758	6,470	8,653	7,296	8,492	6,571	3,749	5,180	5,352	2,608	6,849
Cash earnings (incl discontinued operations)	6,181	3,660	6,161	8,801	7,449	8,706	6,464	2,810	4,891	5,352	2,608	6,849
Cash earnings before tax	8,963	5,631	9,163	12,243	10,348	11,941	9,206	5,421	7,289	8,345	4,748	9,830
Core earnings (A)+(B)+(C)	8,396	8,369	9,958	12,797	12,863	13,138	8,989	8,183	8,208	7,755	7,926	10,624
Dividends paid (per cash flow)	2,834	2,861	4,471	4,132	7,629	6,853	2,682	2,323	3,266	2,846	2,518	4,977
Income tax expense	-2,764	-1,872	-2,678	-3,590	-3,052	-3,437	-2,635	-1,672	-2,109	-2,988	-2,138	-2,975
Profit after tax (statutory basis)	6,179	3,675	6,296	8,843	7,459	8,360	6,471	3,498	5,090	5,458	2,290	6,784
Return on average equity (%)	9.94%	6.19%	10.87%	11.51%	10.30%	12.49%	10.62%	6.39%	9.64%	7.55%	3.83%	10.74%
Notable Items												
Cash earnings (excluding notable items)	7,144	5,259	6,772	9,228	7,750	9,343	6,571	4,772	6,628	6,953	5,227	7,979
Remediation included in notable items (net profit before tax impact)	-327	-383	-585	-575	-454	-851	0	-373	-1,571	-587	-2,104	-1,384
Revenues												
Net interest income (A)	14,161	14,049	14,339	18,839	18,610	18,120	13,797	13,871	13,542	16,714	17,086	16,953
Net interest income (excluding notable items)	14,247	14,021	14,430	18,839	18,610	18,120	13,797	13,920	13,614	16,587	17,229	17,297
Net interest margin (NIM) (%)	1.64%	1.63%	1.75%	2.03%	2.07%	2.10%	1.71%	1.77%	1.78%	2.04%	2.08%	2.12%
Non-interest income (B)	3,286	3,703	4,690	5,317	5,148	6,287	3,009	3,319	3,679	4,324	3,540	3,702
Non-interest income (excluding notable items)	3,927	4,690	4,456	5,317	5,148	6,287	3,009	3,399	4,814	3,807	3,803	4,522
Non-interest income as a % of total income (exld. notable items)	22%	25%	24%	22%	22%	26%	18%	20%	22%	19%	18%	20%
Expenses												
Total operating expenses (C)	-9,051	-9,383	-9,071	-11,359	-10,895	-11,269	-7,817	-9,007	-9,013	-13,283	-12,700	-10,031
Expense/income ratio (%)	-52%	-53%	-48%	-47%	-46%	-46%	-47%	-52%	-52%	-63%	-62%	-49%
Total operating expenses (excluding notable items)	-8,670	-8,649	-8,562	-10,784	-10,441	-10,418	-7,817	-7,599	-8,155	-10,936	-10,161	-9,570
Expense/income ratio (%) (excluding notable items)	-48%	-46%	-45%	-47%	-42%	-40%	-47%	-44%	-48%	-54%	-48%	-44%
Total number of full time equivalent staff	39,684	37,506	37,588	44,375	41,778	42,921	32,741	31,372	34,370	40,143	36,849	33,288
Asset Quality												
Credit impairment expense	567	-2,738	-795	-554	-2,518	-1,201	217	-2,762	-919	590	-3,178	-794
Loss rate (%) (credit impairment expense/total GLAA)	0.09%	-0.44%	-0.13%	-0.07%	-0.32%	-0.16%	0.03%	-0.46%	-0.15%	0.08%	-0.45%	-0.11%
Individual provision funding (exld. write-backs and recoveries)	-824	-1,575	-1,375	-496	-658	-619	-505	-930	-881	-610	-634	-343
Collective provision funding	823	-1,717	-17	-287	-2,043	-724	398	-2,070	-265	1,417	-1,985	182
Gross impaired assets	1,965	2,459	2,029	3,409	3,548	3,622	1,258	1,866	1,972	2,142	2,779	1,763
Gross impaired assets as a % of GLAA	0.31%	0.40%	0.33%	0.42%	0.46%	0.48%	0.20%	0.31%	0.33%	0.30%	0.40%	0.25%
Total provisions for credit impairment	4,045	4,981	3,509	6,211	6,244	4,799	5,171	6,011	4,142	4,999	6,132	3,913
Total provisions for credit impairment as a % of GLAA	0.64%	0.80%	0.57%	0.76%	0.80%	0.63%	0.82%	1.01%	0.69%	0.70%	0.88%	0.54%
Collective provisions	3,379	4,130	2,718	5,311	5,396	3,904	4,521	5,191	3,118	4,167	5,521	3,501
Credit risk weighted assets	342,498	360,037	358,106	381,550	374,194	372,574	348,041	353,991	351,646	357,295	359,389	367,864
Balance sheet												
Total assets	978,857	1,042,286	981,137	1,091,962	1,014,060	976,502	925,968	866,565	847,124	935,877	911,946	906,626
Total average interest earning assets	863,691	862,882	813,219	929,846	897,409	864,174	804,981	781,679	758,836	819,456	821,718	798,924
Total average non-interest earnings assets	172,458	189,081	141,818	109,026	96,634	94,415	90,256	99,785	80,712	86,599	98,362	95,800
Gross loans and acceptances (GLAA)	632,764	621,272	618,295	818,266	778,675	761,013	629,056	594,052	601,352	714,373	698,661	718,378
Total liabilities	915,181	980,989	920,343	1,013,244	942,047	906,853	863,189	805,272	791,520	863,785	843,872	841,119
Deposits	593,600	552,400	511,800	702,215	640,969	578,786	500,258	468,224	424,612	580,317	555,453	524,516
Total equity (excl. minority interests)	63,665	61,287	60,783	78,713	72,008	69,594	62,779	61,292	55,596	72,035	68,023	65,454
Common equity tier 1 ratio (%)	12.3%	11.3%	11.4%	13.1%	11.6%	10.7%	13.0%	11.5%	10.4%	12.3%	11.1%	10.7%
Core equity tier 1 capital	51,359	48,702	47,355	58,536	52,573	48,367	54,234	48,750	43,138	53,808	48,733	45,752
Total risk weighted assets	416,086	429,384	416,961	450,680	454,948	452,762	417,163	425,147	415,771	436,650	437,905	428,794
GLAA / total assets (%)	64.6%	59.6%	63.0%	74.9%	76.8%	77.9%	67.9%	68.6%	71.0%	76.3%	76.6%	79.2%

Footnote: All figures are presented on a continuing cash basis unless otherwise noted.

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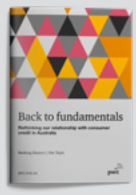

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