Banking Matters | Major Banks Analysis FY22 Half Year

Simplicity raises focus on future

Strong, if uneven, financial result, that was the cleanest in years, bringing focus to strategic fundamentals of banking for the road ahead

May 2022

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Earnings and returns

Cash earnings

+11% hoh
+ 5% pcp

$14.4b

CE up $1.4b on half, driven by reduced notables, reduced expenses (ex notables) and good lending growth, which offset a continued fall in NIM. Credit benefit for the half was lower than prior half and pcp but still a significant boost to results. These offset continued falls in non-interest income.

Return on equity

+109 bps hoh
+29 bps pcp

10.6%

Up with the significant increase in CE, back above 10%, supported also by the distribution of excess capital in the form of dividends and share buybacks which reduced average equity by c. $1.5b despite healthy balance sheet growth.

Revenues

Net interest margin

-9 bps hoh
-12 bps pcp

1.75%

Continuing downward trend, driven by fierce mortgage competition, the tail end of rate switching (from variable to fixed) and only partly allayed by banks' ability to reduce excess liquids. Interest income was still almost $0.2b higher (hoh) to $32b thanks to substantial growth in both business and mortgage lending.

Non-interest income (ex notables)

-5% hoh
-8% pcp

$7.5b

As with NIM, continuing multi-year structural decline, accelerated, as in 2H21, by business disposals. Overall, non-interest income is now lower than at any time since the GFC, and reflects not just the loss of wealth and other 'non-core' businesses, but structural decline in banking fees as well.

Expenses

Operating expenses (ex notables)

-2% hoh
+3% pcp

$19.1b

Costs down (hoh) driven largely by one bank's cost reduction initiatives. This was largely driven by a reduction in premises costs but offset by increased personnel costs as the majors grapple with wage inflation and increased headcount (largely investments to improve regulatory compliance and support customers through COVID).

Expense-to-income (ex notables)

-70 bps hoh
+175 bps pcp

48.5%

Down (hoh) thanks to the growth in lending (and interest income) mentioned above and the reduction in expenses other than personnel costs. Expense-to-income excluding notable items remains high and is close to 50%.

Asset quality

Credit impairment (benefit)

-$0.5b hoh
+$0.1b pcp

$0.22b

1H22 was the third consecutive half to see a multi-billion dollar provision write-back ($1.3b), largely cancelling underlying credit losses to lead to a small net credit benefit. As the net benefit is significantly down (hoh), the impact on earnings growth is negative, but credit expenses remain positive for absolute earnings which would be ~$1-1.5b lower were loss ratios comparable to pre-COVID levels.

Credit provision

-6% hoh
-12% pcp

$19.1b

Once again down ($1.3b) due to gradually improving credit quality and mixed views on economic outlook. Provisions remain substantially higher than 2019 ($16.4b), both in relative and absolute terms (~66bps as a % of gross loans and advances vs 60bps in FY19).

Notable items

Remediation

-50% hoh
-56% pcp

$0.35b

Once again, a substantial reduction from the levels seen in FY19, 20 and 21 ($3.3b, $4.4b and $1b respectively), signalling a return to more 'normal' levels of repair costs. They are now comparable to levels seen before the Royal Commission in 2018.

Reshaping the business (benefit)

+$1.5b hoh
+$0.95b pcp

$0.3b

A net benefit thanks to gains on disposals at two banks which compensated for a number of smaller charges to goodwill, capitalised software and other assets. Overall, substantially reduced relative to recent years as a large wave of restructuring and disposals is behind us.

Balance sheet

Lending growth

-12 bps hoh
+596 bps pcp

+6.7% (12 months)

Although down on the half, lending growth continues to be strong (if uneven), in both business and mortgage lending, which again sustained interest income in the face of a secular decline in NIM. Notwithstanding overall growth, as a whole the banks continue to lose share in mortgage lending in the face of aggressive growth by three large non-majors.

Common equity tier 1

-90 bps hoh
-67 bps pcp

11.8%

Capital surplus reduced thanks to meaningful dividends and share buy backs for several halves, which was accretive to ROE as a result.

Australia's four major banks delivered a strong, if uneven result, earning more than $14b in 1H22, up more than 11% hoh and 5% pcp, in a set of results that gives the clearest view of progress, challenges and future choices facing the banks and appears to put the pandemic shock behind us.

Higher earnings were a product of four key things, one of which is (potentially) sustainable, the other not, and the remaining two remain to be seen. Notable expenses were negligible this half for the first time since before the Royal Commission - a far cry from the $1.5-3.7b per half in 2018-20. There was also a $0.22b credit provision benefit which helped reduce total provisions by $1.3b (enhancing earnings ~$1b after tax), taking total provision coverage down to 66 bps (of GLAA), which is within the range of long-term averages. Finally, the majors in aggregate saw an overall reduction in operating expenses despite inflationary pressures and saw lending grow by 6.7% in the last 12 months, driven by balanced growth in both business and home lending.

Overall, it was another good result, which gave the banks the confidence to announce another healthy dividend ($9.5bn) for the half (the best since before the pandemic), coupled with a $4.5bn capital return via share buyback.

It was also the cleanest result in years, without the notable charges, large restructures and disposals, credit volatility, changes to accounting or capital rules which, over the past decade, have made it hard to see the 'forest for the trees' in the financial results of the banks. This is of course thanks to years of the banks becoming simpler and 'smaller' - remediations, portfolio restructuring, free of material 'non-core' businesses and operations, either overseas or in Australia. The drivers of the financials described in this report were much more normal - the basic fundamentals of banking: margin, balance sheet, fees, productivity and asset quality.

Clarity highlights progress achieved, as well as future challenges and choices, as the banks look to a future that in some key respects is starting to look less and less familiar.

Firstly, and as we have been noting for some time, the traditional core of growth for the banks is increasingly competitive and the base of earnings has narrowed (though many would argue improved in quality) as a result of the 'simplification' over the past decade. Lending growth has been unevenly shared among the major banks and, at least in mortgages, is based on unusually high system growth, of which three non-majors have taken material share, with the resultant pressure on margins. While rising cash rates should provide some benefit, the banks have been careful to manage expectations given the competitive landscape and funding cost implications. This is particularly important given the continued narrowing of less balance-sheet-intensive earnings. Non-interest income continues to shrink, falling to $7.5b, its lowest level since the early noughties and lower than in other comparable banking systems around the world.

Secondly, we are entering an economic environment of inflation and rate rises that a generation of customers (and bankers) has never experienced. While concerns for credit quality appear low so far, the immediate impact for banks is on costs, investment choices (scale) and productivity. Expenses, though down in the half (-2% hoh), appear to remain on an upward trajectory for the foreseeable future. The expense-to-income ratio remains just shy of 50% (ex notables), a psychological threshold it has not breached in decades, and given the ~8,000 additional FTE hired in the past twelve months, in addition to inflation, which appears well underway, the cost of living for banks is under pressure and they will have to work extremely hard and make investment choices to contain it - existing transformations can not let up.

Finally, the landscape of 'new' opportunity and market change feels closer and more real than ever. The decarbonisation of the world will redefine Australia's economy and the banks are in the early stages of transforming to play the critical role in guiding and supporting this change for their customers - with huge opportunities as a result.

Technology is transforming existing processes and customer experiences, but it is also allowing financial services to be both disintermediated from an overall relationship and more deeply embedded in customers' day-to-day actions rather than as stand-alone products.

Payments is perhaps the most clear example of where this is happening at pace - with new providers expanding from an initial service to far broader services, such as lending. This twin-trend of disintermediation and the embedding of finance, together with potential innovation in financial infrastructure through decentralisation, represents huge opportunities for the banks to expand their reach with customers but may also redefine how and by whom financial services are provided.

In short, with NIMs remaining low and non-interest income falling, expenses rising, and the possible end of capital returns and provision adjustments in sight, the future foundation of earnings growth - dependent on more than lending growth - comes into stark relief. Can the banks keep changing fast enough while executing on the here and now? Macroeconomic sentiment is certainly turning, and banks, having spent a decade rationalising and streamlining, reducing themselves to their strategic essentials, are now in a position to ask: where to now? In 5-10 years time, what kind of businesses do they want to be?

Notwithstanding the amount of work still to be done, the banks' progress can not be understated and they remain extremely well positioned for all of the above. They are arguably better at (and working hard at improving) the core functions of a bank - lending and deposits, relationships, payments, managing risk and helping to keep customers safe - than at any time and significant investment is continuing on many of the opportunities highlighted above. The question therefore becomes: are we thinking big enough, moving fast enough and how confident are we that we will deliver?

With so much in flux, we see five key landmarks on the horizon, which we see as the constants that will determine what this industry will look like over the next several years. They are:

Investment, execution and delivery - in the immediate term the focus on operational throughput and digitisation, completing transformation programs, remediation and change. More medium term, the pressure on costs but increasing need to invest in technology and opportunities will require a delicate balancing act on investment choices and prioritisation.

Adaptability and growth - the degree to which banks can innovate and evolve to keep pace with the changing ways people store, transmit and exchange credit and value, whether in the physical or virtual worlds (through such things as digital currencies, embedded finance and new forms of consumer credit), and the degree to which continued growth is dependent on their ability to do that.

Workforce and productivity - as mentioned, a key driver of performance which will become more crucial if system lending growth were to fade in the new economic environment. This will be crucial for three reasons: (i) talent, (ii) cost, and (iii) innovation, discussed above.

Trust - the *sine qua non* of banking, and the area in which this industry has arguably made the most progress over the past few years. Elevated focus in areas including cybersecurity, sanctions, money laundering and financial crime, and now the climate transition will create more and more domains in which trust will be tested (and investments are being made) and earned.

Societal leadership - the opportunity banks have, given the social capital mentioned above, to provide genuine and distinctive societal leadership in areas such as climate, housing, equality and our collective prosperity.[1]

See previous reports, including 'The window of opportunity', Major Banks May 2021, 'From shock absorber to springboard', November 2020 and 'Banking's Kairos moment', 1 May 2020

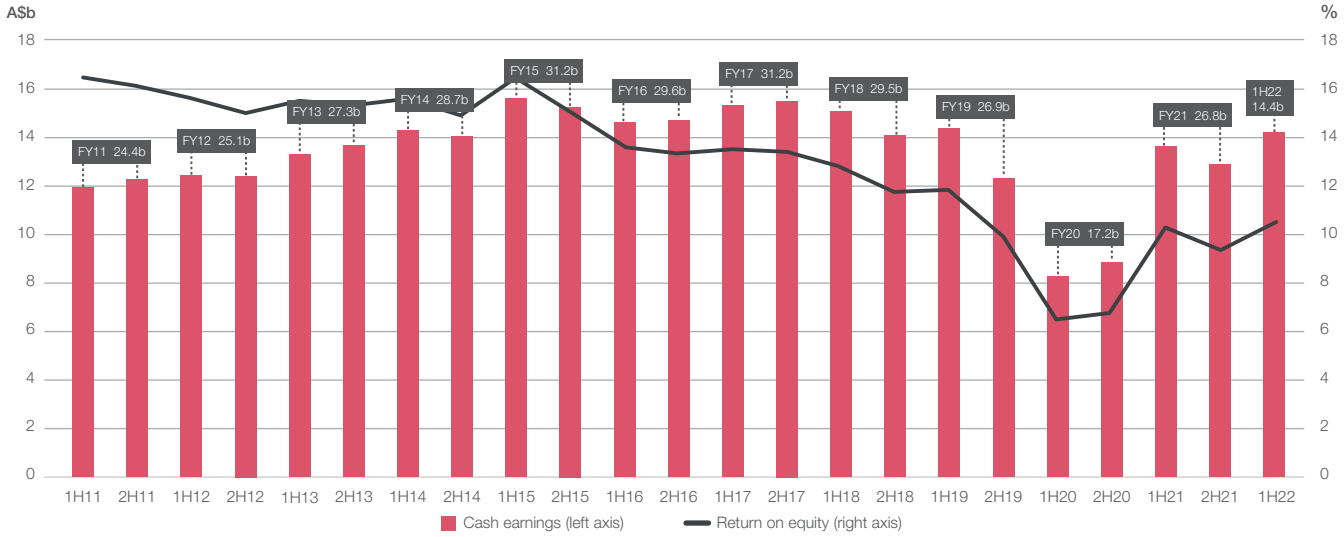
Strong, if uneven, result that was cleanest in years

Bank earnings exceeded $14b for the first time since 1H19, driven dramatically by minimal notables, reduced expenses (both credit-related and operating) and healthy lending growth. As a result, they returned $14b to shareholders: $9.5b in dividends and $4.5b in buybacks. It was the cleanest result in years, free from large notable items, accounting or capital changes, major disposals or distractions from activities which are not 'core'.

Earnings exceeded $14b for the first time since 1H19

It looks like we are past the COVID impacts and in some ways, it's as if it never happened for the major banks. The banks delivered over $14.4b in the half, with RoE back above 10% for the third consecutive half. This is shown in **Figure 1**. However, as in past periods, the result was uneven, with two banks delivering strong earnings and lending growth (and corresponding ROEs well above 11%), and two whose income growth and returns were limited by operational challenges.

Figure 1: Earnings back to pre-COVID levels, with RoE appearing to settle at ~10% level



Source: Bank reports, PwC Analysis

Key features of the results are as follows:

01 **Cash earnings rose to $14.4b,** up from $13.0b in the prior half to a level common in the years before the pandemic. This was driven by minimal notables, expense reduction (both credit-related and operating) and lending growth, each described in further detail below.

02 **RoE is also back above 10%, hitting 10.6%,** up from 9.5% in the prior half, supported by both earnings growth and the return of excess capital. There was an unevenness in the returns among the majors with those better able to capitalise on strong system credit growth delivering better results.

03 **Net interest margin (NIM) decreased to 1.75%**, down 9bps hoh from 1.84%, the lowest level since the early noughties, driven by competition for mortgages, rate switching (from variable to fixed) and only partly allayed by banks being able to reduce excess liquids (temporarily inflated by drawing down the RBA's Term Funding Facility). Despite this decline in NIM, total interest income was broadly flat hoh thanks to strong lending growth in both business and home lending.

04 **Non-interest income decreased to $7.5b** ex notables, continuing its sustained, multi-year decline and is at its lowest level since before the GFC. The decline is driven by the combination of loss of non-bank fees thanks to business divestment, a reduction in bank fees following the Royal Commission and, since FY20, a fall in trading income as market volatility has been less favourable to trading desks (although two banks did better this half). As a share of total income, non-interest income is below 20% for (we believe) the first time ever.

05 **Operating expenses ex notables decreased slightly to $19.1b,** down from $19.5b (-2%) in the prior half. Personnel expenses were up 2.7% hoh through wage inflation and increased headcount added for customer support, compliance and remediation. However, this was more than offset by reductions in other cost items such as spend on technology and premises. Premises costs, though not a large share of total expenditure, was down significantly by ~20% as banks were able to rationalise space.

06 **Expense-to-income fell to 48.5%,** ex notables, but still close to breaching the 50% threshold over which it has not crossed in decades. The reduction in the ratio was due to a combination of reduced operating expenses and slightly increased operating income, which as mentioned, was driven almost entirely by lending growth in the half.

07 **Credit was once again a benefit, but this time just $0.2b,** down from $0.7b in the prior half (dramatically better than the $11.2b expense in FY20). Accordingly, credit was a $0.5b negative for earnings growth, though, compared to the $1.8b level in 1H19 before the pandemic, it is still overall accretive to earnings. As mentioned, earnings would likely be ~$1b lower were credit losses comparable to pre-pandemic levels.

08 **Credit provisions down another $1.3b to $19.1b,** continuing a trend that has seen provision fall from a peak of $23.4b in October 2020. Overall provisions are still approximately $1.7b above trend, reflecting uncertainty in the outlook.

09 **Notable items for the half were almost negligible, falling to $0.1b,** the lowest level since before the Royal Commision. They reflect a balance between remediation expenses of $0.35b and restructuring charges that were a net benefit of $0.3b thanks to gains on disposal of interests in overseas businesses.

10 **Lending grew 6.7% (12 months),** almost $93b hoh, balanced across both business and mortgage lending (though uneven between majors). As in past periods, significant share is being taken by three large non-majors.

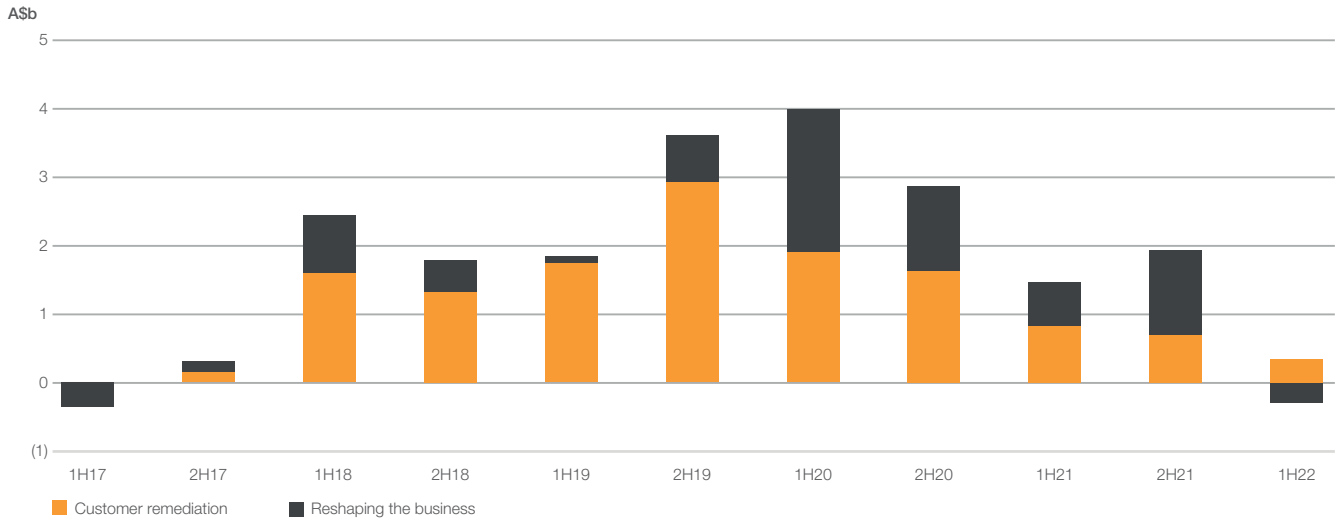
11 **Common Equity Tier 1 (CET1) fell to 11.8%,** down 90 bps, the first material fall since the implementation of Basel 3, thanks to significant capital returns though it still remains well-above expectations of 'unquestionably strong'.

12 **Deposit growth remained strong at $107b,** similar to the $108b seen in the half immediately preceding and $50b the half before that. How long this continues now that monetary policy is becoming less accommodative (and fiscal policy may also after the next election), remains to be seen.

Earnings driven by negligible notables, solid lending growth and low credit expense

The profit increase was driven by three things. The first was notable items, which, as shown in **Figure 2**, were negligible for the first time since before the GFC.

Figure 2: Era of major notable items behind us?

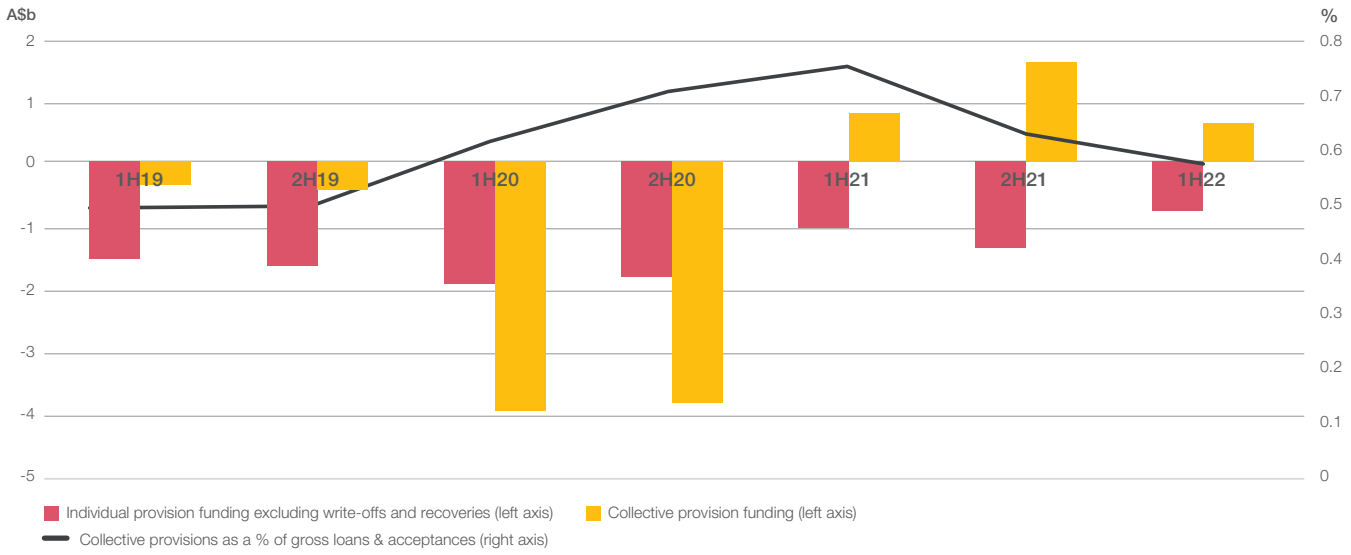


Source: Bank reports, PwC Analysis

Five years since the Royal Commission and with the COVID pandemic years behind us (we hope), this reflects the substantial work to remediate consumers, redress regulatory breaches and put in place the controls necessary to ensure these issues don't happen again. It also reflects a wave of work required to restructure banks around simpler lines of business, core banking services, and contemporary, cloud-based information systems (though clearly that investment will be an ongoing non-notable feature). For now, most of this simplifying and remediating work appears to be done, significantly underway or at least already provided for, especially for restructuring given the number of divestments which are now complete.

The second was a $1.3b reduction in total provisions (shown in **Figure 3**) which added added almost $1b to cash earnings after tax and took total provision cover (collective plus individually assessed provisions/gross loans and acceptances) from 73 to 66 bps, not far from the 60 bps in 1H19 before the pandemic.

Figure 3: Release of collective provisions

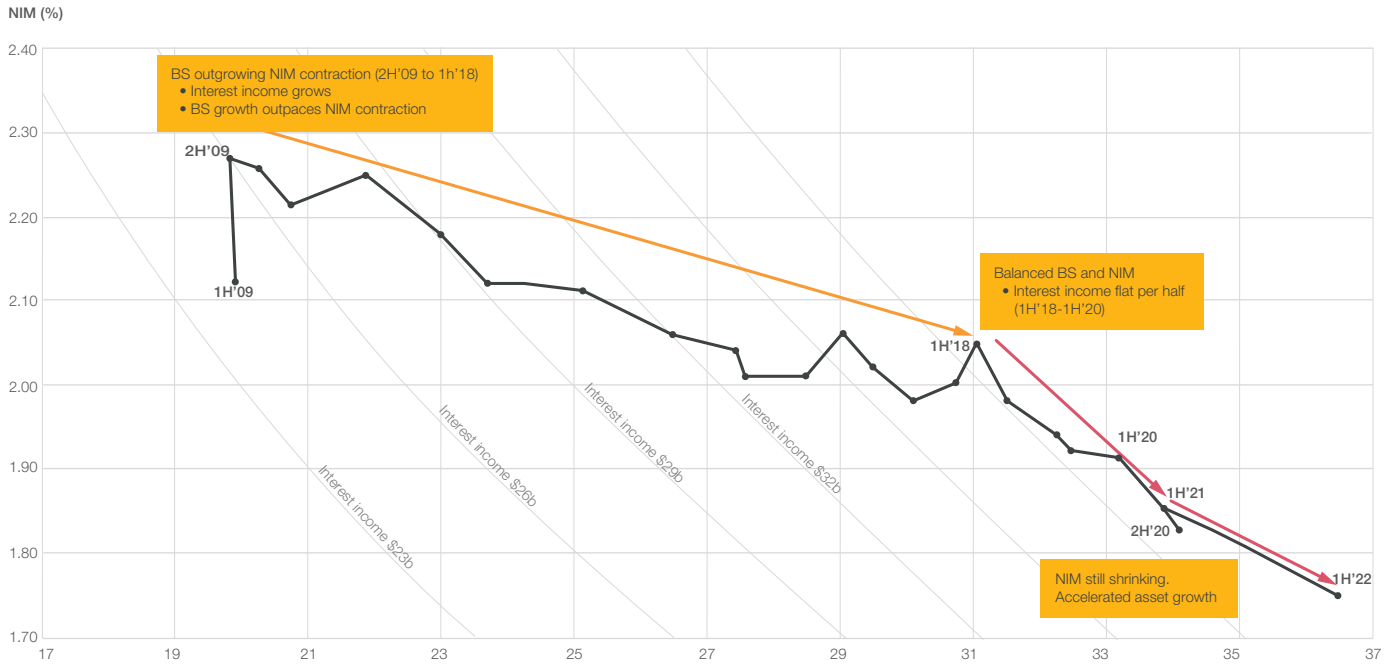


Source: Bank reports, PwC Analysis

Although this difference represents approximately $1.2b in provisions, it remains to be seen what happens as long-term impacts of the pandemic play out, and whether the economic sentiment continues to deteriorate, leaving further adjustments uncertain.[2]

Finally, lending growth continues at pace, and should continue to do so for some months as mortgage commitments continue to track above $30b per month (albeit falling, as discussed below) and business lending appears extremely robust. As shown in **Figure 4**, that growth compensated for ongoing NIM declines driven by both competition and product switching (fixed-rate loans generally contribute to lower NIM in this environment) which saw consolidated NIM fall below 1.8% for the first time ever (and one bank reporting an unprecedented 1.58%).

Figure 4: Interest income supported in face of contracting NIM by loan growth



Source: Bank reports, PwC Analysis

It is worth noting, though NIM levels under 150 bps are unprecedented for Australia and unknown for most Australian bankers, this is a level their peers in Europe and North America have long-since become used to. Putting those together (expanding balance sheet and falling NIM), net interest income rose slightly by $0.12b and was broadly flat hoh.

Capital returns and dividends amounted to $14b

Regardless of the market's future outlook and expectations, banks were able to reward investors with another $9.5b in announced dividend and $4.5b capital return (share buy back), which is the third consecutive half of such elevated rewards for investors.

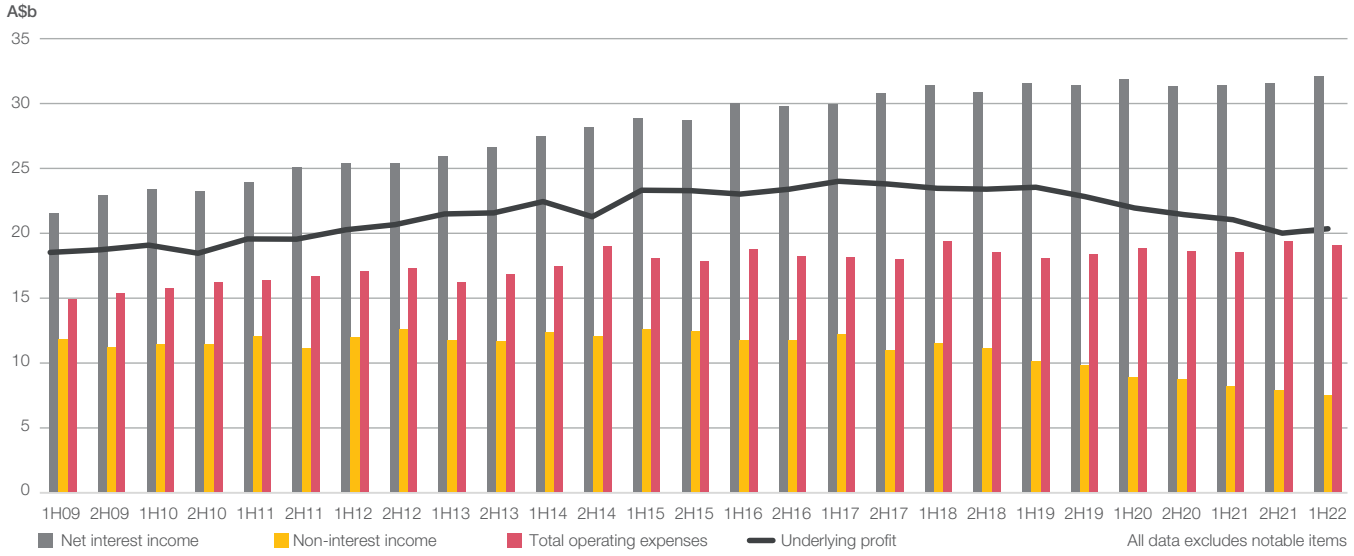
Cleanest result in a generation, following years of simplification, streamlining and focus

As mentioned, it was a clean result. There were minimal notable charges: gains and losses on disposals largely cancelled out remediation expenses. There were no material changes to accounting policy or capital requirements, nor material impacts from restructuring 'non-core' businesses and operations, either in Australia or overseas, and the impact of 'COVID provisions' was muted relative to prior halves, albeit still a large benefit to the half. The drivers of the financials described above were therefore more about the critical fundamentals of banking: margin, balance sheet, fees, productivity and asset quality.

In terms of those basics, the banks have, on the whole, had a very good half. In fact, as shown in **Figure 5**, underlying profit (UP), i.e. income minus operating expenses (excluding credit, notable items, taxes and other expenses) actually rose (1%) for the first time since 2017. However, as discussed below, this performance was not only uneven (between banks), it rests on a narrow base.

2 Note that while collective provisions are much higher than pre-pandemic levels, specific provisions are actually lower, as stimulus and liquidity have made credit conditions exceptionally benign. The $1.2b figure described here represents a return of both to pre-pandemic levels.

Figure 5: Underlying profit, declining since 2017, has ticked up



Source: Bank reports, PwC Analysis

Clarity highlights progress, as well as future challenges and choices

As a result of the 'simplification' over the past decade, the traditional core of growth for the banks is increasingly competitive and the base of earnings has narrowed. Despite a reduction this half, expenses are likely to remain on an upward trajectory, NIMs remain low and non-interest income is falling. Although the landscape of 'new' opportunities feels closer than ever, technology means they will be increasingly contested by both traditional banks and non-banks from all over the world.

In addition, sentiment around the macroeconomic environment is shifting. With the possible end of capital returns and provision adjustments in sight, the future foundation of earnings growth - dependent on more than lending growth - comes into stark relief. Can the banks keep changing fast enough while executing on the here and now?

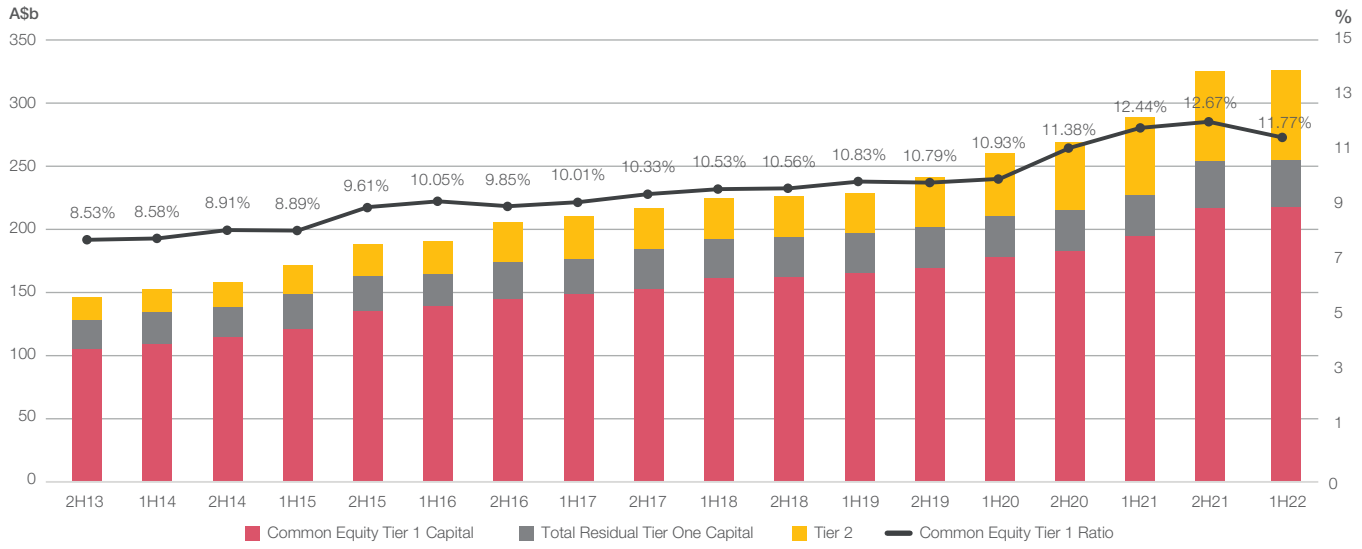
They are better at (and still improving) the core functions of a bank - lending and deposits, relationships, payments, managing risk and helping to keep customers safe - than at any time in recent memory. Significant investment is continuing on many of the opportunities highlighted above. The question therefore becomes: are we thinking big enough, moving fast enough and how confident are we that we will deliver?

Common challenges all banks face - capital, share, non-interest income and expenses

Nevertheless, not all the concerns about banks are 'sentimental'. There are a number of important fundamental issues also at play.

For one, the share buybacks which have helped augment cash returns for shareholders may be coming to an end. As shown in **Figure 6,** the capital 'surplus' is not what it used to be.

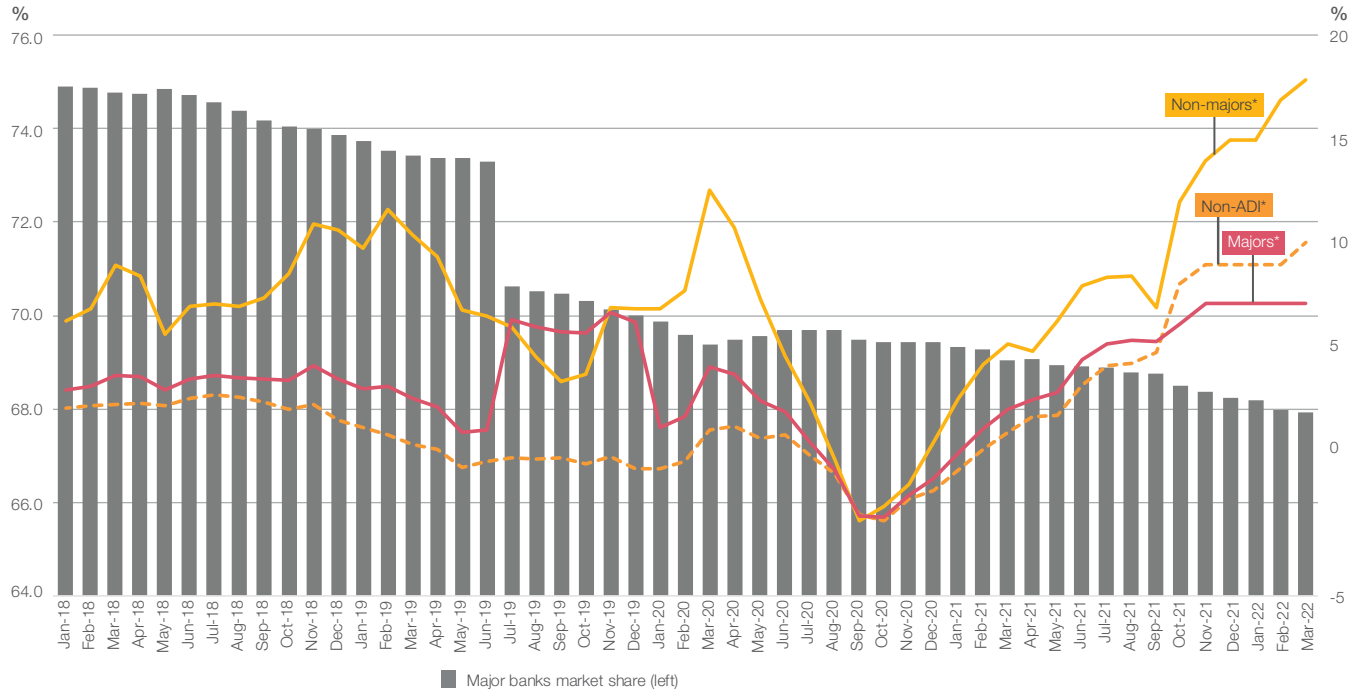
Figure 6: Significant capital returns over the past year



Source: Bank reports, PwC Analysis

Another fundamental issue at play is the continued loss of lending market share to non-majors, three in particular who have been growing very fast, as shown in **Figure 7.**

Figure 7: Majors continuing to lose share to non-majors



*Annual growth - 6 month rolling average credit growth

Source: Bank reports, PwC Analysis

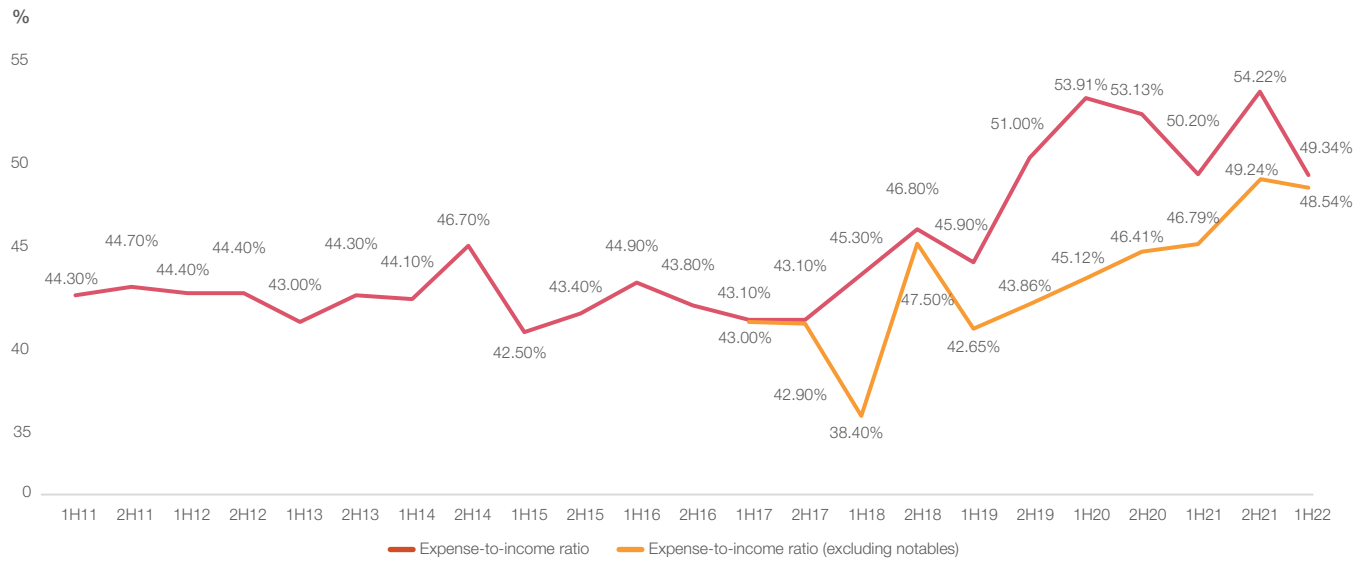
For a long time it was possible to ignore the rapid growth of non-majors, given their negligible relative market share. No more. Despite market share just over 6% in 2019, the 'Next Three' accounted for more than 20% of total loan growth since then.

Finally, we repeat that when it comes to the services part of financial services (as distinct from balance sheet intermediation), the banks have been shrinking for years, partly as a direct consequence of the simpler, smaller franchises they have chosen to become.

Banking fees, which were rationalised after the Royal Commission, are down as banks continue to search for new services for which customers are willing to pay. Canadian banks, for comparison, earn three times the revenue (per dollar asset) from non-interest income as Australian banks do, and while that is a different banking system and totally different operating model and environment, it highlights the extreme concentration of banking income in Australia today. As we have said before, over the long term, we view this as perhaps the most strategically consequential challenge facing the industry today.

In the short and medium term, however, the more acute imperative is to arrest the growth in operating costs and to balance investment decisions as a result. As shown in **Figure 8**, expense-to-income for the majors is approaching 50% excluding notable items, a level not seen in Australia since the early noughties. In announcing the half, each bank made it clear that they were not immune from inflationary pressures and several released themselves from their absolute cost targets. It was not that long ago when banks were talking about an aspirational expense-to-income ratio in the 30s. Clearly the world has changed in ways few expected.

Figure 8: Expenses fell slightly, with inflationary pressures in the outlook



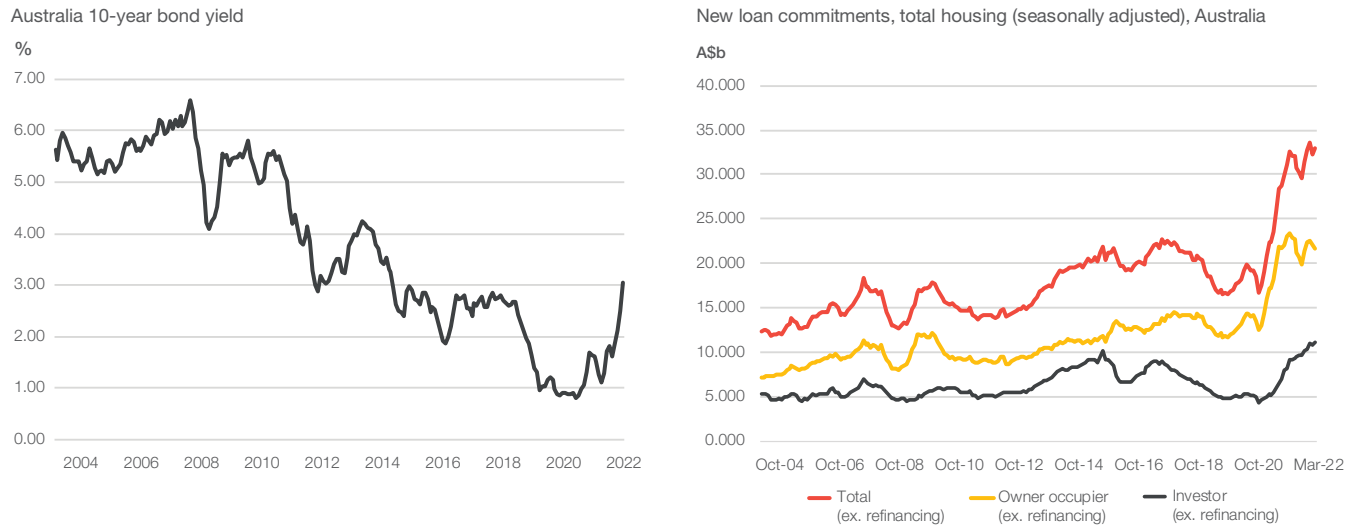
Source: Bank reports, PwC Analysis

Given the need to continue to invest, for many of the factors discussed below, and existing transformations well underway, cost (and productivity) will be a very sharp focus in an inflationary world. Striking the right balance between cost control and investment will therefore remain a critical management judgement. Needless to say, it's something investors are keen to see.

Context of potential turn of multi-decade cycle.
The past 40 years have been a great run for owners of assets, any assets, and the banks who finance them.

There have been many drivers for this, but the most important has been the secular decline in (wage) inflation and (discount) rates. We've been waiting 20 years for it to end, but, as shown in **Figure 9**, it now increasingly appears to indeed have done so (though we won't really know some years to come).

Figure 9: Start of a new four decade cycle? What will house buyers do?



Source: RBA

Source: ABS

Regardless of what one thinks about the new monetary regime and the speed with which it will change, the transition to a new regime of rising rates, potentially sustained wage inflation and expectations and subdued asset-price appreciation is going to be a challenging one for all sectors of the economy, especially banks. It certainly is not positive for balance sheet growth, which is already showing signs of turning.

Although the industry has gone through this before, nobody working today is old enough to really remember it, and in any case it was never with the levels of household, business and sovereign debt that exists today - conditions which in history preceded revolutionary social, political and economic change.

In short, investors and bankers are right to be alert and careful. Nevertheless, it is important to remember two things through all the scary headlines which we expect to see for months or even years to come.

First, one 'benefit' of the extremely high leverage in the world today, as well as the degree to which investor psychology appears so highly tuned to the risk of sustained rate increases, is that it may not take much for central banks to cool inflationary expectations the old fashioned way. The result is that we may see a limited number of rate rises have the desired effect and careful adjustments be made to the path, then followed by a long period of sluggish but positive economic growth, but healthy asset prices.

The second is that by any measure, monetary conditions remain extraordinarily accommodative and will remain so for a long time. It will take many rate rises before we see a historically 'normal' cash rate, and substantial falls in home-loan origination merely to get to levels which not long ago were still considered too high. The point above is that we may in fact never even get there. Banks for their part are less concerned about asset prices (and the impact on credit) given prepayment rates and origination standards, and remain focused on economic sentiment and unemployment - both of which appear robust.

Nevertheless, sentiment, as always, runs far ahead of the fundamentals - but unfortunately sometimes then changes those same fundamentals. This is the kind of self-fulfilling feedback loop we should worry about, and discuss further in the last section below.

What will Australia's banks choose to be?

Twelve months ago we said that Australia's banks are in their best shape in a generation[3], and believe it still today. There was (and is) enormous pent-up demand to be satisfied, liquidity and capital to invest and spend, and enormous challenges and opportunities requiring innovation, funding and advice. Most importantly, there was a unique confluence of factors suggesting a new resolve to address long-standing social issues. It was what we called a 'window of opportunity.'

Notwithstanding the amount of work still to be done, Australia's major banks are indisputably better at the core functions of a bank: lending and deposits, technology, payments, managing risk and helping to keep customers safe. Is that enough? In a world of rising inflation and rates and (potentially) falling asset values, will lending growth continue to deliver? More importantly, in a world where economic and financial activity is moving into increasingly virtual domains, where it can can be disaggregated, automated and reintegrated in totally novel ways, can four large banks continue to play the role they've played in our economy since deregulation simply by getting better and better at doing those 'core' things?

The answer to the above is: 'probably not' and the banks are investing with that in mind. The question is therefore whether they are thinking big enough, moving fast enough and executing well enough to respond and capitalise on the opportunity.

3 See our reports 'From shock absorber to springboard, May 2021' and 'Emerging strong on shifting sands' Nov 2021.

Paying attention to five landmarks on the horizon

With so much in flux, we see five key landmarks on the horizon, which we see as both a mix of immediate term focuses and medium term imperatives that will determine what this industry will look like over the next several years.

Investment, execution and delivery

Given all that has been said regarding the competitive environment, cost pressures and the intense requirement for transformation, it is perhaps not surprise that the first issue is one of 'prioritisation and getting stuff done'.

The first and most immediate need in this respect is the operational delivery of the products and services delivered today - whether that means maintaining or remediating operational capacity and process (e.g. mortgages of late) or completing programs to digitise delivery and reduce human processing. This extends to the succesful completion of several large programs such as cloud-migrations, new digital platforms and the remaining risk/control/governance/disposal initiatives.

Beyond this, we expect the twin issues of cost-control and disruptive-momentum to place an ever-greater focus on investment prioritisation decisions, whether that be opex, capex or acquisitions.

While this has become a well-used muscle given the extraordinary investment programs over the past several years, it will be even more key in years to come - requiring reflections on risk appetite, progress to date and an honest reflection on core capabilities and strategic direction.

Clearly, transformation, investment, execution, and delivery of change has been a core necessary capability for successful banking so far in the 21st century, and it's clear this will not change. In the years to come, we expect to see the execution of M&A and post-merger integration to become more important for the banks than it has been in the past decade.

Adaptability and growth

With mortgage originations running at close to $35b per month and business lending showing significant growth, it's clear where the growth opportunity lies today, and with a somebanks struggling to meet origination volumes with processing capacity, the others have been enjoying record mortgage growth.

There's nothing wrong with making hay while the sun shines, but this is unlikely to be sustainable. Borders are closed, so household formation in Australia is the lowest it's been in a long time. Dwelling construction is likewise constrained by lockdowns and supply chain issues. The mortgage boom is driven by house prices and accommodative monetary policy. It literally is the expansion of the money supply, and the RBA is strongly suggesting this is over.

If they are right, then the lack of growth in non-interest-income will become starker than ever. As mentioned above, if Australian banks could earn even half the OOI (relative to assets) as their peers in, for example, Canada, that could represent an additional $4-5b revenue this half alone (or, equivalently, $1T additional mortgages).

From where could this growth come? Payments is a source of enormous economic friction in which we have seen and expect to see substantial innovation and disruption over the decade, whether from digital currencies, non-bank (tech led) new entrants or simply government policy and regulation. Banks and non-banks alike are doing interesting things with new variants of traditional financial services (e.g. buy-now-pay-later) or entirely new ways of serving customers, such as financial services 'embedded' into third-party applications and other 'Banking-as-a-Service' solutions. As more commerce is performed on integrated platforms able to capture and analyse data, we expect to see transaction data present enormous opportunities for innovation and customer value, especially if consumers begin to share their data in the ways envisioned by the architects of Open Banking regulations around the world.

Security and identity is likewise an area of significant unsatisfied need, and will grow increasingly important as more of our economic life moves online. We expect to see banks develop market-leading innovations in both these areas (they will be required to do so), and to see multi-billion-dollar startups commercialising such innovations, so it will be interesting to see how well banks can commercialise them too.

Finally, as we have written in the past, we see enormous need for funding and capital in areas that are not mortgages, and not just small business, which is appropriately a focus of attention. Green energy, affordable housing, sustainable industry and agriculture are all areas in which there is a clear imperative for investment, and every bank has made public commitments of risk appetite and capital. Nevertheless, the actual funding of 'shovel-ready' projects remains well-short of underlying need. This isn't the fault of banks, but clearly shows that the bottleneck isn't in the 'banking'.

To fulfil their ESG commitments (see below), and realise the enormous growth potential, banks will need to start thinking more like developers and project sponsors and less like banks.

Workforce and productivity

As mentioned above, the need to support and protect customers through the past crisis, maintain operational reliability and ensure nothing falls through the cracks in terms of compliance has led banks to prioritise investment in capacity (people and systems) at the expense of short-term productivity. As cost-to-income ratios rose towards 50%, investors were prepared to be understanding.

Investors appear to be becoming less accommodating, which means we are entering a period when choices regarding operating models, digitisation and priorities will be in very sharp focus, particularly given the extent of digital adoption from customers through COVID:

- branch footprint and delivery channels
- customer support and operations centres (and their locations),
- investment initiatives and their continuation and,
- most importantly, the future for areas of the 'core' franchise that cannot be effectively digitised within speed or investment appetite.

Finally, banks, like all businesses, are having to rethink the future of their workforce, from recruitment to training, supervision, coaching and performance management. Banks are doing this, of course, but with labour in such short supply, the emphasis has been on attracting and retaining whatever skills they need (credit assessment, customer service, software development, etc.), sometimes without the ability to ensure those skills are deployed in the most productive way possible.

Trust

As noted above, one feature of the results is the material reduction in notables, particularly for remediation. This is one illustration of how this industry has changed its reputation in the eyes of government, regulators and society. Given how far it has come, and the cost of doing so, it is imperative not to lose the trust and social capital built up over the past several years.

This is also reflected in a (generally) more clear sentiment from regulators and banks on measures to maintain this progress but to explore ways to make regulation and compliance simpler, more technology-led and, therefore, cheaper. While this does not reflect, in our view, a loosening of intent from regulators or dramatic shift in risk appetite in banks, it can be positive for the outlook.

Two areas of special risk at this time, made more acute by the chaos of war in Europe, are cyber security, as highlighted in the RBA's latest Financial Stability Report, and sanctions compliance and money laundering, the pressure of which will be especially acute potentially hundred of billions of assets (globally, not necessarily in Australia) face being frozen and attempted to be moved by individuals and entities facing either sanction or the risk of sanction.

The scale of investment in the past decade, and particularly the last 5, in KYC, transaction monitoring and cyber security are three areas where the need for comprehensive coverage of controls cannot abate as a result and will require constant investment (noting that, unlike with many operational risks, these involve intelligent agents actively seeking out those gaps). While this could run smack against the productivity imperatives described herein, no bank has expressed any desire to shy away from this need.

The same is also becoming true of Trust in the banks' approach to the carbon transition and broader ESG topics as they become a focal point for stakeholders. In many respects this has the classic features of an opportunity to build or undermine trust - transparency and quality of reporting, managing customer outcomes, stated intent vs outcomes. The topic of 'greenwashing' is the most obvious and immediate example of this with regard to the carbon transition, however this will quickly evolve to broader implications for controls, risk appetite and internal congruence.

As a result, these areas will require careful trade-offs, tough choices about cost and risk appetite and, for some time to come, elevated levels of operating expense and investment.

Societal leadership

Finally, the greatest 'growth opportunity' of all, is, in our opinion, the opportunity created by the events of the past two years for banks to truly play the role in society appropriate for their size and systemic importance. It is a role that would have been familiar to the great banking institutions of a prior era.

Whatever happens in the national election in two weeks time - whether the government is returned with a renewed mandate, or a new government is formed, possibly with the agreement of a number of independents, we believe there will be a unique opportunity for Australians to entertain bold ideas, initiatives and reform.

Australia's banks can and should play a significant leadership role in this conversation, and the progress they've made (re)-building social trust and reputational capital gives them the standing and relevance to do so.

It's an opportunity to make long-overdue progress in tackling our most important societal problems, especially the transition to net zero, the creation of new industries including green steel and carbon-zero agriculture, and housing affordability. To do this banks will have to wear more hats, thinking about more than funding, but also policy, financial sponsorship, alliance-building and consortium management. Nation-scale opportunities require nation-scale leadership which very few institutions besides the banks are in a position to offer.

All of the above horizon issues contain choices - trade-offs on returns today for the future, innovation and risk taking, build v buy, own-the-customer vs as-a-service to name a few. It is the hard work to achieve simplicity and strength of the banks today that has provided them with the capacity and platform to have these choices.It remains fascinating to see how each decides to proceed and, critically, how well they execute on these decisions.

	ANZ			CBA			NAB			WBC		
	1H22	2H21	1H21	1H22	2H21	1H21	1H22	2H21	1H21	1H22	2H21	1H21
Earnings and Returns												
Cash earnings	3,113	3,208	2,990	4,746	4,785	3,886	3,480	3,215	3,356	3,095	1,815	3,537
Cash earnings (incl discontinued operations)	3,108	3,199	2,982	4,846	4,834	3,975	3,551	3,130	3,208	3,095	1,815	3,537
Cash earnings before tax	4,441	4,531	4,432	6,692	6,755	5,513	4,863	4,502	4,704	4,454	3,155	5,190
Core earnings (A)+(B)+(C)	4,157	4,455	3,941	6,617	6,427	6,395	4,865	4,413	4,576	4,593	2,937	4,818
Dividends paid (per cash flow)	1,994	1,955	879	3,548	2,661	1,471	1,939	0	882	2,201	2,127	719
Income tax expense	-1,328	-1,322	-1,442	-1,946	-1,970	-1,627	-1,383	-1,287	-1,348	-1,355	-1,337	-1,651
Profit after tax (statutory basis)	3,535	3,228	2,951	4,741	5,084	3,777	3,571	3,241	3,230	3,280	2,015	3,443
Return on average equity (%)	9.95%	10.21%	9.66%	12.38%	12.46%	10.57%	11.25%	10.37%	10.85%	8.70%	5.03%	10.16%
Notable Items												
Cash earnings (excluding notable items)	3,156	3,337	3,807	4,987	5,118	4,127	3,480	3,215	3,356	3,101	3,134	3,819
Remediation included in notable items (net profit before tax impact)	-173	-161	-166	-93	-333	-241	0	0	0	-82	-172	-276
Revenues												
Net interest income (A)	7,100	7,175	6,986	9,748	9,468	9,371	7,085	6,958	6,839	8,028	8,245	8,469
Net interest income (excluding notable items)	7,103	7,205	7,042	9,748	9,468	9,371	7,085	6,958	6,839	8,021	8,189	8,398
Net interest margin (NIM) (%)	1.58%	1.65%	1.63%	1.93%	2.02%	2.03%	1.62%	1.69%	1.74%	1.84%	2.00%	2.08%
Non-interest income (B)	1,848	1,849	1,437	2,457	2,727	2,590	1,743	1,409	1,600	1,931	1,994	2,330
Non-interest income (excluding notable items)	1,590	1,887	2,040	2,457	2,727	2,590	1,743	1,409	1,600	1,703	1,849	1,958
Non-interest income as a % of total income (exld. notable items)	18%	21%	22%	20%	22%	22%	20%	17%	19%	18%	18%	19%
Expenses												
Total operating expenses (C)	-4,791	-4,569	-4,482	-5,588	-5,768	-5,566	-3,963	-3,954	-3,863	-5,366	-7,302	-5,981
Expense/income ratio (%)	-54%	-51%	-53%	-46%	-47%	-47%	-45%	-47%	-46%	-54%	-71%	-55%
Total operating expenses (excluding notable items)	-4,555	-4,454	-4,216	-5,495	-5,435	-5,325	-3,963	-3,954	-3,863	-5,135	-5,700	-5,236
Expense/income ratio (%) (excluding notable)	-52%	-49%	-46%	-45%	-47%	-45%	-45%	-47%	-46%	-53%	-57%	-51%
Total number of full time equivalent staff	39,529	39,684	37,844	47,532	44,375	42,720	32,932	32,741	31,696	38,823	40,143	38,747
Asset Quality												
Credit impairment expense	284	76	491	75	328	-882	-2	89	128	-139	218	372
Loss rate (%) (credit impairment expense/total GLAA)	0.04%	0.01%	0.08%	0.01%	0.04%	-0.11%	0.00%	0.01%	0.02%	-0.02%	0.03%	0.05%
Individual provision funding (exld. write-backs and recoveries)	-301	-369	-455	-176	-260	-236	-193	-287	-218	-97	-466	-144
Collective provision funding	371	145	687	161	481	-768	81	186	212	10	777	640
Gross impaired assets	1,709	1,965	2,473	3,482	3,409	3,100	1,134	1,258	1,669	1,653	2,142	2,071
Gross impaired assets as a % of GLAA	0.26%	0.31%	0.40%	0.41%	0.42%	0.39%	0.17%	0.20%	0.28%	0.23%	0.30%	0.30%
Total provisions for credit impairment	3,559	4,045	4,250	5,854	6,211	6,815	5,027	5,171	5,745	4,675	4,999	5,482
Total provisions for credit impairment as a % of GLAA	0.54%	0.64%	0.69%	0.69%	0.76%	0.86%	0.76%	0.82%	0.96%	0.65%	0.70%	0.79%
Collective provisions	2,940	3,379	4,285	5,062	5,311	5,943	4,423	4,521	4,975	4,174	4,167	4,918
Credit risk weighted assets	348,817	342,498	341,862	390,687	381,550	376,900	355,102	348,041	348,192	359,673	357,295	347,127
Balance sheet												
Total assets	1,017,361	978,857	1,018,339	1,149,813	1,091,962	1,057,734	975,876	925,968	871,573	964,749	935,877	889,459
Total average interest earning assets	899,678	869,825	857,524	1,008,070	936,883	922,924	872,438	822,737	787,125	872,075	825,926	812,950
Total average non-interest earnings assets	110,098	156,958	188,044	112,818	109,985	107,650	89,008	87,653	92,875	85,758	84,728	88,481
Gross loans and acceptances (GLAA)	653,973	632,764	617,668	850,509	818,266	792,959	659,681	629,056	598,710	723,751	714,373	693,131
Total liabilities	955,605	915,181	955,763	1,075,150	1,013,244	982,731	914,847	863,189	809,996	894,416	863,785	817,358
Deposits	611,100	593,600	561,500	741,046	702,215	680,334	530,400	500,258	475,814	600,872	580,317	550,337
Total equity (excl. minority interests)	61,747	63,665	62,566	74,658	78,713	74,998	61,029	62,779	61,576	70,279	72,035	72,052
Common equity tier 1 ratio (%)	11.5%	12.3%	12.4%	11.8%	13.1%	12.6%	12.5%	13.0%	12.4%	11.3%	12.3%	12.3%
Core equity tier 1 capital	50,511	51,359	50,786	55,464	58,536	57,095	53,924	54,234	51,648	52,126	53,808	52,932
Total risk weighted assets	437,910	416,086	408,166	471,927	450,680	453,616	431,940	417,163	417,610	459,956	436,650	428,899
GLAA / total assets (%)	64.3%	64.6%	60.7%	74.0%	74.9%	75.0%	67.6%	67.9%	68.7%	75.0%	76.3%	77.9%

All figures are presented on a continuing cash basis unless otherwise noted.
NIM is as per PwC calculation (Annualised Net Interest Income / Total Average Interest Earning Assets)

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P0191864