






Banking Matters

Record result, but eyes return to the horizon











Major Banks Analysis

‘Goldilocks’ monetary tightening lifted bank earnings and confirmed the competitive reality of Australian banking. FY24 promises more uncertainty, vigilance and focus.



Full-Year | November 2023



Earnings and returns	Cash earnings +14% yoy -10% hoh \$32.5bn  <p>Cash earnings hit a record \$32.5bn, up \$4bn from \$28.5bn last year, driven by loan growth, NIM expansion and a reduction in notables. It's higher than the last record result, six years ago (\$31.2bn), when the industry was very different to today.</p> <p>Hoh was a different story, with a \$1.7bn reduction driven by lower margins, slower credit growth and rising costs.</p>	Return on equity +138 bps yoy -138 bps hoh 12.0%  <p>At 12% for the full year, bank RoE is the highest it's been in five years. However, after hitting 12.6% in 1H, it fell back to 11.3% for 2H where it has tracked for some time, even prior to the significant risk free rate increases over recent periods.</p>
	Net interest margin +11 bps yoy -7 bps hoh 1.87%  <p>Whilst NIM increased over the year, this was a purely 1H story, with NIM likely peaking in the first quarter.</p> <p>Since then, despite an additional 50bps increase in the cash rate (as well as fixed-rate loans expiring and rolling to newer rates), NIM has been on a downward trend. This is due to rising cost of funds and aggressive competition for lending and deposits.</p>	Other operating income (ex notables) +4% yoy flat hoh \$15.5bn  <p>Up 4% driven largely by a boost to trading income. While this provided a boost to OOI this year, other sources continued on their downward trends with fee and commission and wealth income falling.</p>
Revenues	Operating expenses (ex notables) +5.7% yoy +3.5% hoh \$40.6bn  <p>Expense growth picked up in 2H after a reasonably-restrained 2.7% rise in 1H. As before, the key rise was in personnel expenses with cost per employee increasing 5.7% yoy amplifying a yoy increase of 1.95% in employees. Recent announcements suggest employee expenses growth may slow in the coming year.</p>	Expense-to-income (ex notables) -268 bps yoy +234 bps hoh 45.0%  <p>With a 12% rise in total income, it's not surprising expense-to-income fell. However, it picked up in 2H as income fell while expense growth rose.</p> <p>Overall, at 45%, it is still 2% higher than the last record earnings period, demonstrating the dependency of this year's result on NII growth.</p>
	Credit impairment expense +\$2.9b yoy -\$0.1b hoh \$2.8bn  <p>Credit impairment returns to an expense after four consecutive halves of being a benefit (i.e 'credit') or negligible. However, as a share of GLAA (9bps in FY23) this is still lower than the years before the pandemic (~14-15bps)</p>	Credit provisions +7.5% yoy +2.9% hoh \$20.9bn  <p>Provision coverage rose to 60bps of GLAA. Except for the first two years of the pandemic, this is higher than it has been since 1H15 (pre-AASB 9 and expected credit losses). Yet the share of these provisions related to impaired assets is small, and actual impaired assets (\$7.4bn) as share of the portfolio (24bps) remain at record lows. This indicates the level of provision held to address the uncertainty and caution in the economic outlook.</p>
Expenses	Lending growth rate -232 bps yoy -32 bps hoh +4.7%  <p>Despite having slowed from 7% last year, this was principally driven by a sharp reduction in first half growth. Although the rate of growth is still well off the levels reached in the last great borrowing surge of FY11-15, the larger balance sheet means net lending volume still grew \$12bn per month.</p>	Common equity tier 1 +89 bps yoy +28 bps hoh 12.5%  <p>Up from FY22, thanks to the implementation of capital reforms, which drove a 70bps (average) increase for the majors. Three of the majors have announced a buyback program, with one having already commenced within the period.</p>
Asset quality		
Balance sheet		

Footnote: Westpac's reported Statutory Profit has been adjusted to a Cash Earnings measure for comparability across the banks - all numbers reported are using the calculated 'Cash' basis.

Figures in previously reported period have been updated to align with current period presentation for the purposes of comparison.

Executive Summary

1 / Record full-year result, though the bounce from rates was shorter and shallower than expected

The major banks delivered a record \$32.5bn cash earnings, up \$4bn year-on-year (yoy), and well over the previous \$31.2bn record earnings in FY17. The extraordinary combination of healthy asset growth (7.2% growth in interest-earning assets) and 11bps of NIM uplift saw interest income rise by a full \$9bn, something that has never happened in the history of Australian banking. To that \$9bn growth in interest-income uplift the majors added \$0.8bn in earnings uplift from the continued decline of notable expenses, a cost item that has been falling steadily since its peak of \$5.6bn in FY20 to less than \$1bn in FY23. Finally, other operating income rose modestly for the year (up \$0.6bn), notable not for its size but that the last time that happened was FY14, when OOI was almost \$10bn higher. That's \$10.4bn in additional pre-tax profit, so it's no surprise banks delivered a great result. In the other direction, credit expense and operating expenses (and tax) rose just under \$7bn, bringing the net earnings increase to \$4bn.

Credit expense rose \$3bn (after-tax), which was less about a sharp deterioration in the credit environment as it was about a return to positive credit expense levels following recent years of adjustment to provisions raised during the pandemic that dampened net credit expense. Operating expenses also rose over \$2bn after tax, or 5.7%. This was comparable to overall inflation for the year and the previous year's high inflation, when consumer prices rose almost 2% every quarter.

The end result was to see RoE up 138bps for the year to 12%. This is the highest it's been in five years, but well-short of the 13.6% return recorded in FY17 when the last earnings record was hit. This is because average equity (\$272bn) is up \$3bn on the year and \$43bn more than in FY17.

What's more, this earnings bounce was short-lived. Second-half earnings were down 10% as competition eroded margin and slowing loan growth caused interest income to go backwards, while expense growth accelerated.



2 / All things considered, it has been a 'Goldilocks' economic tightening. Will it last?

Credit and expenses went the other way, as mentioned above, but not too much. Credit losses rose \$3bn, which seems like a lot, but merely reflects a return to positive credit expenses after two years in which it was either a credit (a benefit) or negligible. As a share of the balance sheet, it still reflects muted conditions. Expenses rose over \$2b, most of which was in the second half as expense growth accelerated to 7% annualised.

This was the key to the resilience of the FY23 result. The fiscal and monetary tightening undertaken over the past two years has indeed brought inflation down, and restored balance to many economic settings, even if not as quickly as hoped. And it did so *without* the negative consequences that often accompany such changes. The pain that is spread across household and small-business balance sheets is changing behaviours without (yet) undermining the health of the labour market, asset quality overall or the fundamental outlook for Australia's economy.

The system shook, and it did not break. Can this last?



3 / Outlook clouded by new challenges

To answer that, it's worth returning to the four critical transitions we have written about in the past, and which we see as critical drivers of evolution for this industry and indeed the broader economy: economic, energy, fiscal and digital.

The first of these has been proceeding quite smoothly thanks to the 'Goldilocks' tightening Australia has experienced so far. Nevertheless, banks head into FY24 with a sense of caution. Accumulated stresses on household and business balance sheets, in both Australia and around the world (especially in the US and China) led to overseas tremors that shook confidence around the world at the beginning of the calendar year, but so far have not undermined economic fundamentals.

However, for the banks, long-term trends in expenses, credit, OOI and margins (recent history notwithstanding) have *not* been accretive to earnings for a very long time, even under benign conditions. While NIM remains healthy, balance sheet growth may struggle to be sustained in the event the economy turns down. What's more, global sentiment has notably shifted. Consumer confidence in most markets is at recessionary lows, businesses are being more cautious, and the trauma of events in the Middle East opens an entirely new dimension of global macro uncertainty.

As a result, many are decidedly more sober about the outlook for the year ahead than even six months ago. However, we are not fatalistic. We also, at a time like this, are conscious of Australia's many strengths, and that its banks are well positioned to manage through difficult times while staying focused on long-term opportunities and priorities.

The energy transition continues to be a major challenge for society (which may be especially acute when Australia enters its first 'El Nino' summer since 2015), but remains an enormous and still-barely-tapped opportunity for banks and the financial sector. The fiscal transition is likewise proceeding, with expectations of further pullback in public (commonwealth and state) financial capacity creating additional space for private capital to deliver critical infrastructure and social service needs. Finally, the story of the digital transition introduced a new chapter in FY23 as the latest-generation of Generative AI (GenAI) models bring this capability to every person in Australia.



In short, while there are many things that could go wrong in FY24, and we are realistic about the likelihood of challenging times ahead and critical risks to manage, the long-term opportunities for this industry have not diminished.

4 / Preparing for an uncertain tomorrow while staying focused on the horizon

At a time like this, with the outlook and sentiment changing as rapidly as it has over the past 4-6 weeks, being prepared for what may be a more difficult 2024 is obviously important. At the same time, it's important to remember that Australia, and Australia's banks, remain in terrific shape. They have the capacity to not only successfully navigate challenging global conditions, but potentially secure long-term advantage from them as well.

How? By staying focused on the four themes driving strategic imperatives in banking today. We have described them in the past, and believe they are worth revisiting again:

01

Squeeze on the core,

02

Doubling down on digital,

03

New sources of value and growth, and

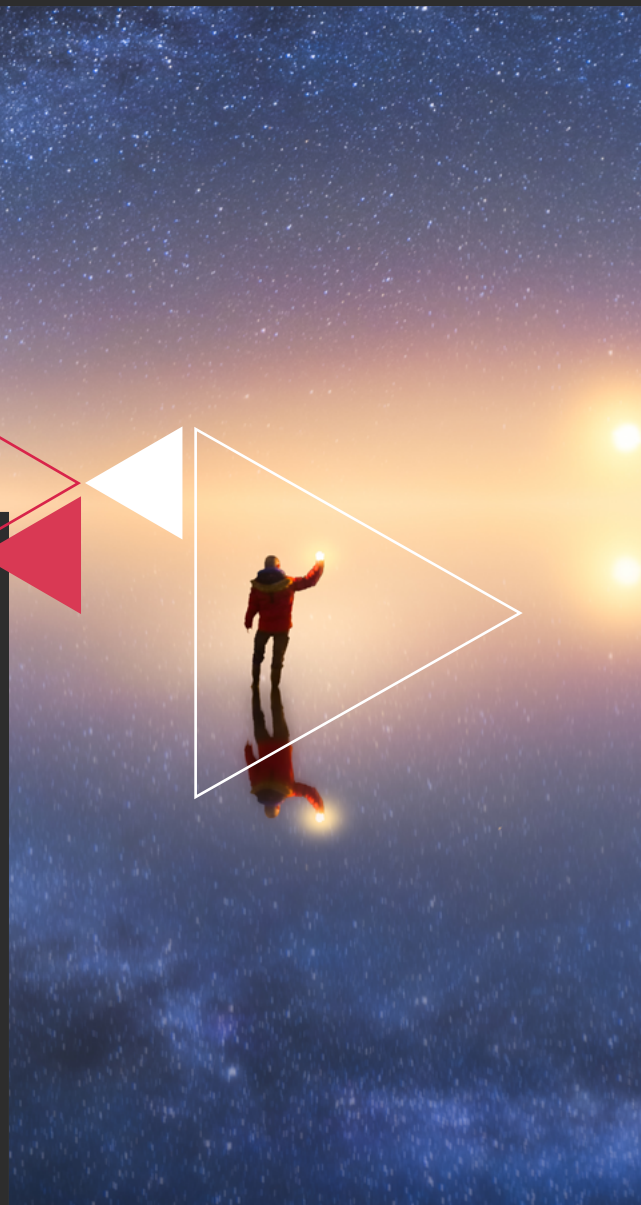
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Tests of resilience and trust

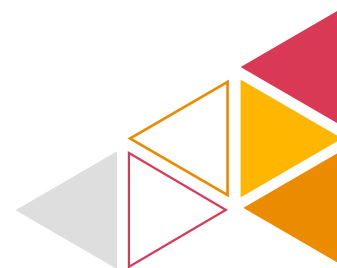
Hot topic: Into the age of AI - finding your marathon pace

In FY23, one of our 'critical transitions' delivered a twist: Artificial Intelligence (AI) has turned a corner. The race to win is underway, is urgent, and adds an entirely new dimension to the imperative to 'double down on digital.'

But it's a marathon, not a sprint, and requires FIs to strike the right balance between prudence, urgency, ambition and sustainable pace. There are real risks in trying to go too fast, without critical skills, tools and capabilities in place. There are also risks in moving too slow. That means leaders need to get smart about AI—not just generally but also very specifically in the context of FS—and start taking pragmatic steps to get moving today.



01



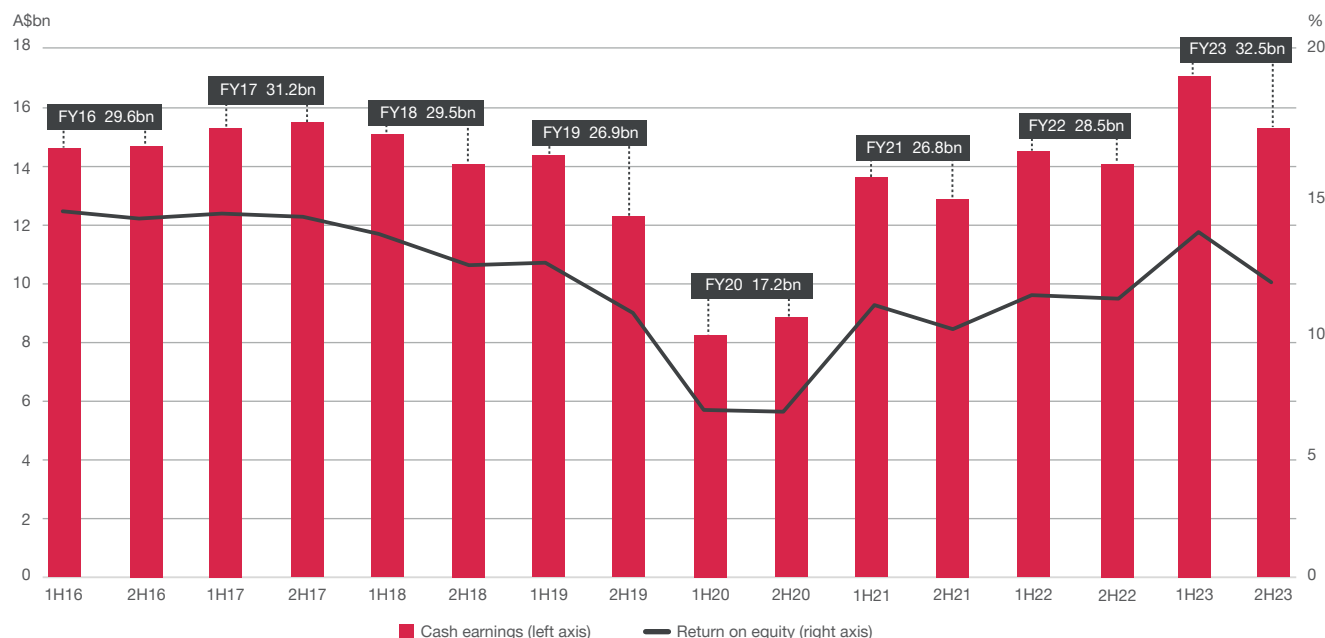
Record result, but bounce from rates was shorter and shallower than expected

\$32.5bn cash earnings, driven by interest income

As shown in *Figure 1*, cash earnings grew by \$4bn to a new record of \$32.5bn for F23, just a bit higher than the previous record set six years before. Readers will note, however, that half-on-half (hoh) earnings fell by just under \$2bn, showing the short-lived impact on earnings of the dramatic rise in the cash rate. Second-half (2H) cash earnings of \$15bn, while certainly healthy, are not unprecedented, and so the year is really a story of two halves, with a margin tailwind in the first being quickly competed down into the second. This is the strategic reality for banking in FY24.

ROE, also shown in *Figure 1*, averaged 12.0% for the year, a 138 bps rise for the year. The first half 12.6% ROE fell back to 11.3% in 2H, which in a world of ~4.5% risk-free rates (compared to <2% in FY21) explains the focus on preserving margin.

Figure 1 Earnings over \$32b for the first time ever, and ROE at 12.0%

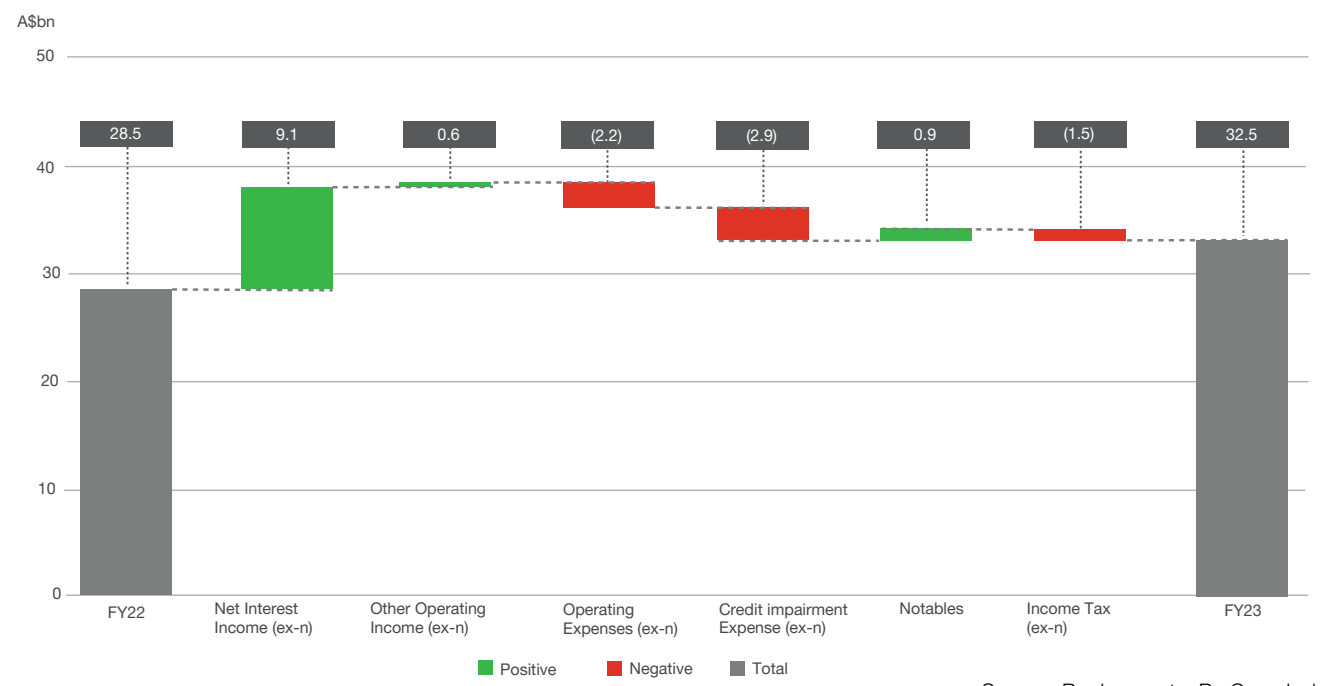


Source: Bank reports, PwC analysis



Figure 2 breaks down the key drivers of this record return. As has been the case almost every year, the most important was the growth in net interest income (further explored below), without which cash earnings would have fallen, not risen. Falling notables also contributed to earnings growth but alone would not have been sufficient to overcome the impact of rising operating expenses and an increase in credit expenses. The latter reflected the end of ‘negative’ credit losses (‘credits’), as well as lending growth and provisioning ahead of any potential deterioration in credit environment, rather than a significant deterioration in asset quality during FY23.

Figure 2 Earnings growth driven by interest income and non-repeat of large notables



Source: Bank reports, PwC analysis

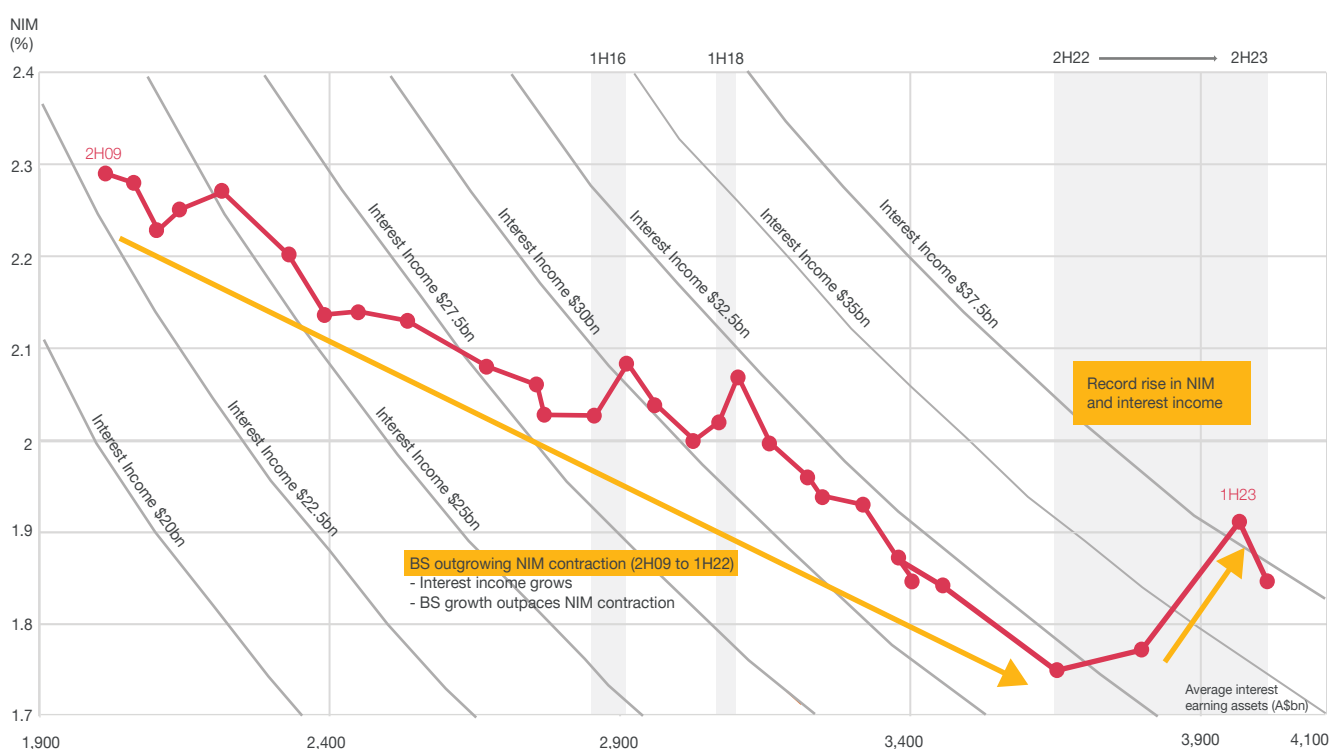




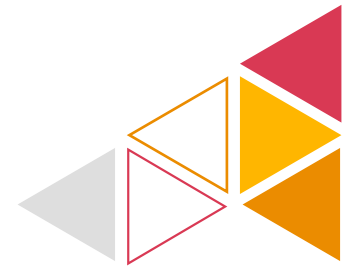
Thus, not for the first time, growth in net interest income was key. As shown in *Figure 3*, for FY23 this was entirely a 1H story. The periods 2H22 and 1H23 saw not only substantial growth in the balance sheet (the x-axis of Figure 3), but also only the third time we've seen two consecutive half-on-half increases in NIM since the GFC (and never before of that magnitude: 16 bps from 1H22 to 1H23).

It didn't continue. In 2H23, the balance sheet growth rate slowed as the intense competition for new lending (as well as record-levels of refinancings) caused some banks to pare back their growth appetite while non-banks surged back into the market after losing share in the first. In addition, NIM turned down once again. It's still, at 1.87%, up 11 bps on the year, but with front-book NIMs reportedly peaking in 1Q, the peak of the fixed-rate conversion 'cliff' benefit for the banks having passed, and deposits a keenly fought for source of funding, the weight of competition continued to exert its influence on margins.

Figure 3 Record increase in NII, driven again by both NIM and lending



Source: Bank reports, PwC analysis

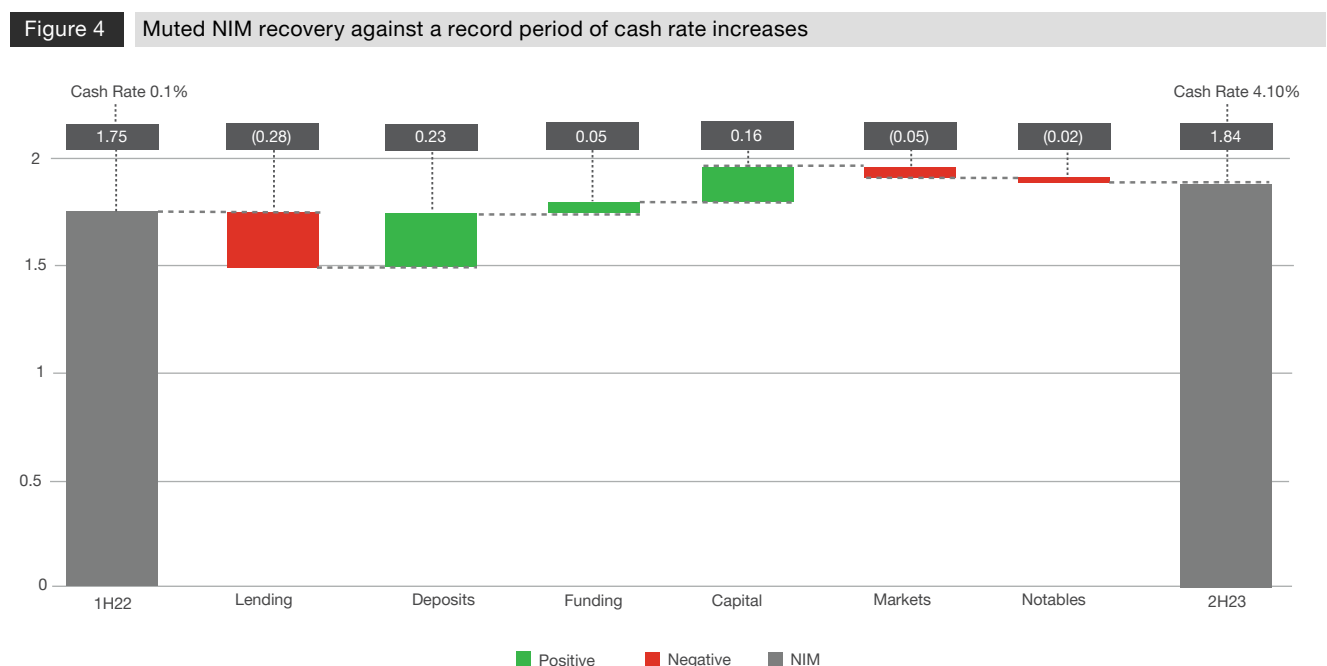


Over the past 18 months, when the cash rate rose 400 bps (to the end of FY23), bank lending and funding markets went through dramatic transformation. Each bank has had its own individual pathway through this transition, reflecting such things as their share of fixed-interest mortgages, business mix, deposit franchise, deployment of liquids and, most importantly, strategic choices in how to balance the trade-off between margin and share.

However, as shown in *Figure 4* below, overall, the impact on NIM was fairly consistent over the three halves during which cash-rates were rising. Competitive pressures drove a sharp decrease in *gross lending margins*, because realised lending rates rose more slowly than the cost of funds. However, the average cost of deposits also rose more slowly, so gross deposit margins actually rose. Unfortunately, these two effects cancelled each other out completely.

As always, most of the *realised* NIM benefit for the banks came from the so-called ‘capital benefit.’ This reflects the portion of every loan funded by capital (which doesn’t require interest) rather than loans or deposits. That provided 17 bps of NIM uplift out of a net 12 bps (from 400 bps in the cash rate!) after the effect of funding mix, markets and other matters.

The end outcome was that NIM rose just 9bps over the cash rate increase of 400 bps, from a low of 1.75% in 1H22 to 1.84% for 2H23 (with 2H23 being a decline). Contrasting that to the 50bps decline in NIM over the (longer) period of cash rate decreases from 3.75% in 2009 through to the 0.1% in 2020, this does suggest that a return to that peak is unlikely in the current dynamic of fierce lending and deposit competition.

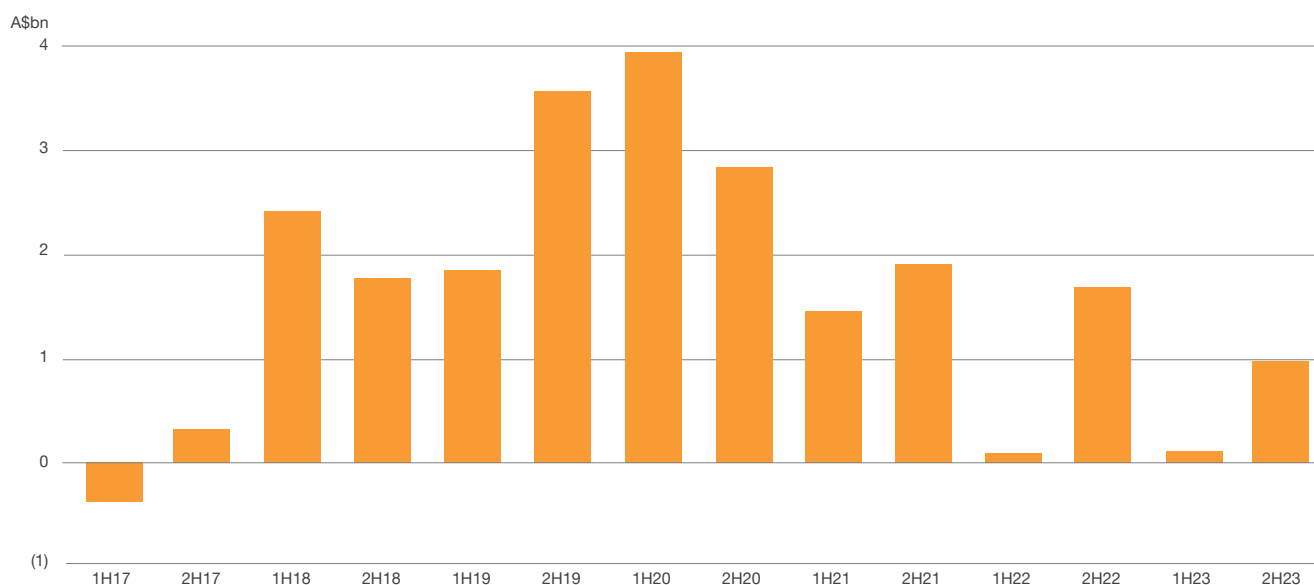


Source: Bank reports, PwC analysis



As for Notables, they were again a mix of benefits and expenses for the banks, and have been relatively small for three of the past four halves. This is illustrated in *Figure 5*. In FY23, we saw the principal themes continue to be customer remediation (albeit at levels far below the post-Royal Commission wave), and restructuring costs and benefits (with a large loss on sale in 2H22 and a mix of remediation and restructuring expenses in 2H23).

Figure 5 Notable expenses come down from their peak in FY19/20



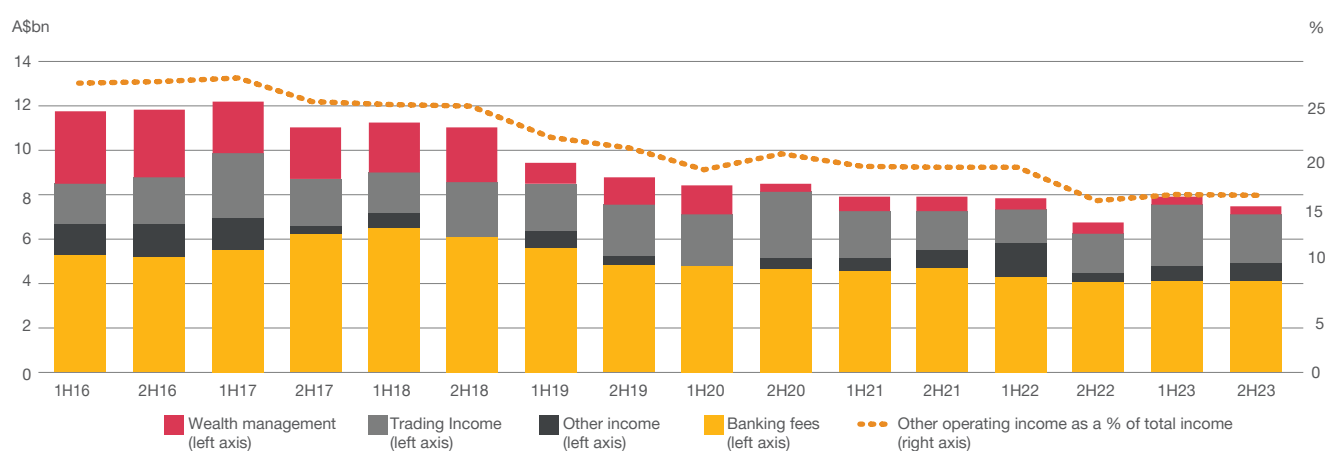
Source: Bank reports, PwC analysis





Other operating income increased in FY23. However, as shown in *Figure 6*, this was due to a large increase in trading income over the year. Given the dependency of that income stream on market volatility and activity, it will always be difficult to call a trend. Looking more broadly at the half-year views, the impact of exiting businesses with wealth management fees and income is now largely complete, the value of trading income whilst variable is generally reverting to the mean, and banking fee income appears to have settled (albeit at historic lows).

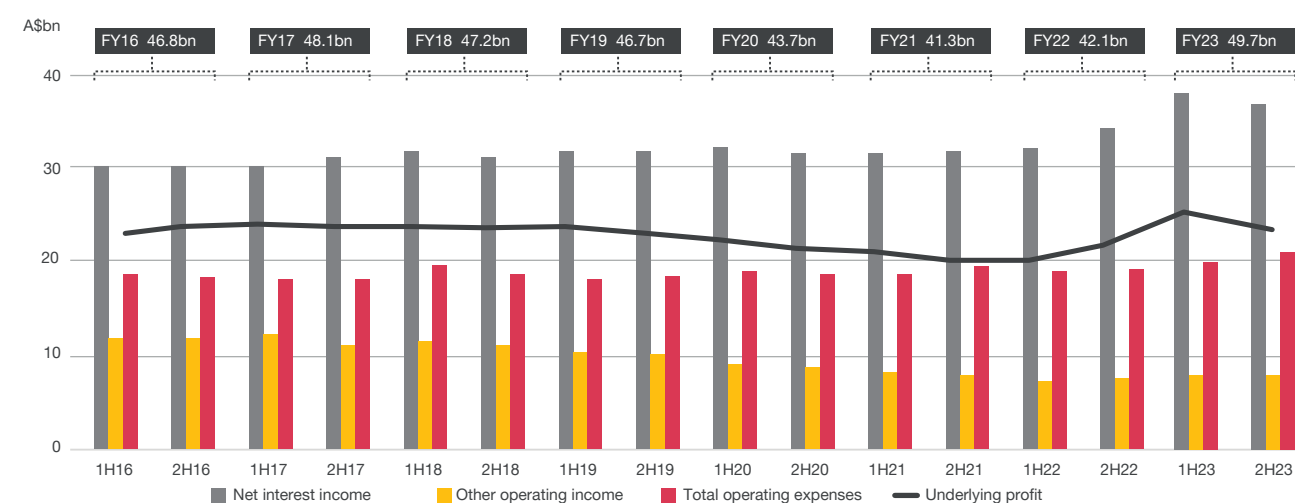
Figure 6 OOI still falling, but at much slower pace



Source: Bank reports, PwC analysis

In any case, with interest income surging in the first half and remaining high in the second, and OOI also briefly recovering, underlying profit overall for FY23 hit a record \$49.7bn for the year, as shown in *Figure 7*.

Figure 7 Underlying profit, declining since 2017, jumps up in FY23, though fell again in 2H



All data excludes notable items

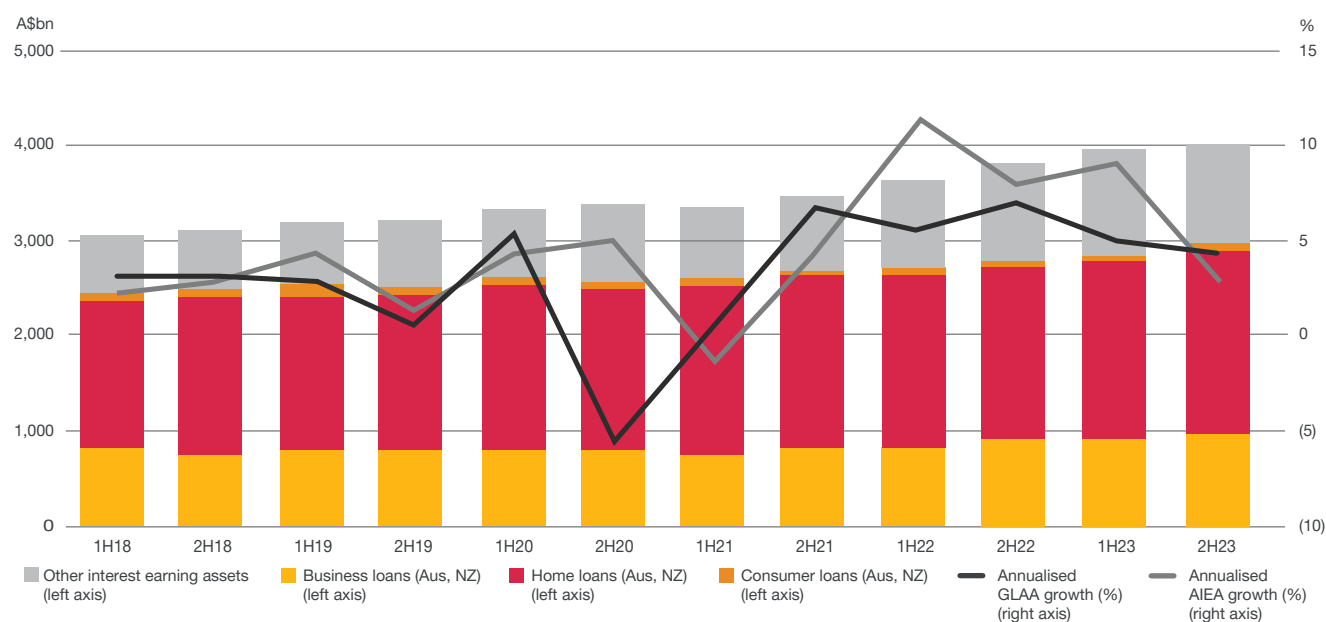
Source: Bank reports, PwC analysis



Lending growth reflecting combination of both business and mortgage lending

Although, as mentioned above, the balance sheet surge that began in late 2021 has tempered, average interest-earning assets still grew at a healthy pace. As shown in *Figure 8*, that surge was driven by the synchronised growth of business and home lending, as well as the acquisition of interest-earning liquid securities which was necessitated by monetary and fiscal stimulus during the pandemic. Both have come down, although the latter more dramatically. As for mortgages, always the most crucial element of Australian bank balance sheets, data on lending commitments (a leading indicator of loan growth) suggests that the slowdown in loan growth bottomed in the first half of FY23, with monthly volumes then rising steadily during the second half, even if nowhere near the heights of 2022.

Figure 8 Growth slowing, but momentum was still evident in 1H23



Source: Bank reports, PwC analysis





Finally, and most importantly, lending growth is not only slowing, its mix is also changing, with business lending continuing to grow faster than mortgages, a trend that began with the return of the economy from lockdown. This is illustrated in *Figure 9* which illustrates business and home loan growth alongside total lending growth.

Figure 9 Business lending outpacing mortgages for the majors since 1H21, though both slowing



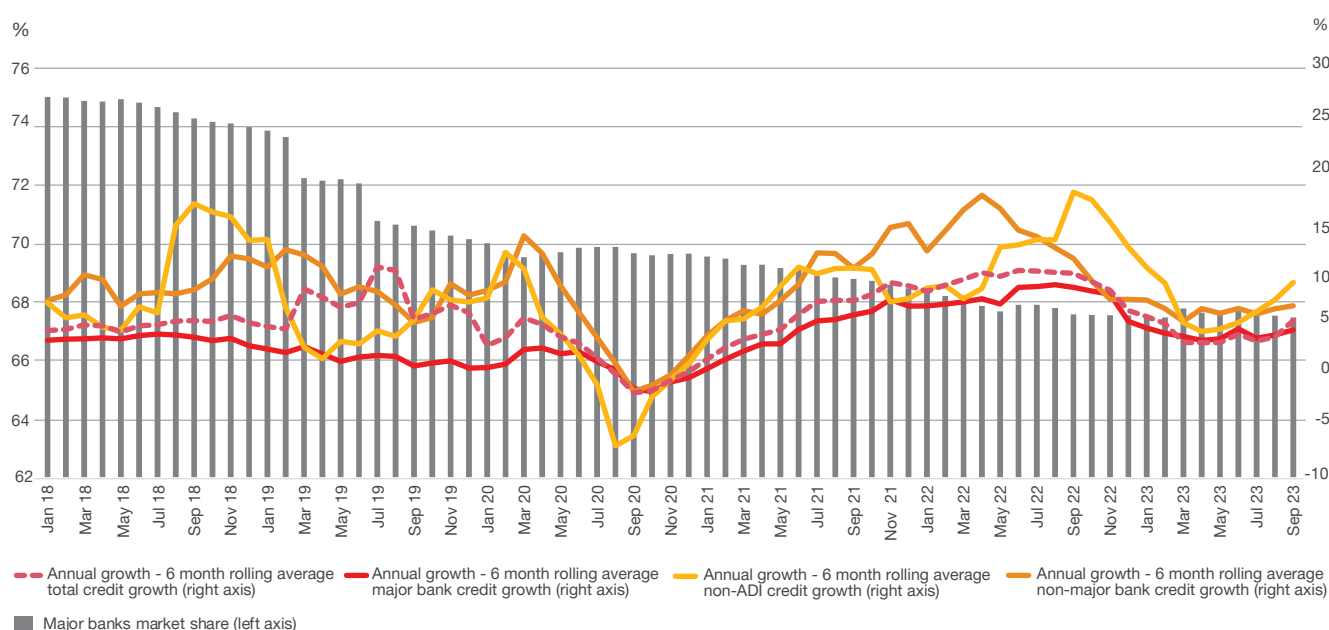
Source: APRA Monthly Banking Statistics, RBA Cash Rate Target, PwC analysis





Our previous report noted a return to growth for the majors, and that it supported the inherent advantages for the majors in uncertain times, such as access to deposits and (relatively) responsive capacity in both balance sheet and lending operations. For FY23, *Figure 10* illustrates both the way the system has slowed for mortgages, but also the way some of the majors have chosen to prioritise margin retention over share, while non-ADIs have clearly come back into the market.

Figure 10 Majors have grown more slowly than both non-majors and non-ADIs



Source: APRA Monthly Banking Statistics, RBA Financial Aggregates Statistics, PwC analysis



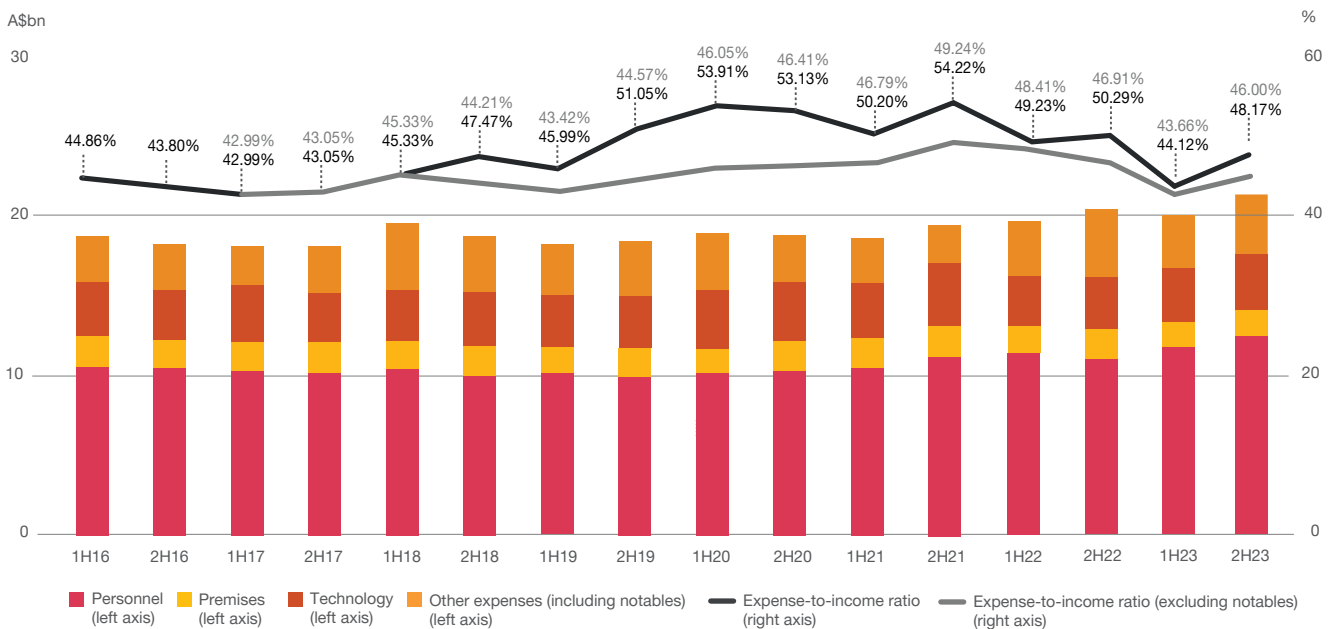
Credit and operating expenses growth a counterweight to the record earnings

As mentioned above, we attribute the record FY23 cash earning to interest income, with both operating and credit expenses otherwise increasing year on year.

Figure 11 breaks down the growth of operating expenses by major category. It suggests that the rate of savings in premises expenses from capacity rationalisation has slowed, while personnel costs continue growing. Personnel costs reflected the impact of inflation, with cost per FTE growing to \$148K, up 5.7% over the year, which coupled with the ongoing FTE growth drove an overall 7.7% increase for the year (albeit the FTE growth was more muted than in previous periods, growing only 1.9% in FY23, compared to 2.5% growth in FY22 and an even higher 6.4% during FY21). With each of the majors having announced some level of redundancies within 2023, we'd expect to see the overall growth in employee expenses start to slow, however wage inflation more generally and the enterprise bargaining agreements entered into in FY23 leave large scale reductions in this expense more unlikely. What remains to be seen is if the banks can close off their transformation and remediation programs, and return to the FTE numbers of 2018/2019 (directly following the first round of post royal commission divestments), as the 10% FTE increase since that time, coupled with 8% employee expense per FTE growth), has been a key driver of the 196bps CTI increase over the same time period.

Technology costs also continued to grow, with inflation, maintenance and licence costs all being contributory factors to the 3.9% increase yoy. 'Other' expenses remained a more varied result for the banks, but across the majors went up yoy, with drivers covering investment spend, ongoing remediation work, general third party spend and the impact of fraud and scams.

Figure 11 Expenses growth picked up in 2H23 driven largely by personnel cost increases

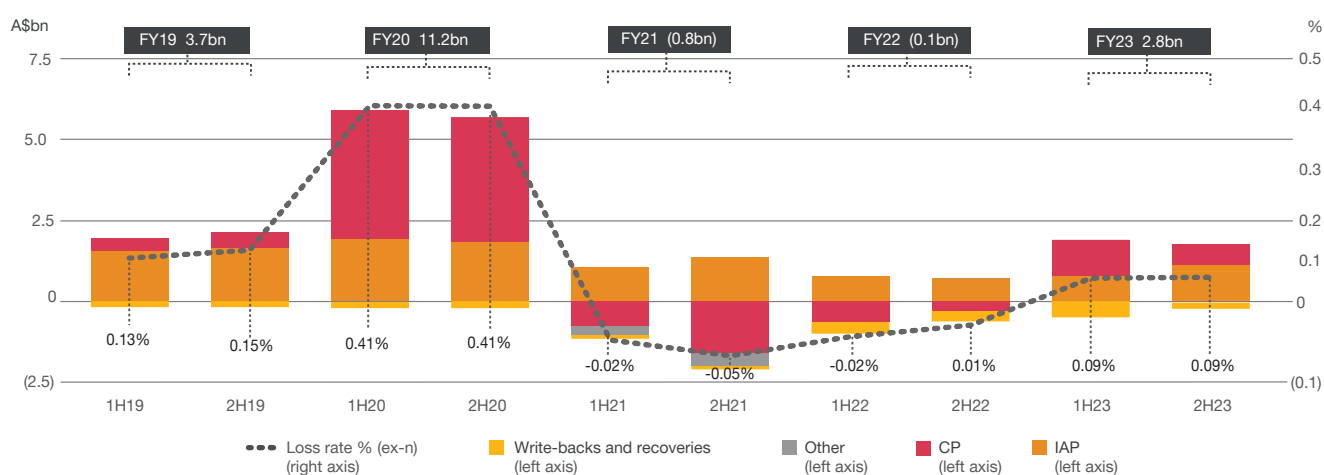


Source: Bank reports, PwC analysis



Figure 12 illustrates credit returning to being a normal expense. For the past four halves it was negative (credit) or negligible, as provisions raised during the pandemic were adjusted and the need for additional provisions in FY21 and FY22 was low as a result.

Figure 12 Credit expense returning to normalcy



Source: Bank reports, PwC analysis





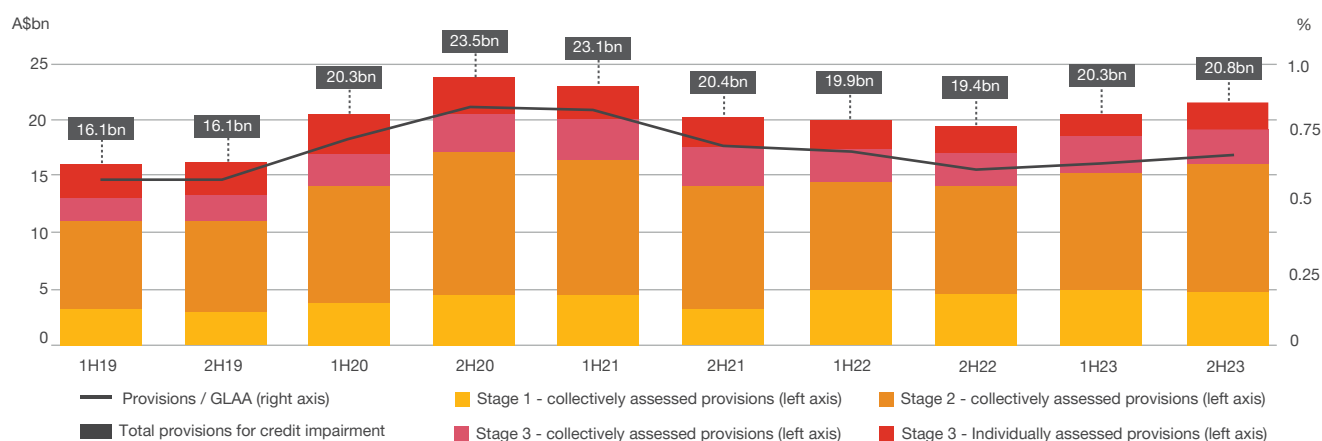
Capital and provisions remain strong, but warning signs emerging

It's early days, and the credit environment remains exceptionally strong. However, warning signs are unmistakable. Accordingly, collective provision cover has risen, as shown in *Figure 13*. Although impaired assets are just \$7.4bn (having risen from \$7bn but still only 24bps of GLAA), recent results note upticks in watchlist loans, 90+ day delinquencies (following early warning signs in 30 day delinquencies from 1H23), and business insolvencies (up 12% yoy in ASIC's latest release).

Further, whilst we noted above the peak of the fixed-rate "cliff" benefit has passed for the Banks, its impact on customers is likely still to be felt. For those customers who are rolling off their record low mortgage rates, likely on to fixed or variable rates that are higher than their original serviceability assessments, the question will be whether the deposit and property value buffers they built up over that time are enough to postpone or avoid any impact.

It is important to note that under AASB 9 (Australia's implementation of the international accounting standard IFRS 9), provisions are based on expected-loss models which, in principle, should moderate the pro-cyclicality that was common in past economic crises. Thus, even in the event of an economic downturn, one would not expect to see the same kind of spike in provisions and credit losses we saw during the GFC.

Figure 13 Collective provisions rising



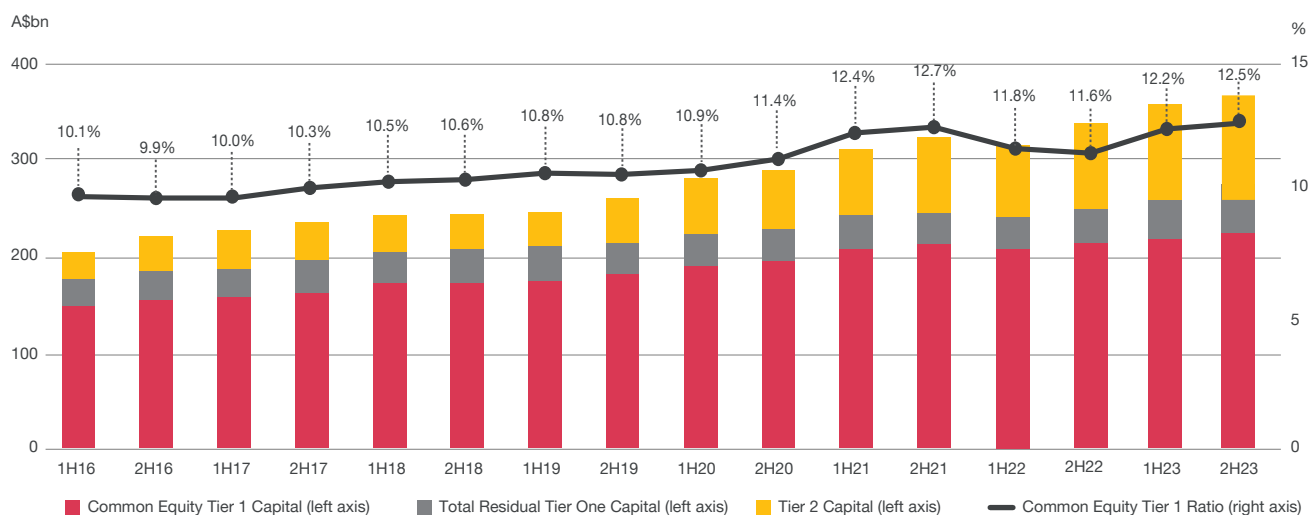
Source: Bank reports, PwC analysis





Total capital, meanwhile, has reached \$364bn, \$224bn of which is CET1, as shown in *Figure 14*. Although the gain in the CET1 ratio over FY23 was largely attributable to the 1 January 2023 implementation of capital reforms, driving a decrease in Credit Risk Weighted Assets across the banks, we expect that this will reduce slightly over the coming period, with one bank needing to complete the remainder of their \$3bn buy back, and two other banks announcing a further \$3bn of buy backs to come. Regardless, we note the trend of growth in total balance sheet capital has been fairly consistent for some time, and the banks are well set for potential headwinds in FY24 and beyond.

Figure 14 Banks remain well capitalised amidst uncertainty



Source: Bank reports, PwC analysis



02

All things considered, it has been a ‘Goldilocks’ tightening

The necessary monetary renormalisation which began in May 2022 and added 400 bps to the cash rate by the end of FY23, provided a powerful stimulus to lending margins. Heading into FY23 there were well-founded fears about how it would all play out, with potentially serious consequences for bank asset quality, lending growth, and the speed at which elevated margins would be competed away. These fears were not limited to Australia, and in February catalysed a mini liquidity crisis that culminated in the failures of a number of high-profile institutions before being resolved after an extraordinary sequence of central bank interventions overseas.

So there was never any guarantee that FY23 would work out for the banks or for Australia as well as it did. However, notwithstanding questions about adequacy and pace, rate rises in Australia *have succeeded* in arresting the runaway growth in inflation, appear to have addressed the risk that inflation expectations would become embedded into wage growth, and did it all without breaking the economy.

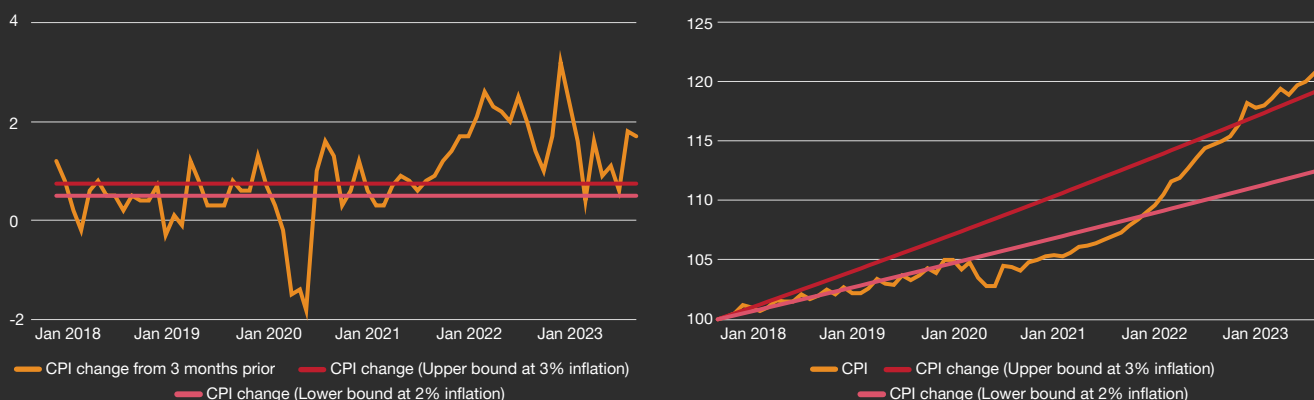


Inflation is coming down, even if more slowly than we'd like

As shown in *Figure 15*, while the uptick in inflation over the last quarter has understandably attracted attention, a longer-term view of Australia's monthly CPI does suggest a clear moderation in the inflationary momentum that was so strong during 2022.

Looking back to September 2017 reveals that consumer prices in Australia today are just a bit above where they would have been had inflation tracked the 3% upper bound of the RBA's target band.

Figure 15 Inflation has declined, notwithstanding uptick, while prices not far off long-term trajectory

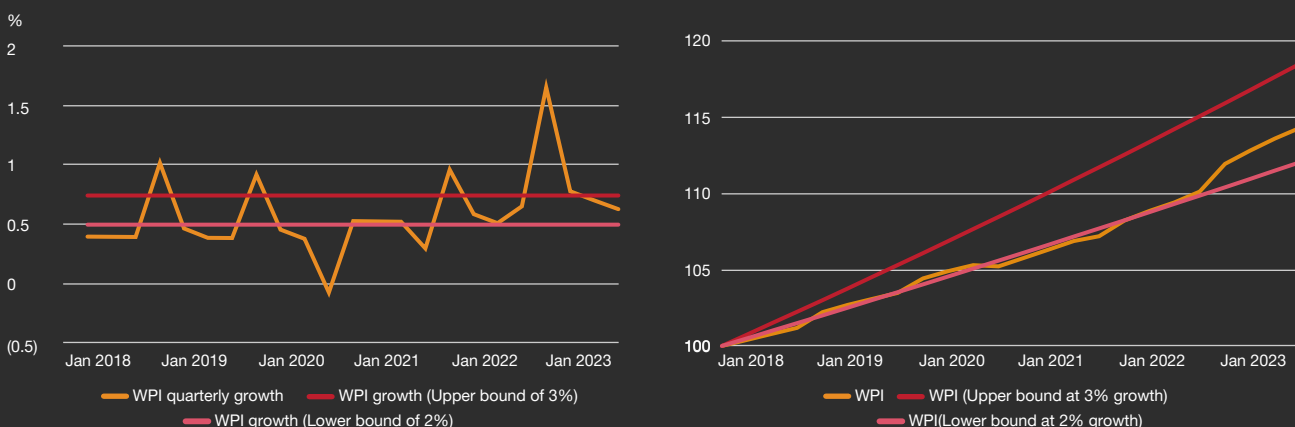


Source: ABS Monthly Consumer Price Index Indicator, PwC analysis

For wages, evidence of embedded inflation expectations is hard to find, as illustrated in *Figure 16*. This is important because wages are, after all, the vector through which price rises can turn into runaway inflation. While there was a clear uptick in quarterly wage growth during 2022 (which helps explain the growth in realised cost-per-FTE for

the banks in FY23), wage growth overall has fallen back into the RBA's 2-3% target band (or 40-74 bps per quarter). Returning to September 2017¹ reveals that accumulated wages growth since then is barely above the RBA's lower bound. We are a long way from a crisis in embedded inflation expectations.

Figure 16 Wages went through clear adjustment, but showing no sign of runaway expectations



Source: ABS Wage Price Index, PwC analysis

1. This is when the ABS's current online WPI data series begins

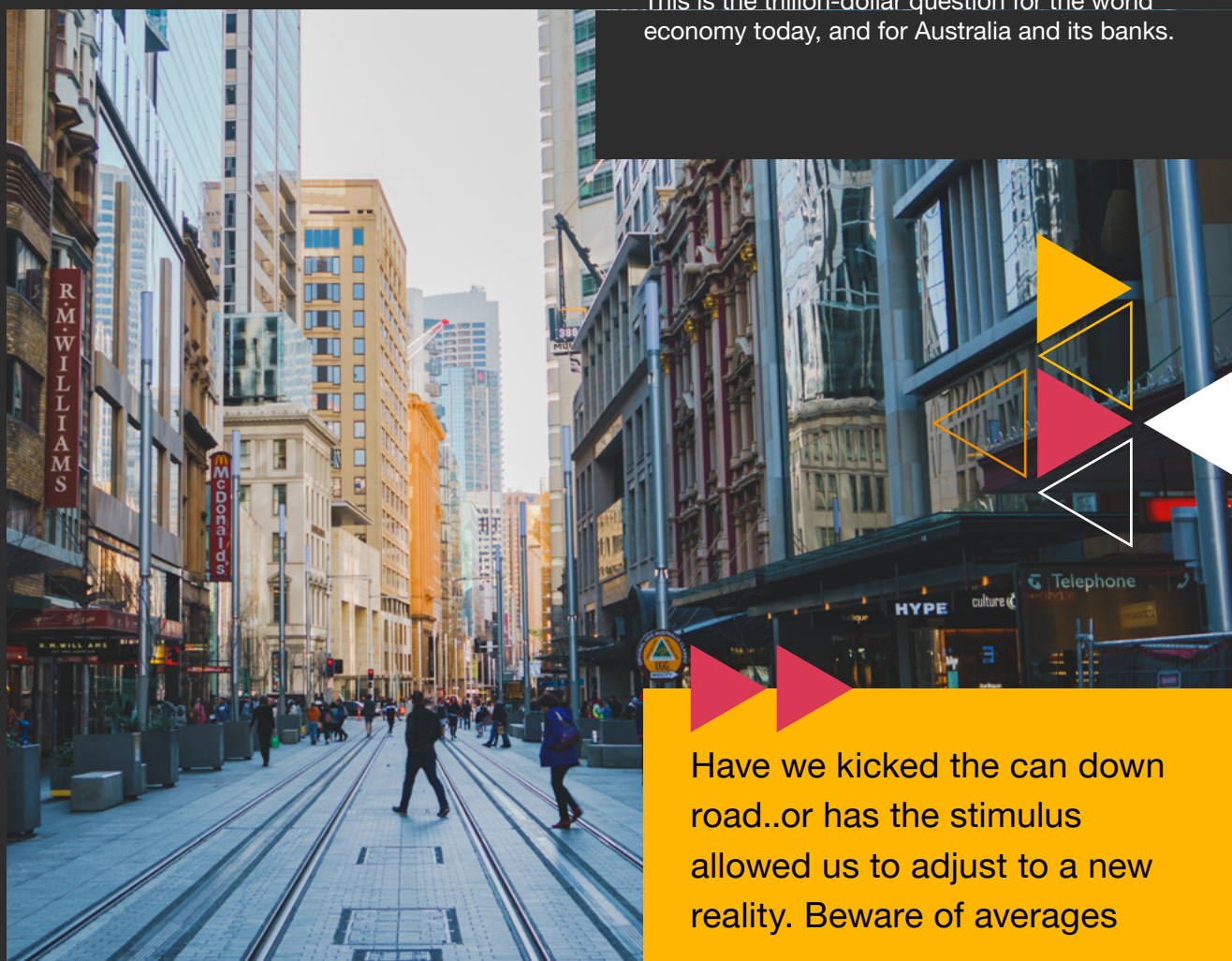
Balance being restored, and so far we are managing

The good news is that actions taken across both fiscal and monetary policy in the past 18 months have helped restore balance to prices and markets all over the world, albeit with turbulence along the way. The price of money is positive again. TINA (*'There is no alternative'*) is done. The bonfire of ZIRP (zero interest-rate policy) vanities has been painful indeed, but it leaves our economy, and therefore our banks, healthier than they would have otherwise been.

Most importantly, as mentioned above, we have (so far) managed through. There has certainly been pain. Consumer spending, especially on discretionary items, has been crimped. The confidence behind many 2022 wage expectations has been blunted. These things are clearly showing up in surveys of both business and consumer confidence (the latter of which is at recessionary lows). This is of course also a toll on many families, not just financial but also mental health.

However, the most severe fears have (so far) not eventuated. Consumer spending has not collapsed, even if real per-capita spending on discretionary items is falling. House price exuberance has given way to serious underlying demand (supported by immigration). New mortgage lending commitments have risen slowly-but-steadily to \$25b in September ² (still a long way from the \$34b peak of January 2022), having bottomed at \$23bn per month in January 2023. Employers have scrutinised their payrolls and hiring plans, and a number of organisations, including banks, have announced redundancies, but employment overall remains robust. A year that began with serious financial tremors finishes with record bank profits in almost every market around the world.

The system shook, and it did not break. And can it last? Has the liquidity built up during the height of the pandemic (not to mention confidence and resilience) fundamentally enabled us to better withstand the shock of this next economic transition? Or, alternatively, has it merely provided buffers that postpone the inevitable? This is the trillion-dollar question for the world economy today, and for Australia and its banks.



Have we kicked the can down road..or has the stimulus allowed us to adjust to a new reality. Beware of averages

2. See Lending Indicators, Australian Bureau of Statistics

03

Outlook clouded by new challenges

Our previous reports have described four critical transitions simultaneously underway in banking and indeed the broader economy which are essential to understand: economic, energy, fiscal and digital. Any one of these alone could be a driver of significant change and transformation. They remain for us the best frame through which to think about the year (and years) ahead.





Economic transition proceeding smoothly, but outlook has become much more uncertain

The economic transition refers to the shift from the pre-pandemic world of ultra-loose monetary policy and fiscal settings (both of which reached their height during the pandemic) to one in which monetary and fiscal settings are more sustainable. As mentioned, this transition is progressing nicely, though next year is critical.

Two potential FY23 scenarios to consider

In the best case: inflation and fiscal deficits continue to fall in an orderly fashion *without* triggering a serious recession. This would allow central banks to leave rates at sustainable levels. If so, we could be on the cusp of a new era of financial moderation, an environment in which a whole host of economic and financial imbalances could be addressed: from the imbalance between wages and asset prices which have priced so many Australians out of the housing market, to the imbalance between mortgage and business lending which frustrate so many small businesses, to the excesses in household leverage and many other things besides.

Alternatively: the interplay of accumulating financial pressures, unresolved financial imbalances in markets from the US to China, and spiralling geopolitical conflict may lead to a global recession. This would be a terrible scenario for the world, obviously. However, the volatility in rates, valuations and supply of funding and capital such a crisis would trigger will also present potentially-attractive long-term strategic opportunities for the major banks. In such a crisis, their balance sheet, reputation and franchise strength could serve them well, assuming they prepare for such conditions appropriately.

We don't know which scenario is more likely, but markets and sentiment suggest the odds of a downturn have increased over the past six weeks. Obviously, the violence in the middle east only makes things worse, and in the US, the yield curve, reverting and flattening since July, is once again steepening downward.

Pressure on households, businesses and balance sheets is building

Even in the ‘Goldilocks’ transition of FY23, consumers have been bearing the pain of higher rates. They have maintained spending (especially on non-discretionary items whose price is rising), but they are running down savings buffers to do so. As pressure on some businesses and households continues to build, history suggests that banks will be impacted not only through asset quality (obviously), but perhaps more significantly through additional demand on customer-support teams, as well as heightened attempts at crime, fraud and scams. There will of course also be serious financial and mental-health concerns for some employees and their families, especially if the job cuts continue.

Overseas, unrealised losses on the balance sheets of regional banks and real estate funds (especially in the US and China) could spell trouble if another crisis of confidence spirals into a crisis of liquidity as it did in March.



Global environment confronting new fissures and sources of polarisation

Finally, the global macro environment never stops changing or surprising. Over the past several years, the forces of global cooperation and integration, from East Asia to Ukraine, from climate change to trade, seemed to have regained momentum. A new era of global cooperation, led by a new US President who declared ‘America is back!’ coincided with a series of setbacks by authoritarians and populists around the world. The idea of a ‘global liberal order’, flawed as it has always been, suddenly seemed not so outdated, at least in comparison to alternatives, and this confidence was crystallised in a series of global agreements on things such as tax, defence, climate and global health.

It is facing an entirely new challenge today. The events in Israel and Gaza have unleashed forces that may manifest themselves in waves of violence and counter-violence that ripple for decades to come. As mentioned above, it will likely have implications for trade, confidence and sentiment. More ominously, the world’s reaction has revealed deep fissures across global society which, in the interconnected world we live in today, now reach into every city, town and indeed every workplace in Australia. Managing a diverse workforce through such times will test leaders of the major banks as well as every large institution in Australia.



Energy and fiscal transitions also underway, but substantial work remains

The energy and fiscal transitions are both well-underway. On both questions, there is consensus on the need for change. COP27³ was a quiet success, even if critics called it underwhelming. In Australia, climate commitments are a key part of the ESG agenda and sustainability reports for every major bank, and indeed for every institution, and there is now broad based (even if not universal) domestic political consensus on what needs to be done, as made clear during the last federal election. There remains, however, a material gap between what needs to be done for Australia to reach its carbon commitments, and investments being made today. This isn't a gap that Australia's banks can close themselves; it's a gap for Australia overall. However, the banks have a critical role to play, not just through deployment of their balance sheets, but also through advice, advocacy and dealmaking.


The fiscal transition is also well-underway. The budget deficit has been brought down from \$140bn in both 2021 and 2022 to less than \$15bn today. However, this has been as much about the end of pandemic stimulus and elevated export revenues as it is about structural change in the share of public versus private allocation of social responsibility. As we have written in the past, there remains significant scope for private initiative to complement and amplify public investment to address a range of social objectives such as housing, infrastructure, public health and climate

action.

Digital transition requires facing into game-changing implications of GenAI

For the digital transition, the past year has seen a major breakthrough in Artificial Intelligence (AI), with Generative AI (GenAI) bursting into broad public consciousness. It's not new, and there's a lot more to the digital transition than GenAI, but it is unquestionably the most important development in this space right now.

3. The 27th United Nations Climate Change Conference of the Parties, held in Egypt last November, is the premier global venue for reporting on global progress against climate goals, agreeing new goals, and for nations and private-sector participants to undertake new commitments.



Preparing for uncertain tomorrow while staying focused on future

With global economic sentiment changing as fast as it has over the past 4-6 weeks, there is no question that being prepared for a potentially more challenging 2024 is important. Of course, as we have written in the past, Australia and Australia's banks remain in terrific shape.

Australia's economy is cushioned not only by its endowment of natural resources, but also by the continuous inflow of highly-skilled people and their families. This backstops both the demand and supply-side of our economy. Australia's banks, likewise, go into 2024 with 'unquestionably-strong' levels of capital, and balance sheets provisioned for a range of economic scenarios.

Moreover, Australia's banks have so-far avoided many of the mistakes that have bedevilled banks overseas. There is no crisis of unrealised IRRBB (interest-rate risk in the banking book) losses here. Nor are there, to our knowledge, systemically-large numbers of commercial real estate or other enterprises with precarious leverage or worrying cash flows. Finally, through the pandemic, the banks demonstrated both the will and the executorial capacity to support customers through difficult times.

So while many are sober about the outlook for 2024, and we believe that being ready for more challenging times is obviously a priority, we also see no reason for anyone to take away focus from long-term priorities, or to forget that challenging times also bring opportunity.

In this light, we revisit the four themes driving strategic imperatives in banking today:

01

Squeeze on the core,

02

Doubling down on digital,

03

New sources of value and growth, and

04

Tests of resilience and trust

Squeeze on core

The squeeze continues. Front-book lending margins, having reportedly peaked almost a year ago, have been falling, while tailwinds on expenses tailwinds aren't abating. Much of the latter was driven by technology uplift which has been proceeding successfully. However, we haven't yet seen it translate into an absolute reduction in expenses or even FTEs. Even as banks make progress in modernising legacy systems, the frontier of best practice (and customer expectation) continues to advance, and in the pandemic, with so much (appropriate) focus on ensuring operational resilience, it is possible that scrutiny of expenses hasn't been as high as it will once again need to be.

Doubling down on digital

The major banks have made more progress on digital transformation than many expected five years ago, or indeed may even realise today. Many of the most important customer-facing systems have been migrated into contemporary platforms in the cloud, with banks even taking a serious look at modernising once-taboo legacy systems like core banking and the general ledger. Customers can see the benefits when engaging with banks online, and the momentum is still building.

However, as mentioned above, both customer expectations and the competitive landscape keep evolving and the execution of these transformations and extraction of benefits remain challenging. The need for digital transformation at pace remains. What's more, with Generative AI (GenAI) bursting into the broader consciousness, a new frontier has opened up for competition on capability. Although this promises significant productivity and other benefits, it will require substantial (additional) attention and investment. We describe this in greater detail in the Hot Topic attached to this report.

New sources of value and growth

FY23, like so many years before it, was a record result because of a rise in lending margins coupled with a rebound in mortgage lending. Yet change is already underway. Business lending, as we've noted above, has been outpacing mortgage lending for most of the past four years, which it needs to do if the Australian economy is to address the challenges confronting it, not least of which is the need to labour productivity and economic capacity (supply), both of which sit at the root of sticky inflation. The fiscal and environmental 'transitions' mentioned above also present substantial opportunities for new value and growth, and while there has been substantial attention and initiative undertaken to address this in



the context of energy, even here there are substantial opportunities still sitting on the table. We expect this and broader opportunities for capital-light or cost-light growth, such as services, to be a keen focus for banks as traditional returns remain under pressure.

Tests of resilience and trust

Most importantly, the period we are entering and have been navigating for some years now is one where the resilience and reliability with which customers are protected and served is critical and has close regulatory attention.

As customers navigate a very challenging economic environment, how banks support and respond (including when things cannot be resolved) is and will be a key test for banks - think hardship, complaints, collections and resolution.

Fraud and scams have materially increased in scale, sophistication and actual losses in a rapid change that has outpaced regulation and some banking systems and raised important questions about the extent of prevention and detection banks owe their customers and the effectiveness of these processes.

Add to these, the importance of information security, including customer data, system reliability and even responsible AI and the expectations, reputational and regulatory focus on 'Operational Resilience' is evident.

How banks respond to this, invest in protection and respond effectively when things go wrong could be the biggest test of all in the coming years.

History shows that being conscientiously deliberative about investing in readiness and resilience, including instilling a culture of risk attention through such exercises as stress-testing, scenario role-playing and strong 2nd-line oversight make a difference in a crisis.

Finally, for the banks, on the formal side of things, the combination of an updated operational risk management standard (CPS 230) and new leadership in domestic regulatory agencies may bring renewed attention from regulators on this topic in Australia.

Hot Topic: Find your marathon pace into the age of AI

By now, there is surely no banker who doesn't appreciate how important AI will be (both GenAI specifically and the field more generally). It has transformative potential. At the same time, the breathless exuberance in some of today's commentary about what is 'just around the corner' can sometimes be too much to make sense of and respond to.

As a result, we see organisations around the world taking very different approaches to GenAI adoption. Some are sprinting for advantage, driven by the call to deploy 'transformative' solutions to deliver value at scale. In some instances, we're seeing insufficient consideration given to the distinct requirements and risks of implementing fast solutions in an industry like financial services.

Others, mindful of the regulatory, reputational and systemic issues at stake, adopt a posture that is

heavy on caution and care. The risk here is that their organisations will fall behind.

It will be many years before it's clear who's got it right, but, as a forthcoming PwC publication will point out, everyone needs to do two critical things:

01

Get smart: Help their organisations think and act smart about AI—not just generally but also very specifically in the context of banking in Australia.

02

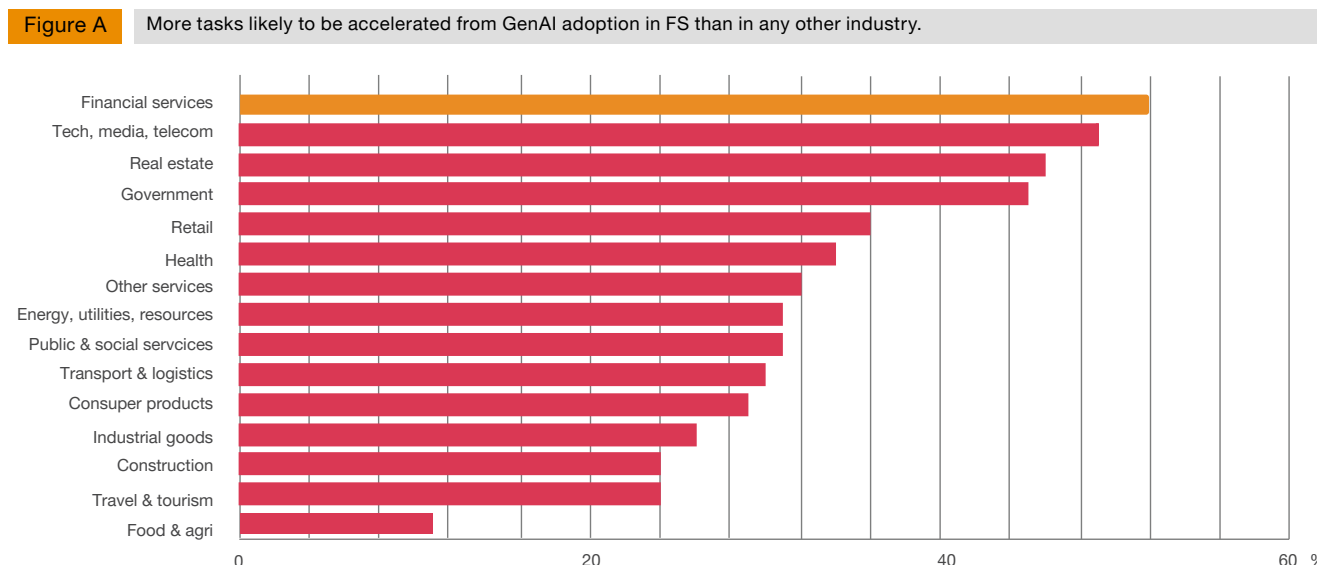
Start moving: Taking pragmatic steps to start on the journey of adoption and transformation.

Let's explain each of these in more detail.



Get smart

Financial services is one of the most likely industries to be changed by GenAI, as illustrated in *Figure A*, which is a synthesis of task-level analysis of work performed at the University of Pennsylvania.⁴



85 3-digit NAIC sectors aggregated for illustration and sorted by unweighted average exposure.

Source: GPTs are GPTs: Early look at the labour market impact potential of large-language models, University of Pennsylvania, OpenAI, 27 March 2023., PwC analysis

Half the tasks performed inside a bank, insurer or wealth manager could be done at least 50% faster through GenAI adoption, and this was more (on average) than for any other industry. In fact, we believe that as the capabilities of GenAI develop, and GenAI is integrated with other systems, that figure will prove to be much higher.

Banks also face ‘indirect’ effects from AI that they need to understand and manage, including the effect AI has on balance sheet, credit risk and business strategy due to its impact on every other part of the economy. All this comes at a time when the industry confronts the fundamental transitions described above.

And yet AI, and especially GenAI, has a critical role to play. Compelling use cases are emerging across all domains in financial services. By deploying GenAI solutions to create even small advantages today, early adopters can accumulate experience, build capability and attract talent that may become consequential advantages tomorrow. Those who fall too far behind might find it difficult to catch up.

Unfortunately, there are many things that can go wrong. When implementing AI, banks have a particular responsibility to make prudent decisions. For banks, there are unique regulatory, legal and increasingly critical ESG obligations that make risks especially acute. In addition, new risks and issues constantly emerge which leaders need to understand, manage, and address. Given these issues, many banks around the world restrict or fully block access to well-known models through their firewall. This provides some protection and might make temporary sense, but it’s a stopgap solution, and its value is rapidly eroding.

4. Researchers performed ‘task-level’ analysis on the impact of GenAI on the speed at which tasks could be performed across different activity taxonomies in use in North America. They then calculated the share of tasks for which there would be at least a 50% increase in speed from the use of GenAI, labelled these tasks as those likely to see most change, and calculated an average ‘exposure’ (their term) for each of the 85 3-digit NAICS (North American Industry Classification System) industry codes. For presentation purposes, we have aggregated those into 15 different sectors.

Start moving

Where to begin? What are the actions needed to begin monetising benefits, getting fit to compete and do it all safely, as mentioned above? We see six critical steps to take right away. They aren't necessarily sequential, but they are all necessary, and (like training for a marathon), require consistent iteration and a disciplined approach. They are:

▶ **Ensure alignment to overall strategy and risk appetite**

▶ **Establish protocols and guardrails for scalable adoption**

▶ **Invest in augmenting capability and readiness**

▶ **Build tools and platforms for model development, assurance, integration and operation**

▶ **Put it together into a holistic 'Responsible AI' framework**

▶ **Select use cases for prioritisation and deployment**



	ANZ			CBA			NAB			WBC		
	FY23	FY22	FY21	FY23	FY22	FY21	FY23	FY22	FY21	FY23	FY22	FY21
Earnings and Returns												
Cash earnings	7,405	6,515	6,198	10,164	9,595	8,653	7,731	7,104	6,571	7,221	5,276	5,352
Cash earnings (incl discontinued operations)	7,405	6,496	6,181	10,182	9,708	8,801	7,782	6,935	6,464	7,221	5,276	5,352
Cash earnings before tax (A+B+C+D)	10,509	9,200	8,963	14,271	13,618	12,243	10,829	9,897	9,206	10,342	7,874	8,345
Core earnings (A)+(B)+(C)	10,754	8,968	8,396	15,379	13,261	12,797	11,631	10,022	8,989	10,990	8,209	7,755
Dividends paid (per cash flow)	4,380	3,784	2,834	7,117	6,535	4,132	4,339	4,006	2,682	4,504	4,337	2,846
Income tax expense	-3,243	-2,685	-2,764	-4,107	-4,023	-3,597	-3,093	-2,793	-2,635	-3,288	-2,724	-2,988
Profit after tax (statutory basis)	7,098	7,138	6,179	10,090	10,771	8,843	7,414	6,891	6,471	7,195	5,694	5,458
Return on average equity (calculated %)	10.9%	10.4%	9.9%	14.0%	12.7%	11.5%	12.8%	11.7%	10.6%	10.1%	8.1%	7.5%
Notable Items												
Notable items (Cash earnings impact)	-307	-154	-946	-212	-124	-575	0	0	0	-147	-1,292	-1,601
Revenues												
Net interest income (A)	16,581	14,874	14,161	23,056	19,473	18,839	16,807	14,852	13,797	18,336	16,605	16,714
Net interest income (excluding notable items)	16,599	14,874	14,247	23,056	19,473	18,839	16,807	14,852	13,797	18,414	16,606	16,587
Net interest margin (NIM) (%)	1.70%	1.63%	1.64%	2.07%	3.79%	2.03%	1.74%	1.65%	1.71%	1.95%	1.93%	2.04%
Non-interest income (B)	4,312	3,673	3,286	4,181	5,216	5,317	3,847	3,444	3,009	3,346	2,406	4,324
Non-interest income (excluding notable items)	4,319	3,386	3,927	4,181	4,700	5,317	3,847	3,444	3,009	3,128	3,299	3,807
Non-interest income as a % of total income (excl. notable items)	21%	19%	22%	15%	19%	22%	19%	19%	18%	15%	17%	19%
Expenses												
Total operating expenses (C)	-10,139	-9,579	-9,051	-11,858	-11,428	-11,359	-9,023	-8,274	-7,817	-10,692	-10,802	-13,283
Expense/income ratio (%)	49%	52%	52%	44%	46%	47%	44%	45%	47%	49%	57%	63%
Total operating expenses (excluding notable items)	-9,718	-9,170	-8,670	-11,646	-10,788	-10,784	-9,023	-8,274	-7,817	-10,232	-10,181	-10,936
Expense/income ratio (%) (excluding notable)	46%	50%	48%	43%	45%	45%	44%	45%	47%	47%	51%	54%
Total number of full time equivalent staff	40,342	38,987	39,684	49,454	48,906	44,375	38,128	35,128	32,741	36,146	37,476	40,143
Asset Quality												
Credit impairment expense	-245	232	567	-1,108	357	-554	-802	-125	217	-648	-335	590
Loss rate (%) (credit impairment expense/total GLAA)	-0.03%	0.07%	0.09%	-0.12%	0.04%	-0.07%	-0.11%	-0.02%	0.03%	-0.08%	-0.05%	0.08%
Individual provision funding (excl. write-backs and recoveries)	-476	-520	-824	-470	-321	-496	-560	-402	-505	-197	-220	-610
Collective provision funding	-152	311	823	-795	506	-287	-469	46	398	-329	27	1,417
Gross impaired assets	1,521	1,445	1,965	3,326	2,951	3,409	1,260	1,029	1,258	1,302	1,514	2,142
Gross impaired assets as a % of GLAA	0.21%	0.21%	0.31%	0.36%	0.33%	0.42%	0.18%	0.15%	0.20%	0.17%	0.20%	0.30%
Total provisions for credit impairment	4,408	4,395	4,045	5,950	5,347	6,211	5,585	5,056	5,171	4,930	4,625	4,999
Total provisions for credit impairment as a % of GLAA	0.62%	0.65%	0.64%	0.64%	0.60%	0.76%	0.79%	0.74%	0.82%	0.63%	0.62%	0.70%
Collective provisions	4,032	3,853	3,379	5,196	4,611	5,311	5,046	4,541	4,521	4,579	4,173	4,167
Credit risk weighted assets	349,041	359,442	342,498	362,869	393,647	381,550	355,554	367,261	348,041	339,758	362,098	357,295
Balance sheet												
Total assets	1,105,620	1,085,729	978,857	1,252,845	1,215,260	1,091,962	1,059,083	1,055,126	925,968	1,029,774	1,014,198	935,877
Total average interest earning assets	975,079	910,037	863,691	1,111,254	1,026,910	929,846	966,705	900,297	804,981	941,376	886,971	819,456
Total average non-interest earnings assets	138,749	125,932	172,458	122,237	119,775	110,483	103,702	96,278	84,570	81,852	87,792	86,599
Gross loans and acceptances (GLAA)	710,590	673,625	632,764	933,251	884,963	818,266	708,471	687,715	629,056	777,687	743,853	714,373
Total liabilities	1,035,574	1,019,328	915,181	1,180,840	1,142,422	1,013,244	997,580	996,094	863,189	957,235	943,689	863,785
Customer deposits	647,119	620,400	593,600	818,974	777,763	702,215	587,384	566,685	500,258	640,951	612,834	580,317
Total equity (excl. minority interests)	69,524	65,907	63,665	72,000	72,833	78,713	61,503	59,032	62,779	72,495	70,452	72,035
Common equity tier 1 ratio (%)	13.3%	12.3%	12.3%	12.2%	11.5%	13.1%	12.2%	11.5%	13.0%	12.4%	11.3%	12.3%
Core equity tier 1 capital	57,794	55,872	51,359	56,909	57,023	58,536	53,136	51,776	54,234	55,885	53,943	53,808
Total risk weighted assets	433,327	454,718	416,086	467,992	497,892	450,680	435,006	449,918	417,163	451,418	477,620	436,650
GLAA / total assets (%)	64.3%	62.0%	64.6%	74.5%	72.8%	74.9%	66.9%	65.2%	67.9%	75.5%	73.3%	76.3%



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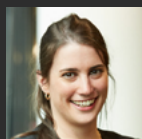
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