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Banking Matters

Major Banks Analysis: December Quarter Snapshot

February 2018

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For the quarter ending December 2017, cash earnings were down (to the extent reported) due to slowing top line growth, a significant $575 million provision for legal and compliance obligations, and the rising costs of organisational change. Despite a general tone of caution on the earnings outlook, the banking fundamentals (volume, margins, asset quality) remain healthy in absolute terms.

The provision taken is a stark example, if one were needed, of the strategic and execution challenges facing the industry in a radically changing social and political landscape. In this context, we may well see the shaping of a congruent and holistic response to genuine concerns covering conduct, trust and accountability as a competitive advantage for any bank over the medium term.

The December quarter has highlighted a discrepancy we have been tracking for some time. On the one hand, banks have continued to deliver extremely strong (underlying) financial results. This has occurred in the context of a very healthy national and global economic outlook, with ebullient financial markets almost everywhere in the world (recent turmoil notwithstanding). On the other hand, investor enthusiasm for the major banks has been subdued in comparison. We remain of the view that this is driven by two interrelated factors.

First, there is a general acknowledgement that the era of higher bank return on equity is behind us, and it remains unclear whether we have already reached the new equilibrium. It is dangerous to extrapolate from a single quarter, but the moderate slowdown in the first quarter result could indicate some early signs emerging.

Second, and related to the first point, there is a growing appreciation of the enormity of the challenge banks are facing to address community expectations in areas such as conduct, compliance, reputation, accountability and trust. This is illustrated most recently by the $575 million provision made by one bank in the quarter for the likely cost of compliance liabilities and ongoing regulatory and legal challenges.

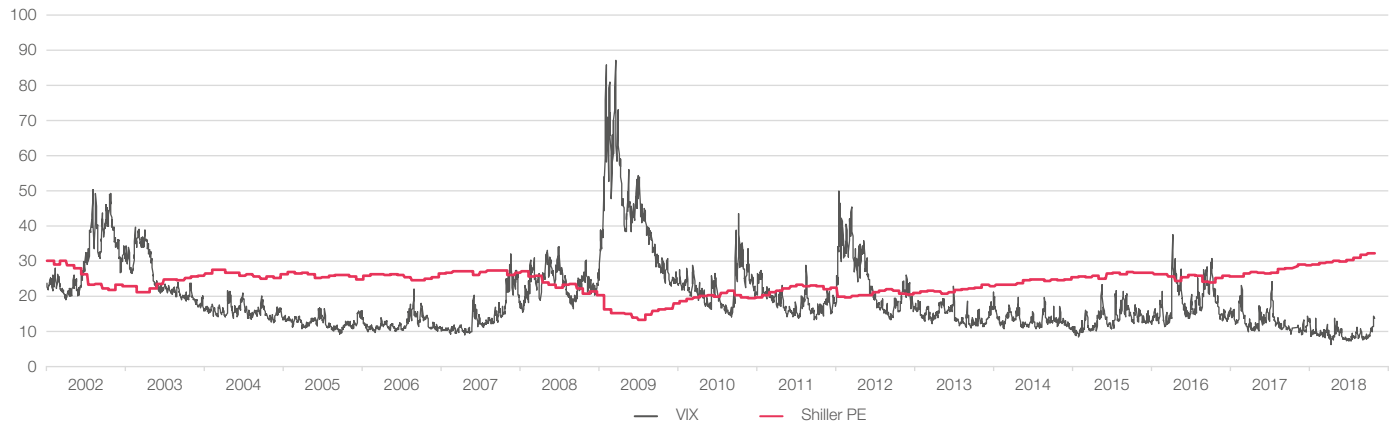
The journey ahead certainly presents some material challenges. It also presents material opportunity to re-engage with customers and the community as a whole, with a view to providing a more transparent, open and fair 'deal' to rebuild the trust that has been lost. What's more, there are useful examples from around the world of institutions and even entire industries grappling with the same issues of trust, accountability, risk and control facing Australia's banks. In addition to our snapshot of the December quarter results, we've summarised how one such location, the City of London, is going about this and hypothesise lessons for Australia.

Goldilocks redux – for everyone but the banks

Synchronised global growth

The global economy is growing almost everywhere, including Europe and Japan. In many markets, unemployment rates are hitting record lows, slack capacity has been largely absorbed, trade is up despite fears of a return to protectionism and the International Monetary Fund has raised its forecast for global growth to almost 4 per cent. In turn, this has further encouraged optimism in financial markets. In the US, the Shiller PE and VIX reached record highs and lows, respectively in the quarter, prior to some adjustment of late (see Chart 1).

Chart 1: Fear and greed: Historical Price Index Comparison Analysis



Source: Bloomberg and Chicago Board Options Exchange

Six months ago, we noted the (then) enthusiastic levels of both equity prices and volatility and suggested that downside risks to the global economy were more material than markets appeared to be reflecting. Since then, the exuberance has only grown, even as the underlying tail risks we highlighted — leverage, inequality, consumer confidence and of course geopolitics — remain unaddressed. Whether recent market turmoil is just a short-term adjustment or a more fundamental reckoning with this reality of course remains to be seen.

For now, in market centres from London to Paris, New York to San Francisco, Shanghai or Singapore, it is hard to resist joining in with the overall sense of optimism and possibility. While central banks are flagging higher rates, there is limited immediate pressure to actually do so. In short, for the first time in a very long time, the phrase 'Goldilocks economy' is being uttered in the financial press.

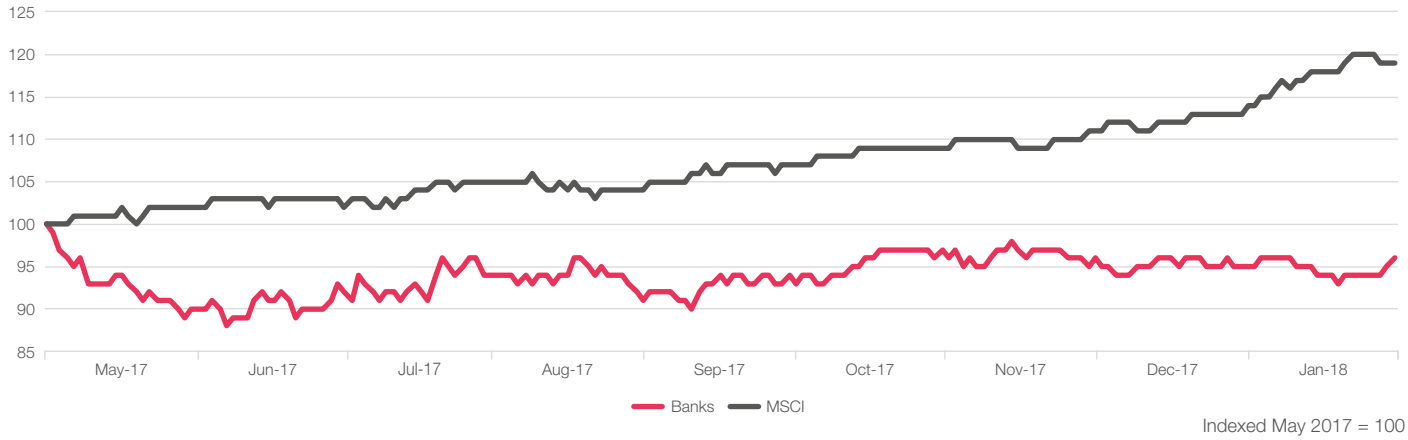
Australian banks are missing out on this confidence

In Australia, the picture is largely the same, although complicated by persistent concerns about house prices and the impact of household leverage on consumer spending. GDP is forecast to grow by 2.5–3.5 per cent for 2018, unemployment remains flat at under 6 per cent, and the budget deficit is shrinking. These conditions have assisted the financial performance of the major banks. Last year to September, they delivered almost $32 billion in combined cash earnings, their highest ever.

December quarter – FY17 growth may be slowing

However, share price trends over the past year have reflected concerns about both the cost of addressing compliance and regulatory challenges, as well as the commercial model that will emerge from the current social and political environment. This has seen Australian bank shares trend sideways for over 12 months – even as the overall Australian market has risen (see Chart 2).

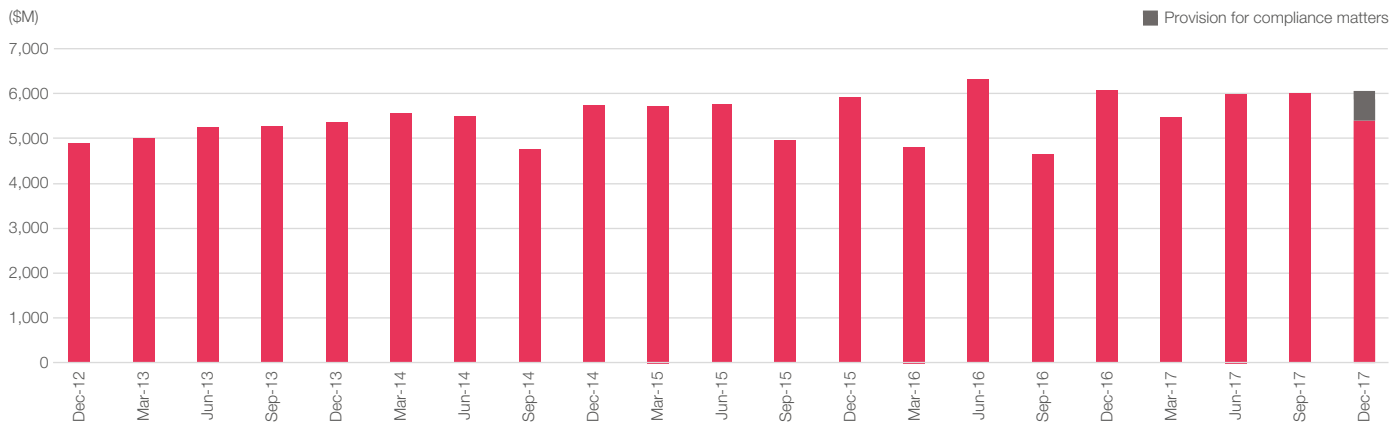
Chart 2: Australian bank shares vs global equities



Source: Yahoo Finance, Bloomberg and PwC analysis

The result for the December quarter, whilst just one data point without the detail for confident extrapolation, does potentially include some element of each of these concerns. Based on reported results (CBA half year and NAB trading update) indicative overall cash earnings were down on the September quarter after taking account of the CBA provision, as illustrated in Chart 3 (showing estimated cash earnings based on the reported results of two of the Big Four banks). Growth in underlying earnings has been maintained, but only just, at 0.2%. This appears to have been driven by the benefits of rate adjustments made in previous quarters and continued but slower growth in lending, offset by higher costs of transformation and a small relative uptick in credit losses.

Chart 3: Estimated underlying cash earnings for three of four major banks by quarter, 2012–17

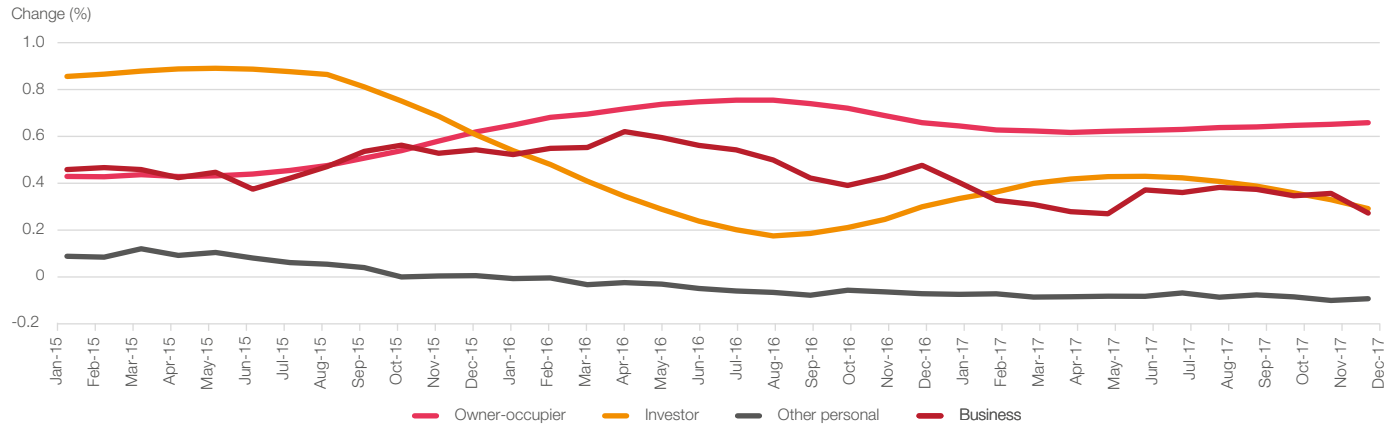


Source: Company statements and PwC analysis[1]

While we can't analyse all of these drivers in detail, we do have the data to consider 2 of the 4 – lending growth and credit costs.

Lending growth continues to taper as the housing market cools with overall system credit growth at only 4.8% in the year to December 2017 versus 5.6% p.a. and 6.6% p.a. in the twelve months ending December 2016 and 2015 respectively. However, at 0.51% per month, the growth in housing lending in particular remains material to the bank results and growth trajectory

Chart 4: Monthly lending growth by category, twelve month rolling, seasonally adjusted



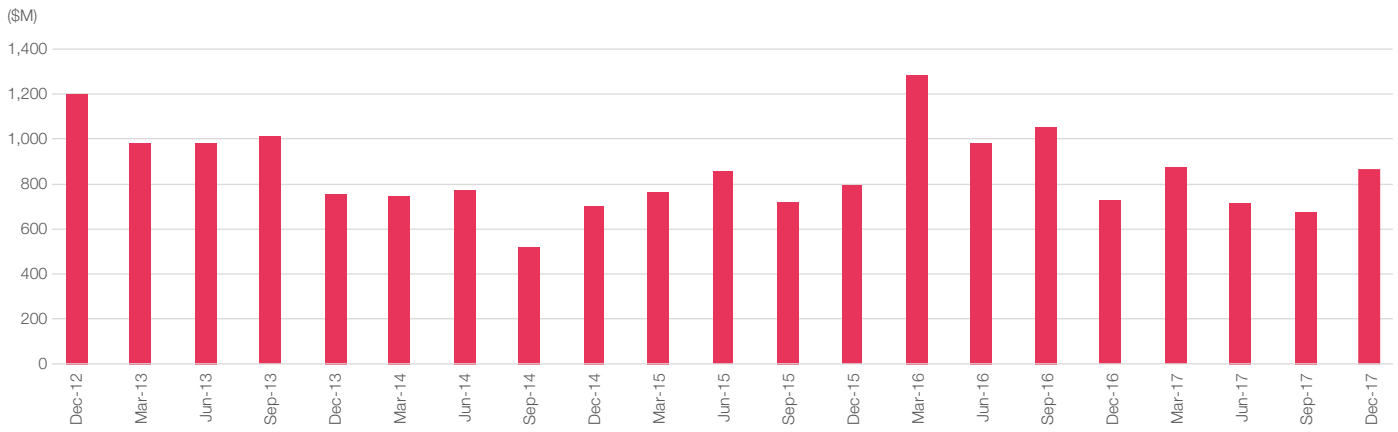
Source: RBA

Asset quality (see chart 5), is broadly stable, but given the historically low levels at which we are operating, even a marginal change in provisioning can give rise to an earnings headwind. Estimates for loan losses in the quarter were only slightly up on an absolute basis, but in relative terms this represents a 28% increase on the unusually low levels of the previous two quarters.

Overall, however, considered over a longer horizon and relative to a growing asset base, loan losses remain stable at historically low levels for now.

[1] *As WBC has historically not released quarterly trading updates, quarterly cashing earnings is based on the three banks only. This quarter ANZ has elected not to release a trading update and so its cash earnings has been estimated based on the proportional cash earnings growth of NAB and CBA excluding provisions for compliance matters.*

Chart 5: Consolidated bad and doubtful debts charges for three of the four major banks by quarter, 2012–17 for available data



Source: Company statements and PwC analysis[1]

Despite some slow down, overall, the fundamentals continue to be healthy for the major banks but with future expectations being dampened by ongoing concerns such as:

- a number of yet-to-be realised tail risks overhanging the industry (household leverage, house prices and geopolitics)
- the ongoing evolution of fundamental return on equity dynamics
- increased competition, particularly as growth within the most profitable parts of the domestic market slow and repercussions of recent Productivity Commission report play out
- the profound non-financial challenges and remediation costs facing the industry in areas such as conduct, compliance, reputation, accountability and trust.

A clear message for banks

Having been surprised in FY17 with a bank levy, Banking Executive Accountability Regime (BEAR), and finally a Royal Commission, bank executives and boards are focused on changing the narrative.

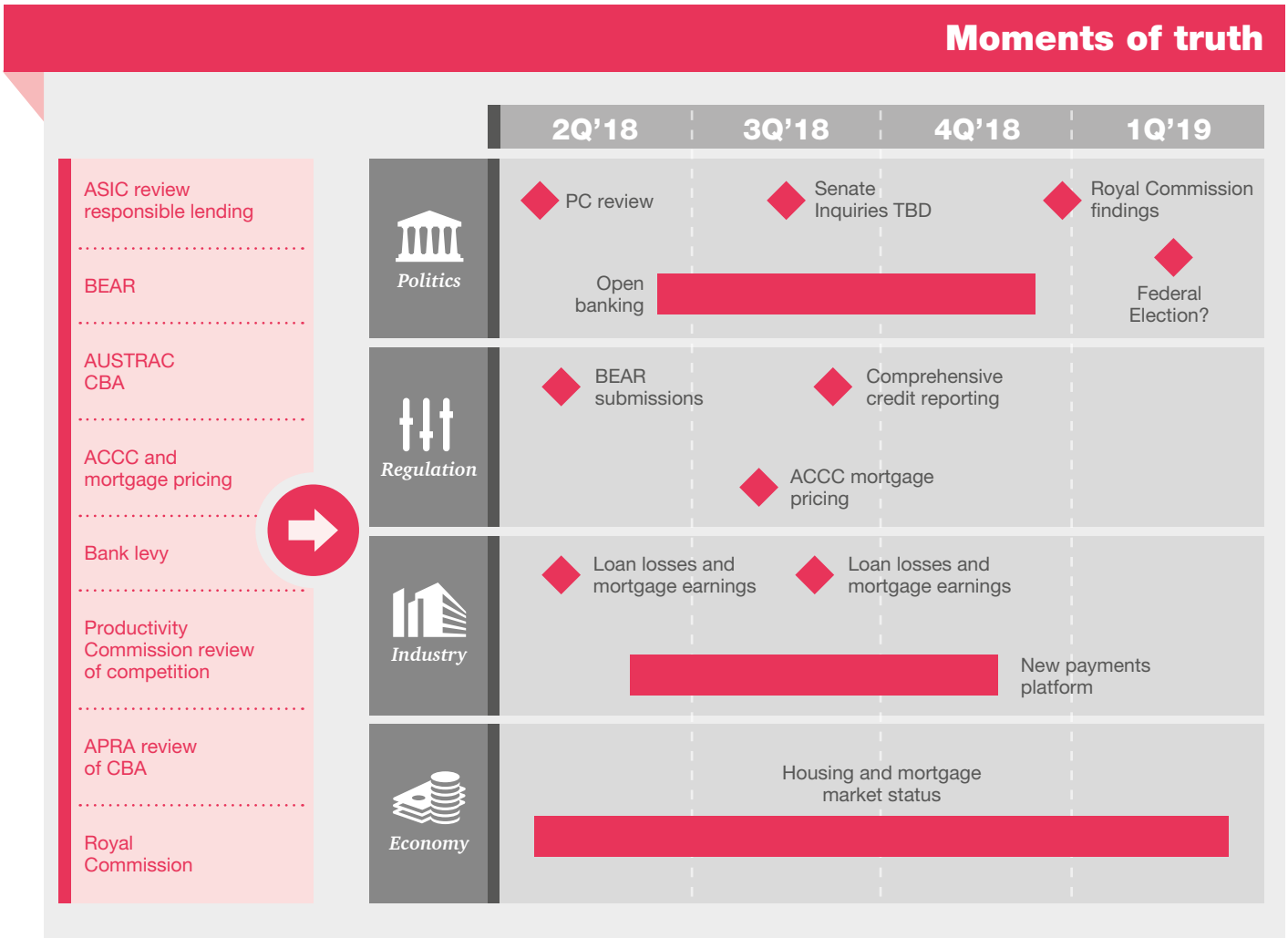
The Royal Commission is ramping up quickly – many institutions had to make their first submissions by the end of January and responses to follow-up inquiries from the Commission are due as early as mid-February. The speed of the feedback from the Commission is a strong reminder, if one were needed, of the rigour and urgency required to deliver outcomes in the timeframes currently envisaged. This is why one bank has explicitly provided for the costs of managing it.

As the Commission progresses there will inevitably be an increasing focus on the shape of the potential recommendations.

While it is really too early to speculate at this stage, it is nonetheless a relatively small jump from the establishment of a Royal Commission on Misconduct to a recommendation for the establishment of a body in the style of the UK's Financial Conduct Authority. There is speculation that the government had progressed the thinking on this prior to the announcement of the Royal Commission.

[1] *As WBC has historically not released quarterly trading updates, quarterly cashing earnings is based on the three banks only. This quarter ANZ has elected not to release a trading update and so its cash earnings is estimated based on the proportional cash earnings growth of NAB and CBA excluding its provision for compliance matters.*

Exhibit 1: Moments of truth



It is also noteworthy that the broad tone among financial institutions is to 'make a virtue of necessity'. Now that the Commission is here, many believe the best approach is to embrace it. This may simply reflect the reality that antagonising the umpire is rarely a winning strategy. But on a deeper level, despite its political conception, the Commission reflects a base level of community concern, and so if institutions can demonstrate this conviction to the broader public then the task of rebuilding trust will be enhanced.

Still a long way to go – but the lessons have already started

The industry's journey is just beginning, and at this stage it is impossible to say precisely where it will lead. But we do envisage that over the next two years there will be a number of important 'moments of truth' (see Exhibit 1) which will give bankers and customers an opportunity to take stock.

Given the formidable milestones in the year ahead, the apprehension described in this report is not without basis. However, it must be remembered that the journey the major banks are on is not unique to Australia, and not without precedent. As we write, the City of London is working on the challenge of trust in a financial services sector that is far larger, more complex, and with a history of far more serious mistakes and transgressions than what has been experienced here. While their journey is also just beginning, there are potential lessons to be drawn.

Shining a light on trust

The UK experience

The City of London Corporation ('the City') is the authority responsible for the city and county representing the historic heart and central business district of London.[2] Given the importance of financial and professional services to the economic and social life of the city, they recently launched a campaign to address a perceived lack of trust in business.

The City started by conducting a number of wide-ranging conversations with members of the public and the business community, culminating in an innovative series of day-long 'citizens' juries' held in London, Nottingham and Edinburgh with participants identified as being broadly representative of society.

In a role similar to a public policy focus group, the citizens' juries reviewed in-depth presentations on a number of issues related to conduct, accountability and trust in the business environment, participated in group exercises and were then given substantial time to discuss and debate. They then had the opportunity to develop their own recommendations for how best to advance trust in business.

The conversations shed light on three elemental aspects of trust which are important to understand and offer potential lessons for Australia.

Defining 'trust' is harder than was expected...

First, 'trust' means different things for different people, and the elements of trust important to some are not necessarily the same as those important to others. So an agenda to advance trust in business must be clear as to whose trust is being considered, and what is important to them.

...but earning and keeping trust may be simpler than we think

Second, notwithstanding different objectives and priorities, there was broadly consistent agreement across all the stakeholders represented on the three juries as to the actions businesses needed to take to earn trust. None of these were revolutionary, or particularly difficult to understand. However, applied collectively, consistently and with purpose, jurors believed they had the promise of fundamentally changing the dialogue about business.

They can be summarised in five principles which they called 'CIVIC':[3]

- **Competence:** doing what you do well.
- **Integrity:** doing the right thing.
- **Value:** having a wider purpose for society beyond profit.
- **Interest of others:** being attuned to the interests of all stakeholders.
- **Clarity:** being open, honest, transparent and clear.

[2] *The City of London Corporation is distinct from the Greater London Authority (GLA) responsible for the greater London metropolitan area, as well as TheCityUK, an industry body representing UK-based financial and related professional services.*

[3] *See 'The Business of Trust: better business trusted by society, City of London, 2017'*

Exhibit 2: CIVIC principles of trust in business

1. Competence: doing what you do well	• Being professional, including maintaining standards, training, knowledge and expertise • Innovating in terms of quality, efficiency and reliability • Acting in accordance to standards under law, regulation and community expectations
2. Integrity: doing the right thing	• Doing what you promise and promising what you will do • Acknowledging and apologising for mistakes • Recognising and rewarding the right behaviours in staff but also of customers (e.g. sharing the benefits of loyalty or other customer behaviours that create value for business) • Creating an environment where stakeholders feel comfortable raising concerns and articulating ideas
3. Value: having a wider purpose for society beyond profit	• Creating distinct value for all stakeholders, by serving customers, treating employees humanely, and having regard for the environment and broader community • Paying fair tax
4. Interest of others: being attuned to the interests of all stakeholders	• Providing your services honestly and at a fair price • Keeping customer data secure and protected against fraud • Building empathetic relationships and responding with compassion at times of need • Constantly collecting feedback, asking how you are doing, and acting on what you hear
5. Clarity: being open, honest, transparent and clear	• Being clear and honest with all stakeholders, including customers, employees, investors and the broader community • Ensuring that information is meaningful, accurate, complete and easy to understand • Being available, easy to reach and ready to respond to questions and feedback from customers, the press and broader public

There are practical steps all stakeholders can take

Third, and most importantly, the principles outlined above needn't simply be aspirational concepts. There are practical things that executives, institutions, and the City of London itself can do to advance each of the principles enumerated above. For the City of London, these include:

Inspiring businesses

- Supporting City businesses to understand, engage with, and lead on emerging responsible business issues
- Encouraging City businesses to embed wider social purpose into their core business, not as standalone corporate social responsibility activities, but as a driver of business performance and competitive advantage
- Assisting City businesses to consider how the guiding principles of trust can be turned into meaningful action

Supporting businesses

- Building a 'Leaders of Tomorrow' network of next generation City leaders to champion responsible business practice and develop their ability to influence their organisations
- Supporting businesses to understand the social, political, economic and technological challenges that have implications for trust

Bringing City stakeholders together

- Sharing and gathering insight on public perceptions of financial and professional services
- Collaborating with partners to convene conversations on the changing role of business in society
- Communicating a vision of what 'better business' looks like

Reaching out beyond the City in the UK and beyond

- Promoting the City as a trusted business centre, underpinned by an internationally renowned corporate governance regime and highly regarded legal system
- Partnering with organisations to promote and export responsible business practices
- Supporting businesses to have a positive local and global impact

Connecting with communities and broader stakeholders

- Working with a forum of experts to develop a specific agenda to build trust, focused on education to help develop trustworthiness
- Engaging London institutions to further develop the CIVIC principles
- Providing communities and individuals with access to the Lord Mayor and Mansion House to debate and develop society's role in the business of trust

To learn more about the City of London Corporation and its Business of Trust agenda, see https://www.cityoflondon.gov.uk/business/economic-research-and-information/Documents/the-business-of-trust-booklet.pdf

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