Banking Matters

Major Banks Analysis

May 2015

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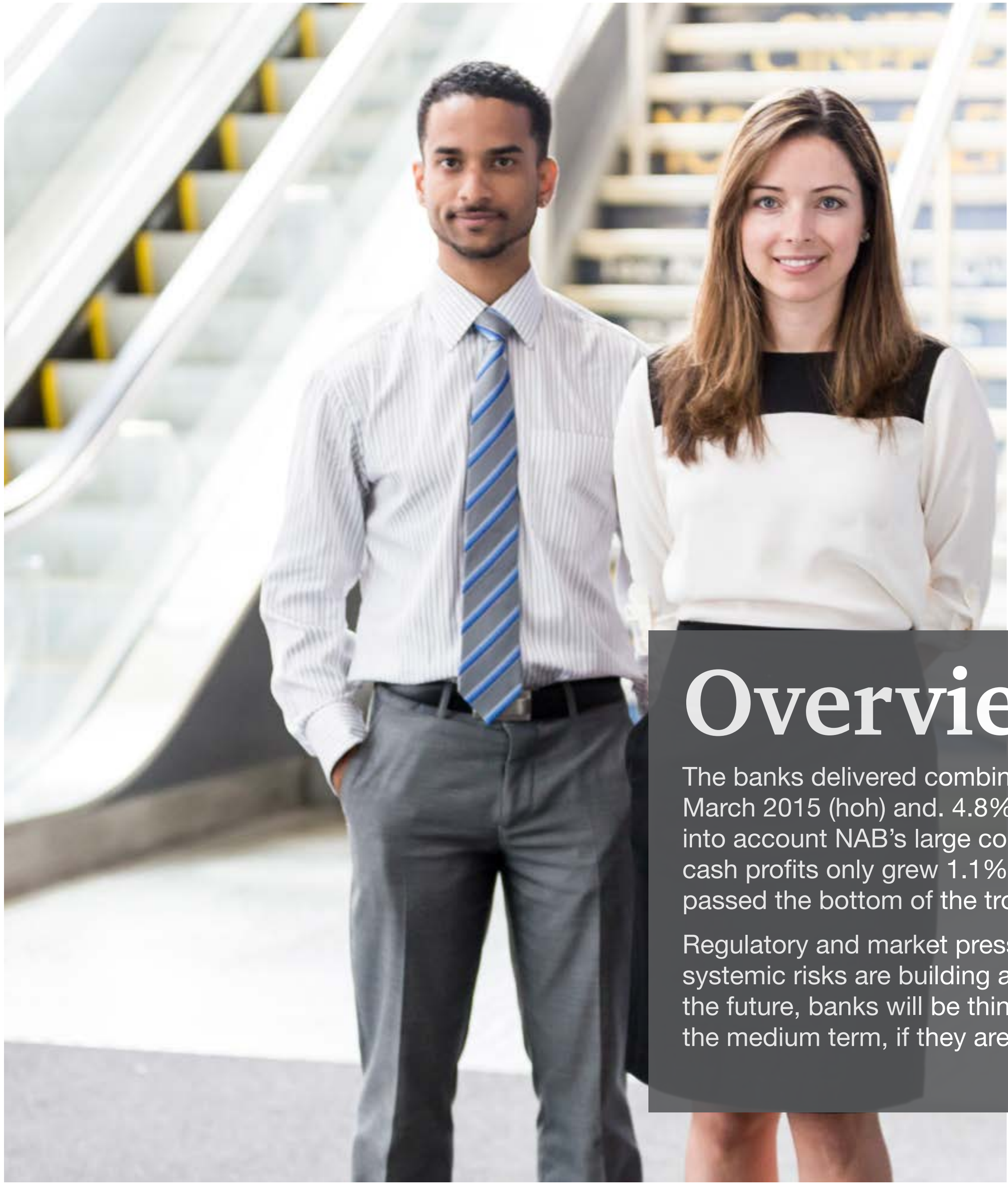

CASH EARNINGS

CORE EARNINGS

ROE

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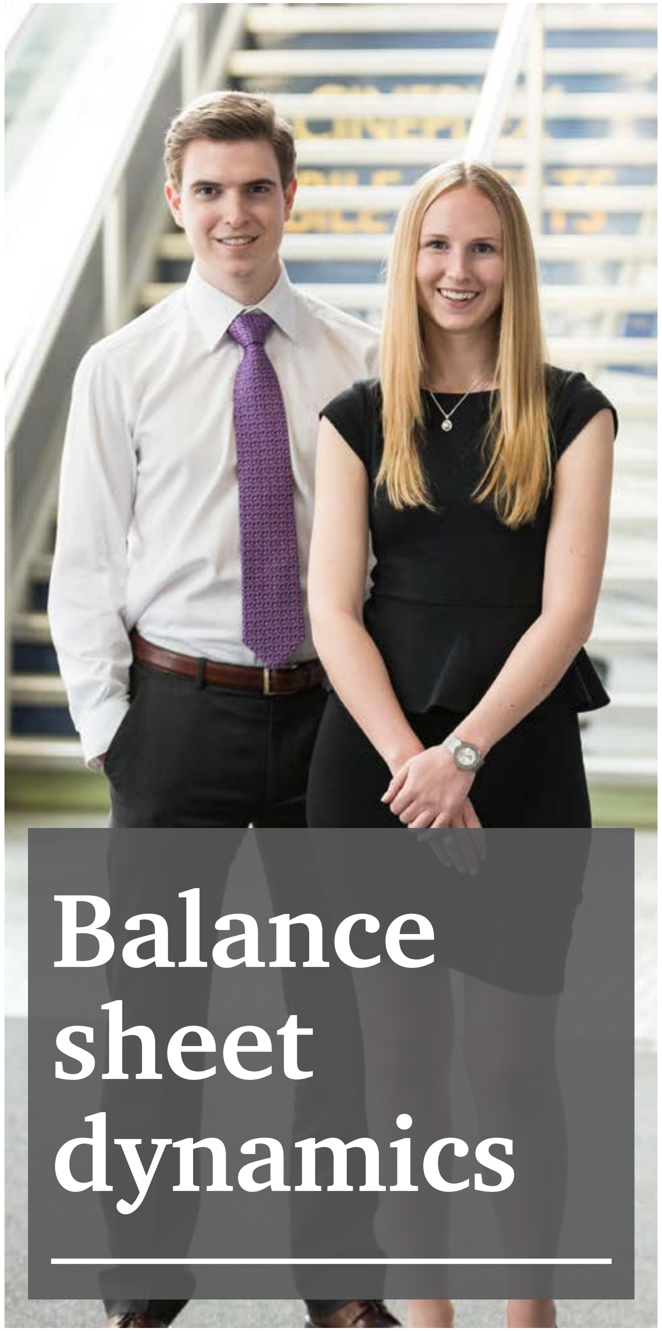
Overview

The banks delivered combined cash profits of $15.5 billion, up 10.8% for the six months to March 2015 (hoh) and. 4.8% compared to the six months to March 2014 (pcp). However, taking into account NAB's large conduct provisions and software write downs in September 2014, cash profits only grew 1.1% hoh. Bad debt expense, a previous driver of profit growth, has passed the bottom of the trough and started to increase again, growing 8.1% hoh.

Regulatory and market pressures are pointing towards all the banks holding more capital, systemic risks are building and digital is changing the price of everything. In setting course for the future, banks will be thinking carefully about where to invest to generate capital growth over the medium term, if they are to achieve their ambitious return on equity targets.



Credit

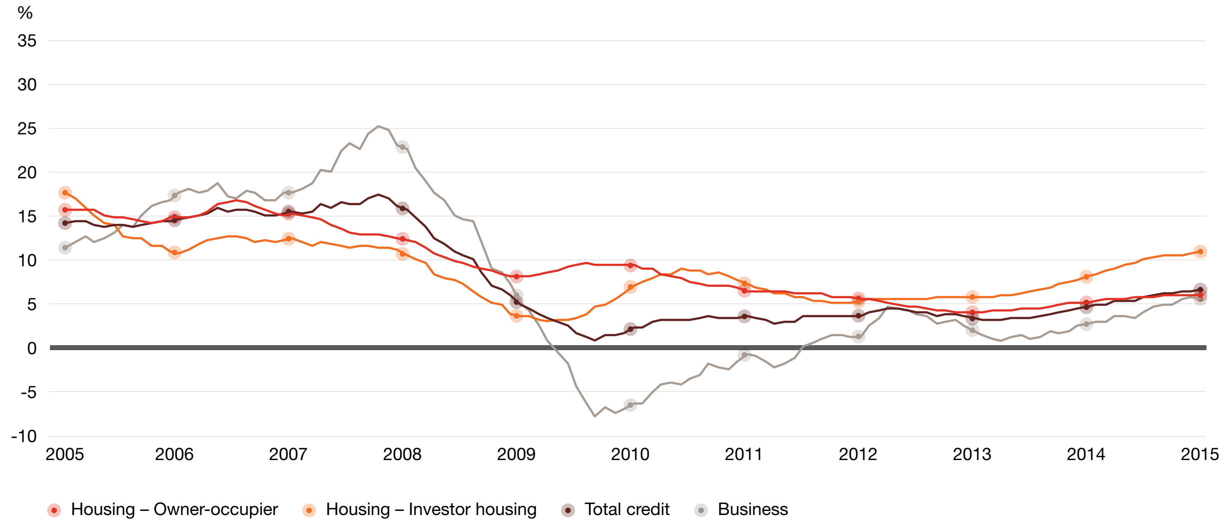
At 6.2% per annum, lending growth is the highest it has been since the onset of the GFC. Owner occupied housing loans, investment housing loans and business loans each contributed a third of new lending over the last six months.

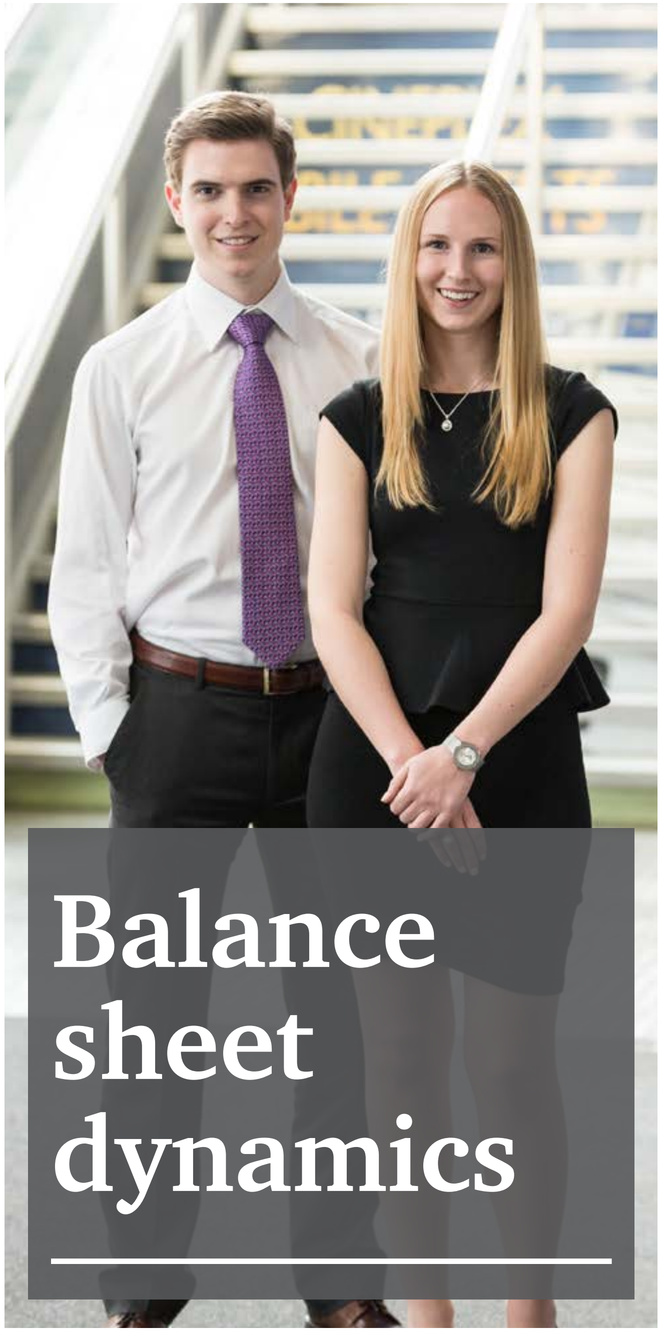
A highlight is the sustained growth in business credit. Business loans grew 5.3% per annum to March 2015, up from 3.8% per annum to September 2014 and 2.7% per annum to March 2014. The last month of negative growth was September 2013. This is a hopeful sign that businesses are starting to invest and is consistent with the pick-up in economic activity in the non-mining states – mining investment was largely funded from the capital markets, not the banks.

In the year to March 2015 housing credit grew 7.3% up from 5.9% the year before. Owner occupied housing grew 5.8% per annum, whereas investment housing grew 10.4% per annum. The growth in investment housing is being fuelled by very low interest rates and is largely responsible for the recent increases in house prices.

The banks are increasingly the main providers of credit. Their proportion of overall lending is now 87.1%, up from 86.5% at September 2014 and 85.5% at March 2014. Prior to the GFC it was closer to 70%.

Domestic Credit Growth (Annual % growth – 12 month rolling average)





Bank deposits

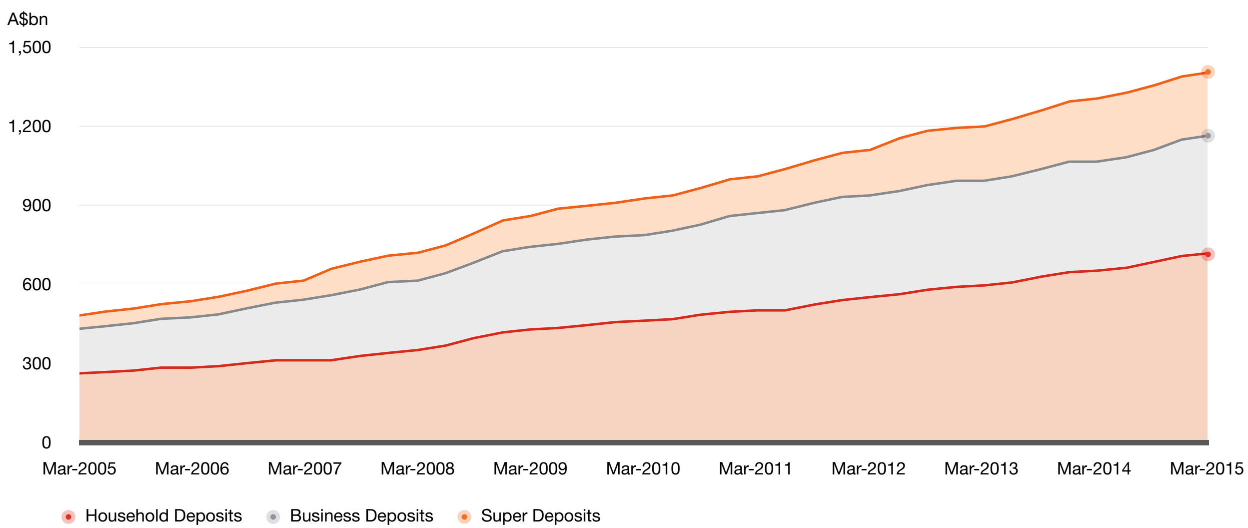
Bank deposits continue to grow at a consistent pace, 7.6% per annum to March 2015, the same as last year.

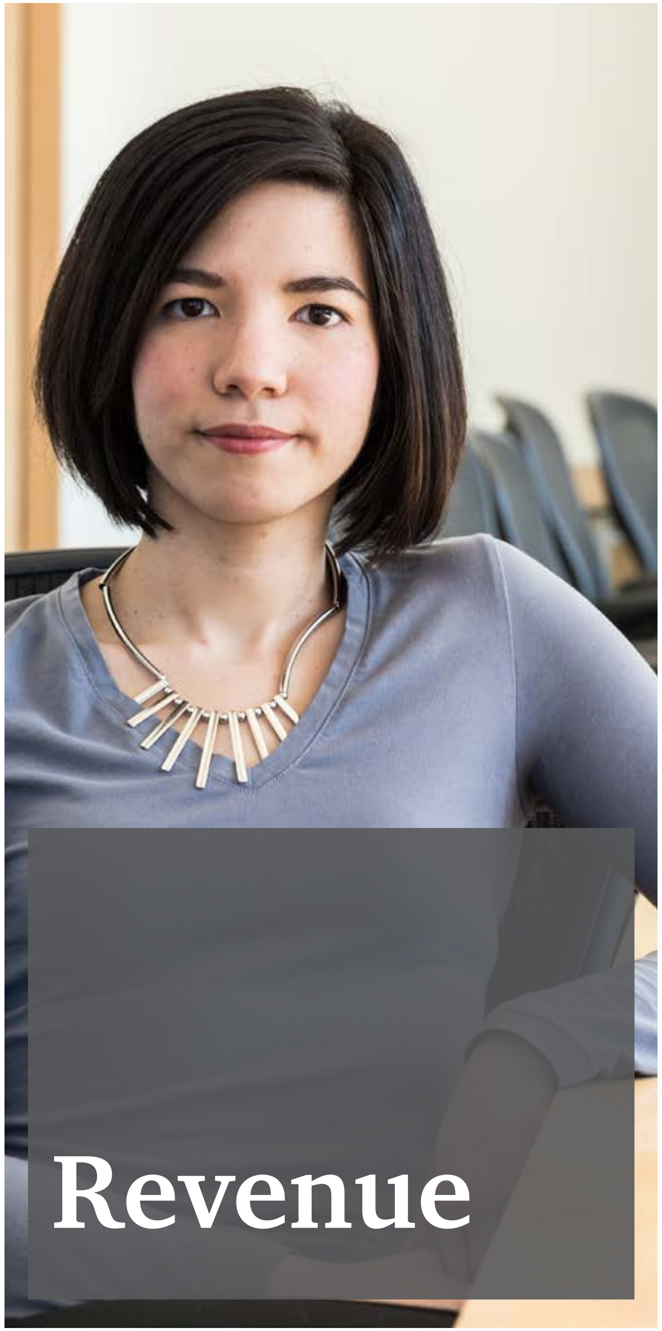
The composition of products changed in response to the newly introduced liquidity rules. Term deposits shrank 2.1% per annum whilst at call and other deposits grew 14.1% per annum. Banks have re-priced deposits favouring more stable saver accounts, which reward customers for leaving their funds untouched, over term deposits.

Deposits from households grew 10% per annum, which continues to be at the top end of our long term expectations of 7% – 10%. Business deposits jumped ahead, growing 9.3% per annum, significantly stronger than the 4.5% per annum to September 2014. Superannuation fund deposits shrank 70 bps, in stark contrast to the 16% per annum of a year ago, reflecting investors' preference for higher yielding investments such as equities.

Demand for credit outstripped the supply of deposits by over $50 billion in the year to March. That is, $1 in every $3 of lending is being funded from the wholesale markets. Growth in business credit is gaining momentum, so the gap is expected to continue to widen – unless demand from other categories, such as investment housing loans, decreases. The deposit to loan ratio has fallen 30bps since March 2014.

Composition of bank deposits (A$bn)





Net interest income

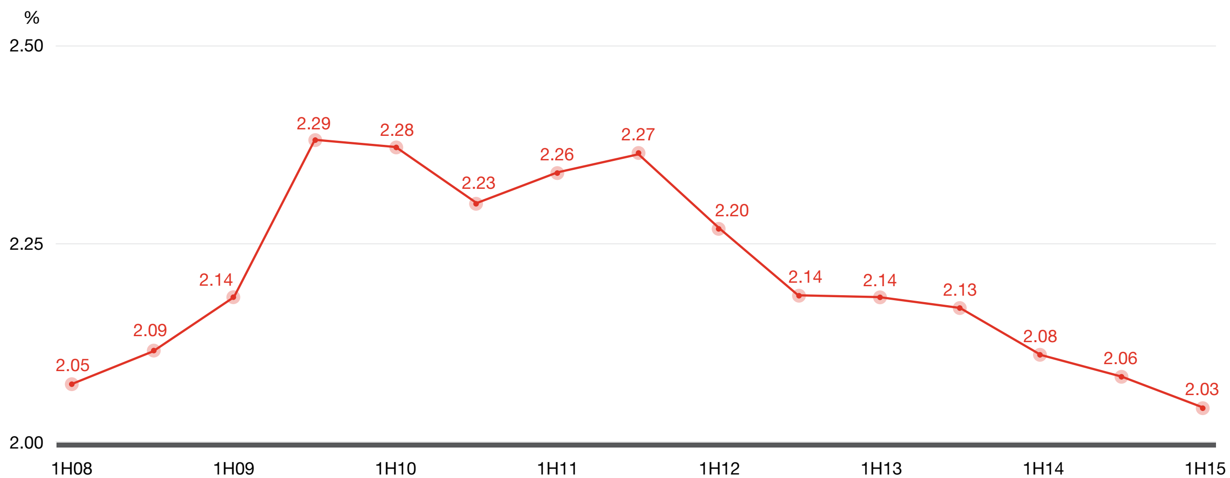
Net interest income, which accounts for 70% of the banks total income, grew 2.3% hoh (4.9% pcp) reflecting strong loan growth offset by a 3 bps decline in net interest margins. The banks' global loans grew 5.3% hoh (8.0% pcp) with 55% of this growth coming from housing.

Net interest margins continue their steady downward trend finishing at 2.03%, down 3 bps hoh (5 bps pcp), lower than the previous low point of 2.05% in early 2008. Looking ahead we expect margin pressure to continue, as competition shows no sign of abating. A change in the global price of money will follow through to our banks, but local conditions will dictate how much passed through to customers.

Contributors to the margin decline were:

- **Lending** – *5bps hoh, (-10 bps pcp)* competition across the board triggering bigger and bigger discounts, particularly in housing.
- **Deposits** – *2bps hoh (4 bps pcp)* competition eased, as banks have stabilised their holdings, wholesale funding remains cheap and special offers on term deposits have been wound back as a consequence the new liquidity rules.
- **Wholesale funding** – *1 bps hoh (1 bps pcp)* lower average cost of wholesale funding as older expensive tranches of debt mature and are replaced by cheaper new issuances.

Combined net interest margin



Other income

Other income, which accounts for 30% of the banks total income, grew 4.2% hoh (1.6% pcp). The major components are banking fees, 45%, trading income 16%, and wealth management 32%. Interestingly these proportions are largely unchanged since 2008.

The outlook for banking fees is low digit growth as regulatory changes and competition continue to bite, and as the new digital economy gives more away for free. The very nature of trading income makes it volatile, with customers' demand for risk products reflecting the volatility in the markets.

Wealth management perhaps has the best prospects, with growth in underlying fund balances driven by super and insurance claims and lapse rates stabilising. The real challenge in this sector is how to modernise product sets to facilitate online sales and prepare for the next wave of regulation which is likely to emulate from the Financial System Inquiry, whilst dealing with the current conduct issues which are weighing heavily on the distribution businesses.

ANALYSIS OF OTHER OPERATING INCOME

Expenses

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Total expenses grew 3.1%, hoh (5.0% pcp), once we look through NAB's conduct provisions and software write downs taken in 2H14.

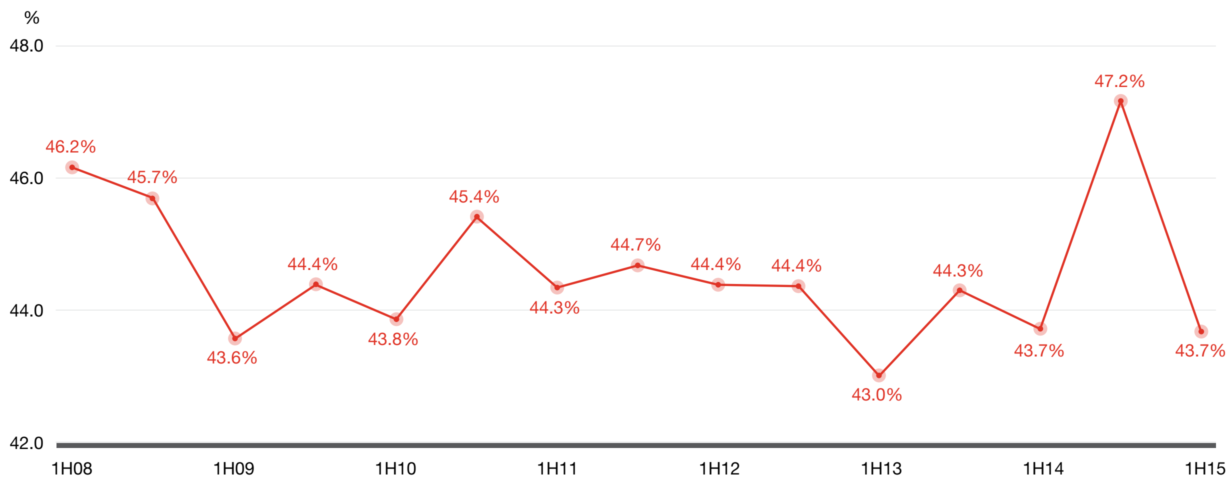
Notwithstanding significant cost disciplines, achieving aggregate efficiency gains appears to be getting harder just as revenue growth is also being challenged. The banks combined expense to income ratio was 43.7%, the same as 1H14.

Salaries were a big driver of the overall increase in expenses. The banks employed 1700 (1.0%) more staff in this half and the average salary cost per staff member increased 2.8% to $59,610 to due inflationary impacts. Changes in staffing mix also had an impact.

The result of these increases was a 3.4% hoh (3.0% pcp) increase in the banks' wages bill.

This challenge in achieving aggregate efficiency gains may partly be indicated by the reduction in investment spend (down 13% hoh, and 7% pcp) as a means of cost containment. IT expenses only grew, 2.1% hoh (6.8% pcp) reflecting higher software amortisation and ongoing investment in IT across all businesses. Capitalised software balances have reached $9 billion, so the amortisation expense will remain high for some time to come. Occupancy costs only increased slightly reflecting rental increases and leasing costs.

Combined expense-to-income ratio



Asset Quality

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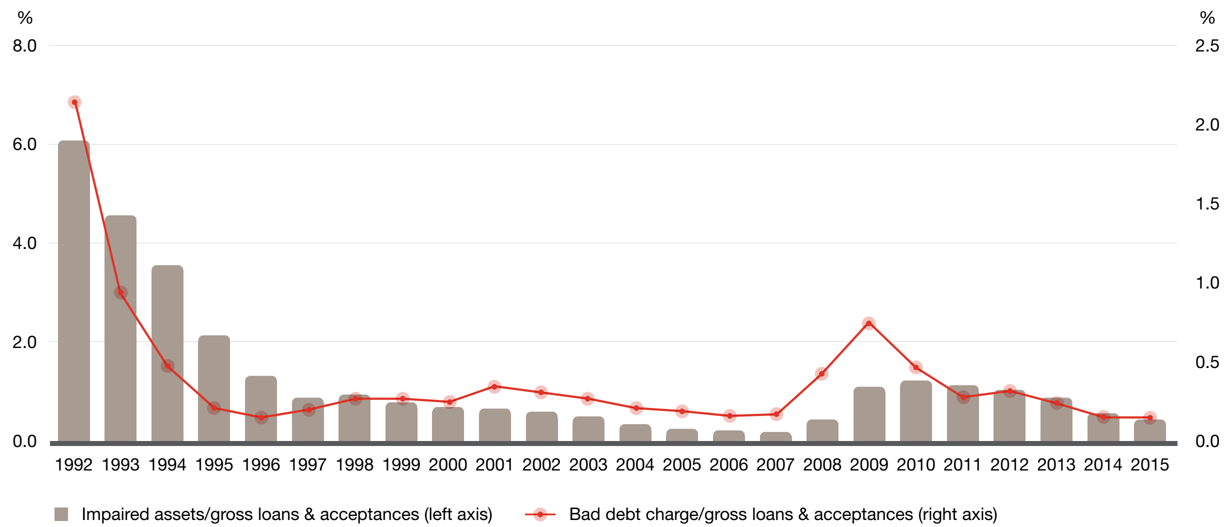
All the indicators are that asset quality is continuing to improve. Net impaired assets now stand at $6.5 billion, 17% lower than at September 2014 and 34% lower than this time last year. Accounts 90 days past due showed a slight uptick – increasing 2% since September 2014, but still 5.4% less than at March 2014. The small increase this half was mainly seasonal.

The improving quality of the credit portfolios reflects in part that most of the problem assets arising around the GFC have been resolved, but also in significant measure the current regime of record low interest rates. Few new problem accounts are emerging at present.

The challenge now is that the global economy is writing an entirely fresh script as we go. We have been struck over the past six months by the extent to which informed market participants have volunteered concern about emerging imbalances and contradictions. "This time is different" is a common refrain – but to voice caution rather than complacency. Beyond that, most people are as unsure about how it might play out as we are.

Impaired assets and bad debt expense



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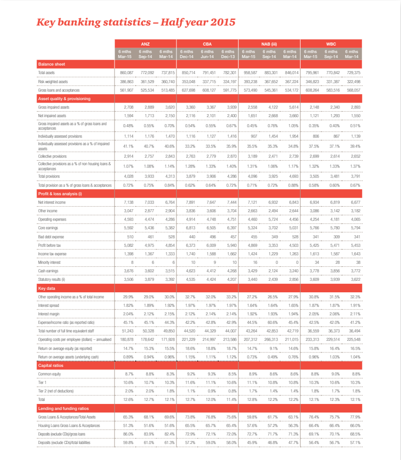
Key banking statistics – Half year 2015

KEY BANKING STATISTICS

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