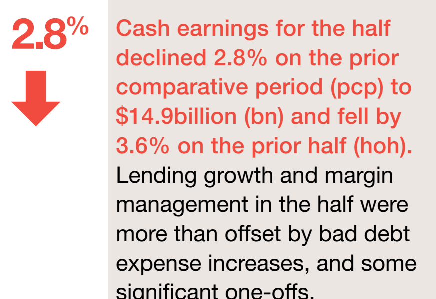
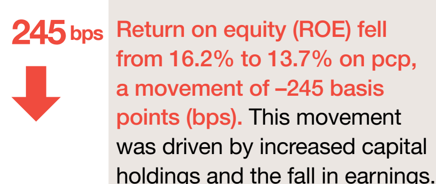
Banking Matters
Wrap-up

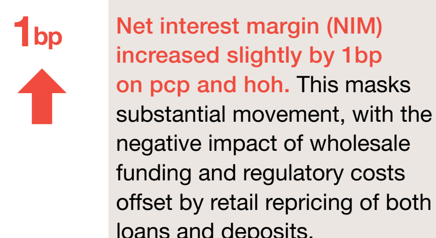
> *“Nobody said it would be easy.*

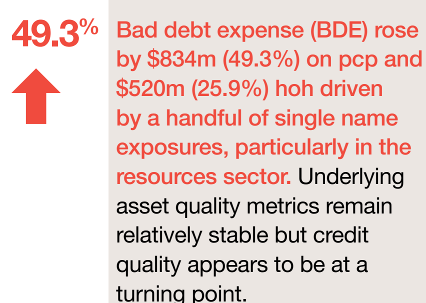
Major Banks Analysis

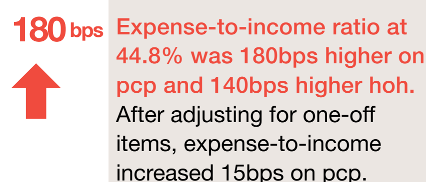
The half year results should serve to remind us just how complicated it is to be a Major Bank in Australia right now – another solid performance but where to from here?

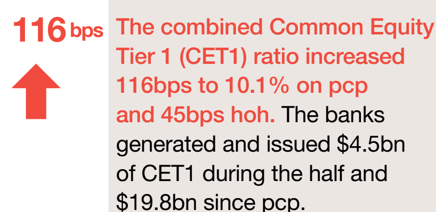












The majors face a confluence of factors that will shape the future of banking: fundamental forces in the external environment, moderation in the traditional drivers of growth and an increasingly binding set of constraints – both external (regulation, capital, funding) and internal (legacy, culture).

At the same time, the social context is changing rapidly with culture and ethics in the spotlight, making for a very challenging outlook.

Fundamentally strong

Cash earnings for the half were $14.9bn, a decrease of 2.8% on pcp and decline of 3.6% on the prior half. Return on equity of 13.7% was down 245bps on pcp and 163bps on the prior half. This represents the 2nd straight half of earnings decline for the majors.

The major’s engine room of lending asset growth and steps to manage margin decline show the importance of the domestic retail and corporate market to their results.

On average, Net Interest Margin (NIM) rose only slightly to 2.04%, demonstrating the importance of asset repricing in late 2015 and deposit repricing given increased wholesale funding costs and institutional bank/offshore margin pressure.

Asset quality remained strong in the core of portfolios but bad debt expense was significantly impacted by resource-related, ‘single name’ impairments. Bad debt expense increased $834million (m) on pcp and $520m hoh to $2.5bn. $801m of the increase related to specifically identified loans with portfolio expense rising only $33m in line with asset growth.

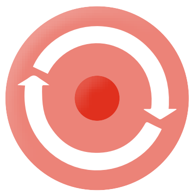
The increasing weight of constraints

The results also demonstrate the increasing weight of constraints facing the banks as they attempt to drive and navigate change with the complexity of decisions and strategic choices required as a result.

Perhaps the clearest example of this was ANZ’s $717m of specified additional cost items during the half. The profile of these items (reassessment of software useful lives, impairment of overseas investments and restructuring costs) are instructive of the capital optimisation and investment decisions facing the majors.

Capital remained an obvious focus for all the majors with CET1 rising 45bps hoh to 10.1% and with approximately $19.8bn of CET1 gained through issuance, restructuring and organic generation on pcp. The outlook for further increases suggests that capital rationing will be a key factor in prioritising where and what is ‘core’ to the longer-term Australian banking franchise. We have already seen how this is translating in to dividend stances.

The cost and investment profile of the banks reflects the challenge of maintaining a large business in a heavily regulated industry while investing to meet rapidly-changing customer expectations.
The average expense-to-income ratio increased to 44.8% and has been in the range of 43%-47% since 2008, including one-offs. The cost of maintaining infrastructure ($0.5bn) and regulatory/compliance ($0.6bn) remain a significant proportion (51%) of the $2.2bn overall investment spend and will continue to factor into prioritisation decisions. Six months ago we noted that with the pace of technological change, payback periods for investments were shortening. The focus on expensing previously capitalised software and projects during the last few periods supports this unequivocally.



Simpler

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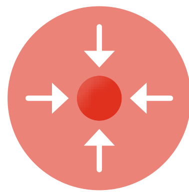

Smaller

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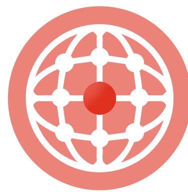

Deeply connected

> *"...we suggest that the banks will need to be simpler, smaller and more deeply connected.*

Credit growth has been remarkably resilient and to date shows no signs of the fragility many are pointing to given political uncertainty (e.g. changes to negative gearing rules) and increasingly bearish commentary in certain areas of the residential property market such as over-supply in some capital cities. Housing credit grew at 7.2% per annum (p/a) across the industry despite APRA succeeding in cooling investor lending (growing at 7.0% p/a compared to 10.2% six months ago). Business credit remained at levels not seen since 2009 with a growth rate of 6.5% p/a.

We expect the cost and profile of funding of the majors to become increasingly critical as the implementation of the regulatory Net Stable Funding Ratio (NSFR) nears from 2018. While there are complexities in the application of NSFR, we expect to see this impact business mix, a lengthening of the wholesale debt profile and/or a preference for 'stable' retail deposit funding. Given funding costs (inclusive of hedging impacts) contributed to a 4bps reduction in margin during the half this may become a further weight on results or put pressure on the banks to revisit asset pricing.

Redefining expectations

At the very same time as the majors are faced with the above challenges, the concept of a social contract between banks and the public is being scrutinised. Royal Commission or not, the resources diverted to an externally-driven change threatens the majors' ability to choose their priorities in a strategic, methodical way which would quite possibly achieve the same outcomes.

Banks operate in a unique and privileged intersect between shareholders, customers, regulators and government and in absolute terms (particularly when we look further afield) has served each well for some 100 years. Yet the context is now shifting dramatically as corporate and political expectations align with the broader social norms that we are now accustomed to – transparency, the renewed primacy of the individual, focus on customer experience, and fair-dealing.

These are not new concepts for banking and present significant opportunities if they are embraced in the right way. They are accelerating a change in focus that was already evident, enabled by a changing technology environment – a shift of the customer to the centre and a focus on trust.

The recent announcement by the Australian Bankers' Association of a fundamental review (including remuneration and incentives) is significant and unprecedented in recent history. The onus on the banks is to deliver on these expectations.

Such changes are not simple, take time and may, as we have said for some time, require a recalibration of returns for a period (possibly permanently), but should lead action and culture down the right path.

The recommendations from the ASIC capability review and subsequent funding announcements also serve to focus attention on which parts of the broader environment need to be strengthened to keep our industry "safe" and restore trust.

Outlook – simpler, smaller and more deeply connected

Our perspective "Banking 2020: the future of banking in Australia" takes a look at the external forces that are driving change, the challenges the majors face as they respond and presents a view on 6 priorities to be considered. In brief, we suggest that the banks will need to be simpler, smaller and more deeply connected, embracing their regulatory constraints for the safety and stewardship they provide.

Six months ago we expected to see the banks continue to focus on steady, disciplined reshaping and making the right investments for an uncertain future. While this has been borne out, the need for action is accelerating:

- Responding proactively to questions on **conduct and culture**, including strengthened regulator relationships to drive outcomes
- Maintaining **sharp focus on credit performance**, business sentiment and the broader economy
- **Stronger emphasis on strategic cost management**, investment prioritisation and make-buy decisions
- **Preparing for transition to the Net Stable Funding Ratio** and its consequential impact on business mix and asset/liability pricing
- **Simplification of customer experiences and offerings**, digitising and embracing Fintech to provide customers multi-channel experiences
- **Strategic capital choices** aligned to potential returns while retaining options in a fluid world
- **Being realistic about the sustainable equity returns** achievable and warranted in a better protected, changing banking sector.

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