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Major Australian Banks: Full Year Results 2015

Courage required

Financial Institutions Performance Summary

November 2015

kpmg.com/au/majorbanks

FULL YEAR 2015 RESULTS SNAPSHOT

Cash profit after tax increased by 5.4% to $30bn

Average cost-to-income ratio of 45.3%, down 28bps

Average CET1 capital ratio 9.6%, up 68 bps

Total credit growth increased 7.8%

Disruptors continue to enter the market providing personalised digital customer experiences

The majors continue to invest in technology and innovation with an additional $2.8bn software cost capitalised

Migration in transaction volumes away from branches to lower cost internet channels

Total charge for bad and doubtful debts increased to $3.8bn, up $363m

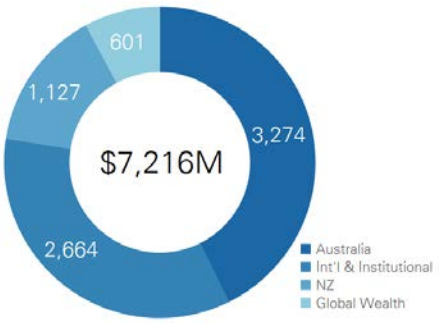
Banks reported an average NIM of 2.02%, down 5 bps

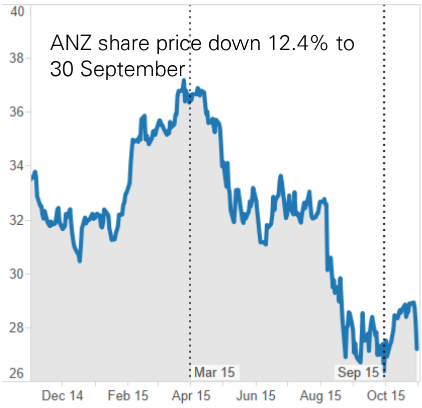
Average ROE of 15%, down 52 bps

Banks will need to balance competing priorities of maintaining ROE and rising regulatory capital

Cost growth was faster than revenue growth – ‘negative jaws’

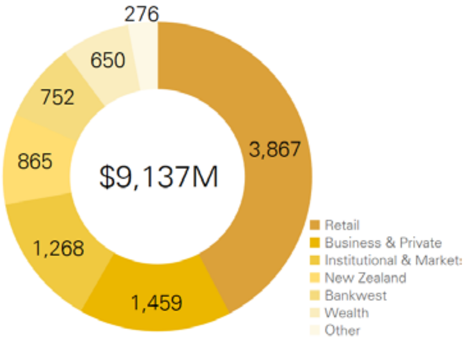
BEHIND THE NUMBERS

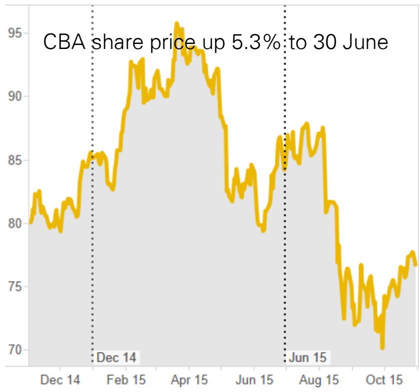




ANZ

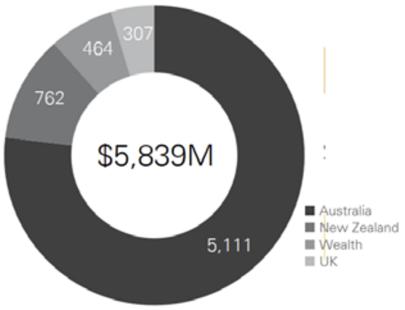
- Cash profit after tax increased 1.4% to $7.2 billion
- Net interest margin declined 9 basis points to 2.04%
- Reported cost to income of 45.6%, an increase of 90 basis points
- Return on equity 14%, down 140 basis points
- Bad and doubtful debt charges increased $193 million to $1.2 billion (19.6%)

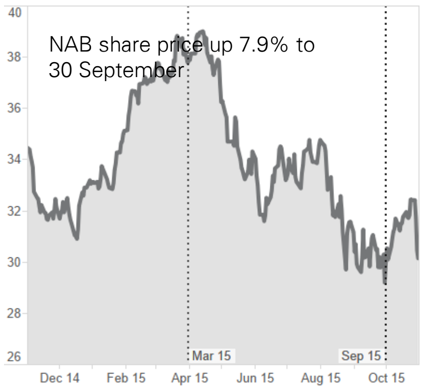




CBA

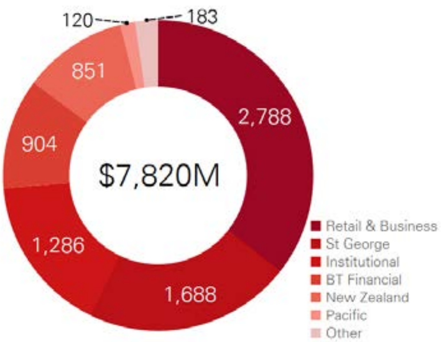
- Cash profit after tax of $9.1 billion, up 5.3%
- Net interest margin fell 5 basis points to 2.09%
- Reported cost to income of 42.8%, improving by 10 basis points
- Bad and doubtful debt charges increased $70 million to $988 million (7.6%)

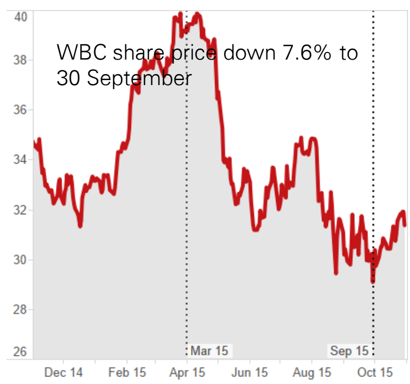




NAB

- Cash profit after tax increased 15.5% to $5.8 billion. Excluding specific items (including the UK conduct charges) the increase was 2.4%
- Net interest margin declined 4 basis points to 1.87%
- Cost to income improved 230 basis points to 50.8%
- Bad and doubtful debt charges improved marginally, down $3 million to $844 million (-0.4%)





WBC

- Cash profit after tax of $7.8 billion, up 2.5%
- Net interest margin flat at 2.08%
- Reported cost to income increased 40 basis points to 42%
- Bad and doubtful debt charges increased $103 million on FY2014 to $753 million (15.8%)

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MAJOR BANKS: COURAGE REQUIRED

The Australian major banks (the majors) reported another record earnings result in FY2015, but return to shareholders is down as the banks face an accelerating pace of change and compounding challenges. The result highlights continued margin pressure, increased capital requirements following the government's response to the findings of the Financial System Inquiry ("FSI") and the transitioning economy which has slowed the growth in profits reported over the past five years.

In this constrained environment, the majors have still reported a combined record cash profit of $30 billion, an increase of $1.5 billion (5.4 percent). Return on Equity, though, is down from 15.5 percent to 15.0 percent from the previous year, and this downward trend is likely to continue as banks continue to increase their capital levels over the years ahead.

The key themes behind the result include tightening margins (**page 12**), the normalisation of loan impairment charges (**page 10**) and a modest improvement in cost to income (**page 23**). Underpinning this result is the impact of increased regulation including implementation of the recommendations from the FSI and other measures such as continued pressure to slow investor-led credit demand. Coupled with the increasing regulatory level of capital (**page 19**), sustained downward pressure on industry returns is evident.

In the face of these challenges, we see the major banks executing their strategies very differently. The majors are navigating a possible structural change in the Australian economy, while contending with the recommendations from the FSI and refining their balance sheets to meet the new liquidity requirements and increased risk weighting on mortgages. How the majors execute on these strategies, from differing base lines, will place further pressure on ROE (**page 25**).

With continued pressure likely, the banks will intensify their focus on further improving their cost efficiency (**page 23**). The majors have shown they have some power to address these cost pressures and tightening margins through recent increases in home lending interest rates. However, shareholder and customer interests need to be balanced carefully in the future to ensure disruptors are not further emboldened to attack established lenders' business models. The rapid pace of change in technology requires the majors to focus their strategies on the opportunities and threats of digitalisation including digital enablement of distribution channels particularly branches which represent such a significant portion of the banks' overall cost base as well as re-designing middle-and-back office processes and increasing the use of outsourcing (**page 6**).

This balance, we consider, will be critical to the majors protecting their current customer base, as customer expectations evolve with technology advancements and disruptors enter the market. Real courage will need to be shown by bank management over the next few years, and if banks push too hard on maintaining short-term return to shareholders, they risk significantly damaging their long term franchise value and reputations.

AT A GLANCE

	ANZ		CBA[1]		NAB		WBC	
	FY15	FY14	**FY15**	FY14	**FY15**	FY14	**FY15**	FY14
Ranking								
By profit before tax	**3**	3	**1**	1	**4**	4	**2**	2
By total assets	**2**	3	**3**	2	**1**	1	**4**	4
By total equity	**1**	3	**4**	1	**2**	4	**3**	2
By market capitalisation	**3**	3	**1**	1	**4**	4	**2**	2
By CET 1 capital ratio	**2**	3	**4**	1	**1**	4	**3**	2
Profit before tax ($ million) – statutory basis[2]	**10,533**	10,308	**12,612**	11,997	**9,080**	7,782	**11,416**	10,740
Profit after tax ($ million) – statutory basis	**7,493**	7,271	**9,063**	8,631	**6,338**	5,295	**8,012**	7,561
Cash profit after tax ($ million)[2]	**7,216**	7,117	**9,137**	8,680	**5,839**	5,055	**7,820**	7,628
Net interest margin – cash basis (basis points)	**204**	213	**209**	214	**187**	191	**208**	208
Cost to income ratio – cash basis (%)	**45.6**	44.7	**42.8**	42.9	**50.8**	53.1	**42.0**	41.6
Impairment charge ($ million) (statutory basis)	**1,179**	986	**988**	918	**844**	847	**753**	650
Basic earnings per share – statutory basis (cents)	**271.5**	267.1	**557.0**	533.8	**252.7**	219.0	**256.3**	243.7
Basic earnings per share – cash basis (cents)	**260.3**	260.3	**560.8**	535.9	**233.7**	211.2	**249.5**	245.4
Return on average equity[3] (%) – cash basis	**14.0**	15.4	**18.2**	18.7	**12.0**	11.6	**15.8**	16.4
Impaired loans to loans and advances to customers (%)	**0.47**	0.55	**0.44**	0.55	**0.35**	0.76	**0.30**	0.40
Collective provision to credit RWA (%)[4]	**0.85**	0.89	**0.87**	0.96	**1.01**	0.83	**0.86**	0.93
Total assets ($ million)	**889,900**	772,092	**873,446**	791,451	**955,052**	883,301	**812,156**	770,842
Total equity ($ million)	**57,353**	49,284	**52,993**	49,348	**55,513**	47,908	**53,915**	49,337
Capital Adequacy Ratios (%)[5]								
– Total	**13.30**	12.7	**12.70**	12.00	**14.2**	12.2	**13.3**	12.3
– Tier 1	**11.30**	10.7	**11.20**	11.10	**12.4**	10.8	**11.4**	10.6
– Common Equity Tier 1	**9.60**	8.8	**9.10**	9.30	**10.2**	8.6	**9.5**	9.0
Market capitalisation ($ billion)	**78.6**	85.2	**138.2**	130.7	**75.7**	74.1	**94.6**	99.9

1 CBA reported as at 30 June 2015.

2 Profit before tax attributable to shareholders (excluding non-controlling interest)

3 Profit before tax is reported on a statutory basis. Return on equity has been reported on a cash basis.

4 Included in the NAB collective provision to credit Risk Weighted Asset percentage is a collective provision relating to loans at fair value. This collective provision is included within the carrying value of other financial assets at fair value.

5 As disclosed in the banks result announcements.

EXECUTIVE SUMMARY

In the face of subdued levels of economic activity and a toughening regulatory environment, the majors have reported a stable full year result for 2015 (FY2015), with a combined statutory result of $30.9 billion, an increase of $2.1 billion. Using the industry preferred 'cash profit after tax' measure, which adjusts for one-off items, discontinued operations and accounting volatility, the majors posted a combined profit of $30 billion, growth of 5.4 percent ($1.5 billion). Return on Equity, though, is down from 15.5 percent to 15.0 percent from the previous year, and this downward trend is likely to continue as banks continue to increase their capital levels over the years ahead.

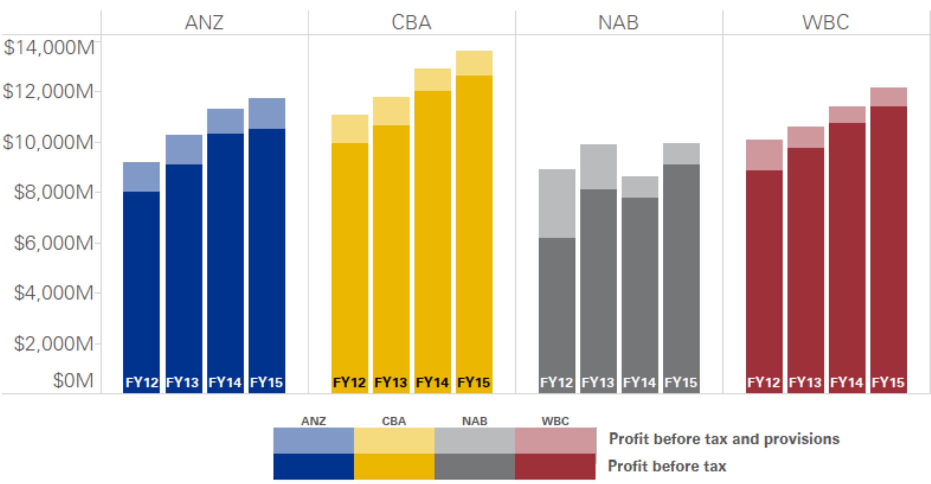
Cash profit growth was modest, softening the growth trend recorded in recent years. ANZ achieved growth of 1.4 percent to $7.2 billion, CBA increased 5.3 percent to $9.1 billion and WBC increased 2.5 percent to $7.8 billion. NAB was an outlier, increasing 15.5 percent to $5.8 billion after raising a significant provision of $1.5 billion in FY2014 related to conduct matters on the sale of its legacy UK product protection insurance. Excluding specific items NAB's increase was 2.4 percent.

> Revenue and margin headwinds, rising costs and capital levels, with a deteriorating credit quality outlook all mean the majors will face challenges in reversing declining returns in the years ahead.

A common feature in the result continues to be the "headwinds" linked to the weaker Australian economy which continue to challenge the majors and impact many facets of performance including credit growth and loan impairment charges, while the changes driven by the regulatory agenda are leading to additional capital requirements, constraining the majors ability to continue to generate the high levels of return reported over the past five years.

The banks' record profits were achieved in the face of strong competition for new lending with net interest margin continuing to contract to a record low 2.02 percent, down from 2.07 percent last year. Softer credit growth and tightening margins are however, taking hold, leading to the rate increase to residential investor loans in July and more recently, across the majors' entire residential lending portfolios. This may lead to a more stable trajectory given the continued front-book competition for owner occupied mortgages.

Profit before tax and provision



> Recent increases in home lending rates have shown that the banks do have some market power to improve margins, but careful balancing of shareholder and customer interests will be required in future to ensure disruptors are not further emboldened to attack established lenders' business models.

The more onerous capital and liquidity requirements, particularly following clear guidance being issued from APRA following the FSI are beginning to materialise, leading to further pressure as the majors further restructure their balance sheets including raising additional equity during the second half of the year.

Charges for bad and doubtful debts increased $363 million to $3,764 million while total provisions increased for the first time in five years, up $80 million (0.6 percent). Whilst impaired assets have declined during FY2015, the rate of this decline has slowed in comparison to prior periods. The banks have reported lower levels of recoveries and provision write-backs during the year and we have seen leading indicators, such as 90+ day delinquencies continue to fluctuate (increasing 2.2 percent), indicating that the historically low credit impairment charges may be coming to an end.

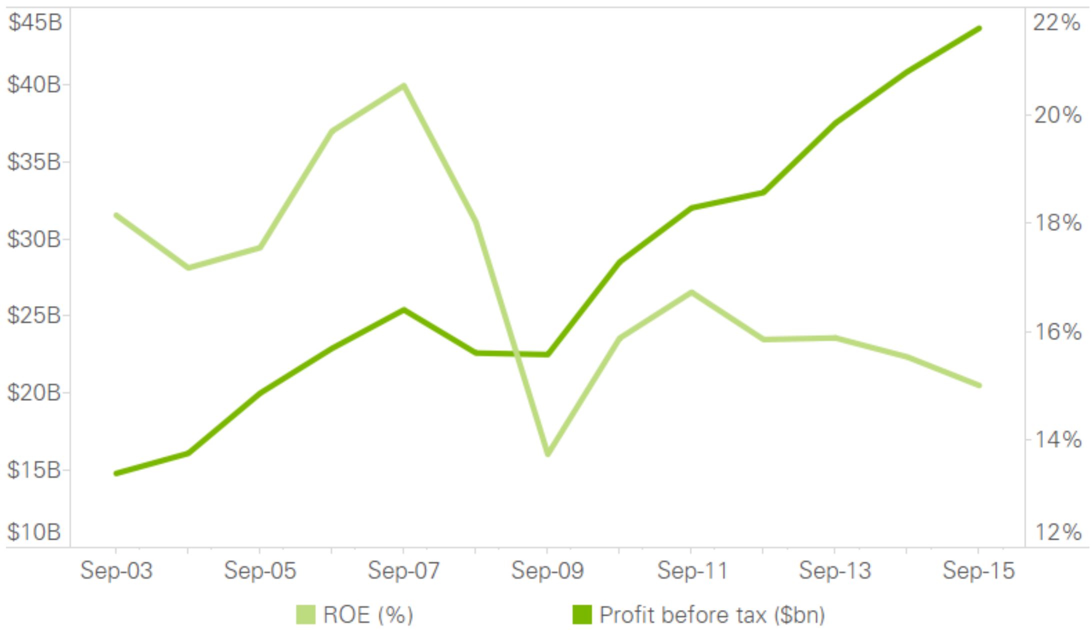
Given the continued challenges within the economy, it appears impairment levels are starting to normalise, returning to longer term averages. As a result, reported charges for bad and doubtful debts increased at 4 basis point of average loans.

Cost to income ratio decreased from 45.6 percent in FY2014, to 45.3 percent. The majors need to fundamentally change their operating models to enable them to both enhance the customer experience, while at the same time, significantly reduce the banks' cost base going forward. Strategically, we believe this advancement in technology and digitalisation will be critical as the majors all compete to extract the value they have invested in their systems and position themselves for the future of banking. Given the rapidly evolving fintech industry, continued investment in these technologies is critical to combat the emergence of new disruptors to the majors' traditional market and to protect their customer base.

This continued investment in IT assets has led to an increase in the capitalised costs of $2.8 billion (before amortisation and impairment) to $9.2 billion. Amortisation charges and one-off IT related impairments of $1.7 billion, an increase on the $1.5 billion reported in FY2014 continue to be a drag on earnings.

Overall, the major banks reported an average return on equity ("ROE") (cash basis) of 15 percent in FY2015, compared with 15.5 percent in FY2014. Excluding NAB, return on equity fell 82 basis points to an average of 16 percent. We expect maintaining a ROE well above the cost of capital will continue to challenge the banks, particularly as APRA responds to Basel 4 and the recommendations of the FSI raising bank capital even further. As illustrated in the following chart, ROE relative to profit continues to trail below pre-GFC levels.

Profit before tax against return on equity



Real courage will need to be shown by bank management over the next few years, and if banks push too hard on maintaining short term return to shareholders, they risk significantly damaging their long term franchise value and reputations

THE FUTURE OF BANKING – WHAT WE FORESEE OVER THE NEXT FIVE YEARS

As the major Australian banks draw a line under another year of aggregate record profits, we look ahead over the next five years (to 2020) to provide some insights into what the future of banking could look like and the implications for the banks' financial performance and strategies. We consider that 2015-16 will mark an inflexion point for the industry and expect the operating environment to be far more challenging over the next five years than even the past five years have been.

Operating conditions

A confluence of factors will combine to create a tough backdrop for major bank boards and senior management teams. We foresee a subdued economic environment continuing, sustained low interest rates, downward pressure on net interest margins, weak demand for loans (and hence, slowing lending growth) and deteriorating credit quality.

Furthermore, as a consequence of the FSI recommendations and the global regulatory community advancing with Basel 4, the Net Stable Funding Ratio and Leverage Ratio, regulatory capital and liquidity will continue to rise, making it increasingly difficult for the major banks to maintain their current level of ROE and high dividend payout ratios.

In addition, we see customer behaviour and competitive dynamics continuing to rapidly evolve, driven by demographic changes, the digital/mobile revolution and the rise of fintech, presenting both threats and opportunities for the major banks. In order to enhance their level of agility, the majors will need to intensify their efforts to simplify, standardise and automate their operating models, as well as preserve optionality in their strategies in order to capitalise on opportunities as they arise.

Productivity

A more sustainable strategy will also require the major banks to escalate their productivity and efficiency agendas. Compared with global banks, Australian major banks' cost to income ratios sit relatively low, currently 45.3 per cent on average (global banks cost to income ratios of 60-70 per cent are relatively common). Over the past five years, the major banks have approached cost management on a targeted "portfolio approach" rather than taking a strategic group-wide approach, with some businesses being operated for efficiency to create investment headroom for other businesses. That being the case, revenue growth has played a more significant role in preserving their relatively low cost to income ratios, than realising substantial cost efficiency gains.

At the core of this will be the digital enablement of distribution channels, particularly branches which represent such a significant portion of the banks' overall cost base (estimated to be 40-60 per cent), as well as re-designing middle-and-back office processes, increasing use of outsourcing and strategic partnerships.

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Distribution channels

Firstly, branch networks will become a key source of medium-term productivity enhancement opportunity. Branches are getting smaller, more differentiated, situated in higher 'footfall' areas, with fewer teller staff, and orientated to activities, such as sales, the provision of advice and education of customers about how to use digital services and self-service capabilities.

However, in an era of lower credit and bank revenue growth we consider that over the next five years, with consumer transactions in branches continuing to decline between 10-15 per cent a year, coupled with consumers (of all ages) being more willing to embrace the convenience of self-service, that the major banks will be able to approach more radical branch transformations, including a modest level of branch closures, while at the same time not negatively impacting their reputation, customer engagement and advocacy.

Moreover, digitising the front office is not enough to realise true cost efficiencies if the bank's culture, organisational alignment, and human resources are not redefined to deal with digital disruption. Failure to look across the firm's value chain (front office to back office and support) continues to cause inefficiencies in realising the benefit of front-office automation and migration to digital channels.

Middle and back office

As the major banks re-design and digitise their customer-facing 'front office', they will need to balance their investment and strategic focus, to ensure they are not leaving their foundational back-end structures cost-inefficient and unresponsive to change. Our observation is that the back-office is often the forgotten customer in digitisation, expected to follow the digital curve without receiving the necessary tools to propel it into the digital universe.

The ideal future state for banks will be a combination of an agile, digital and automated front office, with a highly personalised touch, supported by a lean, highly efficient back office. Put another way, designing an end-to-end digital customer experience, with "the process in mind". This is allow them to simultaneously transform key business activities and produce productivity improvements while driving a more consistent, engaging and higher quality customer experience.

IT investment

With the substantially higher IT investments of recent years, rising capitalised software amortisation charges are now emerging and adversely impacting operating costs and with bank revenue growth now routinely struggling to outpace cost growth, pressure will fall on management teams for decisive action on operational efficiency.

Whilst it should be acknowledged that technology innovation will also play a more critical role in delivering productivity improvements, it is equally important for banks to build leadership and management competencies, as well as cultures that will foster high levels of innovation on an ongoing basis.

Collaboration

We expect to see greater levels of collaboration in the future to deliver on banks' productivity agendas, for example between banks and fintech companies in areas such as digital enablement, data analytics and process automation; between banks and technology companies, leveraging their unique and complimentary assets; and finally, between banks themselves, as they explore 'step change' cost initiatives, such as creating and/or sourcing services from industry utilities, e.g. customer on-boarding.

The banks which can identify and create, in some cases non-conventional, strategic partnerships will be the ones that will most likely succeed in the digital world, where dominant market positions are attained much more quickly and once established are difficult to change.

Customer behaviour

In terms of predicting the changes that are likely to occur over the next five years and beyond, the starting point has to be what we foresee consumers will desire in terms of their financial requirements. Generations

X and Y will dominate the financial landscape over the coming years. Their share of financial assets, which currently stands at 36 per cent, is set to jump to 70 per cent by 2030.

Recent KPMG research reveals these generations have four key attributes which influence their decision-making:

- They want to be in control of their finances and want to be empowered to realise their own ambitions;
- They are less loyal to their financial institutions and are more likely to hold financial products at multiple banks. Indeed, the proportion of those holding products at four or more banks has tripled, just over the past 3 years alone;
- They are seeking advice from alternative sources, that is, they tend to trust their family, friends and online networks ahead of professional advice; and
- They are demanding greater levels of personalisation and immediacy (in return for allowing organisations access to more of their personal data).

To date this group's perception is that they are being 'under-valued' – and this presents both an opportunity and risk for the incumbents. Interestingly, these preference are also slowly being displayed by other demographic cohorts.

For the banks, part of the response will require them to move to a more sophisticated model of gathering customer insights, focusing on "what they do" and "how they do it", rather than relying on what they say they plan to do (in a hypothetical context).

Technology

As many of us are observing ourselves (as consumers) and through our own organisational experiences, there is a clear shift in power from corporations to customers, occurring. In most cases, technology is facilitating this transition.

A few years ago, people performed daily tasks in conventional ways, today "convention" has shifted to digital platforms and devices. Locally have seen the proliferation and widespread adoption of mobile devices, with over 65 per cent of Australians now owning a smartphone, as well as Australia having one of the highest levels of contactless payments globally.

We have also seen an explosion in data, fuelled by social media. It is astounding that 90 per cent of the world's digital data was generated in the past two years. The efficient collection and cleansing of data and how it can effectively be turned into valuable information will be a critical enabler for the banks looking ahead. These capabilities will be applied to identify revenue growth opportunities, target cost reduction efforts and better price risk, for example, leveraging new sources of customer (both current and prospective) insight in credit decisioning.

This revolution is set to continue over the medium term, with the transition to the New Payments Platform in Australia which will go live in 2017, as well as developments such as the Internet of Things, where predictions suggest there will be 75 billion devices connected globally by 2020, and longer-term, the impact of artificial intelligence, cognitive computing and robotics on the banking industry and the economy more broadly.

Barriers to entry are falling

Another key driver of change for the banking industry is that the barrier to entry for digital disruption is falling quickly. It has never been cheaper or easier to commence a technology start-up, with the advent of open source software and low-cost development tools. Unsurprisingly, given the inverse relationship, falling start-up costs are seeing the emergence of a number of new fintech ventures entering the market with simple, low cost and transparent value propositions.

Digital disruption is challenging existing business models, with estimates of around 25-30 per cent of current Australian banking industry revenue at risk, equating to around $27 billion, with the areas of banking most at risk of digital disruption being lending, payments and merchant acquiring.

Trust

Of course, established financial firms are evolving their capabilities to compete and retain their customers, leveraging stronger levels of trust (albeit this is diminishing as a factor over time as consumers become more comfortable with new players and brands. PayPal is an interesting example. They did not exist around 12 years ago. They now have around 6 million active customers in Australia.

In the short-to-medium term, it is expected that the major banks will continue to clawback higher costs through customer re-pricing initiatives (as they have recently done in mortgages), however, this runs the risk of political and more importantly, customer resentment building against the majors, creating a more favourable competitive environment for new entrants to enter (and grow) their brands and build 'trusted' customer relationships.

Conclusion

The major banks have strong financial positions, proven track records of technological innovation, as well as, highly respected brands and senior management teams to look to the future with confidence. The years ahead will undoubtedly be more difficult than those recently past, and the banks that will be most successful will take a more, strategic long term view on their franchises and remain focused on evolving their operating models to best serve the interests of their customers, over short term financially motivated decision-making.

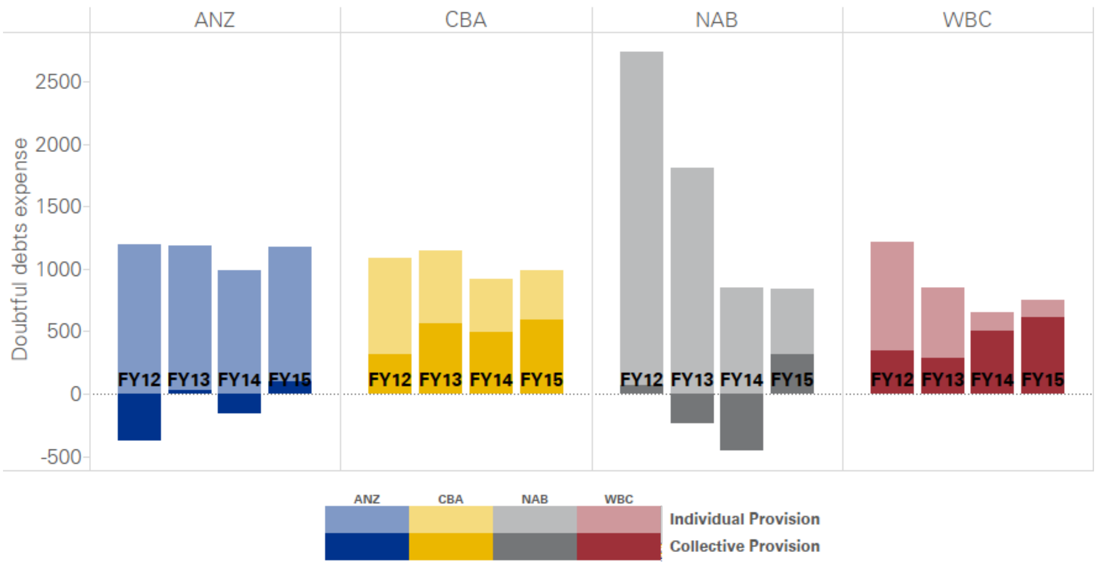
Today we are observing an erosion of trust in established hierarchies, whether that be Government or large corporations and the rise of platforms and marketplaces built on peer trust. As a result, over the medium-to-long term, organisations such as the banks will need to transition their business models to be more open and seen as a facilitator of value, collaborating with other third parties, than being seen as "centralised controllers".

ASSET QUALITY

Total impaired assets across the majors declined $3.2 billion to $9.5 billion (25 percent), continuing the trend seen in recent years. Excluding the impact of the sale of NAB's UK legacy assets, total impaired assets declined by approximately 18 percent. While this decline in impaired assets results from continued lending practice discipline, it has slowed in comparison to recent years and charges for bad and doubtful debts across the majors appear to have reached the bottom of the credit cycle, having increased $363 million to $3.8 billion. Total credit provisions also increased for the first time in recent years, up $80 million (0.6 percent). This increase is consistent with market consensus and has been called out by the majors as the possible beginning of more normalising credit performance.

Economic uncertainty remains with respect to a successful transition of the Australian economy resulting in a continued constrained operating environment. This combined with weak global growth has resulted in a prolonged period of historical low interest rates contributing to an extended cycle of modest delinquency rates and impairment charges. However, this now appears to be beginning to normalise with the majors each reporting an increase in bad and doubtful debt charges on FY2014. The combined impairment charge of $3.8 billion, an increase of 10.7 percent or $363 million reflects higher write-offs and lower level of recoveries coupled with increase in collective impairment as a result of credit downgrades.

Net bad and doubtful debt charge



ANZ reported an increase in the bad and doubtful debt charges on a statutory basis of 19.6 percent to $1.2 billion. While impairment charge was up, it was reported that loss rates remain well under the long term average having risen from their historically low levels. The increase was largely attributable to an increase in collective impairment charge due to both credit downgrades and underlying asset growth in the portfolio. The increase was partially offset by a decrease in specific impairment charge and economic cyclical releases.

> It is likely we have now seen the bottoming of the credit loss cycle, and the trend in lending losses is now on an upward trajectory

CBA recorded an increase in loan impairment charges of 7.6 percent on a statutory basis, increasing $70 million to $988 million. This was primarily driven by higher arrears in the unsecured portfolio in retail banking services and provisions relating to the institutional banking and markets portfolio.

WBC, also reported an increase of 15.8 percent to 753 million in FY2015 due to higher write-off's and lower benefit from stress reduction flowing from decreasing rates.

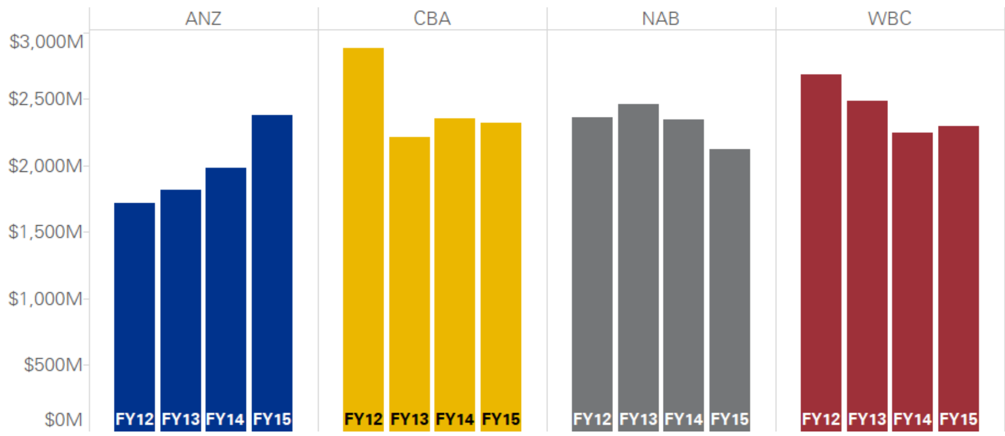
NAB, on the other hand, reported a relatively flat impairment charge of $844m in FY2015, a slight decrease of 0.4 percent. The result was influenced by the early adoption of AASB 9 *Financial Instruments,* reductions reported in business lending impaired assets and the sale of UK CRE loans, reduced write-offs for the unsecured retail portfolio and improved economic conditions in the UK.

90+ day delinquencies

With the exception of ANZ and WBC, 90+ day delinquencies decreased 5.3 percent in FY15 to $4.4 billion as compared to $4.7 billion in FY14. ANZ and WBC both reported an increase in 90 days delinquencies, while NAB and CBA reported an improvement of 9.4 percent and 1.3 percent respectively. The result is a continuation of the fluctuation we have observed in delinquency rates over the past few years driven by seasonal variances, as well as the subdued economic environment. Whilst overall impaired loans are at historic lows, the evidence remains mixed on, with the following observations:

- delinquencies attributable to retail mortgages and personal loans continue to decline across all operating regions;
- a modest increase in delinquencies attributable to small and medium enterprises and wholesale trade sectors; and
- construction and property related exposures delinquencies remain relatively flat.

Accruing loans 90+ days in arrears



NET INTEREST INCOME

Considerable pressure remains on net interest margin (“NIM”). NIM continued to tighten, declining a further 5 basis points to 2.02 percent (cash basis) as a result of record low interest rates, pricing competition, lower earnings on capital and higher liquid asset holdings. The majors have recently moved to address the continued decline in NIM by raising interest rates across their residential lending portfolios by 18 basis points on average. This follows the increase applied to investor loans in July and looks to provide a more stable trajectory for margins given front-line competition for owner occupied mortgages. While the rate increase is expected to have an immediate positive impact of up to $1 billion on earnings in FY2016, it may also provide further incentive and opportunity for the disruptor firms to enter the market and target the majors’ traditional customer base.

Overall, while offset by the decline in NIM, the majors reported an increase in net earnings from average interest earning assets and liabilities of 5 percent to $58.7 billion from growth in housing and business lending volumes.

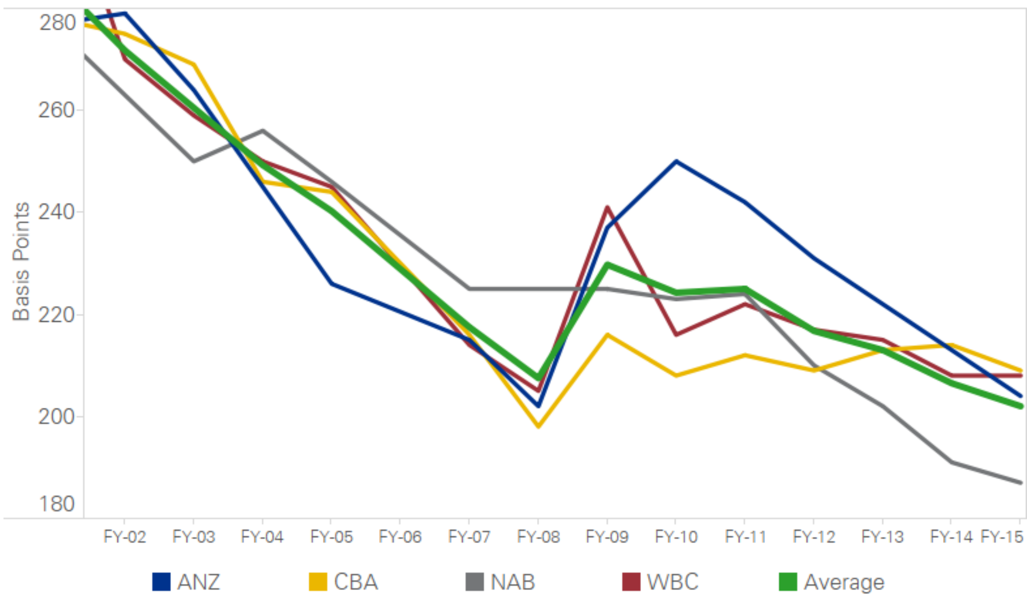
Net interest margin

Pricing in the industry remains competitive as the average net interest margin fell 5 basis points to 2.02 percent (cash basis), driven by ANZ (down 9 basis points), CBA (down 5 basis points) and NAB (down 4 basis points). WBC held NIM at 2.08 percent year-on-year.

Across the board, the majors reported the following pressures on net interest margins:

- Competitive asset pricing across both the domestic and commercial lending books, restricted by historically low interest rates;
- A rise in holdings of liquid assets due to compliance with new regulatory liquidity requirements under Basel III and APRA’s Liquidity Coverage Ratio (LCR) requirements; and
- Lower funding costs, particularly in customer deposits and wholesale markets has eased the negative impact on margins.

Net interest margins

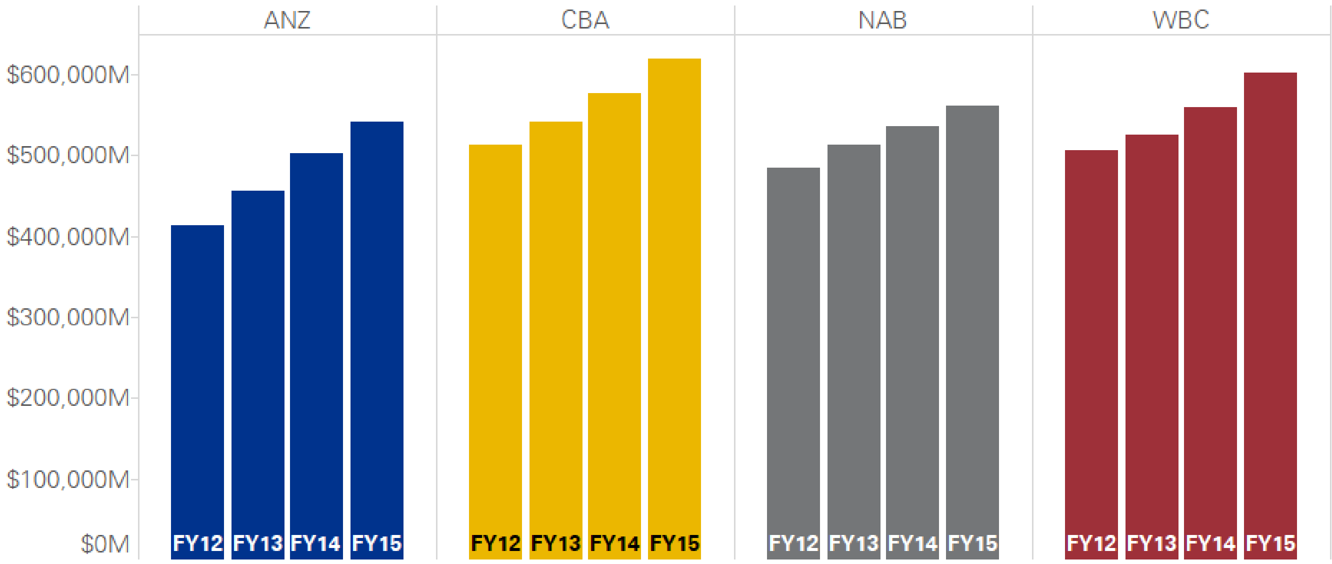


Credit growth

Across the majors, average net interest earning lending assets grew at a steady pace, increasing by 6.9 percent to $2,323 billion (2014: $2,173 billion). This balance sheet growth was driven by continued momentum in residential property markets across the capital cities, offset partially in the latter part of the year by a cap on residential property investor lending introduced by APRA, limiting annual growth to 10 percent.

APRA's intent is to reduce competition for property and in turn demand through limiting the credit available to investors. This in turn, is expected to slow house price growth across the capital cities, particularly in Sydney and Melbourne. As a result, the majors have introduced new measures through repricing and tighter credit assessment metrics to limit investor loan approvals.

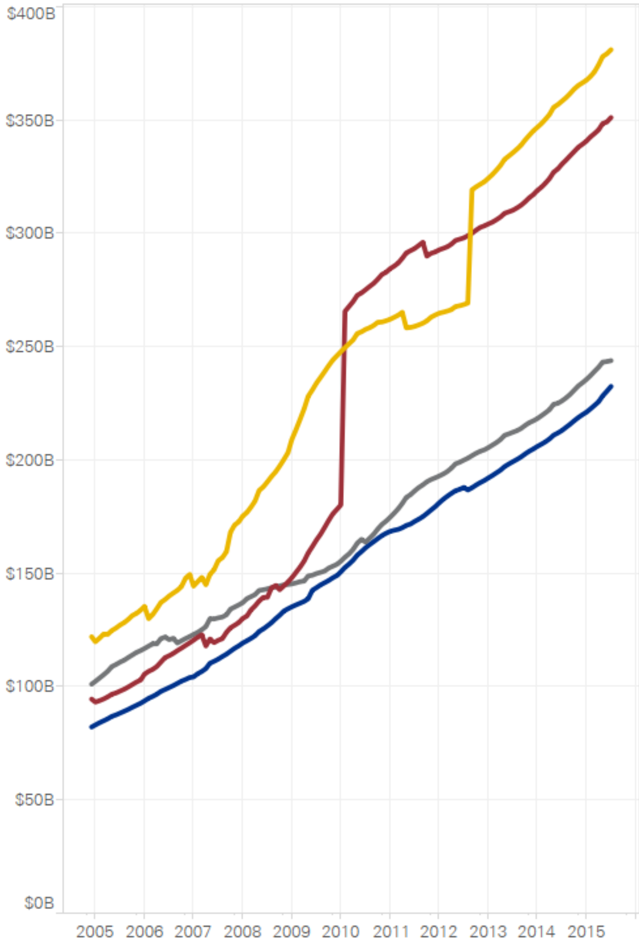
Average net loans and advances



Home lending continues to be core to the majors' domestic franchises. As illustrated below, total loans to households within the financial system have grown steadily during the period, however, the relative market share of the majors has continued to decline slightly in favour of other players.

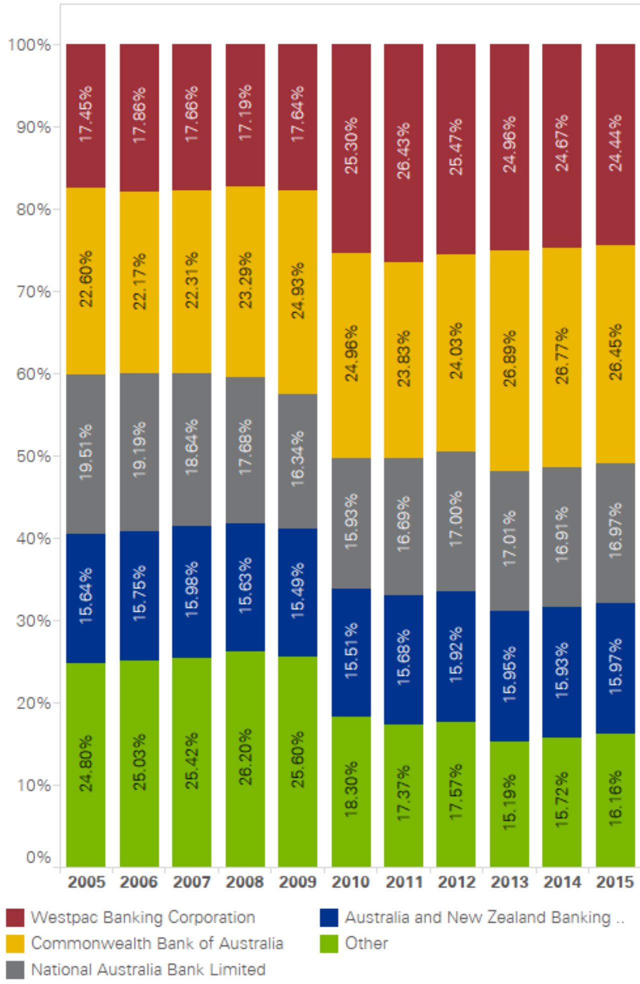
The persistent levels of credit growth experienced by the banking industry in Australia are evident across the 2005 to 2015 period, along with the dominance of the majors. The majors have consistently increased market share over an extended period of growth in the financial system from 2005 to 2013, however in 2014 and 2015 the market share amongst the majors declined (44 basis points this year), pointing to more active levels of competition.

Loans to Households



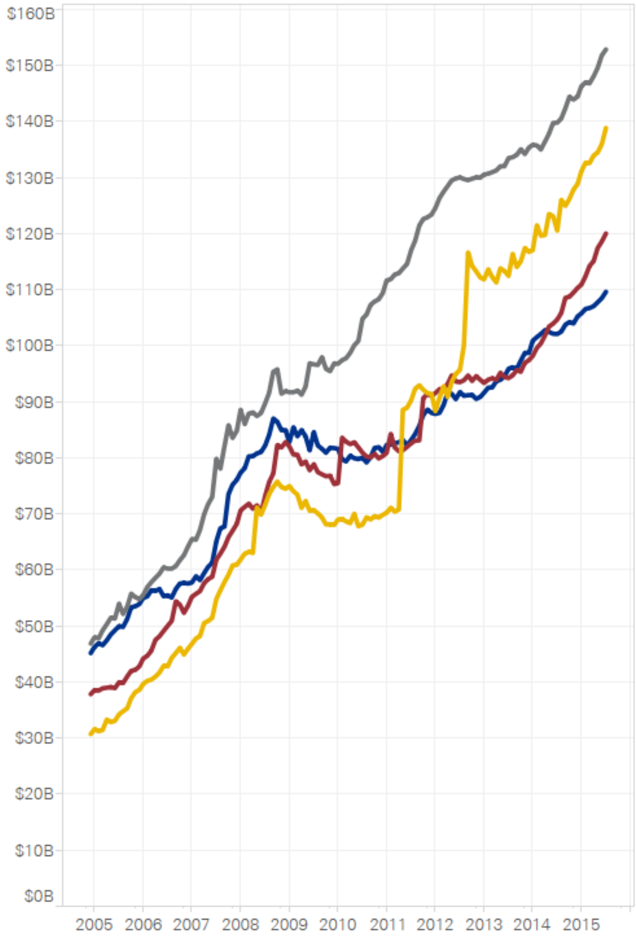
SOURCE: APRA Monthly Banking Statistics

Marketshare of Household Loans %



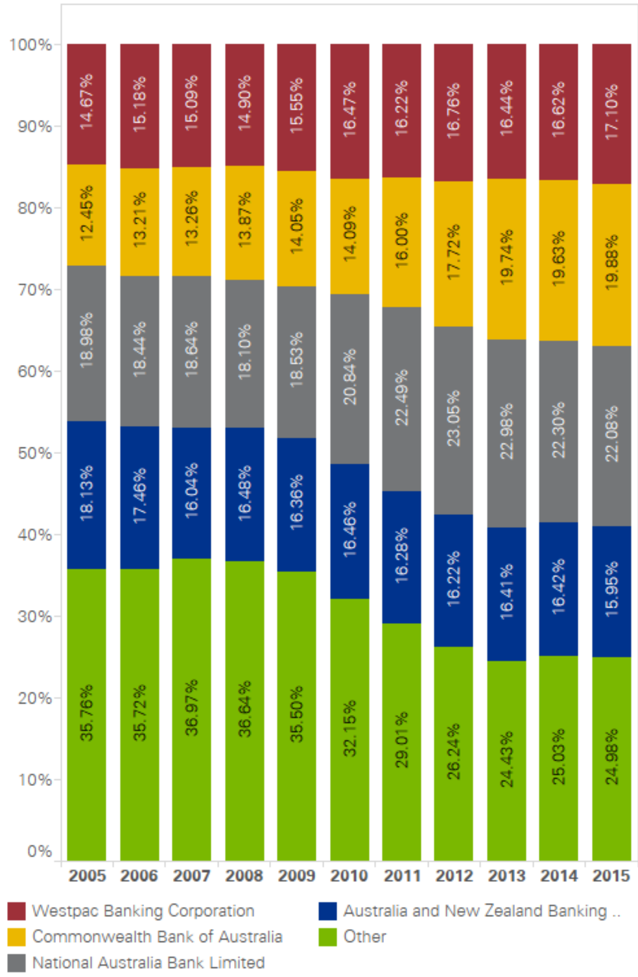
As depicted, the majors continue to maintain a dominant share in the corporate lending market, this has increased 5 basis points during the 2015 full year as a result of falling competition from international banks that are less active in the local market.

Loans to Corporations



SOURCE: APRA Monthly Banking Statistics

Marketshare of Corporate Loans %



Liquid asset mix

Total holdings of liquid assets has increased by over $40 billion in FY2015 to $567.1 billion. The introduction of the new Basel III regulatory requirements and APRA's Liquidity Coverage Ratio (LCR) requirements have caused an increase in holding of assets in order to meet the prudential requirements of high quality liquid assets (HQLA). The majors' continue to focus on holding well-diversified, higher quality liquid assets to meet the criteria. This has, in effect, had a negative impact on net interest margins seen across all of the majors in their 2015 results.

Funding mix

While overall margins have tightened, funding mix again had a positive influence on the margin result.

The full year 2015 saw previous levels of competition from second tier banks for customer deposits taper off slightly. This was reflected in improved deposits pricing and a modest increase in the deposit to loan book funding ratio for the majors to 76.2 percent (2014: 75.8 percent).

Wholesale funding costs were flat across the majors, as high levels of global liquidity and a general flat economic global outlook combined to keep credit spreads in domestic and international debt capital markets steady. However, the sustained favourable conditions has allowed the majors to continue to improve margin while historical debt issuances mature and new debt issued at more favourable prices.

Despite weaker insurance earnings attributable to higher claims, wealth management earnings grew across the majors, driven by favorable investment performance with a lower Australian dollar

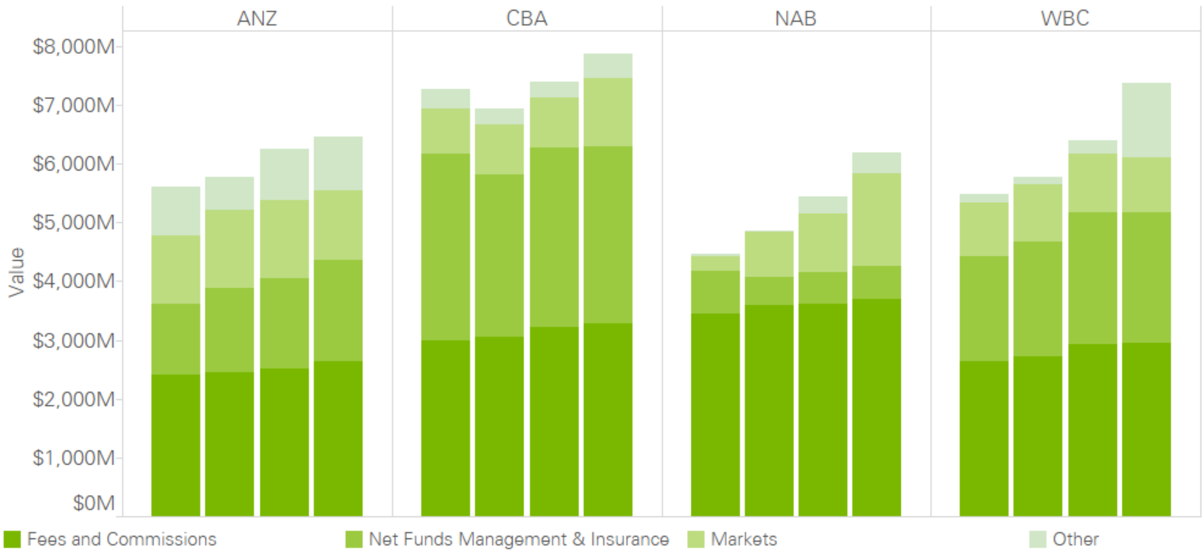
NON-INTEREST INCOME

Non-interest income benefited during the year from one-off asset sales (CBA and NAB), stronger markets, and a lower Australian dollar resulting in higher trading income and wealth management commissions. One-off charges, such as asset sales and valuation adjustments across the majors, continue to impact the underlying quality of earnings. The overall improvement in non-interest income was offset partially by increased insurance claims due to significant weather events experienced during the year.

From differing base lines, the majors are executing against their strategies to strengthen these businesses, with each bank continuing to yield positive non-interest income results. The key themes from the results include:

- ANZ reported non-interest growth was largely attributable to funds management and insurance income driven by an increase in funds under management and growth in insurance income. Net fee and commission income and share of associates' profit benefited from favourable foreign currency translations and improved performance in underlying businesses. These gains were offset partially by the decline in performance of the Global Markets business.
- CBA's growth in non-interest income reflected volume driven growth in commission, stronger markets sales and trading performance and a favourable counterparty valuation adjustments. This growth was off FY2014 comparative which was impacted by the impairment in Vietnam International Bank.
- The improvement in NAB's non-interest income was largely attributable to higher insurance income, performance of NAB wealth, and the gains on the sale of loans in the UK CRE portfolio and other Australia assets. These gains were offset in part by a decrease in trading income of $48 million.
- WBC posted non-interest income growth of 15.3 percent ($980 million) driven by the partial sell down of its shareholding in BT investment management.

Breakdown of non-interest income

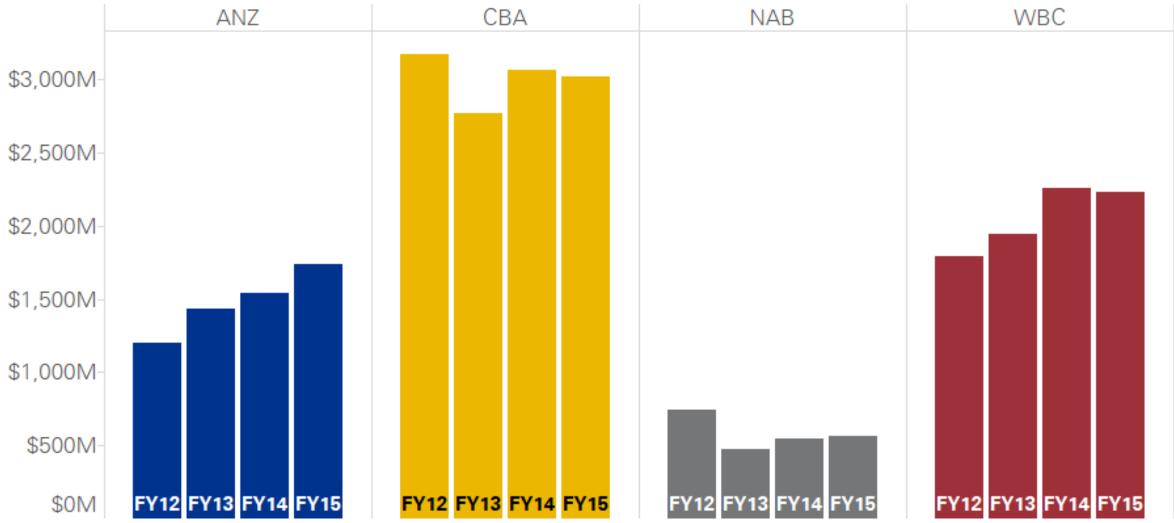


Wealth management and insurance

Wealth management and insurance income was relatively flat, increasing 2 percent to $7.5 billion. While there was an increase in average in-force premiums increase across all the majors, this was partly offset by an increase in insurance claims experience from the number of severe weather events across New South Wales and Queensland.

Average funds under management grew across all the majors on the back of favourable equity markets and investment performance coupled with a lower Australian dollar. This was offset marginally by lower advice revenue. WBC experienced a decrease in wealth management income due to the partial sale of BT Investment Management.

Net funds management and insurance income



Fees and commissions

Fees and commissions increased modestly by 2.4 percent to $12.6 billion in total for all the majors. This was driven by stable lending fees and commissions as well as continued margin pressure extending across all segments of their operations.

Financial Markets

Financial markets performance was mixed however in aggregate increased across the majors by 16.2 percent in 2015 to $4.9 billion. The key drivers behind the majors' results were reported as favourable market conditions, low Australian dollar and improved sales and trading performance. This was however reported as being offset by unfavourable movements on economic hedges, offset in interest income.

CAPITAL

Following APRA's response to the FSI, all of the majors have continued to rebalance their respective balance sheets. Capital remains a key point of focus, not only in ensuring the banks are appropriately protected against a future downturn but also as a tool to level the competitive playing field. In 2H15, a key theme has been capital raising initiatives to comply with APRA's revised guidelines increasing the capital requirements for Australian residential mortgage exposures expected to become effective from 1 July 2016. As a result, Common Equity Tier 1 ("CET1") capital ratios have increased, in aggregate, across the majors, which in turn continues to place downward pressure on ROE.

Increasing capital is a constant theme, as the majors are focused on meeting the regulatory requirements, the strength of their capital base and striking a sensible balance between capital adequacy and the efficient deployment of capital. The active management of capital is evident in the aggregate common equity tier 1 capital (CET1) ratio increasing 68 basis points to 9.6 percent.

The FSI Final Report, which was finalised in December 2014, contained a number of recommendations to improve financial system resilience as follows:

- setting Australian bank capital ratios targets that are 'unquestionably strong' and in the top quartile of internationally active banks; and
- reducing the cost of failure, including by ensuring Australian ADI's maintain sufficient loss absorbing and recapitalisation capacity to allow effective resolution with limited risk to taxpayer funds.

APRA responded to the report in July 2015 confirming the FSI observation that the majors, though on an international comparison basis being well placed, are not placed in the top quartile of their international peers. As a result, APRA has moved to impose higher capital requirements for Australian residential mortgages from 1 July 2016, increasing the average risk weighting for mortgage portfolios to at least 25 percent.

In response to the revised regulations, a number of initiatives were undertaken by all of the majors to increase its capital. NAB raised $5.4 billion through a rights issue during the year and increased its CET 1 capital by dividend reinvestment plan (DRP). ANZ raised $4.3 billion of new equity primarily through Institutional Placement and Retail Share Placement and DRP during FY2015.

WBC increased capital through a DRP offering at the half year end and has announced an additional equity raising of $3.5 billion through a share entitlement offer post year-end. CBA on the other hand boosted its capital by $5 billion through a rights issue.

Apart from the July 2015 announcements, APRA has not made any determination on the other key recommendations. Therefore, the final outcomes from the FSI, including any impacts and the timing of these impacts on the majors remain uncertain. Once the uncertainty subsides, the majors will need to set appropriate capital targets to ensure compliance and satisfy investor expectations for return on equity.

> Maintaining a return on equity well above the cost of capital will become increasingly difficult as APRA responds to Basel 4 and the recommendations of FSI, raising bank capital even further

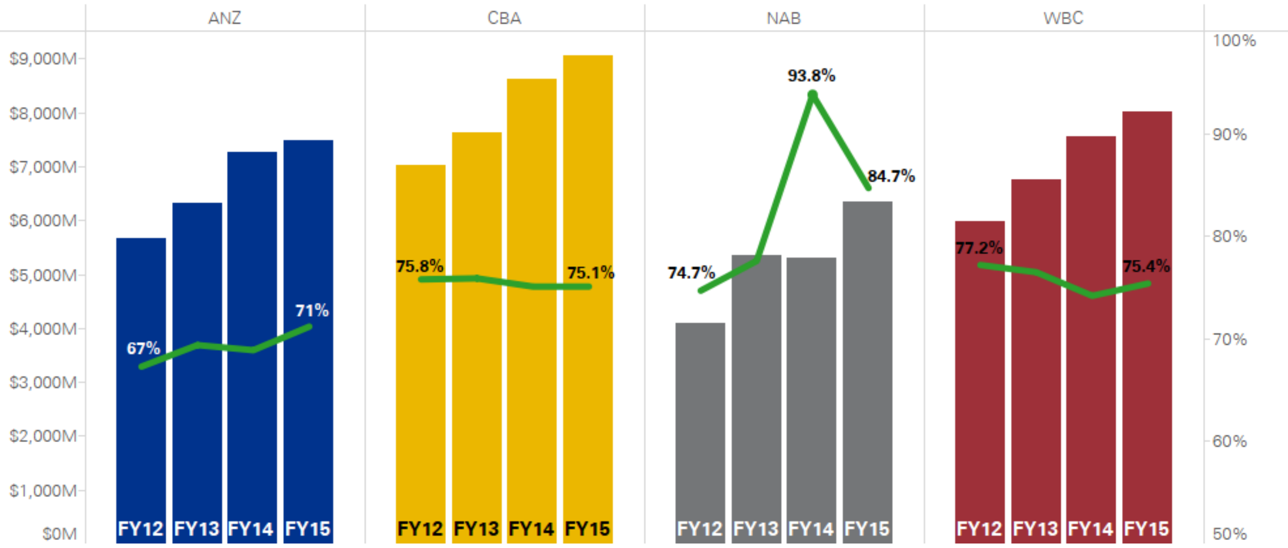
	ANZ		CBA		NAB		WBC	
	FY 15	FY 14	FY 15	FY 14	FY 15	FY 14	FY 15	FY 14
Common Equity tier 1 ratio	9.6	8.8	9.1	9.3	10.2	8.6	9.5	9
Tier 1 capital (total)	11.3	10.7	11.2	11.1	12.4	10.8	11.4	10.6
Tier 2	2	2	1.5	0.9	1.7	1.4	1.9	1.7
Total regulatory capital ratio	13.3	12.7	12.7	12	14.2	12.2	13.3	12.3
Tier 1 Capital ($ billion)	45.5	38.6	41.1	37.6	49.7	39.8	40.8	35.0
Total Capital ($ billion)	53.4	45.7	46.8	40.5	56.6	44.7	47.5	40.7
Risk weighted assets ($ billion)	401.9	361.5	368.7	337.7	399.8	367.7	358.6	331.4
Credit risk weighted assets ($ billion)	349.8	308.9	319.2	289.1	344.3	318.4	310.3	281.5

Dividends

In-spite of majors increasing capital in response to the change in regulations as discussed above, ANZ, CBA and WBC announced an increase in dividend per share of 3 cents, 19 cents and 5 cents respectively in FY2015 compared to FY2014. NAB, however, held their dividend unchanged at 198 cents per share.

Despite the increase, the average payout ratio decreased during the year by 140 basis points to 76.6 percent in comparison to 78 percent in FY2014. This decrease reflects the pressure faced by the majors as a result of increased capital requirements and a local and global challenging economic environment.

Profit against dividend payout ratio



FUNDING AND LIQUIDITY

Average funding costs continue to improve across all of the majors, primarily on account of lower wholesale funding and easing in competition for customer deposits leading to more favourable pricing. However, we expect subdued economic conditions, increased competition and regulatory pressure to have a negative impact on the majors funding cost going forward.

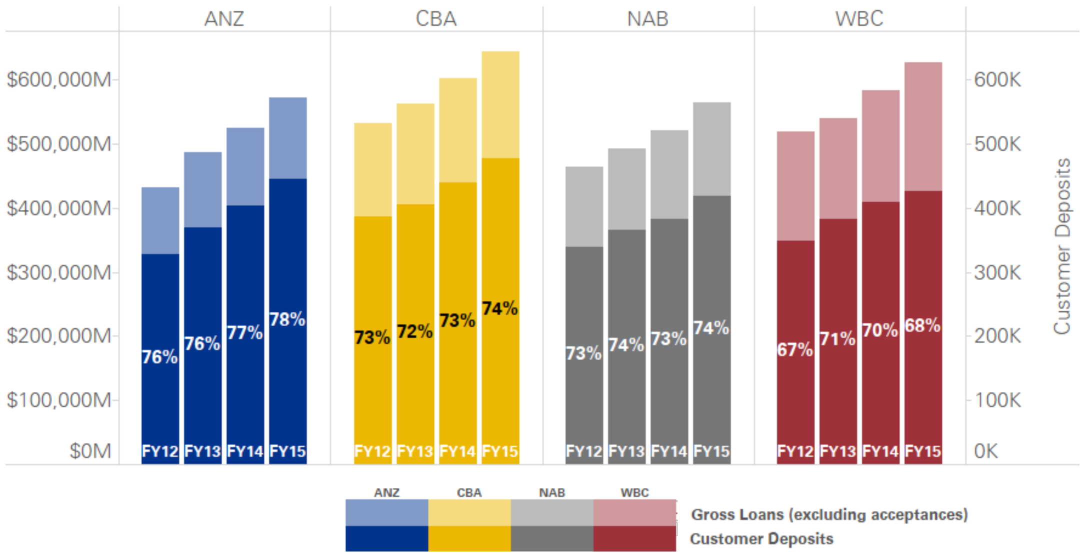
Average funding costs improved across the majors during FY2015. The majors have each benefited from an improvement in wholesale term funding markets and favourable deposit pricing.

With the customer deposit centric funding profile of the majors, duration matching of funding sources against lending assets and the need for high quality liquid assets to balance short-term customer deposits funding remains a key focus.

All of the majors continue to fund a large portion of their loan books with customer deposits as each of them reported a relatively stable funding ratio compared to FY2014. They are focused on maintaining an appropriate balance of customer deposits as a percentage of total gross loans which averaged 76.2 percent across the majors (2014: 75.8 percent). This has been aided through the easing in competition from second tier banks for customer deposits in comparison to the levels seen in recent years.

Consistent with an increase in lending assets during FY2015, the majors have each reported modest growth in deposit funding led by ANZ 10.1 percent to $445 billion, CBA 8.9 percent to $478 billion, NAB 9.4 percent to $419 billion and WBC 4.4 percent to $427 billion.

Customer deposits proportionate to total gross loans



Liquid assets

All of the majors complied with the requirements of Basel III Liquidity Coverage Ratio which had a deadline of 1 January 2015 by having higher quality liquid asset (HQLA1). The cost of compliance and holding of lower yielding, higher quality assets, is a key contributor to tightening of NIM observed across the majors. Managing the return on these portfolios as well as ensuring exposures are appropriately diversified and hedged is clearly a focus and has further influenced the NIM and trading performance.

As a result of this, total liquid assets have increased by over $40 billion to $567.1 billion. The increase is primarily in HQLA1, being largely cash, government and semi-government securities.

COSTS

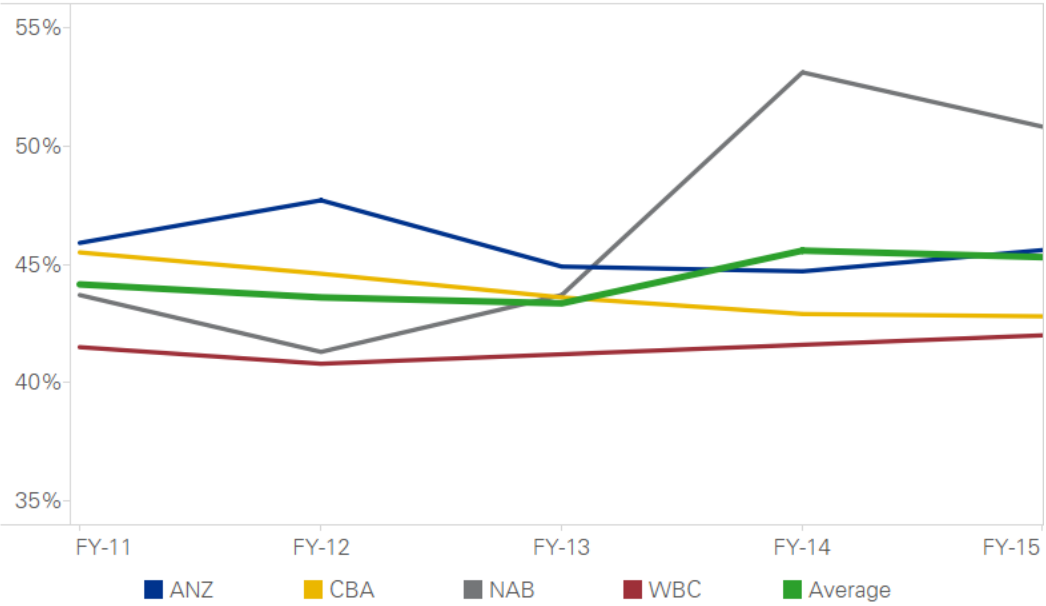
Cost discipline remains a key challenge for the majors. With continued pressure on margins impacting earnings, focus of the majors needs to be firmly on cost efficiency. This however, cannot come at the expense of investment in innovation to digitise the banks and combat the threat being posed by disruptors. The majors have already looked to ease pressure on margin through increasing interest rates. However, this balance between shareholder and customer interests needs to be carefully managed to ensure disruptors are not further emboldened to target the majors' traditional business models. We expect expense management to remain challenging as the majors continue to invest in technology platforms and prepare for industry initiatives such as the New Payments Platform.

ANZ and WBC both have reported an increase in cost-to-income ("CTI") while CBA, when normalised for significant events, was flat. NAB's CTI improved year-on-year largely a result of the provision raised relating for the legacy UK conduct risk matter in FY2014.

Overall, while operating expenses have increased across the board, relative to the higher operating income base, the management of competing priorities and cost demands across each business appear to be managed well. The average CTI ratio decreased across the majors by 28 basis points to an average of 45.3 percent. Excluding NAB though, CTI has increased across the majors by 40 basis points to an average of 43.5 percent.

The tension in the market between competing priorities for investment continue to be reflected in operating expenses. Spend on personnel, IT related and other project related costs such as regulatory and compliance programs have increased across all majors during the year. Significant spend on risk and compliance projects has continued as systems are implemented to assist in satisfying new regulatory obligations, including Stronger Super, Future of Financial Advice (FOFA) reforms, and the Foreign Account Tax Compliance Act (FATCA). Other factors such as inflationary influences and the lower Australian dollar have further increased the overall operating expense recorded by the banks.

Cost to income



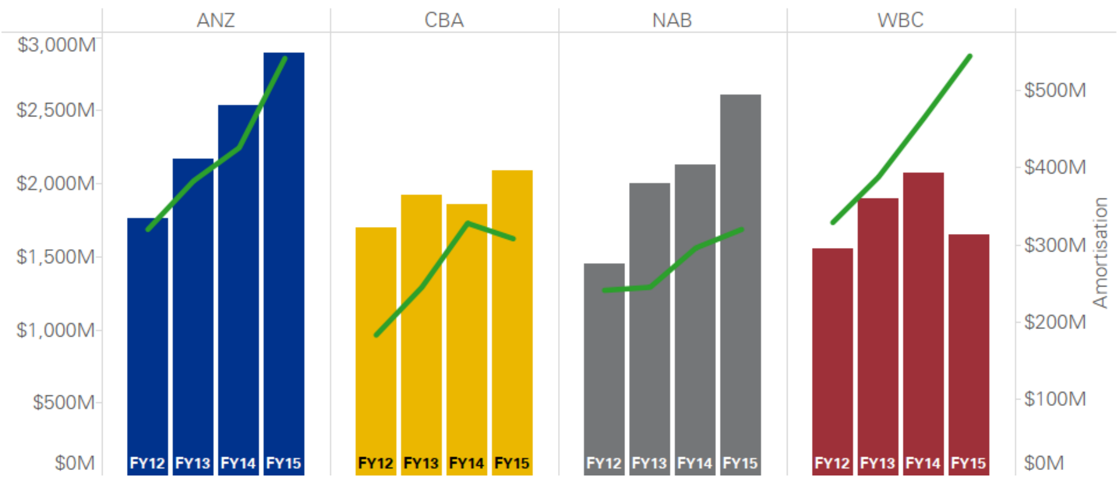
> Longer term, we see customer behaviour and competitive dynamics continuing to rapidly evolve, driven by demographic changes, the digital revolution and the rise of fintech competition, presenting both threats and opportunities for the major banks

IT costs and capitalised software

The majors continue to invest heavy in technology to drive strategic initiatives over the medium to long term, with each reporting ongoing projects linked to the enablement of more efficient capability in processing and digital distribution, as well as in the delivery of compliance with regulatory change programs.

With investment of $2.8 billion (cash basis) for the 2015 full year, the majors reported combined total technology assets of $9.2 billion. While recognising the importance of system and digital capability, the weight of the balance sheet position continues to drag on earnings through amortisation charges. Capitalised software amortisation and related IT impairment charges increased by 13.2 percent to a combined total expense of $1.7 billion for the 2015 year. This reflects the fast pace of digital transformation and continues to challenge the traditional ways of banking. This investment needs to be maintained with emerging start-ups putting pressures on the majors with powerful, advanced and cost-effective alternatives to traditional banking.

Capitalised software



Personnel

Staff numbers have increased in 2015 across the majors by 0.4 percent to 173,167 FTE globally.

The increase in headcount and inflationary influence has led total personnel related costs to increase by 5.1 percent to $20.6 billion, largely driven by local FTE. The lower Australia dollar had a further negative impact on the cost base for those banks with significant foreign operations.

RETURN ON EQUITY

With a challenging local and global economic environment, coupled with increased regulatory requirements for Australian residential mortgages (requiring majors to hold higher levels of capital), sustaining the current level of returns is proving to be a challenge for the majors.

Overall, cash return on equity ("ROE") across the majors was down by 52 basis points to 15.0 percent. With the exception of NAB, which reported an increase of 40 basis points to 12.0 percent, a decline in cash ROE was noted across all the other majors.

ANZ reported a decrease in cash return on equity of 140 basis points to 14.0 percent. While record profits were reported by ANZ, ROE was impacted by equity raising in FY2015, including $3.2 billion in response to APRA's increased capital required for residential mortgages from July 2016. Similarly, equity raisings carried out by CBA and WBC appears to have impacted cash ROE, however due to stronger underlying cash earnings growth, ROE was relatively more stable, with CBA down 50 basis points to 18.2 percent and WBC down 57 basis points to 15.8 percent.

The following key themes were noted across the majors, which restricted the level of cash return on equity in FY15:

- Increased regulatory capital requirements by APRA in response to FSI recommendations effective from 1 July 2016 resulting in majors introducing initiatives to increase capital;
- Competitive market environment and tightening of margins across all business segments although all of the majors have decided to increase the mortgage rates independent of the RBA recently; and
- Higher operating costs, with particular mention of personnel related costs and IT amortisation. Strict cost control measures and disciplined lending processes have managed to offset this decline partially. However, it was noted that only NAB and CBA reported positive jaws on its cost-to-income ratio in FY2015.

In order to enhance their level of agility, the majors will need to intensify their efforts to simplify, standardise and automate their operating models, as well as preserve optionality in their strategies in order to capitalise on opportunities as they arise ”

While the Australian majors' performance in a global context continues to be strong, highlighting the comparative strength of the Australian banking system, we expect the sustainability of current ROEs to be a challenge.

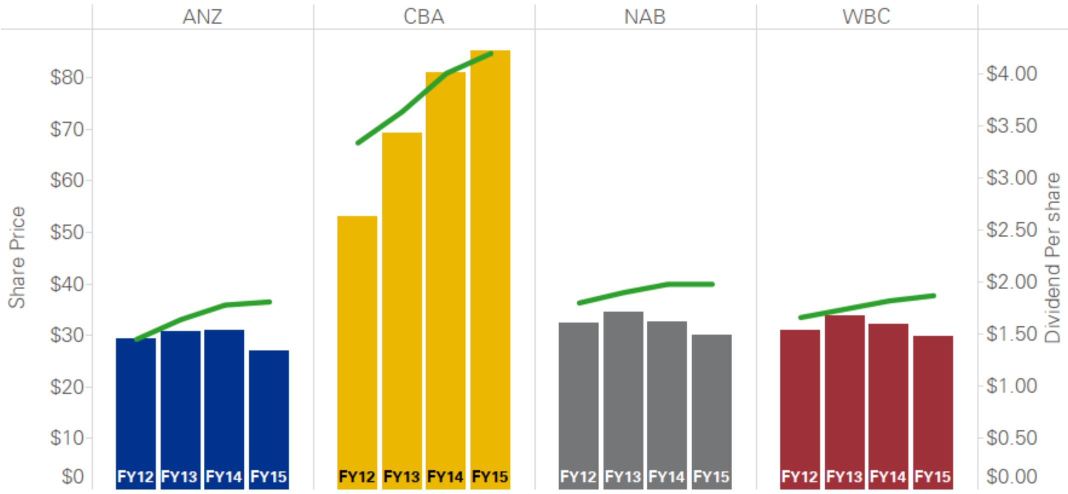
Return on equity – global comparison

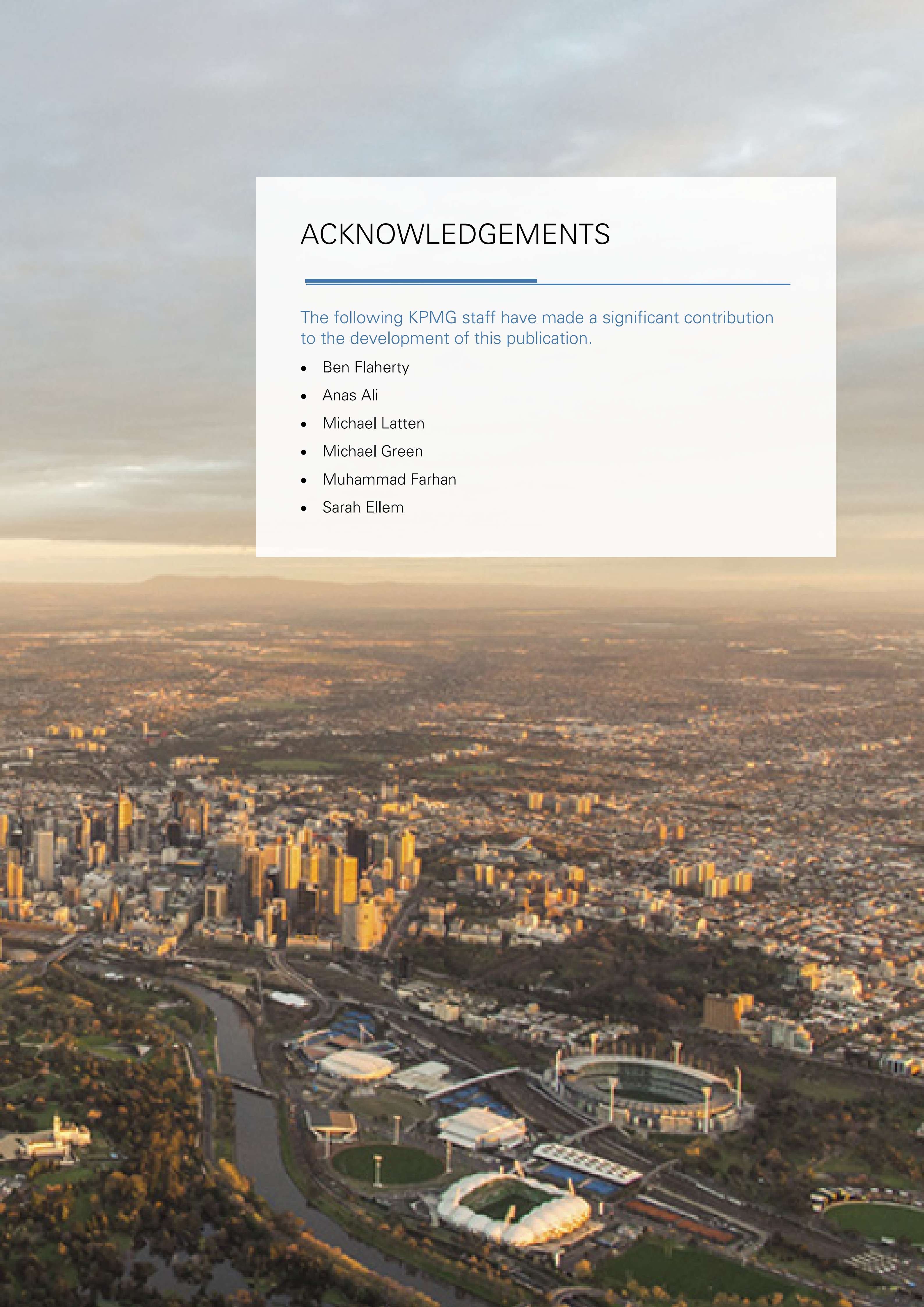
Share price performance

The share prices of all of the majors decreased following global uncertainty and falling commodity prices which resulted in reduced investor confidence affecting ASX heavily in the later part of the year.

While CBA's share price increased by 5.3 percent during the year to 30 June 2015 closing at $85.13, their share price decreased to $76.85 during the period to 2 November 2015. ANZ, NAB and WBC all reported a decline in their share price during the financial year ended 30 September 2015. ANZ declined 12.4 percent to $27.08 at 30 September before improving to $27.16 at 2 November 2015. NAB declined 7.9 percent to $29.98 at 30 September before improving to $30.10 at 2 November 2015. WBC declined 7.6 percent to $29.70 before improving to open at $31.33 on 2 November 2015.

Share price against dividend





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NOTES

NOTES

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