



Major Australian Banks

Full Year 2016 Results Analysis

kpmg.com/au/majorbanks

November 2016

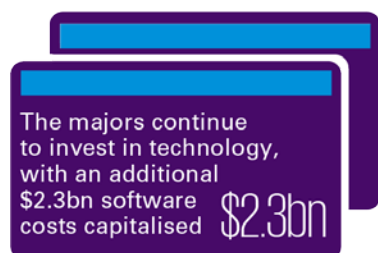
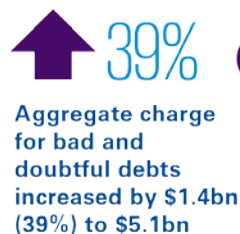
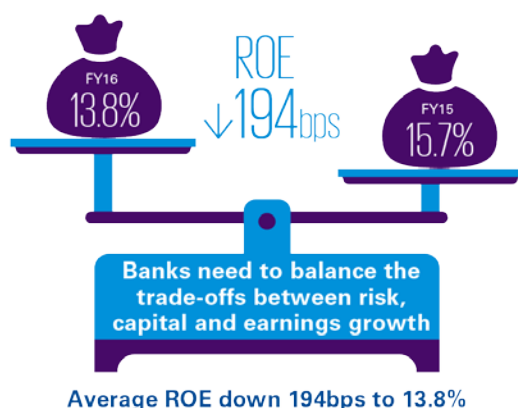




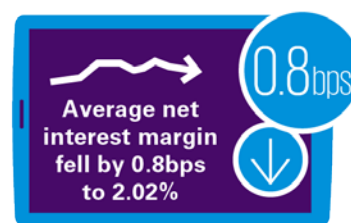
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Full year 2016 results snapshot



Cash profit after tax decreased by 2.5% from FY15 to \$29.6bn



Average CET1 capital ratio up by 28bps to 9.9% of risk weighted assets



Ability to identify cost take-out opportunities without compromising revenue growth prospects will be critical

Slowing balance sheet momentum



Average cost to income ratio increased by 116bps to 44.1%

At a glance

	ANZ		CBA ¹		NAB		WBC	
	FY16	FY15	FY16	FY15	FY16	FY15	FY16	FY15
Ranking								
By profit before tax	4	3	1	1	3	4	2	2
By total assets	2	2	1	3	4	1	3	4
By total equity	3	1	1	4	4	2	2	3
By market capitalisation	3	3	1	1	4	4	2	2
By CET 1 capital ratio	3	2	1	4	2	1	4	3
Financial Performance								
Profit before tax from continuing operations (\$ million) – statutory basis	8,178	10,533	12,854	12,612	8,978	9,515	10,644	11,416
Profit after tax (\$ million) – statutory basis ²	5,709	7,493	9,227	9,063	352	6,338	7,445	8,012
Cash profit after tax (\$ million)	5,889	7,216	9,450	9,137	6,483	6,222	7,822	7,820
Performance Measures								
Net interest margin – cash basis (basis points)	200	204	207	209	188	190	213	208
Cost to income ratio – cash basis (%)	50.6	45.7	42.4	42.8	41.4	41.2	42.0	42.0
Basic earnings per share – statutory basis (cents)	197.4	271.5	542.5	553.7	8.8	252.7	224.6	255.0
Basic earnings per share – cash basis (cents)	202.6	260.3	555.1	557.5	245.1	249.0	235.5	248.2
Return on average equity (%) – cash basis	10.3	14.0	16.5	18.2	14.3	14.8	14.0	15.8
Credit Quality Measures								
Impairment charge (\$ million) – cash basis	1,956.0	1,205.0	1,256.0	988.0	800.0	748.0	1,124.0	753.0
Impaired loans to loans and advances to customers (%)	0.55	0.47	0.44	0.44	0.49	0.28	0.32	0.30
Collective provision to credit RWA (%) ³	0.82	0.85	0.82	0.87	0.85	0.99	0.76	0.86
Financial Position								
Total assets (\$ million)	914,869	889,900	933,078	873,446	777,622	955,052	839,202	812,156
Total equity (\$ million)	57,927	57,353	60,756	52,993	51,315	55,513	58,181	53,915
Capital Measures								
Capital Adequacy Ratios (%) ⁴								
- Total	14.3	13.3	14.3	12.7	14.1	14.2	13.1	13.3
- Tier 1	11.8	11.3	12.3	11.2	12.2	12.4	11.2	11.4
- Common Equity Tier 1	9.6	9.6	10.6	9.1	9.8	10.2	9.5	9.5
Market capitalisation (\$ billion) ⁵	80.9	78.6	127.3	138.2	73.8	74.1	98.7	94.0

Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

¹ CBA reported as at 30 June 2016. All other majors as at 30 September 2016.

² Profit after tax attributable to the owners of the bank (on a statutory basis). Statutory profit after tax for NAB has decreased to \$352 million in FY16, due to discontinued operations of CYBG Group and NAB Wealth's life insurance business.

³ Included in the NAB collective provision to credit Risk Weighted Asset percentage is a collective provision relating to loans held at fair value. This collective provision is held against the carrying value of other financial assets at fair value.

⁴ As disclosed in the results announcements (per APRA Basel III interpretation) of the banks.

⁵ Market capitalisation sourced from the ASX.

Executive summary

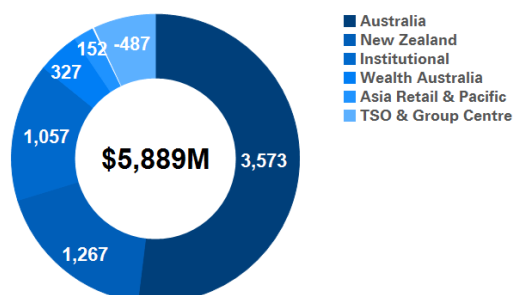
The 2016 financial year results of the Australian major banks (the majors) highlight that record earnings growth seen in recent years is slowing, reflecting the impact of increased regulatory capital requirements and a subdued domestic economy. Margins have continued to decrease across the majors despite asset repricing and increased funding from customer deposits, emphasising the challenges of the current low-interest rate and competitive environment. As the economic outlook remains challenging, the majors will continue to focus on capital efficiency, productivity and further refinement of their business models.

Persistently challenging market conditions, rising regulatory capital, increasing loan impairments and margin compression are all combining to put downward pressure on industry returns

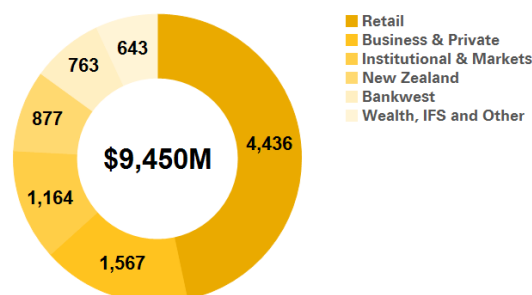
Collectively, the majors reported a cash profit after tax of \$29.6 billion for the 2016 financial year (FY16), down 2.5 percent in 2015 financial year (FY15). The decline in cash earnings is due to decreases in net interest margins, flatter non-interest income, increases in loan impairment charges and higher operating costs. These factors are also evident in the decline in statutory net profit from continued operations⁶ of \$2.6 billion to \$28.8 billion.

Diagram 1. Cash profit after tax by segments

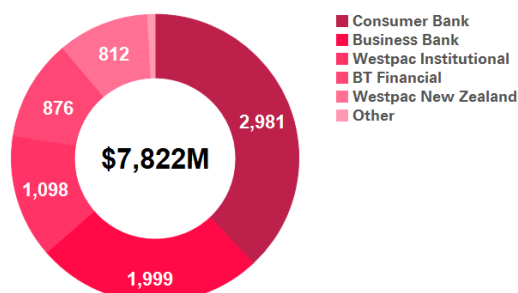
ANZ



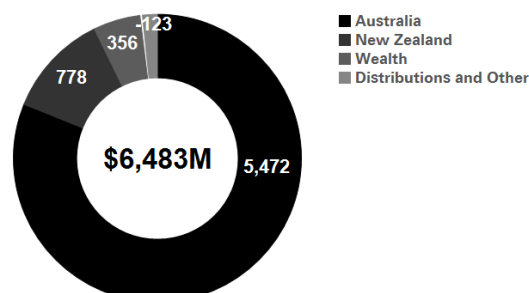
CBA



WBC



NAB

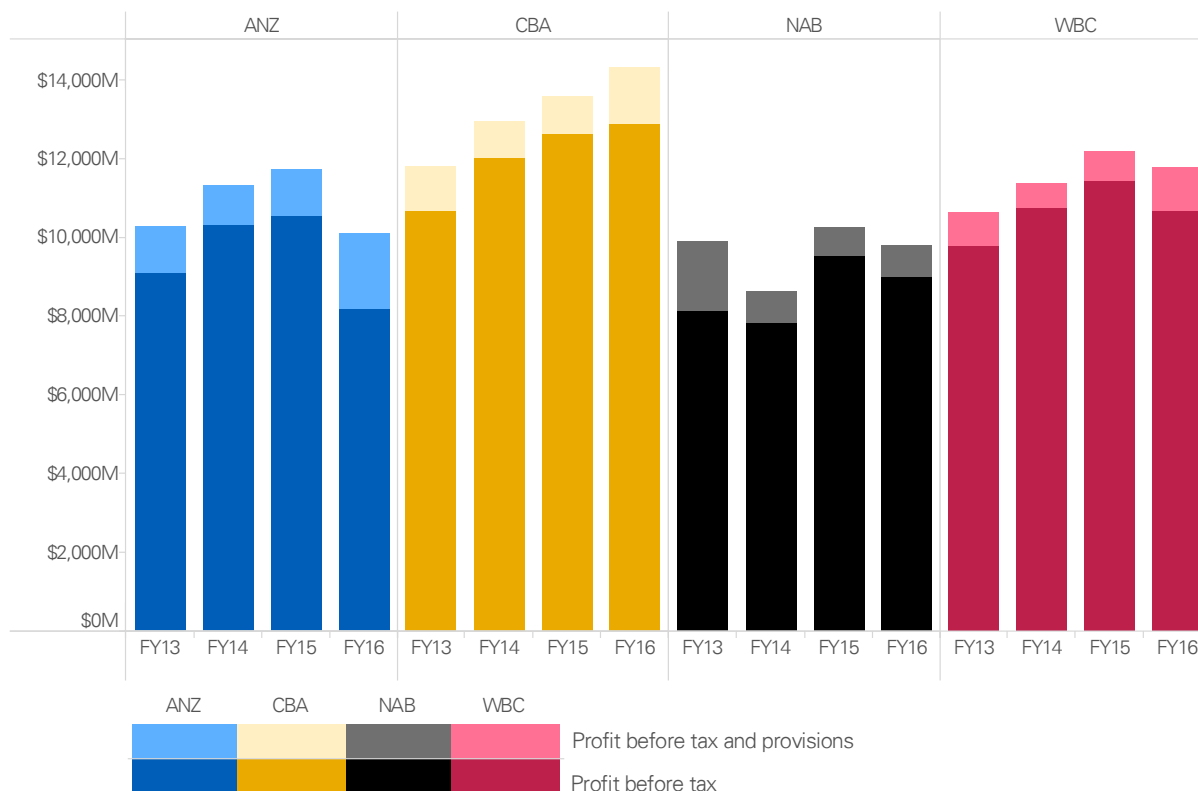


Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

⁶ This excludes NAB's discontinued operations (the demerger of CYBG and sale of its life insurance business to Nippon Life).

Average Return on Equity (ROE) for the majors has decreased from 15.7 percent to 13.8 percent from the previous financial year. The majors' returns, faced with greater competition, increasing levels of regulatory capital and a subdued Australian macro-economic outlook, are likely to see downward pressure continue.

Diagram 2. Profit before tax and provisions vs operating profit before tax (statutory basis)



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

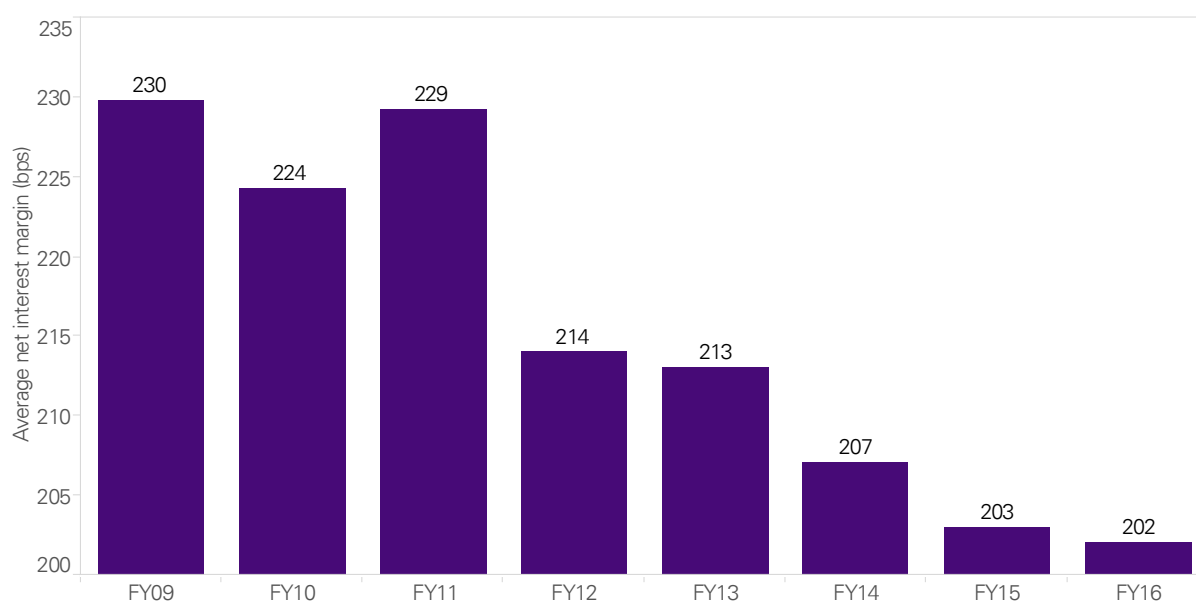
Key features of the combined result for FY16 include:

- Decrease in net interest margin (cash basis), down 0.8 bps to 202.0 bps from FY15 (202.8 bps);
- Average ROE across the majors on a cash basis declined by 193.8 bps to 13.8 percent;
- Increasing loan impairment charges, up by \$1,442 million across the majors to \$5.1 billion;
- Loan impairment charge as a percent of gross loans up 4.3 bps to 20.5 bps across the majors, indicating some deterioration in credit quality;
- Non-interest income decline of 3.1 percent to \$23.5 billion impacted by divestments of non-core businesses and stagnant growth in wealth management and insurance income; and
- Increases in the average cost to income ratio by 115.8 bps to 44.1 percent largely driven by greater ongoing regulatory compliance costs, amortisation of capitalised software and flatter revenue.

Continued net interest margin pressure

Net interest margin has tightened further during FY16. As illustrated below, margin performance has been under constant pressure since the Global Financial Crisis (GFC). This has further accelerated due to falling interest rates, changes to prudential requirements requiring holdings of lower yielding high quality liquid assets, higher wholesale funding costs and strong levels of competition over retail deposits, restricting the majors' ability to recoup through customer pricing.

Diagram 3. Average net interest margin



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Stronger capital, declining return on equity

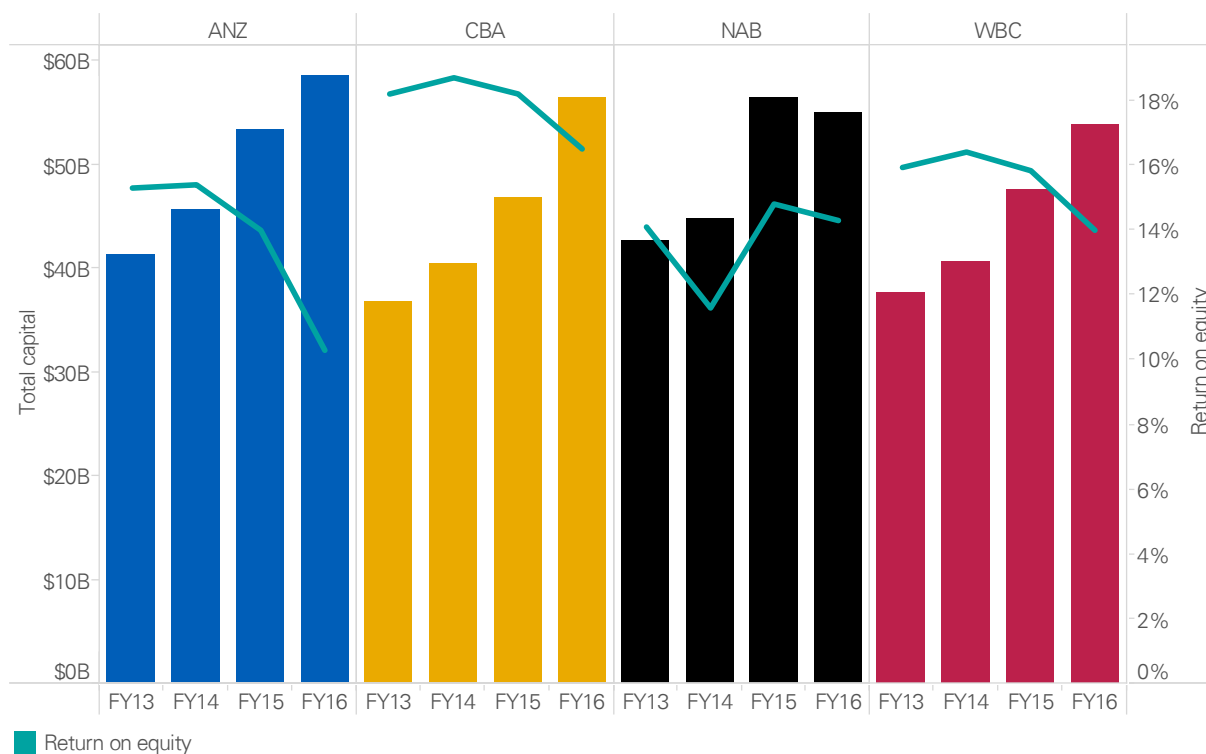
During FY16, each of the majors have continued to respond to APRA's new regulatory capital and liquidity requirements of the Australian Prudential Regulatory Authority (APRA). The need for 'unquestionable' strength as indicated by the Financial Systems Inquiry (FSI) in 2015 has lead the majors to restructure their balance sheets and shore up regulatory capital levels to enhance their resilience to future economic or market shocks.

This has driven the majors to raise \$8.6 billion in equity since FY15 to satisfy regulatory pressures arising from the FSI. As a result, the average Common Equity Tier 1 (CET1) capital ratio increased by 27.5 bps to 9.9 percent of risk-weighted assets (RWAs) reflecting the stronger capital position. However, these capital initiatives have directly placed downward pressure on the majors' ROEs.

Additionally, the majors have reported a move away from increasing total dividends. Each have indicated relatively flat dividend payments and a move to consolidate to historical payout ratios to reflect ongoing demands for capital arising from increased regulatory requirements.

In combination with the future requirements of Basel 4, the Net Stable Funding Ratio (NSFR) and Leverage Ratio, it has been increasingly difficult for the majors to maintain and/or increase their current levels of ROE and high dividend payout ratios.

Diagram 4. Total capital vs return on equity



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Outlook

The challenging outlook for the majors is set to continue driven by weak revenue growth, margin erosion, increased impairment charges, higher regulatory and capital and liquidity charges, all combining to place downward pressure on ROEs and Earnings Per Share (EPS). As a result, the majors' ability to identify cost take-out opportunities that can be realised in the short-to-medium term, without compromising revenue growth prospects will be critical. Importantly, these efficiency efforts are needed to create the financial capacity to invest in their customer and digital agendas.

Looking ahead, it is inevitable that the majors will continue to refine their business models, being much more selective on which markets, products and customer segments to serve and those they may seek to pursue with a different approach and/or exit altogether. Effectively balancing the trade-offs between risk, capital and earnings growth will dictate future performance.

Greater public scrutiny of banks: the new reality

Michael Rowland, Partner, Management Consulting, Financial Services

There is an increasing global perception that banks put shareholders' and executives' interests ahead of their customers and the community. This perception is more real for banks than for other corporates as they are seen to rely not only on compliance with strict regulation, but increasingly on the goodwill of the community and government to continue to operate in their current form.

We are seeing heightened scrutiny of Australian banks, including through the recent Standing Committee on Economics (the Committee) inquiry, becoming a regular feature of media and political commentary, notwithstanding eight separate inquiries since 2009.

There are many reasons for this increased level of oversight, with terms such as "trust deficit" and "trust gap" often cited as the root cause.

It has been argued that the financial services industry has lost touch with the core proposition customers are seeking by forgetting its real purpose in society and becoming too inwardly focussed. These themes were repeated in testimony to the Committee.

APRA authorises deposit-taking institutions to carry on banking business in Australia under the Banking Act. APRA outlines minimum criteria to operate in Australia with specific capital, risk management and compliance conditions and overarching integrity and prudence requirements. There is another licence that is equally as important – the social licence to operate granted by the community and earned through hard won trust and respect. This comes with ongoing expectations around behaviour and fairness, more than regulatory compliance. These later licence conditions evolved at a time when there were much different expectations on banks.

This social licence has come under fire from commentators due to banks' perceived inability to fairly deal with customers and the broader community; whether through inadequate compensation for poor advice; protracted resolution (or avoidance) of claims; aggressive sales practices; excessive executive pay; or high profits and returns.

Fairness has been described in various ways, from measures of customer satisfaction, to levels of fees and charges, to the way banks respond internally and externally to the resolution of customer problems.

However fairness is defined, banks have not adequately demonstrated how they balance the needs of customers and the community with the critical role they play in the economy. They have been seen to defend the status quo, which in some quarters has been perceived as protecting executive remuneration, high fees and interest rates.

This has been compounded by the tendency to adopt “business-speak”, which works well in management circles, but comes across as sneaky to politicians, the media and the public. It comes at a time when big business in general is portrayed as self-interested and not attuned to the needs of employees and the broader community.

Strong banks matter a lot to Australia. Every business and every citizen. And at the moment no one is making this point successfully.

Nor can the industry rely on the current Federal Government to run interference. The Government has put the industry on notice that the onus is on them to explain their actions and motives. As Jennifer Hewitt of the Australian Financial Review recently wrote, “The newly required level of self-defence from the banks includes their interest rate policies but also extends to their profits, their executive pay levels and the whole banking culture now attracting so much opprobrium.”

The emerging reality is that a thorough disclosure of the culture, conduct, standards and social licence of the banks is one the banks should embrace. Failure to do so could be catastrophic for the industry and the Australian economy.

And let’s not forget Australian banks largely avoided the GFC through strong balance sheets, conservative lending policies and a smarter collaborative approach to working well with government and regulators throughout the crisis.

Our banks were, and remain, a lot better managed than international peers.

John McFarlane, Chairman of Barclays PLC recently summed up the situation well: “We must return to the philosophy that banking is a profession as well as a business, and that contribution rather than reward is its centre of gravity. A company needs to make a return but it must also stand for something beyond this. It needs a higher purpose that is the centre of gravity that governs all decisions within the firm.”

McFarlane adds that banks “need to take the actions necessary to earn long-term trust and commitment as a foundation for long-term value creation”.

Unfortunately the reporting of unethical and legal wrong-doing has created the perception that the banks have prioritised short-term financial performance over fair returns and contribution.

To change this situation, Australian banks must take a different approach to earn the trust of the community. They must become more open to criticism and eager to respond and better explain their actions on sensitive issues.

They need to simply and clearly outline their importance to the broader economic well-being of Australia and Australians, and show that without this robust contribution, Australia will be worse for it. The banks employ over 130,000 Australians and pay significant amounts of tax; the banks’ high yielding shares are the foundation of our superannuation system; banks facilitate our foreign trade and investment; and as is often forgotten, the settlement of our daily banking transactions.

This is not to say that the Australian banks are not aware of these problems as we have seen in their presentations to the Committee. The banks need to demonstrate tangible and greater empathy with community concerns and provide real evidence that they have a clear purpose and principles-based operating model, in a way that is easily understood and accepted.

Net interest income

Net interest income increased 5.5 percent to \$60.3 billion (aggregate) driven by continued lending asset growth. However, declining net interest margins across the majors has impacted the profitability of this growth, with competitive front-book pricing for deposits and lending assets combined with the challenging low interest rate environment keeping downward pressure on margins. Low revenue growth and higher funding costs, despite benefits still being realised from repricing, resulted in average net interest margin decreasing 0.8 bps to 2.0 percent.

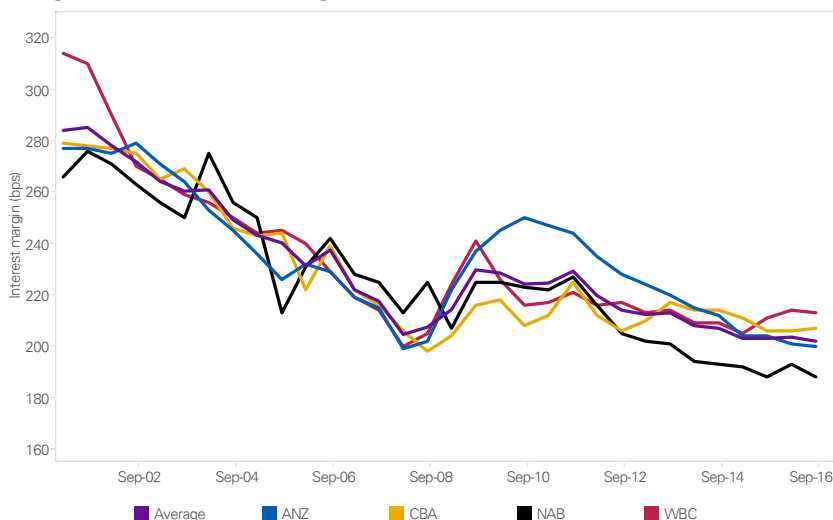
The majors have found it increasingly difficult to preserve their margins through mortgage re-pricing, offset by higher wholesale funding costs, holdings of liquid assets and a falling interest rate environment

Net interest margin

Amidst a low (and falling) interest rate environment and increasing regulatory requirements, active efforts continue across the majors, in an attempt to limit the continued contraction in net interest margins. The Reserve Bank of Australia (RBA) further eased the cash rate by 50 bps to 1.5 percent during the year, due to weak inflation and continued negative impact from the mining downturn and the transition to a services-led economy. Historically low interest rates continue to restrict the pricing initiatives of the majors, placing a drag on interest earning assets.

Yield on lending and liquidity assets continues to tighten due to the intense competition on front-book lending asset pricing across lending segments, particularly residential mortgages. Additionally, regulatory requirements have also led to greater holdings of liquid but lower yield assets which has placed further pressure on net interest margins. This is reflected by the average 0.8 bps decline.

Diagram 5. Interest margins



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

With relatively weak demand for credit, the majors recorded more modest levels of lending growth, which has enabled them to meet a large proportion of their funding requirements from customer deposits



Increased costs of wholesale funding have incentivised banks to aggressively compete for retail deposits in FY16. This follows a period of easing in competition as the majors' strengthened their funding base. However, the increased demand for retail deposits is, in part, driven by the majors' need to comply with the NSFR in January 2018. As such, higher funding costs will continue to be a headwind on margins as the banks reflect the need to lengthen funding duration ahead of the new regulatory requirements.

Westpac was the only major to report an increase in net interest margin, up 5 bps to 213 bps (cash basis). Margins excluding treasury and markets improved 3 bps, largely due to improved deposit spreads and changes in mortgage interest rates including for higher capital. Consistent with all majors, higher wholesale funding costs also impacted margins.

Cash basis	FY16	FY15	FY16 Movement
NET INTEREST INCOME (\$)			
ANZ	15,095	14,616	3%
CBA	16,935	15,827	7%
NAB	12,930	12,498	4%
WBC	15,348	14,239	8%
Aggregate	60,308	57,180	
NET INTEREST MARGIN (bps)			
ANZ	200	204	- 4 bps
CBA	207	209	- 2 bps
NAB	188	190	- 2 bps
WBC	213	208	5 bps
Average	202	203	-0.8 bps

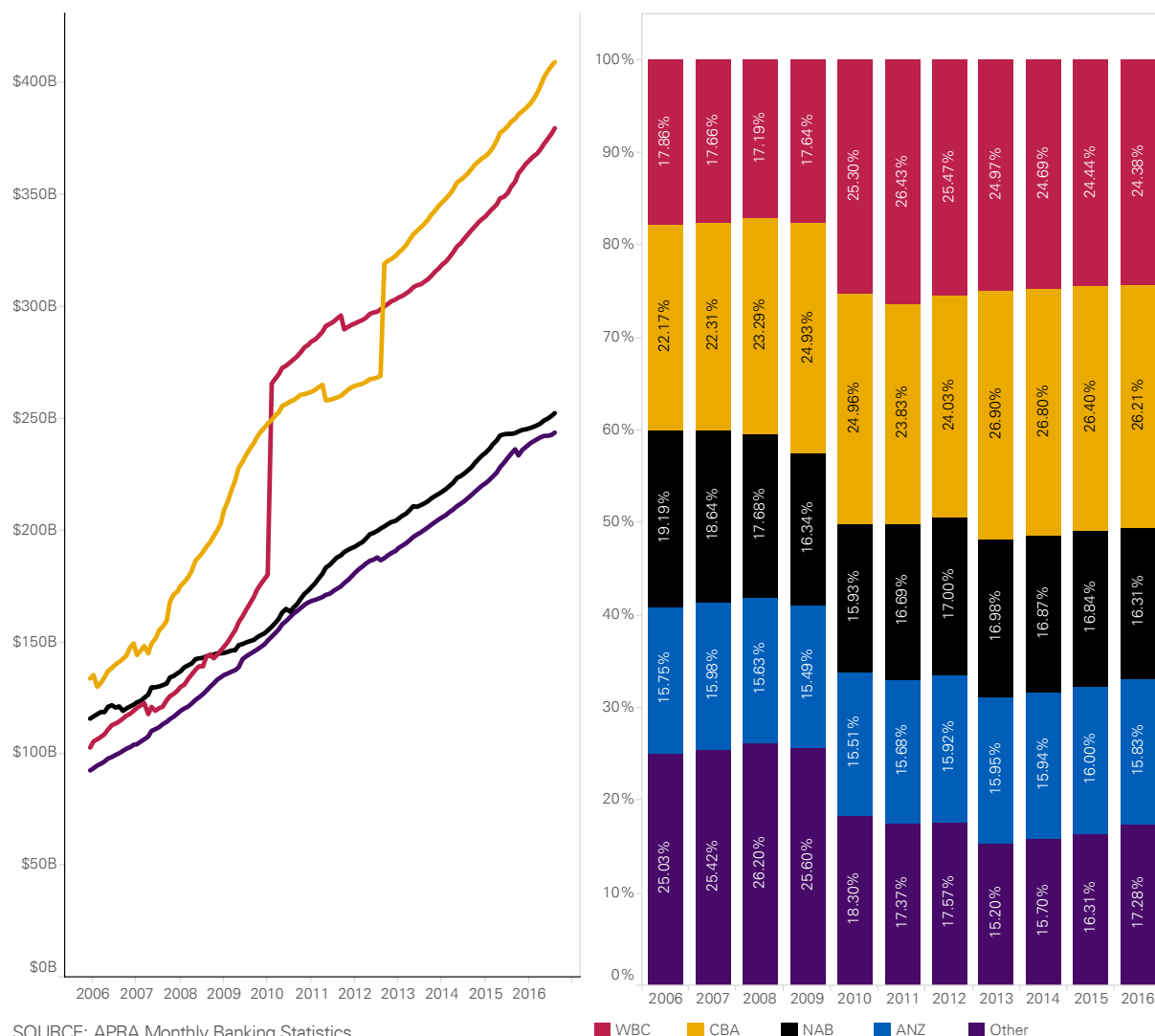
Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Lending asset growth

Average interest earning assets across the majors has continued to grow, increasing by 6.0 percent from FY15 to \$2,983 billion, positively impacting net interest income. The September APRA release⁷ highlights the progressive growth in household loans over the past few years resulting in housing credit growth of 4.2 percent to \$1,541 billion during FY16. Despite this growth, net interest margins have declined primarily as a result of low interest rates and strong competition amongst lenders.

Household lending remains core to the majors' domestic franchises. As illustrated on the following page, competition in household lending between the majors and second tier banks has continued since FY15. This has resulted in a decline in market share amongst the majors by 97 bps to 82.7 percent during FY16, continuing from the 61 bps decline from FY14 to FY15.

⁷ September APRA Monthly Banking Statistics issued on 31 October 2016.

Diagram 6. Loans to households and market share of household loans

Recently, there has been increased scrutiny over the concentration risk of the housing loan portfolios across the majors (and all authorised deposit taking institutions), especially within the inner suburbs of the major cities such as Sydney and Melbourne. However, we have seen sustained focus on debt serviceability and loan to value ratios, as well as restrictions from APRA (e.g. mandated caps), to address these risks. Continued discipline will be important for the majors to ensure that asset quality and resilience is maintained, especially if the housing market in geographically concentrated segments experience an abrupt correction, interest rates rise and/or unemployment increases dramatically.

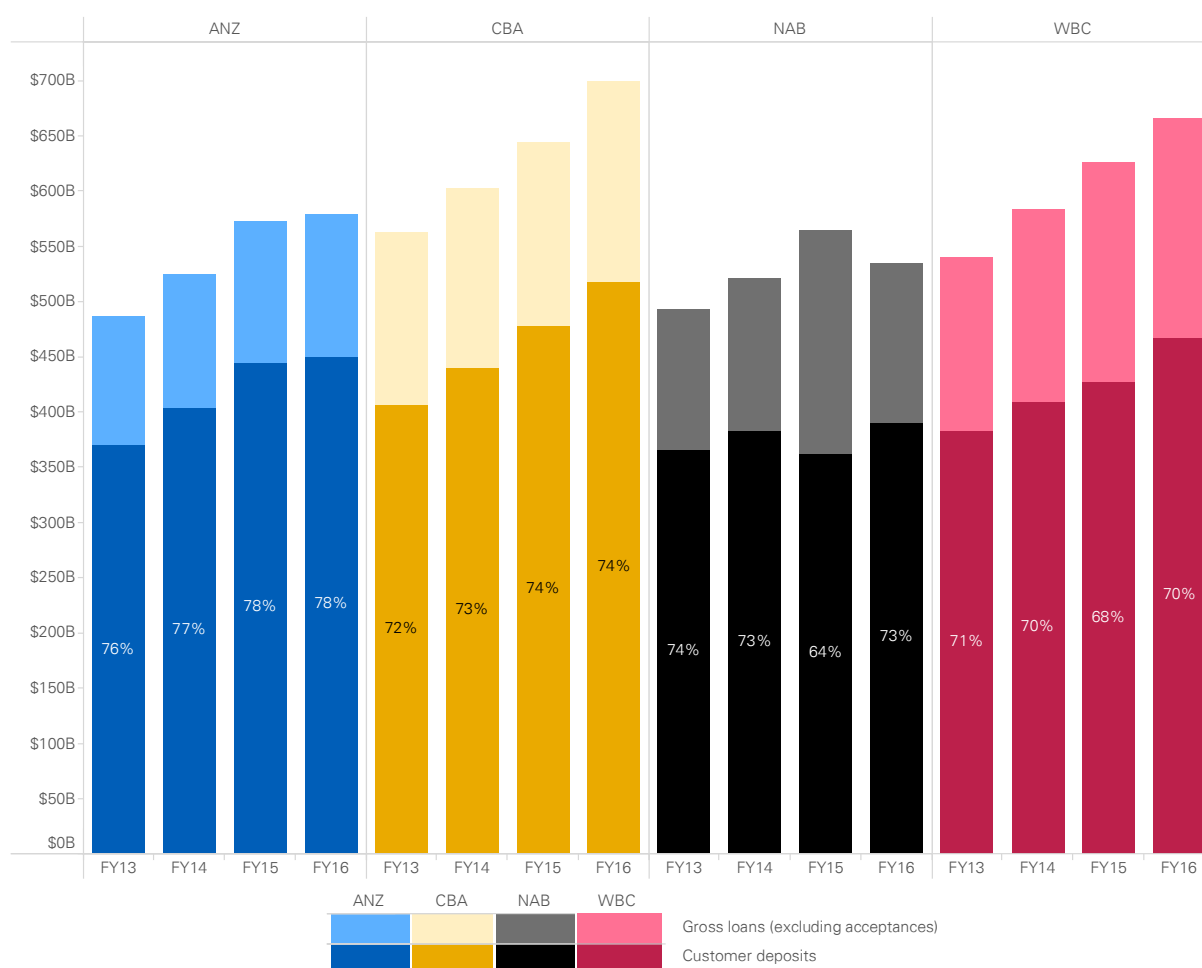
Funding mix

The majors have also seen margins reduced over the period by increases in wholesale funding costs and increased competition for deposits, reflected in an increase in the average deposit to loan book funding ratio by 254.6 bps to 73.6 percent.

Despite the improved funding ratio, the benefits from mortgage back-book repricing is being reduced by competitive pressures in Australian housing, New Zealand, and across deposits as well as loans, reducing the majors' net interest margins.

Wholesale funding costs are likely to stabilise at current rates notwithstanding any negative changes to the long term credit ratings of the majors and the Australian Commonwealth. However, if Australia's credit rating is downgraded to AA+, as indicated by Standard and Poor's recently, it is possible that the credit rating of the majors will be cut to A+, directly increasing wholesale funding costs.

Diagram 7. Customer deposits proportionate to total gross loans



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

The four ways risks must change, now

Mike Ritchie, Partner, Risk Consulting, Financial Services and
Jacinta Munro, Partner, Risk Consulting, Financial Services

As protecting an organisation from risk becomes increasingly complex and costly – yet more vital than ever – the Risk function of banks must embrace new ways of operating. Risk must get more efficient, find new ways to tackle cultural issues, embrace the power of technology, and recharge its role in leadership to add the most value to organisations.

The Risk function of a banking organisation has a critical role, but new regulations, the need for specialist capabilities, and the fast-paced, global, competitive environment are putting immense strain on the function. Risk must revolutionise itself in order to remain relevant, value-adding and on the front foot of a continually changing risk landscape.

Here are four key areas that risk functions must overhaul to ensure they are offering the best protection for banks in this increasingly disruptive world.

1. Efficiency

In the face of cost pressures and emerging risks, the Risk function must be simultaneously efficient and effective. This must take into account the capabilities of people in the team, the skills required, and how it can be more time and cost effective.

“The Risk function needs to move away from solo subject matter experts to more outcome focused risk people,” says Mike Ritchie, Partner, Risk Consulting, KPMG.

The second step is to look at processes and the operating model, with the goal of seeing how it can be refined to improve results.

“It is important that CROs embrace all the technology options that could fundamentally change and reduce the time it takes to do risk activities,” he says.

2. Culture

The Risk function must be open minded to constantly changing culture and conduct risk, and innovate to solve challenges.

“What has been done in the past is not going to keep organisations and their customers safe in the future,” says Jacinta Munro, Partner, Compliance and Conduct, KPMG.

“Expectations of customers, regulators, media and the public have changed and businesses must respond.”

Steve Clark, Director, People and Change, KPMG says that with the Australian Securities and Investment Commission's (ASIC) increased focus on banking and insurance products, risk functions will have even more reason to improve their approach to culture and conduct risk.

"More regulation could encourage firms to take a holistic approach to the customer," Clark says. "Examples in Europe show it's about establishing governance that looks at the whole cycle, so businesses can focus on assuring customer outcomes – moving away from a focus on just financial outcomes for shareholders and the firm."

3. Technology

Cognitive Computing, Robotic Process Automation, ecommerce, digital mobility, the cloud and big data are transforming organisations.

Guy Holland, Partner, Technology Advisory, KPMG, says the Risk function must be at the frontline of this technology change. It needs to engage with advanced technology to broadly and deeply assess risk. For example, big data and analytics can boost the speed, insight, accuracy and coverage of critical risk oversight functions.

"Much of the compliance, monitoring and review activities currently performed by risk staff will be replaced with cognitive and automation technologies," Holland says.

"Traditional manual verification of small sample sizes will no longer be effective. Change will be driven by the need to maintain effective risk oversight in a digital environment, and cost efficiencies will be a secondary benefit."

4. Leadership

The Risk function has long supported leadership by assessing and warning of the risks that could impact an organisation's ability to fulfil its strategy. However, it's time for risk to step forward and take a leadership role of its own.

Martin Green, Partner, Advisory, KPMG says risk teams of the future need to up skill now, and demonstrate the powerful insight that risk can offer in this disruptive environment.

"As organisations become more complex, and data influences more decision making, the need for CROs and their teams to take a strategic position is fundamental," he says. "Businesses will need people who understand the bigger picture, how to turn data into business intelligence, and how to manage risk."

Amid these pressures, the Risk function of the future needs to step up the value it adds to its organisation, demonstrating its power to confidently steer businesses into the unknown.

For more information on how risk must transform you can read more in our series of insights, *Risk Function of the Future* at kpmg.com.au

Asset quality

Continued pressure in the resources and related sectors have deteriorated asset quality, elevating the impairment charges across the majors by 39.0 percent to \$5.1 billion for FY16. As the Australian economy rebalances from the end of the resources boom, underlying consumer and business confidence remain low, and further deterioration is expected in parts of Western Australia and Queensland.

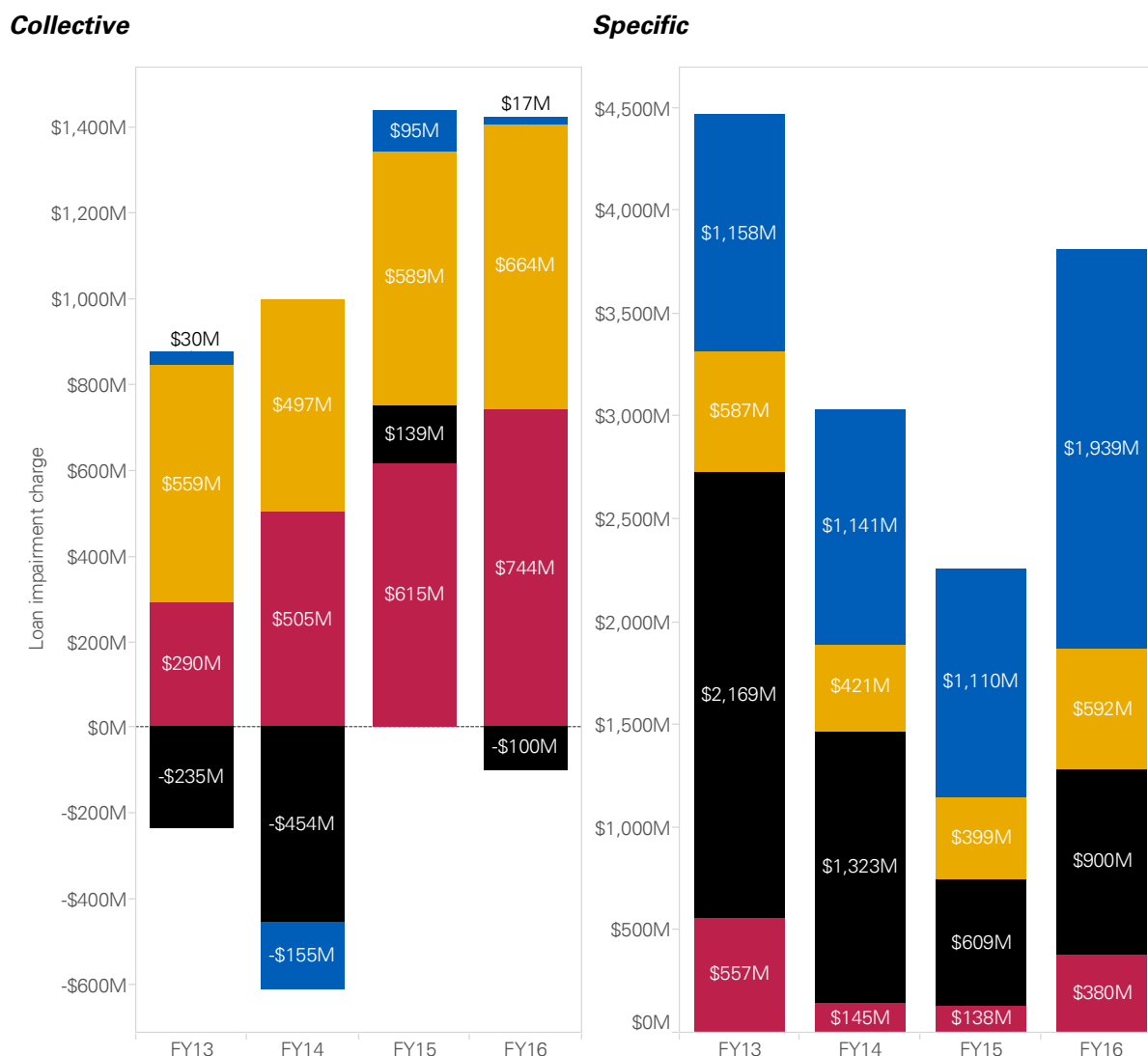
While asset quality has broadly remained sound for the majors, rising loan impairments have continued to increase and are more prominent in sectors exposed to resources and manufacturing industries



Increases in specific impairment charges reported in 2016 have been largely restricted to single name losses in the corporate and institutional banking segments. While the credit environment is broadly stable, partially supported by low interest rates, pockets of credit deterioration continues to be experienced. This was highlighted across all four banks, where it was reported that deterioration of the mining and other resource related sectors, as well as parts of the manufacturing and agriculture sectors, were the main drivers in the \$5,136 million impairment charge in FY16. This stress has been reported as having largely passed through the institutional portfolios and now progressing through the commercial and retail segments. As such, we expect the losses incurred in 2016 to be, in part, reflected again in 2017.

Combined collective impairment charges decreased across the majors in the past financial year due to the shift of single name bad loans to specific provisioning. For FY16, combined collective impairment expenses across the majors decreased by \$113 million to \$1,325 million.

Impairment charges as a ratio to gross loans and advances on average increased by 4.3 bps from 16.3 bps to 20.5 bps in the FY16. This has been primarily driven by higher retail and commercial losses across the portfolios, primarily concentrated in mining-exposed locations.

Diagram 8. Loan impairment charge

Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

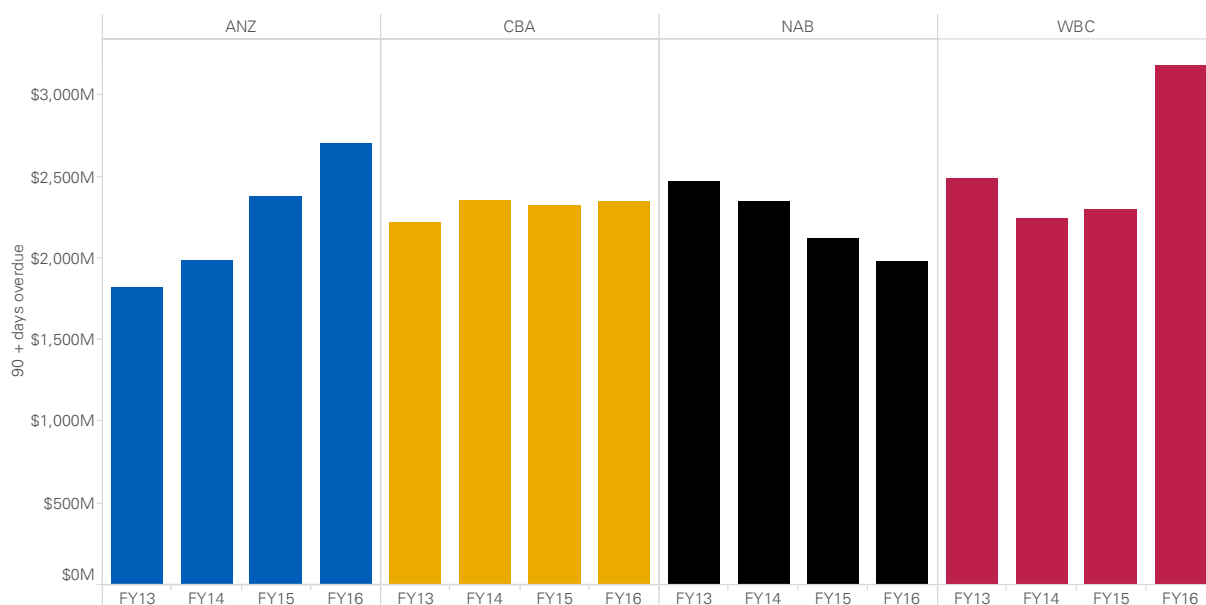
90+ day delinquencies

90+ day delinquencies remained relatively stable, increasing by 2.5 bps in FY16 to 37.3 bps of gross loans and advances, despite CBA's reported decrease of 3 bps from 36 bps to 33 bps.

This increase has been mainly driven by a subdued economic environment. The following was reported for the period:

- Mortgages and unsecured personal lending have continued to deteriorate in regions largely exposed to the mining and resources sectors, particularly Western Australia and Queensland.
- Increased deterioration of asset quality in the New Zealand agricultural sector, primarily concentrated in dairy.

Diagram 9. Loans past 90 days but not impaired



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Productivity is a strategic imperative for Australia's banks

Michael Rowland, Partner, Management Consulting, Financial Services

Australia's majors have demonstrated a strong track record of delivering cost savings and have often ranked favourably in cost-to-income ratio comparisons with international banking peers. This has come from a combination of robust levels of income growth seen over previous years, as well as disciplined management of costs, process improvement and outsourcing. At the same time, banks have been increasing their cost per FTE consistently with limited headcount reductions.

However, Australian banking now faces the greatest array of challenges in over 30 years. While the GFC dented customer confidence and returns, the industry is now facing a barrage of challenges including "lower for longer" levels of revenue growth and ROE, omnibus regulatory change, disruption and disintermediation, heightened customer demand for better value products and services, and growing community concerns over the industry's conduct.

We strongly support the need to continue to invest in the medium term to address these demands, but it is clear that a radically different approach to productivity – akin to the sorts of structural transformation last seen in the 1990s – is required to release resources, create the financial capacity to invest in transformation and deliver acceptable financial results.

Some of the drivers of the underlying structural cost problems include:

- **Staffing and operating models.** Staffing levels and salaries have grown consistently over time with low spans of control, and a skew to non-customer facing roles; particularly in head office and supervisory functions
- **The cost of change is prohibitive.** Technology change is hamstrung by relying on traditional approaches to project identification, mobilisation and delivery
- **The regulatory and compliance burden** continues to grow unfettered
- **Reliance on third party origination** results in sub scale and inefficient physical distribution channels and service
- **Inconsistent use of internal and external services and change delivery** (sourcing vs. internal capability vs. specialisation vs. managed services) adds complexity, bureaucracy and unnecessary cost burdens.

So how can banks rethink their approach to productivity to deliver positive material change in their cost bases?

Most importantly, delivery of sustainable productivity requires a mind-set change in the way it is managed. Productivity must become a structured core element of banks' strategic agendas and be delivered in agile bursts – not part of a traditional project-type.

Individual leaders must take personal accountability, effectively resource the change and improvement activities required over a clear time horizon, measure success and hold staff accountable for delivering successful outcomes.

Consistent, organisation-wide communication is a critical element of success to build a cost-conscious mindset and encourage staff to think commercially about how they spend money directly and use resources indirectly.

Typically, successful banks are pursuing cost productivity in a consistent way:

Simplify the operating model by deploying customer-centric approach with simplified, empowered businesses oriented around customer segments managed by a small corporate core, flatter management layers, wider spans of control and a culture of **personal accountability**

Channel optimisation, including providing options for sales and service, removing cash and waste and transforming sales and service in branches, contact centres, and through partners

Customer coverage refocused on sectors and segments that deliver value

Revert back to core by exiting non-core businesses, products and markets

Develop strategic outsourcing / offshoring propositions and partnerships to leverage scale and innovations including robotics

Obsess about **digitisation and simplification of end-to-end processes and products**

Adopt a **“lean” approach to change** with new ways of working and partnering externally

Drive **disciplined cost management** using zero-based design for all BAU / run costs

Transform technology through infrastructure, change delivery and system / platform rationalisation.

Non-interest income

The majors have reported a combined \$23.5 billion in non-interest income decreasing by 3.1 percent from the previous financial year. One-off impairment and divestments away from wealth management and insurance businesses have headlined the results, whilst underlying income for these businesses decreased by 3.7 percent to \$7.1 billion for FY16.

Looking ahead, it is inevitable that the majors will continue to refine their business models, being much more selective on which markets, products and customer segments to serve and those they may seek to pursue with a different approach – or exit altogether

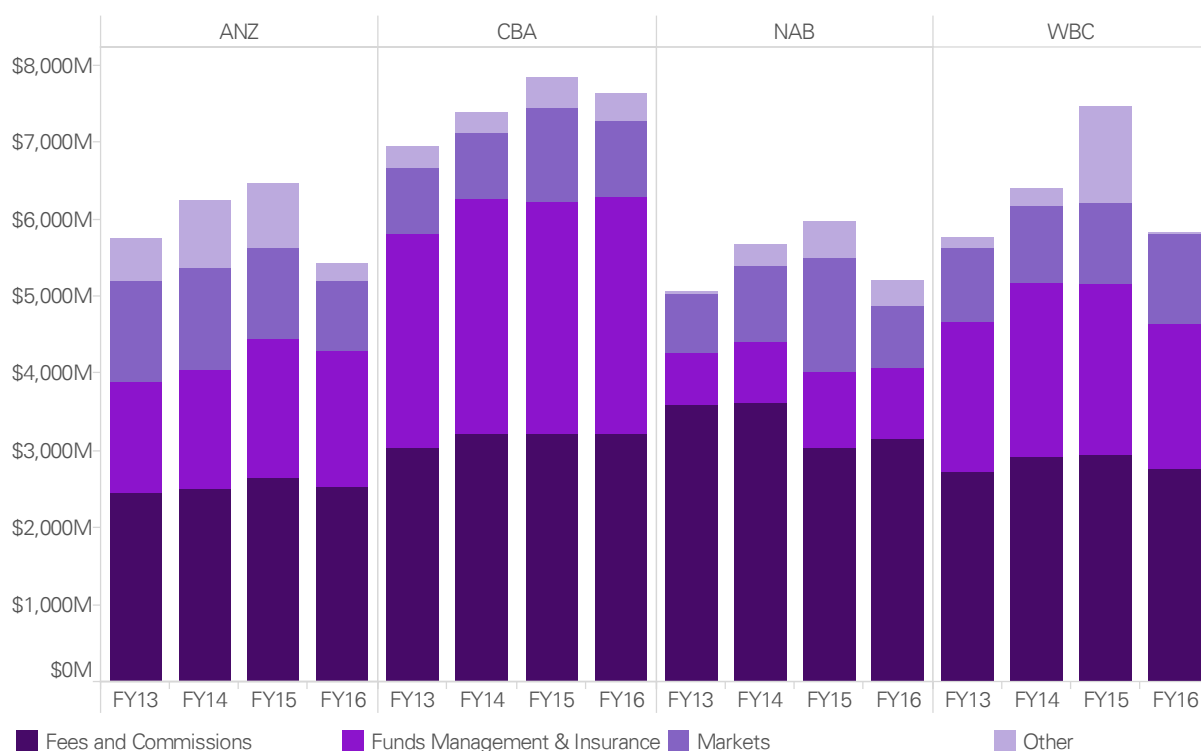


During the period, NAB reported the sale of 80 percent of its life insurance business to Nippon Life, Westpac announced the partial sale of BT Investment Management (BTIM) and ANZ divested its Esanda Dealer Finance operations and announced the sale of its retail and wealth businesses in five Asian countries. These transactions indicate a wind back of non-core businesses and response to increased regulatory capital requirements and decreasing returns.

A key component of NAB's result was the loss on the sale of both CYBG and 80% of its life insurance business of \$6.1 billion. This impacted NAB's statutory profit after tax, reducing by 94.4 percent. Excluding discontinued operations, NAB's statutory profit decreased by 5.6 percent to \$6.4 billion.

For continuing operations, NAB posted a flat non-interest income performance for the year, down 0.1 percent to \$4.5 billion due to favourable economic hedges and derivative valuation adjustments, offset by one off items the previous year and lower markets performance.

CBA posted a \$130 million increase in non-interest income, primarily in trading income (\$48 million) and funds management income (\$78 million), to \$7.7 billion. Stronger sales in Markets, higher treasury earnings and net funds under management (FUM) inflow were the primary drivers, offset by unfavourable derivative valuation adjustments and economic hedges.

Diagram 10. Breakdown of non-interest income (statutory basis)

Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Wealth management and insurance

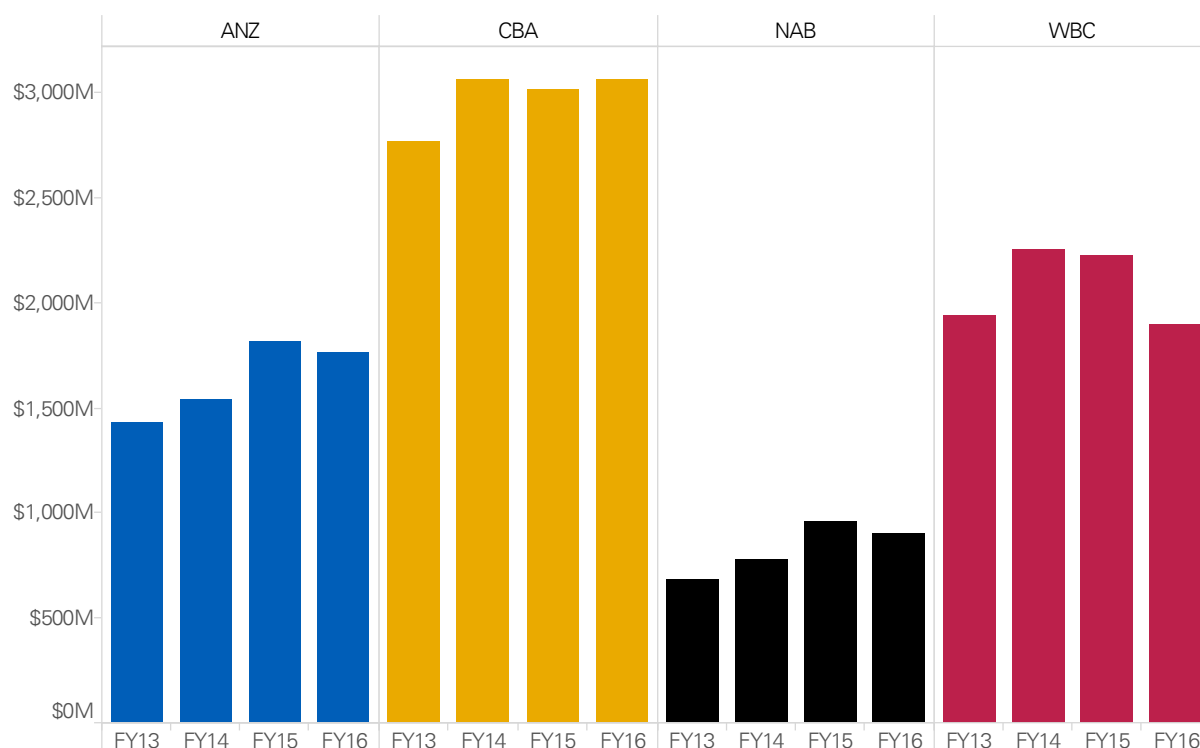
Across the majors, there has been a soft performance in wealth management and insurance income for FY16, decreasing by 3.7 percent to \$7.1 billion. Increased average FUM have been reported by the majors, with the exception of Westpac due to the one-off deconsolidation of BTIM. Higher insurance product margins and lower claims rates have also been reported by the majors.

ANZ's strategic review has concluded that "ANZ does not need to be a manufacturer of Life and Investment products". ANZ's position combined with NAB's recent divestment of its life insurance arm and stagnating revenue growth in the current year further emphasises potential future scale-downs across the majors away from non-core business areas.

Average FUM, excluding the partial divestment of BTIM by Westpac, has increased across the majors by 6.2 percent to \$528.3 billion⁸. Continued favourable performance of equity markets and positive net funds inflow in the New Zealand market were the primary factors in driving the increases in FUM for FY16.

⁸ Average FUM for BTIM in FY15 was \$41.5 billion, which was derecognised on the partial sale of the business by Westpac.

Diagram 11. Net funds management and insurance income



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

The Gen Y demands that banks must meet

Daniel Knoll, Partner, Management Consulting, Financial Services and
Kristina Craig, Director, Innovation

The expectations of the young professional Gen Y cohort must be embraced by the banking industry, as this group of future 'mass affluents' are the customers to attract now, and retain as they travel through life.

KPMG's latest and third *Banking on the Future* report shows some patterns are developing regarding how these young, mobile and digitally savvy professionals are banking, and what they expect as customers.

KPMG surveyed over 1,400 young professionals between the ages of 18 and 30 across Australia, with common traits including university education, relatively well-paid jobs and digital aptitude – making them a strong indicator of a future 'mass affluent' demographic. They were not aligned to any one bank and so provided us with a broad range of experiences and preferences.

As highlighted in previous studies, we believe the attributes of this digital native group are profoundly different to their peers of previous generations. Therefore, the economic importance of ensuring products and services appeal to this group cannot be underestimated.

Although many of this group are approaching the historically typical age for home buying, it is important that providers understand the evolving nature of their priorities and ways of interaction. This group is actually delaying home buying – instead looking to build wealth. They are prepared to go to great lengths to manage their financial wellbeing. Banks should consider ways to support, understand and facilitate the short-term goals of this generation – with a view to creating the genuine trust that results in long-term loyalty.

Here are eight dominant forces shaping the way Gen Y want to bank, and what they demand as customers.

1. Digital is king

A digital banking experience has remained the most highly coveted banking attribute. Online has held on to the number one position, with mobile banking en route to overtake it in the immediate short term.

2. Cherry picking is on the rise

Gen Y customers hold multiple products with multiple banks, picking the offers with the best features for their needs. The decider could be anything from interest rates or lower fees, to cash back or frequent flyer points. This group isn't being disloyal for the sake of being disloyal. People are simply choosing products that tick all the right boxes for them.

3. Gen Y: Savers and spenders

Gen Y are focused on saving (and spending) rather than investing – with the noble savings account being the investment vehicle of choice. Products relevant to their goals are not particularly well formed in many incumbent banks and consequently, we're seeing new fintech players step in and fill that space. Innovative fintech players that 'force them to save' are attractive to this segment.

4. Spending habits: #YOLO (You Only Live Once)

With the rise in social media and the 'sharing' culture, Gen Y are spending more on luxury items, experiences and travel. They are delaying big commitments such as property ownership. Instead, they prefer to pay for access on an as-needed basis at a fraction of the cost, rather than buy services or items outright.

5. The quantified self

This group is spending 1.5-2.5 hours per month on managing their finances, with many acknowledging that it is still not enough. Gen Y are eager for financial advice that is aimed at their needs and available on demand. Online financial management tools such as personal financial spreadsheets are becoming increasingly popular.

6. Wallet-less transaction

'Invisible payments', such as the system used by Uber, resonate well with this group and are a growing expectation for Gen Y. They want services that consolidate and automate their money, payments and notifications. Basically, Gen Y want to replace their physical wallets with do-it-all apps on their phone or watch.

7. A global model

Gen Y want their banking at maximum convenience for minimal to zero cost. Capabilities for when they are travelling or buying internationally are seen as particularly important for this group. There is also opportunity to tailor product features, benefits and reward programs to maximise the experience of customers while they are both planning, and going on holidays (e.g. group holiday payment sharing).

8. The next frontier: Banking with tech giants

Over half of the respondents would consider banking with a tech giant – if the offer was right. Privacy and security are a key consideration for the group, and means not all tech giants are seen as equal. Google and Apple would be more seriously considered, whilst Facebook is not seen as a preferable banking option.

These eight trends show there is no single route to capturing and retaining the custom of Gen Y. However, it is clear that banks must urgently consider their high expectations, particularly around digital aptitude, and step up their level of delivery to attract them. Failing to act will ensure competitors, or up-and-coming fintech disruptors, move in and take the prize.

For more about the banking expectations of Gen Y and to delve deeper into the report findings, visit kpmg.com.au

Capital

The majors continue to balance meeting the regulatory requirements (to be “unquestionably strong”) whilst optimising their capital deployment, focusing on efficiency. The active management of capital is evident in the average Common Equity Tier 1 capital (CET1) ratio increasing 27.5 bps to 9.9 percent in FY16.

The majors' capital position continued to strengthen, with their average CET1 capital ratio rising by 28 bps over the year to 9.9% of RWA

To manage the ongoing need for greater regulatory capital levels and to mitigate against inherent risks in credit growth, the majors are recalibrating and lowering their dividend payout ratios to increase organic capital growth. Divestments of non-core businesses have allowed for reallocation of capital across their banking franchises. This exhibits the majors' forward-looking behaviour in actively managing their capital deployment to support customers in the long term and to protect against potential surprises in earnings or credit losses.

The major banks are maintaining healthy buffers against specific Basel III ratios:

- The Liquidity Coverage Ratio (the amount of high quality liquid assets held that can be used to meet the bank's liquidity needs for a 30 day calendar liquidity stress scenario) is running at an average of 125 percent versus the 100 percent minimum; and
- Leverage Ratio (the amount of Tier 1 capital held divided by average total consolidated assets of the bank) for the majors is at an average of 5.1 percent⁹ versus the currently agreed minimum requirement of 3 percent.

Diagram 12. Capital adequacy metrics

	ANZ		CBA		NAB		WBC	
	FY16	FY15	FY16	FY15	FY16	FY15	FY16	FY15
Common Equity tier 1 ratio	9.6	9.6	10.6	9.1	9.8	10.2	9.5	9.5
Tier 1 capital ratio	11.8	11.3	12.3	11.2	12.2	12.4	11.2	11.4
Tier 2 capital ratio	2.5	2.0	2.0	1.5	2.0	1.7	1.9	1.9
Total regulatory capital ratio	14.3	13.3	14.3	12.7	14.1	14.2	13.1	13.3
Tier 1 capital (\$ million)	48,285	45,484	48,553	41,147	47,336	49,743	45,785	40,798
Total capital (\$ million)	58,613	53,435	56,477	46,808	54,945	56,550	53,768	47,534
Risk weighted assets (\$ million)	408,582	401,937	394,667	368,721	388,445	399,758	410,053	358,580
Credit risk weighted assets (\$ million)	352,033	349,751	344,030	319,174	331,510	344,326	358,812	310,342

Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

⁹ NAB leverage ratio reported as at 30 June 2016 (30 September 2016 Pillar III report yet to be released).

Costs

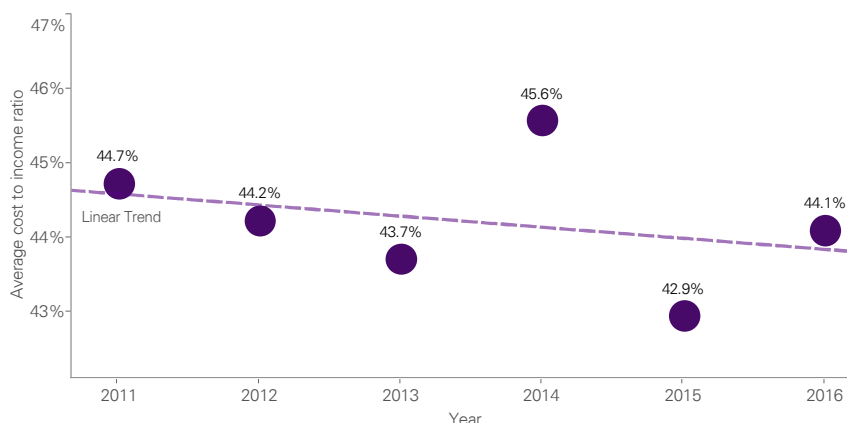
Continued pressure on margins and earnings has required disciplined cost management to support profitability. Investment in technology and digital platforms to enhance customer experience and keep pace with market disrupters remains critical areas of investment, whilst maintaining ongoing costs to adhere to regulatory change remains as a deadweight.

The majors ability to identify cost take-out opportunities that can be realised in the short-to-medium term – without compromising revenue growth prospects – will be critical

Operating expenses have grown in the 2016 financial year, increasing by 5.4 percent (\$1.9 billion) to \$37.2 billion across the majors. The two-speed increase of expenses to revenues is largely attributed to greater spending by the majors in meeting regulatory and compliance requirements, streamlining and enhancing digital capabilities of existing processes and divestments of non-core businesses. While benefits have been delivered to the majors in ongoing operating cost reductions, these have been offset by increased amortisation and restructuring expenses.

The average cost to income ratio on a cash basis rose 115.8 bps to 44.1 percent. Overall, while operating expenses have increased, this has been influenced by one-off items and low revenue growth. The majors have reported that continued investment in digital technology and automation, including initiatives to simplify processes and remove complexity from products, continues to improve efficiency and productivity. However, competing investment priorities remain as the majors' balance the need for investment in technology and innovation to further improve customer experience against the ongoing demands of regulatory compliance programs whilst maintaining ongoing operating expenditure.

Diagram 13. Average cost to income ratio



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Other key factors influencing the costs include:

- Expense inflation, including a 2.7 percent increase in personnel expenditure;
- Foreign currency translation expenses have impacted on foreign operations expenditure due to a lower Australian dollar;
- Costs were partially offset by realisation of incremental benefits from productivity and restructuring initiatives;
- Increased investment spend and resulting higher depreciation and amortisation in addition to incremental support costs; and
- These costs were partially offset by the continued realisation of incremental benefits from productivity and restructuring initiatives.

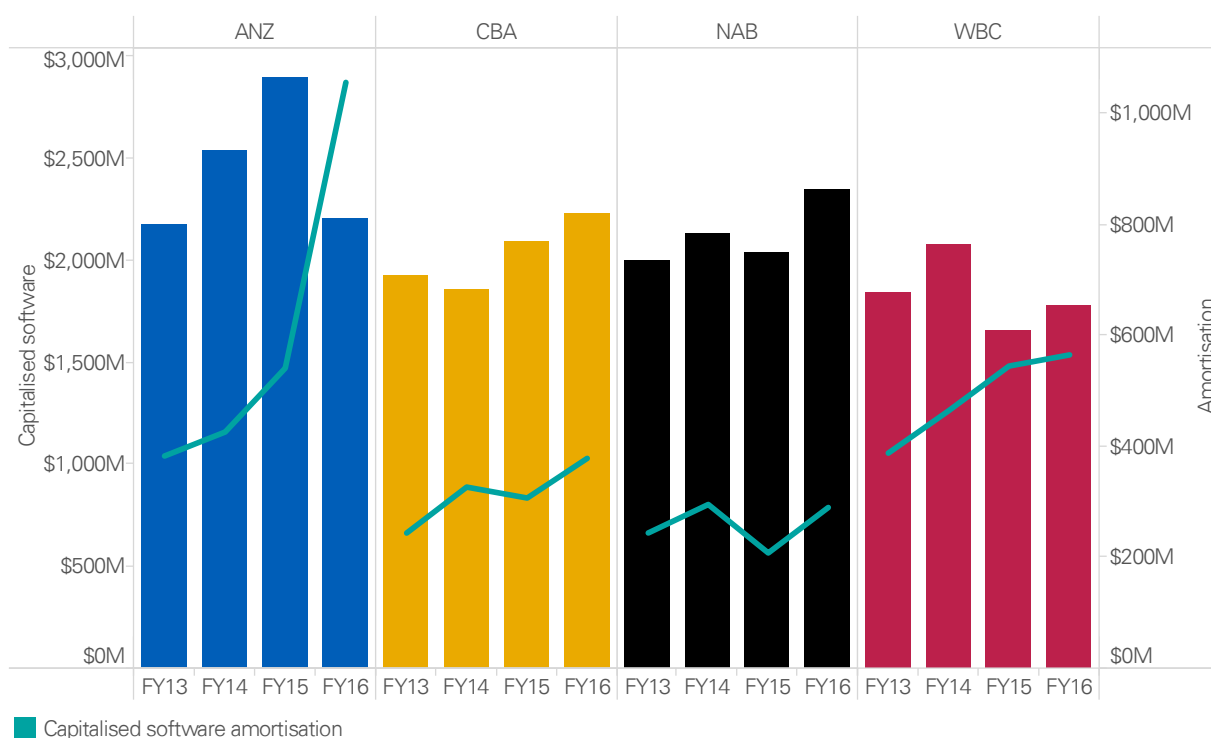
Technology

As a result of the majors' continued focus on innovation initiatives and investment in new technologies, technology related costs remain a significant contributing factor to higher cost to income ratios. The average increase for technology expenses is 18.1 percent. Increases in software amortisation expenses, including additional charges attributable to shortened useful lives and impairment, have been significant contributors in FY16.

The majors continue to invest in technology, with an additional \$2,256 million software costs capitalised. The balance taken to profit or loss for FY16 is reported at \$6.6 billion (an increase of \$1,003 million) which, in part, reflects ANZ and Westpac's change in the application of their capitalisation policies in the first half of FY16.

Furthermore, costs have increased across the board due to a continuation of regulatory compliance programs and enhanced compliance requirements by 4.4 percent (excluding CBA's increase of 34 percent) due to required investment in new or modified systems, processes and customer remediation activity, particularly in light of recent public scrutiny into banking and insurance industry practices.

Diagram 14. Capitalised software

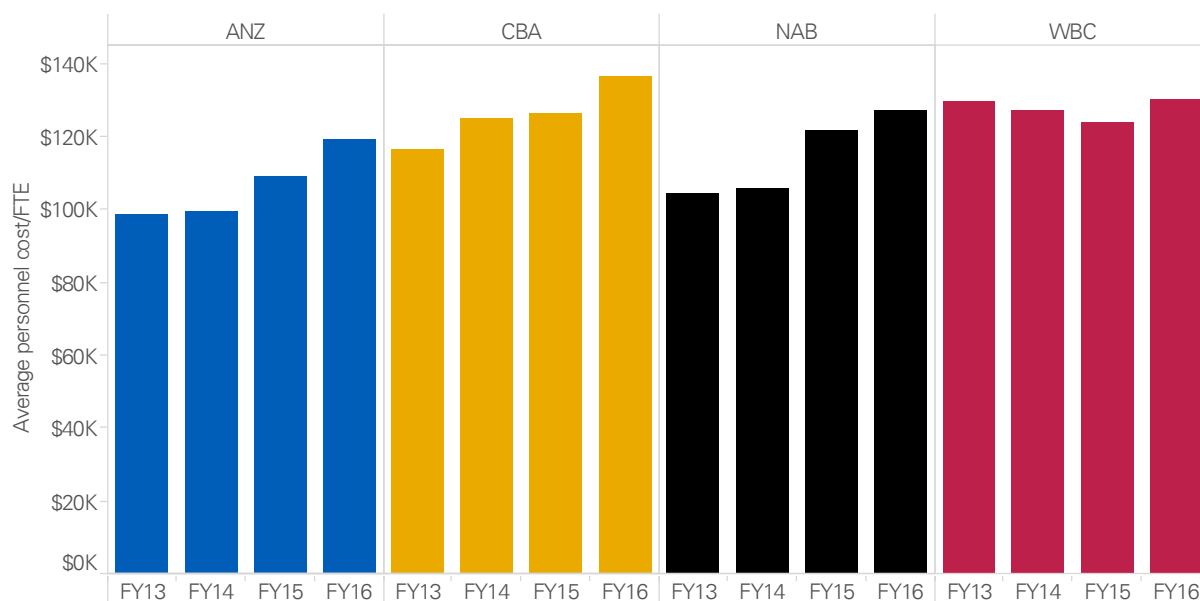


Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Personnel

Staff numbers have decreased in FY16 by 2.4 percent to 161,226 FTE globally. Despite this, total personnel related costs have increased, largely driven by increases in one off items such as frontline workforce salaries, Enterprise Bargaining Agreement (EBA) wages and incremental support costs from deploying products.

Diagram 15. Average personnel costs per FTE



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Banking in 2030: Invisible Bank?

Ian Pollari, Partner, Head of Banking

By 2030, technology will drive an even deeper fundamental shift in banking – moving it from being hidden to completely invisible. However, it will be more intertwined in the lives of consumers than ever before. It's time to meet EVA and see the possibilities.

Click [here](#) or visit kpmg.com/au/meeteva to watch a video of what a customer journey could look like in 2030

In the near future, banking will be made of three distinct components: The Platform Layer, the Product Layer and the Process Layer. Together, they will make the new Invisible Bank, introducing opportunities and challenges for the industry.

The Platform Layer

Standing for Enlightened Virtual Assistant, EVA is the platform through which consumers will connect with the Bank. EVA is made possible by technologies that are all available today – advanced data analytics, voice authentication, artificial intelligence, connected devices, application programming interface (API) and cloud technology.

EVA is all about connectivity. Rather than simply making an automatic payment, perhaps she will coordinate information from a customer's calendar, their social media, wearable devices and music apps to determine that they have been stressed lately, and ask if she should book and pay for a yoga class. She will be constantly available and can be personalised to each customer's needs.

Customers are on the path to accepting this type of platform. They are already increasingly using channels to fulfil functions previously dominated by banks. PayPal offers loans and credit; Amazon offers inventory finance. Can banks keep up?

Teaming up with technology organisations may be the way. Technology hardware is a global business, whereas banks are becoming increasingly national. Technology firms also invest far more of their revenue into research and development. Some banks, who have the capacity and willingness, will try to develop their own Platform Layers. Most will need to partner.

The Product Layer

Banks currently fulfil three vital economic functions: they 'create' money through making loans, they give people a safe place to store cash and they facilitate maturity transformation.

These functions are possible because of a strong regulatory and risk management environment, access to government support and an understanding of credit risk. Banks are well placed to build on these core strengths and develop bespoke products that suit the lives of customers in the new landscape of 2030.

In KPMG's vision of banking in 2030, large parts of the traditional bank have disappeared. Customer service call centres, branches, sales forces, IT, swathes of the back office – gone. To own and optimise the Product Layer, banks must be willing to undergo the necessary evolution and put customer needs first.

The Process Layer

The biggest banks might well retain an element of transactional infrastructure – the Process Layer – but that will be opened up to competitors as a distinct utility business.

Competition in this market will be intense – led by a range of industrywide solutions in payments, settlements, core platforms and client onboarding. A rich ecosystem of new fintechs, major outsourcers and existing industry players will serve the banks.

Shifts in the regulatory context

In the world of the Invisible Bank, cyber risk becomes even more acute, and regulation will have to quickly change to meet it. With a Platform Layer like EVA, there is massive systemic risk. If EVA books and pays for a yoga appointment that a customer didn't want, is that grounds for complaint? And who is responsible for the error? The platform? The payment agent? The hardware provider?

Banking regulation will need to become real time and potentially even present at the point of sale. If it can be proven that platforms like EVA make the customer outcomes better, lower cost and more accessible, then regulators will need to keep step with the industry to ensure that these risks are managed.

Building an invisible future

Banking is only 10 percent through its journey of change. The Invisible Bank is of course only one possible future, but there are many other alternative scenarios.

For more about the future of the Invisible Bank, read our new report, *Meet EVA, Your Enlightened Virtual Assistant and the future face of the Invisible Bank* at kpmg.com/au/meeteva

Return on equity

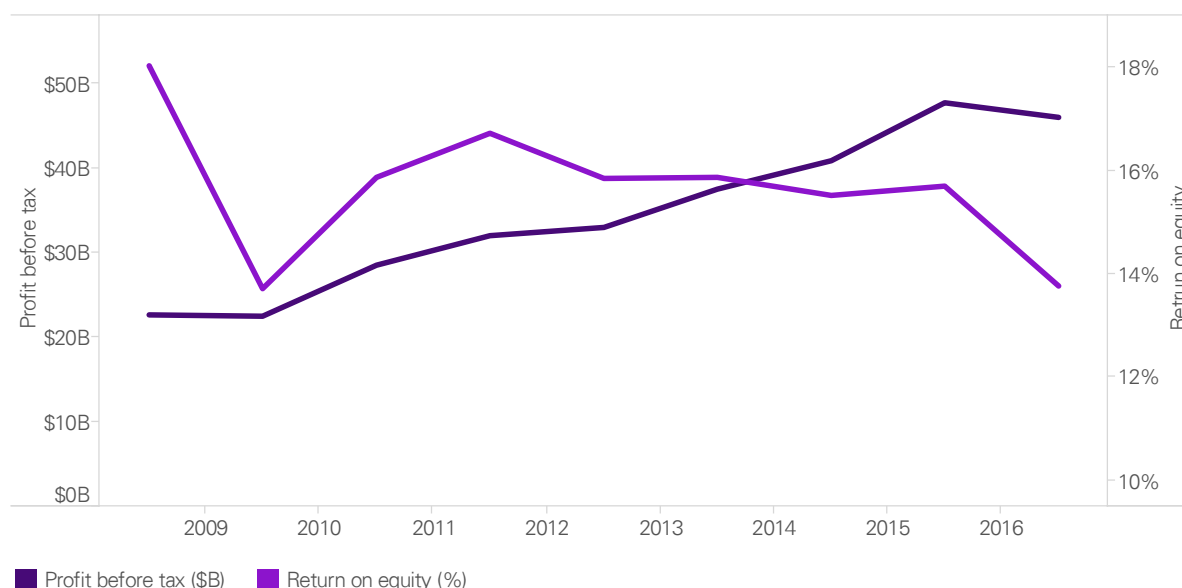
In a lower growth environment, together with increased regulatory requirements (requiring majors to hold higher levels of capital) and rising loan impairments, it is becoming increasingly difficult for the majors to maintain their current level of industry returns.

The impact of significantly increased regulatory capital requirements saw the majors' EPS and ROE. ROE fell by 194bps to an average of 13.8% for the year

The majors' average ROE has decreased by 193.8 bps to 13.8 percent on a cash basis for FY16. This is consistent with expectations following the capital raisings undertaken by all the majors as a result of APRA's response to the recommendations of the FSI for capital levels to meet the "unquestionably strong" target and moves towards an emerging Basel 4. Capital raisings during FY16 amounted to \$8.6 billion in total.

While the Australian majors continue to perform strongly in a global context, highlighting the proportional strength of the Australian banking system, ROE has continued to trend downwards since 2010.

Diagram 16. Profit before tax against return on equity



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

The key themes restricting the level of cash ROE in FY16 were:

- Lower earnings growth in Australian banks primarily driven by decreasing margins, rising bad debts and greater market competition;
- Increased holdings of lower yield high quality liquid assets associated with the transition to Basel III Liquidity Coverage Ratio framework; and
- Higher operating costs, in particular, increases in personnel related costs, IT expenses, professional services and restructuring expenses were reported for the period.

Historical ROE – cash basis (%)

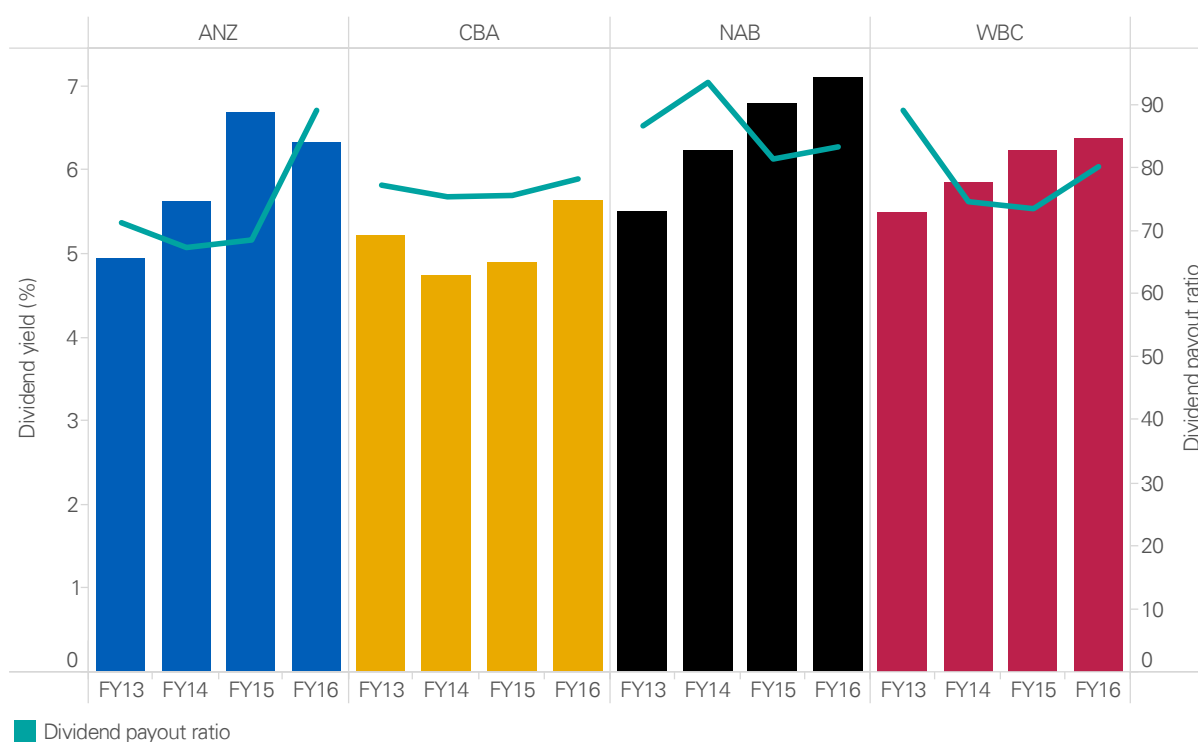
	FY16	FY15	FY14	FY13	FY12	FY11	FY10	FY09	FY08	FY07	FY06
ANZ	10.3	14.0	15.3	15.1	14.7	15.7	16.4	12.5	13.5	19.6	20.7
CBA	16.5	18.2	18.8	18.6	18.1	20.0	18.9	16.3	19.9	22.1	21.3
NAB	14.3	14.8	9.1	14.3	13.5	15.2	13.5	10.9	11.9	17.1	17.7
WBC	14.0	15.8	16.4	15.8	15.9	15.6	15.8	13.4	21.9	24.0	23.0
Average	13.8	15.7	14.9	16.0	15.6	16.6	16.2	13.3	16.8	20.7	20.7

Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Dividends

Dividends remained relatively flat in comparison to FY15 for CBA, NAB and Westpac. ANZ has reduced their final dividend to 80 cents per share, with full year dividend at 160 cents per share, a decrease of 21 cents per share compared to FY15.

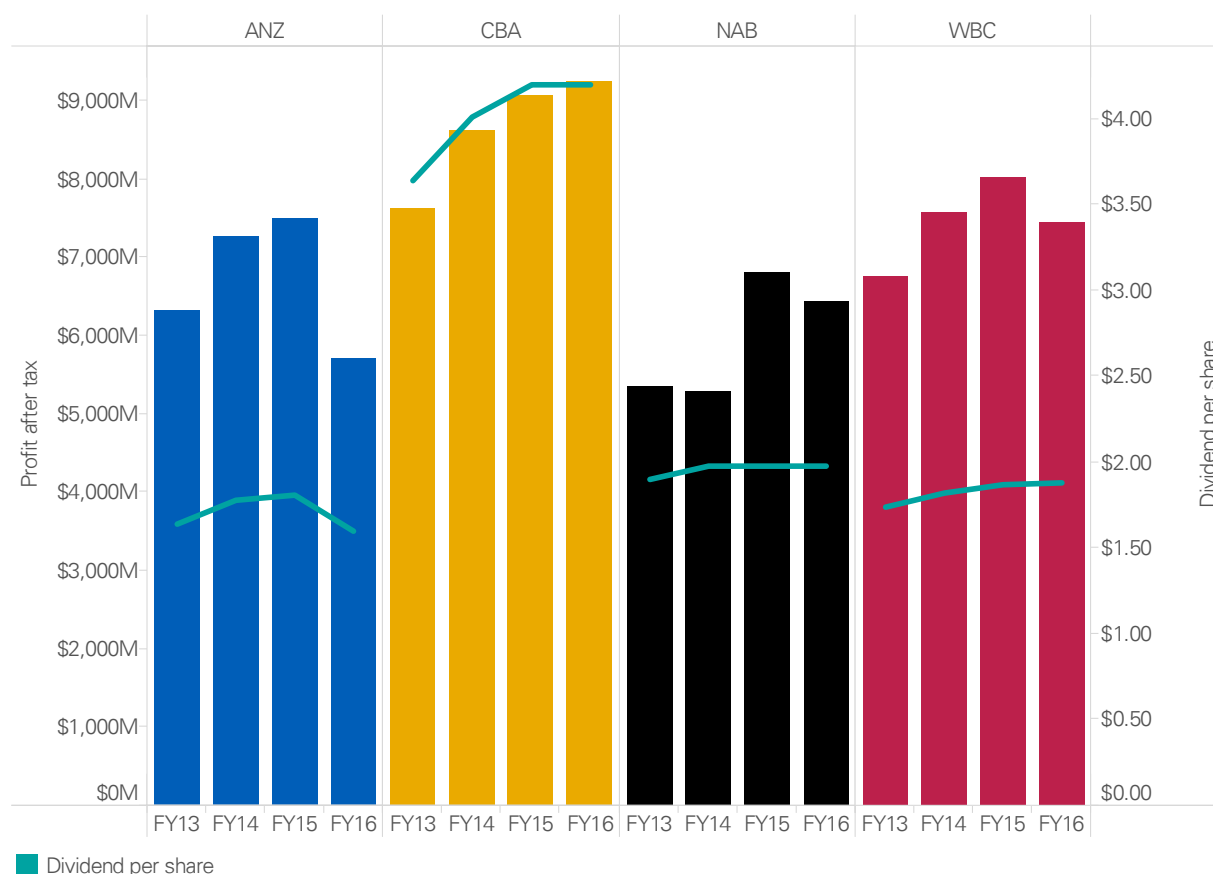
Diagram 17. Dividend yield vs payout ratio



Source: KPMG analysis from Bloomberg data

The result reflects the challenges faced by the majors in response to changing local and global rules that are demanding banks to hold more capital. The majors are aiming to balance the long-term stability of dividends and maximising the utilisation of franking credits, against shareholder pressure, primarily retail investors and superannuation funds, and their intention to organically generate capital in response to regulatory capital requirements.

Diagram 18. Profit after tax vs dividend per share



Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

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