KPMG

Major Australian Banks

Full Year 2018 Results Analysis

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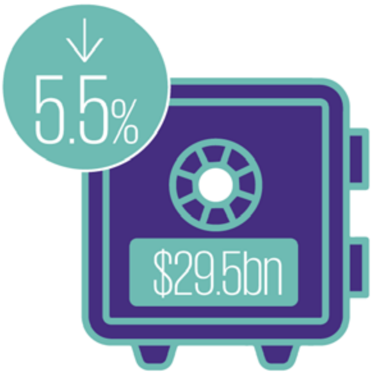
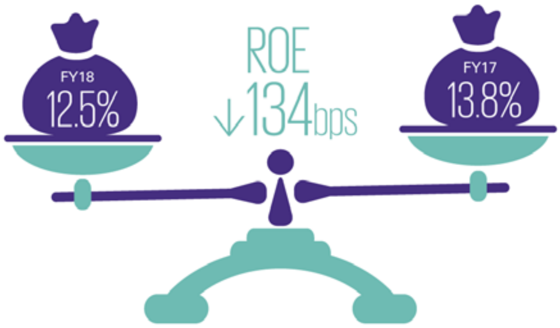
Contents

Full Year 2018 Results Snapshot

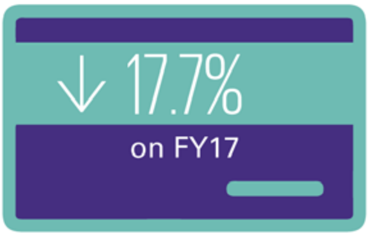


Cash profit after tax decreased by 5.5% on FY17 to $29.5bn

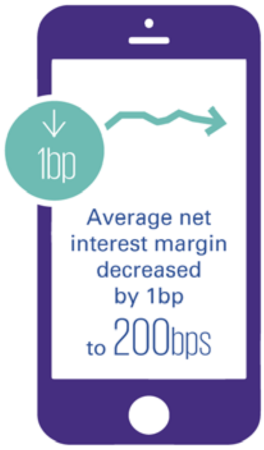


Average ROE down 134bps to 12.5%

Average cost to income ratio increased by 356bps to 46.6%



Aggregate charge for bad and doubtful debts decreased by $702m (17.7%) to $3.268m



Average net interest margin decreased by 1bp to 200bps

Average CET1 capital ratio up by 25bps from FY17 to 10.6% of risk weighted assets

Risk and compliance project spend increased by 567 basis points to 35.1% of total investment spend

Slowing balance sheet momentum

Compared to FY17:

Housing credit
FY17 ↑5.3%

Non-housing credit
FY17 ↑0.1%

Deposits
FY17 ↑5.0%

At a glance

	ANZ		CBA[1]		NAB		WBC	
	FY18	FY17	FY18	FY17	FY18	FY17	FY18	FY17
Ranking								
By profit before tax	3	3	1	1	4	4	2	2
By total assets	2	2	1	1	4	4	3	3
By total equity	3	3	1	1	4	4	2	2
By market capitalisation	3	3	1	1	4	4	2	2
By CET 1 capital ratio	1	1	4	3	3	4	2	2
Financial performance (continuing operations)								
Profit before tax ($ million) – statutory	9,895	9,233	13,420	13,665	8,400	8,661	11,731	11,515
Profit after tax ($ million) – statutory	7,111	6,359	9,394	9,786	5,945	6,181	8,095	7,990
Cash profit after tax ($ million)	6,487	6,809	9,233	9,696	5,702	6,642	8,065	8,062
Performance measures (continuing operations)								
Net interest margin – cash (basis points)	187	199	215	210	185	185	211	209
Cost to income ratio – cash (%)	48.1	45.3	44.8	42.1	50.0	42.7	43.7	42.2
Basic earnings per share – statutory (cents)	245.6	218.0	536.9	567.9	215.6	228.2	237.5	238.0
Basic earnings per share – cash (cents)	223.4	232.7	528.6	563.4	210.4	249.3	236.2	239.7
Return on average equity (%) – cash	11.0	11.7	14.1	15.7	11.7	14.0	13.0	13.8
Credit quality measures								
Impairment charge ($ million) - statutory	688	1,198	1,079	1,095	791	824	710	853
Impaired loans to loans and advances (%)	0.33	0.41	0.42	0.43	0.26	0.30	0.20	0.22
Collective provision to credit RWA (%)	0.75	0.79	0.75	0.73	0.92	0.86	0.73	0.76
Financial position								
Total assets ($ million)	942,624	897,326	975,165	976,318	806,510	788,325	879,592	851,875
Total equity ($ million)	59,383	59,075	67,860	63,660	52,712	51,317	64,573	61,342
Capital measures								
Capital adequacy ratios (%)								
- Total	15.2%	14.8%	15.0%	14.2%	14.1%	14.6%	14.7%	14.8%
- Tier 1	13.4%	12.6%	12.3%	12.1%	12.4%	12.4%	12.8%	12.7%
- Common Equity Tier 1 (CET1)	11.4%	10.6%	10.1%	10.1%	10.2%	10.1%	10.6%	10.6%
Market capitalisation ($ billion)[2]	81.0	86.9	128.0	142.9	75.8	84.3	95.9	108.3

[1] CBA as reported as at 30 June 2018. All other majors as at 30 September 2018.
[2] Market capitalisation sourced from statutory account or ASX.

Executive summary

The 2018 full year results of the Australian major banks (the majors) delivered an overall decline in aggregated cash profits from continuing operations and a reduction in return on equity (RoE). The result underscores a challenging regulatory and operating environment for the majors, with slowing revenue growth, margin pressure and increased regulatory and remediation costs, as the industry continues to work to restore trust with stakeholders. The majors have managed to maintain credit quality and increased their capital levels during this period, which includes the benefits of increasing divestments of non-core businesses.

Growth continues to be a challenge in this new era of industry transformation around the customer. As the majors reshape their operations, we expect to see them emerge with more efficient, simpler and transparent business models.

The results underscores a challenging regulatory and operating environment for the majors.

Results

The majors' cash profit after tax from continuing operations decreased by 5.5% to $29.5 billion.

There is continued downward pressure on interest margins across the majors, with a decrease of 1 basis point in average net interest margin (cash basis) to 200 basis points. This modest decline in margins was driven by mortgage competition, higher short term wholesale funding costs and the first full year impact of the Major Bank Levy, offset by mortgage re-pricing, lower deposit costs and funding mix.

Cost to income ratios across the majors have increased from an average of 43.1% to 46.6%, driven by regulatory, compliance and customer remediation costs, as well as restructuring expenses.

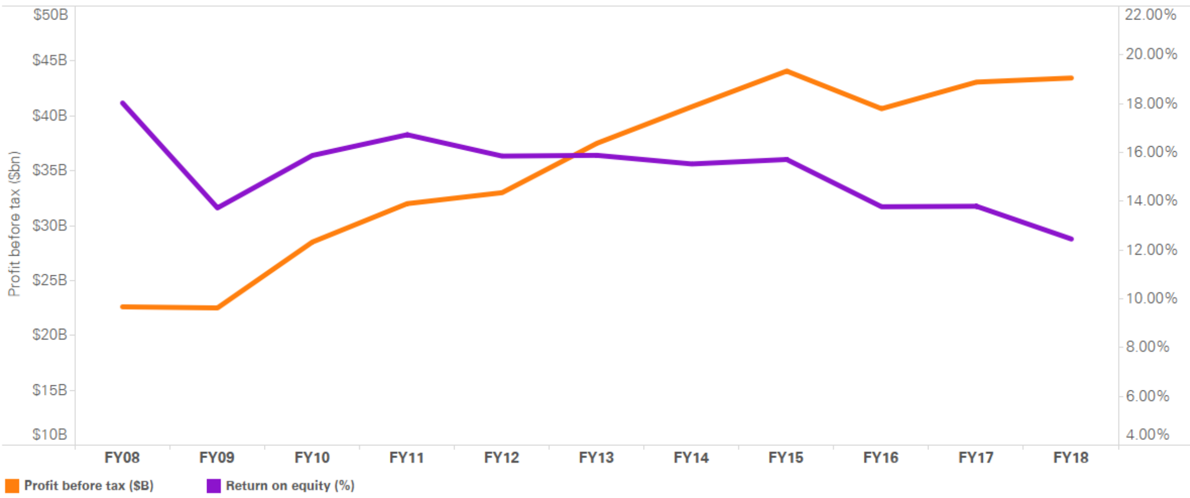
Impairment charges continue to decrease as a result of relatively subdued economic conditions and sustained low interest rates. Notwithstanding the benign credit environment, we noted on average a slight increase in delinquencies across the majors, with 90 days past due growing by 4 basis points to 0.48% of gross loan advances.

The majors have maintained a strong CET1 capital position of 10.6% of Risk-Weighted Assets (RWA) and are well positioned to meet APRA's "unquestionably strong" benchmark CET1 ratio of 10.5% by 1 January 2020.

Key observations

FY18 has been a challenging year for the major banks, which is clearly illustrated by their reduced Returns on Equity (RoE) performance. Across the majors, a number of strategic themes have been driving the underlying reduction in cash profit and RoE – and are pulling the revenue, margin, expense and capital levers all at the same time.

Diagram 1. Profit before tax against return on equity



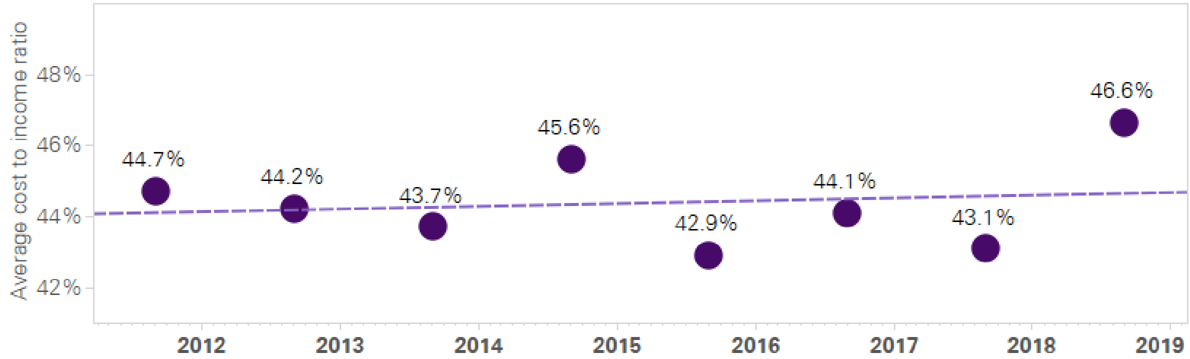
Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

At the top-line, while net interest income growth performance across the majors is mixed, non-interest income has fallen. The (lending and deposit) volume growth that has dominated the banks' results in the last decade has peaked. To an extent, the majors have been able to soften the impact of lower volume growth through mortgage re-pricing.

The decline in non-interest income has been driven by a number of factors including the removal and reduction of fees (e.g. ATM, interchange), the sale of wealth businesses in Australia and overseas as part of business model simplification and fee reversals as a result of remediation efforts within the wealth businesses.

Generally, margins are increasingly under pressure in a competitive environment and as a result of higher funding and regulatory costs (e.g. Major Bank Levy).

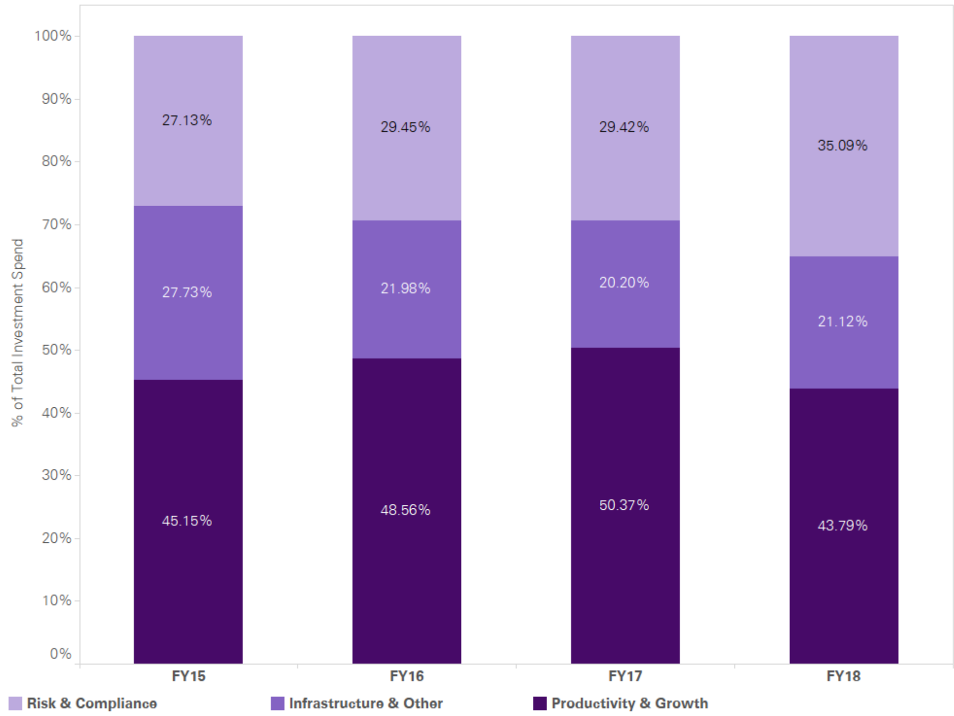
Diagram 2. Average cost to income ratio



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

It is clear that the impact of the Royal Commission, APRA's Prudential inquiry into CBA and the AUSTRAC case against CBA on financial crime are felt by all of the banks, in particular the majors. Not only have the various compliance and remediation costs translated into higher cost-to-income ratios, the majors' investment spend on risk and compliance projects has also increased strongly. While total investment spend has increased, in most cases the proportion of investment spend on growth initiatives has decreased on a relative basis.

Diagram 3. Investment Spend



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

The majors are executing against their restructuring and simplification programs in order to re-position for the future.

Outlook

Looking ahead, the expectation is that housing growth will continue to slow, as a result of falling demand. In addition, competition is predicted to remain robust with non-bank players and new challenger banks entering the market. Combined with higher funding costs from rate increases on global wholesale markets, there will be pressure on the all-important interest income from mortgages.

The outlook for business lending and business deposits appears rosier, but business and corporate banking cannot be expected to pick up all of the slack from the mortgage market. As a result, total net interest income will remain relatively subdued. Further income decreases will come from the divestment of wealth and insurance businesses.

There is a risk that high household leverage levels, higher lending rates, tightening credit conditions, the maturity of interest-only mortgages and continued high consumer confidence will drive an uptick in delinquencies and impairments. It should be noted that this risk is uncertain in terms of its timing and impact.

Despite the revenue headwinds, expenses (both operating expense and investment) on risk and compliance are expected to continue at their current elevated levels. This necessary expenditure will result in temporarily higher than normal cost-to-income ratios for each of the majors.

In this constrained environment, the challenge will be to balance institutional investors' RoE expectations and the necessary growth and transformation investments. While in FY18 potential shareholder concerns about RoE performance have been (partially) offset by higher payout ratios, albeit these will become more difficult to maintain at their current levels.

In FY19, we expect to see leaner and simpler banks emerging. Most of this slimming down is in response to regulatory pressure, and another big component is the divestment of non-core businesses. On top of this, the majors need to continue to focus on remaining competitive and relevant (with a greater focus on customer outcomes), and invest in digital innovation and the transformation of their banking business models.

A strategic approach to bank simplification

Hessel Verbeek, Partner, Banking, KPMG Strategy

As banks face a myriad of complexities, including changing customer demands and regulations, they need to focus on simplifying their model and becoming a truly connected enterprise.

For the vast majority of Australia's banks, complexity is a major strategic and operational challenge in the delivery of customer, regulatory and organisational (efficiency, agility and culture) outcomes.

However, while banks recognise the need to simplify their approach, it is exactly their high degree of complexity that stops them from pursuing simplification with more vigour.

Therefore, a logical and systematic approach to bank simplification is required to get started and to maintain momentum.

An environment of challenge

The Australian banking industry is facing a confluence of factors, making simplification vital, but also complex.

These include evolving customer preferences, increasing and new forms of competition, a converging sector focus, slowing credit growth, a low interest rate environment, increased policy and regulatory reforms, and the need to provide greater transparency to re-build trust.

These changes are forcing banks to confront their strategies and operating models. Without change, incumbent banks will struggle to meet shareholder, customer and regulatory expectations.

Bank simplification

The target state for bank simplification is a 'connected enterprise', which is entirely organised around customer needs and is omni-channel, but with a digital focus. This bank is streamlined from front-to-back, with every process putting the customer at the core. It is not organised in product or channel siloes, has no legacy restrictions, and is open to the outside world.

A simplification roadmap will be distinct for each bank, depending on its strategic objectives and on its current state. The five step bank simplification approach outlined below defines how a bank can arrive at a 'connected enterprise'.

Five steps to simplification

1. Clarify the bank's strategic focus (e.g. customer experience, value, ease, innovation) and make clear choices around competitive positioning. This will drive choices around the bank's architecture and operating model.
2. Choose a direction for the bank's business architecture (e.g. organisation of customer journeys, distribution and operations). Many banks are organised along product and channel lines, giving rise to siloes, which need to be broken down.

   Typical considerations for business architecture include:

   - Customers journeys, segments and product needs
   - Sales and service approach (e.g. by channel vs integrated) and incentivisation (e.g. profit or cost centre)
   - Multi-brand management and fulfilment
   - High level systems architecture
   - Operations and technology, including centralised services between bank divisions.
3. Determine which activities are strategic and provide a competitive advantage, given the bank's agreed focus in the first step. This will drive choices around which activities should be retained in-house, and which could be outsourced.
4. Assess the simplification options for the bank's activities, in line with its strategic focus, its business architecture and the (strategic) nature of its activities. Four main options should be considered for each activity:

   - **CoE creation** – Leverage current capabilities with potential for high performance. This is likely to be the adoption of a current Centre of Excellence (CoE) for the wider bank (e.g. migrating all secured and unsecured consumer credit assessments to the state-of-the-art mortgage credit assessment platform).
   - **Transformation** – Transform existing assets/capabilities that are not restricted by legacy issues (e.g. HR management supported by a newly implemented cloud-based ERP system).
   - **Development for replacement** – Build a new unconstrained capability, to take over activities with too many legacy issues to be transformed (e.g. full replacement of bank-wide data and analytics functions by a central hub).
   - **Third-party solutions (including partnering/outsourcing)** – Consider third-party solutions for non-strategic activities that are not high performing (e.g. ATM network operation for a digital bank). Decisions should be based on reduction of complexity, organisational rigidity or risk, rather than on productivity alone.

An increasingly attractive alternative to transforming existing bank activities is the establishment of a new (low cost) direct bank within the group. Provided that there are opportunities for platform convergence (e.g. development on a shared core banking system), this approach can allow the bank to develop, test and mature future capabilities for the existing bank. The existing bank could either use these capabilities as-a-service, or adopt them as replacements. This is a client-centric cost-efficient approach to bank simplification.

5. The fifth and final step is to develop the simplification roadmap, taking into account various dependencies. The roadmap will be bespoke for every bank, given their vast differences in starting position, strategic activities and simplification options.

RBS in the UK is an example of a major incumbent bank combining several of these simplification options into a single strategy. In the last 5 years, RBS (which struggled with complexity and operational issues, including as a result from a failure to fully integrate systems following the 2000 merger with NatWest) embarked on a journey that combined radical rationalisation (e.g. more than halving the number of technology systems and applications) with the creation of disruptors (a number of newly created digital consumer and small business banks) within the group. It is tying this together by creating group-wide assets and capabilities (such as a customer data lake) across its legacy and new businesses. The results from this simplification are not just a better customer and financial performance, but also vastly improved operational resilience and agility.

Simplification journeys

Adopting these five steps will result in very different strategic choices for different banks. Here are three potential journeys:

1. Full-service bank with a focus on mass-affluent customers and small business

The full-service bank will organise itself to be responsive to customers, and to maintain full control of all activities that impact the customer. In its simplification journey, it is likely to focus on extending existing Centres of Excellence, as well as transformation of existing capabilities.

Simplification will be achieved by the removal of siloes and the rationalisation of bank-wide activities (including products, systems and processes), including migration to automated processes. Its transformation pace will be measured, out of risk considerations.

2. Mainstream bank with a 'value' strategy

The value-focused bank will be focused on simplicity and efficiency. It will be more likely to develop-to-replace (including through a neobank) or adopt third-party solutions. A critical factor in enabling this more aggressive approach to simplification is a relatively radical focus on rationalisation (especially of products and channels).

3. Large bank repositioning itself as an embedded finance institution

This bank provides access to the bank when and where the customer needs it, rather than putting itself behind a firewall. The embedded finance bank will open itself to an eco-system of partners (e.g. social media platforms, ecommerce, retail partners, fintechs), and partnering will be a strategic activity. It is likely to replace rather than transform many of its banking modules, as it needs to keep pace with rapidly evolving standards. It will need to simplify fast, in order to stay ahead of challengers.

Starting now

Given the priority and urgency, banks should start planning for simplification immediately. The planning process requires management and Board focus.

It starts with agreeing on the bank's long-term strategic focus. This could be done concurrently with a maturity assessment of the bank's existing activities. These two preparation steps provide the basis for a blueprint of (strategic) activities and the identification of high-level simplification options for each. This planning work also lets the bank determine its prioritisation of areas of the bank for simplification.

Net interest income

Net interest income across the majors increased by 2.2% to $62.7 billion in aggregate. The majors benefited from mortgage repricing and growth in lending volumes. This was partially offset by the impact of mortgage competition, customers switching from higher margin interest only to principal and interest loans, as well as growth in lower margin liquid assets.

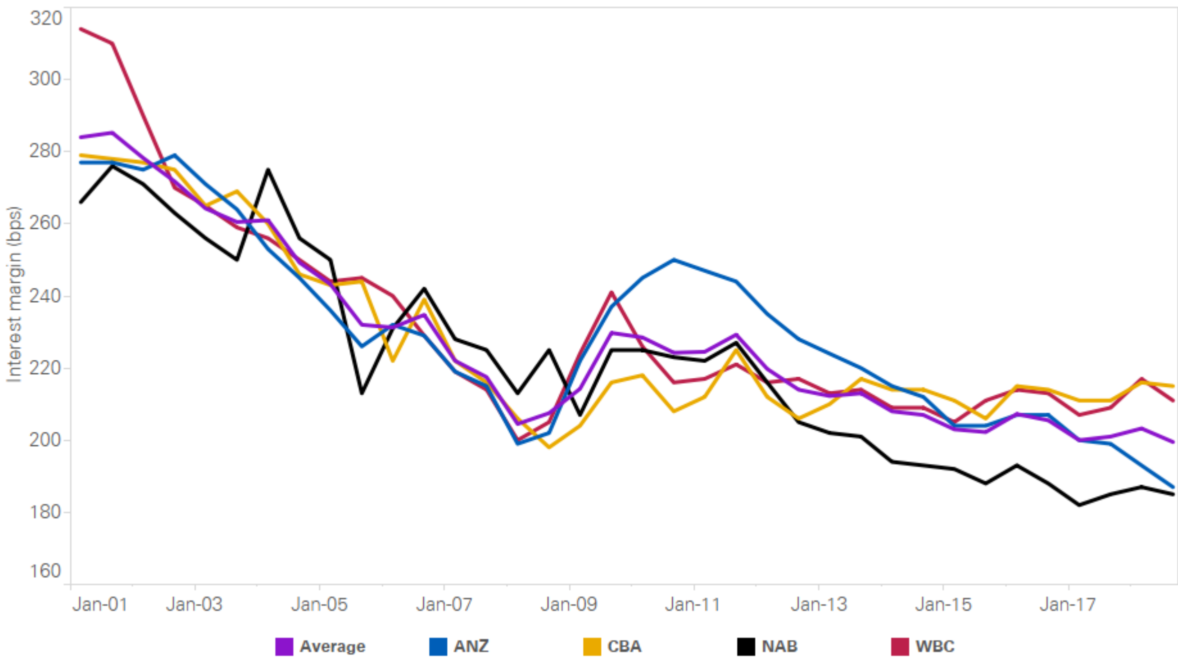
Notwithstanding the increase in net interest income, margins are under continued downward pressure with net interest margin (cash basis) decreasing 1 basis point to an aggregated average of 200 basis points. Results varied between the majors due to both product and funding mix differences.

Cash basis	FY18	FY17	Movement
NET INTEREST INCOME			
ANZ	14,514	14,875	(2.4%)
CBA	18,341	17,543	4.5%
NAB	13,467	13,166	2.3%
WBC	16,339	15,704	4.0%
Aggregate	**62,661**	**61,288**	**2.2%**
NET INTEREST INCOME MARGIN			
ANZ	187	199	(12) bps
CBA	215	210	+5 bps
NAB	185	185	-
WBC	211	209	+2 bps
Average	**200**	**201**	**(1) bps**

Net interest margin

Net interest margin has been impacted by mortgage competition, the first full year impact of the Major Bank Levy and increases in short term wholesale funding costs. Notwithstanding these headwinds, the majors benefited from mortgage repricing and improvements in funding mix including lower deposit costs.

Diagram 4. Interest margins

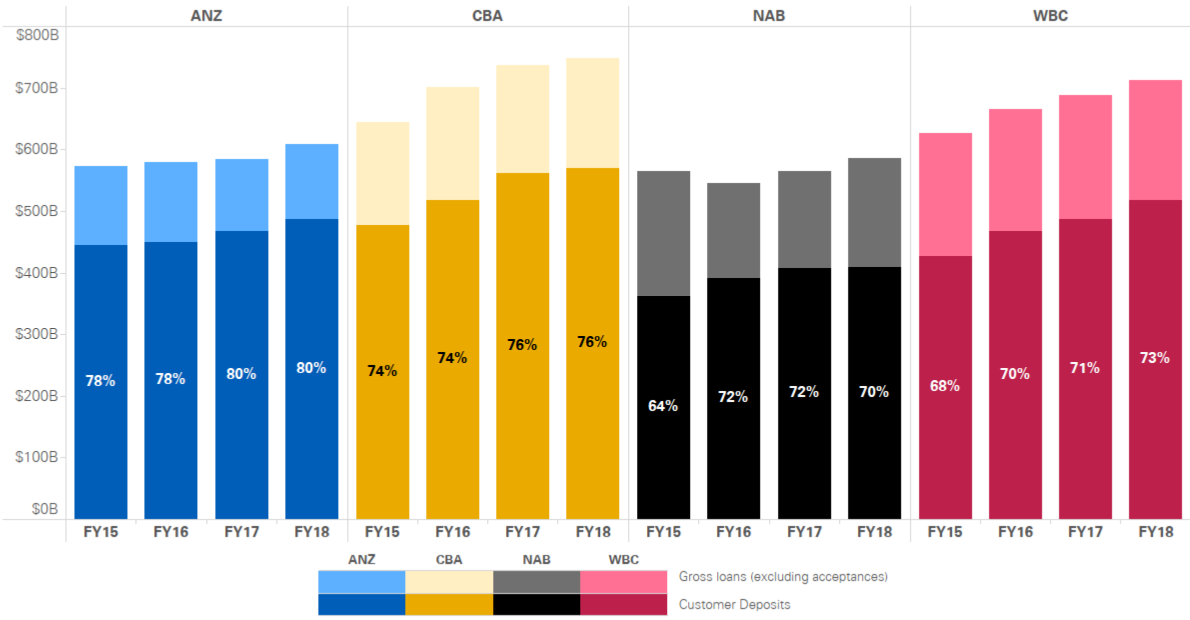


Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Funding mix

Changes in the funding mix have softened the impact of declining margins for the majors in 2018. Continued growth in customer deposits provide the majors with lower funding costs, which partially offset increases in short term wholesale funding costs. In strengthening the balance sheet, the majors continue to take steps to actively replace short-term wholesale funding with lower cost long term wholesale funding.

Diagram 5. Customer deposits proportionate to total gross loans



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

Lending asset growth

Interest earning assets across the majors continue to grow, albeit at a slower pace. Aggregated average interest earning assets increased by 2.8% to $3,131 billion, reflecting a slower growth environment as a result of more stringent regulatory requirements, slowing economic growth, low interest rates and increased competition.

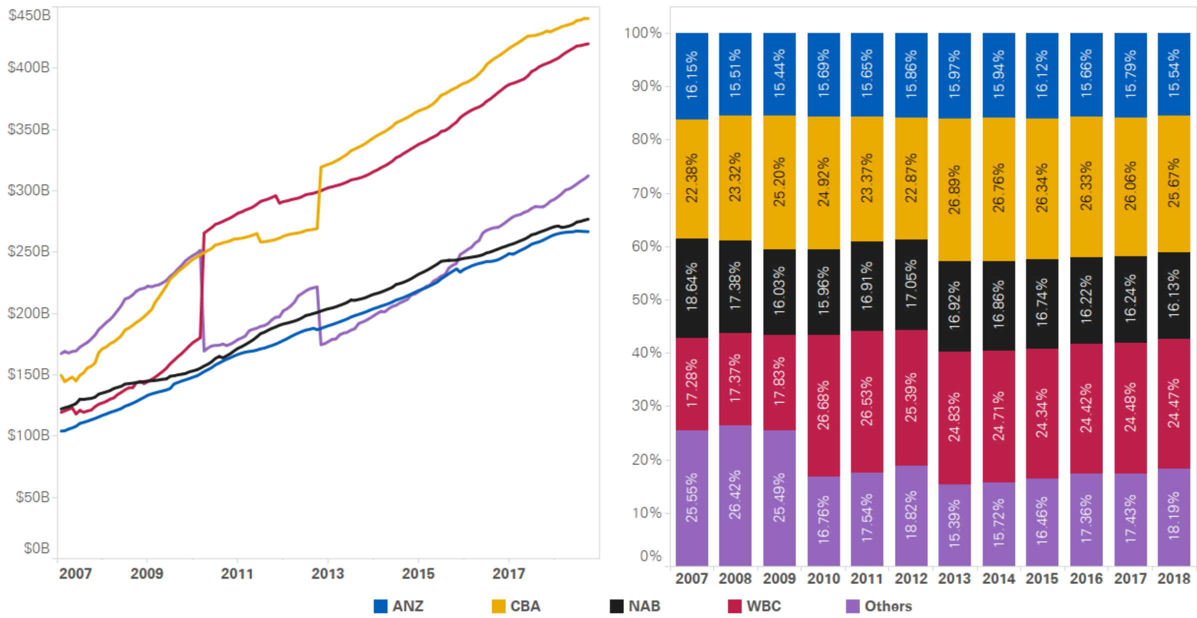
The increase is mainly attributed to housing credit growth, with owner occupier loans outpacing investor loans. The majors reported an aggregated growth of $53.8 billion, at a lower growth rate of 3.3% compared to the prior year of 5.3%.

The lower growth rate has been due to tighter APRA lending restrictions and increased competition, particularly from non-bank lenders. Whilst APRA has announced plans to remove the investor loan growth benchmark of 10%, the banks are still under heightened scrutiny to lift the lending standard due to other permanent measures including limiting the flow of new interest-only lending to 30% of total new residential mortgage lending, setting appropriate levels of serviceability metrics and restraining lending growth in higher risk segments of the portfolio.

The majors' market share in household lending excluding credit cards marginally decreased by 76 basis points, reflecting increased competition from other lenders.

Non-housing credit across the majors increased 2.9% in aggregate to $977 billion. This was largely driven by higher institutional lending balances as a result of the low interest rate environment and favourable industry conditions, partially offset by portfolio optimisation initiatives.

Diagram 6. Loans to Households and market share



Source: APRA Monthly Banking Statistics.

Are you ready for Open Banking?

Ian Pollari, Partner, Head of Banking, KPMG Australia & KPMG Global Co-Lead Fintech | **Ivan Vaptzarov**, Manager, Management Consulting

With little more than six months until Open Banking is introduced in Australia, financial institutions need to prepare for new compliance, technology and operational processes, but also for new opportunities to emerge from the new data economy.

Open Banking is the latest policy and technology innovation at the forefront of the evolution of the financial services industry, designed to put customers in control of their data. Through the use of Application Program Interfaces (APIs), banks and financial institutions will be provisioning open access to customer banking data, and facilitating the use of 'open source' innovation and product development to create more personalised experiences and new, customer-focused services.

In May 2018 the Australian Government proceeded to implement Open Banking following recommendations from an independent Australian Open Banking Review by law firm King & Wood Mallesons. For Australian banks this means returning ownership of data to their customers, starting with data from debit and credit card deposit and transaction accounts, then eventually encompassing all banking products. The Government's goal is to boost innovation through fairer and more personalised banking services, allow customer to compare and seek 'better deals' and ultimately, to stimulate greater competition in the banking industry.

Part of a global shift

The Australian Open Banking movement has been influenced by global shifts in banking legislation, particularly the European Union's adoption of the revised Payment Services Directive (PSD2), General Data Protection Regulation (GDPR) and the UK's Open Banking regime. PSD2 legislates a push to drive innovation, product development and integration in the payments market by leveraging online and mobile payment data in an Open Banking world. The UK Competition Market Authority (CMA) issued a mandate requiring the nine largest UK banks to allow licensed start-ups/developers direct access to their data (through Open APIs) with the intent to increase competition in financial services and to provide better outcomes for consumers and small businesses.

Notwithstanding the move to Open Banking has been influenced by overseas experiences and models, Australia is also exploring some differences, with the Consumer Data Right (CDR) meaning Open Banking will extend to other sectors, the concept of reciprocity of data flows between data holders and recipients (i.e. two-way), as well as being 'read-only' (information exchange) from day one.

With the Open Banking Regime to be deployed in Australia in July 2019, banks and fintechs will be looking to gain the upper hand in a new banking landscape. Similarly retailers, start-ups, technology players and others will be investigating how they can gain access and benefit from the valuable customer data the banks preside over today.

Building the frameworks

Since accepting the recommendations of the Open Banking Review in May 2018, a collaborative network of Australian statutory and regulatory representative groups have taken action to build the transformation framework for enabling Open Banking. The ACCC, the RBA, ASIC, and APRA share responsibility to support the reforms required to deliver Open Banking and as such, are under pressure to deliver the required clarity for industry participants to be ready for July 2019.

One critical legislative artefact which will ultimately govern Open Banking is the CDR (as mentioned earlier). The CDR is Australian legislation which gives customers a right to control and direct the personal information that they already share with their bank, and allow access to third party service providers and others they trust. This gives customers freedom of choice and convenience in managing their financial services, confidence in the use of their data, and allows customers to independently assess and determine the value of their data. Implementation of Open Banking in Australia will be phased to incrementally introduce the effects of CDR into the industry and to customers, starting with the major banks on 1 July 2019.

How can Australian banks prepare?

The disruptive implications of the Australian Open Banking regime creates both significant opportunities and challenges for both existing and emerging players:

- **Market efficiency and integration** - Organisations need to consider the impacts of an increasingly efficient market, particularly the rapid speed-to-market of new financial products and services, and unpredicted customer adoption of innovative and seamless banking products through third parties.
- **Consumer protection** - Companies are realising the value of the data they hold and investing heavily in safely leveraging its value to drive innovative customer solutions, build loyalty, enhance operations, etc. However, doing this without causing adverse effects on privacy will require implementation of adequate systems and processes to keep customers in charge of how, when, where and with whom their data is shared with as per the CDR.
- **Competition and choice** - With financial institutions understanding that the key driver for Open Banking is the increased competitive pressures between banks, the race to be ahead of the pack has now become a critical consideration for all market players.
- **Data security** - The open access and use of banking data includes sensitive customer and associated information created as part of banking records. This information is highly confidential and requires organisations to place emphasis and priority on ensuring that sensitive information is kept in safe hands and held to the most rigorous data security standards.
- **Digital identity** - Open Banking relies heavily on an integrated digital identity at its foundation. Consolidation of the holistic online profile for a person, organisation or electronic device will enable a secure and seamless authentication experience, and be a competitive lever between banks and other financial service providers.
- **Access management** - Banks will need the capability to securely and confidentially link a customer to their data. This will require a framework governing access (and revocation) rights, usage limitations and security. Much like using a social media account to login to a banking account, customers require either a standardised or customisable set of access management protocols defined for the sharing and use of data with third party service providers.

In summary

Australian financial institutions will need to be flexible in their approach to adapting to the Australian Open Banking regime due to the uncertainty in how the regulatory, competitive and security standards will develop. There is no doubt that a lot of activity will need to be undertaken by the majors to prepare for and be ready for next year. However, given the intent to broaden the regime to other sectors, this does present new opportunities for banks that see Open Banking more than a compliance requirement.

Asset quality

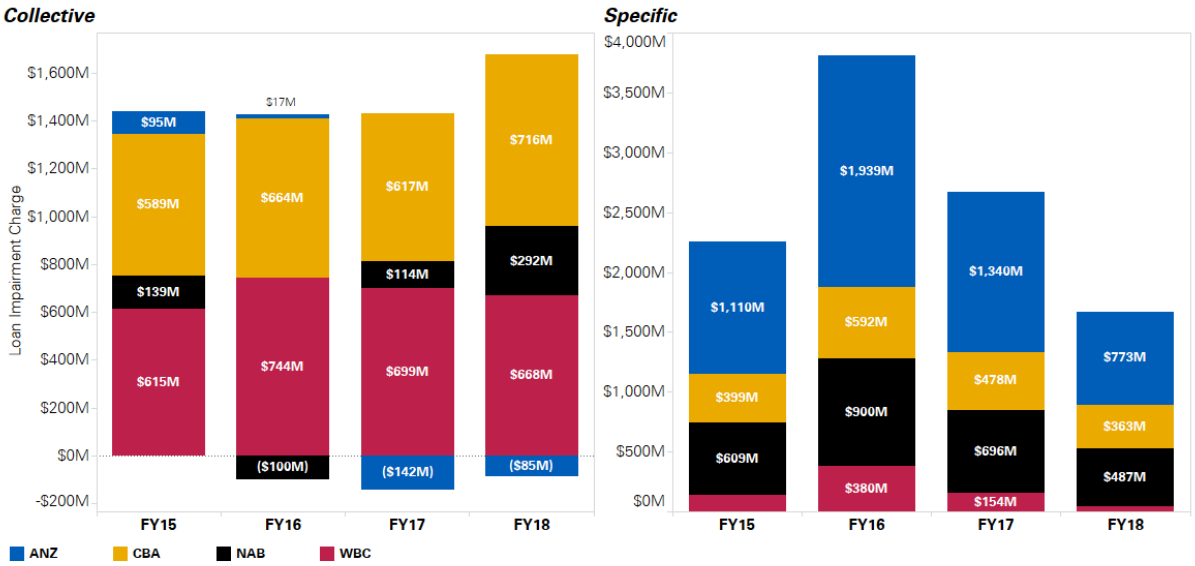
Asset quality continued to improve across the majors, with aggregated impaired assets decreasing 8.0% to $8.1 billion and aggregated loan impairment expenses decreasing 17.7% to $3.3 billion. However, the results also indicated a slight increase in the level of overdue accounts, with 90 days past due delinquencies up by 4 basis points from prior year.

Loan impairment charge

The benign asset quality reflects the majors' focus on meeting prudential lending standards and strong macroeconomic conditions. The majors' balance sheets remain strong with 4 basis points decrease in loan impairment expense as a proportion of gross lending assets (GLA).

The decrease in aggregate impairment charge is largely driven by the decline in individual impairment charges attributable to reduced risk profile across the portfolios, low levels of default in institutional portfolios and favourable macroeconomic conditions. Collective credit impairment charges have increased primarily due to enhanced credit loss modelling.

Diagram 7. Loan impairment charge

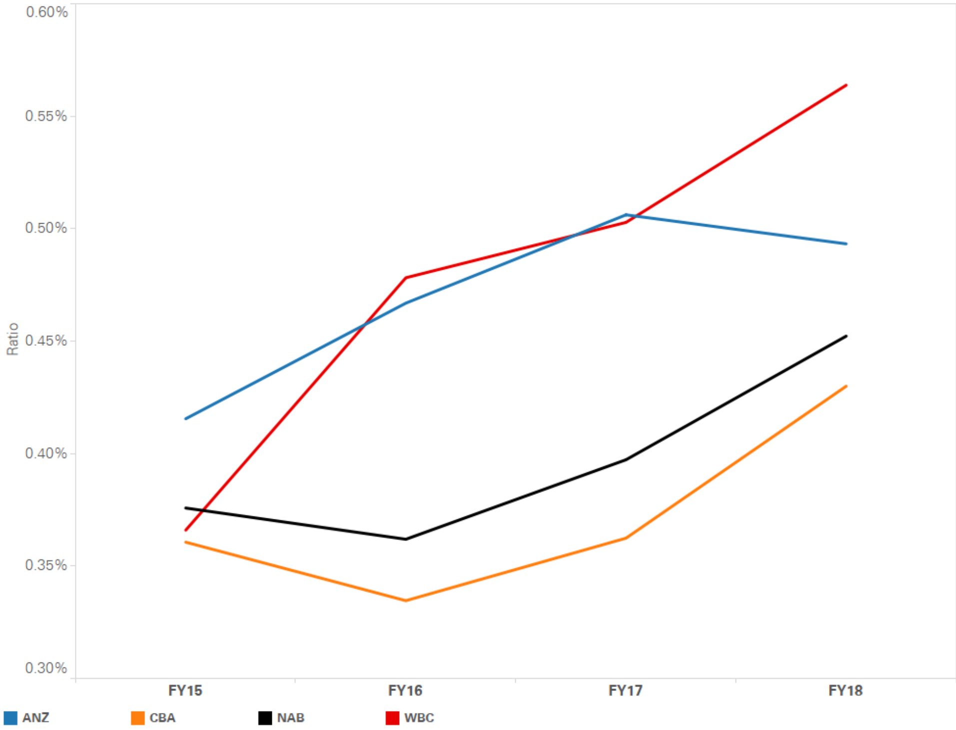


Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Delinquencies

Across the majors, 90 days past due delinquencies have been trending up slowly (and from a low base) over the past four years, driven by factors such as low wage growth and rising essential costs. This has led to some credit deterioration in areas of Western Australia, South Australia and New South Wales.

Diagram 8. 90 days past due delinquent loans as a proportion of gross loans and advances



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

AASB 9 Impairment provisions

AASB 9 *Financial Instruments* (AASB 9) becomes effective for reporting periods commencing after 1 January 2018 (i.e. for FY19) for all majors except NAB (who adopted AASB 9 early).

The implementation of AASB 9 will increase impairment provisions as it requires forward-looking factors and lifetime expected credit losses on stage 2 loans. In a deteriorating credit environment, its impact will be more pronounced. The increase in the impairment provision, as a percentage, are estimated to be: CBA +31%, ANZ +27% and Westpac +35%.

The new requirements will be applied retrospectively with the transition adjustments recognised in retained earnings with no impact on profit or loss or cash earnings.

Building customer loyalty in banking

Michael Rowland, Partner, Customer, Brand and Marketing Advisory, KPMG

With technology making it easy for customers to walk away, and with challengers and start-ups hot on the heels of incumbents, Australian banks that don't recognise loyalty will lose out.

Financial services providers have had rewards programs in place for many years – notably linking credit card spend to frequent flyer programs. However, consumers don't accept that these appropriately recognise their loyalty. This is why so many customers switch credit cards to chase rewards – meaning the programs are not generating true loyalty.

The issue of recognising customer loyalty appropriately is pertinent amid today's environment of customer dissatisfaction and digital disruption in financial services. The ACCC estimates that rates for existing mortgage customers are 32 basis points higher than for new home loan customers. If banks don't preference existing customers, they risk many hundreds of millions of dollars in revenue as customers flee elsewhere.

Technology is allowing challenger banks and start-ups to sign up customers, enquire and fulfil transaction accounts, deposits and loans, and offer competitive terms and pricing, all online. And there are currently more than 20 companies that have applied for a banking licence, which will offer ease of transacting and new, attractive digital experiences. These start-ups will provide compelling customer experiences and lure customers away from incumbent banks.

The good news is that incumbent banks and wealth managers have the opportunity to take a new approach to recognising and rewarding the loyalty of existing customers. There is still a chance to mitigate the material risks to reputation and profitability from consumer dissatisfaction, disruption, and a lower-return future.

What customers think

A recent KPMG Acuity survey of over 500 Australian consumers about their attitudes towards their bank found evidence of the limited effectiveness of traditional loyalty programs, and the need for banks to find better ways to recognise loyalty as a priority.

Some key findings were:

- Six in 10 (61%) of customers said it was extremely/very important for their bank to focus on 'finding better ways to reward loyal customers', with 26% saying it was quite important. Only 10% did not think this was an important issue.
- 'Finding better ways to reward loyal customers' was even more important to big banking customers (63% extremely/very important) than non-big four customers (57%); it was more important to women (66%) than men (54%); and particularly important to the 26-35 year old cohort (76%).

- More consumers placed importance on this particular issue than, for example, the proportion who said it was extremely/important for their bank to focus on 'improving online banking' (57%), 'offering greater flexibility in payment terms and options' (56%), 'making application processes easier' (52%), 'improving branch service' (49%) or 'automating more services' (45%).
- Almost one in 10 (9%) of customers said 'finding ways to better reward loyal customers' should be their bank's number one priority; 45% said it should be in their top five priorities.

The potential of reward

Customers expect to be offered loyalty programs, and by not doing so, incumbents risk further exacerbating customer dissatisfaction.

The financial and reputational value that could be gained by the first bank or wealth manager offering a truly valuable loyalty program would be significant. Most financial institutions see value in loyalty programs and have some form of rewards scheme.

So the question is: *how do banks and wealth managers rethink loyalty in a way which rewards existing customers?*

Successful loyalty programs require relevant, honest and believable engagement which is consistent across channels. Existing customers need to be preferenced with simple, appealing and relevant rewards for loyalty. This can take many forms, however the core attributes should include 'best offers' to existing customers; easy sign up and servicing; consistent experience across channels, and effortless complaint resolution.

The financial institutions that prioritise investment and transformation in a way which develops compelling customer loyalty will be well placed to turn around customer dissatisfaction, and avoid the significant reduction in returns that the new era of financial services beckons.

Non-interest income

The majors reported an aggregated non-interest income (cash basis) of $22.4 billion, down 3.7% from FY17, as they face challenging trading conditions and continue to divest non-core businesses and focus on meeting capital requirements.

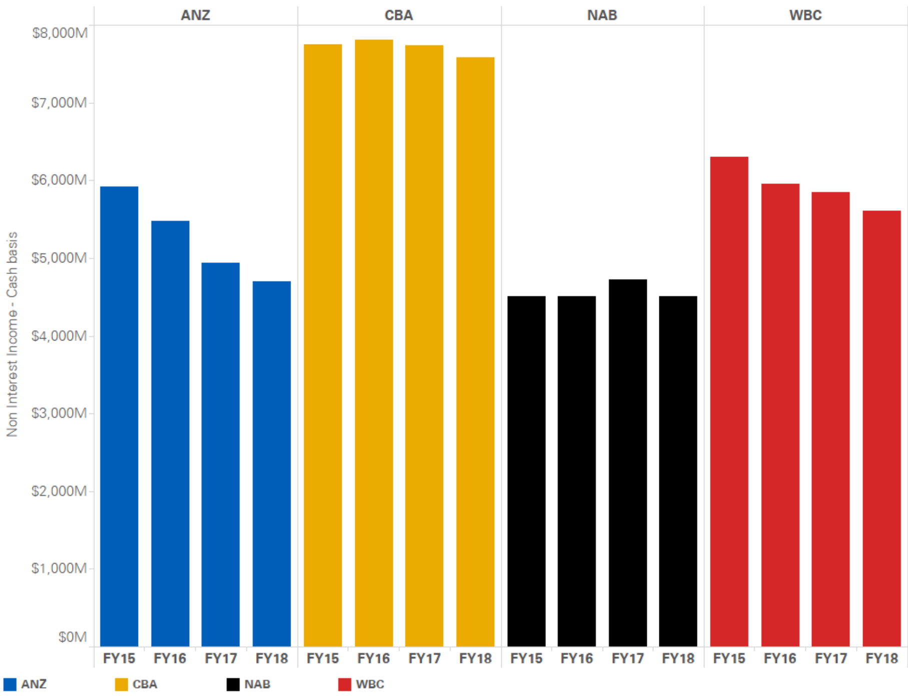
CBA's non-interest income decreased 2.0% to $7,583 million. Excluding one-offs, the decrease reflects weaker trading performance from widening spreads on trading inventory, offset by an increase in funds management income from higher FUM, and an increase in insurance income due to lower weather event claims and premium increases due to risk-based pricing initiatives.

ANZ's non-interest income decreased by 4.9% to $4,700 million. This primarily reflects the sale of the Asia Retail and Wealth business, lower lending fees, customer remediation, removal of ATM fees and lower Markets revenues.

NAB's non-interest income decreased by 4.6% to $4,510 million. This reflects the sale of the life insurance business last year and customer remediation activities. This has been slightly offset by higher corporate finance fees and improved trading income.

WBC's non-interest income decreased by 4.1% to $5,612 million. This decrease mostly reflects lower Markets income due to a reduced fixed income trading result, and lower fees and commission income relating to customer remediation. This has been partially offset by fees associated with the exit of Hastings.

Diagram 9. Non-interest income – cash basis



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

Asset sales

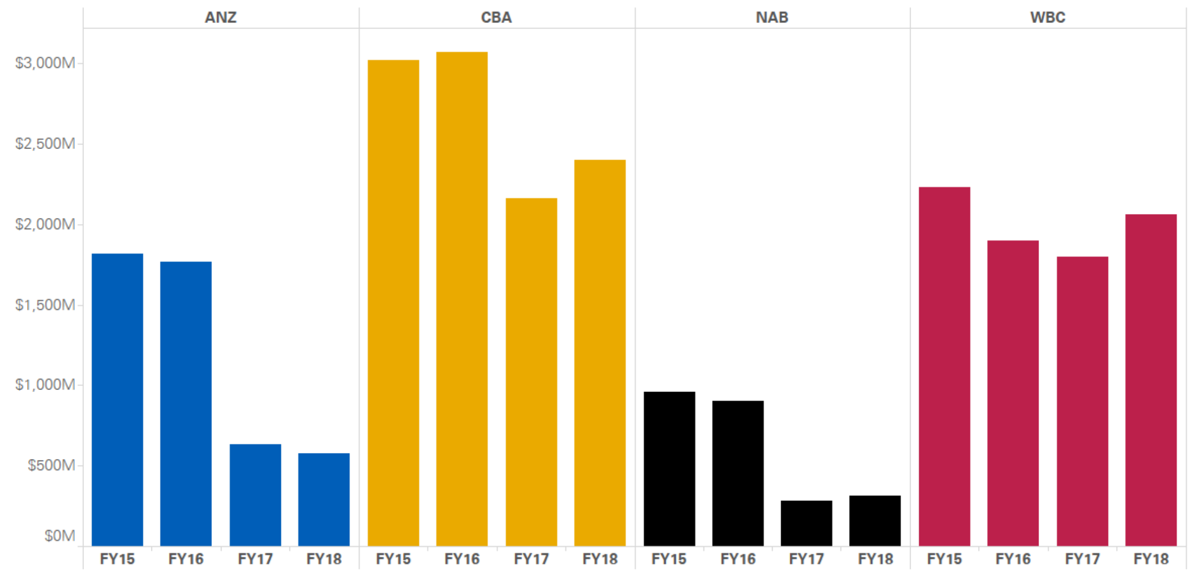
The majors continue to divest non-core businesses. The following divestments were announced in the second half of the year:

- NAB's sale of its Advice, Platform and Superannuation and Asset Management businesses which are currently under its MLC and other brands. The transaction is expected to be completed in 2019.
- CBA will sell its stake in BoComm Life Insurance Company to Mitsui Sumitomo Insurance, which is expected to be completed by the end of 2018.
- Amongst other non-core business sales, ANZ announced the NZ$700 million sale of its OnePath NZ business to Cigna Corporation. A 20 year strategic alliance will be in place to continue distributing life insurance products to ANZ customers in NZ. Regulatory approval was received subsequent to the reporting period and is expected to complete in the first half of 2019.

Subsequent to the reporting period:

- CBA announced in October 2018 the $4.1 billion sale of its global asset management business, Colonial First State Global Asset Management (CFSGAM), to Mitsubishi UFJ Trust and Banking Corporation. The sale is expected to be completed mid-2019. CFSGAM had $213 billion of FUM as at 30 June 2018.

Diagram 10. Net funds management and insurance income



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

BEAR – the challenges and potential

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Banks and other financial institutions have more work to do under the Banking Executive Accountability Regime, but it's also an opportunity to build a stronger culture of transparency.

The Royal Commission into Financial Services and APRA's Prudential Inquiry into CBA has highlighted the increasing focus on accountability in Australia, and follows the significant changes which have already occurred in the United Kingdom and Hong Kong.

The implementation of the Banking Executive Accountability Regime (BEAR) in July 2018 for large Authorised Deposit taking Institutions (ADIs) requires ADIs to consider who they identify as Accountable Persons (APs), and to analyse their roles and allocated responsibilities.

As a result, BEAR is changing how ADIs organise themselves and operate, given the specific focus on individual accountability.

What has changed?

This increasing focus on individual accountability has been driven by two main factors:

1. Following the global financial crisis, a drive to ensure that an ADI is managed prudently.
2. To hold individuals to account, either through the lever of remuneration and/or disciplinary action, when regulatory breaches and other failures do occur.

BEAR is explicitly focused on prudential matters. However, the level of attention on conduct in the current environment, along with the potential impact of conduct issues on financial institutions' financial standing, calls into question the boundary between conduct and prudential management.

What is the challenge?

Whilst individual accountability is a relatively easy concept to understand, in practice pinpointing the accountable owner in any situation is becoming harder. Organisations are growing in size, becoming more siloed due to a need for specialisation, increasing their geographical distribution, offshoring parts of their processes, and using more third-party providers. Layering in the increased expectations of Board oversight, a strong regulatory requirement to have three lines of defence, and the expanding use of technology such as artificial intelligence – it may seem like an impossible task. Or is it?

BEAR lessons to date

ADIs have had to ask themselves, ‘What do we do and what risks are we facing?’ They have then assessed ‘how’ they do what they do, and ‘who’ is doing what. This involves a significant amount of time by very senior people discussing, debating and ultimately agreeing who does what.

The exercise isn’t sufficient to just ‘tick the boxes’ by identifying a list of APs, producing a set of individual responsibilities, and an overall mapping of governance arrangements. The large ADIs have made significant investment in getting it right, and engaged with the spirit of the regime. This isn’t a one off compliance exercise, as the ADI has the ongoing challenge of notifying APRA when there are any changes to their APs and what they are doing. APs are also obliged to exercise reasonable steps in the execution of their responsibilities (and to be able to demonstrate this in relation to matters that may have taken place in the past[1]). This requires a significant amount of internal control and awareness of their obligations. Through the recent hearings at the Royal Commission, it is clear that this is easier said than done – particularly giving notification to the regulators in a timely manner.

The large ADIs have taken different approaches to implement BEAR, but the challenges they have faced are similar, namely:

- Addressing current organisational structures and identifying accountabilities with in a ‘matrix management’ structure;
- Variability in current operational processes across the ADI; and
- Interpretation of reasonable steps.

BEAR is limited at this stage to the most senior management in the ADI. One of the key challenges for ADIs is how they leverage their accountability principles and cascade this throughout the organisation to ensure there is a consistent understanding of roles and responsibilities which can support effective and agile decision making.

Building a better culture

The introduction of BEAR has put significant pressure on ADIs. In the absence of prescriptive guidelines, ADIs have also had to take their own view on how an AP can demonstrate that reasonable steps have been implemented. Where this isn’t consistent issues tend to emerge.

The implementation of BEAR is only the start. The bigger challenge for organisations is how to maintain the focus on accountability and build a strong accountability culture. In considering this challenge, ADIs should give consideration to how they articulate reasonable steps and guide AP record keeping.

[1] The reasonable steps obligations only related to occurring after BEAR comes into effect for the ADI. However, the need to be able to demonstrate reasonable steps after this point in time is open-ended.

Capital

The majors have maintained a strong capital position and are focused on meeting APRA's "unquestionably strong" Common Equity Tier 1 (CET1) capital ratio benchmark of 10.5% by 1 January 2020. Sale of non-core assets has supplemented slowing organic capital growth.

The majors' capital position continues to rise, with their average CET1 capital ratio rising by 25 basis points over the year to an average of 10.6% of RWAs, reflecting the impact of increased regulatory capital requirements.

As profits decrease, the majors look to other means to increase capital, including continued divestment of non-core businesses and RWA optimisation. All the majors maintain that the benchmark will be met by 2020.

	ANZ		CBA		NAB		WBC	
	FY18	FY17	FY18	FY17	FY18	FY17	FY18	FY17
Common Equity tier 1 ratio	11.4	10.6	10.1	10.1	10.2	10.1	10.6	10.6
Tier 1 capital (total)	13.4	12.6	12.3	12.1	12.4	12.4	12.8	12.7
Tier 2	1.9	2.2	2.7	2.1	1.7	2.2	2.0	2.2
Total regulatory capital ratio	15.2	14.8	15.0	14.2	14.1	14.6	14.7	14.8
Tier 1 capital ($ million)	52,218	49,324	56,432	52,684	48,254	47,417	54,383	51,175
Total capital ($ million)	59,509	57,993	69,011	62,076	55,008	55,707	62,715	59,910
Risk weighted assets (RWA) ($ million)	390,820	391,113	458,612	437,063	389,684	382,114	425,384	404,235
Credit risk weighted assets ($ million)	337,580	336,834	369,528	377,259	331,381	325,969	362,749	349,258

Other key capital and liquidity ratio requirements for the majors remain healthy:

- 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 at an average of 134% versus the stipulated 100% minimum; and
- The Leverage Ratio (the amount of Tier 1 capital held divided by average total consolidated assets of the bank) for the majors is running at an average of 5.6% which is also in excess of the currently agreed minimum Basel requirement of 3%.

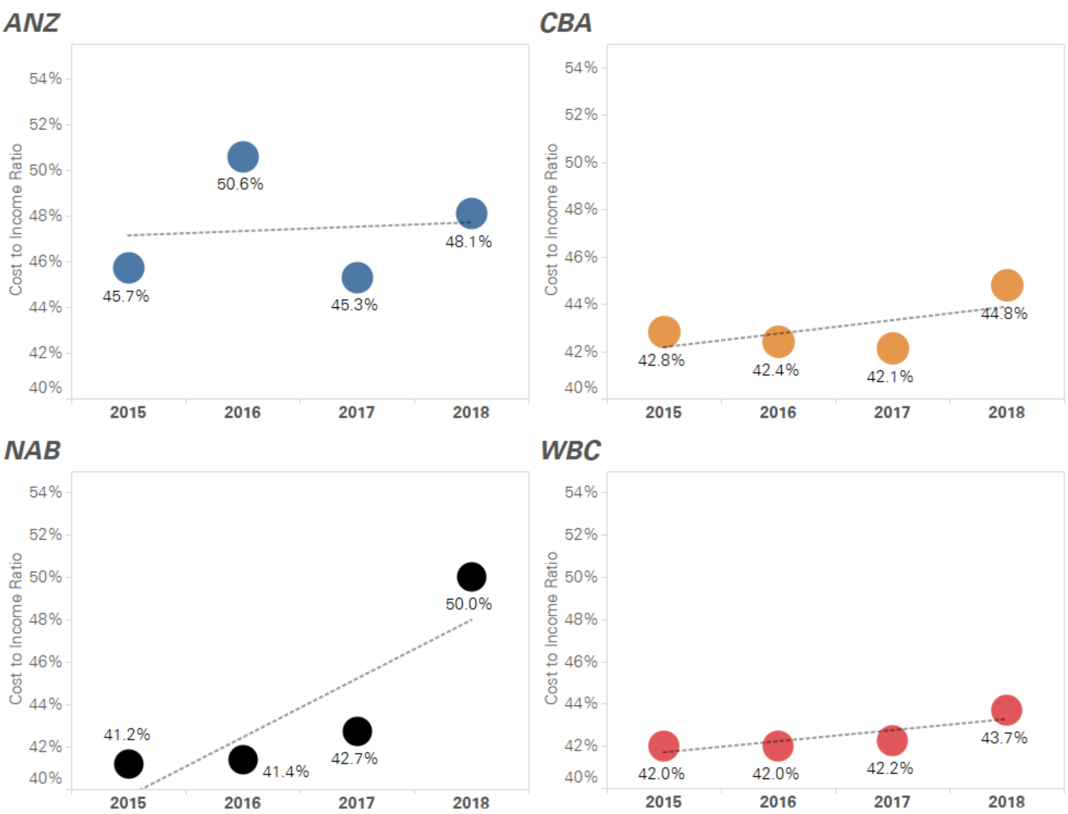
Costs

Across the majors, operating expenses have increased, mainly driven by regulatory, customer remediation and restructuring costs. In addition, overall investment spend is higher with a greater proportion of funds allocated to risk and compliance.

Operating expenses have increased in aggregate by 8.5% to $39.4 billion across the majors. The 2018 results include several notable items: CBA's $700m AUSTRAC civil penalty, and for the majors combined customer remediation costs of $414 million and restructuring costs of $1,096 million (largely NAB).

The average cost to income ratio has increased by 356 basis points to 46.6%, mainly due to the above items.

Diagram 11. Average cost to income ratio



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

Investment spend

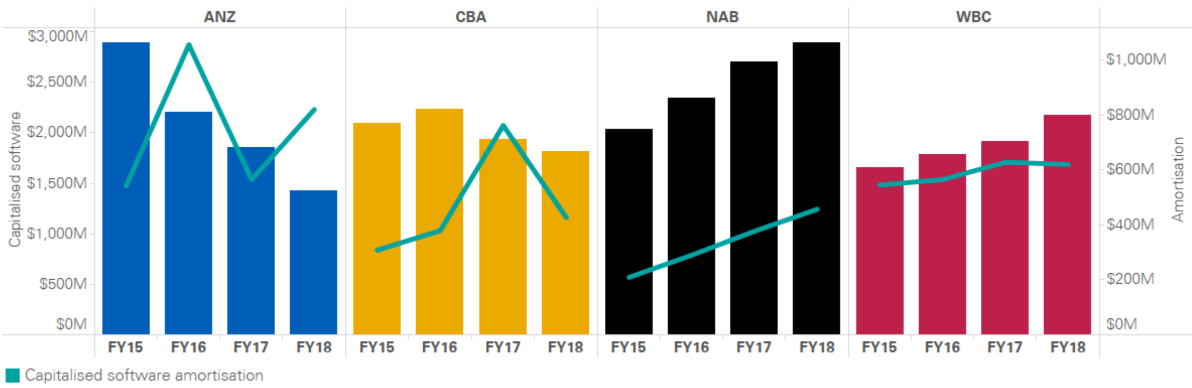
Overall investment spend across the majors[3] has increased by 16.8% to $4,266 million. Investment spend is allocated broadly between growth, infrastructure and risk and compliance. There has been an increased focus on risk and compliance across the majors during the reporting period, driven by customer remediation programs, the Royal Commission, as well as bank specific focus areas such as AML/CTF and Markets in Financial Instruments Directive II (MIFID II).

Technology

Technology expense continues to increase, rising 6.9% to $7.2 billion across the majors. The continued investment in technology enables the majors to strengthen and streamline their product offerings and operating models, to provide an enhanced customer experience and address growing areas of concern, such as cyber and information security.

During the period, ANZ increase in technology expense of $297 million mainly related to the accelerated amortisation of specific assets. CBA technology cost decreased by $172 million largely due to accelerated amortisation of capitalised software in the previous year, partially offset by increased capitalised software impairments of $65 million. NAB increase in technology expense of $233 million related to its accelerated investment in technology and capitalised software impairments due to restructuring.

Diagram 12. Capitalised software



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

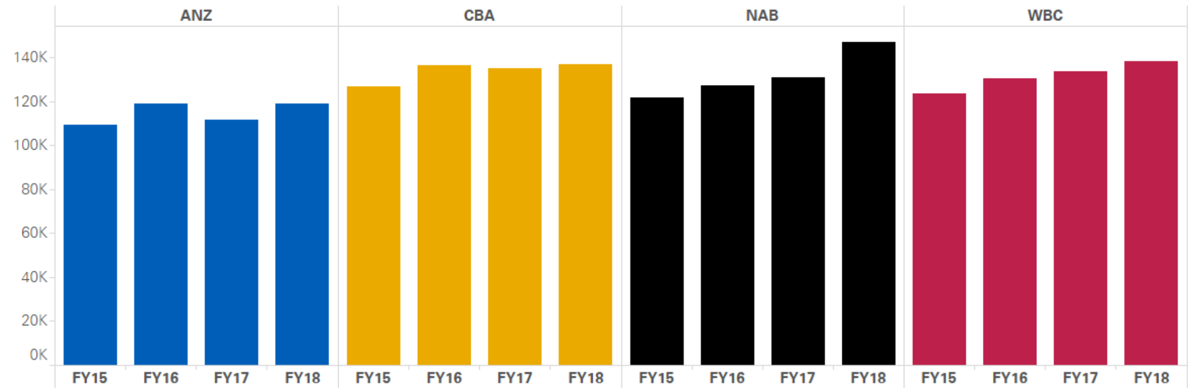
[3] Excluding ANZ as investment spend was not separately reported in their FY18 results announcement

Personnel

Overall, personnel numbers across the majors continue to decline with Full Time Equivalents (FTE) decreasing by 5,206 to 149,943. Most notably, ANZ reported a reduction of 4,972 FTE, mainly driven by the sale of its Asia Retail and Wealth businesses and benefits from continued workforce optimisation through process automation and simplification.

As structural and technological change continues, FTE will decline albeit at a slower pace. Jobs replaced by automation and digitisation will give rise to new roles with differing skillsets to those that the current majors' workforce do not readily possess. Average personnel cost per FTE reflects personnel-related restructuring costs and higher salaries for new roles.

Diagram 13. Average personnel costs per FTE



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

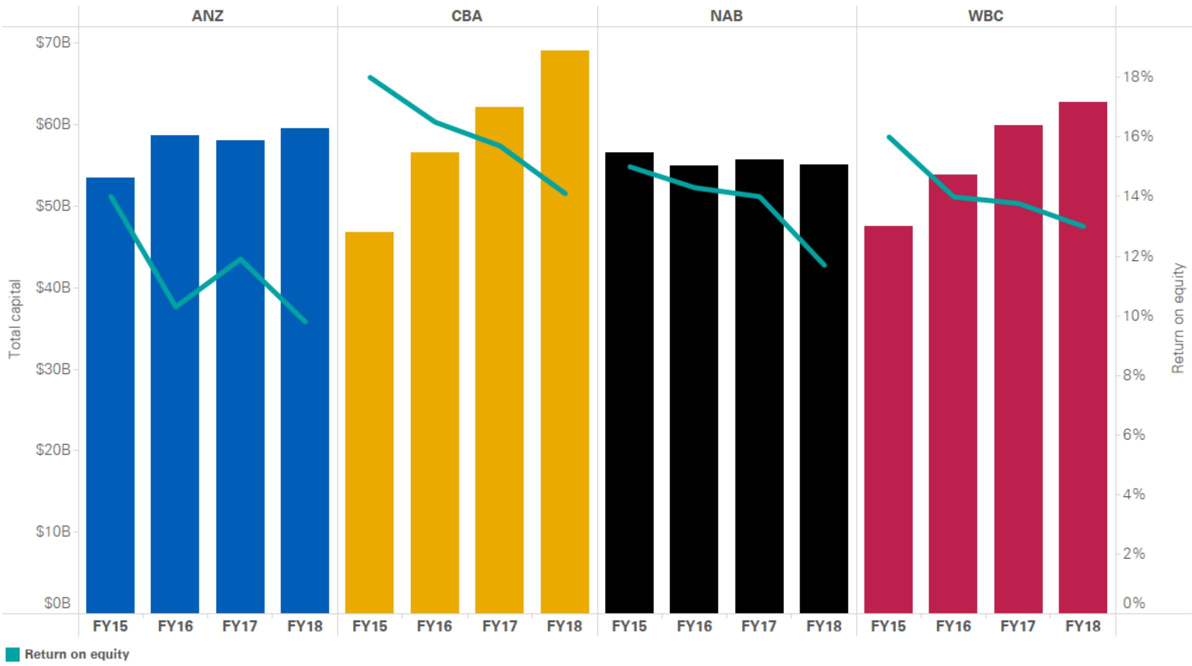
Profits and return on equity

Increasing regulatory capital requirements, combined with weaker earnings growth and higher operating expenses will continue to challenge the majors in maintaining shareholder expectations for high returns on equity.

A reduction in cash earnings combined with ongoing momentum across the majors to meet APRA's "unquestionably strong" CET1 capital target of 10.5% by 2020, has continued to place pressure on RoE during the period.

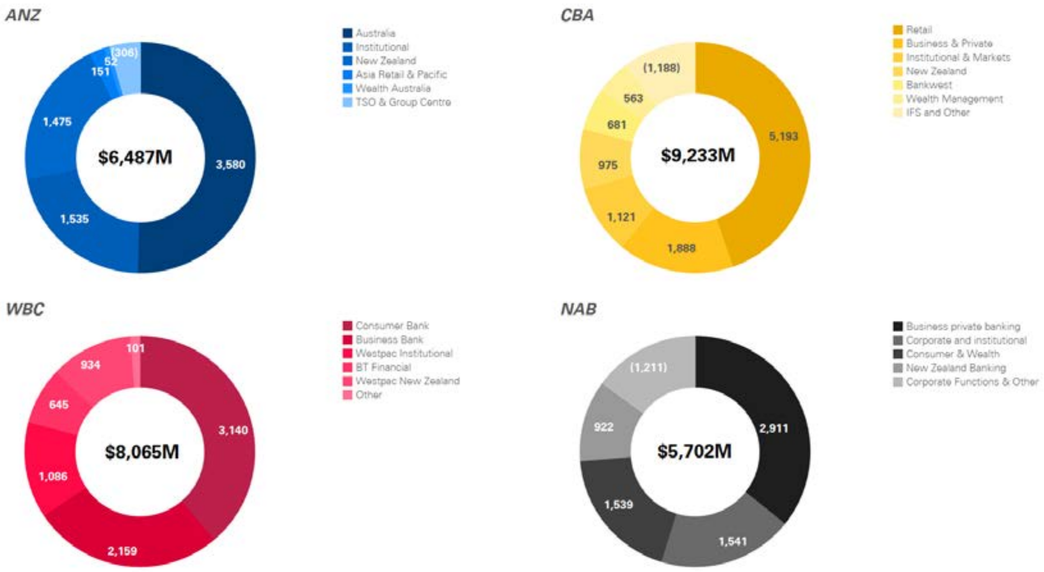
Average RoE across the majors decreased by 134 basis points to 12.5%, primarily due to regulatory, customer remediation and restructuring costs, divestments and the average increase of 25 basis points in CET1.

Diagram 14. Total capital vs return on equity



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

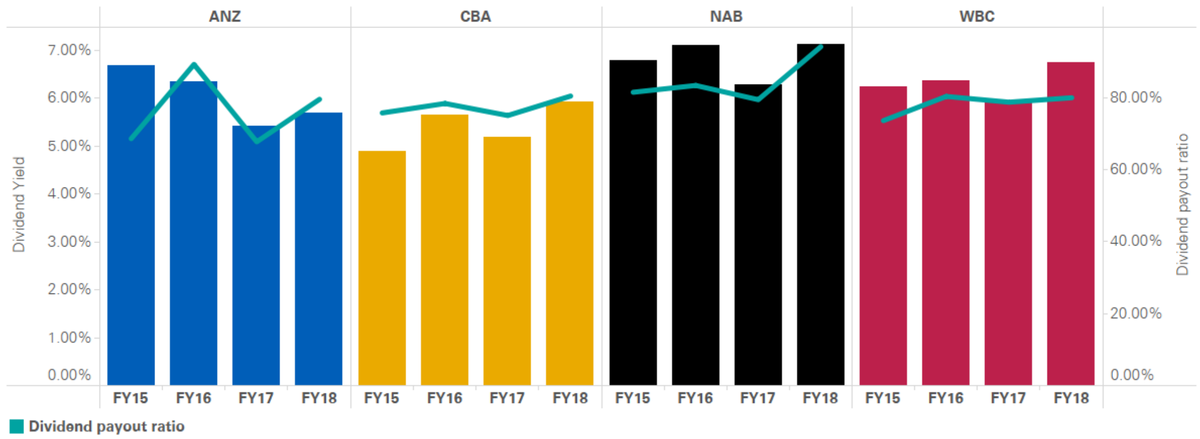
Diagram 15. Cash profit after tax by segment



Dividends

Whilst cash profit decreased across the majors, dividends remained the same except for CBA who increased dividends by 2 cents per share. This resulted in the dividend payout ratio increasing across the majors on average by 828 basis points to 83.5%. With the growing structural headwinds facing the industry, sustaining this level of payout ratios will be challenging, although bank managegment teams have done well to preserve shareholder dividends.

Diagram 16. Dividend yield vs payout ratio



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

The following KPMG staff have made a significant contribution to the development of this publication.

Ashley
Trang

Danny
Pang

Dejia
Li

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Swanepoel

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