



Major Australian Banks

**Majors prove resilient but risks
are mounting**

Full Year 2020 Results Analysis

November 2020

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Full Year 2020 Results Snapshot

Revenue



Operating income
decreased by **1.7%** to
\$79.3 billion

Net interest income
increased by **0.9%** to
\$63.6 billion

Earnings



Cash profit after tax
decreased by **36.6%** to
\$17.4 billion

Average **net interest margin**
decreased by **5 bps** to
189 bps

Shareholder Returns



Average **return on equity**¹
decreased by **458 bps** to
6.7%

Average **dividend payout ratio**
decreased by **29.1% pts** to
52.2%

Expenses



Average **cost to income ratio**
increased by **598 bps** to
53.2%

Share of **risk and compliance of total investment spend** increased by **12.3% pts** to
52.5%

Asset Quality



Loan impairment expense
(as % of GLA) increased
by **28 bps** to
0.42%

COVID-19 related impairments
recognised of
\$6.9 billion

Provisions for **credit impairment** increased
by **45.3%** to
\$24.8 billion

Balance Sheet



Average CET1 **capital ratio** increased **59 bps** to
11.4%

Deposit to loan ratio
increased **676 bps** to
82.4%

Lending assets
decreased **22 bps** to
\$2.7 trillion

* Comparisons are to the 2019 financial year, adjusted for restatements as applicable.

¹ Includes notable items

At a glance

	ANZ		CBA ¹		NAB		WBC	
	FY20	FY19	FY20	FY19	FY20	FY19	FY20	FY19
Ranking								
By profit before tax	2	3	1	1	3	4	4	2
By total assets	1	1	2	2	4	4	3	3
By total equity	3	3	1	1	4	4	2	2
By market capitalisation	4	4	1	1	3	3	2	2
By CET1 capital ratio	3	1	1	2	2	4	4	3
Financial performance (continuing operations)								
Operating income (\$ million) – cash	17,752	19,029	23,758	23,577	17,190	17,434	20,626	20,655
Profit before tax (\$ million) – statutory	5,516	8,920	10,479	11,376	5,163	8,345	4,266	9,749
Profit after tax (\$ million) – statutory	3,676	6,311	7,459	8,101	3,498	5,905	2,292	6,790
Cash profit after tax (\$ million)	3,758	6,470	7,296	8,221	3,710	5,853	2,608	6,849
Performance measures (continuing operations)								
Net interest margin – cash (basis points)	163	176	207	209	177	178	208	212
Cost to income ratio – cash (%)	52.9	47.7	45.9	45.9	52.4	46.7	61.6	48.6
Basic earnings per share – statutory (cents)	129.8	222.1	421.8	458.3	112.7	208.2	63.7	196.5
Basic earnings per share – cash (cents)	132.7	227.6	412.5	465.5	120.9	209.3	72.5	198.2
Return on average equity (%) – cash	6.2	10.9	10.3	12.1	6.5	11.4	3.8	10.8
Credit quality measures								
Loan impairment expense (\$ million) – statutory	2,738	794	2,518	1,201	2,752	927	3,178	794
Impaired loans to loans and advances (%)	0.40	0.33	0.46	0.48	0.31	0.33	0.40	0.25
Collective provision to credit RWA (%)	1.39	0.94	1.44	1.05	1.56	0.96	1.54	0.95
Financial position								
Total assets (\$ million)	1,042,286	981,137	1,014,060	976,502	866,565	847,124	911,946	906,626
Total equity (\$ million)	61,297	60,794	72,013	69,649	61,293	55,604	68,074	65,507
Capital measures								
Capital adequacy ratios (%)								
- Total	16.4	15.3	17.5	15.5	16.6	14.7	16.4	15.6
- Tier 1	13.2	13.2	13.9	12.7	13.2	12.4	13.2	12.8
- Common Equity Tier 1	11.3	11.4	11.6	10.7	11.5	10.4	11.1	10.7
Market capitalisation (\$ billion) ²	48.8	80.7	122.7	146.3	58.3	85.4	60.8	103.4

¹ CBA reported as at 30 June 2020. All other Majors as at 30 September 2020.

² Market capitalisation as at the reporting date of the Majors.

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“Despite the substantial challenges, the Majors have proven resilient in the last year and through the strength of their balance sheets, played a critical role as shock absorbers for the economic downturn.”

– Ian Pollari, KPMG Australia’s Head of Banking

Executive Summary

As the impact of the COVID-19 pandemic continues to evolve, the Australian Major Banks (the Majors) have maintained a strong focus on supporting their staff and customers, as they demonstrated resilient operations and continued lending.

While they have significantly increased their loan loss provisions and allowed customers to defer loan repayments, to date their actual loss experience has been minimal. The open question is to what extent loan losses will materialise in 2021, as the Commonwealth Government unwinds its economic support measures.

Key highlights

The Majors reported a **cash profit after tax** from continuing operations of \$17.4 billion in FY20, down 36.6 per cent on FY19. The profit fall was a function of a number of factors, including some large, notable items like restructuring costs associated with divestments as well as ongoing regulatory and remediation costs. It was also negatively impacted by rising loan impairment charges and credit provisions, in advance of an expected deterioration in the economy as Government support comes to an end.

The average **net interest margin** (cash basis) saw continued compression, decreasing 5 basis points compared to FY19. Declining net interest margin (NIM) was driven by repricing of deposits, mortgages and business lending assets amidst RBA rate cuts and increased competition in the market. Excess liquidity from an inflow of deposits also hurt margins. However, the Majors benefited from favourable wholesale funding pricing, which saw the BBSW benchmark rate decline below that of the cash rate target of 0.25 basis points in the second half of the year.

Cost-to-income ratios have increased from an average 47.2 per cent to 53.2 per cent, in large part driven by rising IT related expenses which included higher costs associated with mobilising their workforces for remote working conditions and higher software amortisation charges. In addition, one of the Majors reported significant items relating to regulatory matters.

Excluding these, average cost to income ratio increased by 177 basis points to 45.2 per cent, with increases reported for each Major.

Aggregated **loan impairment expenses** increased by 201 per cent to \$11.2 billion, coming off a historically low provision base at the end of FY19. This increase reflects the Majors expecting higher loan losses and customer defaults as a result of the pandemic, and continued uncertainty in the economic outlook. As a result, total provisions increased to \$24.8 billion, providing a significant buffer for potential future losses. While the actual loss experience has been modest to date, a big question for FY21 is to what extent loan losses will materialise as the Commonwealth government unwinds its economic support measures.

The Majors have maintained a strong **Common Equity Tier 1 (CET1) ratio** capital position of 11.4 per cent, increasing 59 basis points from FY19. This result has been driven by prudent capital management, and decisions to reduce dividends in line with current APRA guidance, which saw the **dividend payout ratio** reducing to 52.7 per cent from 81.3 per cent. Westpac and NAB additionally reported a \$2.8 billion and \$3.5 billion capital raising respectively earlier in the year. While regulators have provided guidance to the banks that in current conditions it would be acceptable to temporarily reduce their capital ratios, it appears that the Majors have preferred the safety of strong balance sheets heading into an uncertain FY21.

The focus on balance sheet strength and reduced profitability has continued to impact **returns on equity (ROE)**, which decreased 458 basis points on the prior comparative period to an average of 6.7 per cent. As the Majors continue to focus on supporting customers, investing in the necessary transformation and maintaining strong balance sheets, shareholder value creation will be an important challenge in upcoming years.

Key observations

The Majors contended with ongoing challenges throughout FY20, including bushfires, a global pandemic and an economic recession amidst the contrasting interests of customers, regulators and investors in a post Royal Commission world.

COVID-19

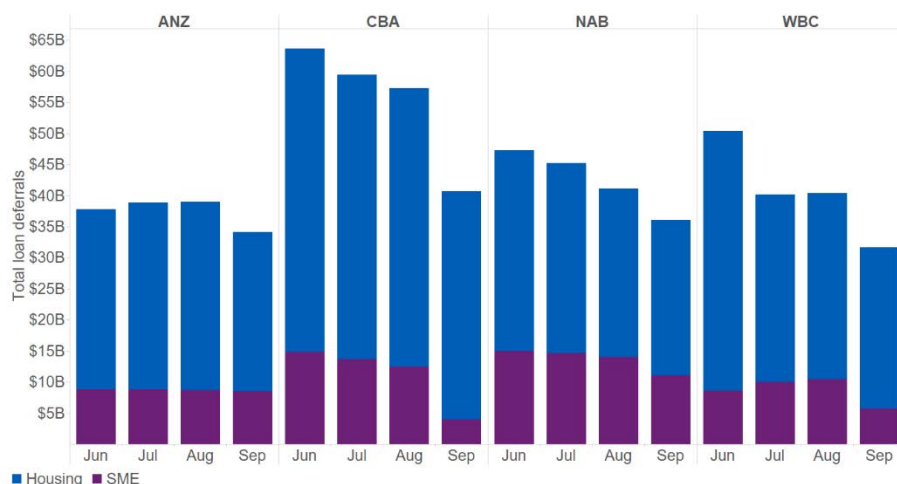
After a period of elevated economic uncertainty and volatility within financial markets following the onset of the pandemic, the impacts of the crisis have now begun to materialise. We have observed governments and central banks implement unprecedented measures to contain the spread of the virus and its economic fallout, ranging from lockdowns and restrictions to varying forms of stimulus packages. Whilst Australia has fared favourably compared to other developed economies, the impacts are still pronounced and are reflected in the Majors' FY20 results.

The Majors have offered temporary loan repayment deferrals to mortgage and SME lending customers, since the onset of COVID-19 in Australia. Large numbers of borrowers, representing significant loan volumes, have taken up these offers. Due to government support measures (especially the JobKeeper and JobSeeker payments), the Majors have seen the number of borrowers on deferral arrangements come down from their initial levels in 1H20. Across the Majors, deferrals decreased from \$199.1 billion at June 2020 to \$142.4 billion as at September 2020 as many customers resumed repayments.

As the global and local banking industry enters a period of economic and digital disruption, the Majors remain focused on supporting customers, protecting their balance sheets and investing in the future."

– Hessel Verbeek,
KPMG Banking Strategy Lead

Diagram 1. Housing and SME temporary repayment deferrals - Majors



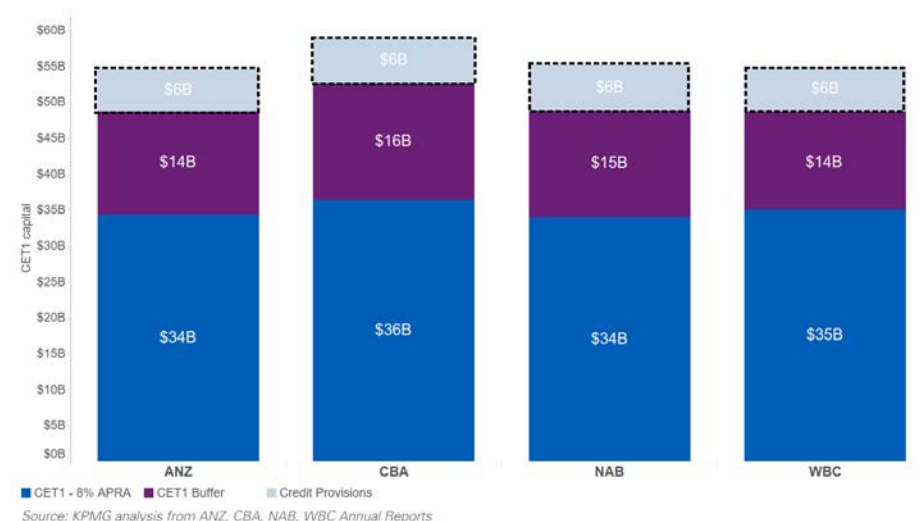
Source: KPMG analysis from APRA statistics

Against this trend, provisioning levels have continued to increase as the economic outlook becomes clearer. Loan loss models built upon historical loss experiences have proven inadequate in the face of current levels of uncertainty, resulting in the Majors applying increased judgement in estimating their credit loss provisions (including significant management overlays). It should be noted the Majors' loan provisions are still well below those seen in many other countries. There is an expectation that Australia may avoid a loan loss fallout compared to what could be experienced in other countries, given our economic outlook, greater success in managing the spread of the virus and lower risk portfolios which have favoured secured residential lending.

The 'Resilience' of balance sheets

Despite the sharp decline in profitability, the Majors have continued to strengthen their balance sheets and maintain substantial capital buffers to position themselves for any potential future shocks. Capital levels are at record levels and their capital ratios continue to be in excess of APRA's requirements despite regulatory guidance to temporarily relax 'unquestionably strong' targets where needed to continue lending to customers.

Diagram 2. CET1 buffer



Investors have borne the brunt of lower ROEs and the Majors' decisions to reduce payout ratios to below their pre-COVID levels in line with current APRA guidance. It remains to be seen when higher payouts will be restored, as the Majors continue to focus on maintaining financial and operational resilience.

The search for new efficiencies

Aggregated operating income declined 1.7 per cent in FY20 to \$79.3 billion, reflecting the slowdown in lending and continued downward pressure on interest margins. At the same time, costs have continued to increase as a result of operational resilience measures, customer remediation expenses and regulatory costs. The outcome is that cost-to-income ratios inclusive of significant items for most Majors have now climbed above 50 per cent. Against this backdrop, improving cost efficiency has been a focus for the Majors in recent periods. It is expected that a key question from investors in periods to come will be when cost-to-income ratios will begin to decline again and reflect the focus and efforts from the Majors' transformation investments.

In this difficult environment, the Majors are challenged to find earnings growth to aid their recovery. One area where increasing activity has been observed is in partnering with and acquisitions of Fintechs to help them more quickly digitise processes, launch new products and services and build new business models. Recent examples have included the CBA-Klarna and Westpac-Afterpay tie-ups.

Outlook

The economic outlook in Australia presents a vastly different picture to that of six months ago, with easing restrictions in Victoria signalling the path to recovery. On a global level, whilst significant uncertainty still exists with key economies where cases of the virus are still prevalent or increasing, financial markets have been able to withstand the initial liquidity challenges of the crisis. In Australia, the Majors have held substantially higher levels of capital and liquid assets compared to prior crises which has positioned them well to absorb significant shocks.

As announced by the RBA on 3 November 2020, the cash rate and interest rate charged under the Term Funding Facility (TFF) Program has been reduced from 25 basis points to 10 basis points. This, coupled with the estimated \$100 billion quantitative easing program announced, will ease the pathway to recovery with the Majors benefiting from cheap funding sources.

Much of the initial government's and banks' response to the crisis has focused on preserving liquidity and their attention is now shifting to the solvency of borrowers as support measures (such as JobKeeper and JobSeeker) and loan repayment deferrals (in some cases extending out to March 2021) come to an end. It will be important for the Majors to continue monitoring the loan deferral situation carefully and in particular providing support for customers in hardship situations. Whilst a number of these customers may become delinquent at the end of the relief period, the Majors have significant buffers to absorb potential losses.

Changing customer sentiments

Banks need to consider the shifts in consumer behaviours due to COVID-19 and build and embed digitisation efforts already made.

Carmen Bekker, Partner Customer Brand & Marketing Advisory and
Benjamin Kilpatrick, Director Customer Brand & Marketing Advisory

COVID-19 has seen a sustained and permanent shift in customer behaviours. Our global research findings³ show that a new consumer is emerging – one that is financially constrained, more advanced in their use of digital technologies, more thoughtful and selective in their decision-making, and keen to see COVID-19 as an opportunity to reset values in the world. Most notably we're seeing:

- **The economic impact of COVID-19 will influence behaviours for some time to come.** Australian customers in general are now more selective in their purchases (47 per cent) than pre COVID-19, and value is the key purchasing decision driver for consumers. Across all sectors, 70 per cent of Australian respondents rated value as important to their decision making. For Australian customers of banks this drops to just 57 per cent, closely followed by customer experience (50 per cent) and trust in the brand (49 per cent).
- **The new consumer is digitally savvy and embraces the ease with which they can interact with organisations through digital channels.** In Australia, 32 per cent of banking customers who previously preferred face-to-face interactions now say they prefer using digital channels.
- **Consumers are increasingly purchasing from organisations they trust, at a time where trust is becoming more complex to build.** At the start of COVID-19 banks benefited from an upsurge in trust as they stepped in to support the economy and their own customers

(16 per cent uplift for established Australian banks). Since May, however, this trust has been on the decline with now only 10% of consumers feeling like they trust their banks more than before.

- What does the emergence of this new consumer mean for banks in Australia? And how should they shape their future channel strategies to meet these behavioural changes? We believe there are four key steps that banks should now take:

Maintain and enhance brand and trust

With trust in the brand being of heightened importance for bank customers³ – banking providers need to develop a sustained plan to maintain and enhance customer trust beyond their initial COVID-19 response.

Consumers have told us that banks need to focus on:

Societal responsibility: 96 per cent of Australian consumers said they would be willing to pay more for goods and services where their spending has a noticeable impact on the local economy. For banks – careful consideration of the localised impact of physical network changes and customer's perception of the bank's support of localised recovery will take on greater importance.

Supporting vulnerable segments: 39 per cent of Australian respondents highlighted this as being the most important thing that banks should be focused on now^B.

Improving digital security and user confidence: Driven by loss aversion^A local consumers are placing greater importance on security, with 37 per cent of respondents highlighting digital security and 38 per cent seeking protection advice aimed at online fraud and scams as being critical focus areas for their banks^B. Organisations also need to address the digital trust gap, as more than 30 per cent of over-65 year old clients of Australian financial institutions do not have a high level of trust in digital channels⁴. As channel strategies shift, failing to address this will result in customer alienation (and churn) as well as misalignment of resources.

Build trust through open, simple and transparent communications

Proactive communications from their banking providers was ranked in the top three priorities^B by 38 per cent of Australian consumers. Customers continue to want simplified and clear communications from their banks. Organisations must continue to keep dialogues open with their customer base – and explain why decisions have been made, and why they are fair and reasonable. This approach saw them perform well in the early stages of the pandemic. As we move into dealing with hardship and vulnerable customers, communications to customers need to be clearer and more timely than ever.

³ KPMG International – Consumers and the New Reality (Australian Results)

Enhance digital customer experience and cross-channel integration

While past barriers have been broken down as use of digital has accelerated – we see an emerging risk of a behavioural snap-back as restrictions are eased, which may undermine the sustainability of the benefits realised. The scale of this will depend on how successfully providers achieve the following:

Seamless omni-channel: Customers have indicated that they are likely to use online services more if they can access multiple channels for different activities ^{C4}. Investment in how banks make this happen for both new and existing digital adopters is critical.

Availability and convenience: Consumers of all age cohorts identify convenience (e.g. call-back options) and availability (e.g. 24/7 webchat) as being the two most important benefits from using digital channels – these design principles must be at the foundation of the bank's digital strategy.

Interestingly, a much higher percentage of under - 40 clients of Australian financial sector businesses perceive quality of service/experience and personalisation as a key benefit of going digital compared with older cohorts – demonstrating the ever-increasing level of customer expectations for what digital channels will deliver⁴.

High value product digitisation: Our research into the Australian mortgage market highlighted that the mass

affluent local banking customer shows a significant preference for online channels across the end to end journey (preference to perform the following online: 90 per cent - research, 76 per cent - servicing and 58 per cent - application)⁵. As consumers become more comfortable with the use of digital channels to purchase high value products, banks need to invest in making these as convenient, personalised and secure as possible.

Reassess the role and scale of the physical network and contact centre strategies

The cost benefits to an organisation of the digitisation of customer channels have long been propounded. At an aggregate level our research shows a decrease in intent to use branches to perform standard banking activities (65 per cent pre COVID-19 versus 44 per cent in the new normal)³. However, nuances exist that need to be understood specific to the customer base and segments. For example, our research shows:

- For purchasing a high value product – the use of the branch both pre and post COVID-19 remains static at an aggregate age level (40 per cent versus 42 per cent respectively) for Australian banking customers. However, in the 25-34 age cohort this falls from 37 per cent to 23 per cent.³
- For product enquiry – the use of the contact centre increases by 5 per cent for Australian banking customers aged between 18-44 ³.

- 81 per cent of 65+ year-old consumers of Australian financial services agree that they like to have access to telephone or face-to-face support in addition to digital channel options (compared to 66 per cent of under 40s) ^{C 4}.
- For mortgages, 30 per cent of local respondents indicated they prefer to apply for a mortgage through the traditional branch channel. While this is down 15 per cent since 2017 – it demonstrates the need for a physical network to service this requirement⁵.

While the market impetus to reduce physical footprint is well understood, banking providers need to transition with a well-planned implementation to avoid alienating (or even losing) certain segments. Banks should not forget the importance of face-to-face, or at least voice-to-voice engagement channels ^D – which provide an ever-decreasing opportunity to build personalised and trusted relationship with customers.

We believe now is the time for banks to look at persistent shifts in consumer channel preferences and build on their actions taken during COVID-19. Providers should stay the course with their focus on digital, investing in capabilities that will compliment a leaner branch network – notably seamless cross-channel integration and high-value transaction digitisation. Failure to do so provides an even greater opening for challenger and digital-only banks ^E to entice Australian customers to a more valuable proposition.

⁴ KPMG Australia - [Financial Services Customer Sentiment Research](#) - Extracting key insights on financial services as a result of COVID-19

⁵ KPMG Australia – [The evolving mortgage market](#) – Winning the fight for customers (October 2020)

Net interest income

Net interest income increased by 0.9 per cent to \$63.6 billion in aggregate. Interest income growth from an increase in interest earning assets was offset by margin pressure from further reductions in the cash rate, rate competition between lenders and higher deposit inflows.

Cash Basis	FY20	FY19	Movement
Net Interest Income (\$million)			
ANZ	14,049	14,339	(2.0%)
CBA	18,610	18,224	2.1%
NAB	13,871	13,542	2.4%
WBC	17,086	16,953	0.8%
Aggregate	63,616	63,058	0.9%
Net Interest Margin (basis points)			
ANZ	163	176	(13)
CBA	207	209	(2)
NAB	177	178	(1)
WBC	208	212	(4)
Average	189	194	(5)

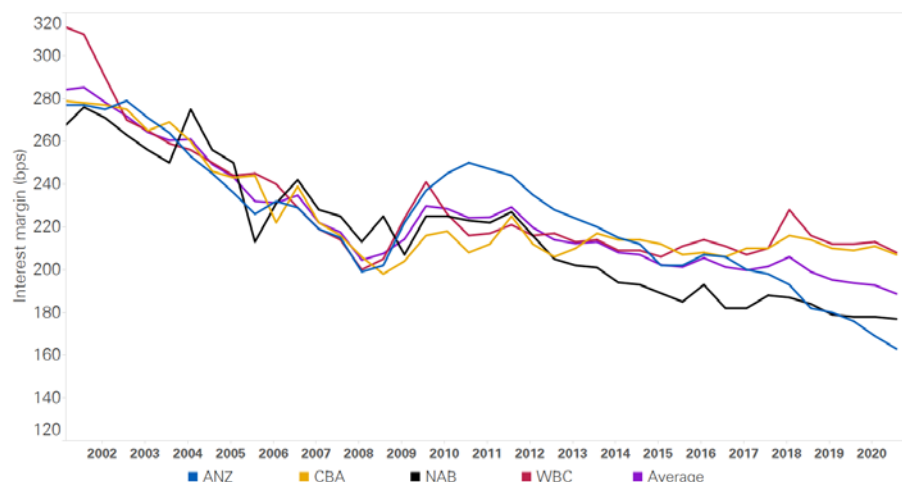
Net interest margin

Net interest margin across the Majors continued to be compressed in FY20, decreasing on average by 5 basis points, despite continued efforts in repricing and lower wholesale funding costs. Thematically, the key drivers of margin pressure across the Majors were consistent. These key factors include:

- Continued reductions in the cash rate and lower margins on customer deposits;
- Ongoing competition across housing and business lending from challenger banks, non-bank lenders and amongst the Majors;
- Deployment of excess liquidity generated by strong deposit inflows in lower yielding assets; and
- Change in lending portfolios as customers take advantage of lower interest rates to refinance their loans.

These were partially offset by home loan repricing and lower short-term wholesale funding costs reflecting reductions in the cash rate and activity from the Reserve Bank of Australia (RBA), including the Term Funding Facility.

Diagram 3. Net Interest Margins – cash basis



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

Interest earning assets growth

Average interest earning assets increased by 3.7 per cent in aggregate from FY19 to \$3,364 billion. This was primarily driven by stronger growth in mortgage lending and interest-bearing securities, partially offset by lower unsecured consumer finance balances.

Aggregate non-housing credit declined by 3.4 per cent from FY19, with performance mixed across the Majors. This decrease is largely due to lower unsecured lending, lower discretionary spend due to the COVID-19 pandemic and lower institutional lending.

Across the Majors, mortgage lending growth remained relatively soft in FY20, with an aggregate growth of 1.6 per cent compared against FY19. This softness was largely driven by:

- Faster repayments of loan principal due to the low interest rate environment;
- Increased competition from challenger banks and non-bank lenders; and
- Lower overall investor housing system growth in Australia.

This was partially offset by higher system growth in New Zealand and foreign currency movements.

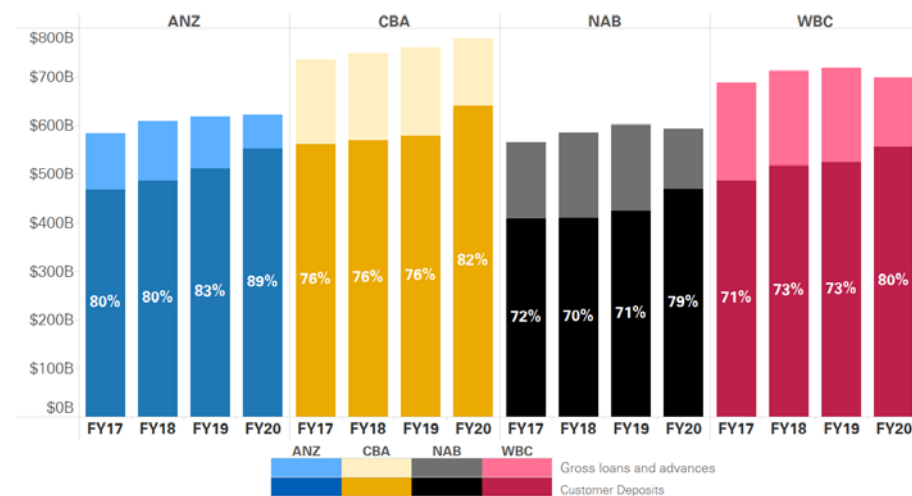
Growth in interest-bearing securities and other non-lending interest earning assets across the Majors was primarily due to increased holdings in HQLA to maintain healthy LCR buffers during the current uncertain environment, as well as deployment of higher deposit balances into HQLA

Funding mix

The Majors continue to increasingly have customer deposits as the main source of funding. As households reduced discretionary spending and increased their savings ratios during the COVID-19 pandemic, the average proportion of customer deposits to total gross loans and advances across the Majors have increased by 676 basis points to 82.4 per cent.

However, the rate of growth in customer deposits of 8.7 per cent has significantly exceeded the ability of the Majors to grow their lending assets. In comparison, total gross loan and advances decreased by 0.2 per cent. Across the Majors, excess funding from customer deposits has been deployed into lower yielding treasury assets in order to generate a return (but resulting in lower margins nevertheless).

Diagram 4. Customer deposits proportionate to total gross loans



Rediscovering the lost art of product management

How major banks can deliver customer outcomes and drive growth beyond DDO and product simplification

Brett Watson, Partner Payments Advisory and Alisha Malhotra, Associate Director, Risk Assurance

Overview

In a world of evolving regulation, rapid digitisation and changing customer preferences the role of the product manager is becoming more important than ever before. These pressures are demanding more of product managers to centre on the customer by reducing the complexity and risk of their portfolios and to make it simpler for customers to interact with their bank in a digital way.

To some extent, better product management practices are codified through the Design and Distribution Obligations (DDO) which financial product issuers and distributors will need to comply with by 5 October 2021. DDO is ultimately centred on designing and selling products that meet customer needs, and ensuring products deliver on what is promised.

For product managers addressing DDO is only part of the solution. Product managers must:

- Look beyond ticking the box on DDO and bank-wide product simplification.
- Employ agile and iterative approaches to product design, with continuous customer feedback loops across the product lifecycle.
- Be data-driven in research and development and ensure that designing and testing of products happens throughout the product lifecycle.

- Embrace a holistic approach to product management across the bank value chain.

When leveraged as part of a holistic product management process, DDO and product simplification together can help drive growth for banks by centring on the customer with a simpler set of digital ready products.

Best practice product management goes beyond DDO

DDO codifies some aspects of good product management, for instance through a customer focus in product design and sales (target market determinations (TMD)), measuring value and product success (TMD triggers, reporting obligations) and ultimately simplifying product portfolios to ensure that only products that deliver what is promised and are suitable for the target customer remain on sale.

However, to truly focus on the customer and drive growth, reduce risk and reduce cost, banks need to propel towards and embed best practice product management. This cuts across the bank's value chain and brings together a customer focus, product strategy, systems, processes, data along with risk and regulatory facets.

Customer Focus

To reduce the risk of product mis-selling, it is a business imperative that there is a customer focus in the development and sale of products. In particular, TMDs and measuring whether products actually deliver value for customers need to be documented to ensure fairness and suitability of products for the identified customer group.

Leading product managers are customer-led, for example by bringing their target customers along the product development journey, co-designing products through testing and gathering direct insights and behaviours to ensure products will meet real and evolving customer needs.

Product Strategy

A simplified product portfolio streamlines DDO compliance – this is its net strategic impact. Banks need to look beyond this to achieve a customer focus and drive growth. This means, sales processes need to be streamlined, product collateral simplified, customers migrated and products completely removed from the ecosystem. Further, banks will need to leverage data to truly understand the economics of individual products, and product simplification needs to be bank-wide. Migrating customers to more suitable products when others are grandfathered will help to reduce risk, compliance and servicing costs. Banks will also need to consider reducing distribution channels as one way to manage product mis-selling risk, oversight and monitoring efforts.

Systems, Processes and Data

DDO requires banks to leverage existing and new triggers to assess when a product is not performing as intended. Quality data, clear and reliable processes and controls will be necessary to ensure issues are detected and resolved in a timely manner. Bringing together a holistic feedback loop across research, product, marketing and distribution will enable banks to move towards best practice product management. Taking this further, product managers must be proactive in absorbing real-time data on how their products are performing for customers, rather than waiting for incidents or complaints to happen.

Moreover, embedding voice of the customer data in daily processes will equip product teams to respond with agility to market and customer changes. This ultimately helps to reduce costs and drive growth by informing when to iterate or pivot.

Risk and Regulatory

Most importantly DDO ensures there are feedback loops for customers when products are not operating as intended. Further, end-to-end accountability for distribution, servicing, product performance and pricing is being driven away from operational teams, and re-established into product and sales teams.

Best practice product management entails linking product design and decisioning to the bank's customer outcomes and sales governance frameworks. This aligns product strategy and customer needs with sales strategy, product marketing and execution. Targeted customer-centred metrics should then be used to measure the performance of the product throughout its lifecycle, with problems anticipated, not reported. These metrics could include measuring customer engagement across digital channels, how customer product use and retention changes when new products are released by a bank, responsiveness and action in response to customer feedback etc.

To effectively respond to regulatory change, digitisation and changing customer preferences, banks need to move beyond siloed DDO and product simplification programs and embed these programs into a holistic product management approach across the value chain. Leveraged together, this will ensure a high-performance product portfolio that truly focusses on the customer and enables growth.

Asset quality

The uncertainty around the economic impact from the COVID-19 pandemic has led to a significant increase in loan impairment expenses across the Majors, totalling \$11,186 million for the full year.

The ongoing COVID-19 pandemic has evolved rapidly throughout the year with far-reaching implications on the global and Australian economy. Drastic measures taken by governments globally to contain the spread of the virus, including border closures, lockdowns and shutdowns of businesses, have distorted the normal operation of economies around the world, including Australia. In response, central banks and governments have implemented a range of mitigating measures, from economic stimulus packages to employment-related measures and increased unemployment benefits.

Australia saw its first wave of infections from March 2020, which sent the nation into a lockdown. The Majors with a March half year (ANZ, NAB and Westpac) initially recorded \$5,073 million in loan impairment expense in the first half of 2020 to reflect the expected deterioration in the Australian and global economy over the following months. In the second half of 2020, all states, with the exception of Victoria, gradually eased restrictions and economies began to slowly re-open. However, it became apparent that recovery would be protracted, with certain customers and industries more impacted than others. As a result, the Majors, including CBA⁶, recorded a further \$5,464 million in loan impairment expense in the second half of 2020. As the pandemic situation outside Australia remains largely uncertain, the Majors remain on high alert as they continually revisit key economic assumptions applied in estimating the loan impairment expense. The economic climate continues to remain extremely fluid and volatile, particularly with regard to estimating the duration and severity of the anticipated economic downturn and an assessment of the government's economic stimulus measures and their effectiveness.

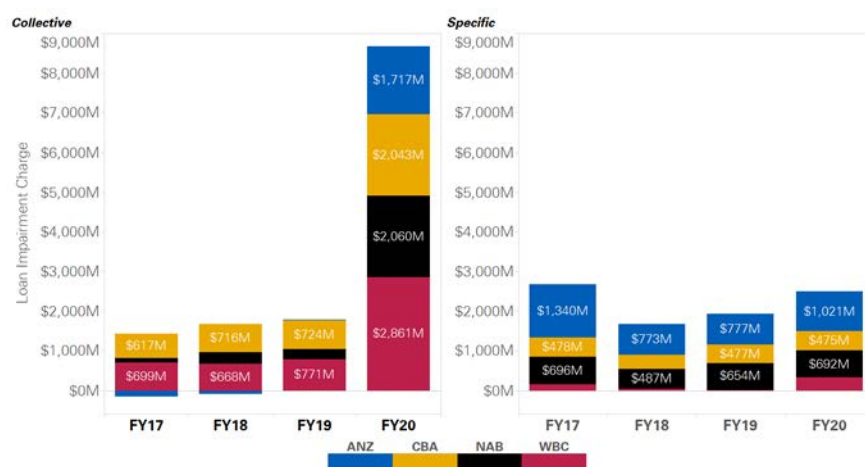
As governments around the world continue to balance saving lives, protecting livelihoods and reviving struggling economies, it is evident that the full impact of the pandemic situation may take a long time to manifest. The crisis will persist as a significant challenge that the Majors need to contend with for some time to come. In the longer term, the question is whether the crisis will lead to permanent structural changes to the global economy.

Loan Impairment

Collective impairment charges across the Majors have increased by \$6,896 million. This increase reflects expected future credit losses required to be estimated under the AASB 9 accounting standard, including the incorporation of probability-weighted forward-looking economic scenarios. Notably, key economic assumptions and probability weightings applied vary significantly across the Majors. Significant model overlays are also applied, emphasising the uncertainty ahead. While loan loss provisions have increased significantly and the Majors have allowed customers to defer loan repayments, to date their actual loss experience has been relatively benign. A major question for the Majors to work through is to what extent loan losses will materialise in FY21, as the Commonwealth government starts to unwind its economic support measures.

Specific impairment charges across the Majors increased by \$574 million predominately driven by a number of larger institutional exposures.

⁶ We note that CBA reported half year results as at 31 December 2019, prior to the impact of the COVID-19 pandemic in Australia and the impact of this on the credit provision is reflected in its second half results.

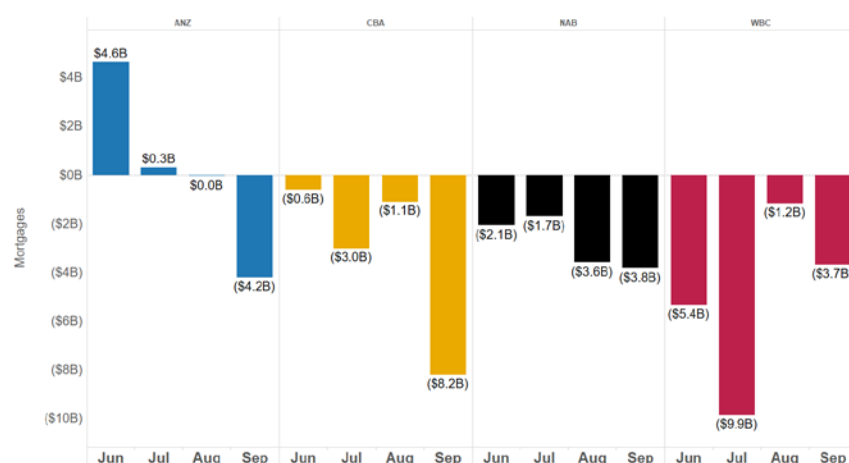
Diagram 5. Loan impairment expenses


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

Loan Deferrals

In March 2020, the Majors introduced six-month temporary loan deferrals for customers facing hardship. Subsequently, in July, a four-month extension in deferrals was made available for assessment on a case by case basis, amidst concerns around the impact of a hard withdrawal and a second wave of infections in Victoria. Exits from loan deferral programs continue to outweigh new entries, and the rate of net decrease has accelerated significantly in September with the majority of these loans returning to a performing status.

The total number of mortgage deferrals across the Majors declined from 373,303 loans in June (\$151.8 billion) to 273,451 loans in September 2020 (\$113.1 billion). This represents approximately 8 per cent of the total mortgage lending portfolio for the Majors, down 3 percentage points from 11 per cent in June 2020. It remains to be seen whether remaining deferrals will resume payments as the economic gradually recovers or if there are structural issues in the mortgage book.

Diagram 6. Net movement in deferred mortgages since June


Source: KPMG analysis from APRA statistics

Delinquencies

Delinquencies (90+ days past due) as a proportion of gross lending assets increased by 16 basis points from 59 basis points in FY19 to 75 basis points in FY20 (largely within the residential mortgage lending portfolio). Westpac reported its delinquencies inclusive of customers who had been granted hardship assistance.

While delinquencies increased across all geographies, Western Australia and Queensland remain the key drivers of past due residential mortgage loans.

Are all provisions created equal?

An international comparison of ECL provisions.

Paul Lichtenstein, Partner Audit, Assurance & Risk Consulting,
Shruti Hegde, Director, Actuarial & Financial Risk Management
and Adrian D'Alfonso, Associate Director, Actuarial & Financial
Risk Management

Previous economic downturns have been caused by shocks to the financial system, such as stock market crashes and credit crunches. This current economic crisis is different – a global pandemic and each government's response have changed market forces in an unprecedented manner. As banks brace for the economic headwinds and potential increase in customer defaults, provisions for the associated expected losses continue to mount. Government interventions coupled with regulatory action will help to reduce the impacts on the sector.

Recent changes to accounting rules mean that the previous method of recording provisions on an incurred loss basis was changed to an expected loss approach as required under International Financial Reporting Standards 9 (IFRS 9). The expected loss approach requires modelling credit risk indicators to estimate losses that will emerge for current loans.

Emerging Themes

Forward-looking provisioning estimates require forecasts of a portfolio's future state risk profile. Perfect forecasts don't exist, so a number of forecasts, each with an associated likelihood of occurring, are used. The expectations around the forecast likelihood will change so provisioning levels will need

to be continually adjusted. Generally, COVID-19 impacts are captured through adjustments to these forecasted model inputs and other out-of-model adjustments, rather than by changing model design.

Banks are now finding that previous behavioral trends indicating risk have been replaced by new risk indicators in response to external influences. In the context of COVID-19, the speed and levels of government intervention have changed the timing that we can expect customers to show elevated levels of risk. This reduces the level of reliance that can be placed on modelled outcomes when estimating loan loss provisions.

This has meant that human judgment is being used more in the risk modelling process. Using human judgement to establish key risk drivers alleviates some concerns around automated risk assessments biased on historical experience, but it does make it difficult to directly compare portfolio risk composition.

The increased importance of qualitative risk management and its effect on provisioning has meant there needs to be more work done to ensure clear and transparent reporting. However, differences between geographies and government responses to the crisis make direct comparisons challenging.

International Perspective

Provision coverage ratio is a commonly used metric to assess a bank's risk profile relative to peers. This captures the total impairment provisions held by a bank as a proportion of total gross loans and advances. It reflects total funds set aside for losses as a percentage of the principal amount of loans and advances written by the bank. Across the world, there have been substantial increases in provisioning coverage ratios, up to 2.5 times, owing to COVID-19 and the broader economic slowdown.

An international comparison of the impact of COVID-19 on coverage ratios for the last reporting period pre COVID-19 and the first reporting period post COVID-19 is shown for selected countries in the chart above. The relative levels and increases in coverage ratios have generally mirrored a bank's portfolio mix and geographical location.

For a number of reasons including population growth, sustained property price increases and tax incentives, the Australian banking segment is heavily skewed to residential property lending. Given this comparatively low risk portfolio mix, Australian bank coverage ratios have typically been lower than those of international peers. The impact of COVID-19 has been very similar across the Australian majors.

In January 2020, the provisioning approach of US banks moved from a one-year historical loss model to a lifetime expected loss model. This, coupled with the country's economic conditions, has created the most pronounced increases in provisioning coverage ratios.

The similarity of the level of provisioning and impact of COVID-19 on expected credit losses within a country is clear but the cause is less so. In addition to credit quality considerations, other factors may include local regulatory interpretations, government stimulus action, benchmarking to domestic peer banks, cultural influences and the actual or perceived impact of COVID-19 within a country.

Timing considerations

KPMG recently conducted a survey of banks across Europe to gauge industry sentiment on the expected timing of the loan impairment peak, and by extension the impact that COVID-19 restrictions and the offsetting government interventions would have on impairment provisions.

The results showed the majority of respondents (53 per cent) believed that impairment levels have not yet peaked, as potentially, relief measures made available are supporting businesses and masking the true impact.

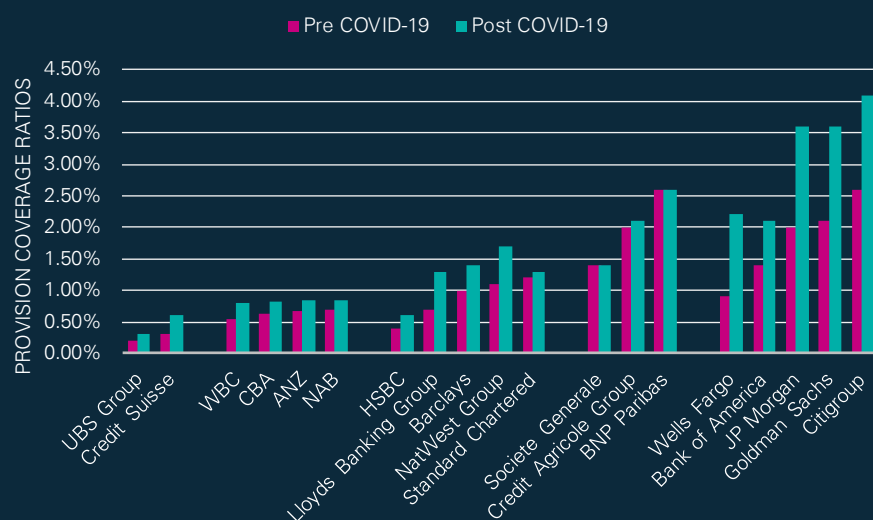
Another large portion (47%) of respondents thought the peak has already passed due to the speed with which governments enforced COVID-19 restrictions.

Focus Areas Moving Forward

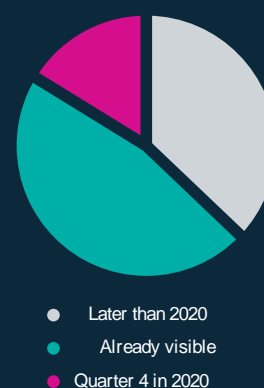
With the uncertainty of the COVID-19 crisis and its continuing effects on bank policies, risk modelling and accounting, it is important that banks have a robust, technically sound and agile system in place to quickly identify the models, data and outputs that are sensitive to COVID-19-related decisions. Banks also need to determine key modelling levers that can be used to stay on top of modelling challenges (for example in relation to recalibration or model overrides).

It will be critical to undertake targeted credit quality reviews and intelligently capture data in customer interactions when considering the potential timing of issues flowing through portfolios. This data will be valuable for banks in risk decision-making and mapping out customer strategies through the pandemic.

For banks to cope with this crisis as it evolves, banks will need a strong and thorough governance framework related to adjustments on credit risk models, accounting policies and decisions taken.



EXPECTED PEAK IN
IMPAIRMENT LEVELS IN THE EU



Notable items

Customer remediation programs, regulatory action and asset impairments continue to be key features across the Majors.

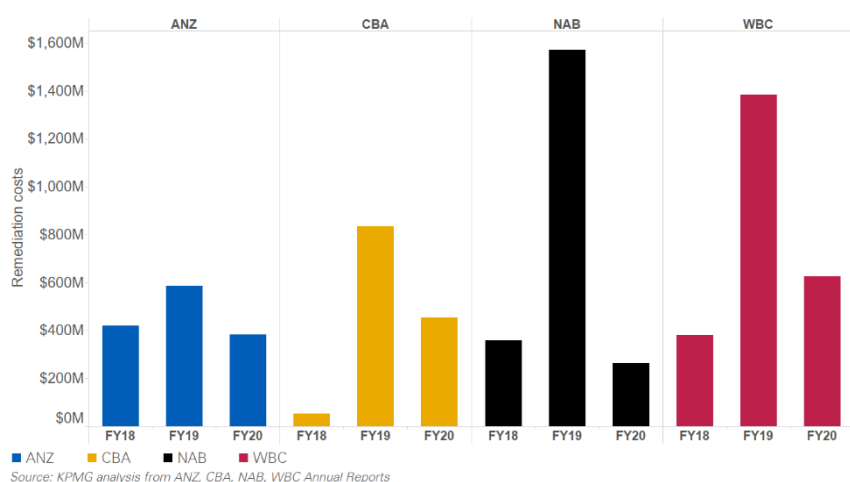
Customer remediation and regulatory costs

Following the trends of previous years, remediation charges continue to negatively impact the financial results for all Majors as 'notable items' within their cash profits.

During the period, a further \$1.7 billion in costs and reversals of revenue were incurred in relation to ongoing remediation programs of work. In addition, Westpac recorded a \$1.3 billion penalty in relation to AUSTRAC matters and an additional \$178 million in associated costs, highlighting the evolving landscape over regulatory compliance.

Since 2018, customer remediation programs have totalled \$7.3 billion in repayments to customers and expenses across the Majors. Following significant remediation provisions raised in previous years, continued remediation expenditure have been necessary.

Diagram 7. Customer remediation costs



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

Other Notable Items

Other notable items during the period include:

- ANZ recorded a \$815 million statutory impairment charge on its investment in Asian associates of AmBank (Malaysia) and Panin Bank (Indonesia) as a result of adjustments in the short to medium term growth estimates of these investments to reflect the impact of the COVID-19 pandemic.
- ANZ incurred a \$77 million impairment on goodwill in its Pacific and New Zealand divisions, due to the impact of COVID-19 on the economies of the Pacific region and the wind up of a managed investment product offered in New Zealand and a \$197 million statutory amortisation charge from continuing operations as a result of accelerated software amortisation.
- NAB announced the sale of MLC Wealth to IOOF for \$1.44 billion, as the bank continues to simplify and focus on its core banking business, while recording a \$199 million impairment on goodwill attributable to this.
- NAB recorded a \$134 million pre-tax impairment on property-related assets, \$128 million in payroll remediation costs and a \$950 million statutory amortisation charge from continuing operations as a result of changes in accounting policies pertaining to software amortisation.
- Westpac announced the sale of its 10.7 per cent equity stake in Zip Co Limited, resulting in a \$303 million revaluation gain before tax.
- Westpac recorded a \$668 million impairment on goodwill and intangible assets pertaining to its Life insurance and Auto Financing businesses.

Restoring trust in banking

**Banks have come some way in earning back trust,
now there is opportunity to form long tenured sentiment.**

Daniel Knoll, National Industry Leader for Financial Services, Anthony Donohoe,
Partner Risk Strategy & Technology and David Latham, Financial Services Head of Strategy

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services handed down its final report just 18 months ago – a report that was received by the public and the media with much concern and alarm.

Boards and executives have been held accountable and the industry has been focused on taking steps to make amends since. CEO's have exited, boards and executive teams have turned over, customers are being remediated, remuneration programs have been reformed, and the government remains focused on an ambitious regulatory reform agenda.

Despite these efforts, trust – a fundamental and intrinsic element of banking – was taking time to be rebuilt. Then the COVID-19 pandemic happened.

[KPMG's 2020 Customer Experience Excellence report](#), published in September, revealed that the pandemic, and associated lockdowns, gave customers cause to shore up that which was most important in their lives. They prioritised going back to basics and essential services, like banking, telecommunications and insurance, observed a net increase in trust.

Throughout the COVID-19 pandemic Banks have demonstrated the critical role they play in the moments that matter. Banks absorbed the initial financial shockwave by deferring loan repayments, waiving fees and pumping

additional credit into the economy. As a result, trust in banking improved as the crisis peaked in Australia.

“The pandemic has given the sector a strong platform to demonstrate humanity and its societal purpose in helping Australia recover economically”

Professor Nicole Gillespie, KPMG Chair in Organisational Trust & Professor in Management at The University of Queensland

A KPMG sponsored consumer pulse survey conducted in five waves between May and August 2020 revealed an improvement in net trust in the banks from +4 per cent in Wave one to +7 per cent in Wave two. This is where it peaked. Net trust has trended downwards in subsequent waves.

This demonstrates that opportunities continue to exist for the sector to restore trust in the moments that matter – when the purpose of banking aligns perfectly with its customers' requirements. With payment deferrals ending and temporary insolvency relief measures concluding, the next 6 to 12 months will present such a moment. Trust is a complex concept. But there are three key qualities that contribute to the building of trust that banks should keep front of mind: ability, integrity and humanity.

“Trust in the banks was harmed because they were perceived to be prioritising profits over people. As a critical part of the Team Australia story, banks demonstrated that their purpose and long-term value creation is intrinsically aligned with their customers. This is their moment to show that they have learned the lessons of the Royal Commission, and that they have fundamentally changed”

Professor Nicole Gillespie, KPMG Chair in Organisational Trust & Professor in Management at The University of Queensland

Perceptions of ability: the capacity to understand a customer's needs and the situation they find themselves in.

Perceptions of integrity: doing the right thing by adhering to accepted ethical and moral principles.

Perceptions of humanity: demonstrating genuine care for those who have been affected by the COVID-19 crisis.

In action, these three qualities can be embedded and demonstrated by adhering to four general principles:

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- **Perceptions of ability:** the capacity to understand a customer's needs and the situation they find themselves in.
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In action, these three qualities can be embedded and demonstrated by adhering to four general principles

1 | **Build fit for purpose infrastructure to support your vulnerable customers**

The humanity of a business is judged on the impact it has on its most vulnerable stakeholders. All stakeholders will expect banks to 'do the right thing' – even in the face of complex customer hardship cases.

- The situation will be made more difficult by the sheer volume of vulnerable customers who will begin applying for hardship or defaulting on payments. In this circumstance, building fit for purpose infrastructure to support the volume of vulnerable customers will be crucial.

Banks should consider:

- Analysing customer segments to identify segments or individual instances of vulnerability. Identify early warning indicators and develop robust plans to support identified customers.
- Providing staff with the resources, skills, authority and delegations to manage a customer's case from beginning to end.
- Simplifying the business and leveraging technology to optimise standard processes and focusing resources on the high touch moments of customer interaction.
- Having third party referrals readily available. Vulnerable customers will need someone to turn to in moments of difficulty.
- Establishing metrics that are focused on supporting long term value creation – for customers and the bank.

2 | **Care for your people**

A crisis of the current scale is a once-in-a-generation event. Front line staff will be exposed to a significant volume of difficult and gruelling customer circumstances – and they will take memories of these home with them. Prioritising the welfare of your people, keeping them mentally fit and stepping in when moments are tough will make all the difference.

Banks should consider:

- Making sure your people are 'eyes wide open' and adequately prepared for the challenging period they will be facing into.
- Ensuring leaders are staying in touch with their teams. There is nothing more powerful than hearing from your people how they are doing, and what support they need.

3 | **Ensure customers have a sense of control**

A lack of communication and structure about how customers will transition through to their new normal will amplify their uncertainty and contribute to them feeling out of control. Imposing an outcome on a customer will challenge their trust, but providing them with meaningful options will strengthen their sense of control and give them comfort that their bank is supporting them.

Banks should consider:

- Keeping customer choices simple and effective. Focus on the agenda to simplify the organisation to make it easier to navigate for customers and staff.
- Listening deeply to customers and understanding their unique situations.

- Maximising communications that encourage the customer to proactively contact the bank.

- Communicating in a timely and responsive manner – doing so will reduce the trust gap.

Leveraging customer insights (including complaints), machine learning and AI to monitor services to surface issues early and adapt proactively.

4 | **Treat stakeholders fairly and transparently – and give them options to find support**

A core way to show humanity and respect is to explain, transparently and honestly, how a decision was made and why it was decided to be the most fair and reasonable course of action. Following fair and consistent processes when making decisions that impact others is always important for trust, but particularly when such tough choices need to be made. It will also be important to recognise that what constitutes fair treatment will be different to pre-pandemic times – customers will expect more leniency and support.

Banks should consider:

- Making it simple for customers to make decisions on their own terms.
- Do not discount the power of human connection. Front line staff with deep empathetic skills will be critical.
- Leveraging behavioural science to ensure all communications channels are effectively engaging with customers in their own language.
- Demonstrating leadership and accountability and accepting when things have gone wrong.

Capital

The Majors' balance sheets are well prepared for the uncertain environment.

Capital adequacy

Despite the ongoing challenges posed by the COVID-19 pandemic, the Majors remain well capitalised with strong balance sheets and robust capital buffers. The Majors' capital positions each exceeded the 'unquestionably strong' threshold set by the Australian Prudential and Regulatory Authority (APRA) and are amongst the strongest capitalised banks internationally.

Average CET1 ratio increased by 59 bps to 11.4 per cent. This was largely driven by flow-on effects from the divestment of non-core wealth and insurance businesses in previous periods, prudent payout of dividends in line with current APRA guidance, strong take-up in dividend reinvestment plans and a capital raising by NAB and Westpac during the year. Offsetting this were disappointing FY20 results and a larger cohort of underperforming and impaired loans in the current year, attracting higher capital risk weightings due to the COVID-19 pandemic.

Despite the Majors maintaining strong capital levels, APRA set expectations on 29 July 2020 that ADIs will retain at least half of their earnings, actively utilise Dividend Reinvestment Plans and other capital management initiatives to mitigate the diminution in capital from dividends and to maintain ongoing lending capacity. As a result, dividends across the Majors decreased significantly in FY20.

	ANZ		CBA		NAB		WBC	
	FY20	FY19	FY20	FY19	FY20	FY19	FY20	FY19
Common Equity Tier 1 (%)	11.3	11.4	11.6	10.7	11.5	10.4	11.1	10.7
Tier 1 Capital (%)	13.2	13.2	13.9	12.7	13.2	12.4	13.2	12.8
Tier 2 Capital (%)	3.2	2.1	3.6	2.8	3.4	2.3	3.2	2.8
Total Regulatory Capital ratio (%)	16.4	15.3	17.5	15.5	16.6	14.7	16.4	15.6

The average leverage ratio across the Majors increased by 12 basis points to 5.7 per cent. This remains well above APRA's proposed minimum requirement of 3.5 per cent for internal ratings based ADIs.

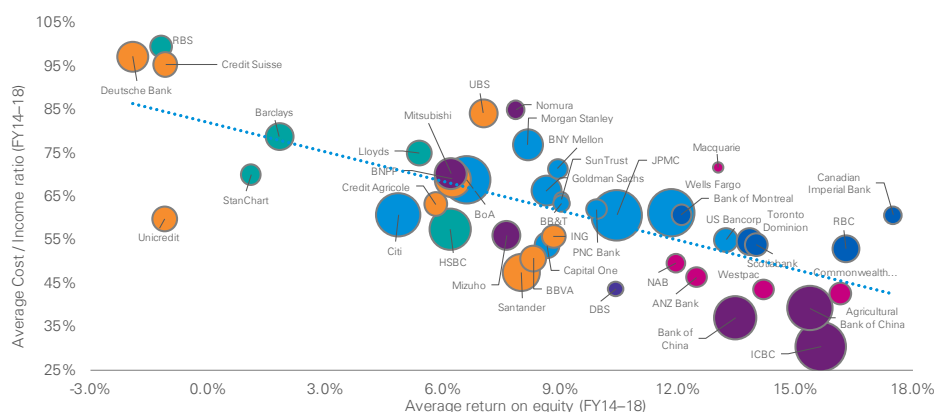
Liquidity

Across the Majors, liquidity ratios remain healthy, with the average liquidity coverage ratio (LCR) increasing by 13.8 percentage points to 145.8 per cent, largely driven by increasing customer deposits, an increased supply of money injected into the financial system by RBA and higher holdings of High Quality Liquid Assets (HQLA) across the Majors. This is despite a system-wide reduction in the Committed Liquidity Facility as of 1 January 2020.

Global lessons on bank cost efficiency

Hessel Verbeek, Partner KPMG Strategy and Adrian Harkin,
Global Co-lead, Banking Cost Optimisation

Australia's major banks have a very broad national ownership through institutional investors, superannuation funds and retail investors. For these investors, return on equity (ROE) is the top financial metric for a bank's performance that drives their ability to return value to shareholders. KPMG research data for major banks across six large global markets demonstrates that ROE is largely driven by cost efficiency.

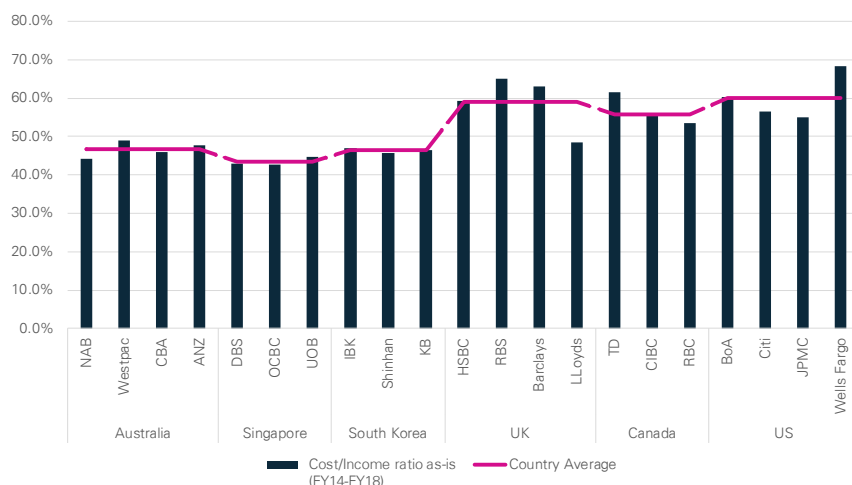


HEADQUARTERED COUNTRY:

- US
- UK
- China
- Australia
- Canada
- EMA (ex. UK)
- APAC (ex. China)

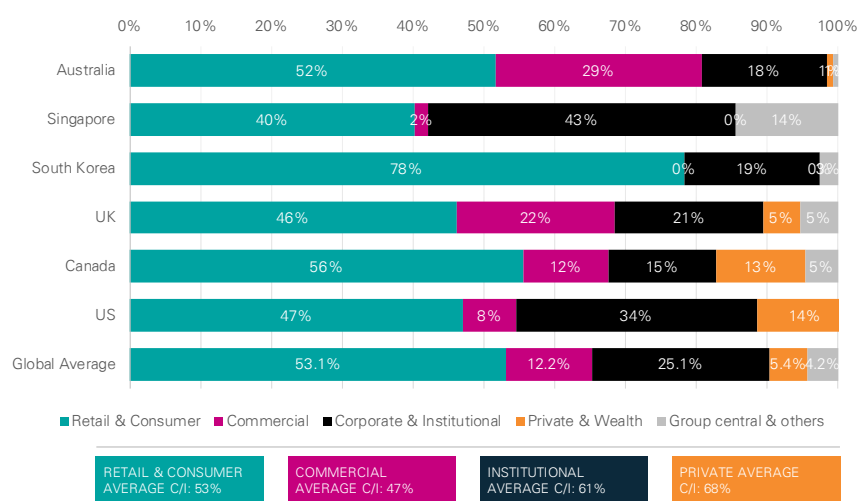
Note: the size of the bubble depicts the FY14-18 average revenue of the bank

Before COVID-19, Australia's major banks were consistently top performers globally in terms of ROE, with returns in the 10-13 per cent range. As shown above, this performance can be linked in a large part to their relatively low cost-income ratios. The reported cost-income ratios for the Australian majors have been favourable by global comparison (while this is driven by both costs and income, the focus in this article is on costs).

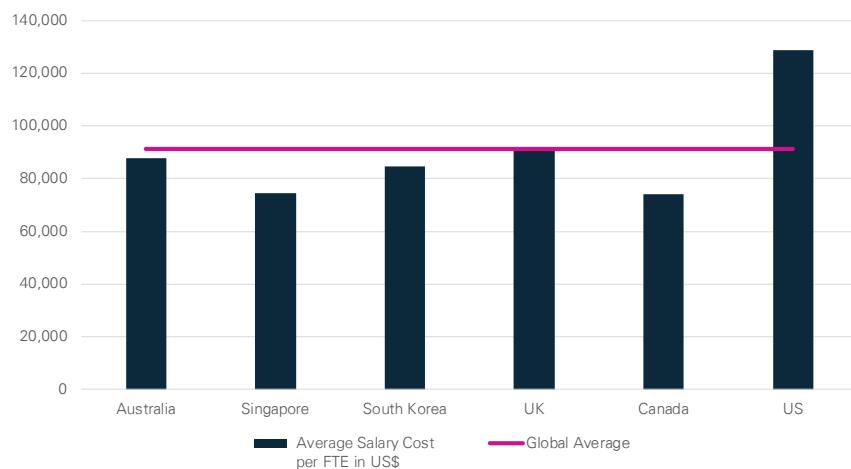


This finding appears surprising at first glance. Previous research ([The New Reality For Bank Profitability](#)), indicated that Australian banks have been trailing their global peers on taking cost efficiency measures (as their financial performance has been supported by positive underlying market conditions such as economic growth, house prices and above-zero interest rates). To understand the underlying cost efficiency performance better, KPMG normalised cost-income ratios for business mix, staff costs and property costs to explain some of the variations in ratios between different markets.

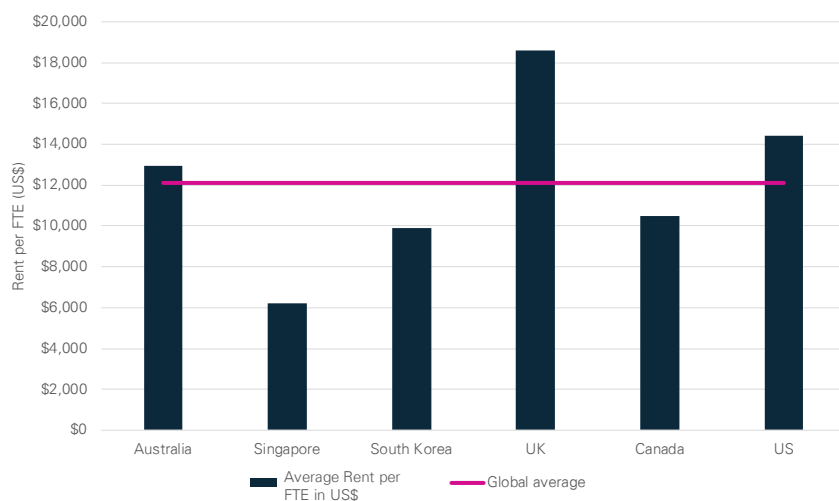
- Business mix – typically, the cost-income ratios for consumer and business banking are lower than for institutional and private banking, therefore a business mix that is 'heavy' on consumer and business banking is favourable for cost efficiency. Banks' business mixes constantly change, including as a result of M&A activity.



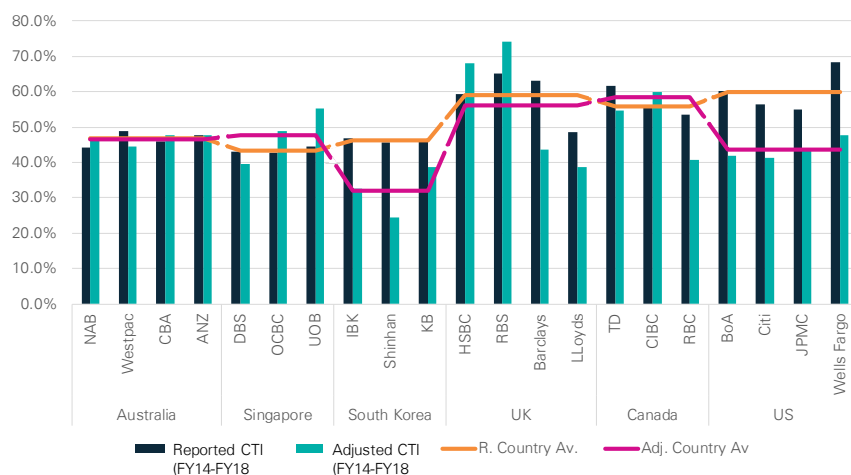
- Staff costs – salary levels and the cost to employ differ globally, and banks in countries with lower staff cost levels benefit from this.



- Property costs – property rental costs differ globally as well, and banks in countries with lower property costs levels benefit.



Australian banks, while still having relatively low cost-income ratios, benefit from a favourable business mix and lower input costs compared to peers in other markets such as the UK and the US.



The cost impact of digital adoption

Another lever that many bank executives look to pull to manage cost efficiency is digital adoption by customers. A shift to digital sales and service interactions has many benefits, especially from a customer experience perspective. But contrary to popular belief, customer digital adoption by itself is not a big cost differentiator for major multi-channel banks (although it clearly is for direct-only banks). The main reason for this is that the major banks operate several assisted (e.g. branch), direct (e.g. digital, phone) and third party (e.g. mortgage brokers) channels. Driving up digital adoption and the share of digital in the channel mix does respond to customer needs but it does not remove (much) of the non-digital channel costs. After all, banks are not closing branches or reducing contact centre capacity at the same rate that customers are switching to digital. This is borne out in KPMG's data: digital adoption for major universal banks does not drive down distribution costs significantly. Of course, this does not reduce the importance of digital distribution strategies, from a customer and growth perspective. It should also be noted that middle- and back-office digitisation (end-to-end redesign and automation of processes) does lead to major cost improvements.

To further improve the underlying cost efficiency, our banks should focus on operating model simplicity and process digitisation. The current Australian trend to divest non-core businesses is a clear manifestation of simplification, and other levers include transformation of cumbersome legacy systems, rationalisation of product books, simplification of organisation design and improvements in the effective delivery of change programs

Costs

Operating expenses remain stubborn with operational resilience measures, continued regulatory, compliance and customer remediation obligations hampering efforts to reduce the cost base.

Operating Expenses

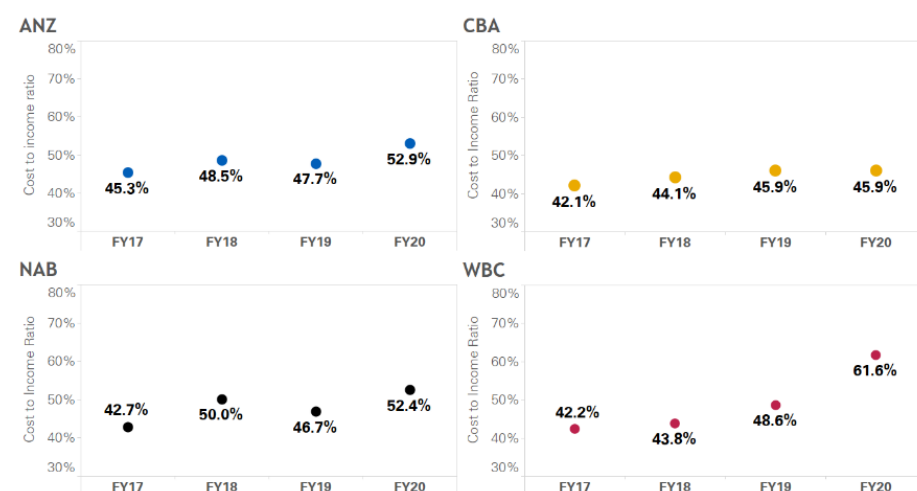
Operating expenses from continuing operations have climbed 10.3 per cent from FY19 to \$42.0 billion across the Majors. As a result of the increases in operating expenses outpacing increases in operating income, the average cost to income ratio for the Majors increased by 598 basis points from FY19 to 53.2 per cent, with ANZ, Westpac and NAB reporting increases. Excluding notable items, average cost to income ratio increased by 177 basis points from FY19 to 45.2 per cent, with increases reported for each Major.

One-off significant items noted in this result include:

- Revision of ANZ's and NAB's software capitalisation policies, resulting in \$1.1 billion in additional amortisation costs from continuing operations;
- Westpac's AUSTRAC charges of \$1.3 billion;
- Impairment of goodwill and associates totalled \$1.5 billion across ANZ and Westpac; and
- Customer remediation of \$1.7 billion across the Majors.

Excluding these items, operating expenses across the Majors increased by \$1.1 billion to \$36.5 billion. The primary drivers for this increase were higher personnel costs as the Majors increased staffing in response to the operational impacts of COVID-19, a focus on risk and compliance teams, as well as higher technology costs as a result of increased investment spend and accelerated amortisation.

Diagram 8. Average Cost to Income ratio – continuing operations



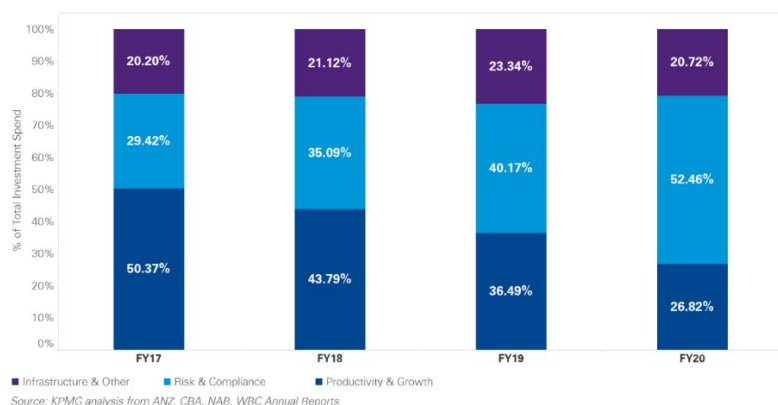
Source: KPMG analysis from ANZ, CBA, NAB, WBC Annual Reports

Technology and Investment Spend

Aggregate investment spend across the Majors has increased by 8.1 per cent to \$6.3 billion. The previously observed shift in focus from productivity and growth to risk and compliance continued to accelerate, with the Majors, excluding ANZ⁷, each increasing their risk and compliance spend significantly (\$196 million, \$95 million and \$303 million for CBA, NAB and Westpac respectively), driving an increase in aggregate risk and compliance contribution from 40.2 per cent to 52.5 per cent of total investment spend. As a result, investments in productivity and growth initiatives have been significantly curtailed.

Technology operating expenditure across the Majors increased from \$7.6 billion in FY19 to \$8.8 billion in FY20, as amortisation of previously capitalised investment spend accelerated across the Majors. Additional software licensing costs were incurred to increase capacity and capability to facilitate staff working remotely in light of the COVID-19 pandemic.

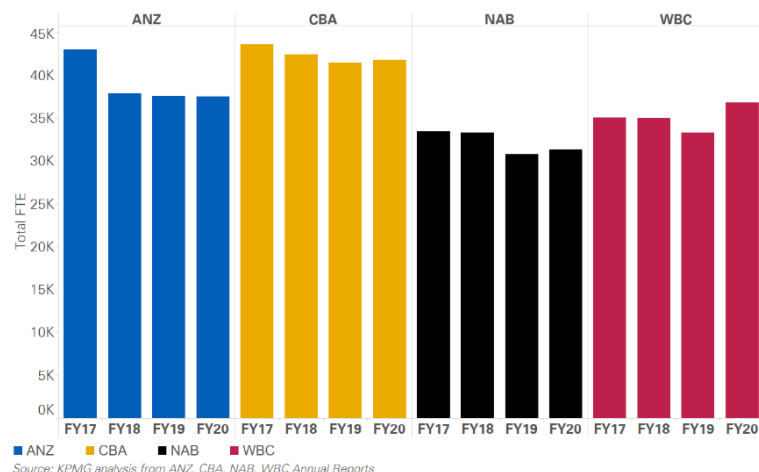
Diagram 9. Investment Spend



Personnel

The aggregate number of Full Time Equivalent (FTE) staff employed by the Majors has increased by 4,395 from FY19. However, between the Majors, movements were mixed, with ANZ reporting a slight decrease. Most notably, Westpac reported 3,561 more FTE in FY20. Changes in staffing across the Majors were primarily due to additional operational staff as they responded to higher workloads associated with COVID-19, as well as greater resourcing for risk and compliance roles, partially offset by productivity benefits achieved.

Diagram 10. Total FTE – continuing operations



⁷ ANZ does not report the split in its investment spend

The importance of operational excellence in the new reality

Karen Parkes, Partner Management Consulting and
Vincy Ng, Director, Management Consulting

Australian banks are experiencing much pressure to simplify their systems and processes in order to reduce costs, risks and the complexity of their operations. A focus on core processes will allow banks to comply with increasing regulatory requirements, and to refocus operations on the heart of their organisation - the customer. Redesigning fit-for purpose operating models will assist with cost reduction and value chain management.

Despite the disruptions and challenges, the current period offers a unique opportunity to re-evaluate the existing operating models. Stringent cost management of each part of the business is necessary, executives need to be aligned on cost management projects, and leadership teams need to be held accountable on cost expectations.

End-to-end process redesign

Redesigning end-to-end processes and reducing silos across the business will be critical to staying competitive and resilient. This redesign is crucial to drive customer benefits and reduce organisational complexities. It must extend beyond legal and regulatory

compliance, and should be future focussed for business resilience.

Banking providers have limited capacity for maintaining business-as-usual operations while conducting change programs. This trade-off is forcing them to refine and refocus efforts on key priorities across the end-to-end value chain. Adopting a disciplined change management approach utilising Lean principles will allow banks to remove waste and non-value adding activities while improving the speed of execution and operational excellence. Focusing on core processes such as mortgage lending applications will also improve throughput and the time to decision. Understanding what is necessary now and what is likely required in the future will help develop a robust roadmap to combat uncertainty.

It is critical to stay focused and resilient in the market. New regulatory compliance measures and uncertainties in the market present a lot of new challenges as well as opportunities to improve the financial performance of banks. Moving away from bespoke processes to standardisation across the end-to-end value chain will also uplift overall productivity, thereby improving the customer experience and financial performance for financial organisations.

Implementation of digital solutions and automation

Traditional business models and customer value propositions need to fundamentally change to respond to shifting customer preferences for an increased use of digital channels, which accelerated during the pandemic.

Banks will need to find ways to remain relevant in an age of increased digital customer service solutions, but also respond to customers who require extra support to move to a digital banking experience. We have seen a marked rise in online loan applications, automation of property settlements, account openings initiated online, and most importantly, identification and verification through digital channels.

As society continues to move toward being cashless and digitisation accelerates, banks will need to evaluate all distribution channels and question whether they are core to the business. By creating new channels, opportunities to reinvent products will result - such as contactless payment options and real-time payments. Banks will be tasked to evaluate what will be most relevant to customers in five to ten years, at the same time considering how to best move away from the more costly paper-based products such as cheques, while maintaining support for the less digitally savvy segments of the population.

As customers move more online, further consideration will need to be given to what new technology will be required. With the current influx of new technology-based service providers entering the market, banks will need to devise strategies to harness these opportunities overhauling legacy systems.

Embedding new ways of working

The pandemic has changed the way we work. Leaders must consider how remote working practices and flexible working arrangements can be optimised and embedded into the workforce on a more permanent basis. At the same time, systems need to cater for business productivity improvements through better use of technology solutions, such as upskilling teams to virtual visual management boards to drive productivity. Executing well in the new ways of working will require leaders to help staff instil and adopt best practice behaviours to embed a high-performing team culture. This will require a systematic approach of listening to customers' needs and working collaboratively to determine the best way to deliver on these requirements, while using resources more effectively.

As automation and AI take on a bigger role in how banks execute their work, the skills of the future workforce will be focused on essential human capabilities such as emotional intelligence (EQ). Managers will need to work to understand what other human capabilities are required and develop those skills internally to support their innovation agenda.

This means that banking leaders must consider the right target operating model for critical services, including service delivery (insourced, outsourced, offshored), organisational structure, processes, technology, performance insights and data and governance.

When considering a workforce that may spend more time working remotely, consideration will need to be given to the purpose and use of corporate real estate and ensuring the right infrastructure is in place.

Essentially, banks will need to drive productivity, improve capability and build skills, at a time where more and more people are working remotely. Those that embrace and execute on these changes and accelerate the transformation agenda during this period will come out of this time ahead of their competitors.

“

By focusing on cost reduction through process improvement, banking providers can transform to more efficient and sustainable organisations.

Shareholder returns

New regulatory requirements and a continued decline in aggregate cash earnings have significantly impacted the Majors' ability to maintain previous levels of Returns on Equity and dividends.

Return on equity (ROE)

Return on equity continued to deteriorate in FY20, with average ROE decreasing 458 basis points to an average of 6.7 per cent for FY20. This continues the trend identified in the first half of 2020 where average ROE reduced to single-digits. Excluding customer remediation, impairment in associates and intangibles and penalty provisions, the average ROE across the Majors was 9.0 per cent (335 basis points down from FY19).

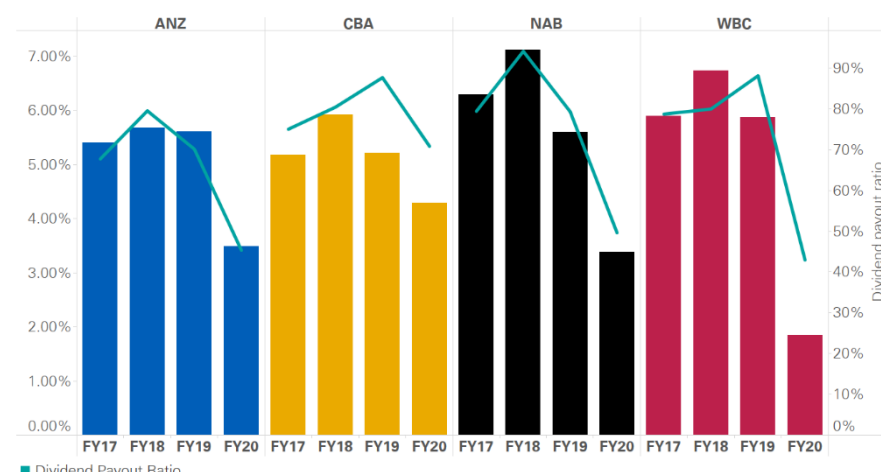
With the impacts of COVID-19 casting a shadow of risks, restoring ROE to levels previously experienced will be a significant challenge for the Majors.

Dividends

In response to the current COVID-19 economic crisis, APRA set expectations on 29 July 2020 that ADIs will retain at least half of their earnings, limit discretionary distributions of capital, so that they can continue to lend to the broader Australian economy during the COVID-19 pandemic, while maintaining strong capital buffers.

As a result, each of the Majors reduced their dividends paid to shareholders in FY20, noting their focus on supporting customers while building the strength of their balance sheets. Across the Majors, dividends decreased significantly with average dividend payout ratios declining 29.1 percentage points to 52.2 per cent.

Diagram 11. Dividend Yield vs Payout Ratio



Source: KPMG analysis from Bloomberg data

The role of fintech partnerships in bank growth

In this new reality banks need to create the capacity to invest, innovate and transform, at velocity, to remain competitive.

Ian Pollari, Banking Lead Partner and Global Co-Lead Fintech,
Dan Teper, Partner and Australia Fintech Lead and
Hessel Verbeek, Partner KPMG Strategy

In order to accelerate their revenue and cost transformation agendas, Australian banks will need to create the capacity to invest and innovate in their core operations, and one strategic pathway is to increase their focus on identifying and executing fintech partnerships.

KPMG's analysis in our recent *Major Australian Banks Results Analysis* reports shows that the Majors in aggregate have been allocating a reduced proportion of their capital budgets to transformation programs – this is a direct result of the increased investment in risk and compliance, in the aftermath of the Hayne Royal Commission. This trend away from transformation investment is exacerbated by the banks' reduced profitability, and therefore their ability to invest.

Given that the larger banks have more complex operating models, organisational structures and systems, it can be challenging to compete with emerging, nimble challengers with simple models, focussed (often monoline) product offerings and a more seamless customer experience that is unencumbered from legacy systems, processes and compliance undertakings.

In recognition of these issues, partnering with fintechs to accelerate innovation has become an increasingly adopted strategy for global banks,

a trend we are now starting to see emerge in the local financial services landscape.

Three approaches to fintech partnering for banks

There are various fintech partnering models to consider, ranging from white-labelling technology platforms to partial or full acquisitions. Instead of on the models, focus should be on the strategic objectives – of which we see three main primary paths to support earnings growth in banks.

1. Partnering to innovate in existing products, channels or processes.

The partner path seeks to give the bank access to the fintech's products, channels or processes to deliver the innovation, in replacement, or addition of, the existing business. This can be an efficient way to go-to-market, for example to introduce digital mortgages when the bank's origination platform is outdated and still highly manual in nature.

Other examples include compliance with regulatory requirements (e.g. Open Banking), the introduction of automated credit decisioning or the use of Artificial Intelligence (AI) in back office processes.

Case study: Bendigo and Adelaide Bank and Tic:Toc:

Tic:Toc was established in 2017 with the aim of automating the mortgage application and approval process. Bendigo and Adelaide Bank became a partner and cornerstone shareholder early on, and more recently launched Bendigo Express, a fast online mortgage product with automated approval that is powered by Tic:Toc's technology and processes.

2. Partnering to launch new products and services

This partner pathway aims to let the bank fill in product gaps or enter new product categories, through a partnership with a fintech that already has a product presence in the target market.

Joining up with challengers can be the best way to compete – an example of this is banks partnering with Buy-Now-Pay-Later (BNPL) platforms, to introduce their own BNPL product. Other examples include partnering with personal financial management (PFM) fintechs, peer-to-peer (P2P) platforms or business cashflow lenders.

Case study: CBA and Klarna

CBA announced an initial investment in Swedish headquartered BNPL provider Klarna in 2019. The initial investment (and subsequent investment in January 2020, totalling circa US\$300 million) secured an exclusive partnership between CBA and Klarna in Australia and New Zealand, and CBA subsequently rolled out Klarna's product suite through its own banking applications.

3. Partnering to develop new business models and revenue streams

This approach to partnering looks to leverage a fintech's capabilities to create entirely new business models or business model extensions for the bank. This is the most disruptive of the three pathways and can apply in situations where the bank needs to pivot quickly and transform its business and operating model. Typically, the aim is to open up new opportunities in the bank's existing markets.

A clear example of this is the bank entering into offering banking-as-a-service for third parties, through the partnership with (cloud-based and innovative) banking system providers. Partnering with the same banking platforms to establish a new digital bank is another example.

Case study: Westpac and 10x

In 2019, Westpac announced it was partnering up with UK-based cloud-native banking technology provider 10x Future Technologies to build a standalone digital banking-as-a-service platform. Once delivered, the platform would essentially enable businesses (e.g. fintechs like AfterPay) without a banking licence to deliver banking services from Westpac via APIs, something that would be cost-prohibitive with Westpac's existing banking and operating platform.

Fintech partnerships are not the answer to every banks' challenges. Partnering is only really required in areas where the banks existing core can't deliver on the growth and transformation objectives.

Banks should be selective in which areas of their business they use partnerships to accelerate go-to-market opportunities. Where fintech partnerships are the clear answer, the three pathways above have several benefits in common:

- they provide the banks with access to new capabilities (e.g. products, experience design, processes, systems, people), in order to better serve customer needs;
- they offer the banks a faster speed to market than in-house development provides;
- they come with lower costs and investments, as transformation of legacy businesses isn't required; and
- they reduce project delivery risks, given that they plug into existing businesses.

The need to focus on partnering... selectively

There are clear benefits for banks to partner with fintechs and technology partners to drive revenue growth or cost improvements – they can access opportunities for earnings growth more quickly, cheaply and with less risks. It is imperative that the banks consider where in their business and operating models they would benefit from partnering with fintechs rather than continuing to exclusively build in-house or limit their vendor community to traditional providers.

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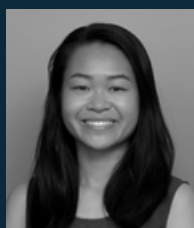
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