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Major Australian Banks: Full Year Results 2014

Tensions are rising

Financial Institutions Performance Summary

November 2014

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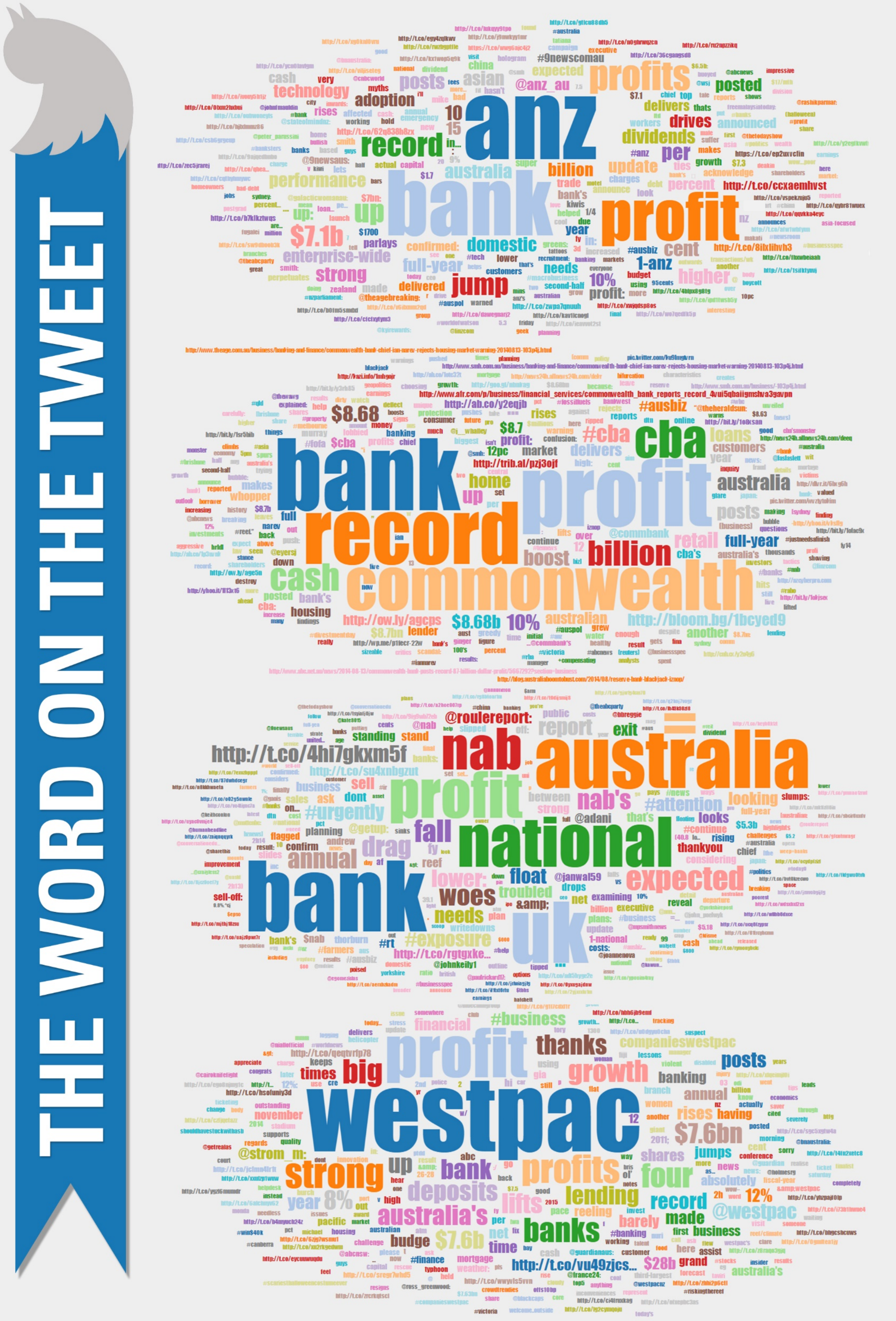
THE WORD ON THE TWEET
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profit
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bank
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westpac
profit
strong
big
growth
$7.6bn
four
profits

Contents

1 At a glance

	ANZ		CBA[1]		NAB		WBC	
	FY 14	FY 13	**FY 14**	FY 13	**FY 14**	FY 13	**FY 14**	FY 13
Ranking								
By profit before tax	**3**	3	**1**	1	**4**	4	**2**	2
By total assets	**3**	3	**2**	2	**1**	1	**4**	4
By total equity	**3**	3	**1**	4	**4**	2	**2**	1
By market capitalisation	**3**	2	**1**	1	**4**	4	**2**	3
By CET 1 capital ratio	**3**	2	**1**	4	**4**	3	**2**	1
Profit before tax ($ million)	**10,308**	9,077	**11,997**	10,645	**7,955**	8,088	**10,740**	9,772
Profit after tax ($ million)	**7,271**	6,310	**8,631**	7,618	**5,295**	5,355	**7,561**	6,211
Cash profit after tax ($ million)	**7,117**	6,492	**8,680**	7,760	**5,184**	5,747	**7,628**	7,063
Net interest margin (basis points)	**213**	222	**214**	213	**193**	202	**209**	214
Cost to income ratio – statutory basis (%)	**43.7**	44.6	**42.9**	43.6	**54.2**	45.6	**42.9**	42.9
Impairment charge ($ million)	**986**	1,188	**918**	1,146	**855**	1,810	**650**	847
Basic earnings per share – statutory basis (cents)	**267.1**	232.7	**533.8**	474.2	**222.1**	225.9	**243.7**	218.3
Basic earnings per share – cash basis (cents)	**260.3**	238.3	**535.9**	482.1	**219.7**	244.9	**245.4**	227.8
Return on average equity[2] (%) – cash basis	**15.4**	15.3	**18.7**	18.2	**11.8**	14.1	**16.4**	15.9
Impaired loans to loans and advances to customers (%)	**0.51**	0.77	**0.56**	0.77	**0.75**	1.26	**0.37**	0.65
Collective provision to credit RWA (%)[5]	**0.89**	1.00	**0.96**	1.02	**0.83**	0.94	**0.93**	0.99
Total assets ($ million)	**772,092**	702,995	**791,451**	753,857	**883,301**	809,870	**770,842**	701,097
Total equity ($ million)	**49,284**	45,603	**49,348**	45,537	**47,908**	46,376	**49,337**	47,537
Capital Adequacy Ratios (%)								
- Total	**12.7**	12.2	**12.0**	11.2	**12.2**	11.8	**12.3**	12.3
- Tier 1	**10.7**	10.4	**11.1**	10.3	**10.8**	10.4	**10.6**	10.7
- Common Equity Tier 1	**8.8**	8.5	**9.3**	8.2	**8.6**	8.4	**9.0**	9.1
Market capitalisation ($ million)[3]	**85.2**	84.5	**130.6**	114.3	**75.1**	57.0	**99.3**	81.5

2 Executive Summary

The 2014 full year saw the majors sustain their current level of high returns, underpinned by robust growth in housing credit and wealth management, further declines in bad and doubtful debt charges, lower funding costs and continued cost discipline.

The Australian major banks (the majors) reported another strong financial result for the 2014 full year, with a combined statutory profit of $28.8 billion which represents an increase of 10.5 percent ($2.7 billion) on 2013. Despite this strong result, tensions continue to rise as Australian banks will need to work hard to maintain these returns in the face of ongoing regulatory uncertainty flowing from the Financial System Inquiry, likely increased impairment charges and technological and structural change.

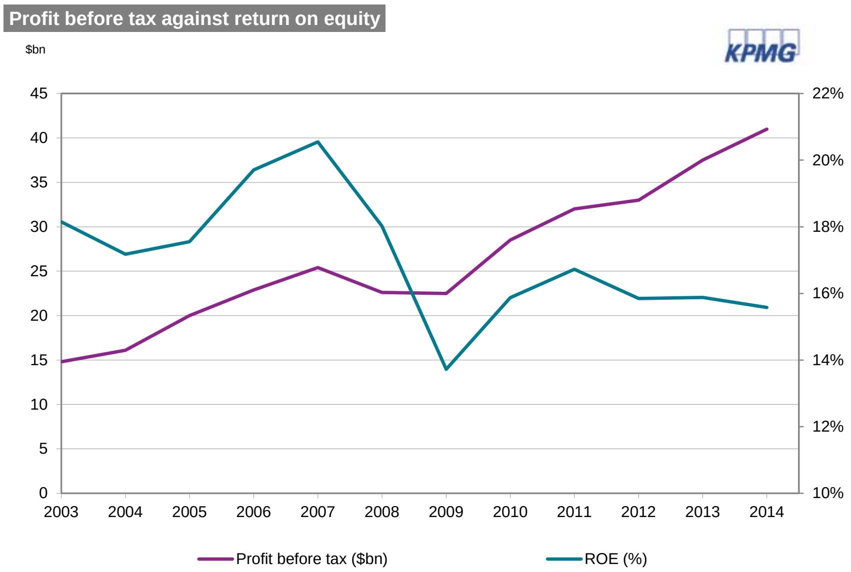
The full year 2014 saw the Australian major banks sustain their current level of high returns, supported by credit growth off the back of improved performance in residential property markets, historically low impairment charges and growth in the wealth management and insurance sectors.

Notwithstanding the above, the result has been posted in a challenging environment with margins continuing to tighten through 2H14. Higher capital requirements, uncertainty from APRA's further Basel III clarifications and the unknown future regulatory environment pending the Financial System (Murray) Inquiry Final Report remain front of mind for the majors. Leading indicators such as 90+ day delinquencies indicate that the historically low impairment charges of previous years may be coming to an end, whilst the amortisation of elevated capitalised software and one-off IT related impairments have dampened earnings.

The majors achieved combined statutory profit growth of 10.5 percent in 2014. Using the industry preferred 'cash profit after tax' measure, which adjusts for one-off items, discontinued operations and accounting volatility, the majors posted combined profit of $28.6 billion, a growth of 5.7 percent ($1.5 billion) for the full year 2014.

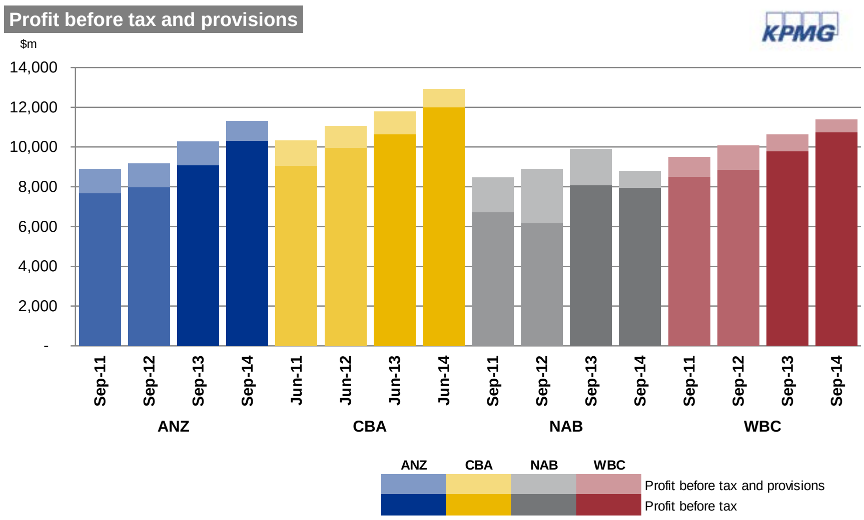
Statutory profit growth year-on-year was mixed for the full year 2014, continuing the trend from first half: ANZ recorded growth of 15 percent, CBA increased 13 percent and WBC increased 12 percent, whilst NAB declined 1 percent off the back of raising a significant provision of $1.5 billion related to conduct matters on the sale of its legacy UK product protection insurance product.

Despite the record profits recorded by the banks, pressures continue to mount on the majors' ability to generate higher returns reflecting the impact of significantly increased regulatory capital requirements. The major banks reported an average return on equity (cash basis) of 15.6 percent for the 2014 full year, compared with 15.9 percent in 2013. As illustrated in the following chart below, return on equity relative to profit continues to trail below pre-GFC levels.



Overall, the majors' investment in operational efficiency programs and exits from non-core businesses has been reported as assisting in the management of costs and sustaining generally low cost-to-income ratios. The average cost-to-income ratio increased across the majors by 175 basis points, mainly the result of one-off items. The majors recorded an average 45.9 percent cost-to-income ratio for the 2014 full year. In the medium term, we expect the majors to intensify efforts to improve productivity levels and realise efficiency gains whilst actively managing margins across all portfolios.

With these competing priorities and the continued pressure to deliver sustainable return on equity, the majors will need to continue to pursue focused growth strategies and invest in strategic capability, whilst maintaining disciplined lending practices in an environment where interest rates are expected to rise and leading indicators suggest an end to the historically low levels of impairment charges. With the increasing regulatory burden, this is critical to the majors ability to balance capital 'adequacy' and the efficient and flexible use of their capital to satisfy investor expectations for return on equity.



The key components of the statutory results are:

- The sustained, intensely competitive environment and historically low interest rates continue to impact **net interest income**. Furthermore, restrictions introduced under Basel III liquidity requirements have led the majors to increase their holding of lower yielding, higher quality liquid assets (HQLA). **Net interest margin** on average tightened 6 basis points for the period to 207 basis points. However, housing credit growth driven by strong investor-led demand for credit, and easing in deposits pricing and wholesale funding markets, saw net interest income increased $3.3 billion to $56.2 billion.

- The strength of the asset quality of the major banks' loan portfolios are at a historical level, with **loan impairment charges** falling since 2009, decreasing a further $1.6 billion to $3.4 billion in 2014. Across the board, asset quality metrics show continued improvement leading the majors to release $198 million in economic overlays. However, leading stressed asset ratios and delinquency indicators are mixed across the majors, with 90+ day delinquencies declining marginally by $65 million during 2014 full year.

- **Non-interest income**, including wealth management and insurance businesses, fees and commissions, and financial markets increased by $2.2 billion to $25.5 billion (9.4 percent). With persistently low margins, the diversification of revenue streams across segments and jurisdictions has been a key priority for the majors. Strong performances have been recorded in their wealth and Insurance businesses during 2014, with some volatility observed in Treasury and Markets results.

- **Increased capital levels** were observed as the majors added to their capital adequacy levels in preparation for new capital requirements, such as the Conglomerates Standard and the D-SIB (domestic systematically important banks) surcharge, currently being phased in. Aggregate Common Equity Tier 1 capital ratios increased by 38 basis points over 2014, to 8.93 percent of risk weighted assets, largely reflecting the accumulation of retained earnings. However, increased capital has been reported as driving significantly higher costs and restricting the deployment to lower yielding HQLA. The majors continue to be challenged by striking an appropriate balance between 'adequacy' and the efficient and flexible use of this capital to satisfy investor expectations for return on equity.

Redefining the future of banking

Looking ahead, there is considerable uncertainty with respect to the future structure of the Australian banking industry. As discussed by Andrew Dickinson, KPMG's Asia Pacific Head of Banking, in the article 'The future structure of the Australia Banking Industry', the G20 Brisbane Summit and release of the David Murray FSI Final Report into the Australian financial system are expected to yield considerable change, ranging from regulatory capital requirements to possible Gone-concern Loss Absorbency Capacity liabilities.

We believe the majors are currently well positioned to respond to changing market forces by adapting their growth strategies, executing against major transformation programs and evolving their operating models. While the majors remain cautiously optimistic about economic prospects for the year ahead, the tension is rising with respect to deployment of capital in innovation and technology, while dealing with continued restrictions being applied under the regulatory reform agenda.

This is transpiring at the same time as a structural shift is occurring in traditional banking channels, primarily driven by technological change and evolving consumer preferences. Ian Pollari, KPMG's National Head of Banking, discusses how innovation and collaboration are key to the banking industry's future success and that Financial Technology (Fintech) is redefining the industry - mobile payments, peer-to-peer lending, crowd-funding and digital currencies.

The ability of the majors, in the face of the expected recommendations flowing from the FSI and the G20 in Brisbane, to balance these competing objectives will be critically important to the long term success both of their own institutions and the Australian economy.

The future structure of the Australia banking industry

There are two major events occurring in Australia in the next few weeks which will be important in shaping the structure of the Australian Banking Industry for many years to come. These are the G20 Brisbane Summit and the release of David Murray's report into the Australian financial system.

Interestingly there are several overlaps and consistencies in the likely outcome of both these events, particularly in the areas of potential higher capital requirements and dealing with too big to fail.

Key issues that the Financial Stability Board (FSB) will bring to the G20 in Brisbane

The post-financial crisis work programmes of the FSB have been dominated by the four core areas on which the G20 has focused:

- **Building resilient financial institutions**, through higher levels and quality of capital and liquidity, limitations on leverage, and improved risk governance. The key proposals for discussion in Brisbane under this agenda item will be around Bank's use of internal ratings based capital models, and the likely imposition of floors to the level of capital required here;
- **Ending "too-big-to-fail"** through both resilience and recovery and resolution. The FSB is due to bring high-level proposals to the Brisbane summit on Gone concern Loss Absorbency Capacity (LAC) and the set of resolution powers that national authorities should have in place to deal with failing financial institutions.

  These are expected to cover:
  - The types of liability that could be included within LAC;
  - The minimum amount of LAC that banks should issue (with this minimum amount likely to depend on the systemic importance of each bank, globally and domestically); and
  - Where in a banking group structure this LAC should be held – at parent/holding company level (the so-called single point of entry approach) or in each operating company (the so-called multiple point of entry approach).
- **Addressing shadow banking** risks, by understanding these risks, regulating non-bank credit intermediation, and limiting the interconnectedness between banks and the shadow banking sector; and
- **Making derivatives markets safer**, through the central clearing of derivatives.

The Murray Report into the Australian Financial System

Similarly, it is expected that David Murray's FSI report will recommend floors to the capital required to be held by the major banks against residential mortgages in accordance with their internal ratings based models and a higher level of capital (by 1-2 percent) through an increase in APRA's D-SIB buffers. There is also discussion emanating from the Inquiry around the need for bail in, loss absorbent, liabilities for the Australian Banks.

Tensions are rising

Interestingly, however, the G20 (and the Australia Government) want their primary focus to become the jobs and growth agenda. There is tension between financial stability and wanting the financial services sector to contribute to the creation of jobs and economic growth.

It is important that the G20 recognise the many contributions that the financial sector can make to jobs and growth. We believe that the focus therefore needs to shift to how regulatory reform can encourage and facilitate the contribution the financial sector can make to jobs and growth.

Secondly, we believe that there comes a point where the impact of higher levels of capital drives significantly higher costs and reduced availability of financial products and services, localisation and fragmentation arises from the inconsistent implementation of regulatory reforms across jurisdictions, and there is continuing uncertainty over the end point. At some stage (and it seems we have now reached this point) these costs begin to outweigh the benefits of reducing the probability of another financial crisis. A completely safe financial sector would be of little economic and social value.

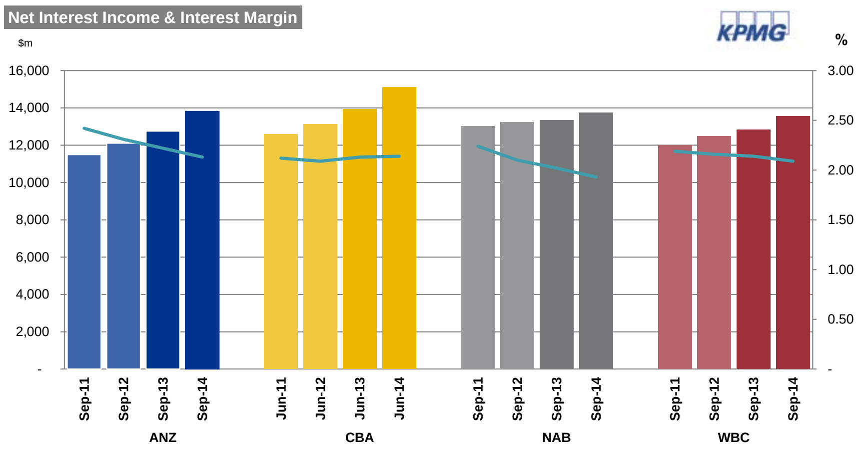
The ability of Murray and the G20 to balance these competing objectives will be critically important to the long term success of the Australian Banking Industry, and the Australian economy.

3 Net Interest Income

Margin pressures for the majors have been most acute in business and institutional lending, as well as the front book lending in domestic mortgages.

Improved net interest income across the majors reflected an increase in earnings from average interest earning assets, primarily driven by elevated activity in the residential property market. However, net interest margin continues to be constrained as a result of competitive pricing offset in part by the easing in wholesale funding markets.

Net interest income across all four majors increased by 6.3 percent to $56.2 billion (2013: $51 billion). CBA posted a record result with an increase of 8.4 percent to $15 billion, ANZ and WBC reported increases of 8.3 percent to $14 billion and 5.6 percent to $13.5 billion respectively. NAB reported an increase of $388 million (2.9 percent) to $13.8 billion supported by a favourable foreign exchange rate movements of $401 million.



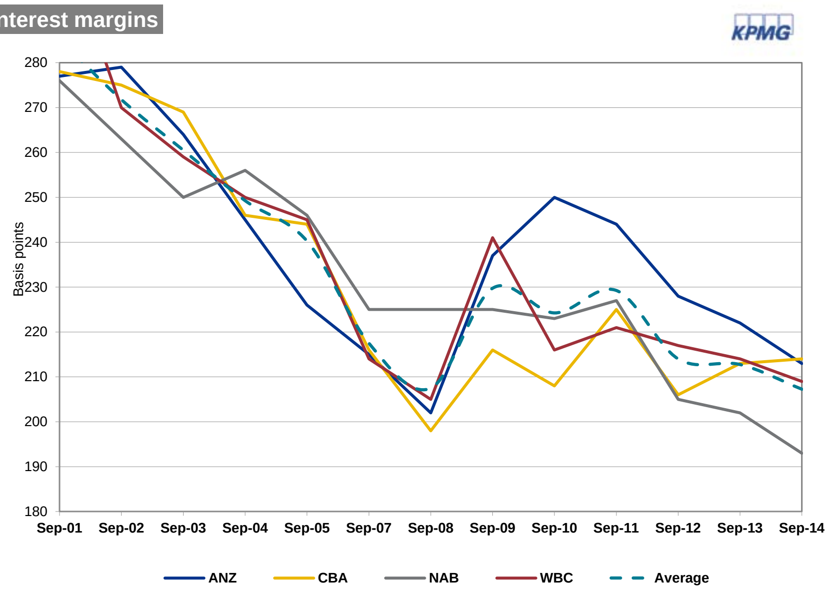
Net interest margin

Pricing between the majors as they compete for growth in average interest earning assets has seen a continued decline in lending margins. The average net interest margin (statutory basis) fell 6 basis points to 207 basis points (2013: 213 basis points). CBA was the only bank to record an increase in net interest margin of one basis point to 214 basis points for the full year 2014. ANZ and NAB both reported a reduction in statutory net interest margin of 9 basis points to 213 and 193 basis points respectively. WBC reported a reduction of 5 basis points to 209 basis points.

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

- competitive asset pricing across both the domestic and commercial lending books (particularly on the front book lending for mortgages and institutional lending) restricted by historically low interest rates. This, combined with an increase in customer preference for fixed rate home loans, has led to a tightening in lending margins;
- compliance with new regulatory liquidity requirements under Basel III has further decreased net interest margin across all banks; and
- a favourable improvement in funding costs, particularly in customer deposits and wholesale markets has eased the negative impact on margins.

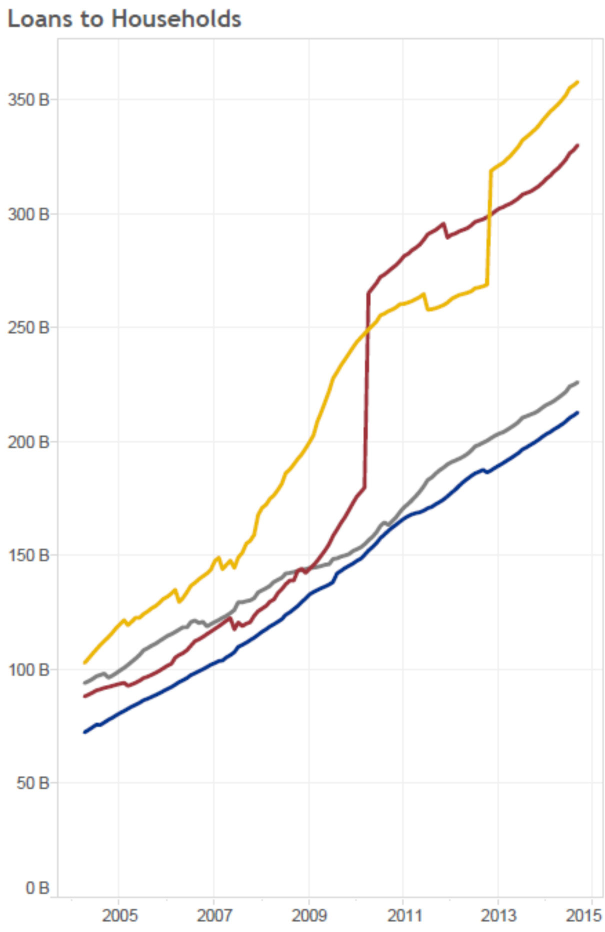
Interest margins

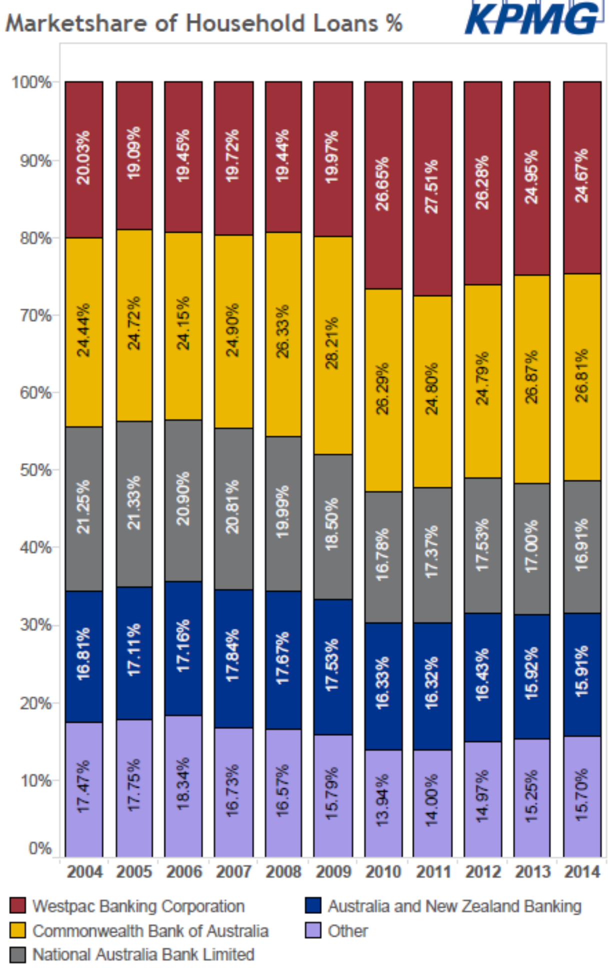


Credit growth

Across the majors, average interest earning assets grew steadily, increasing by 7.4 percent to $2,122.9 billion (2013: 1,977.0 billion). This improving balance sheet growth was driven by continued momentum in the residential property market and strong investor-led demand for credit, resulting in housing credit growth of 7.2 percent to $1,370.5 billion for the 2014 full year.

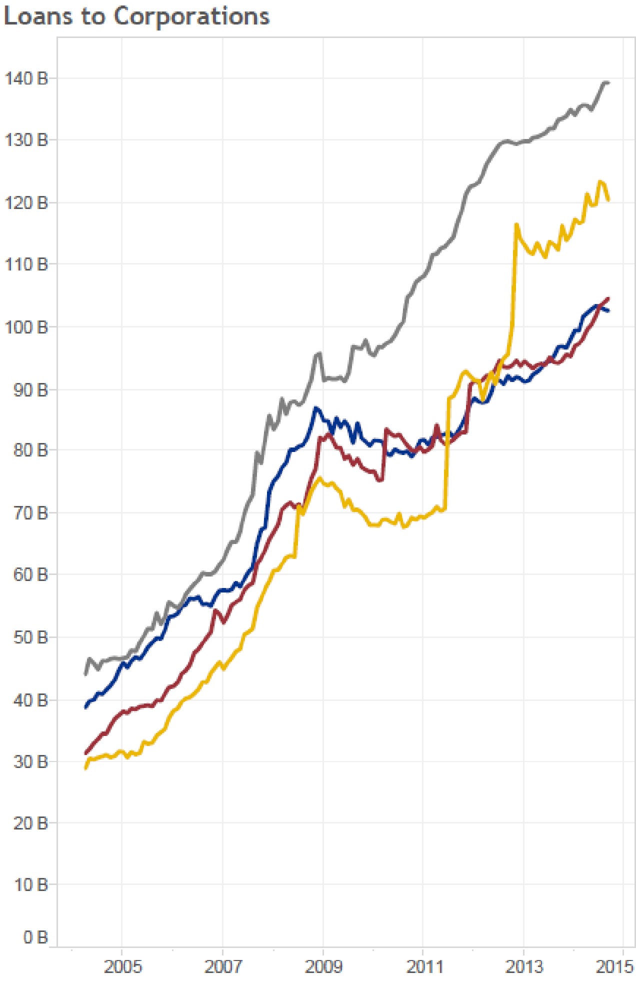
NAB reported growth in average gross loans and advances of 6.1 percent to $507.3 billion on the back of strong volume growth. ANZ saw its portfolio grow by 10.1 percent to $505.6 billion, with September 2014 being ANZ's nineteenth consecutive quarter of above market growth in home lending. CBA's portfolio grew 6.5 percent to $582.9 billion and WBC grew 7.1 percent to $527.0 billion.



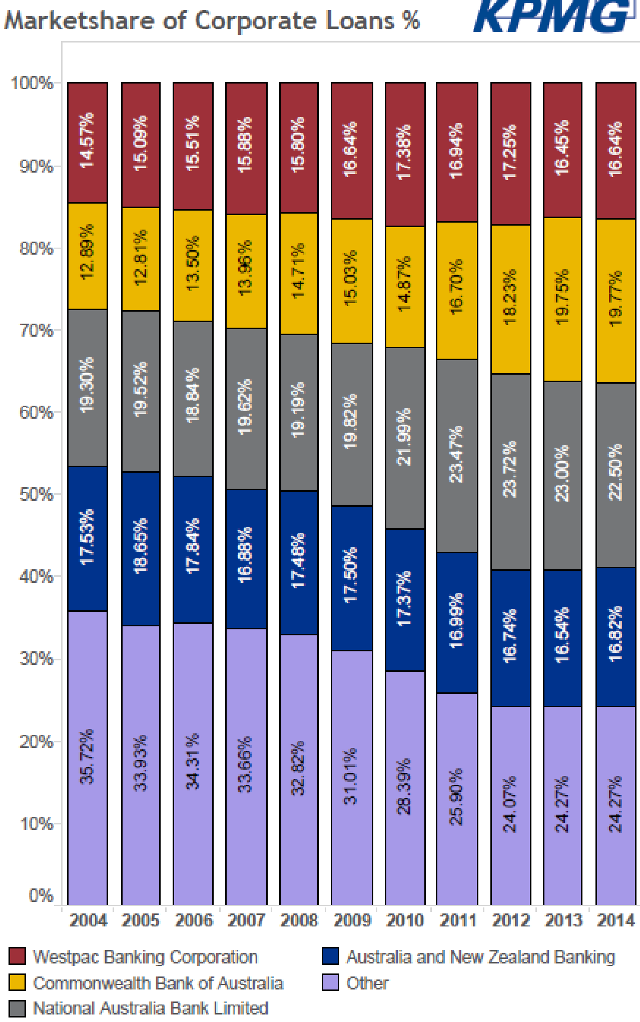


SOURCE: APRA Monthly Banking Statistics

Home lending continues to be core to the majors' domestic franchises, as the charts above demonstrate total loans to households within the financial system and the relative market share of the majors and their competitors. The persistent levels of credit growth experienced by the banking sector in Australia are evident across the 2004 to 2014 period, along with the dominance of the majors. The majors have consistently increased market share over an extended period of growth in the financial system, but over the last three years we have observed the market share of the big four trend down marginally, particularly within the residential book, pointing to more active levels of competition.



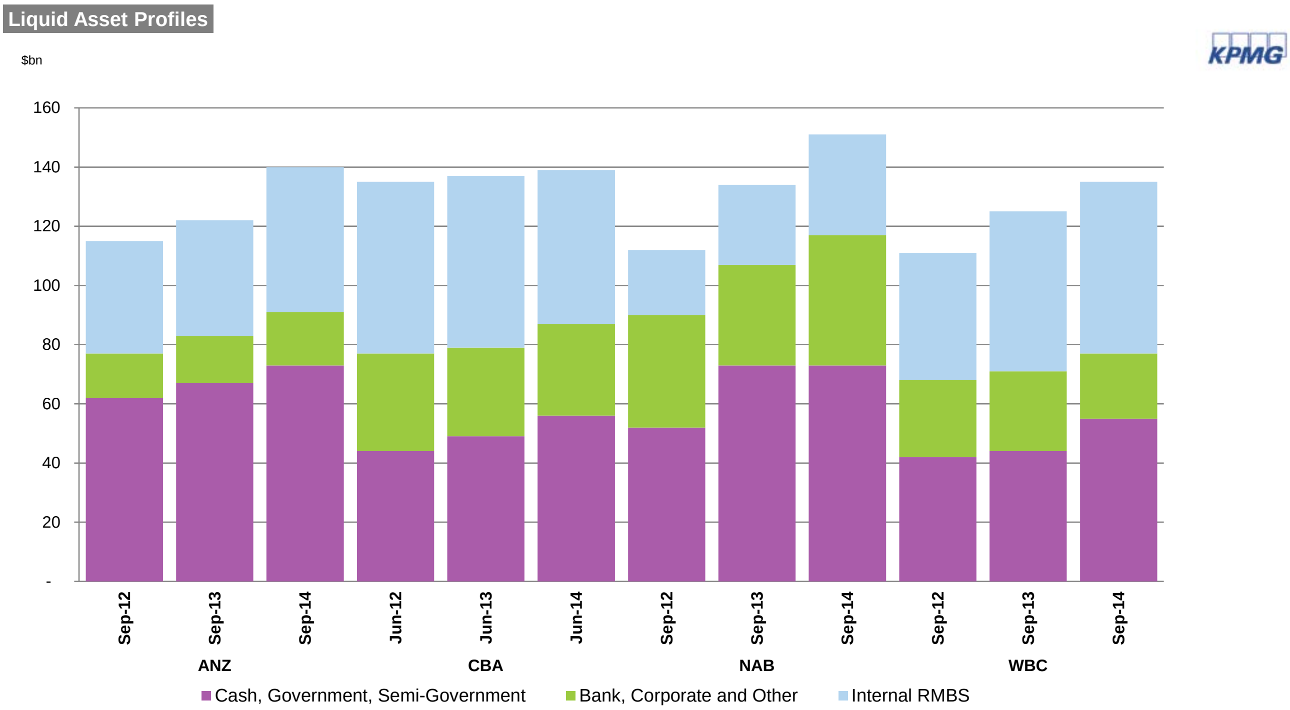
SOURCE: APRA Monthly Banking Statistics



Despite stronger credit growth, the sustained competitive and low interest rate environment has continued to constrict the majors lending margins. NAB reported the heaviest impact with a decline of 12 basis points primarily in its domestic housing book. Additionally, CBA and ANZ have highlighted a change in asset pricing mix following a recent shift in customer preference toward fixed rate home loans as contributing to a 5 basis point and 10 basis point reduction in net interest margin respectively.

Liquid asset mix

Total holdings in liquid assets has increased by $39 billion in 2014 to $567 billion. The uncertainty around capital requirements as a result of Basel III clarifications made by APRA and the (FSI) continue to see the majors focus on retaining well diversified high quality, but lower yielding liquid asset portfolios. This shift to an increased holding of assets meeting the prudential requirements of high quality liquid asset (HQLA) has had a negative impact on net interest margin.



Funding mix

While overall margins have tightened, funding mix had a positive influence. The full year 2014 saw previous levels of competition from second tier banks for customer deposits taper off slightly. This was reflected in improved deposits pricing and a modest increase in the average deposit to loan book funding ratio for the majors to 74.7 percent (2013: 74.5 percent).

Long-term wholesale funding markets have improved on the levels seen in recent years, leading to the majors issuing debt at lower rates and rolling of the last of the government guaranteed debt.

4 Non-interest Income

Non-interest income continues to grow as the majors focus on diversifying earnings and leveraging capital efficient revenue streams.

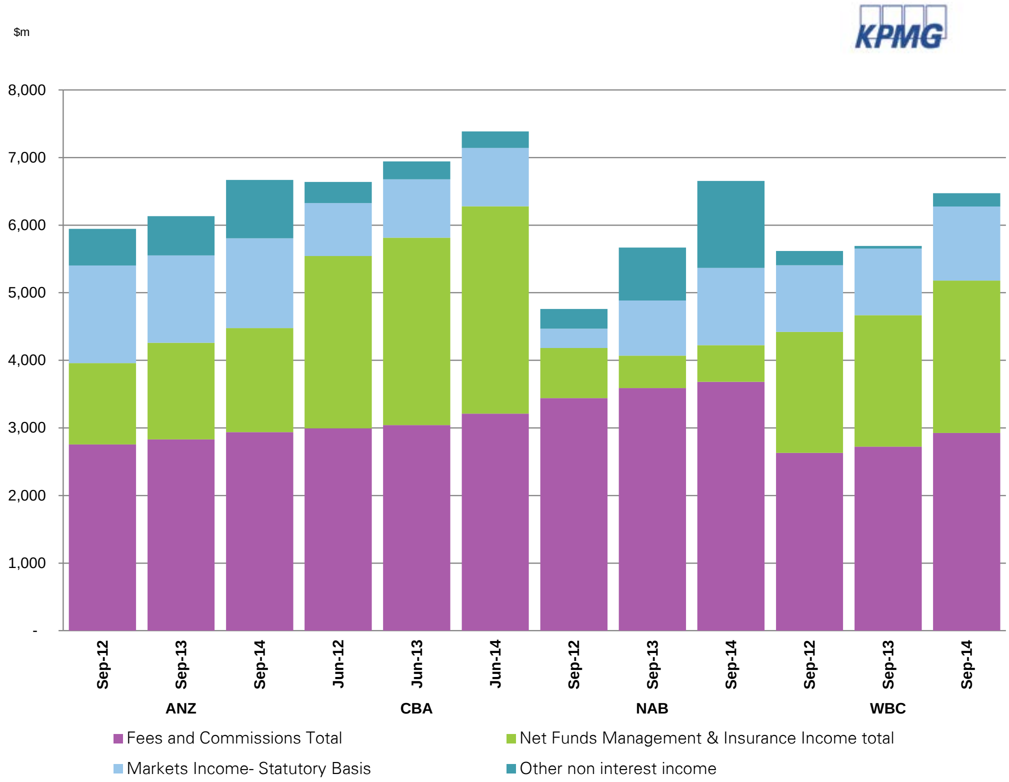
Wealth management and insurance income were the key drivers of the majors' improved non-interest income result, which increased 9.4 percent to $25.5 billion. Although credit markets continue to improve, the focus of the majors on growing diversified, capital efficient revenue streams is continuing to yield positive non-interest income results. Fees and commissions, and wealth and insurance income streams continue to be the largest contributors to non-interest income.

WBC and NAB saw the most significant increase in non-interest income for the full year. WBC's non-interest income increased by 10.8 percent to $6.4 billion on the back of a strong result from its wealth and insurance businesses offset in part by trading income.

NAB's non-interest income improved by $657 million to $5.5 billion (13.5 percent), largely attributable to strong growth in funds under management and the gain on sale of loans in the UK CRE portfolio. ANZ posted non-interest income growth of 8.3 percent ($480 million) driven largely by strong performance in global markets income and increased funds under management. ANZ also benefited by the $125 million gain on sale of ANZ Trustees.

CBA's 6.3 percent ($221 million) 1H14 growth in non-interest income stabilised in 2H14, resulting in full year growth of 6.4 percent or $445 million.

Breakdown of Non-Interest Income



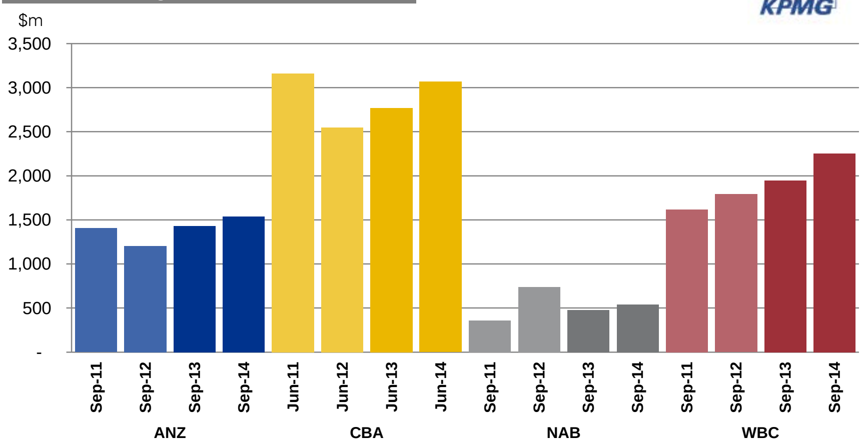
Wealth management and insurance

Wealth management and insurance was a key driver of the growth in non-interest income for all majors in 2014, all returning strong growth on 2013. WBC recorded growth of 16 percent ($310 million) in this segment, followed by NAB with 13 percent ($63 million), CBA with 11 percent ($297 million), and ANZ with 8 percent ($107 million) in growth.

Average funds under management grew across on the back of positive net inflows, investment market gains and the lower Australian dollar. Investment net income was however offset marginally by lower margins, reflecting a trend to lower margin wholesale and institutional products.

Insurance net income continued to be a stable and profitable source of secondary income for the majors. Performance was noted as improving on average by each bank, partially as a result of positive claims experience and in-force premium growth including reduced lapse rates.

Net Funds Management & Insurance Income



Fees and commissions

Fees and commissions increased 4.7 percent to $12.8 billion in total for the majors (2013: $12.2 billion), a modest result when compared with the growth experienced in wealth management and insurance. This was characterised by largely stable lending fees and commissions as well as continued margin pressure extending across all segments of their operations.

Financial Markets

Financial markets remained relatively stable across the majors for the full year 2014. This was characterised by continued demand for financial risk products, offset marginally by the lower Australian dollar and flatter yield curves. CBA had no change at $864 million relative to 2013 reporting a mixed result of stronger trading performance and growth in offshore trade finance income offset by unfavourable counterparty fair value adjustments. WBC reported an 11.1 percent increase to $1,096 million. ANZ's result, driven in part by strong client activity across Asia showed an improvement of 2.7 percent to $1,327 million. Finally, NAB posted a strong result of $1,145 million, an increase of 40 percent ($328 million) relative to 2013 on a statutory basis.

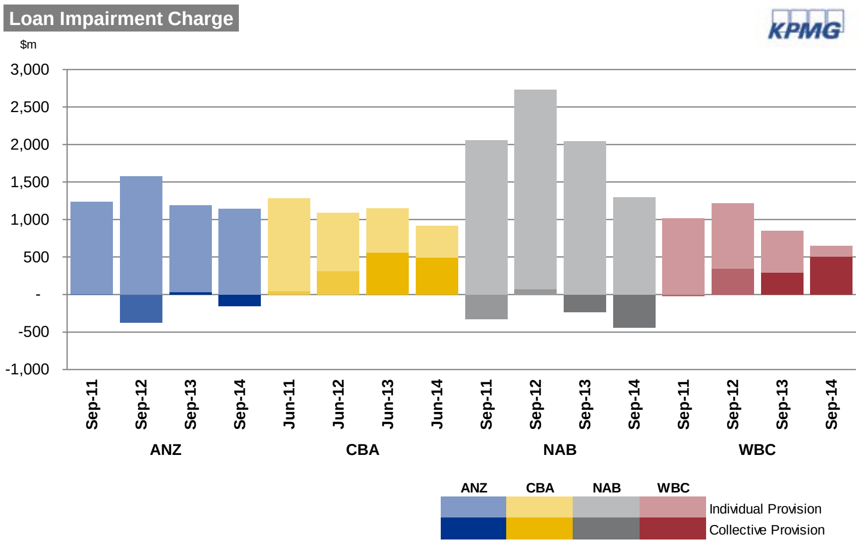
5 Asset Quality

Given the high level of household indebtedness, the majors will need to ensure that loans originated in the current environment can still be serviced by borrowers in less favourable circumstances – for instance, at higher interest rates or during a period of weaker economic conditions.

While lending asset growth remains a key strategic objective for the majors, current year results suggest that growth has not been at the expense of quality. Across the board, asset quality shows continued improvement and is consistent with the historically low interest rate environment globally. Problem loans and stressed asset ratios have improved across the majors however 90+ day delinquencies continue to be mixed.

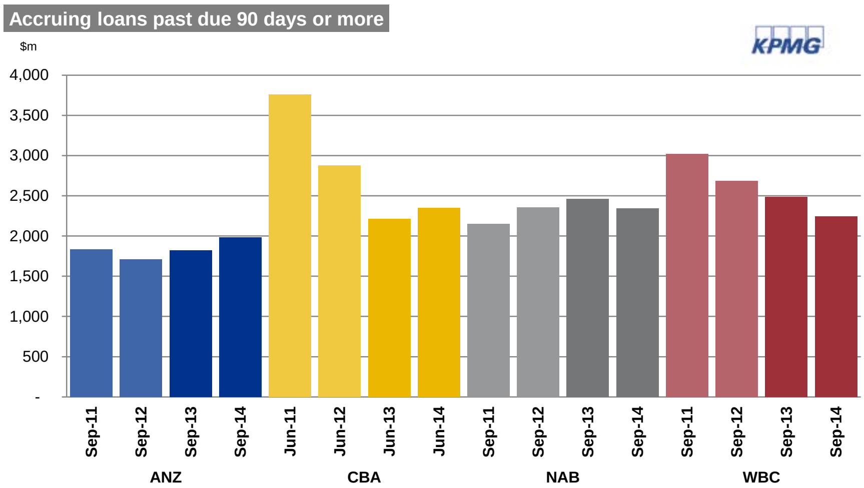
Total impaired assets across the majors declined $5.8 billion to $12.7 billion (31.4 percent) demonstrating the current strength in the system. Whilst provision expenses continue to fall, leading indicators such as 90+ day delinquencies are providing evidence that historically low impairment charges may be coming to an end. Continued focus on credit risk management, particularly in the current cycle of low interest rates and strong property price appreciation, is critical in order to sustain loan impairment charges at their current levels.

Overall, combined impairment charges declined year-on-year by $1.6 billion to $3.4 billion (31.7 percent) on the back of the low interest rate environment in Australia and in key offshore operating markets. NAB realised a 54.7 percent reduction to $877 million in bad and doubtful debt charge driven primarily out of its Australian and European portfolios. The result comprised of an improvement in new categorisations of impaired loans requiring a specific provision and a write-back of $442 million in its collective provision across all operating regions. CBA, ANZ and WBC all reported improvements in impairment charges consistent with the current low interest rate environment and disciplined lending practices.



As a result, the total provision for impaired assets has continued to trend downwards in recent periods. This has been a result of low interest rates which have persisted over a number of years, supported by the recent resurgence in property valuation. Each of the majors have reported a reduction in classifications of newly impaired loans and a release in collective provisions due, in part, to the improvement in the current economic cycle locally and in offshore markets.

The ANZ and NAB result has been assisted through the release of economic overlays of $198 million, collectively. ANZ released $49 million year-on-year as a result of improved credit quality and a reduction in the economic cycle overlays held for legacy events and global uncertainty. NAB's release of $149 million was driven primarily by provisions held against its Australian ($50 million) and NAB UK CRE ($99 million) portfolios.



90+ day delinquencies

90+ day delinquencies decreased 0.7 percent in 2014 to $8.9 billion. The movement in delinquencies was a mixed result across the majors highlighting that whilst overall impaired loans are currently at historic lows, evidence suggests this prolonged downward trend may be concluding. Key trends observed included:

- a significant reduction in delinquencies attributable to retail mortgages across all operating regions;

- a modest increase in delinquencies attributable to small and medium enterprises and wholesale trade sectors; and
- construction and property related exposures continuing to show signs of weakness with increases reported by CBA.

CBA continued the increase in arrears reported at 1H14, with a year on year increase of $138 million (6 percent) driven mainly by construction, property and manufacturing related exposures, while ANZ followed with an increase of $489 million (4 percent) primarily driven by its residential mortgage book.

NAB reversed their 1H14 result with a $184 million reduction (7 percent) for the half year to 2H14, a year-on-year improvement of $121 million (5 percent). Declining delinquencies were reported across all regions with the majority of tightening in its New Zealand portfolio. Consistently, Westpac further strengthened its 2013 result with a reduction of $246 million to $2.2 billion (9.9 percent).

6 Capital

With the increasing regulatory burden, this is critical to the majors ability to balance capital adequacy with the efficient and flexible use of their capital to satisfy investor expectations for return on equity.

Capital remained a key focal point for the majors in 2014, with most banks still formulating capital targets as a result of APRA's further Basel III clarifications and the pending outcomes from the FSI.

The majors continued to strengthen their capital base organically through increases in retained earnings and capital efficiency programs, and assisted by continued improvement in the quality of loan portfolios. The challenge for the majors once the uncertainty caused by the FSI abates will be to set appropriate capital targets that strike a balance between 'adequacy' and the efficient and flexible use of this capital to satisfy investor expectations for return on equity.

Capital adequacy

APRA's current prudential requirements obligate the major banks to hold a minimum Common Equity Tier 1 ("CET 1") ratio of 4.5 percent plus a conservation buffer of 2.5 percent. In the medium term, this will increase by a further 1 percent to a total 8 percent by 1 January 2016 as a result of the additional CET 1 DSIB (domestic systematically important banks) buffer. There is speculation the FSI will recommend increasing this buffer to 2 or 3 percent and will increase effective risk weightings (and capital requirements) for residential lending.

As illustrated in the table below, combined total capital increased $13.1 billion to $171.7 billion (8.3 percent) year-on-year. The CET 1 ratio of each major exceeded the prudential minimum requirement increasing on average by 38 basis points to 8.93 percent of risk weighted assets. Tier 1 and total capital ratios under Basel III increased across the majors throughout the period, up on average 37 basis points to 10.8 percent and 41 basis points to 12.3 percent, respectively.

	ANZ		CBA		NAB		WBC	
	FY 14	FY 13	FY 14	FY 13	FY 14	FY 13	FY 14	FY 13
Common Equity tier 1 ratio	8.8	8.5	9.3	8.2	8.6	8.4	9	9.1
Tier 1 capital (total)	10.7	10.4	11.1	10.3	10.8	10.4	12.3	12.3
Tier 2	2	1.8	0.9	0.9	1.4	1.5	-1.7	-1.6
Total regulatory capital ratio	12.7	12.2	12.0	11.2	12.2	11.8	10.6	10.7
Tier 1 Capital ($ billion)	38.6	35.2	37.6	33.8	39.8	37.5	35.0	32.7
Total Capital ($ billion)	45.7	41.4	40.5	36.8	44.7	42.7	40.7	37.7
Risk weighted assets ($ billion)	361.5	339.3	337.7	329.2	367.7	362.1	331.4	307.4
Credit risk weighted assets ($ billion)	308.9	287.7	289.1	279.7	318.4	314.7	281.5	260.3

Dividend

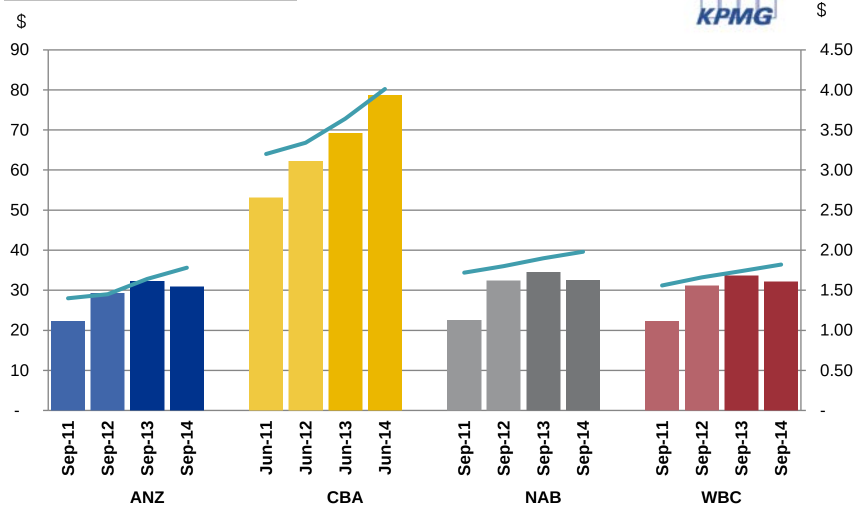
Full year dividend payments are set to increase across the board with each of the majors announcing an increase in final dividends and full year dividends on 2013.

	ANZ		CBA		NAB		WBC	
	FY 14	FY 13	FY 14	FY 13	FY 14	FY 13	FY 14	FY 13
Interim dividend	83	73	183	164	99	93.0	90	86
Final Dividend	95	91	218	200	99	97.0	92	98
Full year dividend (cents)	178	164	401	364	198	190	182	184
Dividend yield (%)	5.8	5.1	5.1	5.3	6.1	5.5	5.7	5.5
Dividend payout ratio (%)	67.4	71.4	75.1	80.5	90.1	77.6	74.2	76.5

Despite the increase in dividends across the board, the dividend cash payout ratio across ANZ, CBA and WBC all fell during the year from the high seen in 2013. This would appear consistent with the majors' intention to strengthen capital holdings organically in an effort to comply with the new regulatory requirements discussed above.

NAB moved against this trend and increased its dividend payout ratio by 125 basis points which has upheld a consistent dividend payment profile with 2013. The full year dividend of 198 cents is a marginal increase of 4 percent on 2013 and has been declared following a decline in cash and statutory earnings, a result which was significantly impacted by the uptake of conduct related provisions with respect to the ongoing UK payment protection insurance (PPI) matter.

Share price against dividend



7 Funding

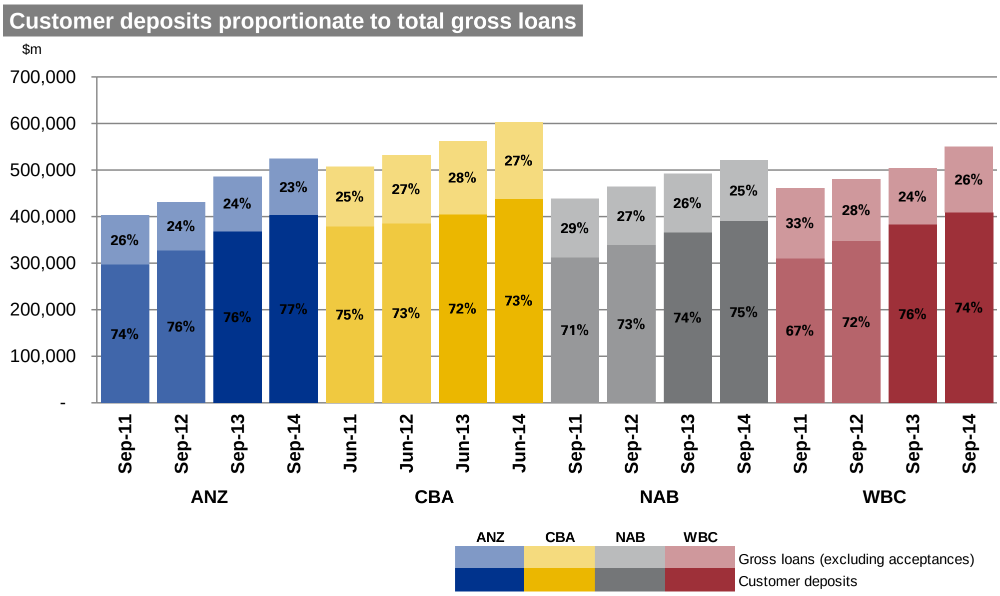
Although the banking industry has benefited from lower wholesale funding costs and easing deposit pricing, downward pressure on margins have continued.

Funding margins improved across the majors as competition for deposits eased and wholesale term funding markets became more benign. Despite this, uncertainty around regulatory capital requirements as a result of Basel III clarifications made by APRA and the FSI continue to see the majors focus on their funding and liquidity profile.

Each of the majors continue to build on their existing strong capital, funding and liquidity positions, in line with their ongoing Basel III regulatory capital compliance programs and commitment to build balance sheet strength. The major banks continue to look to fund a large portion of their loan books with retail deposits, maintaining a consistent funding profile between customer funding and term funding mix.

Improvements in wholesale term funding markets and favourable pricing of deposits has improved funding margins across the board, however pressure from ratings agencies for banks to reduce their dependence on short-term wholesale funding saw only modest growth in this funding source. With the customer deposit centric funding profile of the majors, duration matching of funding sources against lending assets and the need for high quality liquid assets to balance short term customer deposits remains a key focus emphasised by the high quality liquid asset requirements under APRA's clarified Basel III requirements. The balance of managing these competing influences has offset the benefit of the improved funding margin.

Loan book funding for the majors continues to draw significantly from retail deposits with each bank maintaining a relatively stable funding ratio compared with both 2H13 and 1H14. Customer deposits as a percentage of total gross loans averaged 74.7 percent across the majors (2013: 74.5 percent) as the funding landscape saw competition from second tier banks for customer deposits taper off slightly from the levels seen in recent years. This is evidenced by the modest growth in deposit funding led by ANZ 9.5 percent to $404 billion, CBA 8.3 percent to $439 billion, WBC 7.0 percent to $409 billion, and NAB 6.9 percent to $391 billion.



Liquid assets

Uncertainty around the outcomes of the FSI and the current debate on "too big to fail" capital levels has caused competition for high quality liquid assets to persist as the majors continue to focus on the liquidity and funding position. Total liquid assets have increased by 9.1 percent overall for the majors to $565 billion (2013: $518 billion), with cash, government and semi-government securities increasing 10.3 percent to $257 billion.

This has marked a shift away from residential mortgage backed securities relative to 2013 with a decline of $15 billion (8.4 percent) across the majors.

8 Costs

In the medium term, we expect the majors to intensify efforts to improve productivity levels and realise efficiency gains whilst actively managing margins across all portfolios.

Cost discipline clearly remains a key priority of the majors with continued reduction in cost-to-income ratios when normalised for significant items.

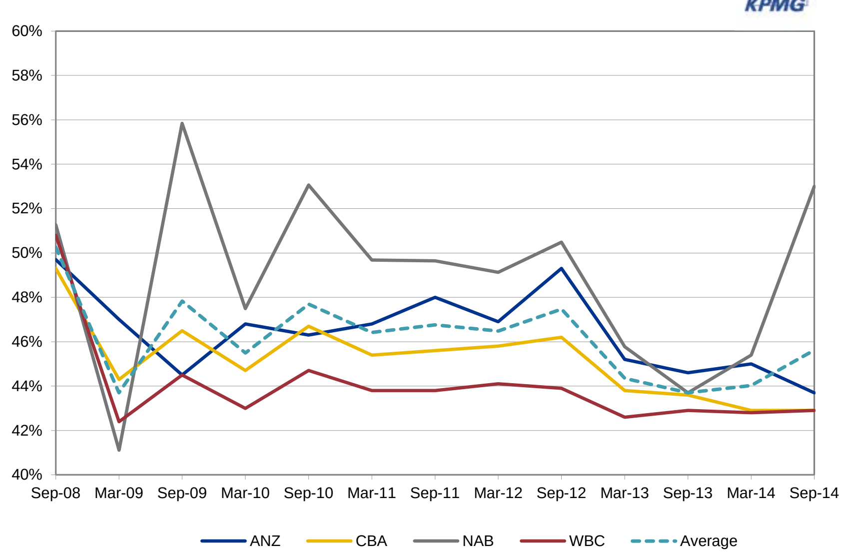
Overall, while operating expenses have increased across the board, relative to the higher operating income base, the management of competing priorities and cost demands across each business appear to be managed well. The average cost-to-income ratio increased across the majors by 175 basis points to 45.9 percent, mainly the result of one off items. Excluding NAB, statutory cost-to-income across the majors improved by 53 basis points to an average of 43.2 percent.

NAB's result, being impacted significantly by a $1.5 billion provision in relation to the legacy UK conduct risk matter and a $297 million IT related impairment, recorded an increase in statutory cost-to-income of 860 basis points to 54.23 percent.

When normalised for significant items, the continual decrease in the cost-to-income ratio reflects long-term strategic initiatives as the majors continually implement stringent cost control measures over a sustained period and realise the benefits of operational efficiency programs implemented in prior years.

The tension in the market between the competing priorities for investment continue to be evident in operating expenses. Spend on personnel, IT related and other project related costs such as regulatory and compliance programs have increased across all majors during the year. Other factors such as inflationary influences and the lower Australian dollar have further increased the overall operating expense recorded by the banks.

Cost to income ratio

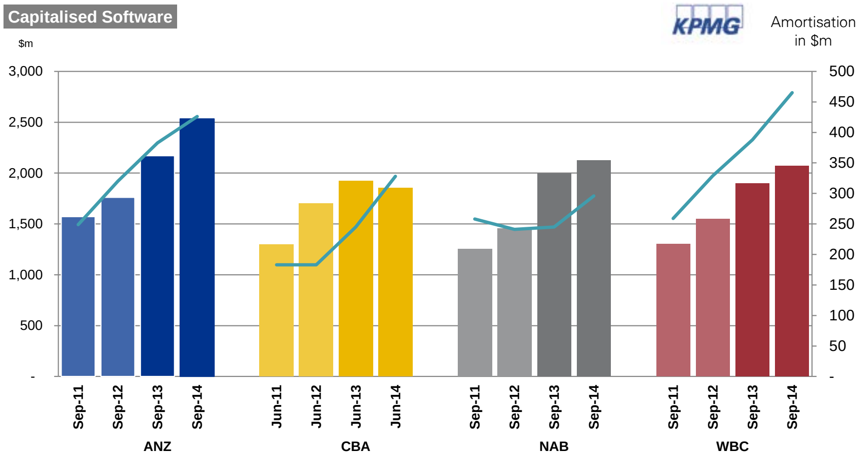


IT costs and capitalised software

A resounding theme amongst the majors continues to be the drag on earnings due to the effect of previous significant investments in technology and software. Capitalised software amortisation expense and related IT impairment charges for the period increased across the majors by 20.7 percent, a combined total expense of $2 billion for the 2014 full year.

With the exception of the impairment recognised by NAB across its NAB Wealth and Australian Banking businesses (including certain assets associated with the 'NextGen' project) of $297 million, the increase in IT costs is largely driven by additional software assets becoming available for use and amortisation periods beginning.

The continued upward pressure on amortisation charges will need to be offset by reduced operating costs in future years to ensure future improvements in cost-to-income ratios. To manage this tension the banks appear to be easing the rate of investment in new IT assets. Despite the majors remaining committed to increasing infrastructure, offering additional capabilities and driving innovation, current levels of investment in capitalised software appears to be more measured in light of a more cost focused environment.



Personnel

Movements in staff numbers varied across the majors, albeit marginally. Collectively, the major banks employ on average 43,471 FTE globally.

The increase in headcount and inflationary influence has led total personnel related costs to increase by 4.4 percent to $20.1 billion, largely driven by local FTE. The lower Australian dollar had a further negative impact on the cost base for those banks with significant foreign operations.

FTE	FY14	FY13	% Movement
ANZ	50,328	49,866	0.93%
CBA	44,329	44,969	-1.42%
NAB	42,853	42,164	1.63%
WBC	35,597	35,675	-0.22%

9 Return on Equity

While favourable economic conditions have seen profits increase substantially over the past decade, return on equity remains below the level achieved 10 years ago.

Faced with mounting tension between regulatory requirements to hold greater and higher quality capital and the competing needs of stakeholders for greater return and sustainable lending, the majors have been able to maintain solid and internationally competitive levels of returns.

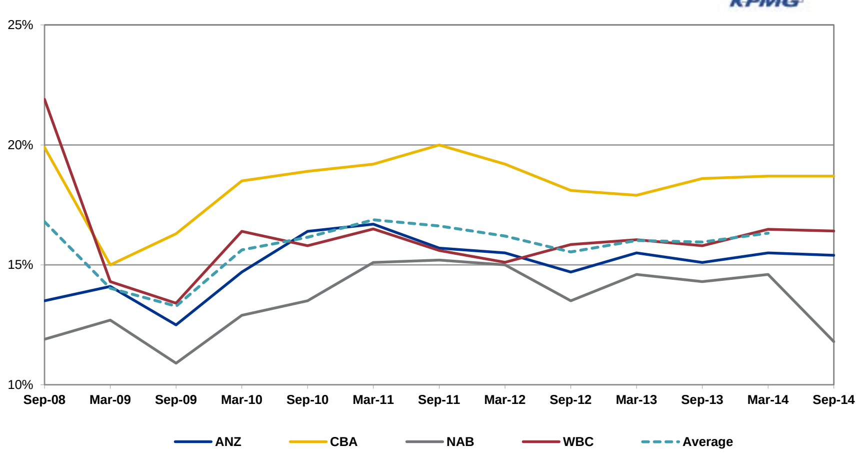
Overall, the majors reported an average cash return on equity of 15.6 percent for the 2014 full year, compared with 15.9 percent in 2013. Excluding NAB's result, cash return on equity increased modestly across the majors on 2013. NAB's return on equity fell year on year by 230 basis points to 11.8 percent impacted by lower earnings combined with the recognition of a $1.5 billion provision and $297 million impairment charge relating to legacy UK conduct related matters and write-downs to the carrying value of software assets respectively.

Across the board, the following themes were reported as restricting the level of cash return on equity in 2014:

- Competitive market environment and relatively low lending growth;
- Higher capital costs associated with the transition to Basel III; and
- Higher operating costs, with particular mention to the level of IT amortisation expense and impairment.

CBA increased cash return on equity by 50 basis points to 18.7 percent, driven by positive returns on net interest income and other banking income which increased revenue by $19.4 billion, however this was offset by an increase in operating expenses, including higher IT costs.

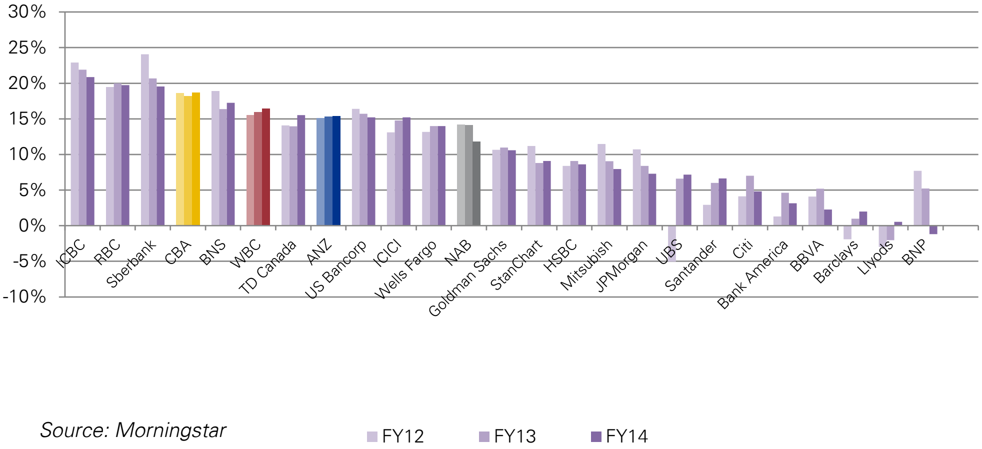
Return on equity



Australian Majors in a global context

With many global institutions continuing to produce sub 10 percent returns, the majors' current year results, in a global context, underline the overall strength of the Australian banking system.

Return on equity - Global comparison

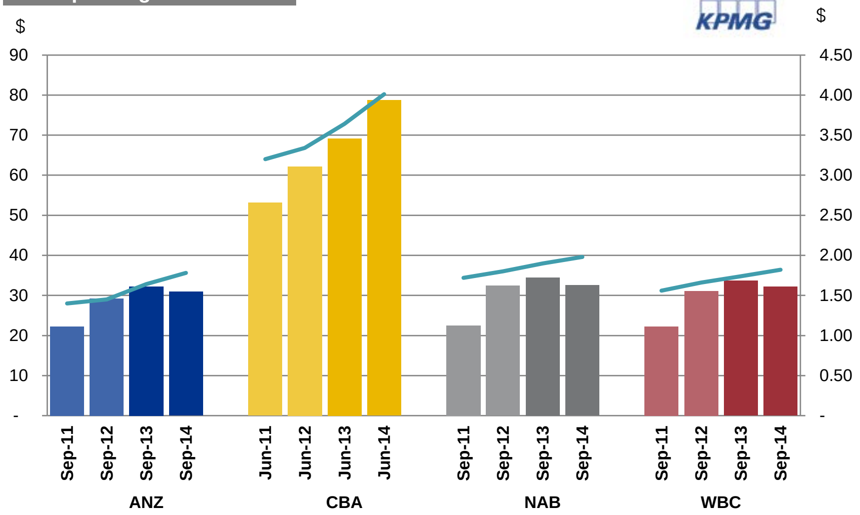


Source: Morningstar

Share price performance

CBA was the only major to increase its share price during the 2014 full year, up 13.8 percent to $78.71 at 30 June 2014. ANZ, NAB and WBC share price all declined during the year closing at $30.92 (down 4.1 percent), $32.54 (down 5.5 percent) and $32.14 (down 4.5 percent) respective to the year ended 30 September 2014.

Share price against dividend



Innovation and collaboration are key to the banking industry's future success

As the major banks close another strong year of financial results, the question begs, what holds the key to the banking industry's success in the future?

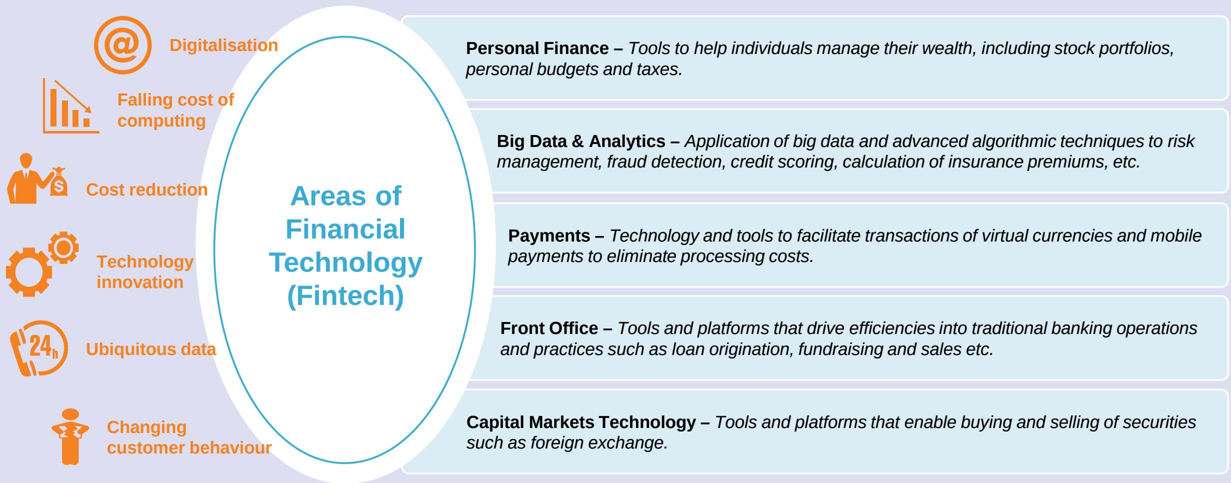
The world of banking and finance as we know it today is rapidly changing – branch banking and physical money is giving way to mobile payments, peer-to-peer lending, crowd-funding and digital currencies - with the emergence of new business models and non-traditional entrants to the industry accelerating.

There is a clear shift in control, from organisations to customers, that is occurring. Consumers are embracing new technology, seeking advice from alternate sources and are increasingly less loyal to their financial institutions. Their demand for highly personalised service is growing. In most cases, technology is facilitating this control shift and allowing greater levels of personalisation.

Technology-led change has and will continue to drive structural change in the financial services industry. As a result, one of the fastest growing sectors in the industry is 'Fintech', the agglomeration of technology and financial services, which is quickly disrupting the industry.

The Fintech sector is experiencing rapid growth internationally, rising from US$100 million in 2008 to US$3 billion today. Future financing activity is predicted to rise globally to US$6-8 billion by 2018.

This strong growth is being driven by a convergence of six key trends: the digitalisation of financial services (increasing electronic transactions); the falling cost of computing and IT services; the need for cost reduction; technology innovation; ubiquitous data; and changing customer behaviour (proliferation of devices and willingness to adopt new things).



Forward thinking and innovative Fintech start-ups are increasingly providing flexible and affordable solutions that are giving consumers and businesses alternative ways to borrow and save, spend and transfer their money and manage their assets. They are directly challenging existing business models, and in doing so, experiencing rapid growth, e.g. Lending Club, Zopa.

Leaders of the world's largest, most successful financial institutions recognise the emerging threat and imperative for change.

This is best exemplified in an article written for the Financial Times by Peter Sands, the CEO of Standard Chartered last year, titled "Banking is heading towards its Spotify moment". He contends that given the "digitisable" nature of banking, technology could fundamentally transform the way banking and financial services works, similar to what has occurred in the music and book shop industries. He states that: "Customers will benefit enormously. Greater transparency will mean better prices for customers. Digital delivery will mean never having to go to a branch. More information and more flexible service configurations will put the customer in control."

Of course, industry incumbents are not standing still. Banks globally are taking a wide range of approaches in trying to keep up with the wave of technology innovation, with Fintech emerging as an enabler, with banks setting up their own accelerators, incubator programs and corporate VC funds, for example, Westpac's investment in Reinventure (a technology focused Venture Capital fund) and CBA recently launching a new innovation hub.

The pace of technological advancement will continue with new entrants altering the traditional financial services landscape and established financial firms evolving their capabilities to compete and retain their customers, leveraging strong levels of trust.

Increasingly, banks are recognising that collaboration with early stage start-ups offers a broader range of new ideas and commercial possibilities. Historically, a financial services firm may have relied on one or two IT vendors to deliver innovation as part of their contractual obligations. However, a different model, whereby a financial services firm can directly engage and collaborate with a range of Fintech start-ups, is quickly emerging.

In this model, established firms can advance their competitive position and cut time to market by adopting new concepts and products developed by start-up firms. In turn, Fintech start-ups can gain access to expertise, resources, data and capital that an established firm can offer.

In conclusion, no-one can predict which specific technologies or business models will be winners (or losers) nor determine their implication on the industry. Therefore, the focus for government and industry should be on fostering a more collaborative environment, allowing entrepreneurial activity and innovation from new Fintech start-ups and established financial institutions to flourish.

Acknowledgements

The following KPMG staff made significant contributions to the development of this publication:

Ben Flaherty

Adeel Khan

Matthew Brunton

James Kidd

Sarah Ellem

End notes

1. CBA report as at 30 June.
2. As disclosed in the banks results announcements.
3. Source from Capital IQ as at 30 September 2014.
4. Profit before tax is reported on a statutory basis. Return on equity has been reported on a cash basis.
5. Included in the NAB collective provision to credit Risk Weighted Asset percentage is a collective provision relating to loans at fair value. This collective provision is included within the carrying value of other financial assets at fair value.

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