

# Perspectives

May 2009

Major banks analysis

## Rising to the challenge

The major Australian banks have now reported their results for the first half of the 2009 financial year in the midst of the worst banking crisis since the Great Depression. They have certainly risen to the challenge, limiting the decline in their aggregate underlying cash earnings to 5.6% compared to the same period a year ago. These results must be viewed as creditable. They of course compare very favourably with the results in overseas markets – in the UK, for instance, the five largest banks reported annual net losses in the order of GBP21 billion in 2008; in the US, net profit for federally-insured banks fell by about 90%.

Unfortunately these results for the majors do not coincide with the end of the Australian economic recession, but rather with its beginning. The December 2008 and March 2009 quarters represent the first six months of a period of negative economic growth which will continue for some time. Even allowing for the expansionary settings of both fiscal and monetary policy at present, and evidence of “green shoots” in some overseas economies, a weak domestic economy will be the operating environment for our banks until at least this time next year.

The banks have responded to these tough times by placing balance sheet strength and stability as the most important single priority, and have increased capital through a range of measures. This, coupled with the decline in earnings, has seen a reduction in their return on equity to an average of 14.1% in the latest half.

The main drag on earnings this half has been the near trebling in bad debt expenses compared to a year ago. This primarily reflects the collapse of some large highly-g geared corporate borrowers plus the provisioning for more pain to come, including through the small to medium size business exposures. History tells us that the full impact on asset quality does not occur until the back-end of the recession, if for no other reason than most borrowers do all they can “to hold on”. Clearly the level of write-offs is going to increase considerably. Given the provisioning in place however, it remains an open question as to whether the level of expenses will increase again. Over the next few periods a significant determinant will be the extent to which unemployment (and underemployment) will continue to rise.

The slowing of demand for credit over the coming year will likely be a restriction on income growth for the banks. In fact total system credit growth in the March quarter was only 0.4%. With business loans in particular continuing to be repriced upwards, credit growth threatens to dip into negative territory. On a more positive front, the majors have continued to pick up market share, which positions them well in a competitive sense for when the markets recover.

The path of net interest margins over the next year is harder to judge precisely because, prior to the financial crisis, both risk (primarily in lending) and funding (including customer deposits) were under-valued and are now being repriced upwards. The fact that borrowers are paying higher margins gets much attention, but how often do we read for instance that many retail deposit rates – at call and even some short-dated term deposits – are above the official cash rate at present? Banks are paying customers for the value implicit in deposits in a way unprecedented since the deregulation of the Australian financial system.

All that said, the guidance from history, both in Australia and overseas, is that bank interest margins ordinarily widen during the first phases of

a recession as banks rebuild stressed balance sheets through internal capital generation. In our view, if this enables banks to continue to lend and hence support economic growth, this is a preferable outcome to the alternative, even though inevitably the cost is spread across bank customers.

Non-interest income streams will likely face some headwinds: including bank fees, through both lower transaction volumes and pricing pressure; and wealth management, reflecting weak investment markets and fee reductions. In addition, in this period the majors benefited significantly from very strong trading income given the volatile markets; however, it is unlikely to be sustained at such levels on an ongoing basis.

The banks of course will respond by looking for further efficiency gains and cost cutting as a means to profit growth and capital generation. Over the past year, the four majors have increased costs by 5.7%. This is somewhat higher than the inflation rate, whereas the 2.2% cost growth in the latest six months was more in line with underlying inflation. These latest results are consistent with the ongoing emphasis on efficiency gains but also with some elements of “steady as she goes” as the banks have focused on navigating the financial crisis. We expect the focus on cost reduction to accelerate over the coming year. All four banks either have major bank integrations, transformations, or core systems programs under way at present.

Another key element of the coming year will be vigorous regulatory debate. The Henry taxation review is under way; the Government has just released draft legislation for the proposed national consumer credit code; terms of reference for the Government’s superannuation review are expected shortly; and the implications for Australia of the G20 Communiqué in relation to financial services regulation will become increasingly important. All this will be happening as a recession unfolds, unemployment rises, and as bank asset quality continues to deteriorate.

Throughout, it will be critically important to remember that this recession is playing out *in spite of* Australia’s strong financial system *not because of* it. In reviewing why the Australian financial system has fared so well to date, we conclude that it was the *combination* of generally good private sector practice with robust economic policy and industry supervision which has served Australia so well, allowing us to avoid the worst international excesses building prior to 2007.

Unfortunately we cannot avoid the consequences of those international excesses. But as the inevitable strains on all sides arise over the next year and beyond, we all need to remember that it is the very combination of a strong and profitable banking system in tandem with robust economic policy and industry supervision which is our best chance to enable us to emerge from this recession even more strongly than we entered.

The PwC Banking Gauge predicts that the major banks underlying earnings for FY09 will finish relatively flat on FY08. But there is a very wide range of forecasts across the banks by the banking analysts that comprise the PwC Banking Gauge. Whichever way you look at it though, our majors are in the relatively (by global standards) happy position of not being in crisis mode. How well they perform longer-term will depend in part on the seeds that they sow in this next period.

## Four majors' combined performance

The overall financial results for the four major Australian banks are summarised below, based on an underlying (rather than statutory or cash) basis. The key elements of the 1H09 results are very clear:

- very strong growth in income;
- disciplined management of costs;
- a near trebling of bad debt expense compared to 1H08;
- overall, only quite modest reduction in underlying cash earnings.

In arriving at “underlying cash earnings”, a number of adjustments are made to the “statutory results” to exclude significant non-recurring items and to eliminate “accounting noise”, in an attempt to reflect profits normally available to shareholders. To some extent, the scope of these adjustments seems to be increasing.

The non-recurring items typically include gains or losses from the sale of assets, the fair valuing of assets on acquisition, and significant expenses related to restructuring, transformations and acquisitions. In the 1H09 results one of the banks has included the results from “non-continuing businesses” where the strategic decision has been made to exit certain businesses but have not yet been effected.

## Net Interest Income

Strong growth in net interest income in the half-year has been a key factor underpinning the banks' results. Net interest income grew by 18.9% compared to the March 2008 half, and 10.4% compared to the most recent half. This was achieved despite the slowing of balance sheet growth; for instance, gross loans rose by 2.2% over the most recent half (excluding Bankwest). It should be remembered though that deposit growth was very strong during that period (12%), reflecting the flight to quality.

For the second half-year in a row, net interest margins have risen. Net interest margins rose by 6 basis points in the half-year from a weighted average of 2.08% in 2H08 to 2.14% in 1H09, having risen from 2.05% in 1H08.

This latest rise in net interest margins can be attributed to the following factors:

- Re-pricing of loans to better cover credit risk, which was undervalued prior to the credit crunch. This contributed 19bps, coming mainly from business loans (including adjustment of individual customer risk margins) and to a lesser degree housing loans.
- Fierce pricing competition for customer deposits decreased NIM by 10bps
- A further increase in the holding of liquid assets decreased NIM by 3bps.
- The credit crisis has pushed up the price of wholesale funding for the banks, reducing NIM by 2bps.
- “AIFRS volatility” added 4bps to NIM. This relates mainly to the banks' use of relatively cheaper offshore funding, which they then hedge for foreign currency risk. This lower funding cost increases NIM but can be offset in other operating income.

Four majors' combined performance – \$A million-underlying cash earnings

	1H09	2H08	1H08	1H09/2H08	1H09/1H08
Net interest income	20,927	18,950	17,606	10.4%	18.9%
Other operating income	11,398	10,656	10,651	7.0%	7.0%
Total income	32,325	29,606	28,257	9.2%	14.4%
Operating expense	14,069	13,766	13,315	2.2%	5.7%
Core earnings	18,256	15,840	14,942	15.3%	22.2%
Bad debt expense	6,463	4,388	2,326	47.3%	177.9%
Tax expense	3,176	2,954	3,510	7.5%	-9.5%
Outside equity interests	72	60	52	20.0%	38.5%
Underlying cash earnings after tax before significant items	8,545	8,438	9,054	1.3%	-5.6%
Statutory profits	8,829	7,282	9,223	21.2%	-4.3%

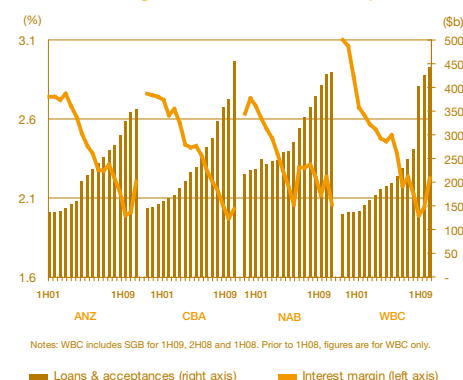
We point out that the accounting issues underlying these results are as complex as we have seen for some time.

To start with, two major acquisitions occurred in this half year:

- WBC's merger with of St George Bank (SGB) was completed on 17 November 2008. WBC provided comparative information for prior periods as if SGB had always been owned. The numbers in this report therefore treat WBC/SGB as a combined entity in all reporting periods. In previous editions of Perspectives, SGB was included as a stand-alone bank.
- CBA's acquisition of Bankwest was completed on 19 December 2008, shortly before the conclusion of CBA's half-year on 31 December. Bankwest is included in the consolidated CBA balance sheet for the half, but the balance sheet comparatives for prior periods have not been adjusted. Naturally there is minimal contribution from Bankwest to the underlying earnings in the half, and Bankwest financials were not previously included in our Perspectives analysis.

The largest of the accounting noise eliminations this period have related to hedging of interest rate and foreign exchange risk. Some hedge contracts do not meet the requirements of AASB 139 for hedge accounting or are not fully effective. Where this is the case, unrealised gains/losses are eliminated as they will reverse over time to be matched with the profit or loss from the underlying hedged item as part of the statutory profit.

### Interest margins and loans & acceptances



In the short term, it is possible that this increase in margins will continue, as business loans continue to be repriced upwards, and potentially the holdings of liquid assets can be reduced as market conditions stabilize further. However, until the period of rapid changes in monetary policy comes to an end, and the full impact of pre-GFC funding rolls off bank balance sheets, it is impossible to predict the direction of margins. This is especially the case as the importance and value of retail deposits for bank funding has increased dramatically in consequence of the crisis. This transfer of value from borrowers to depositors still has a way to run, and until finished is another source of uncertainty about where bank margins will ultimately land.

## Deposits and Lending

Nowhere is the impact of the economic environment more evident than in relative growth rates of deposits and lending. While lending has consistently grown more quickly than deposits for more than two decades, the opposite is now true. For instance, in the six months to March, household deposits in all banks grew by 11% while total credit grew by 1%, with virtually no growth in credit (0.4%) in the March quarter.

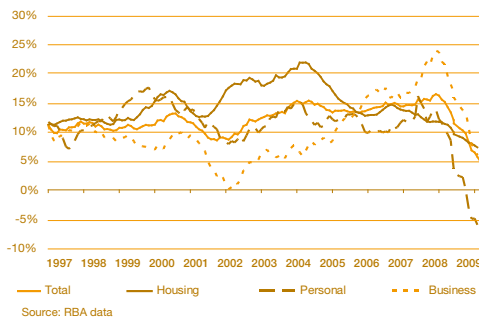
## Deposits

In the year to March 2008, household deposits in all banks grew by 24% while business deposits grew by 16%. Such growth is unprecedented in the two decades of available data; prior to September 2008 household deposits had never grown by more than 16% in a twelve month period.

Despite intense price competition from smaller banks, the majors have held their share of household deposits steady at 81.9%. Moreover the majors increased their share of business deposits from 82.7% to 83.5%, mainly at the expense of foreign banks.

We expect the growth rate for deposits will slow over the coming year, reflecting a reduced flow of funds from other investments (especially equities) together with increased pressures on both household and business cash-flows due to the recession. Bank competition for deposits will remain intense as they look for stable and lower cost alternatives to wholesale funding.

### Domestic Credit Growth (Annual % growth)



## Consumer Lending

Total systems growth in housing loan outstandings has slowed dramatically, having risen by only 7.2% in the year to March 2009. This is the lowest over-the-year growth recorded in housing loans since the deregulation of the Australian financial system, well below previous lows of 9.7% (year to December 1986) and 10.6% (year to September 1991). In fact, all time low growth in this series (which stretches back to September 1977) is 7.1% recorded in the year to February 1983 as the economy was beginning to emerge from the early 1980's recession. We may dip under this growth rate in coming months, as unemployment rises and the boost from the First Home Buyers' Grant wanes.

The major banks grew housing market share at the expense of smaller bank and non-bank competitors. A number of reasons underpin this – funding restrictions (either volume or price) have forced some smaller players to either stop or dramatically slow their lending for housing; the major banks have been able to use their superior funding to undercut some competitors on price; and the majors have also benefited from general flight to quality from consumers. In all, the major banks' market share has risen by 277 basis points since March 2008 and by 87 basis points since September 2008 to stand at 70.4%.

Total personal lending outstandings (which comprise secured and unsecured personal loans and credit cards) shrank 6.2% over the year to March 2009, reflecting consumers' reluctance to take on further debt and

relatively high interest rates for unsecured borrowing. Credit cards balances are still growing slightly but more as a reflection of reduced repayments rather than an increase in transactions. The major banks' market share of personal loans grew by 40 basis points to 57.4% in the year to March 2009, while their share of credit card debt remained static at 66.2%.

## Business Lending

Total system business lending growth has reduced sharply, growing by only 4.1% in the year to March 2009, compared to a peak growth rate of 23.9% in the year to December 2007. In fact, total business outstandings actually fell in the March quarter, by 0.8%. While the occasional quarterly fall was experienced earlier this decade, the combination of recession and the upward repricing of risk margins for business currently under way, suggests that business borrowings could continue to fall for some time. At the trough of the last recession, business outstandings fell by 8% over the year to December 1992.

In terms of market share for business lending, the major banks have fallen from 72.9% in March 2008 to 72.6% in March 2009. While some of these gains have been won by regional banks, the majority of the gain has been won by foreign banks, indicating the foreign banks may not quite be the spent force in the Australian market as some might suggest.

# Economics Report

Last time we went to print in October 2008, the IMF was forecasting that the global economy would grow by 3.0% in 2009, only a touch below its long term average. It was hoped that the raft of packages being announced to stimulate developed economies could restore investor confidence, thaw out the credit markets and prevent these economies from sliding from an economic downturn into a recession. In Australia, the official cash rate stood at 6.0% and there was hope, albeit fading, that China's insatiable appetite for commodities would keep the Australian economy growing throughout 2009.

It is not often that the macroeconomic environment can alter so dramatically in such a short period of time. This perhaps reaffirms the gravity of the current situation. What we have witnessed over the past nine months are the impacts of a massive structural adjustment in the global economy, from an environment of cheap and plentiful debt to one of debt scarcity. The impact of this adjustment has expanded from the balance sheets of major financial institutions and volatility in equity markets to the rapid slowing, and then contraction, of economies around the globe. The IMF currently expects

the global economy to contract by 1.3% during 2009, the weakest outcome in the post-war period.

The Australian economy has now followed its international counterparts into recession, with further contractions forecast throughout 2009. However, an examination of the S&P/ASX 200 indices since March 2008, as a proxy for the health of Australian industries in general, offers some interesting insights into where the stress in the Australian economy is really being felt. The least affected areas are health care, energy and civil contracting. These all provide basic services to society at large and have a significant dependence upon Government funding, regulation or procurement. The farming sector has also performed strongly of late on the back of good harvests; however the return of these harvests has been tempered by the fall in commodity prices.

At the other end of the spectrum the building materials and industrial products industries have fared poorly as construction is postponed and manufacturers cut production. The consumer discretionary sector is also under pressure as households show caution in uncertain times.

We all hope that the relative health of the domestic banking sector should not only help dampen the severity of the downturn in Australia, but may also help contribute to a quicker recovery for the Australian economy. Which brings us to the question currently posed to all economists: how far off is a recovery?

Recent weeks have seen some international commentators starting to hint at 'green shoots' emerging from the recent tide of negative news. While this is encouraging, it is crucial not to mistake a stabilising of the economy, to be expected after a period of extreme volatility, with an economic recovery. A recovery will only be sustainable upon stable and solid foundations. These foundations will firstly require the bottoming out of house prices in the US. Confidence in global financial systems will also need to be renewed, brought about by the appropriate removal of toxic assets of bank balance sheets and the unthawing of credit flows. A period of prolonged economic recovery could be sustained once these conditions are restored.

## Other Operating Income

Other operating income increased 7.0% on the March 2008 half representing 35% of total income for 1H09.

### Bank Fees and Commissions

Bank fees and commissions in total rose by 1.6% in last half year, and by 2.8% over the March 2008 half. Lending fees (which account for 33% of the total) rose by 13.7%, as facilities for business became subject to review. Other fees and commissions, which are dominated by transactions and related activities, fell by 3.5%, reflecting the slowdown in economic activity (including M&A activity) and ongoing competition for transactional activity. For instance, a number of banks ran fee-based marketing campaigns for transactional products as a tactic to increase deposit balances. Towards the end of the period the new “direct charging” model for ATM fees also came into effect.

The slowdown in economic activity will continue to impact this category, including on lending fees. In addition, it is likely that regulatory scrutiny will continue to put downward pressure on fee pricing. For instance, there has been renewed discussion about exit, default or penalty fees in consumer lending contracts. The Governor of the Reserve Bank noted in March that the Payment Systems Board would be “pragmatic but determined” in pursuing the Board’s two statutory goals, namely risk control and the promotion of competition and efficiency in the payment system.

### Trading Income

Trading income has been a very important component of bank income growth over the past six months, with trading income rising from \$1,092m to \$2,517m, an increase of 130%.

The issue with trading income is always how durable it is over the longer term. The recent high market volatility has created favourable conditions for banks, in terms of both increased demand from clients for risk management products and the greater opportunity for proprietary trading by the banks. The market volatility will not endure indefinitely, and hence the level of trading income is unlikely to be sustainable.

### Wealth Management

As expected the cash earnings from the major banks’ wealth management businesses fell sharply in the latest six months, by some 18.8%. After a long period of strong growth, wealth managers are clearly facing pressures

from every side. The particular challenge through 2008 was the decline in asset values, which of course has a direct impact on funds under management and hence income streams to wealth managers. The December quarter was a particularly difficult period for equity funds, with the ASX 300 losing 20% in those three months alone.

Despite the difficult market conditions, the major banks are broadly maintaining their share of the reduced pool of net inflows into investment vehicles. Going forward, net inflows will be impacted by both investor risk appetite and investor preferences around management options.

Managers have indicated that while income has fallen in line with asset values, margins are relatively steady. Again, there are a number of pressures on margins, including competition within the sector as the pie shrinks, customer pressure in response to falling unit prices, and customer asset reallocation to lower risk (and lower margin) products. In addition, the Federal Government has announced an inquiry into superannuation and it is expected that fees and commissions will receive significant scrutiny. A realistic view to the inquiry is that average costs to superannuants will be lowered. An optimistic view would include a focus on removing impediments in the value chain to greater efficiency, such as streamlined requirements in relation to advice, useful product rationalisation legislation and so on. These structural changes could act as important catalysts for the fee reductions desired by the Government.

For the banks, cost reduction is of course both a critical and challenging objective right now, as they struggle to rein in spending without disrupting funds management expertise. The most recent accounts suggest that disciplined cost management in this area is being achieved by all of the banks.

While investment markets have performed more strongly since mid-March, it is far too early to call an end to equity price impacts of the GFC. Interestingly, an IFSA/CoreData survey calibrates current investor sentiment at -22.3, indicating that investors are not yet ready to start investing funds again. (The survey takes into account investor expectations regarding performance of investment markets, their perceptions of their current financial situations and their future investment intentions.)

Consolidation and a reduction in the number of players are likely outcomes as the battle for funds intensifies but success will also rely on delivering performance for a fee that the investor sees as commensurate with the service being provided. The challenges for the industry are arguably now greater than those seen at any time over the last twenty years.

## Efficiency

The combination of strong revenue growth and disciplined expense management saw each of the major banks register an improvement in efficiency ratios in the half-year. In aggregate, total underlying expenses rose by 2.2% compared to the previous six months, and by 5.7% compared to twelve months ago. This translated into an average cost-income ratio of 43.5% in 1H09 compared to 46.5% in 2H08.

The primary driver of cost discipline in the half-year was a fall of 2.8% in the “other expense” category, consistent with the banks restricting discretionary expense items (such as travel, advertising, entertainment and so on) as an immediate lever in response to the sharp deterioration in operating conditions. Three of the four banks registered a fall in this category.

Staff expenses rose by 3.2% over the half-year, which is in line with the increases we have seen in recent half-years, although average FTE numbers for the four banks rose by only 0.6% (excluding BankWest). Recent statements by the banks indicate that the increase in salary costs per FTE will be modest in the coming year. We expect this to be more likely in the range of 2.0-2.5%, rather than the 4-5% level of recent years.

Total occupancy costs rose by 5.2% in the half-year, roughly in line with previous trends, mostly reflecting the ongoing impact of contractual rent reviews. Computer expenses increased by 8.3%, although there was a large divergence between the banks in this category, reflecting their different strategies and positions in relation to technology.

Looking forward, the difficult operating environment will place an ever-increasing focus on cost management as a lever for profit growth. The banks do seem determined however to avoid a “slash and burn” approach and to focus rather on process improvement as a means of achieving sustainable cost reductions and the maintenance of prudent risk management. The challenge of course is that such programs come with an expensive price tag before benefits can be realised. As we have often noted, this emphasises the importance of implementation quality as the key determinant of organisational success.

Reported banking expense to income ratio

	1H09	2H08	1H08
ANZ	41.8%	43.6%	44.4%
CBA	44.3%	49.4%	48.4%
NAB	43.4%	46.7%	47.0%
WBC	40.4%	42.0%	44.8%

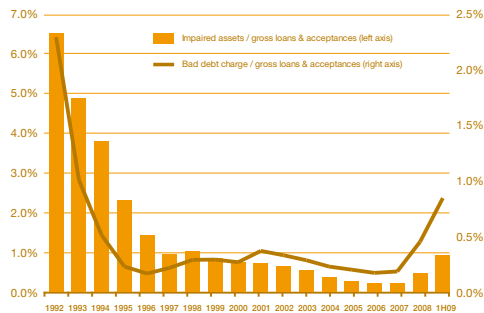


## Asset Quality

As predicted, the banks' combined bad debt charges have risen sharply, and more sharply than many anticipated. In fact, the aggregate bad debt expense for the half year has nearly trebled over 1H08, to \$6,493m.

This is against the backdrop of a three-fold increase in impaired assets over the year to March 2009 to \$14,098m, compared to \$4,351m as at March 2008. The total provision coverage ratio (total provisions to gross loans and acceptances) now stands at 95bps, up from 60bps a year ago.

### Four majors: impaired assets and bad debt expense



Notes: Historical data based on AGAAP. 2006, 2007, 2008 and 1H09 based on AIFRS.

Seeing these results in the context of the actual events of the half-year is critical. In simple terms, when the half year started there was still some doubt about whether the Australian economy would or would not escape recession. By the end of the half, there was no doubt that Australia had entered a recession, with negative economic growth recorded in the December quarter and every expectation that the March quarter will show a further slowing in activity, notwithstanding the significant easing in monetary and fiscal policy from October onwards. Published labour force data shows that the labour market remained relatively robust up to December, but weakened noticeably in the March quarter. Unemployment rose from 4.4% to 5.7% between December 2008 and March 2009.

The available evidence suggests to us that demand conditions for many businesses softened progressively over the course of 2008, but really fell sharply in early 2009.

A number of recent comments from the bank CEOs are consistent with this view.

Whatever the exact timing and magnitude, the key point is that the most recent half-year of bank results represents the "tipping point" into recession and, almost certainly, trading conditions for many companies were substantially more difficult at the end of the quarter than at the start. In turn, the second-round impacts through reduced employment and increased underemployment (e.g. shorter working hours) were only just beginning to be felt at the end of half-year. Further, reductions in official cash rates have been offset by increases in interest risk margins for many businesses.

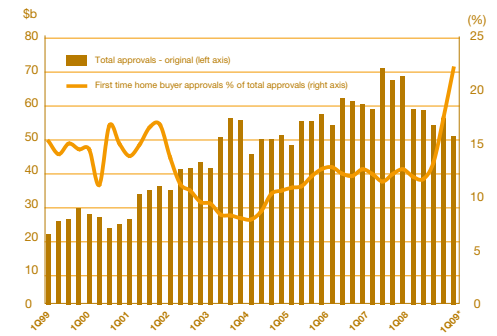
In short, trading conditions for business will be much weaker for the balance of 2009 and into 2010 than they were in the half-year just finished. So far we've seen a number of very large corporate defaults – typically highly geared companies with business models that were found wanting when the crisis began to bite. Now we are beginning to see more pain emerge from the small to medium business sector.

While commercial property prices have held up reasonably well to date (especially office space; retail and some residential developments have been weaker), the reality is there has been relatively little security realisation so far by the banks. We expect the banks to continue to take a very constructive approach to avoiding forced sales where possible, but again we must expect an increase in security realisation, and that this will occur against the backdrop of recession.

However, the majors have raised healthy provisions in their balance sheets, including appropriately for losses which at period end, have been incurred but not yet specifically identified. So while it is inescapable that loan write offs will rise considerably, it is not yet clear whether the bad debt expenses in the short-term will need to rise.

Household lending exposures have held up well to date, as consumers have used still buoyant labour market conditions, coupled with falling interest rates, to stay on top of their debts. Indeed one of the most striking aspects has been how well performing the credit card portfolios have been – to us this is explained by consumers' desire to "stay out of trouble" in the current environment. However there are early signs of weakness, with the latest figures showing that total credit card outstandings continue to rise, although driven now by reduced repayments rather than an increasing trend in credit card transactions. A significant rise in unemployment and underemployment will only strengthen any trend in increased household arrears. In this regard, the

### First time home buyer approvals as a % of total housing approvals



Note \*: 1Q09 estimated as March data not available at time of issuing report

deterioration in household asset quality in New Zealand, as recently reported by the banks, provides an indication of likely trends in Australia.

House prices remain a key determinant of overall asset quality for the banks. House prices have eased but by no means collapsed over the past year. In aggregate terms, house prices have dropped approximately 7%, although this disguises wide variations between regions and market segments. The increase in the Federal Government First Time Home Buyers Grant (FTHBG) last October has underpinned a dramatic increase in that market segment, as the chart below demonstrates. New loan approvals to first home buyers have risen by 25% and the average loan to these buyers has increased by 6% to \$280,000, whereas overall average loan size for all approvals decreased slightly to \$253,000. We expect the Government to wind back the increase in the grant in next week's Federal Budget. There is also some anecdotal evidence that rents have recently stopped their upward climb in line with increased unemployment. In all, we expect the overall shortage of housing in Australia to support house prices, but with a downward bias.



## Why have the Australian banks weathered the global financial crisis so well?

Given the apparent similarities between the Australian banking market and those of many other Western countries, one of the most interesting questions of the past two years has been why the Australian banks have fared so much better than their offshore competitors.

In fact, when you look at balance sheets from different banks around the world, there are some striking differences, as shown by the following comparisons as at December 2007.

2007	Trading & Investment Assets: Total Assets %	Deposits: Total Liabilities %	Loans: Deposits %
Australian Banks	14	51	142
US/Canadian Commercial Banks	37	49	98
UK Banks	42	39	131
European Banks	55	33	86
US Investment Banks	74	13	14

The most striking observation is the very low percentage of trading and investment assets held by the Australian banks – at 14% of total assets, it was barely one third of the US/ Canadian commercial banks or UK banks, and less than one fifth of US investment banks. The importance of this is, of course, that the global financial crisis had its immediate origins in the dramatic fall in value in tradable credit instruments such as CDOs, triggered by the US sub-prime crisis. Indeed for the global banking system over the past two years, write-downs on the value of securities far outweigh traditional lending losses.

The table also shows the more conservative approach to funding employed by the Australian banks, which held a higher proportion of relatively stable deposits in their funding mix, rather than relying on wholesale instruments which – as is now painfully clear – are susceptible to wide swings in sentiment and hence cost and availability. In other words, the Australian banks entered the crisis with a much more stable funding base and thus better equipped to respond to adverse market movements.

The final column in the table highlights a potential vulnerability for the Australian banks, namely the relatively high proportion of loans to deposits. In part, of course, this simply reflects the flip-side of a relatively low proportion of investment assets – with fewer investment assets to fund, there is scope to fund a higher proportion of traditional loans. But the risk remains: a higher proportion of loans carries with it the risk of a higher proportion of loan

losses, especially if the underlying lending standards are not appropriate. In truth, this test for the Australian banks is only partly run. The evidence so far is that the Australian banks resisted the temptation of a significant lowering of credit standards but it is only now, when the economy has moved from slowing to contracting, that we will really see whether the banks' credit standards are appropriate given the depth on this slowdown.

So why did the Australian banks end up avoiding the temptations to which other banks succumbed? At least five factors were at play:

- the previous boom-bust cycle in Australia (late 1980s/early 1990s) had been driven by lax lending standards (especially by some of the larger banks) and, in general, bank

management in Australia since that time had been determined not to repeat those mistakes by embedding proper lending standards in bank operations;

- likewise, the Australian regulators had also been determined to ensure appropriate lending standards, and have been effective and diligent in pursuing this through a range of means, such as oversight of lending practices, consumer credit codes, and higher capital requirements for riskier mortgage products. Lessons learnt by the collapse of insurance company HIH in 2001 had a positive impact on supervisory effectiveness thereafter;
- while Australia has a more stringent code of consumer protections at the time when the loan is made, so too does it have a stringent code of protecting the lender's rights should a consumer default on the loan – 'full recourse' mortgages being an obvious example. Australia has a strong culture of debt repayment and this helps to underpin sensible borrowing decisions by customers;
- real interest rates did not decline in Australia through the mid-2000s to the same extent as in some other countries; in fact, monetary policy was tightened progressively in Australia from May 2002. These higher real rates tempered demand for "speculative borrowing" in Australia. Also, the demand by investors for "yield enhancement" was less in Australia than in economies with much lower real interest rates;

- Australia ran large current account deficits and so was a net importer of foreign capital. In other words, Australia's banks needed to raise funds offshore to finance their domestic lending, rather than looking for tradable assets in which to invest excess Australian domestic savings, unlike for instance some European countries where banks had an excess domestic savings relative to domestic lending opportunities.

In summary, it was the combination of generally good private sector practice with robust economic policy and industry supervision which served Australia so well, allowing us to avoid the worst international excesses building prior to 2007. Inevitably the private sector will emphasise those things it did well, and the official family will emphasise their positive contributions. But in truth Australia would not today have such a strong banking system if not for the very combination of strengths and prudence on both sides.

Having entered the crisis in very good shape relative to other banking systems, the challenge is now to ensure that the Australian banks emerge from the crisis in even better comparative shape. Just as it did prior to 2007, success beyond 2009 will rely on the combination of good private sector practice combined with robust economic policy and industry supervision.

In general we see the current signs from the major banks as positive in terms of their stance through this recession. This includes for example, staying on track with their underlying strategies and ensuring appropriate capitalisation, down to simple but very important things such as emphasising practical steps to assisting customers in difficulty. We see it as particularly pleasing that the banks have remained committed to investments in technology to improve operating efficiency and customer outcomes.

Likewise, we see also the tenor of the regulatory response to date as positive. Internationally, the thrust of changes discussed in relation to international banking supervision (such as in FSA Chairman Turner's report and at the G20 meeting) are generally measured and sensible. Of course there will need to be careful consideration given to the transition and implementation costs of change relative to the long-term benefits.

Domestically, the easing of both monetary policy and fiscal policy has been very welcome. So too has been the emphasis by all branches of the official family on the enablers of bank lending – and hence economic growth – such as the ongoing availability of funding for the banks. The danger is that, as unemployment rises further, the policy focus shifts, albeit unintentionally, to factors which tend to restrict bank lending. If this happens, the recession will be longer than it needs to be.

In short, it is now more important than ever that we recognise that our current comparatively strong positive reflected soundness and responsibility on both sides over a long period of time. The key challenge now is to keep true to this in the face of rising unemployment.

# Key banking statistics – Half year 2009

	ANZ			CBA (iv)			NAB			WBC (iii)		
	6mths Mar-09	6mths Sep-08	6mths Mar-08	6mths Dec-08	6mths Jun-08	6mths Dec-07	6mths Mar-09	6mths Sep-08	6mths Mar-08	6mths Mar-09	6mths Sep-08	6mths Mar-08
<b>Balance sheet</b>												
Total assets	502,798	470,293	437,759	618,761	487,572	472,664	676,001	656,799	612,013	594,230	587,114	541,417
Risk weighted assets	280,882	275,434	267,486	239,289	205,501	198,228	352,373	343,511	336,398	280,029	195,505	186,963
Gross Loans and acceptances	362,812	355,347	337,729	466,868	383,502	366,313	443,716	438,303	414,048	453,015	435,875	413,574
<b>Asset quality &amp; provisioning</b>												
Gross impaired assets	4,158	2,673	1,114	2,714	683	562	3,927	2,149	1,474	3,299	1,407	1,201
Net impaired assets	2,817	1,998	799	1,580	404	373	2,650	1,504	947	1,701	806	695
Gross impaired assets as a % of loans and acceptances	1.15%	0.75%	0.33%	0.58%	0.18%	0.15%	0.89%	0.49%	0.36%	0.73%	0.32%	0.29%
Individually assessed provisions (vi)	1,341	675	316	1,134	279	189	1,277	645	527	1,416	458	375
Individually assessed provisions % of impaired assets	32.3%	25.3%	28.4%	41.8%	40.8%	33.6%	33.5%	30.0%	35.8%	42.9%	32.6%	31.2%
Collective provisions (vi)	2,742	2,821	2,340	2,474	1,466	1,191	3,584	2,649	2,309	3,067	2,131	1,863
Collective provisions % of non housing loans & acceptances	1.54%	1.57%	1.37%	1.23%	0.87%	0.73%	1.47%	1.11%	1.05%	1.60%	1.13%	1.05%
Total provisions	4,083	3,496	2,656	3,608	1,745	1,380	4,861	3,294	2,835	4,483	2,589	2,238
% of risk weighted assets	1.45%	1.27%	0.99%	1.51%	0.85%	0.70%	1.38%	0.96%	0.84%	1.60%	1.32%	1.20%
% of loans & acceptances	1.13%	0.98%	0.79%	0.77%	0.46%	0.38%	1.10%	0.75%	0.68%	0.99%	0.59%	0.54%
<b>Profit &amp; loss analysis (i)</b>												
Net Interest Income	4,822	4,074	3,781	4,543	4,008	3,899	5,884	5,839	5,303	5,678	5,029	4,623
Other operating income	2,218	2,241	2,199	3,473	3,376	3,075	3,078	2,414	2,796	2,629	2,625	2,581
Total operating expenses	2,944	2,751	2,655	3,551	3,643	3,378	4,218	4,156	4,058	3,355	3,216	3,224
Core earnings	4,096	3,564	3,325	4,465	3,741	3,596	4,744	4,097	4,041	4,952	4,438	3,980
Bad debt expense	1,435	1,364	726	1,607	597	333	1,811	1,763	726	1,611	664	541
Profit before tax	2,661	2,200	2,599	2,858	3,144	3,263	2,933	2,334	3,315	3,341	3,774	3,439
Income tax expense	749	606	759	697	739	891	725	497	911	1,005	1,112	949
Minority Interest	4	5	3	16	16	15	11	(2)	1	41	41	33
Cash earnings after tax before significant items (underlying profit)	1,908	1,589	1,837	2,145	2,389	2,357	2,197	1,839	2,403	2,295	2,621	2,457
Operating profit after tax and outside equity interests (v)	1,417	1,356	1,963	2,573	2,420	2,371	2,664	1,849	2,687	2,175	1,657	2,202
<b>Key data</b>												
Other operating income (% of total income)	31.5%	35.5%	36.8%	43.3%	45.7%	44.1%	34.3%	29.2%	34.5%	31.6%	34.3%	35.8%
Interest Spread	1.84%	1.59%	1.59%	1.72%	1.62%	1.74%	1.90%	1.74%	1.64%	2.05%	1.74%	1.68%
Interest margin	2.22%	2.02%	2.00%	2.04%	1.98%	2.06%	2.07%	2.25%	2.13%	2.24%	2.05%	2.00%
Expense/income ratio (headline reported ratio - as reported)	41.8%	43.6%	44.4%	44.3%	49.4%	48.4%	43.4%	46.7%	47.0%	40.4%	42.0%	44.8%
Total number of full time equivalent staff	37,046	36,925	35,482	45,013	39,621	38,452	39,150	39,729	39,421	36,733	36,690	37,562
Operating costs per employee (dollars)	79,599	75,987	76,036	89,747	93,323	88,516	106,574	104,467	103,812	91,388	86,624	86,781
Return on average equity % (as reported)	14.1%	13.5%	16.7%	15.9%	20.2%	20.6%	12.7%	11.9%	16.8%	14.3%	21.9%	22.7%
<b>Capital ratios</b>												
Tier 1	8.20%	7.70%	6.90%	8.75%	8.17%	8.17%	8.31%	7.35%	6.90%	8.40%	7.80%	7.40%
Tier 2 (net of deductions)	2.80%	3.40%	3.20%	2.64%	3.41%	3.91%	3.88%	3.59%	3.38%	3.00%	3.00%	2.70%
Total	11.00%	11.10%	10.10%	11.39%	11.58%	12.08%	12.19%	10.93%	10.27%	11.40%	10.80%	10.10%

All figures in AUD million unless otherwise indicated

- i In arriving at "underlying profit", income and expenses exclude significant items and certain non cash items. Non cash items include provisional gains on acquisition of controlled entities, impact of hedge accounting and revaluation of treasury shares and other items reported by the banks. Significant items include the gains on disposal of businesses, non-continuing businesses, restructuring and transformation costs and other items reported by the banks. Some components of income and expenses have been reclassified to improve comparability between banks.
- ii NAB underlying cash earnings after tax before significant items are shown before distributions to holders to National Securities and investment earnings on shareholder's retained profits and capital in life business - Mar 09 \$144 million and \$26 million, Sep 08 \$155 million and \$5 million, Mar 08 \$157 million and \$9 million.

WBC underlying cash earnings after tax before significant items are shown before SGB preference dividend - Mar 09 \$0 million, Sep 08 \$16 million, Mar 08 \$15 million.

- iii WBC merged with SGB on 17 November 2008. Wherever possible we have included WBC and SGB combined information (proforma information) as presented in WBC's half year ASX announcement for both the current reporting period and comparatives.
- iv CBA acquired BankWest on 19 December 2008. CBA's results do not include any results for BankWest and hence we have not included BankWest in either the current period results or comparatives. BankWest is included in CBA's balance sheet only at 31 December 2008.
- v Statutory result as reported by the banks, unadjusted.
- vi Sep 2008 and Mar 2008 comparatives have been updated where information is available.

[pwc.com/au/mba](http://pwc.com/au/mba)

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Note: the PwC Banking Gauge is a consensus view across the four banks and across five of Australia's leading banking analysts – Ben Zucker (Macquarie), James Ellis (Credit Suisse), Jonathan Moffat (UBS), Matthew Davison (Merrill Lynch) and Scott Manning (JPMorgan)

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