KPMG

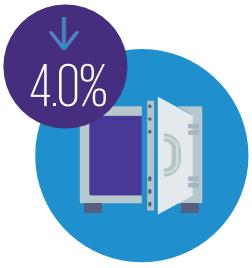
Major Australian Banks

Half Year 2019 Results Analysis

kpmg.com.au

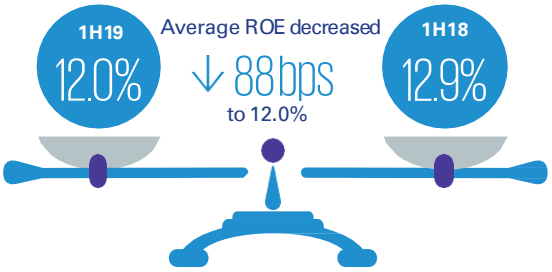
Contents

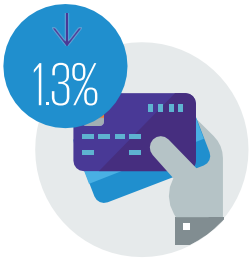
Half Year 2019 Results Snapshot



Cash profit after tax decreased by 4.0% on 1H18 to

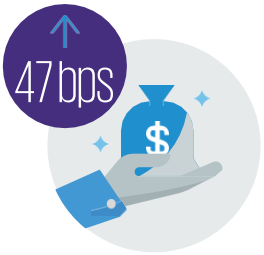
$14.5b





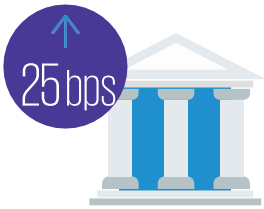
Charge for bad and doubtful debts decreased by $23m (1.3%) on 1H18 to

$1.8b



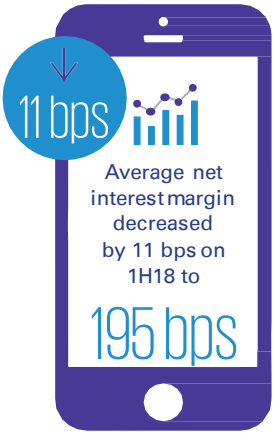
Average cost to income ratio increased by 47 bps on 1H18 to

46.1%



Average CET1 capital ratio increased by 25 bps from 2H18 to

10.8%



Average net interest margin decreased by 11 bps on 1H18 to

195 bps

Risk and compliance investment spend increased to

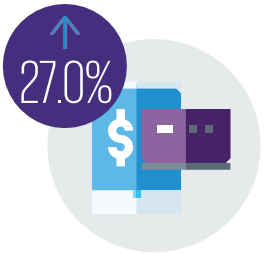
39.6%

of total investment spend, up from 29.0% in 1H18

Cost of customer remediation increased by

$1.5b

from 1H18



Provision for credit impairment up $3.6b from 2H18 to

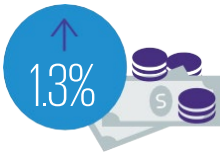
$17.0b

largely due to the adoption of AASB 9 for three of the majors

Continued challenging conditions

Compared to 2H18:

Housing credit



Non-housing credit

Deposits

At a glance

	ANZ		CBA[1]		NAB		WBC	
	1H19	PCP[2]	1H19	PCP[2]	1H19	PCP[2]	1H19	PCP[2]
Ranking								
By profit before tax	3	3	1	1	4	4	2	2
By total assets	2	2	1	1	4	4	3	3
By total equity	3	3	1	1	4	4	2	2
By market capitalisation	3	3	1	1	4	4	2	2
By CET 1 capital ratio	1	1	2	4	4	3	3	2
Financial Performance[3] – P/L								
Profit before tax ($ million) – statutory basis	4,536	5,356	6,412	6,797	4,124	4,058	4,555	6,035
Profit after tax ($ million) – statutory basis	3,243	3,923	4,575	4,764	2,904	2,874	3,173	4,198
Cash profit after tax ($ million)	3,564	3,493	4,676	4,598	2,954	2,759	3,296	4,251
Performance Measures[3] – P/L								
Net interest margin – cash basis (basis points)	180	193	210	216	179	187	212	228
Cost to income ratio – cash basis (%)	44.8	45.3	42.6	43.2	47.0	52.2	49.9	41.7
Basic earnings per share – statutory basis (cents)	114.1	134.8	259.6	273.7	103.5	104.7	92.3	123.7
Basic earnings per share – cash basis (cents)	124.8	119.4	265.2	264.3	107.2	102.2	95.8	125.0
Return on average equity (%) – cash basis	12.0	11.9	13.8	14.2	11.7	11.4	10.4	14.0
Credit Quality Measures								
Impairment charge ($ million) (statutory basis) – P/L	392	408	577	596	454	382	333	393
Impaired loans to loans and advances to customers (%) – B/S	0.33	0.33	0.47	0.42	0.26	0.26	0.24	0.20
Collective provision to credit RWA (%) – B/S	0.98	0.60	1.03	0.75	0.94	0.92	0.98	0.73
Financial Position – B/S								
Total assets ($ million)	980,244	943,156	980,430	975,165	826,943	806,510	891,062	879,592
Total equity ($ million)	59,971	59,405	68,578	67,860	54,091	52,712	63,935	64,573
Capital Measures – B/S								
Capital Adequacy Ratios (%)								
- Total	15.3	15.2	15.8	15.0	14.0	14.1	14.6	14.7
- Tier 1	13.4	13.4	12.9	12.3	12.5	12.4	12.8	12.8
- Common Equity Tier 1	11.5	11.4	10.8	10.1	10.4	10.2	10.6	10.6
Market capitalisation[4] ($ billion)	73.7	81.0	128.0	128.0	70.8	75.8	89.4	95.9

[1] CBA as reported as at 31 December 2018
[2] Prior comparable period (PCP) data comprises of 1H18 for profit and loss (P/L) metrics and 2H18 for balance sheet (B/S) metrics, unless otherwise stated
[3] On a continuing operations basis
[4] Market capitalisation sourced from statutory accounts or ASX as at the reporting date

Executive summary

The first half year 2019 (1H19) results of the Australian major banks (the majors) showed an aggregate decrease in cash profits after tax from continuing operations when compared to the first half year 2018 (1H18). The results deteriorated from 1H18 largely due to a challenging regulatory and operating environment, margin pressure, slight deterioration in credit quality, divestment of non-core businesses and continued customer remediation costs being featured in the results.

Falling housing demand, tightening credit standards and greater competition, in particular from the non-bank sector, have combined to constrain the majors' revenue performance in retail banking.

Results

The majors' aggregate cash profit after tax from continuing operations decreased by 4.0% from 1H18 to $14.5 billion. While this reflects the aggregate results, three of the majors reported modest increases in cash profits from 1H18 due to the timing of some one-off regulatory and restructuring costs occurring in 1H18.

Preserving interest margins continue to be a challenge across the majors, with a decrease of 11 basis points from 1H18 in average net interest margin (cash basis) to 195 basis points. The decline from 1H18 was driven by unfavourable changes in asset mix, particularly home loans, and higher short-term wholesale funding costs, offset by mortgage re-pricing and lower deposit costs.

Asset quality measures have deteriorated slightly from 1H18, as a result of a decline in residential property markets, increasing arrears (from a very low base) and an increase in specific provisions on single name exposures against a backdrop of a weakening Australian economic outlook.

The average cost to income ratio across the majors has increased to 46.1% in 1H19 from 45.6% in 1H18. The movement was largely due to significant costs pertaining to customer remediation, partially offset by improved productivity and simplification and non-recurrence of some one-off regulatory and restructuring costs. However, we note that three of the majors reported decreases in cost to income ratios due to the timing of these one-off costs in 1H18.

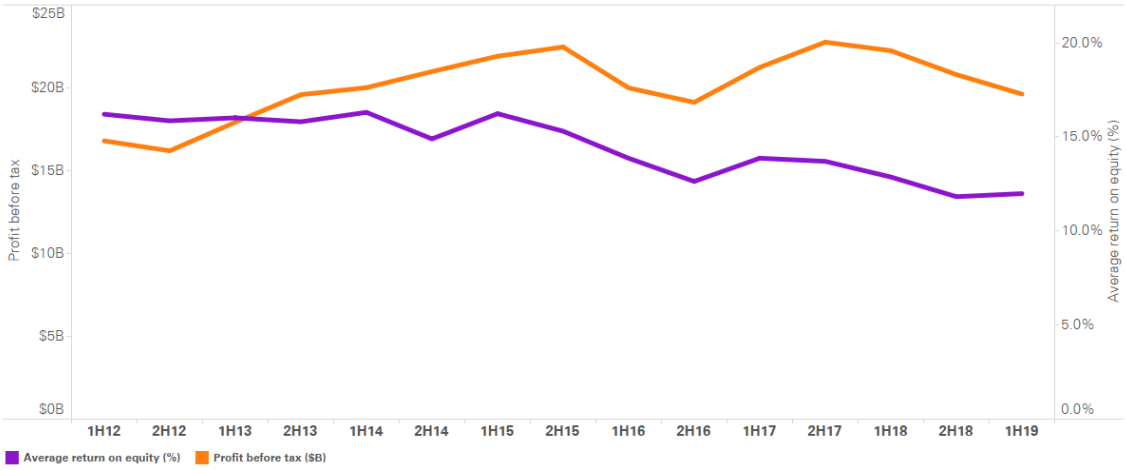
The majors have continued to maintain a strong CET1 capital position increasing 25 basis points from second half of 2018 (2H18) to 10.8% of Risk-Weighted Assets (RWA) and are on track to meet APRA's "unquestionably strong" benchmark CET1 ratio of 10.5% by 1 January 2020.

Key observations

The first half of 2019 has been a challenging period for the majors, as illustrated by the mixed performance in cash profits and return on equity (RoE), with a decline in RoE of 88 basis points to 12.0% for 1H19.

Net interest income and non-interest income for 1H19 have both decreased from 1H18. The volume growth in both lending and deposits, that were central themes in past results have peaked, with further pressures on margins arising from the switch from higher margin, interest-only loans to lower margin, principal and interest loans, offset through lower deposit costs and mortgage repricing.

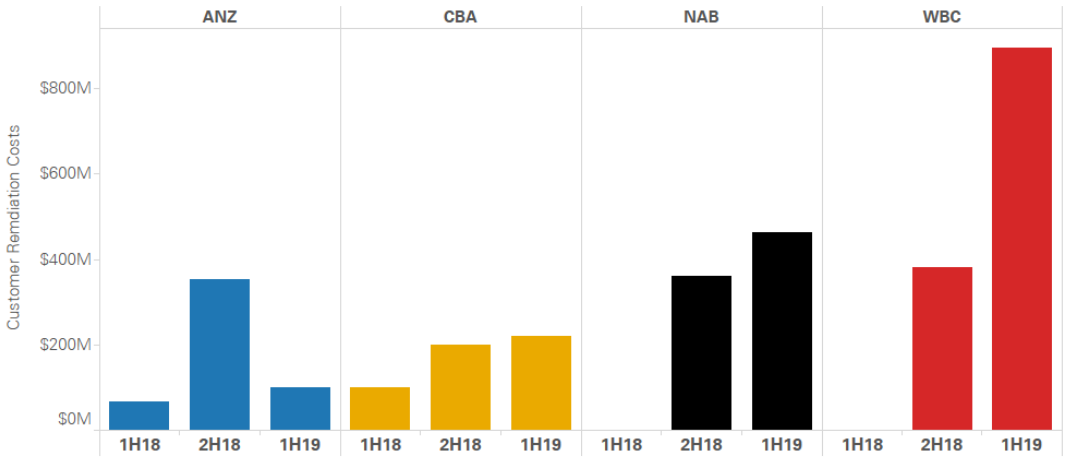
Diagram 1. Profit before tax against return on equity



Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

The majors continued to divest their non-core business in an effort to simplify their operating models, as well as reducing and/or removing the number of fees charged. As a result, non-interest income has decreased by 11.1% from 1H18. This has been compounded by fee reversals as a result of ongoing customer-related remediation efforts, particularly in their wealth businesses.

Diagram 2. Customer Remediation cost and revenue reversal – continuing operations basis



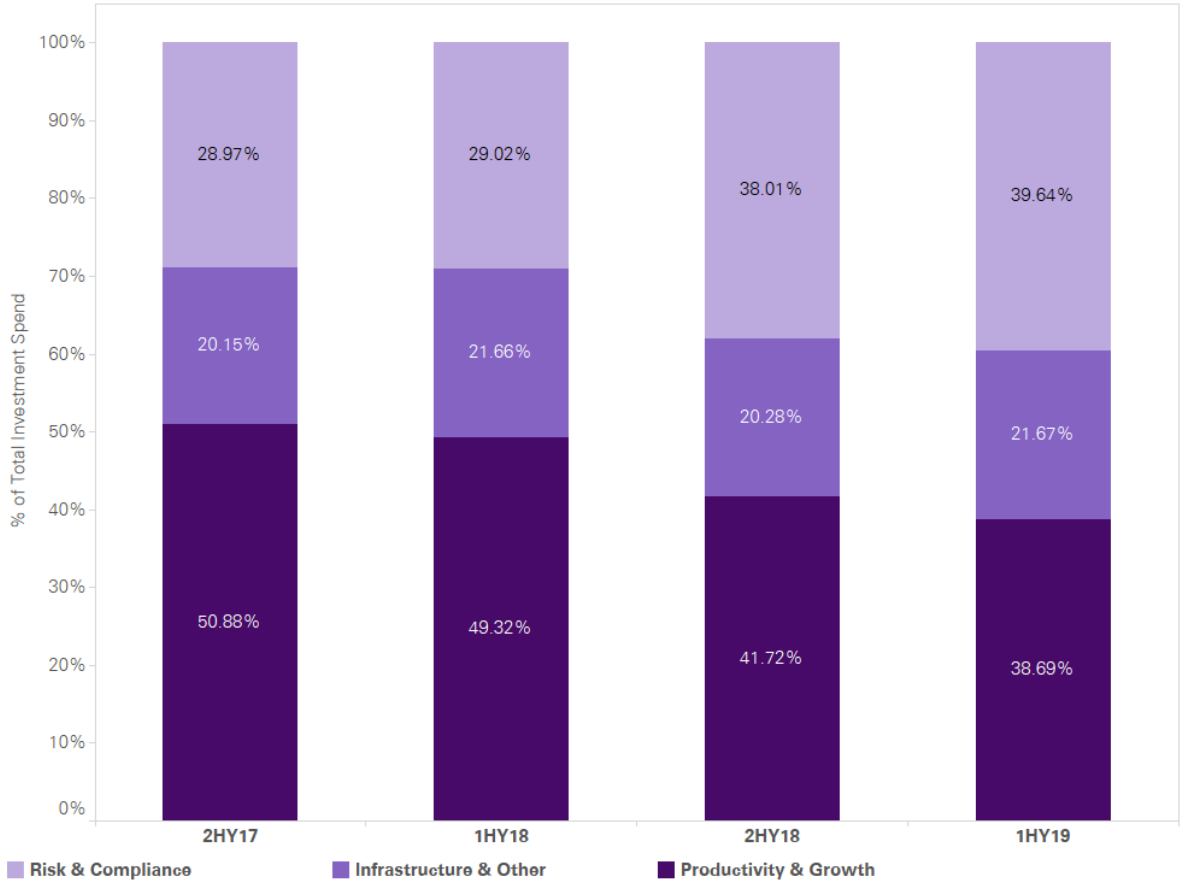
On a continuing operations basis

Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

As the majors deal with risk and compliance challenges, they will continue to focus their efforts on simplification as they seek to drive greater efficiency in their core franchises to manage their financial performance.

Across the majors, investment spending has been re-positioned and re-focused on risk and compliance projects as a result of the findings from the Royal Commission, APRA Prudential inquiry into CBA and the AUSTRAC case against CBA on financial crimes. Spending on risk and compliance initiatives increased significantly from 29% of total investment spend in 1H18 to 40% in 1H19. While total investment spend has increased since 1H18, productivity and growth investment projects decreased on both an absolute and relative basis.

Diagram 3. Investment Spend



Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

Outlook

Looking ahead, a slowing housing market, tighter serviceability assessments and softening economic growth make housing credit growth uncertain. This situation remains highly sensitive to interventions from the Reserve Bank of Australia or APRA.

Furthermore, heightened competition for market share continues from both traditional ADIs and non-bank lenders across housing lending. With a softer revenue outlook, we expect there to be increased competition within non-housing lending and deposit markets, putting further pressure on interest margins.

The outlook for business and institutional lending remains positive in a low interest rate environment, providing some relief from the headwinds being experienced elsewhere across the majors.

The majors continue to divest non-core businesses and we expect this trend to continue as they become leaner and simpler, and as a result, moderating the ability of the majors to offset weaker growth in interest income.

Compounding challenges in revenue growth, expenses (both operating and investment spending) remain elevated and are expected to persist. This is expected to present further difficulties in maintaining the level of RoE and dividends. We expect further reductions in FTEs as the majors continue to simplify.

The operating environment ahead for the majors remains challenging. However, the majors are actively transforming their business models in order to become more efficient and rebuild trust in an increasingly competitive market.

Net Interest Income

Net interest income across the majors decreased by $518 million, down 1.6% compared to 1H18 to $31.6 billion in aggregate. The result was driven by unfavourable changes in asset mix as customers switched from interest only to principal and interest home loans, higher short-term wholesale funding costs and increased mortgage competition, partially offset by improved deposit margins and mortgage repricing. Margins across the majors continue to be eroded, decreasing by 11 basis points from 1H18, to an average of 195 basis points.

Cash basis	1H19	1H18	Movement
NET INTEREST INCOME			
ANZ	7,299	7,350	(0.7)%
CBA	9,134	9,257	(1.3)%
NAB	6,734	6,750	(0.2)%
WBC	8,389	8,717	(3.8)%
Aggregate	**31,556**	**32,074**	**(1.6)%**
NET INTEREST MARGIN			
ANZ	180	193	(13) bps
CBA	210	216	(6) bps
NAB	179	187	(8) bps
WBC	212	228	(16) bps
Average	**195**	**206**	**(11) bps**

Net interest margin

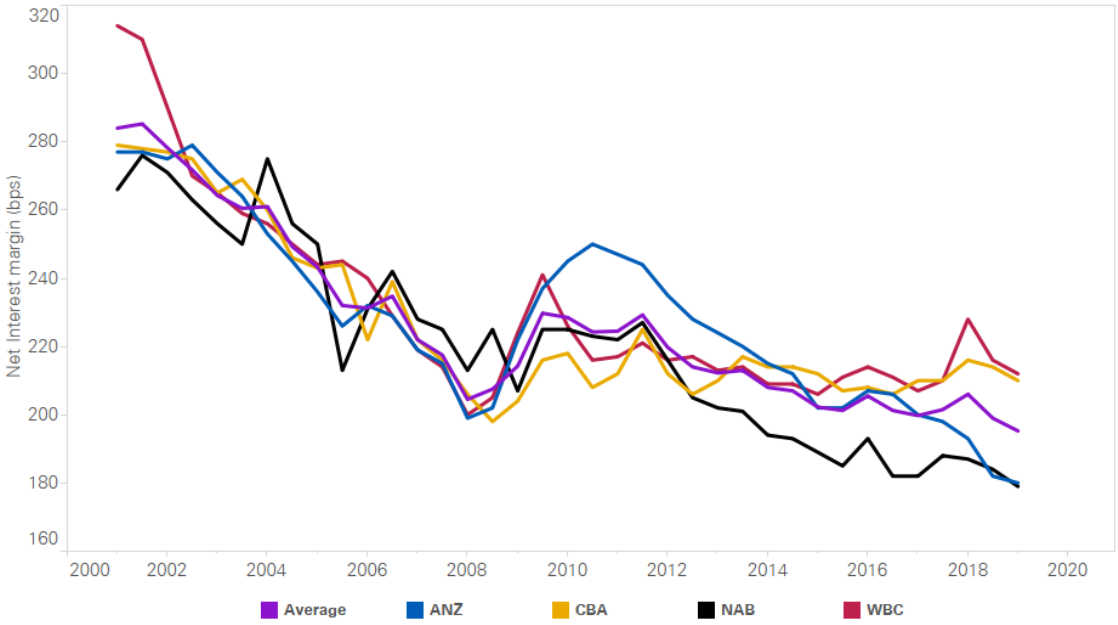
The decrease in net interest margin across the majors has been primarily driven by domestic retail lending. The key observations are:

- Customers switching from higher margin interest only loans to principal and interest home loans as interest only terms matured and price differentiation encouraged switching;
- Reversal of revenue due to customer remediation; and
- Increase in short term wholesale funding costs.

The spread between the three month bank bill swap rate and overnight indexed swap rate (basis risk) increased during 1H19, causing an elevation in short-term wholesale funding costs and was a significant contributing factor on the drag on margins for the half across the majors.

Notwithstanding these headwinds, the majors have benefited from out-of-cycle mortgage repricing and lower deposit costs.

Diagram 4. Net Interest margins – cash basis



Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

Lending asset growth

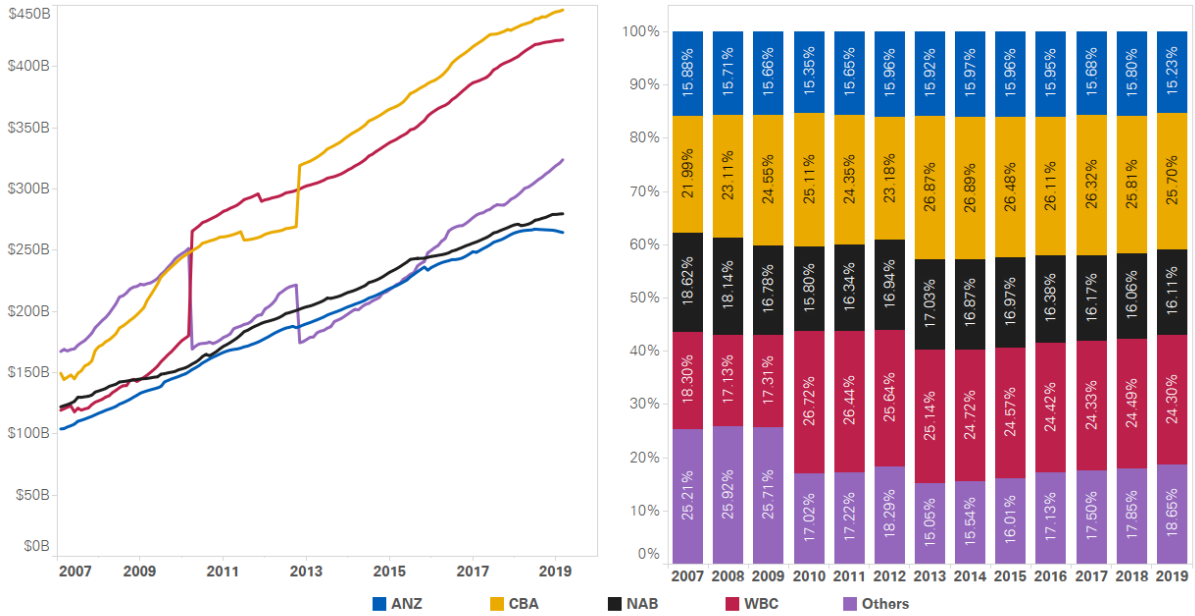
Interest earning assets across the majors continue to grow, although at a slower pace. In aggregate, the average interest earning assets increased by 2.3% from 2H18 to $3,224 billion, reflecting a competitive environment and slowing economic growth.

The primary driver for this result pertains to softening housing credit growth, with the majors reporting an aggregate growth of 1.5% in 1H19 to $1,702 billion (compared to 1.8% growth in 1H18). This reflects a weaker property market and increased competition from other ADI's and non-bank lenders. This has also resulted in a reduction in the majors market share in household lending (excluding credit cards), which has decreased by 80 basis points from 1H18 to 81.35%.

While home loan demand has slowed in Australia, this has been compounded by the majors stepping away in certain segments. Post Royal Commission, the majors remain under heightened scrutiny to lift lending standards around mortgage applications, including setting appropriate levels of serviceability metrics and restraining lending growth in higher risk segments of their portfolio, in order to ensure compliance with responsible lending laws.

Non-housing credit across the majors increased 1.3% from 2H18 in aggregate to $990 billion. This was largely driven by higher institutional and business lending as a result of the low interest rate environment, offset by subdued business confidence and investment and efforts to diversify their lending activities.

Diagram 5. Loans to Households and market share



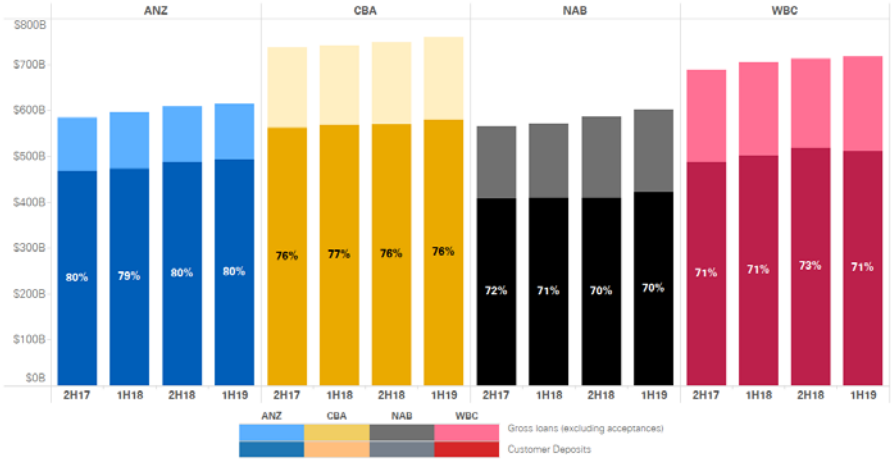
Source: APRA Monthly Banking Statistics.

Funding mix

The majors' funding mix has remained relatively consistent, with the proportion of customer deposits to total gross loans remaining steady at an average of 74%, providing the majors with a continuing base of cost effective funding. From a net interest margin perspective, this partially offset the increase in short-term funding costs that was seen in the first half.

There was a minor shift in the mix between at-call deposits versus term deposits for the majors, with term deposits increasing in aggregate by 2.8%, driven by campaigns and customer preference for higher yielding term deposits.

Diagram 6. Customer deposits proportionate to total gross loans



Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

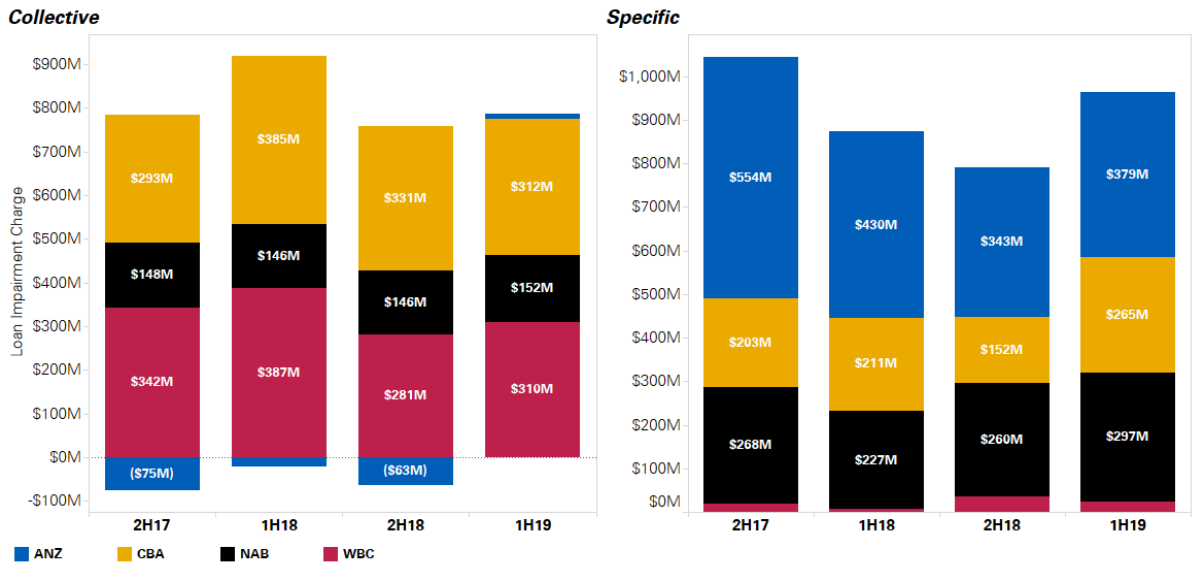
Asset Quality

While the majors reported an aggregated decrease of 1.3% in loan impairment charges for 1H19, there has been a slight deterioration in measures of asset quality, reflected by a 9.4% increase in aggregated impaired assets to $8.9 billion. The results also illustrated an increase in the level of overdue accounts, with 90 days past due delinquencies up by 16% from 1H18.

Loan impairment charge

A weakening Australian economic outlook largely affecting the retail portfolios, combined with changes in provisions for single name exposures within institutional portfolios and enhancements to credit models, were identified as common themes in the results.

Diagram 7. Loans impairment charge

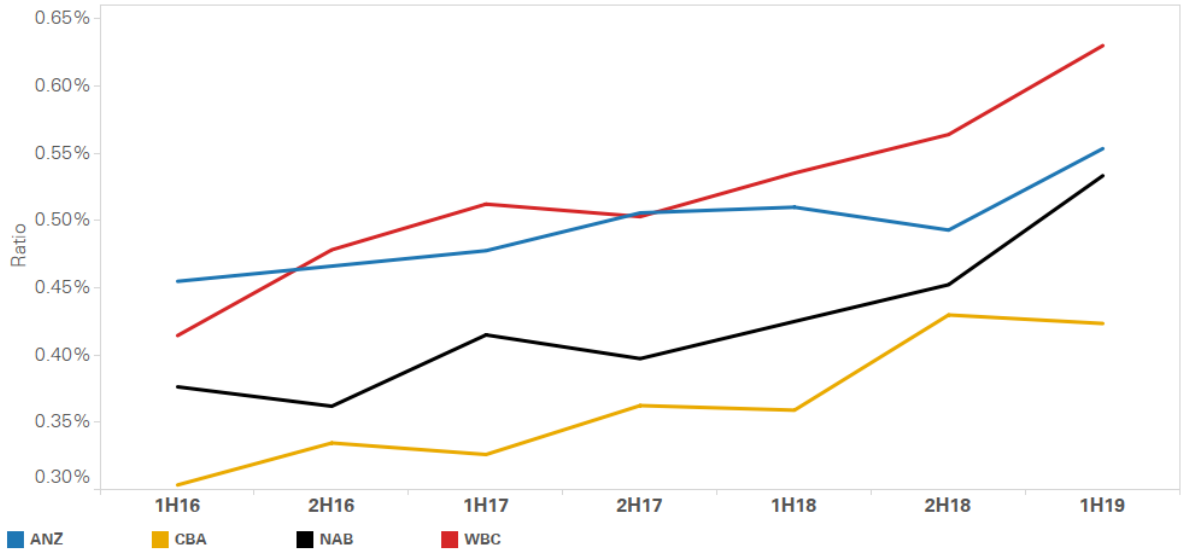


Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

Delinquencies

Across the majors, 90 days past due delinquencies continue to trend upwards (off a low base). This increase accelerated in 1H19, particularly in the home loan portfolio, noted by the majors as being driven by low wage growth and rising essentials costs. This has led to some credit deterioration across each State, particularly in Western Australia and Queensland.

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



Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

AASB 9 Impairment provision

AASB 9 *Financial Instruments* became effective in 1H19 for all major banks except NAB, who adopted AASB 9 early. AASB 9 requires banks to measure provisions for credit impairment using an expected credit loss (ECL) basis, in contrast to the incurred loss basis under the previous accounting standard.

The implementation of AASB 9 resulted in an increase in credit provisions of $2.9 billion compared to 2H18. This increase reflects the incorporation of forward looking factors and an assessment of macroeconomic conditions and forecasts.

The transitional impact of AASB 9 across the majors was recognised in opening retained earnings, and did not affect current period earnings.

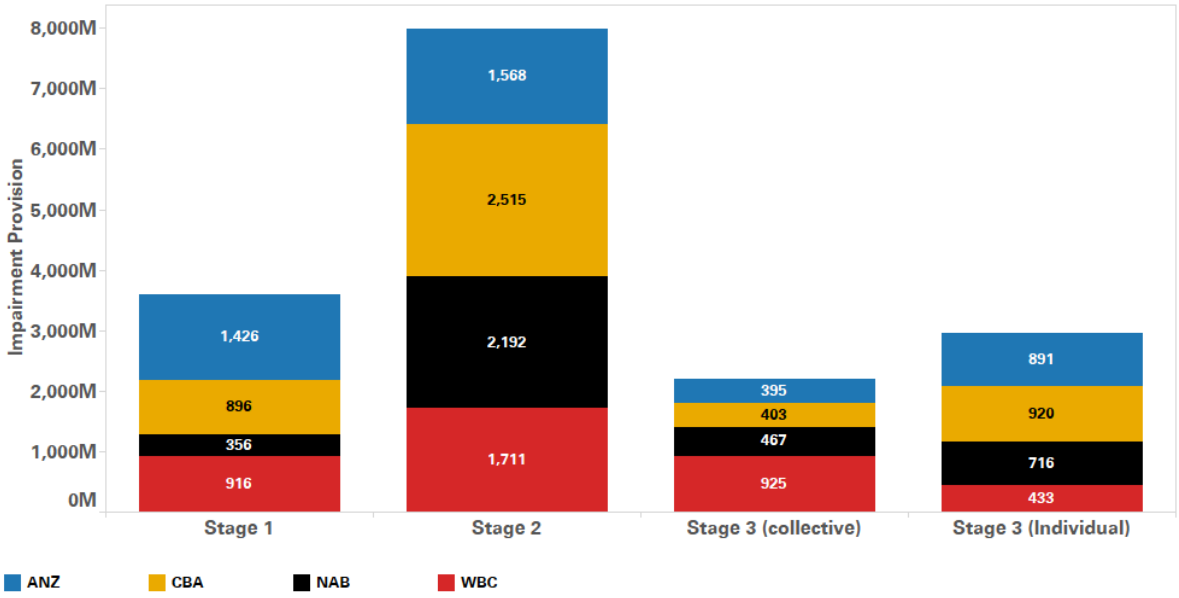
Under AASB 9, assets carried at amortised cost (e.g. loans) are classified across three stages, reflecting the change in the level of credit risk since origination. The extent of expected credit losses (ECL) recognised vary across the three stages.

Assets classified under Stage 1 have not experienced a significant increase in credit risk since initial recognition. For these assets, ECL over the next 12 month period are recognised.

For assets that have had a significant increase in credit risk since initial recognition but that do not have objective evidence of impairment, these are classified under Stage 2. For these assets, ECL over the expected life of the financial instrument (lifetime ECL) are recognised.

Assets that are credit-impaired assets are classified under Stage 3 and lifetime ECLs are recognised. However, for these assets, interest income is only recognised on the balance net of impairment.

Diagram 9. Expected Credit Loss by Stage



Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

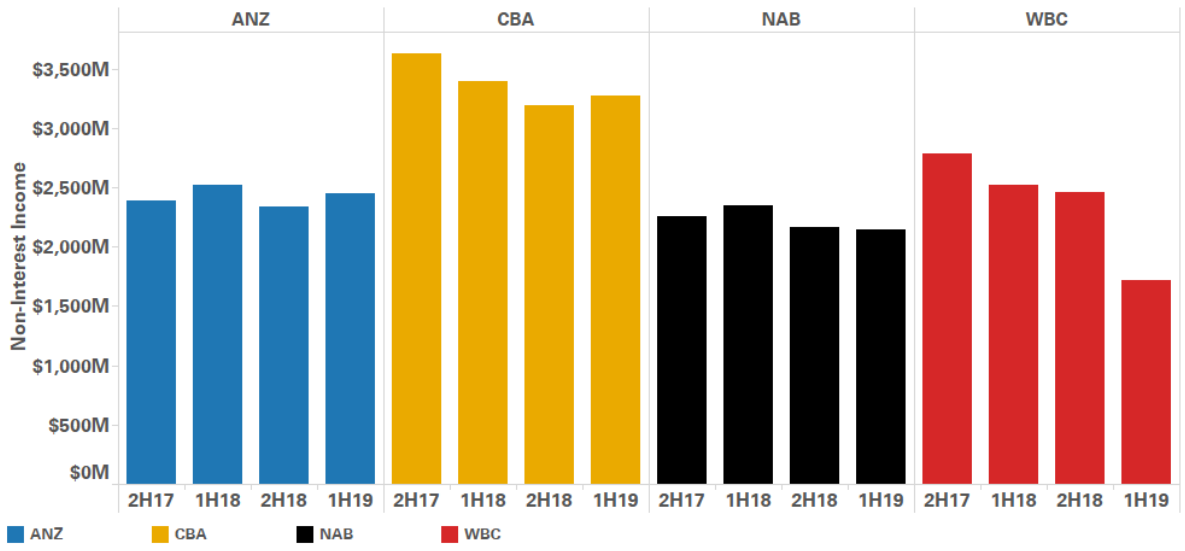
Non Interest Income

The majors reported a combined decrease in non-interest income of $1,199 million (cash basis), down 11.1% from 1H18. Revenue reversal due to customer remediation combined with lower business volumes headlined the result.

CBA recorded a reduction in non-interest income of $115 million, down 3% from 1H18. The decrease reflects weaker markets trading performance (due to lower client demand and widening spreads) and higher insurance related claims experience from weather events in NSW and Victoria. Fee income declined as a result of reduced overdrawn account fees following the introduction of pre-emptive customer alerts and the removal of ATM fees, partially offset by higher loan fee income driven by a shift in customer preference to fee based products.

ANZ posted a decrease in non-interest income of $73 million, or 3% from 1HY18, largely driven by lower volumes in both financial planning and non-financial planning and loss of income following the sale of its Asia Retail and Wealth businesses. During the period, ANZ recorded a reversal of income of $64 million due to customer remediation activities. This was partially offset by favourable market conditions in international rate markets, improved institutional client flow in Asia and increased share of associates' profits.

Diagram 10. Non-interest income – continuing operations and cash basis



Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

NAB recorded a decrease in non-interest income of $203 million, or 9% from 1H18, primarily due to reversal of revenue for customer-related remediation in the Wealth business. This was moderated by higher risk management income and unrealised gains on economic hedges.

Westpac reported a reduction in non-interest income of $808 million, or 32% from 1H18, mostly attributable to a $600 million reversal of revenue pertaining to customer remediation. Other contributing factors include reduced fee income due to lower business volumes, higher insurance related claims following adverse weather events in NSW and Queensland, decreased platforms and superannuation income as a result of increased competition and change in product mix as well as the exit of the Hastings business in 2H18.

Asset Sales

During the period, the majors continued to divest non-core businesses with several key transactions completed which include:

- CBA's sales of Sovereign and TymeDigital were completed in 1H19, resulting in a statutory net gain on sales of $91 million recognised during the period.
- ANZ reported a statutory net gain on sale of $234 million following the completion of sales of OnePath Life (NZ) Limited and Paymark Limited.
- Westpac reported a statutory net gain on sale of $3 million following the sale of its interest in Ascalon Capital Managers (Asia) Limited and Ascalon Capital Managers Limited to Generation Development Group on 8 February 2019.

Divestments announced during the period include:

- CBA announced the sale of its 80% interest in its Indonesian life insurance business, PT Commonwealth Life (PTCL), to FWD Group, which is expected to be completed in the first half of 2019.
- CBA's sale of its global asset management business, Colonial First State Global Asset Management to Mitsubishi UFJ Trust and Banking Corporation. The sale is subject to regulatory approval and is expected to complete mid-2019.
- Westpac announced the sale of its financial advice business within BT Financial Group to Viridian Advisory, which is expected to be completed in second-half of 2019.

Furthermore, we note that NAB remains in preparation for the divestment of its Advice, Superannuation Investment Platforms and Asset Management businesses (MLC), which is expected to occur in FY20.

Capital

The majors continue to maintain a strong capital position and remain on track to meet APRA's "unquestionably strong" Common Equity Tier 1 (CET1) capital ratio benchmark of 10.5% by 1 January 2020.

The majors' capital position continues to rise, with their average CET1 capital ratio rising by 25 basis points from 2H18 to an average of 10.8%, reflecting continued growth in organic capital generation.

With the ongoing review of the capital adequacy framework in New Zealand by the RBNZ, the majors may seek other initiatives to increase capital or decrease their balance sheets in NZ, including further divestments of non-core business to meet any increase in requirements. These proposed amendments are currently subject to consultations with the industry. All majors maintain that APRA's 'unquestionably strong' regulatory benchmark will be met by 2020.

	ANZ		CBA		NAB		WBC	
	1H19	2H18	1H19	2H18	1H19	2H18	1H19	2H18
Common Equity tier 1 ratio (%)	11.5	11.4	10.8	10.1	10.4	10.2	10.6	10.6
Tier 1 capital (total) (%)	13.4	13.4	12.9	12.3	12.5	12.4	12.8	12.8
Tier 2 (%)	1.9	1.9	2.9	2.7	1.6	1.7	1.8	2.0
Total regulatory capital ratio (%)	15.3	15.2	15.8	15.0	14.0	14.1	14.6	14.7
Tier 1 capital ($ million)	53,075	52,218	57,518	56,365	50,185	48,254	53,896	54,383
Total capital ($ million)	60,644	59,509	70,450	68,944	56,445	55,008	61,357	62,715
Risk weighted assets ($ million)	396,291	390,820	445,144	458,612	403,205	389,684	419,819	425,384
Credit risk weighted assets ($ million)	345,523	337,580	369,356	369,528	345,397	331,381	362,762	362,749

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

- Liquidity Coverage Ratio (the amount of high quality liquid assets held that can be used to meet the bank's liquidity needs for a 30 day liquidity stress scenario) is at an average of 134% versus the stipulated 100% minimum; and
- Leverage Ratio (the amount of Tier 1 capital held divided by the total consolidated assets of the bank) for the majors is running at an average of 5.6% which is also in excess of the currently agreed minimum Basel requirement of 3% as well as APRA's proposed minimum ratio requirement of 3.5% for internal rating-based approach (IRB) banks, which includes the majors.

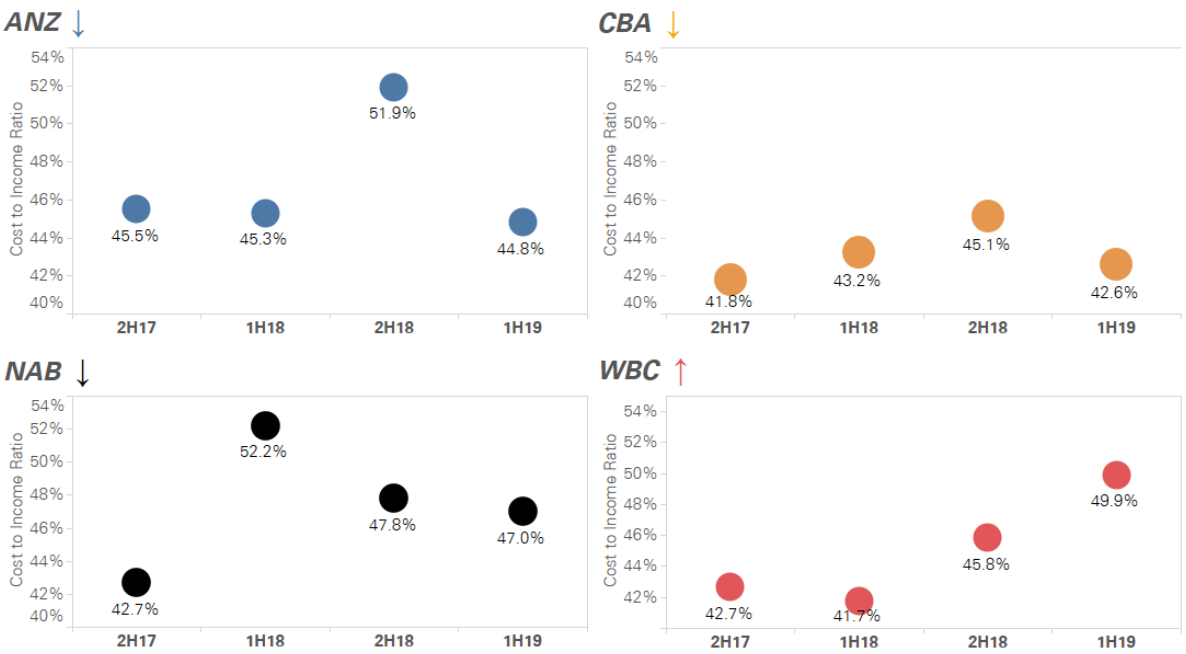
Costs

Operating expenses have decreased across the majors due to some one-off expenditures in 1H18 not recurring in the current period. The majors remain focused on optimising their cost bases through improved productivity and simplification initiatives in an environment of elevated regulatory, compliance and remediation costs.

Operating expenses have decreased in aggregate by 2.6% from 1H18 to $18.9 billion across the majors. Non-recurrence of significant prior year events, including CBA's provision for the AUSTRAC proceedings ($375m) and NAB's restructuring costs ($755m) were the primary drivers for the reduction in operating expenditure. This was partially offset by continued operating expenses pertaining to customer-related remediation.

The average cost to income ratio for the majors has increased by 47 basis points from 1H18 to 46.1%, despite three of the four banks reporting a slight decrease. Westpac reported an increase in their cost to income ratio by 816 basis points from 1H18 to 49.9%, mainly as a result of costs and revenue reversal pertaining to customer remediation.

Diagram 11. Average Cost to Income ratio – continuing operations basis



Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

Investment Spend

Overall investment spend across the majors[5] has increased by 8.6% to $2.1 billion. Investment spend has re-focused from productivity and growth in 1H18 to risk and compliance in 1H19. This change has been driven by expenditure related to growth, regulatory and compliance projects to strengthen regulatory and compliance frameworks such as the AML/CTF Act, and to implement systems to satisfy regulatory obligations related to comprehensive credit reporting and New Payment Platform.

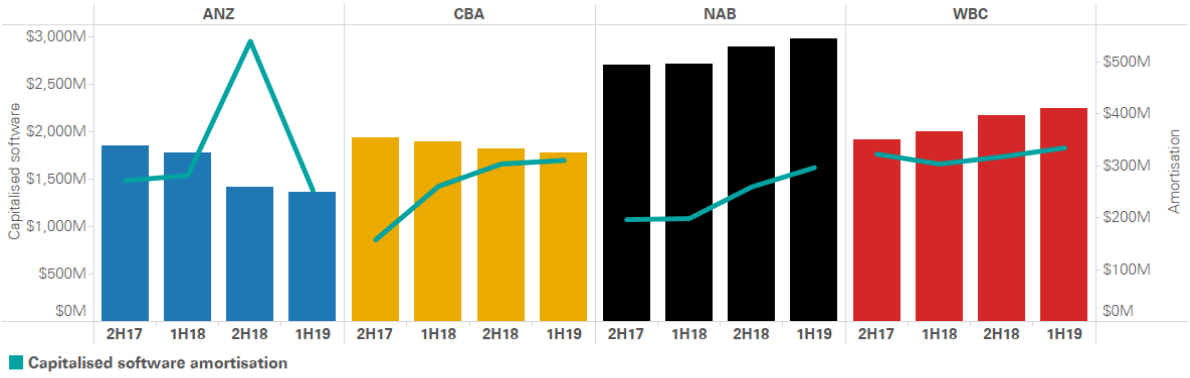
Technology

Technology expense continues to increase, rising 4.3% from 1H18 to $3.5 billion across the majors.

The majors continue to invest heavily in technology to enhance customer experience, improve technology resilience, maintain regulatory compliance and address growing concerns over cybersecurity.

Another underlying feature of the result was higher amortisation expense on capitalised software reported by three of the four majors.

Diagram 12. Capitalised software



Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

[5] Excluding ANZ as investment spend was not separately reported in their 1H19 results announcement

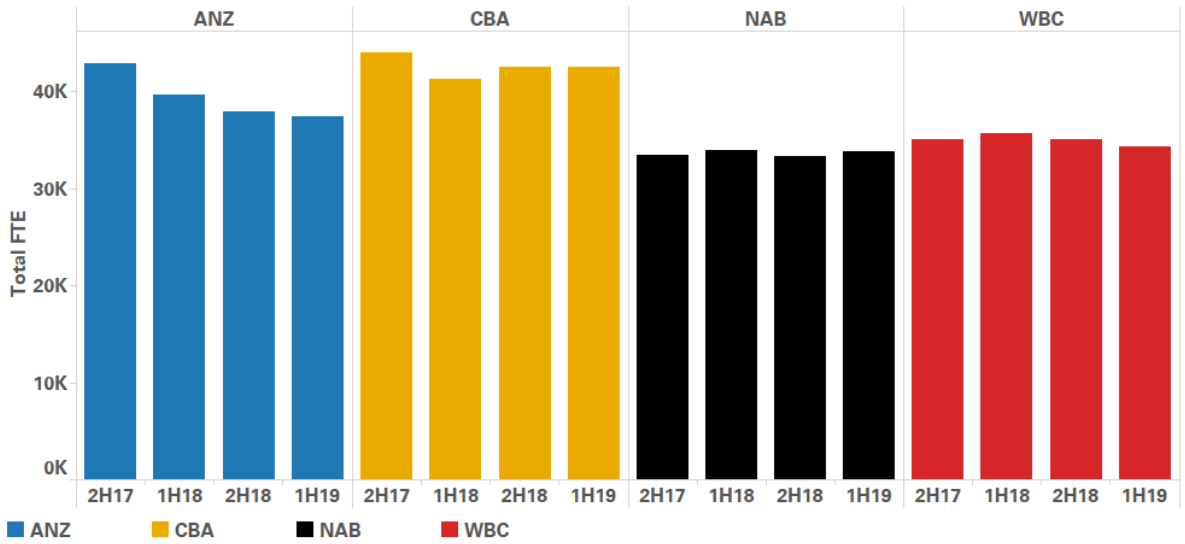
Personnel

Overall, personnel numbers across the majors continued to decline with aggregate Full Time Equivalent (FTE) staff decreasing by 2,713 (1.8%) from 1H18 to 147,914.

Apart from CBA, the majors' reported a decrease in their FTE staff from 1H18, with workforce optimisation being the main driver. Most notably, ANZ's sale of its OnePath Life NZ and Asia Retail and Wealth businesses, and continued workforce optimisation through process automation and simplification, resulted in a reduction of 2,291 FTE staff.

CBA reported an increase in risk and compliance staff to meet ongoing regulatory requirements, as well as increased project demand, which resulted in an uplift of 1,211 FTE staff from 1H18.

Diagram 13. Total FTE – continuing operations basis



Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

Return on equity

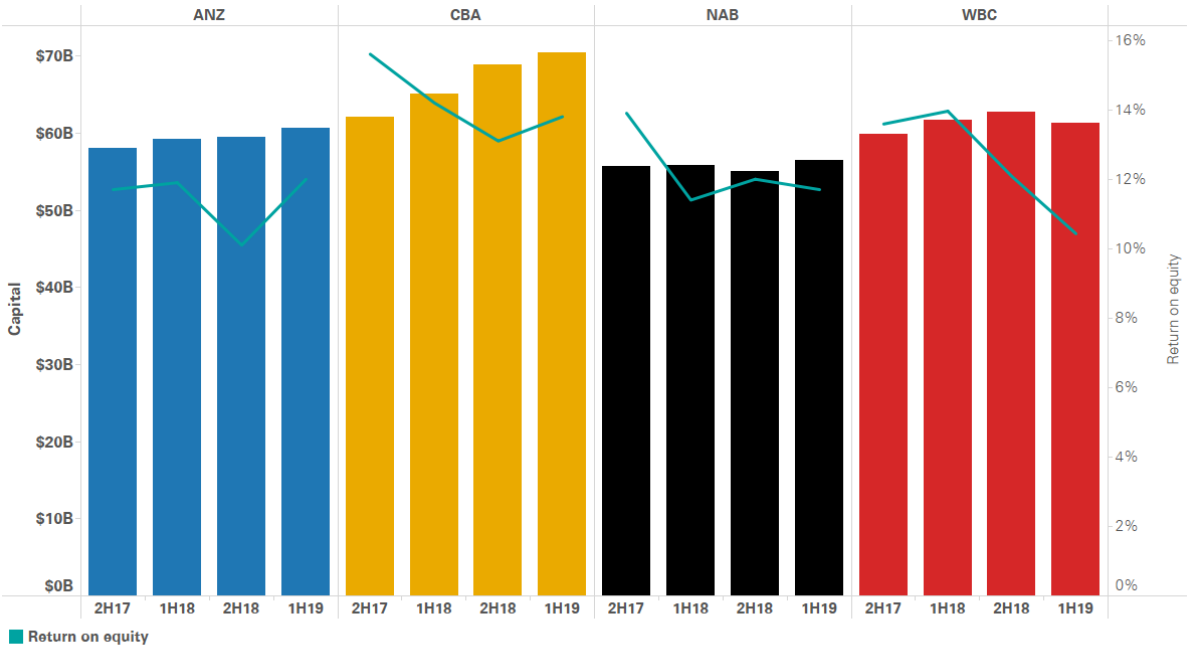
A decline in aggregate cash earnings, increasing regulatory capital requirements and ongoing customer remediation continue to challenge the majors' ability to maintain shareholder expectations for high returns of equity.

The majors have continued to increase the amount of capital held in meeting APRA's "unquestionably strong" CET1 capital target of 10.5% by 2020, and this has placed further pressure on return on equity (RoE) during the half.

This has been compounded by the decline in aggregate cash earnings, decreasing average RoE of the majors by 88 basis points from 1H18 to 12.0%.

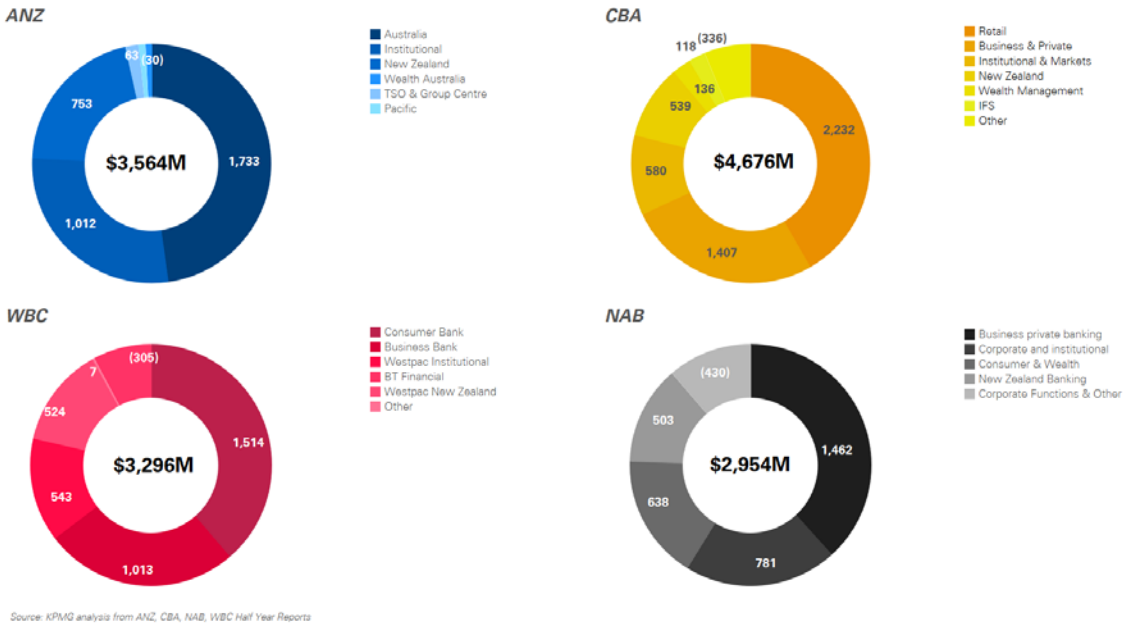
With continued headwinds from ongoing customer remediation, potential for further regulatory change and weak earnings growth, the majors remain challenged in maintaining current RoE.

Diagram 14. Total Capital and Return on Equity



Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

Diagram 15. Cash profit after tax by segment



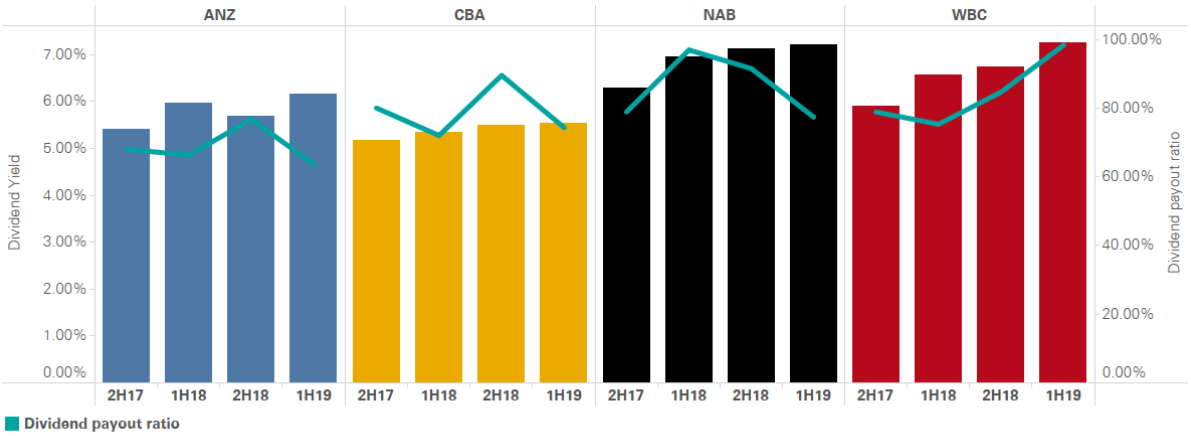
Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

Dividends

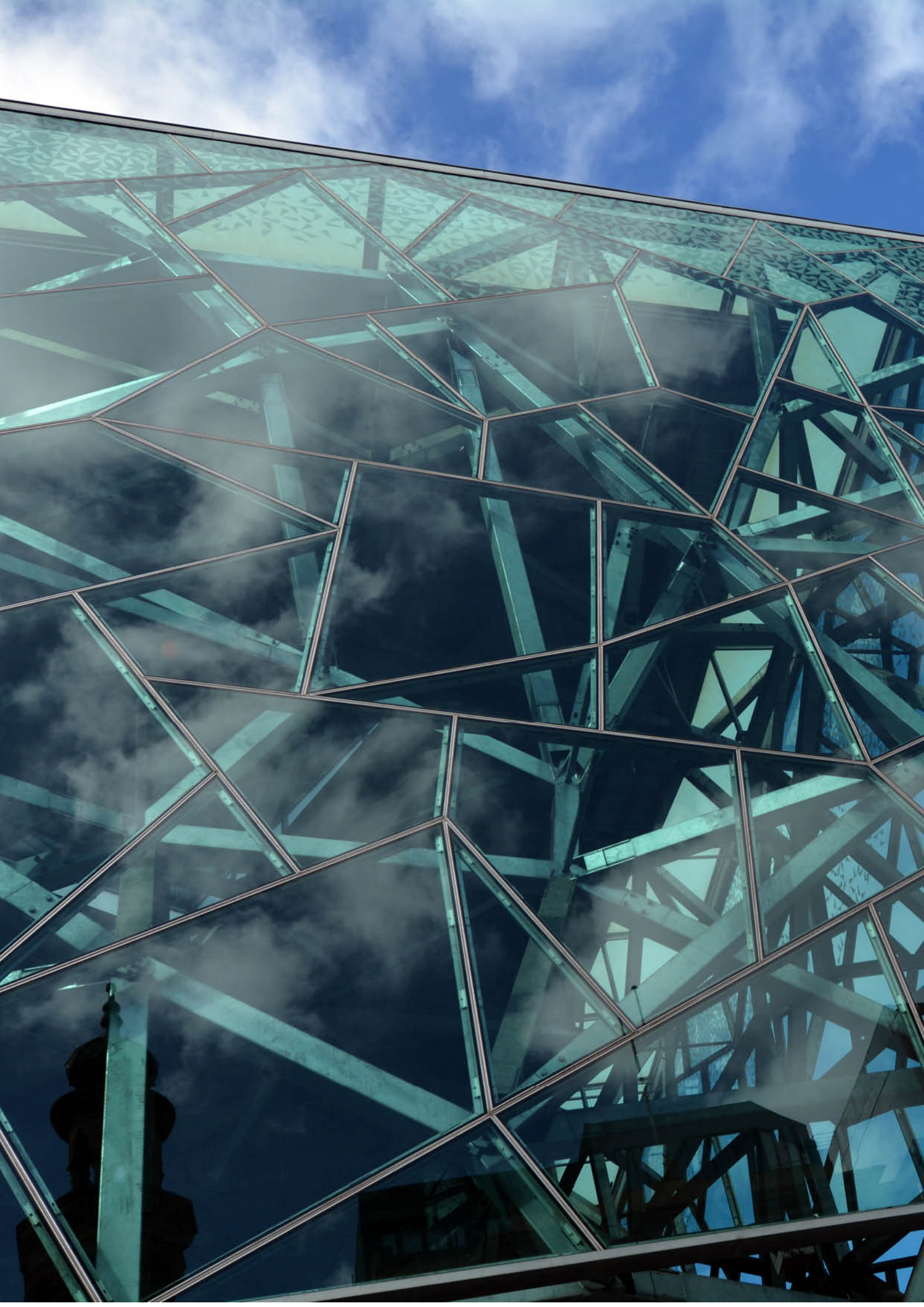
Cash profits decreased in aggregate across the majors, while interim dividends remained constant, with the exception of NAB who reduced theirs by 16 cents per share. As a result of lower overall cash profits and a relatively constant dividend per share, the dividend payout ratio across the majors has increased by 79 basis points from 1H18 to 78.4%.

While bank management teams have done well to maintain the level of dividends and payout ratios, increasing capital requirements and structural headwinds facing the industry will place further pressure on dividends in the future.

Diagram 16. Dividend Yield vs. Payout Ratio



Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports



Acknowledgements

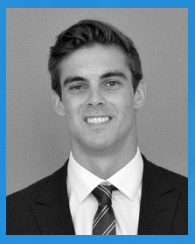
The following KPMG staff have made a significant contribution to the development of this publication.

Ben
Adamson

Danny
Pang

Kaily
Rivera

Deija
Li



Keaton
Swanepoel

Hong
Chen

Vicky
Zhou

Contact us

Ian Pollari
National Sector Leader, Banking

+61 2 9335 8408
ipollari@kpmg.com.au

Hessel Verbeek
Partner, Banking, KPMG Strategy

+61 2 9458 1540
hverbeek@kpmg.com.au

Ben Flaherty
Partner, Audit, Assurance & Risk Consulting

+61 7 3233 3218
bflaherty@kpmg.com.au

kpmg.com/au/majorbanks

www.kpmg.com.au

May 2019