KPMG

Major Australian Banks

Navigating to a new reality

Half Year 2020 Results Analysis

Organisational Flex

May 2020

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Contents

Half Year 2020 Results Snapshot

REVENUE

Operating income decreased by **3.0%** to
$39.9 billion

Net interest income increased by **1.6%** to
$32.1 billion

EARNINGS

Cash profit after tax **decreased** by **42.6%** to
$8.3 billion

Average **net interest margin decreased** by **2.5 bps** to
193 bps

SHAREHOLDER RETURNS

Average **return on equity**[1] **decreased** by **5.6% pts** to
6.4%

Average **dividend payout ratio decreased** by **44.4% pts** to
35.0%

EXPENSES

Average **cost to income ratio increased** by **8.8% pts** to
54.8%

Share of **risk and compliance of total investment spend** increased by **11.7% pts** to
51.3%

ASSET QUALITY

Credit impairment charge (as % of GLA) increased by **30 bps** to
0.43%

COVID-19 related impairments[2] recognised of
$3.4 billion

Provisions for **credit impairment** (exc. COVID-19) **increased** by **6.8%** to
$18.2 billion

BALANCE SHEET

Average CET1 **capital ratio increased 14 bps** to
10.93%

Deposit to loan ratio increased 2.2% pts to
77.8%

Lending assets increased 2.7% to
$2.8 trillion

*Comparisons are to the 2019 financial year, adjusted for restatements as applicable.
[1] Includes notable items [2] Includes ANZ, NAB and Westpac figure

At a glance

	ANZ		CBA[1]		NAB		WBC	
	1H20	PCP[2]	1H20	PCP[2]	1H20	PCP[2]	1H20	PCP[2]
Ranking								
By profit before tax	2	3	1	1	4	4	3	2
By total assets	1	1	2	2	4	4	3	3
By total equity	3	3	1	1	4	4	2	2
By market capitalisation	4	4	1	1	3	3	2	2
By CET 1 capital ratio	3	1	1	2	4	4	2	3
Financial performance (continuing operations) – P/L								
Operating income ($ million) – cash	8,579	9,746	12,419	12,411	8,573	8,874	10,341	10,103
Profit before tax ($ million) – statutory	2,614	4,536	6,387	6,412	1,789	4,124	2,185	4,555
Profit after tax ($ million) – statutory	1,636	3,252	4,573	4,581	1,210	2,905	1,190	3,173
Cash profit after tax ($ million)	1,413	3,564	4,477	4,676	1,436	2,954	993	3,296
Performance measures (continuing operations) – P/L								
Net interest margin – cash (basis points)	169	180	211	210	178	179	213	212
Cost to income ratio – cash (%)	53.7	44.8	43.7	42.6	62.4	47.0	59.6	49.9
Basic earnings per share – statutory (cents)	57.8	114.1	258.6	259.6	40.6	103.5	33.2	92.3
Basic earnings per share – cash (cents)	49.9	124.8	253.1	265.2	49.2	107.2	27.7	95.8
Return on average equity (%) – cash	4.7	12.0	12.7	13.8	5.3	11.7	2.9	10.4
Credit quality measures								
Impairment charge ($ million) – cash – P/L	1,674	392	649	577	1,161	454	2,238	333
Impaired loans to loans and advances (%) – B/S	0.39	0.33	0.44	0.48	0.33	0.33	0.30	0.25
Collective provision to credit RWA (%) – B/S	1.17	0.94	1.08	1.05	1.21	0.96	1.40	0.95
Financial position – B/S								
Total assets ($ million)	1,149,955	981,137	979,868	976,502	927,628	847,124	967,662	906,626
Total equity ($ million)	61,375	60,794	71,153	69,649	58,378	55,604	67,646	65,507
Capital measures – B/S								
Capital adequacy ratios (%)								
- Total	15.5	15.3	17.4	15.5	14.6	14.7	16.3	15.6
- Tier 1	12.5	13.2	14.1	12.7	12.0	12.4	12.9	12.8
- Common Equity Tier 1	10.8	11.4	11.7	10.7	10.4	10.4	10.8	10.7
Market capitalisation ($ billion)[3]	48.1	80.8	141.4	146.5	49.8	85.6	58.4	103.4

[1] CBA reported as at 31 December 2019 and does not incorporate the impact of the coronavirus epidemic. All other Majors as at 31 March 2020.
[2] Prior comparable period (PCP) data comprises of 1H19 for profit and loss (P/L) metrics and 2H19 for balance sheet (B/S) metrics, unless otherwise stated.
[3] Market capitalisation as at the reporting date of the Majors.

Executive Summary

The 2020 half year results of the Australian Major Banks (the Majors) are just starting to reflect the severity of COVID-19. Given the unprecedented nature of the crisis, the Majors have quickly mobilised to keep staff and customers safe and worked closely with the government and regulators to support households and businesses. However, a weakening Australian economy has led to significant increases in the Majors' loan impairment provisions. With the rapidly changing economic outlook, the Majors will face a substantial test of their resilience.

Key highlights

The Majors reported a combined **cash profit after tax** from continuing operations of $8.3 billion for the half year, down 42.6% compared to the previous corresponding period. This decrease is consistent across the Majors, reflecting ongoing downward pressure on margins and substantial remediation and regulatory compliance costs.

Preserving **net interest margins** continues to be a challenge for the Majors, with the average NIM (cash basis) decreasing by 3 basis points compared to 1H19. The decline was largely driven by switching from higher margin interest-only loans to principal and interest, lower interest rates and competitive pricing pressures, in particular related to the front book.

Loan impairment expense increased by 226% to $5.7 billion, driven by changes in underlying economic forecasts in response to the COVID-19 pandemic (with the exception of CBA which reported as at 31 December 2019). These changes reflect a significant deterioration in the Major's outlook regarding the future state of GDP, unemployment and property prices. With CBA still to report the impact of COVID-19 and the considerable uncertainty noted by the Majors in estimating the economic impact of the crisis, loan impairment expense is expected to remain heightened over the remainder of FY2020 into FY2021.

The Majors reported an increase in average **cost-to-income ratios** from 46.1% to 54.8% reflecting the elevated costs associated with large and ongoing customer remediation and regulatory programs, in particular related to the management of non-financial risks (operational risk, conduct and compliance), as well as a large amortisation increase by one of the Majors.

APRA's 'unquestionably-strong' **Common Equity Tier 1 (CET1)** benchmark of 10.5% was maintained despite the experienced reductions in cash profits. Pressures from the regulator to ensure a strong balance sheet position in the current environment were seen as a key driver behind decisions to reduce or defer dividends for three of the four Majors noting that CBA announced its interim dividend before APRA wrote to banks and insurers guiding them to seriously consider deferring decisions on the appropriate level of dividends until the outlook is clear.

As a consequence of maintaining strong capital requirements in an environment with decreasing earnings, the Majors returns continue to compress. **Returns on equity** (ROE) for the 2020 half decreased by 5.6 percentage points to an average of 6.4%, signalling the end of the double-digit ROE era. Downward pressure on ROEs will remain for the foreseeable future, given the ongoing impact of a deteriorating global and local economy.

"While the Majors have proven resilient so far, it is too early to estimate the full impact of the COVID-19 crisis on their 2020 performance."

Key observations

COVID-19 Pandemic

The impacts of the COVID-19 pandemic continue to unfold in real-time with pronounced effects on households, businesses, the public sector as well as local and global financial markets. While it is too early to estimate the full impact on the Majors, the half year results reflect the onset of the crisis.

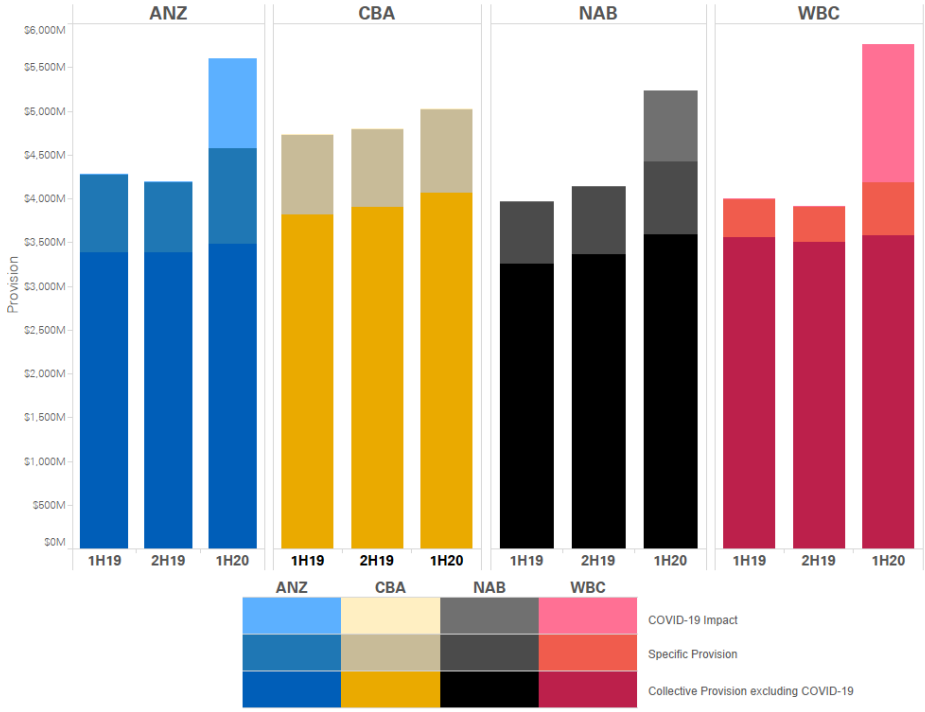
The initial focus of the Majors has naturally been to keep their staff and customers safe. This required an unprecedented mobilisation of resources to service customers (and a surge of COVID-19 enquiries) via phone and digitally, while implementing split teams and remote working arrangements and dealing with (offshore) disruptions with their service providers. The initial response required an enormous coordination effort by the Majors.

The economic effects from the lockdown, job losses and income uncertainty are being felt across Australia's historically highly leveraged businesses and households, resulting in unprecedented volumes of financial assistance requirements from the government and the banks. The Majors have been working closely with government and regulators to support their customers, both households and businesses, as they manage the economic impacts of the restrictions imposed by governments. In the reporting period, the Majors approved a combined 280 thousand requests to defer Australian customer mortgage repayments (with a total value of $102 billion) and deferred $33.1 billion of loans to support working capital needs for Australian businesses[4].

[4] Figures as reported in the respective Majors' Half-Year Reports and Investor Presentations. Timing of these statistics vary slightly between the Majors. We note that CBA reported as at 31 December 2019 and key COVID-19 statistics including loan deferrals and impact on loan impairment provisions have yet to be reported.

Much of the longer term impacts of loan repayment holidays and hardship requests will not be known for another six to twelve months, as normal payment terms resume. With a rapidly changing economic outlook, it is clear that the effects of the crisis are going to be long-term. The existing methods to estimate expected credit losses based on historical losses have limitations in the current economic environment and as a consequence, the assumptions applied on forward-looking macroeconomic indicators vary between the Majors. Futhermore, across the Majors, 'out-of-model' overlays have been used to adjust for model limitations. Over the half, the Majors recorded an increase of $4 billion in impairment losses largely in relation to the COVID-19 pandemic. Provisions for loan losses will continue to be updated, including in the second half of this financial year.

Diagram 1. Loan provisioning[5]



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

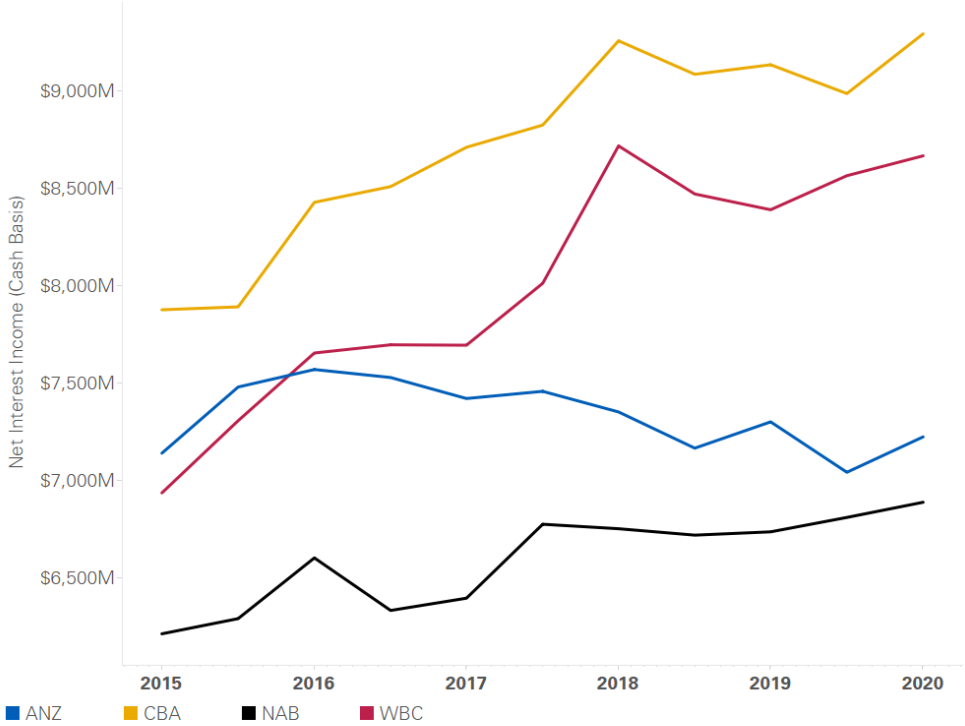
[5] We note that CBA reported as at 31 December 2019, prior to the impact of the COVID-19 pandemic in Australia and the impact of this on the collective provisions have yet to be reported.

Little fuel left in the interest income growth engine

There has been much commentary on the Majors passing on rate cuts to (mortgage) customers in previous reporting periods. Of the four 25 basis point reductions announced by the RBA since July 2019, an average 64 basis points in total were passed to borrowers by the Majors on owner-occupied loans.

The current ultra-low interest rate environment means that margins have become thin. Whilst growth in lower cost deposit funding has traditionally been utilised to preserve margins, this is now increasingly challenging as interest rates edge closer to the 0% floor on many savings accounts. With two thirds of the Majors' income being derived from interest income, we expect the Majors to look to diversify their income streams within the existing businesses, given the long-term outlook for interest margins on mortgages (and continued expectations of high shareholder returns).

Diagram 2. Net Interest Income (cash basis)



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

The "unquestionably strong" balancing act

Continuing the recent trend of ROE decline, the Majors have experienced a further decrease in ROE in 1H20. The Majors have now entered the domain of single digit ROEs, and with continued pressure on revenues, costs and impairment expenses it is unlikely that returns will return to their previous levels any time soon.

In addition, APRA has maintained its 'unquestionably strong' capital requirements for the Majors. In this reporting period, this included guidance to consider deferring or reducing dividend payments until the outlook is clearer in order to protect balance sheet strength.

In this half year, the Majors have therefore reduced or deferred dividend payouts. However, as significant contributors to investor portfolios (including for retirement income), there is ongoing pressure on the Majors to continue their historic dividend payout ratios.

The Majors will need to consider how to best balance the interests of regulators, investors and customers. However, a quick return to high dividend payouts appears unlikely.

"The Majors have the opportunity to use COVID-19 as a catalyst to accelerate their digital transformation, simplification and operational resilience efforts."

Outlook

With increasing economic uncertainty and volatility in global markets, there is a resemblance to the GFC. The global economic outlook is different however. Also different is the preparedness of the banking sector. Decisive actions and stress testing imposed by regulators since 2008 have resulted in strengthened balance sheets and a stronger position from which the Majors can respond and recover.

The Majors have capital ratios that are 6-7% higher than in 2007 and have Liquidity Coverage Ratio's well above the 100% minimum regulatory requirement.

The ultra-low interest rate environment, locally and globally, is expected to be the 'new normal' following the RBA's decision to reduce the cash rate to 0.25%, temporarily impose a 3-year target yield of 0.25% on Australian Government Bonds and further easing of monetary policy by overseas central banks.

In the short term, the Majors will continue to remain focused on their customers' recovery and returning their operations to the next stage (including return to the office and branch scenarios). In the medium to longer term, the Majors have the opportunity to use the lessons from the current situation as a catalyst to accelerate their digital transformation, simplification and operational resilience efforts.

Major Banks' Response to COVID-19

Horizon 0

Reaction
Focus on **safety**

The major banks have each responded quickly to keep their staff and their customers safe as the pandemic hit Australia:

- Implementation of split team arrangements whereby critical teams are working across multiple locations and during different times of day to limit the impact on essential services
- Enhancement of capacity for employees to work remotely (with the majority of the Majors' staff working remotely)
- Establishment of centralised control rooms to manage business continuity
- Redeployment of staff to service inbound customer inquiries (e.g. over 800 frontline reassignments at NAB, to deal with over 650,000 inbound calls with COVID-19 enquiries)
- Rapid deployment of digital service options, e.g. debit cards replacing passbooks
- Reduction in branch numbers, opening hours and over-the-counter transactions & services

Horizon 1

Resilience
Focus on **viability**

Together with the Australian government, the banking sector has quickly delivered a range of measures to support households and businesses:

- Delivery of the Coronavirus Small and Medium Enterprises (SME) Guarantee Scheme to support up to $40 billion of lending to SMEs
- Temporary suspension of responsible lending obligations for credit to existing SME customers
- Participation in RBA's $90 billion Term Funding Facility at a fixed interest rate of 0.25%

Each of the major banks has announced measures to support households and businesses:

- Repayment deferrals for mortgages (as of late April, reported between $25-40 billion per major) and business lending (on average over $10 billion per major)
- Significant hardship assistance to mortgage customers
- Reduction in minimum monthly repayment amounts, late payment fee waivers and interest rate reductions on credit cards and personal loans
- Capital preservation measures, including capital raises and dividend reductions / deferrals

The major banks have been decisive with their COVID-19 **reaction** and their community **resilience** response; they now need to turn their minds to **recovery** and forging a **new reality.**

Horizon 2

Recovery
Focus on **performance**

The major banks are starting to consider what permanent transformation they will pursue when restrictions are lifted and the global economy starts to recover, for instance:

- Distribution transformation, with increased focus on direct channels, and reduced branch footprint and cash handling
- In response to shift in customer behaviour, increased digital sales, on-boarding and self-service functionality
- Focus on end-to-end digital products, including direct mortgages
- Significant simplification of product portfolios, operating models and processes (including automation)
- New ways of working, including remote working, part-time and flexible roles, agile teams and multi-skilling (and impact on physical branch and office space)
- Consider positive changes to governance and internal decision-making processes and implement them into go forward BAU
- Consolidation of renewed customer trust and bank reputation

Horizon 3

New Reality
Focus on **growth**

Structural environmental and economic changes mean that the Majors will need to adapt some of the fundamentals of their business models, for instance:

- Development of new sources of revenue (especially given the expected reduction in mortgage interest income as interest margins are shrinking, activity in the housing is slowing and property values are reducing) from new customer segments, new products and new service offers
- Redefine employee value proposition to maximise the flexibility and outcome focus achieved during the crisis
- Enhance strategic agility and more regularly stress test operational resilience, enabled by insights from COVID-19 experience and with a clear focus on customer impact
- Overhaul of operating models for critical services and call centres, including on-shoring, in-sourcing, managed services and distributed staff models
- Re-assessment of long term office property strategy

Asset quality

Ongoing uncertainty around the COVID-19 pandemic and the incorporation of forward-looking economic factors have underpinned a significant increase in credit impairment charges across the Majors, totalling $5,722 million for the half.

The COVID-19 pandemic has had a profound impact on the global and Australian economy. Authorities around the world have taken drastic measures to stop the spread of the virus and reduce the adverse health impacts on their communities. The effectiveness of the health policies depends on deliberately distorting the operation of the economy, including decelerating large parts of the economy with varying degrees of severity. While these actions have been offset in part by economic policies to support businesses and households, the deliberate slowdown introduces discontinuities into the behaviour of the economy (e.g., industries and/or activities being shut down), and skews the behaviours of businesses and households.

Under the accounting standard AASB 9, the Majors are required to incorporate forecast macroeconomic assumptions in their estimation of the expected credit loss (ECL) collective provision. As a result, the COVID-19 outbreak has led the Majors with a March period end (ANZ, NAB and WBC) to significantly increase their collective provisions to reflect the expected deterioration in the Australian and global economy. These Majors have highlighted that the economic forecasts used to determine their collective provisions are subject to significant estimation uncertainty. The rapid and severe onset of the crisis and timing of the half year end has resulted in disparities in key economic assumptions used by the Majors in determining their provisions. These assumptions include the extent and duration of the economic downturn, its quantifiable impact on economic indicators (e.g. GDP, unemployment and house prices), as well as estimated downstream effects on loan loss provisions.

It is clear that the impacts of the crisis are going to be long-term. Much of the longer term impacts and the effectiveness of economic policies introduced by the government to support workers who have lost employment and businesses see through the crisis will not be known for some time. With CBA still to report the impact of COVID-19 on its book and the considerable uncertainty noted by the Majors in estimating the economic impact of the crisis, loan impairment expense is expected to remain heightened. Consequently, the half year results only represent the onset of the impact of COVID-19 as the true impact to the economy manifests over time.

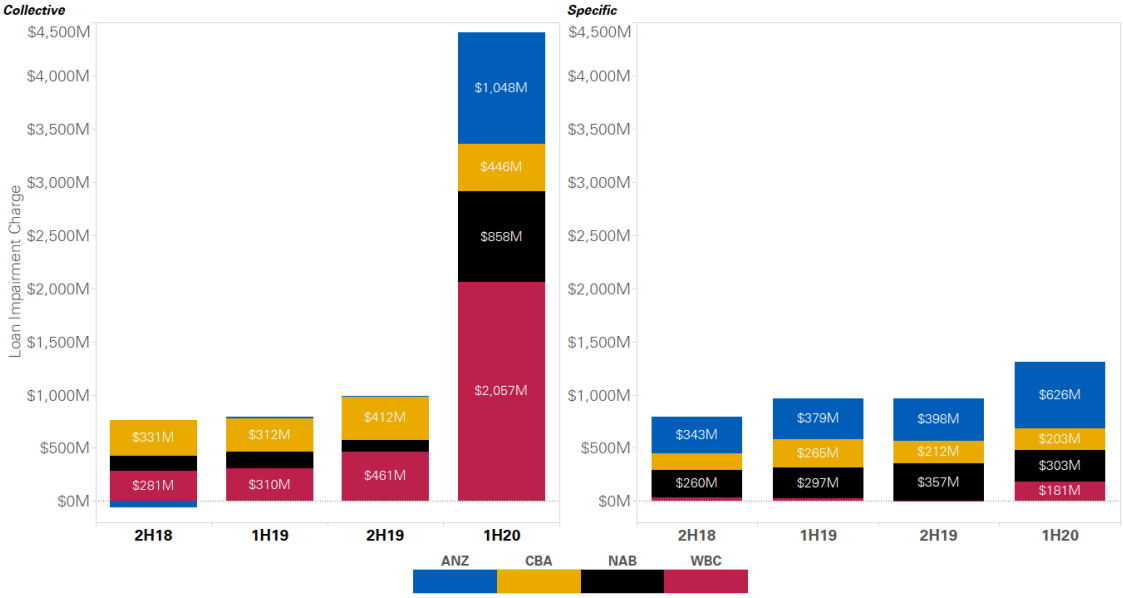
Loan Impairment

Collective impairment charges across the Majors have increased by $3,617 million primarily due to the incorporation of forward-looking economic factors as a result of the COVID-19 outbreak. This does not include any COVID-19-related adjustments made by CBA due to the timing of the end of their financial period being prior to the COVID-19 outbreak in Australia.

Excluding the impact of the COVID-19, underlying collective impairment charges have increased across the Majors by $198 million, reflecting the weak Australian economic outlook leading into the pandemic, in particular the discretionary retail sector and the lingering economic impact on regional centres, and accommodation and tourism operators, from the drought and the severe 2019/2020 Australian bushfire season.

Across the Majors, specific impairment charges increased by $349 million driven by a small number but larger institutional exposures.

Diagram 3. Loans impairment charge



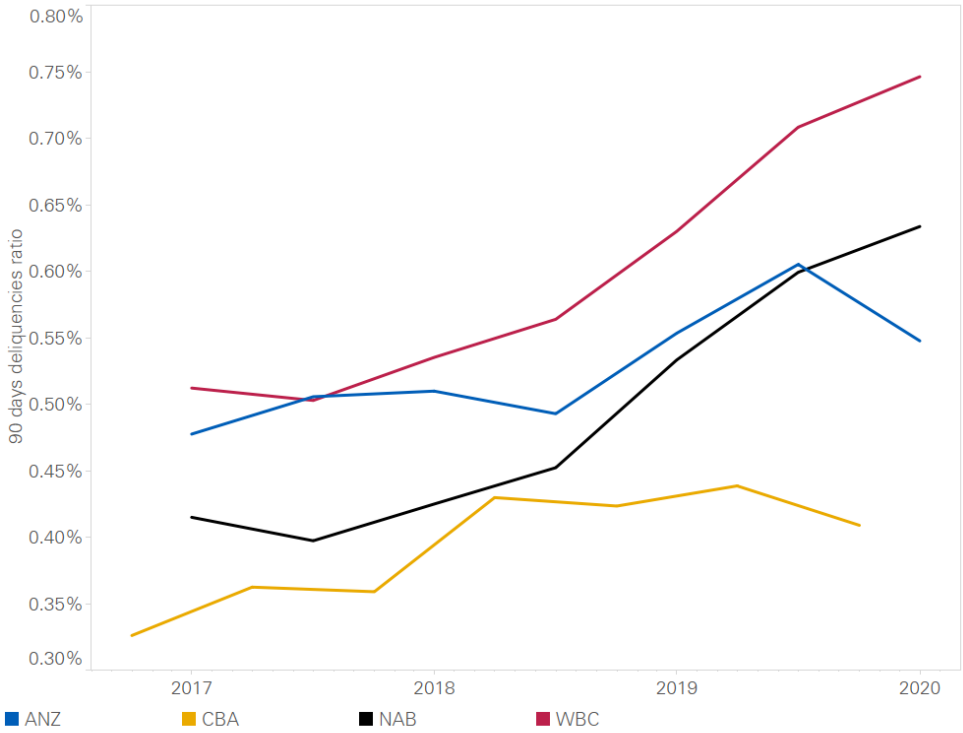
Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

Delinquencies

Delinquencies (90+ days past due), excluding those granted a six-month repayment deferral, as a proportion of gross lending assets, decreased by 1 basis point from 59 basis points in 2H19 to 58 basis points in 1H20, driven primarily by the residential mortgage lending portfolio.

Geographically, Western Australia, Northern Territory and Queensland remain the key drivers of past due residential mortgage loans.

Diagram 4. 90 day delinquencies as a proportion of GLA



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

Capital

Despite mixed results on capital metrics for 1H20, the Majors continue to maintain healthy capital and liquidity buffers, underpinning a strong financial system.

Capital Adequacy

The Majors continued to meet the unquestionably strong thresholds set by the Australian Prudential and Regulatory Authority (APRA) in 1H20 despite the challenges posed by the ongoing COVID-19 epidemic and APRA's statement on the 19th March 2020 for banks to utilise their large capital buffers to support ongoing lending to the Australian economy.

Average CET1 ratio increased slightly by 14 bps to 10.9%. This was largely driven by flow-on effects from the divestment of non-core businesses in previous periods and strong take up in dividend reinvestment plans, partially offset by increased risk weighted assets due to lending growth and migration of loans between risk weight categories.

Despite the Majors maintaining strong capital levels, we note reductions or deferral of interim dividends across the Majors until the economic impact of COVID-19 is clearer. This, is in addition to NAB's $3.5 billion equity raising subsequent to 31 March, indicates a continued focus to maintain strong capital buffers and remain 'unquestionably strong' in uncertain times.

	ANZ		CBA		NAB		WBC	
	1H20	PCP	1H20	PCP	1H20[6]	PCP	1H20	PCP
Common Equity Tier 1 (%)	**10.8**	**11.4**	**11.7**	**10.7**	**10.4**	**10.4**	**10.8**	**10.7**
Tier 1 Capital (%)	12.5	13.2	14.1	12.7	12.0	12.4	12.9	12.8
Tier 2 Capital (%)	3.0	2.1	3.3	2.8	2.7	2.3	3.4	2.8
Total Regulatory Capital ratio (%)	**15.5**	**15.3**	**17.4**	**15.5**	**14.6**	**14.7**	**16.3**	**15.6**

[6] This does not include the effect of the capital raising announced on 27 April 2020.

The average leverage ratio across the Majors has decreased by 13 basis points to 5.50%. This remains well above APRA's proposed minimum requirement of 3.5% for internal ratings based ADIs. Whilst we note that movement was mixed across the Majors, primary drivers of this were organic capital generation and divestment of non-core businesses, offset by growth in exposures and securities financing.

Liquidity

Across the Majors, we note liquidity ratios remain healthy, with the average liquidity coverage ratio (LCR) increasing by 875 basis points to 140.8%, largely driven by an increased holding of High Quality Liquid Assets (HQLA) across the Majors. This is despite a system wide reduction in the Committed Liquidity Facility as of 1 January 2020.

Net interest income

Net interest income for the half increased by 1.6% to $32.1 billion in aggregate. The result was primarily driven by an increase in interest earning assets offset by a decrease in margins due to further reductions in the cash rate and increased mortgage competition.

Cash Basis	1H20	PCP	Movement
Net Interest Income ($million)			
ANZ	7,222	7,299	(1.1%)
CBA	9,293	9,134	1.7%
NAB	6,886	6,734	2.3%
WBC	8,666	8,389	3.3%
Aggregate	**32,067**	**31,556**	**1.6%**
Net Interest Margin (basis points)			
ANZ	169	180	(11)
CBA	211	210	1
NAB	178	179	(1)
WBC	213	212	1
Average	**193**	**195**	**(3)**

Net interest margin

Net interest margin across the Majors continued to be under pressure in 1H20, decreasing by an average of 3 basis points, despite continued efforts in repricing. Thematically, the key drivers of margin pressure across the Majors were consistent. These key factors include:

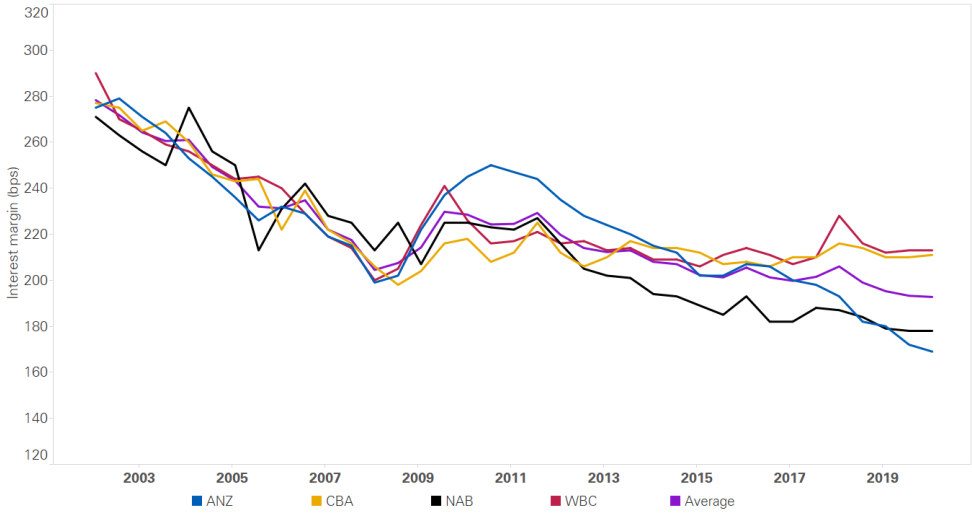
- Continued competition across housing and business lending from challenger banks, non-bank lenders and amongst the Majors;
- Changing customer preferences as customers switch from higher margin interest only products to principal and interest repayments;
- Shifting product mix as owner occupied housing loans grow at a faster rate than higher margin investor loans (impacted by negative investor system growth) and consumer finance loans;
- Lower spread from customer deposits as the Majors continues to balance the interest of deposit holders and borrowers; and
- Decreased earnings on capital and markets due to the low interest rate environment, interest free and very low interest rate accounts.

These were partially offset by

- Lower short-term wholesale funding costs reflecting reductions in the cash rate and activity from the Reserve Bank of Australia (RBA); and
- Mortgage repricing activities and one-off benefit from the timing of passing on cash rate cuts.

The RBA made two reductions in the cash rate towards the end of 1H20. While the Majors have responded with the repricing of lending and deposit products, the impact of these cuts will be reflected in the second half and into FY2021.

Diagram 5. Net Interest Margins – cash basis



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

Interest earning assets growth

Average interest earning assets increased by 2.2% in aggregate from 2H19 to $3,318 billion. This was primarily driven by stronger growth in non-housing credit and interest-bearing securities held for treasury and markets activities, as well as softening housing credit growth.

Aggregate non-housing credit grew 5.2% from 2H19, largely due to institutional and business customers drawing down on additional funds in response to the uncertain operating environment (e.g. travel restrictions) due to the COVID-19 pandemic.

Across the Majors, housing credit growth continued to slow, with an aggregate growth of 1.2% on 2H19. This softening growth was largely driven by:

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

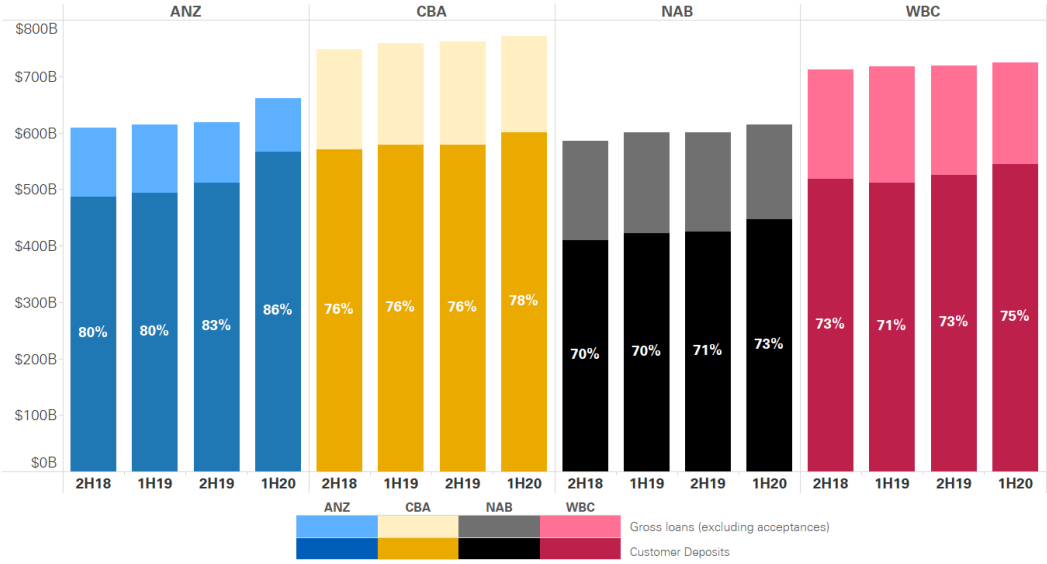
This was partially offset by higher system growth in New Zealand and foreign currency movements.

Growth in non-lending interest earning assets across the Majors was primarily due to increased holdings in HQLA to maintain healthy LCR buffers during the current uncertain environment, as well as increased securities balances held for markets related activities for some major banks.

Funding mix

While overall funding levels have increased, the Majors continue to place a strong emphasis on customer deposits as the main source of funding. Across the Majors, the portion of customer deposits to total gross loans and advances increased by 224 basis points to 77.8%, primarily due to consumers managing the impacts of the COVID-19 pandemic and the Majors' continued focus on deposits as a continuing base of cost-effective funding.

Diagram 6. Customer deposits proportionate to total gross loans



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

Notable Items

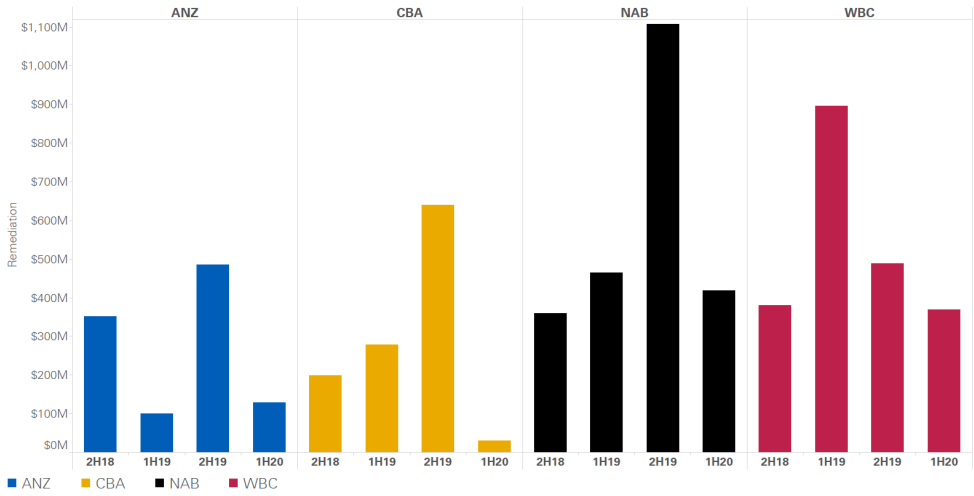
Customer remediation programs, regulator action and asset impairments continue to feature as notable items in the half year results across the Majors.

Customer Remediation and Regulatory Costs

During the period, a further $946 million in costs and reversals of revenue were incurred in relation to ongoing remediation programs of work. Furthermore, Westpac recorded a $1.06 billion pre-tax charge in relation to AUSTRAC matters, of which $900 million has been provided for penalties.

Since 2018, customer remediation programs have in aggregate resulted in a $7.2 billion impact across the Majors. Whilst significant amounts were provided in previous years, continued remediation charges in 1H20 exemplify the immense complexities involved in addressing previous errors and misconduct, as the extent of known issues are better understood and remediated, and new matters are identified.

Diagram 7. Customer remediation costs



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

Other Notable Items

Other notable items during the period include:

- NAB announced a $3.5 billion capital raising and a $1.06 billion statutory amortisation charge as a result of changes in accounting policies; and
- ANZ recorded a $815 million statutory impairment charge on its investment in Asian associates of AmBank (Malaysia) and Panin Bank (Indonesia) as a result of adjustments in the short to medium term growth estimates of these investments to reflect the impact of the COVID-19 pandemic.

Costs

Operating expenses remain elevated with ongoing efforts to meet regulatory and compliance obligations, uplift risk capability and deliver against customer remediation programs continuing as a primary focus.

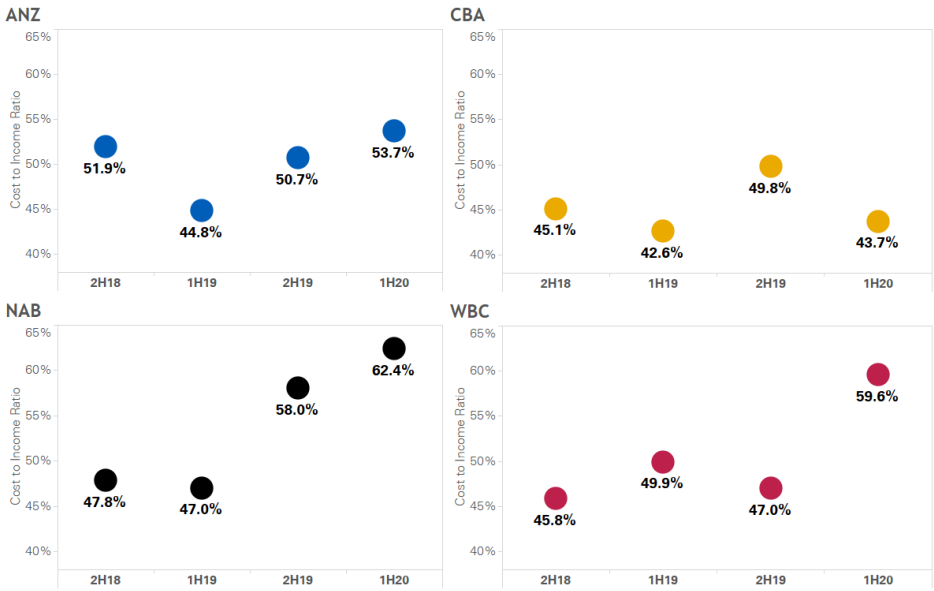
Operating Expenses

Operating expenses have increased in aggregate by 14.2% from 1H19 to $21.5 billion across the Majors. This was largely driven by changes in NAB's software capitalisation policy resulting in $1.06 billion in additional amortisation costs and Westpac's AUSTRAC charges of $1.06 billion.

Excluding these items, operating expense across the Majors increased by $560 million to $19.4 billion, primarily driven by increased personnel costs due to wage inflation and technology costs as a result of increased investment spend. These were partially offset by lower operating expenses from customer remediation programs in the half.

As a result of increase in operating expenses outpacing increases in operating income, average cost to income ratio for the Majors increased by 877 basis points from 1H19 to 54.8%, with all four banks reporting an increase.

Diagram 8. Average Cost to Income ratio – continuing operations



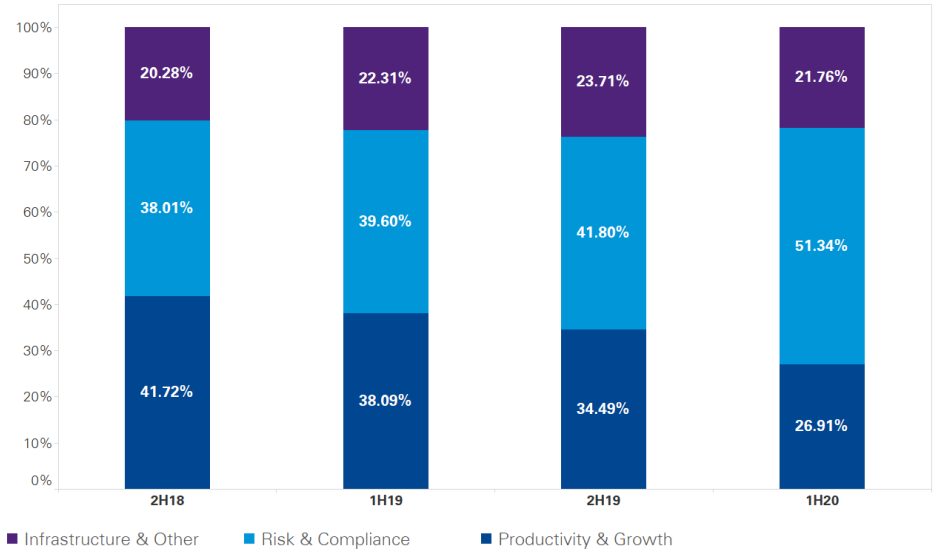
Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

Technology and Investment Spend

Aggregate investment spend across the Majors has remained flat at $2.2 billion. The previously observed shift in focus from productivity and growth to risk and compliance has accelerated, with CBA, NAB and WBC each increasing their risk and compliance spend significantly, driving an increase in aggregate risk and compliance contribution from 40% to 51% of total investment spend. As a result, investments in productivity and growth initiatives have been significantly curtailed.

Technology operating expenditure across the Majors increased from $3.5 billion in 1H19 to $4.1 billion in 1H20, as new systems are being implemented to meet regulatory obligations and the use of cloud-based technology continues to be accelerated. Increasingly, there is a trend towards deploying regulatory technology (RegTech) as a solution to the meet the ever-increasingly complex regulatory compliance environment and to remediate past regulatory events. (e.g. AML/CTF).

Diagram 9. Investment Spend

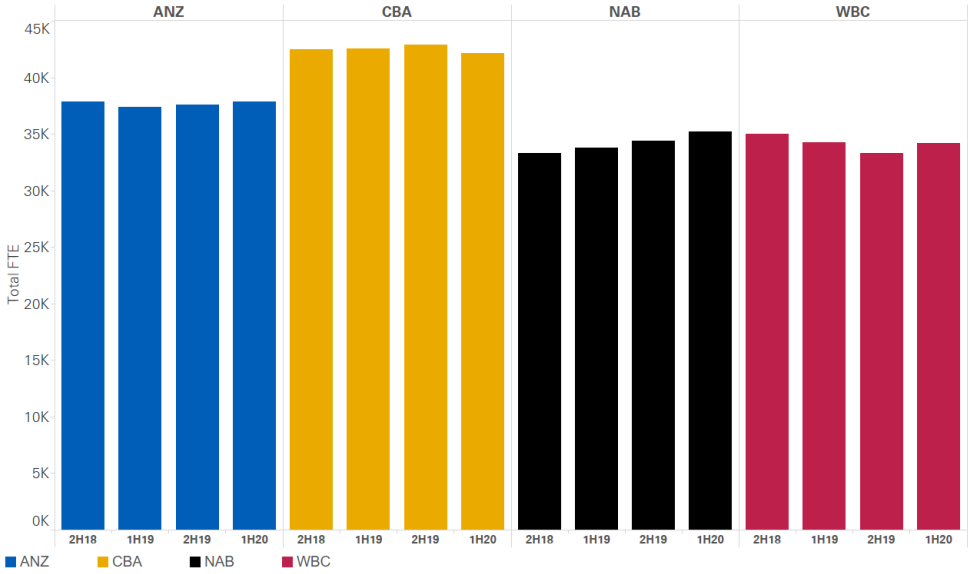


Source: KPMG analysis from ANZ, CBA, NAB, WBC Half Year Reports

Personnel

The aggregate number of Full Time Equivalent (FTE) staff employed by the Majors has remained largely flat from 1H19. However, between the Majors, movements were mixed, with NAB reporting 1,455 more FTE staff than in 1H19. Changes in staffing across the Majors were primarily due to greater compliance staffing, temporary projects and staff insourcing, with partial offsets achieved through continued productivity and workforce optimisation.

Diagram 10. Total FTE – continuing operations



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

Shareholder returns

A decline in aggregated cash earnings combined with pressures to meet ongoing and new regulatory requirements have impacted the Majors' ability to maintain previous levels of Returns on Equity and dividends.

Return on equity (ROE)

Return on equity continued to deteriorate in 1H20, with average ROE decreasing 557 basis points to an average of 6.4% for 1H20. This represents the first time over the medium term that average ROE has reduced below double digits. Excluding COVID-19 related impairment charges, impairment in associates, accelerated amortisation of capitalised software and penalty provisions, ROE has still decreased by 169 basis points across the Majors from 1H19.

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

Dividends

In response to the current COVID-19 economic crisis, the Majors with a March period end (ANZ, NAB and WBC) all have elected to defer, in part or full, their interim dividend. This direction has been taken until the economic impact of COVID-19 can be better estimated and to maintain a strong capital position.

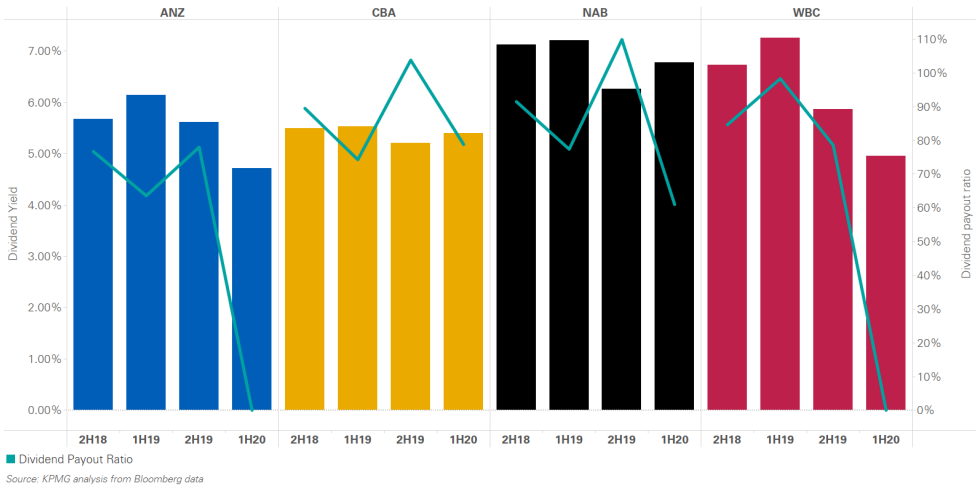
The capital position of all ADIs has been a focus of the regulator. APRA issued guidance to all Authorised Deposit-taking Institutions (ADIs) that it expects them to limit discretionary distributions of capital, including prudent reductions or deferral of dividends, so that they can continue to lend to Australian households, businesses and the broader economy during the COVID-19 pandemic. This guidance has been reflected with the Majors materially reducing or deferring their interim dividend, with the exception of CBA who had declared and paid its interim dividend prior to this guidance being issued.

Furthermore, the Reserve Bank of New Zealand has imposed a temporary prohibition on the payment of dividends by New Zealand banks, including those to their Australian parent entities. All four Majors have significant New Zealand operations and this in turn has an impact on the Australian Majors' capacity to pay dividends to shareholders.

Individually, the decision towards reducing or deferring dividends for the half was varied across the Majors with:

- ANZ elected to defer their interim dividend, until there is greater clarity regarding the economic impact of COVID-19;
- NAB reduced its interim dividend by 64% to 30 cents per share; and
- Westpac also elected to defer an interim dividend, accepting APRA's guidance on dividends and commenting the decision was prudent at this point in time.

Diagram 11. Dividend Yield vs Payout Ratio



As a result, average dividend payout ratio[7] across the Majors decreased by 44.4 percentage points from 1H19 to 35.0%.

[7] For the purposes of this calculation, we have assumed the interim dividend for ANZ and Westpac to be zero.

Acknowledgements

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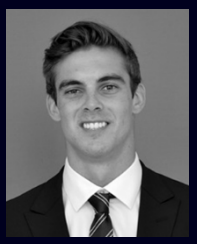

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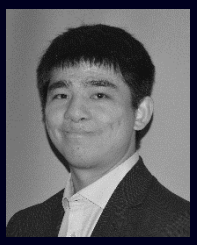

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