The new reality for bank profitability

Australian banks will need to find new sources of profit and growth in the aftermath of COVID-19
Introduction

During the past decade, profit growth by the Australian major banks (the majors) has been underpinned by the strong performance of the housing market.

Data from KPMG’s Major Banks report show that in the last 5 years up until the end of FY19, for the 4 majors in Australia returns on equity (ROE) of 10 – 13 percent were made possible by net interest margins (NIM) of 180-210 basis points (bps) and mortgage lending growth of 1-4 percent per annum.

In the last 20 years, housing lending has developed into the undisputed profit and growth engine for Australian banks. This class of lending clearly is the largest source of bank income (net interest income makes up circa 75 percent of the major banks’ total income, and mortgages make up 56-69 percent of their lending balances\(^1\)). Furthermore, mortgages have represented strong credit growth, a lower risk weighting and attractive margins.

As a result, the majors’ results are highly sensitive to the mortgage market (a recent estimate was that every 5bps reduction in mortgage NIM results in a 1-2 percent reduction in cash earnings for the majors\(^2\)).

The top-line growth from mortgages has been the primary driver of Australian bank profit performance. While net interest income was growing at an average 1 percent per annum between FY14-19, the average cost-to-income ratio for the majors stayed largely constant between 43-49 percent during this period.

Costs continued to grow at 2 percent per annum despite the banks’ continued focus on making productivity improvements through such measures as automation, outsourcing and organisation re-design.

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\(^1\) Macquarie Research, “Australian Banks: Bad debts, bad debts, Whatcha gonna do…”, 16 March 2020

\(^2\) Credit Suisse, “Commercial Banks”, 21 January 2020
For comparison, in the UK the combination of disruption from the Global Financial Crisis (GFC), lower economic growth performance and a low interest rate environment since 2008, has pressured the banks to substantially improve productivity. As a result of operating in a more challenging environment, the UK banks have had to make tougher choices than their Australian counterparts to improve their productivity. Compare for instance the performance on branch network reduction: the UK majors closed over 3,500 branches since 2015 (33 percent of total branches) versus circa 900 branches (14 percent of total branches) for all Australian banks during the same period.

Another example is product portfolio simplification: most UK banks have initiated and completed major rationalisation programs to reduce their number of frontbook / on-sale and backbook / off-sale products (often by 50 percent), while the Australian banks have not been able to do the same.

**European banks have made tough productivity choices**

Reduction in cash usage has been an enabler of branch rationalisation in Australia and abroad.

- **14% reduction** in Australian bank branches (2015-2020)
- **33% reduction** in bank branches in the UK (2015-2020)
- **Danske Bank:** c.40% of branches closed since 2014
- **Nordea:** c.35% of branches closed since 2014

Global comparator banks are greatly simplifying their products and systems, and realising productivity improvement.

- **RBS:** 11% reduction in cost-income ratio from 2015 – 2019 through product and systems simplification
- **Lloyds Bank:** c.20% absolute reduction in total cost base since 2011 through simplification
- **Santander:** 90% simplification of UK accounts
- **Major UK bank:** 40% product suite simplification and migration of 1.2m customers from legacy platforms

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3 Which? 2019 (UK); APRA ADI PoP

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As we pointed out in KPMG’s Major Australian Banks: Full Year 2019 Results Analysis report, the Australian banks’ long run of profit performance was already coming to an end due to a combination of lower credit growth and (in a lower interest rate environment) shrinking NIMs. The COVID-19 crisis has drastically accelerated the speed of this ‘profit pivot’. The majors’ 1H20 results were already starting to show the impacts of this, with lower NIMs (193bps in 1H20 vs 195bps in 1H19), lower profits (42.6% lower than in 1H19), increased loan loss provisions (total $21.6 billion) and a dramatic fall in ROE (6.4% in 1H20 vs 12.0% in 1H19). While these results included ‘one-off’ COVID-19 items, we expect the impacts going forward will continue to be pronounced.

In the ‘new reality’ that will define the period as the world slowly emerges from the COVID-19 crisis, there are a number of drivers behind the fall in bank profitability and revenue growth, the main ones being:

- Elevated loan losses and loan repayment holidays, as a result of Australia’s lower economic performance - impacting profits directly;
- Persistently lower interest rates, as the RBA attempts to stimulate economic recovery - impacting profits through lower NIMs;
- Mortgage market focus on refinancing, as home owners take advantage of lower interest rates - impacting profits through lower NIMs;
- Reduced housing market activity, as lower net immigration and higher unemployment reduce demand - impacting growth through lower mortgage interest income growth; and
- Lower house prices, as a result of the economic downturn and a rebalancing between housing supply and demand - impacting growth through lower mortgage interest income growth.

According to analysis by Dr Brendan Rynne, KPMG Australia’s chief economist, the outlook for the banking industry doesn’t support a rapid return to bank profit growth. The economy-wide outlook is for GDP to decrease by 4.2 percent over 2020 (compared to 2019) and for unemployment to average 7.2 percent during the year, which suggests that Australia will be grappling with the impacts of the global COVID-19 pandemic for at least another 12 months. In response, the RBA is expected to keep interest rates at their current low levels for a prolonged period – and the same is true for central banks in the rest of the world. Another major driver for Australia’s economic performance, and the housing market, is immigration - and Dr Rynne expects net migration to fall by around 70-75,000 persons during FY20.

In this new reality, Australian banks require a hard reset to adapt to the conditions they are facing. Beyond recovery from the initial shock from the COVID-19 crisis, the banks need to transform their expectations regarding profit and growth, as well as their strategies. We provide our view on the new reality reset across three connected areas: capital returns, costs and revenue.
Capital returns

Capital returns for the Australian banking industry will be lower than what investors have become accustomed to. This is a major issue, as many institutional investors (and the millions of superannuation savers on whose behalf they act) and retail investors (including self-funded retirees) rely on the banks to provide a significant yield and dividend performance contribution within their investment portfolios. The reset requires the banks to:

- Manage investor expectations around future ROE performance (compare 1H20 major bank ROE of 6.4%, including COVID-19 response impacts, to their average ROE of 13.6% in the period between FY14-19);

- Adjust dividend payout ratios from their long-run average (compare 1H20 major bank payout of 35%, including the deferral of dividend payments by some as a direct result of the uncertainty caused by the COVID-19 crisis, to an average payout of 78% in the period between FY14-19); and

- Reduce capital investment spend, especially as many post-Royal Commission risk and remediation programs are completed (between 2H18 and 1H20, the share of Risk & Compliance investment spend for the major banks grew from 38% to 51%).

The majors’ payout ratio will continue to be lower in the new reality
Costs

Following the example of overseas banks, such as those in the UK, the banks will need to target a step-change improvement in productivity. In the last year, the cost-to-income ratio for the major banks deteriorated significantly to 55 percent, coming from a FY14-19 average of 46 percent. As they enter a period of lower income growth, the banks will need to reduce their cost bases in absolute terms in order to manage their profitability. Incremental productivity improvements aside, the banks should consider further simplification and major cost levers, including:

- Further divestments of non-core businesses (beyond wexit), including for instance international subsidiaries / branches and infrastructure assets such as ATM networks and payment switches;
- Reduction of operating model complexity to increase end-to-end management of value chains, and promote greater cost focus and accountability;
- Application of ‘zero based budgeting’ to head office organisations, to align the cost base with those (and only those) activities that are either required or strategically important;
- Significant product and systems simplification and rationalisation, including customer migration from and permanent closure of backbook products and the associated decommissioning of aged systems and applications;
- Acceleration of branch footprint reductions, to bring branch numbers, opening hours and formats / staffing in line with current customer needs and behaviour;
- Greater focus on digital origination and customer self-service, better aligning with customers’ needs and preferences and reducing the cost to serve; and
- Further automation and digitisation of their workflow and processes, in order to reduce manual intervention and improve efficiency.
Finally, Australian banks will need to look at diversifying their revenue base as mortgage interest income and mortgage NIMs are no longer able to underpin (lending) revenue growth. In order to make sure that this objective is in line with the bank simplification agenda that is needed, revenue growth will (predominantly) come from existing customer segments. Also, the banks will not be able to reverse the relatively recent removal of fees for non-value adding activities (e.g. account keeping fees, ATM withdrawal fees). Therefore, some of the potential revenue growth options will require creativity and innovation:

- Re-balancing their activities and income, as some activities continue to offer growth potential for (non-interest) income. This will be more feasible for diversified banks, and less for highly focused retail banks;
- Development and monetisation of a deeper and wider range of value-added services, including potentially data driven insights to retail, business and institutional customers (facilitated by the introduction of the Open Banking regime) but also for instance robo advice to the mass market; and
- Product innovation to better cater to changing customer needs, including for instance the development of new unsecured payment and credit offers as some customer segments eschew credit cards and personal loans and prefer Buy-Now-Pay-Later options.

**NIM and interest income are lower in a low interest rate environment, as demonstrated by the majors’ recent results**
Conclusion

In conclusion, Australian banks are facing a serious challenge to their profitability and growth performance. As there are no easy choices available in the new reality as the world continues to deal with the COVID-19 crisis and its aftermath, this means that tough decisions will need to be made. Our banks will need to transform how they deal with their capital returns (and investor expectations), with their productivity and with revenue growth. These step changes will bring them more in line with leading banks globally, which have been facing serious headwinds since the GFC.
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