Banking Agenda: Challenging times

Australian major banks’ half year results 2015

May 2015
The strength of the Australian banking sector continues to be tested by local and international influences.

The Australian economy is in transition, with modest consumer and business confidence, record low interest rates, government fiscal constraints, and the majority of credit flows to real estate and construction rather than to the broader economy.

Australian banks are also managing the continued impacts of an uncertain global economy, falling commodity prices and imminent potential changes to the capital requirements of banks. In economies still struggling to rebuild after the Financial Crisis, central bankers are doing what they can to stimulate consumer and business confidence as the traditional levers are unavailable due to political gridlocks or current fiscal positions. Just this week, the RBA announced that the cash rate would be reduced to 2.0%, a record low.

All of these factors have certainly given Australian bank Directors and Executive teams a full agenda to manage. In the face of these challenges, the majors on the whole have continued to deliver solid financial results, with headline cash earnings of $15.4bn reflecting an increase of $692m from the comparative period.

Growth in net interest income has been achieved off the back of modest loan growth. This has been somewhat mitigated by net interest margins contracting. We are also seeing some early signs that the growth fuelled by the mortgage sector is tapering. As loan amortisation rates accelerate, banks have a major imperative to retain customers by improving the customer experience. The pressure to adhere to credit quality, from both within institutions and from regulators, may be starting to kick in.

The issue of conduct risk remains front and centre. Recent disclosures by some of the major banks, and the focus of parliamentary forums, has again turned the spotlight on governance and conduct in wealth and financial planning organisations, particularly those under the control of the major banks.

To monetise their investments in vertically integrated operating models, the majors will have to considerably enhance governance, risk and controls to win back consumer trust.

Conceptually, work on the capital agenda – whether based on ‘unquestionably strong’ or ‘Basel 4’ – is coming to a close. But the implications associated with proposed changes remain an area of material uncertainty for the major banks.

Looking ahead, the majors face a number of challenges that will put pressure on earnings, see jaws contract and capital become even more important.

Figures throughout this report are calculated on the prior corresponding period unless otherwise stated.
The conduct and culture of major financial institutions has remained in the spotlight with recent Parliamentary Joint Committee and Senate Inquiries into financial advice, ASIC performance and professional, ethical and education standards. These reviews have been conducted alongside the Financial System Inquiry (FSI)'s final report, and the Trowbridge report into Retail Life Insurance advice.

Although the industry is responding to these reviews with transformational initiatives, ongoing scrutiny of wealth management operations is likely.

In this context, managing conflicts in vertically integrated operations, professional standards and disclosure adequacy will be continuing areas of focus. With ASIC due to issue another report in the second half of 2015 and pending Government responses to the FSI and current Senate Inquiries, further reforms are expected.

That said, we consider any ‘structural’ separation of vertically integrated business models unlikely. Such models are used extensively in the Australian financial services market by both aligned and independent banking, asset manager, superannuation, insurance, platform, research house, asset consultant and advice providers.

Despite this, we believe ongoing interrogation of business model integrity, more transparent disclosure of key business practices and ‘restricted labelling’ arrangements are distinct possibilities. As well as recognising the inherent frailties of the disclosure regime, these approaches are likely to focus on helping consumers to genuinely understand potential conflicts and product and service limitations, and to better ‘vote with their feet’.

In response, financial institutions will need to continue to make cultural improvements and strengthen their preventative risk management capabilities, including by using more robust data analytics tools. They will also need to appropriately align product monitoring, advice and distribution activities to minimise the possibility of future consumer detriment.

Such responses are not only about complying with advice and product suitability reform recommendations. The industry is seeking to demonstrate its capacity for self-regulation to avoid the reputation and financial impacts of remediation and regulator intervention.

To this point, APRA’s suggestion that it might introduce additional capital charges where operational risk failings linked to wealth management signify the potential for broader deficiencies, is significant. Such statements are adding further impetus to transformation initiatives.

Conduct issues are not the sole preserve of retail markets, as demonstrated by ASIC’s continuing investigations into the potential for bank bill swap rate manipulation in wholesale markets.

Australian banks have been insulated from the scale of overseas scandals. But recent inquiries, and the resulting loss of consumer trust, have again raised the spectre of damage to the local sector’s social licence to operate. We view this ‘trust deficit’ as particularly significant in light of changing consumer preferences and empowerment, digital disruption and the possibility of alternative market competitors.

In response to these challenges, we believe financial institutions need to prioritise three interrelated customer experience and risk transformation initiatives:

1. Enhancing customer safety and promoting actions in the customer’s best interest, via strengthened conduct, culture and preventative risk management frameworks.
2. Promoting enhanced buy in to products and services, via tailored, integrity-driven business models, delivered by multi-channels over any device.
3. Promoting enhanced buy in to the organisation, via strong leadership and operations that make positive contributions to their communities.

We believe these initiatives are central to regaining the trust of consumers, which is vital for future success in financial services.
Net interest margin (NIM)

NIM continues to contract, falling by between 2 and 11 basis points compared with 12 months ago. This generally reflects lower margins on lending, due to price competition for growth, and the higher costs of holding more liquid assets, due to new liquidity requirements partly offset by lower funding costs.

In an environment of continuing intense price competition, and a prolonged low official cash rate, margin on residential lending remains under pressure.

APRA is focussing on portfolio elements it considers to be higher risk. This is evident though APRA’s Prudential Practice Guide APG 223 Residential Mortgage Lending as well as its December 2014 letter to Authorised Deposit-taking Institutions (ADIs). In relation to investment home loans, the letter indicated that, “annual investor credit growth materially above a benchmark of 10% will be an important risk indicator that supervisors will take into account when reviewing ADIs’ residential mortgage risk profile.”

Although largely flat and priced competitively, business and institutional lending is an area of potential growth that may help to relieve margin pressure. However, this will depend on business confidence and the overall health of the economy.

On the liability side, price pressure has continued to ease on retail deposits; while wholesale funding costs remained favourable compared to prior periods. This provided some relief to ongoing margin pressure on the asset side of the balance sheet.
Wealth operations

The banks’ Wealth Management businesses are still under pressure. The impact of conduct risk is high and will continue to be significant as banks incur the costs of safeguarding against future issues and rebuilding trust. Technology enablement remains on the agenda as the banks’ Wealth Management businesses look to ‘own’ the customer and provide better, more efficient service.

Nonetheless, underlying businesses continue to improve. Net cash inflows have increased year-on-year for wealth businesses, particularly from superannuation. This, coupled with positive investment markets, has given Wealth Management fees an appreciable uplift year-on-year.

Additionally, the head winds battering life insurance businesses over the last few reporting periods are now better understood and claims management processes are more robust. The claims experience, particularly for income protection and group risk, has improved and is now tracking to expectations.

These positive developments aside, Wealth Management businesses continue to be capital intensive and returns on equity are still challenging. Although Australian wealth management is expected to double in size over the next 10 years, the debate continues over whether vertically integrated models are appropriate for banks.
Increasing importance of social media

Australia’s banking sector is leading the way in digital, with smartphones and social media revolutionising the way banking customers source information, make decisions and interact with providers. The sector’s success in moving the vast majority of customer interactions online – while still offering offline channels – has reduced costs as well as significantly improving customer convenience and service.

Under pressure from disruptive forces and unprecedented competition – and in the face of growing consumer expectations driven by global entertainment experiences – banks can’t afford to lose momentum.

Social media is still an emerging channel, but it is creating significant opportunities within the banking sector. According to EY Sweeney’s Digital State of the Nation report, social media represents one of Australia’s most popular regular online activities. The consumer survey commissioned for EY’s recent Digital Australia: State of the Nation 2014 report, found that more than two-thirds of Australians access various social media platforms at least once a week, with 62% of those surveyed using Facebook daily.

In line with these findings, interactions across the major retail banks’ social media channels are growing at more than 150% per annum – predominantly across Facebook, Twitter, LinkedIn and blogs and community sites. But, as interaction volumes grow, so do customer expectations.

In 2015, we see significant opportunities to get better returns from the ongoing banking investment in social media. The biggest wins will come from activating social as a mainstream channel and integrating it into the broader banking distribution strategy. Social is critical to providing a truly engaging, multi-channel, multi-device customer experience with a reduced cost to serve. Banks can also make better use of customer data from social media channels to improve data quality and insight. These insights will help banks to build customer engagement, resulting in increased customer satisfaction, retention and cross sales and upsales.
Cost to income

Operational efficiency is contributing significantly to solid profitability in the majors, relative to the international banks.

Over the last six months, banking jaws narrowed. For some institutions, this trended negative for the first time in many reporting periods, primarily driven by payroll, technology and compliance costs, exacerbated by contracting net interest margins and growth volumes.

During this period, cost to income ratios remained relatively flat. The banks’ aspiration to drive well below the ‘glass floor’ of 40% is not proving to be easy — particularly if the aim is sustainability.

Early efforts to drive costs down focused on labour arbitrage and outsourcing. Over the short to medium term, further efficiency gains will depend on banks’ ability to efficiently utilise technology, including digitising manual processes.

Over recent years, many of the banks have increased their technology spend. However, of the majors, only two are in the process of extracting benefits from re-platforming new core banking systems. The remainder continue to make tactical IT investments in their legacy systems.

In future, core systems replacement will deliver benefits to the consumer and enable banks to meet and satisfy regulators’ demands for more granular data and stress testing of portfolios. Most importantly, the new infrastructure will be agile, enabling system enhancements and adaptations to be implemented quickly and easily.

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1 The NAB cost to income ratio and JAWS calculation has been adjusted for specific items as per results announcement on October 30 2014
Increasing focus on productivity

Low growth and concerns around the potential revenue at risk due to fintech disrupters are forcing Australian banks to focus on productivity. This is leading to significant investments in technology to address changing customer habits and defend against digital disruption.

Consistent with their global peers, Australian banks are investing significant incremental funds in technology to reshape the customer experience to meet changing consumer expectations. Investment in areas such as branch networks, real-time services, and the ability to better manage and leverage insights from customer data, will continue.

Realising the benefits from this major investment in customer experience will be critical to protect revenue streams against fintech disruptors. Disruption will accelerate in payments and lending, where the banks may need to collaborate with digital disruptors to retain market share.

In a period of lower than historic trend growth, the banks must protect shareholder returns while also funding significant ongoing technology investment. This will necessitate robust investment prioritisation decisions and a greater focus on benefits realisation. The majors need to reduce “run the bank” technology costs and continue to transform their operations.

This will require further digitisation and automation of key processes. In doing so, banks will increasingly need to consider the relative benefits of lean reengineering, Business Process Management, core systems investment and lower cost automation solutions such as robotics software.

The banks are likely to seek additional efficiencies by increasing outsourcing and offshoring. Be that as it may, the actual numbers of offshore resources are unlikely to increase as banks demand greater efficiencies in their third party and captive offshore resource base. We also expect the banks to continue to explore the benefits of cross-industry utilities for activities that do not create competitive advantage.

This overall environment requires much greater focus by the banks on their workforce just to maintain, let alone improve, their engagement and productivity. Existing employees are increasingly uncertain of the impact of greater technology investment on their existing roles.

The pace of technological change is making it increasingly difficult to predict what skills will be needed to drive future growth in productivity and innovation. Banks need to define the workforce of the future, taking into account the different needs and wants of a multi-generational workforce. Technological change means banks will need fewer employees. They will have to carefully consider the right balance between delivering returns to shareholders and their obligations to society.

“33% of Australians believe their role is unlikely to exist in 20 years’ time due to emerging digital technologies and automation”

Source: EY Productivity Pulse™, September 2014
Capital management

Capital management and return on equity continue to be areas of significant focus for ADIs, regulators and commentators, both domestically and at a global level.

On average ROE declined by 37 bps over the last 12 months and even though the major Australian banks continue to deliver relatively better ROE than their international peers, continuing to optimise capital to fund growth remains imperative. The extent and term over which current low credit losses continue will also have a bearing on capital in the future.

The Tier 1 Capital ratios of majors remain healthy, ranging between 10.3% and 11.6%, with a marginal strengthening over the last 12 months. Despite this strong capital position, the capital outlook remains uncertain from a regulatory perspective – both domestically as the sector waits for the Government’s response to the FSI’s recommendations and internationally through Basel 4.

The FSI recommended narrowing the mortgage risk weight differential between Standardised and Advanced banks. Basel 4 consultation focusses on capital floors and calibration to standardised methods, levelling the playing field between standardised banks and advanced accredited banks. APRA will need to come up with new capital requirements that reduce the risk of standardisation in capital and risk measurement, while adequately taking into account the FSI’s recommendations and Basel Committee on Banking Supervision consultations.
Asset quality

Low, bad and doubtful debt charges continue to buoy the sector’s results, with continued improvements in asset quality across all of the majors – well beyond expectations. Although the benefit to underlying performance is welcome, this is not sustainable in the long term. Banks cannot base their strategies on the positive impact of asset quality as a substitute for credit growth on bottom line results.

Without a marked rise in credit demand in the corporate sector, the race for growth seems to hinge on gaining market share. Regulators are concerned that banks will lower credit writing standards to support the increase in institutional lending volumes. This has been echoed in the focus on mortgage serviceability and responsible lending by regulators. With APRA broaching the idea of capital penalties for accelerated growth in certain mortgage products, it’s hard to see where growth will come from.

Housing lending volumes continue to grow on the back of historically high housing prices in NSW and Victoria – afforded with assistance from historically low interest rates. The potential for this housing bubble to burst is real. Significant declines in commodity prices and the knock on impact on mining and mining services enterprises, minimal inflation and rising unemployment make it all the more likely. If both interest rates and unemployment rise, credit quality may well change dramatically.

If the bubble does burst, the change in banks’ loan loss profiles could be marked. The new impairment requirements under AASB 9 – Financial Instruments will bring this into even sharper focus, with loan loss provisions based on ‘expected’ rather than ‘incurred’ losses. This will bring forward the impact of future credit losses driven by the expected change in macroeconomic factors. The current predictions of future credit deterioration will be taken into account in the balance sheet provisions today, generating a quite different performance outcome.

The need to track the next areas of emerging market pressure and potential credit loss will be critical to assessing credit quality under AASB 9 as well as in response to the anticipated change in the credit cycle. In the banks’ race for growth, it will be challenging to maintain credit standards and sustain an appropriate risk appetite while simultaneously growing above system.

With serviceability and responsible lending being added to more traditional growth and profit metrics, banking is entering a brave new world.
Asset quality (continued)

Aggregate Impairment ($m) vs Total Provisions ($m)

Specific Provisions ($m)

Collective Provisions ($m)

Impairment Charges (Statutory) ($m)
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