Australian major banks’ half year results 2019

Turbulent start to the year hits big banks’ profits

Overview

Combined statutory profit: $13.9 bn  Decrease of 11.8% (total of all four major banks)

Net interest margin: 1.95%  Decrease of 11 basis points

Cost to income: 47.8 %  Increase of 230 basis points

Note:

► Figures throughout this report are calculated on the prior corresponding period unless otherwise stated.

► ANZ, NAB and Westpac’s full year reporting periods ended on 31 March 2019. CBA’s full year reporting period ended on 31 December 2018.

► Unless otherwise specified, references to the major banks in this publication refer to the ‘big four’ Australian banks: ANZ, CBA, NAB and Westpac.

It’s been a turbulent half year for the Australian banking sector, challenged by contracting loan growth, growing customer remediation programs and the delivery of the Financial Services Royal Commission outcomes. The major banks have embarked on the long journey of rebuilding trust and addressing misconduct, with emboldened regulators. Add a flagging economy and increased competition, and the growth outlook for the major banks looks increasingly uncertain. The combined impact of these headwinds is evident in the major banks’ half year 2019 results, with remediation costs a significant drag on profits.
Major banks’ strategic refocus

The Royal Commission has disrupted the banks’ risk appetites and business flows, forcing them to revisit their strategic priorities. The number one priority is to address compliance obligations, as the majors prepare for more intensive levels of regulatory supervision and enforcement from APRA, ASIC and AUSTRAC. Other priorities will include:

► Changing the existing production line for retail credit distribution by simplifying and re-balancing portfolios, and re-engineering processes to improve efficiencies in the front-book.

► Accelerating the use of technology to optimise costs in both the front and back office.

What are the strategic priorities for the major banks?

1. Prepare for more intensive supervision and enforcement, as APRA and ASIC are transformed into more accountable, collaborative and responsive institutions
2. Simplification of product portfolios and reengineering of processes to drive future growth
3. Accelerate the use of technology to optimise costs
4. Continue driving strategies in remediation, culture, governance and remuneration and broker model to address the key recommendations of the Royal Commission
Australian economic outlook

After 28 years of uninterrupted economic growth, Australia's economy has lost considerable momentum. In annualised terms, economic growth collapsed from 3.9% in 1H2018 to just 0.8% in 2H2018. The economy's 2.3% year-on-year growth rate is now below that required to generate lower unemployment and higher inflation. At the same time, the global economy has also weakened, with several central banks taking a more dove-like tone.

Importantly, the slowdown predominantly reflects a softening housing market (particularly in Sydney and Melbourne) and fragile consumer confidence. Consumption growth has moderated to 2.0% from 2.8% a year ago. And the headwinds are mounting as low-saving households face anaemic wage growth, record-high debt closing in on 200% of disposable income, a record portion of budgets being taken up by non-discretionary spending1 - and, now, falling housing prices. Bipartisan income tax cuts may provide some support over the second half of 2019, unless households pay off debt rather than spend the additional income.

This downturn in the housing cycle is difficult to analyse because it was triggered by a contraction in the availability of credit rather than a rise in the cost of credit. Nationwide (combined capital cities), house prices have fallen 8.4% over the year to April 2019, but performance has been varied across the nation with larger falls in Sydney and Melbourne. Leading indicators suggest further weakness is to come.

While banks have already acted to improve lending standards in the interests of the customer, an outcome has been that accessing credit is more onerous and takes longer - and maximum borrowing capacity is lower. Unfortunately for the majors, expectations of further price falls have dampened demand. The slowdown in housing prices and credit tightening are also hampering lending to small businesses and residential developers.

Yet, housing prices do not fall forever. While this cycle is longer and deeper than most, supply and demand do adjust. We've already seen a considerable drop off in property listings, suggesting that supply is contracting. Improved affordability will eventually support demand. Encouragingly, the number of home loans for First Home Buyers, and their average size, rose in February. A turn in the ‘credit impulse’ (the credit rate of change) would be an encouraging sign that the housing slump is coming to an end (see Figure 1).

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1 Essential services include the following spending categories from ABS: healthcare services; water and sewerage services; electricity, gas and other fuel; communication services; education; insurance and other financial services.
The residential construction cycle has also suffered from falling housing prices and tighter credit conditions. Construction peaked a little earlier than expected, and leading indicators suggest further weakness ahead (see Figure 2). The solid pipeline of work in progress will sustain the level of residential construction for the rest of this year, particularly in Sydney and Melbourne. But construction activity looks set to weaken considerably in 2020.

Source: ABS, RBA, EY

The labour market has remained solid, with the unemployment rate at just 4.9%. How jobs growth fares in coming months will be important, as job security alters how households respond to falling housing prices.

It seems inevitable that we’re in for a period of slower economic growth. For Australia's banks, this will present an ongoing challenge, especially if households look to deleverage.
Revenue under pressure

For the majors, the rate of growth in housing lending has slowed, reflecting tightened responsible lending and verification criteria, and strengthening capital requirements.

System mortgage credit growth continues to slide, falling from 6.1% to 4.0% over the 12 months to March 2019. Growth in the higher margin investor segment has fallen to less than 1% over the same period.

In this environment, competition for housing loans among the majors remains intense. Added competition is coming from second-tier banks, benefiting from the majors’ tarnished brands. Non-banks are also growing their housing loan books, with borrowers seemingly attracted by faster approval times and the perception that obtaining finance with the majors is now more difficult.

Repricing should have supported net interest margin (NIM) for the majors in 1H2019. However, a combination of aggressive front book pricing and a decline in higher margin lending saw a decline in average NIM across the banks.

Figure 3: Net interest margin (cash basis)

Average return on equity (ROE) on a cash basis has declined despite improvements in cash earnings for most of the majors. Growing compliance and regulatory costs, and increased technology spend may further impact this figure lending or the full year 2019, placing further focus on the need to achieve operating cost efficiencies during 2H2019.

Figure 4: Return on equity (cash basis)

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With the fall in house prices leading some borrowers into negative equity territory, and high debt-to-income ratios, more and more households are facing mortgage stress\(^3\). RBA data saw the household debt-to-income ratios rising to 189.6 in December 2018, with the housing debt-to-income ratio for owner-occupiers hitting a new record of 140.2\(^4\). Data on housing price movements suggests only 2.75% of loans are in negative equity by value despite significant housing price declines\(^5\), but further falls in house prices may see this figure rise.

Business credit growth showed mixed results in 1H2019. Factors constraining growth include the banks’ retreat from higher risk lending (e.g. property developments), tighter criteria for SME lending, falling house prices (given SME lending is often secured by the business owner’s house) and competition.

**Remediation costs rising**

Growing remediation costs reached $1.9bn across the four banks in the first half, crimping profits. Overall remediation costs hit $4.8bn over the last year and half, driven by misconduct issues in wealth management. This has been far greater than the initial estimates by the majors and is not the end of the road. On-going investigation into product design and compliance will likely further increase the banks’ remediation burden, putting cost to income ratios under renewed pressure.

**Operating costs well managed**

Operating costs declined in 1H2019 for most of the majors, supported in part by continued strong management of underlying costs by the banks. However, the combination of slowing revenue and higher remediation costs saw cost to income ratios rise for most of the majors\(^6\).

With earnings growth and margins under pressure, reducing costs and increasing productivity is imperative for the banks as a future growth driver. The banks continue efforts to tighten their cost bases and increase efficiencies by focussing on simplification of their businesses and reengineering front book processes. They are working hard to balance the need to invest in advanced technology (with the associated cost of change and deployment), and rising regulatory and compliance costs.

Technology spend on IT systems, processes and specialist resources will continue to increase as banks further simplify products and reduce branch footprints in favour of customer-centric digital platforms. This is where the future of long-term growth lies.

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\(^3\) Households are defined as ‘stressed’ when net income (or cash flow) does not cover ongoing costs. They may or may not have access to other available assets, and some have paid ahead. But households in mild stress have little leeway in their cash flows. Whereas, those in severe stress are unable to meet repayments from current income. In both cases, households manage this deficit by cutting back on spending, putting more on credit cards and seeking to refinance, restructure or sell their home. Those in severe stress are more likely to be seeking hardship assistance and are often forced to sell.


\(^6\) The cost to income ratio is calculated by EY as operating expense (statutory) over operating income (statutory). The cost to income ratio reported by the major banks is typically on a cash basis.
Asset quality under pressure

Bad and doubtful debt charges remain at historic lows. However, a number of factors are driving concerns over the mortgage book, such as rising probability of default (driven by an increase in loans 90-plus days past due) and back book exposure. This has contributed to a rise in total provisions.

Figure 6: Bad and doubtful debt charges

Non-performing mortgages remain well secured, but some past-due housing loans could become impaired if housing values continue to fall. Further risks will emerge as interest-only loan periods expire and borrowers struggle with higher repayments. The proportion of impaired housing loans is very low, at 0.2% of all residential mortgages. While the RBA believes borrowers will be able to manage higher payments, this may not be the case if the economy slows and unemployment rises.

Funding drivers

In Australia, APRA’s funding requirements have left CET1 ratios above the APRA benchmark of 10.5% using current risk weights, with the majors switching to more liquid assets. As a result, ROE has stabilised over 1H19. For the majority of the majors, having met the increased funding requirements in the latter half of 2018, wholesale funding costs have declined in 1H2019 from their peak in January 2019.

In New Zealand, headwinds continue with the draft RBNZ proposal to increase capital requirements likely to lead to further front book re-balancing through loan and deposit repricing, if risk-adjusted returns are insufficient to meet growth.

7 Source: Bloomberg, RBA
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