Perspectives

Major banks analysis

May 2008

Charting a course through the storm

Six months ago, as the US subprime crisis had begun to roll through international markets, we saw Australian banks as sturdy ships in rough waters. The latest interim profit announcements have confirmed that view. Even as international conditions deteriorated markedly and an equity market rout added to the financial sector's woes, Australia's five major banks have navigated their way through the waves and presented creditable results. In aggregate, their combined underlying cash earnings grew in 1H08 by 2.8% over the same period last year.

Certainly compared to their international peers – many of whom reported significant losses – the Australian majors performed solidly. They avoided the toxic waste of subprime loans and related investments, and were aided by a relatively buoyant economy.

The highlight of their result was volumes in both lending and deposits. They benefited from a 'flight to quality' as the headwinds battered some of their domestic competition, in particular the non–bank financial institutions (NBFIs).

Nonetheless the extraordinary financial disruption has not left our majors unscathed. Net interest margins have been compressed a further 7bps on average during the half, reflecting primarily the banks' increased funding costs and their retention of higher levels of low–yielding liquid assets.

This is despite the five majors increasing housing loan interest rates by between 30 – 40bps above the official cash rate since the turn of the year. While this has not compensated them entirely for their increased cost of funds, it has been enough to spark public rumblings reminiscent of the bad old bank bashing days. Maintaining the hard won gains in customer satisfaction and trust will be a major challenge in the immediate future.

This is at a time when the demand for credit is softening, putting further pressure on lending–related income. Plus the long predicted uptick in credit losses has now commenced. The market turmoil caused the uptick to be more pronounced than pre–crunch expectations, with the majors' bad debt expenses more than doubling.

So the short–term outlook for the majors will remain challenging. With revenues under pressure they will need to rein in costs and keep bad debt expenses under control.

It is, however, an open question whether the current turbulent conditions will turn out to be a net benefit or a net liability for the majors. On the benefit side of the equation lies the weaker competitive environment. The majors have experienced recent market share gains and for the immediate future, the weakness in the non–bank lending market will limit consumer choice. Once conditions settle down, however, we would expect to see a new wave of industry innovation to challenge the banks position.

Also on the bank's side are early signs of recovery in the wholesale funding market. As the banks continue to re–price upwards their lending books, and the cost of funding comes down, there is some potential upside for banks' margins for the first time in a long time.

Meanwhile, there are suggestions that the reports of the death of the US economy may be premature. Further, we are generally optimistic that the impact of China and India's rapid urbanisation will continue to place some floor under Australian economic growth for the foreseeable future.

In addition, the banks have been provided with a cushion from conditions in the form of $1.2 billion in one–off gains from the Visa IPO. This will allow them more strategic flexibility than we might otherwise expect at this stage in the cycle, and will provide them with options other than cutting investment which might threaten future earnings growth. A number of the banks have flagged the use of these one–off gains to reinvest in the business, including some significant back–office and systems transformations.

The PwC Banking Gauge predicts that the major banks' FY08 cash earnings will be up 4.3% on FY07, and will then grow 8.8% in FY09. We should note, however, that the range of forecasts across the analysts comprising the PwC Banking Gauge is quite wide. Uncertainty and volatility are likely to remain for some time.

We suspect the banks' current balance sheet strength may enable them to take advantage of any acquisition opportunities. With a change in leadership at three out of the five major banks, not to mention a new Government hitting its stride in Canberra, the next six months are set to be fascinating.

Note: the PwC Banking Gauge is a consensus view across the five banks and across five of Australia's leading banking analysts – Ben Zucker (Macquarie), Brian Johnson (JPMorgan), Jeff Emmanuel (UBS), Matthew Davison (Merrill Lynch) and Nick Selvaratnam (Credit Suisse).

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Net Interest Income

NII boosted as volumes up

Total net interest income across the five majors for the first half was $17.6 billion, an increase of 10.0% over the same period last year. This was delivered despite significant increases in funding costs, and reflects growth in volumes in both lending and deposit markets.

There are now signs that demand for lending is slowing as rising interest rates and concerns about the economy trigger a moderation in consumer and business confidence. On the other hand, the majors are expected to benefit from the 'flight to quality' as alternative institutions, until recently strong competitors, struggle in the more challenging funding conditions.

Market by market

Housing : The flight to quality has been evidenced in real gains to the majors of 106bps in market share for 1H08, to 65.4% at March 2008. Indeed the banks are now providing over 90% of the system credit growth in mortgages. This is despite home loan interest rate increases in excess of the official cash rate. The majors and some foreign banks have gained primarily at the expense of the NBFIs and other smaller institutions that relied heavily on the securitisation market to fund their mortgage businesses.

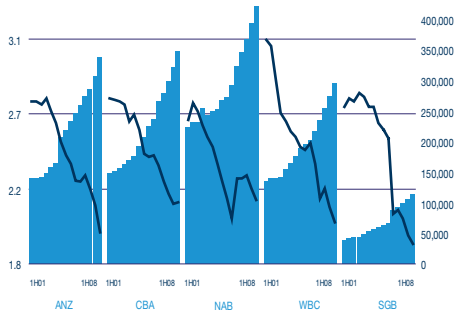
Unlike the US and the UK, where house prices have come off significantly in the last 12 months, the Australian housing market has remained mostly firm. However, overall housing loan systems growth continues to moderate, slowing to 11.2%pa from a peak of 22.0%pa in 2004. The downward trend looks set to continue, with housing loan approvals falling by 5.9% in February, the biggest fall for nearly 4 years as interest rate rises bite and affordability becomes an increasing barrier to owning a home.

According to JP Morgan & Fujitsu Consulting, origination by brokers appears to have capped out at 38%, and has declined subsequent to the onset of the credit crunch. There is an open question as to whether the brokers' influence will continue at this level. On the positive side for the brokers, much of the growth in housing loans is expected to be driven by refinancing, and consumers generally go to brokers when looking for a better deal. However, in the current environment the majors are taking the opportunity to revamp broker commission arrangements and, as a minimum, reduce their origination costs.

Personal lending : Personal lending is the weakest sector of the credit markets. Total personal loan growth was 9.8%pa with negative growth being recorded in the first calendar quarter of 2008. Credit card outstanding balances, which represent approximately 30% of total personal loans have continued to grow, at around 10.2%pa in 1H08. The majors lost 21bps of market share, down to 63.9% at March 2008, due mainly to BankWest and Citigroup's targeted pricing and promotions in this segment.

Business lending : Throughout the half, business lending continued to grow strongly at 21.4% pa down slightly from its peak of 24.1%pa in December 2007. However there has been a marked slow down in growth between December 2007 and March 2008, to 10.8%pa. With the banks raising interest rates on business loans and rationing some credit, plus the generally softening economic conditions, business confidence has dipped and system credit growth is now expected to remain in the 10–12% range for the second half.

Interest margins and gross loans & acceptances



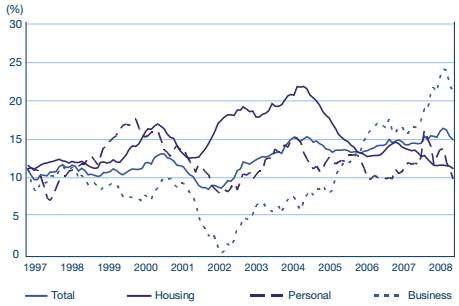
Note: Historical data based on AGAAP. 2006, 2007 and 2008 based on AIFRS.

Deposits : Household deposits have grown by 13.3%pa in 1H08, up from 12.6%pa for the prior year, as consumer preference moves away from investing in equities. But having gained 50bps in market share in 2H07, the majors failed to consolidate this advantage, losing 24bps in market share between September and December 2007 with all the gains going to regional banks with aggressive rates.

Into the new year, however, the majors increased rates partly reflecting the importance of deposits to the banks' overall funding strategy. Consequently they regained 18bps in market share in 2Q08 mainly at the expense of the foreign banks. They finished with a market share of 77.8% at March 2008.

Business deposits showed a much stronger picture for the majors, with overall deposits growing at 11.7%pa in 1H08. The major banks gained 55bps in market share, which reached 76% at March 2008, winning share from many of the smaller foreign banks, with the likes of Citigroup losing 74bps, reflecting the uncertainty around foreign institutions caught up in the US subprime market fallout.

Domestic Credit Growth (Annual % growth)



Interest margins

Margins continued their downward slide by 7bps from a weighted average of 2.16% in 2H08 to 2.09% for 1H08.

Last year the banks' margins were under pressure from greater competition primarily from the NBFIs and foreign banks. This competition has fallen away with the turmoil in the credit markets, but new factors have put significant pressure on banks margins in this latest half:

- Increased funding costs contributed approximately 4bps on average to the decline. As we discuss in more detail later, both short term and long term debt spreads ballooned during the period. Consequently the banks' cost of funds increased markedly and they were not fully passed on to the banks' borrowers.
- Increased holdings by the banks of low margin liquid assets contributed a further 4bps to the decline. The banks will continue to hold elevated levels of liquid assets while the markets remain so volatile.

Liquidity, funding and capital management will remain a focal point for some time. Banks will be carefully managing what they need and when. The banks' ability to manage margins will be directly impacted by both their current funding maturity profile and deposit/wholesale funding mix. Undoubtedly, as the back–book of funding is replaced there will be some further pressure on margins in the short–term.

But in the longer–term, it would appear that, for the first time in recent history, there may be some potential upside for the banks' margins. Banks are likely to continue to re–price the risk in their lending books (ie increase rates) at the same time that the cost of their wholesale funding is eventually and slowly reined in. Plus as confidence returns to the market they will release some of the holdings in liquid assets. It may not happen swiftly but it will be interesting to monitor.

Other Operating Income

Other operating income was up 6.3% on 1H07 and now represents 36% of total income, down from 37% in 1H07. This excludes one–off gains of $1.2 billion related to the Visa IPO.

Bank fees

Income from fees – which comprise lending fees 27% and other fees and commissions 73% – rose by 10.8% in 1H08 over the prior comparative period. The increase has been driven by the ongoing growth in volumes across all portfolios, as well as brokerage, transaction accounts and merchant services.

There are, however, some genuine question marks over the continued growth in these fees as certain components are the focus of much attention from the Government – see Focus on Fees below. The challenge for the banks will be to reform fees in line with community and Government expectations while continuing to grow the fee line.

Trading income

Trading income was a highlight for the banks in 1H08. It grew by 24.4% over the prior period comparative to $1.3 billion.

By its nature trading income is driven by risk and volatility. In the current financial climate the banks have been entering into a much higher volume of trades as customers seek to manage their interest rate and currency risks. How long this will last is clearly uncertain, but the markets are likely to remain volatile through the second half, and the banks will make hay while the sun continues to shine (in this regard!).

Wealth management

Overall, the banks' wealth management businesses posted strong results for the half, with underlying cash earnings (income less operating expenses and tax) up 16.0% on 1H07. However, it was a story of a positive first quarter and a flat second quarter.

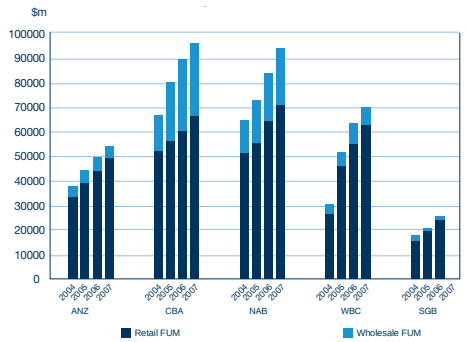
In the period October to December 2007, the business momentum continued to be supported by the 2007 changes to voluntary superannuation and strong equity markets.

However, the subsequent equity market collapse – wiping 15% off the ASX 200 in the first three months of 2008 – caused earnings growth to stall. The reduced income due to lower returns on capital invested and reduced funds under management / administration contributed to the flat cash earnings growth for 1H08 in comparison to 2H07, up only 1.0% across the banks.

The wealth management industry is entering a new phase: "tail winds" have been replaced with "head winds". Continued inflows from superannuation may help some managers to maintain positive net inflows (sales less redemptions), but negative investment returns will cause margin pressure and may see many investors either moving between fund managers or exiting the market altogether. Fund administrators should fair better as investors can move between asset managers without leaving the platform.

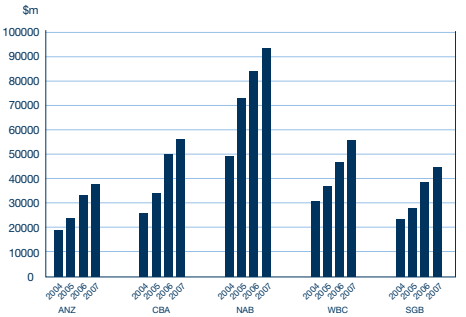
The banks' different approaches to asset management lie across the spectrum from full in–house capability to predominantly outsourced fund of fund models and equity participation through joint ventures. It will be worth watching which of, or whether one of, these models fares better as economic conditions unfold.

Funds under management



Source:ASSIRT Market Share reports as at December 2007. (*SGB not available.)

Funds under administration



Source:ASSIRT Market Share reports as at December 2007.

One thing the banks have in common is that they have positioned themselves to participate in the more lucrative end of the value chain – closer to the customer – by investing in distribution capability. Most also have strong platform offerings, which place them better than many smaller or specialist fund management competitors through turbulent times, as margins in these areas are less impacted by negative investment returns.

Costs will also be under close scrutiny. In these volatile times with unpredictable revenue, a key differentiator will be the ability to balance investment for the future and controlling costs in the right areas. Responding quickly, and knowing which levers to pull, requires both astuteness and agility. The cost levers will include salary incentive payments, with some distributors already opting to pay their planners on a salary and bonus system, rather than commissions.

Focus on Fees

The Government and regulators have a range of bank fees in their sights.

Mortgage Fees

An ASIC report published in April found that total fees as a percentage of the loan book increased roughly 70bps over the last 12 years largely due to early termination fees which rose from 19% of total fees to over 40% in the same period.

The Government is concerned that early termination fees make it more difficult to switch banks. It wants to make disclosure of these fees more transparent in order to raise consumer awareness and discourage banks from levying them.

Exception Fees

A Senate review last year into banks charging of "excessive exception fees" – fees charged for dishonoured cheques or EFTPOS transactions – encouraged the banks to provide more transparency around such fees and some have introduced accounts that have low or no exception fees particularly for low income groups.

But the story doesn't end there. A private members bill has moved to prevent banks from charging more than a cost recovery fee for exception transactions, and the Senate has recently launched a new Inquiry into this. Exception fees are in the spotlight in the UK as well . The UK High Court will be considering the issue of the fairness of unarranged overdraft fees. Before the case, the UK banks had paid out GBP500m in related claims in 2007 and it is estimated this could escalate to GBP1b if the court finds against the banks.

Interchange Fees

Debit and credit card interchange fees are also in the spotlight. It's now been several years since the Reserve Bank's major overhaul of credit and interchange fees. Having announced last year that ATM interchange fees are to be removed, the Reserve Bank has now endorsed recommendation for further reform of EFTPOS and credit card interchange arrangements, reflecting concern that benefits are not flowing through to consumers.

While it has left the industry to respond to its suggestions, it has also flagged that in the absence of sufficient voluntary reforms, it will impose fee reductions on the industry. For instance, it has flagged the reduction in credit and debit card interchange fees from 50cents to 30cents per transaction, as well as aligning interchange fees between EFTPOS (at 5cents) and scheme debits (currently at 12cents).

Efficiency

With revenues under pressure and bad debts rising, the banks will be renewing their focus on their expense base. In recent times the banks' efforts to increase the gap between rising revenues and rising costs ('the jaws') have been somewhat hampered by increasing salary costs.

This latest period has seen some reining in of these increases. In the six months to March 2008, aggregate expenses rose by 5.1% over the prior comparable period and 1.4% on 2H07.

Salaries now represent 57% of total expenses and rose by 7.1% over the prior year comparable period and 4.8% over 2H07. Increases in salaries continue to be driven by CPI (currently close to 4%), a tight labour market, improved incentives for key staff such as investment managers and the expanding number of customer facing staff due to new branches and more business relationship managers – these initiatives started in early 2007 and are now mostly reflected in ongoing expenses.

Investing in the downturn?

At this time of the cycle we would ordinarily expect the banks to reconsider their investment and cost strategies, carefully prioritising and perhaps red–lining or postponing certain projects. We anticipate this will be the case, however, at the same time the banks have been handed a substantial windfall gain from the Visa IPO.

This windfall should act as a cushion, enabling the banks to pursue investments in their businesses or systems that they might not otherwise have proceeded with.

Some of the majors have signalled intentions to significantly transform processes and/or replace legacy systems, with a view to boosting productivity and distribution and improving the customer experience. Further offshoring has also been foreshadowed.

Reported headline expense–to–income ratios

	1H08	2H08	1H07
ANZ	44.4%	45.1%	44.3%
CBA	48.4%	49.9%	48.6%
NAB	47.0%	49.9%	51.8%
SGB	42.5%	42.4%	42.6%
WBC	44.4%	44.3%	45.9%

Asset Quality

As predicted, the extraordinarily long benign credit period has ended. The first signs of change came following the subprime collapse in July last year, but it wasn't until towards the end of calendar 2007 that the liquidity crunch started to convert into real credit concerns. Thus far the fallout has been contained to a small number of high profile company collapses.

As a result, the banks' charge for bad and doubtful debts rose by 125% over the prior comparable period to $2.6 billion, having a significant impact on cash earnings. In aggregate the charge represented 34bps of loans and advances – up from 17bps for FY07 – and as high as it has been since 1994.

There has also been a similar increase in the level of impaired assets which are up 82% from September 2007. They now represent 29bps of loans and acceptances, still below long–run averages and reasonably low compared to international peer banks.

There has been some discussion in the market concerning the extent to which the adoption of new accounting standards (AIFRS) has impacted the bad debt charges recognised by the banks. Under the old accounting rules, most banks held bad debt provisions to cover all the inherent 'expected losses' in their portfolio. Under AIFRS, the provision is restricted to 'incurred losses' only; these should include losses that have been incurred but not yet individually identified, while not including future losses expected as a result of a future event.

The main change in measuring the provision, therefore, has been to restrict the old calculation of full expected losses (over the remaining life of the portfolio) to a calculation of losses already 'incurred' (and expected to emerge over a shorter period). The new AIFRS provision measurement still moves dynamically with the change in size and quality of the portfolio, but generally more gradually than the old accounting treatment. In some circumstances however (eg when impaired asset levels change significantly), the AIFRS results can be more volatile.

Consumer stress?

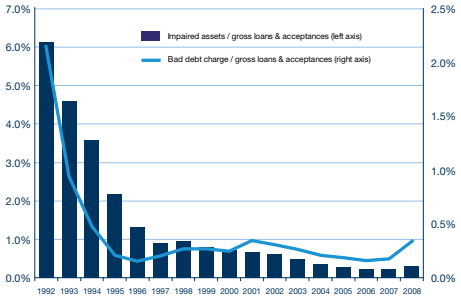
Mortgage loan portfolios have largely remained of good quality supported by good house price growth, up 13.8% between March 2007 and March 2008, across all states. The question dominating the broader economic and political climate is the extent to which rising interest rates and a slowing economy will increase mortgage stress and arrears rates.

Having said that, many commentators are saying that the fundamentals around housing affordability in Australia have changed significantly. The Reserve Bank has suggested that the oft–quoted 30% rule – that households spending more than 30% of their after–tax income on housing might suffer from mortgage stress – may now be somewhat dated as a measure of housing affordability. According to the Reserve Bank, rising levels of income have enabled households to devote a larger share of their income to housing repayments while maintaining their overall standard of living.

Australia does have small pockets of mortgage stress, where households appear to have bought near or at the peak of the last house price cycle, their incomes have grown more slowly then the national average, and more of the loans were provided by non–bank lenders.

More generally though, arrears rates are fairly steady. Although consumer confidence has quite naturally declined recently, the underlying economy remains sound – albeit softening – and whilst ever unemployment is kept low, we do not expect to see a significant increase in consumer lending bad debts.

Five majors: impaired assets and bad debt expense



Note: Historical data based on AGAAP. 2006, 2007 and 2008 based on AIFRS.

Nervousness in the business segments

Banks' business lending portfolios also appear to be holding up well generally, despite the deleveraging that is taking place across many financial services institutions and fallout related to the international turmoil. Business earnings have been solid for some time and, for the most part, balance sheets are not overly geared. However, recent survey results have suggested that businesses expect their profits to decline.

Perhaps one the biggest threats to businesses, aside from economic instability, is that of credit rationing. The continued disruption in the global credit markets has meant that the banks have become the primary lenders to business again. It is possible that well–funded businesses may run into difficulties when their debt requires renewal.

Some credit rationing is already occurring naturally as a result of banks increasing rates on business loans, tightening conditions and reducing their duration. If banks continue to struggle to secure funding and capital at a reasonable price, with housing loans continuing to grow at around 10%pa, they are more likely to place much sought after funds in this, relatively less risky market. Mortgages attract two thirds less regulatory capital than business loans.

If there is a specific concern it might be commercial property lending. While an equity market correction has now followed the debt market correction, there is also concern that the corporate property market is due a correction also. This is a focal point for all the banks.

Inevitably, given the increasing cost of borrowing and a softening economy, it is expected that corporate bad debts will increase from their recent historic lows. There is some risk they could be significant, and the market is acutely aware of this uncertainty. But they are predicted by most to remain within manageable levels.

Liquidity : the perfect storm

Our last Perspectives, published in November last year, was relatively sanguine about the collapse of the US subprime mortgage market. For the Australian majors "it could have been a lot worse", we wrote.

It got worse.

Many recognised the subprime crisis as a correction that had to happen, but most expected it to be over relatively quickly and its secondary impacts to be largely confined to the US. In particular, most thought that the banks' initial caution in lending to each other would be relatively short–lived.

It wasn't clear, even up until the end of 2007, that the emerging crisis in the financial markets would have such a significant and lasting real impact on the broader economy globally. Investors remained bullish until January. Equity markets continued to go from strength to strength.

That confidence evaporated early in the new year as the markets – belatedly and severely – reacted to the continual stream of bad news about the global financial system:

- Many of the large US and European banks continued to report massive write downs related to subprime assets. Problems spread to other players such as the mono–line insurers which underwrote US subprime loans and related investments. Rating agencies downgraded a number of significant financial institutions, and continue to do so.
- The subprime collapse developed into an extended liquidity crisis. The complexity of subprime risk combined with more general concern about credit derivatives, not to mention concerns of a US – and hence global – recession, led to further evaporation of financial institutions' trust in each other. The collapses of Northern Rock and Bear Stearns only reinforced these concerns.
- Capital market spreads failed to return to pre–crisis levels and shorter term interest rate spreads also started to expand – a phenomenon that was reflected around the globe. The number of financial institutions crippled by the crisis multiplied.
- Cheap sources of debt dried up. Securitisation markets all but closed. For many, the magnitude of the credit crisis was revealed only once companies had to refinance debt some 3 – 6 months after the initial waves of the credit crunch were felt. Some businesses which relied on short term debt to fund long term assets ran into real trouble. High profile examples in Australia included Allco, Centro, MFS and RAMS.

An equity market rout started in January and continued through the first quarter. Australia was particularly hard hit where equities had outperformed international markets over previous years. December 2007 to March 2008 saw $185 billion vanish from the value of the ASX 200, a fall of 15%. The financial services sector, seen by investors as being at the heart of the problems, as well as at the end of a long bull run, was particularly hard hit, losing some 23% of its value in this period.

Australian majors: sturdy ships in stormy seas?

As we noted in our last Perspectives, Australia's banks had sailed relatively smoothly past the storm. In March the Reserve Bank wrote: "The financial system has coped better with the recent strains than have the financial systems of many other countries. The banking system remains highly profitable and well capitalised."

That said, the availability and cost of funding and capital remain significant issues for our major banks.

Reflecting general caution in lending to banks, the amount of debt accessible in wholesale markets has contracted materially with corresponding increases in interest spreads. The banks' average cost of wholesale funds is significantly higher than it was six months ago, with senior long term debt spreads averaging 50bps against the bank bill rate compared to 10bps before the credit crunch. Short term money market spreads (90day BBSW to overnight swap index) – normally stable at less than 10bps – have been fluctuating widely, hitting over 80bps at times, while at present they have settled down to around 50bps.

The Reserve Bank, it should be said, responded swiftly and sensibly to support the unusual demand for liquidity and help calm nerves. This included expanding both the type of assets they are prepared to lend against and the length of time over which they will lend. It could be argued they reacted more effectively than some other overseas central banks, and without relying on public and expensive auctions.

On the bright side for the majors, their funding includes drawing between 40%– 60% of their funding from domestic depositors. A real advantage compared to their competitors, be they global banks, local regional banks, or NBFIs. At the same time, the majors are still considered a relatively good credit risk in international capital markets, and so the offshore markets have been by no means totally closed to them – the five majors raised some $35 billion in the first quarter of 2008, as the international storm raged at its fiercest. Smaller competitors in the Australian market do not have the same flexibility, and are suffering much greater challenges raising funding including capital.

How sturdy the majors remain will depend in part on the economic outlook. With the exception of the period immediately after the introduction of the GST in 2000, measured inflation is at its highest level in 12 years. Even more challenging is the extent to which inflation is being driven by factors which at best have an indirect link to interest rates, most notably fuel costs, food prices and other traded commodity prices. Certainly the high Australian dollar is helping to insulate some of the flow–through to domestic prices.

Most importantly the commodities boom and the growth of China and other emerging economies should underpin domestic growth. It is an open question about how hard the Reserve Bank will have to tighten monetary policy in order to bring inflationary expectations into check. That said, there seems no doubt that higher interest rates are currently slowing the growth in private demand, including for housing.

In the aftermath of the storm a "New Normal" will dawn

One crucial factor influencing both the economic environment and the banks' performance will be how and when the storm in the international capital markets subsides. The one certainty is that the landscape will be different in the aftermath. Things will return to normal, but it will be a "new normal".

As we write, although very wary of the risk of more unexpected bad news, markets appear to be settling down. The debt markets are showing signs of reopening, albeit with higher risk premiums than six months ago. Where they eventually settle will depend partly on the extent of pent up demand.

Other aspects of any "new normal" might include:

- New terms: In addition to higher spreads, debt will attract higher effective premium through more constrained structures and lender protections.
- New regulation: Banks have long complained about over–regulation, but we could see the regulatory capital rules responding to an enlightened view of liquidity risk, plus perhaps more legislation around certain fees, together with hopefully some reform to simplify consumer protection law.
- Non–traditional sources of capital: For instance the international sovereign funds (some further cashed–up by record oil prices) and, closer to home, the $60 billion Australian Future Fund, will provide an important and influential sources of capital.
- New innovative instruments: the international capital markets crisis has pressed the pause button on financial services innovation, but the new normal will press "play" as astute players respond to the higher cost of equity and debt.

The innovation might also involve the Government. One area attracting attention at present is the concept of a Government–backed mortgage securitisation scheme in Australia, similar to those in operation in the US and Canada. The suggestion is this could help to provide a cheap and secure source of funding for prime loans to lower income earners, together with increasing market liquidity and improving the financial system solvency.

To date the Australian majors have proven able to manage through these turbulent times. While there has been some mention of the need to further ration credit, on the whole the majors appear – subject to any more large international shocks – to be adequately funded and capitalised.

As we look into the longer term – and as mentioned in other sections of this report – there may be some silver linings to the current clouds:

- the significant downward pressure on the majors' net interest margins will ease – as their lending books continue to be re–priced upwards while their wholesale funding costs come down;
- the ongoing flight to quality and hence increasing market share for the majors will help to offset the moderation in system credit growth;
- and while credit losses will be higher than in recent years, we expect the medium–term run rate will be quite manageable.

Hence we are optimistic about what the "new normal" might mean for the majors and the Australian banking system more generally. In any event, this is secondary to the fact that the Australian financial system seems to have coped well with one of the most serious financial services disruptions since the second World War.

Five major's combined performance – $A million – underlying cash

	1H08	2H07	1H07	1H08/2H07	1H08/1H07
Net interest income	17,640	16,541	16,030	6.6%	10.0%
Other operating income	10,123	10,129	9,521	(0.1%)	6.3%
Operating expenses	(12,768)	(12,590)	(12,151)	1.4%	5.1%
Core earnings	14,995	14,080	13,400	6.5%	11.9%
Bad debts	(2,590)	(1,301)	(1,150)	99.1%	125.2%
Tax expense	(3,443)	(3,616)	(3,534)	(4.8%)	(2.6%)
Outside equity interests	(52)	(54)	(49)	(3.7%)	6.1%
Underlying cash earnings after tax before significant items	8,910	9,109	8,667	(2.2%)	2.8%

Key banking statistics – Half year 2008

	ANZ			CBA			NAB			SGB			WBC		
	6mths Mar–08	6mths Sep–07	6mths Mar–07	6mths Dec–07	6mths Jun–07	6mths Dec–06	6mths Mar–08	6mths Sep–07	6mths Mar–07	6mths Mar–08	6mths Sep–07	6mths Mar–07	6mths Mar–08	6mths Sep–07	6mths Mar–07
Balance sheet															
Total assets	438,355	392,773	351,849	454,549	425,139	397,261	604,622	564,634	508,835	136,309	125,800	111,980	401,717	374,821	328,200
Risk weighted assets	267,486	275,018	250,485	272,609	245,347	234,569	384,418	355,266	330,457	69,693	63,226	57,117	186,963	228,077	211,984
Gross loans and acceptances	338,325	307,384	285,771	347,682	321,653	299,085	421,280	394,651	366,502	113,781	106,552	99,046	296,336	273,914	254,553
Asset quality & provisioning															
Gross impaired assets	1,401	792	749	562	421	338	1,474	1,094	769	120	78	95	956	540	572
Net impaired assets	857	490	447	294	222	167	947	787	574	70	50	59	533	274	291
Gross impaired assets as a % of loans and acceptances	0.41%	0.26%	0.26%	0.16%	0.13%	0.11%	0.35%	0.28%	0.21%	0.11%	0.07%	0.10%	0.32%	0.20%	0.22%
Individually assessed provisions	544	302	302	189	100	79	527	307	195	58	34	39	317	148	162
Individually assessed provision % of impaired assets	38.8%	38.1%	40.3%	33.6%	23.8%	23.4%	35.8%	28.1%	25.4%	48.3%	43.6%	41.1%	33.2%	27.4%	28.3%
Collective provisions	2,404	2,028	2,016	1,191	1,156	1,151	2,224	1,800	1,918	313	291	283	1,550	1,410	1,325
Collective provisions % of non housing loans & acceptances	1.41%	1.35%	1.47%	0.81%	0.88%	0.94%	0.97%	0.86%	1.02%	0.76%	0.78%	0.84%	1.14%	1.14%	1.18%
Total provisions	2,948	2,330	2,318	1,380	1,256	1,230	2,751	2,107	2,113	371	325	322	1,867	1,558	1,487
% of risk weighted assets	1.10%	0.85%	0.93%	0.51%	0.51%	0.52%	0.72%	0.59%	0.64%	0.53%	0.51%	0.56%	1.00%	0.68%	0.70%
% of loans & acceptances	0.87%	0.76%	0.81%	0.40%	0.39%	0.41%	0.65%	0.53%	0.58%	0.33%	0.31%	0.33%	0.63%	0.57%	0.58%
Profit & loss analysis (i)															
Net interest income	3,780	3,691	3,611	3,899	3,551	3,485	5,303	4,966	4,799	1,192	1,115	1,078	3,466	3,224	3,089
Other operating Income	2,222	1,995	1,770	3,075	3,025	3,015	2,327	2,491	2,353	493	552	527	1,964	2,002	1,771
Total expenses	2,667	2,567	2,386	3,378	3,283	3,144	3,598	3,719	3,709	716	707	683	2,409	2,314	2,229
Core earnings	3,335	3,119	2,995	3,596	3,293	3,356	4,032	3,738	3,443	969	960	922	3,021	2,912	2,631
Bad debt expense	980	327	240	333	239	195	726	400	390	118	85	93	433	250	232
Profit before tax	2,355	2,792	2,755	3,263	3,054	3,161	3,306	3,338	3,053	851	875	829	2,588	2,662	2,399
Income tax expense	678	799	817	891	844	913	911	877	845	233	267	248	716	800	687
Minority interest	3	5	2	15	14	13	1	0	0	0	2	0	33	33	34
Cash earnings after tax before significant items (underlying profit) (ii)	1,674	1,988	1,936	2,357	2,196	2,235	2,394	2,461	2,208	618	606	581	1,839	1,829	1,678
Operating profit after tax and outside equity interests (iii)	1,963	2,078	2,102	2,371	2,279	2,191	2,687	2,442	2,136	529	605	585	2,202	1,810	1,641
Key data															
Other operating income (% of total income)	37.0%	35.1%	32.9%	44.1%	46.0%	46.4%	30.5%	33.4%	32.9%	29.3%	33.1%	32.8%	36.2%	38.3%	36.4%
Interest spread	1.57%	1.71%	1.74%	1.81%	1.79%	1.86%	1.67%	1.76%	1.85%	1.67%	1.76%	1.86%	1.72%	1.80%	1.90%
Interest margin	1.99%	2.15%	2.24%	2.17%	2.16%	2.22%	2.18%	2.25%	2.33%	1.92%	1.97%	2.07%	2.05%	2.14%	2.25%
Banking expense/ income ratio (headline reported ratio)	44.4%	45.1%	44.3%	48.4%	49.9%	48.6%	47.0%	49.9%	51.8%	42.5%	42.4%	42.6%	44.4%	44.3%	45.9%
Total number of full time equivalent staff	35,482	34,353	33,183	38,452	37,873	37,216	39,421	38,822	39,033	8,801	8,722	8,727	28,761	28,018	27,312
Operating costs per employee (dollars)	75,165	74,724	71,904	87,850	86,684	84,480	91,271	95,796	95,022	81,354	81,059	78,263	83,759	82,590	81,612
Return on average equity %	15.1%	19.6%	19.6%	20.8%	21.0%	22.6%	16.8%	17.7%	16.5%	20.3%	23.1%	23.2%	22.7%	24.2%	23.6%
Capital ratios															
Tier 1	6.90%	6.70%	6.70%	7.27%	7.14%	7.06%	6.51%	6.67%	7.33%	7.00%	6.70%	7.20%	7.40%	6.50%	6.50%
Tier 2 (Net of deductions)	3.20%	3.40%	3.60%	2.40%	2.62%	2.72%	3.20%	3.32%	3.18%	3.10%	3.50%	3.30%	2.70%	3.00%	2.90%
Total	10.10%	10.10%	10.30%	9.67%	9.76%	9.78%	9.71%	9.99%	10.51%	10.10%	10.20%	10.50%	10.10%	9.50%	9.40%

i In arriving at 'underlying profit', income and expenses exclude significant items and certain noncash items. Significant items include the impact of accounting changes, gains on disposal of businesses and other items reported by the banks. Some components of income and expenses have been reclassified to improve comparability between banks.

ii NAB cash earnings after tax before significant items underlying profit are shown before distributions payments to holders of National Income Securities – March 08 $157 million, September 07 $146 million and March 07 $137 million.

iii Statutory result as reported by the banks, unadjusted

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