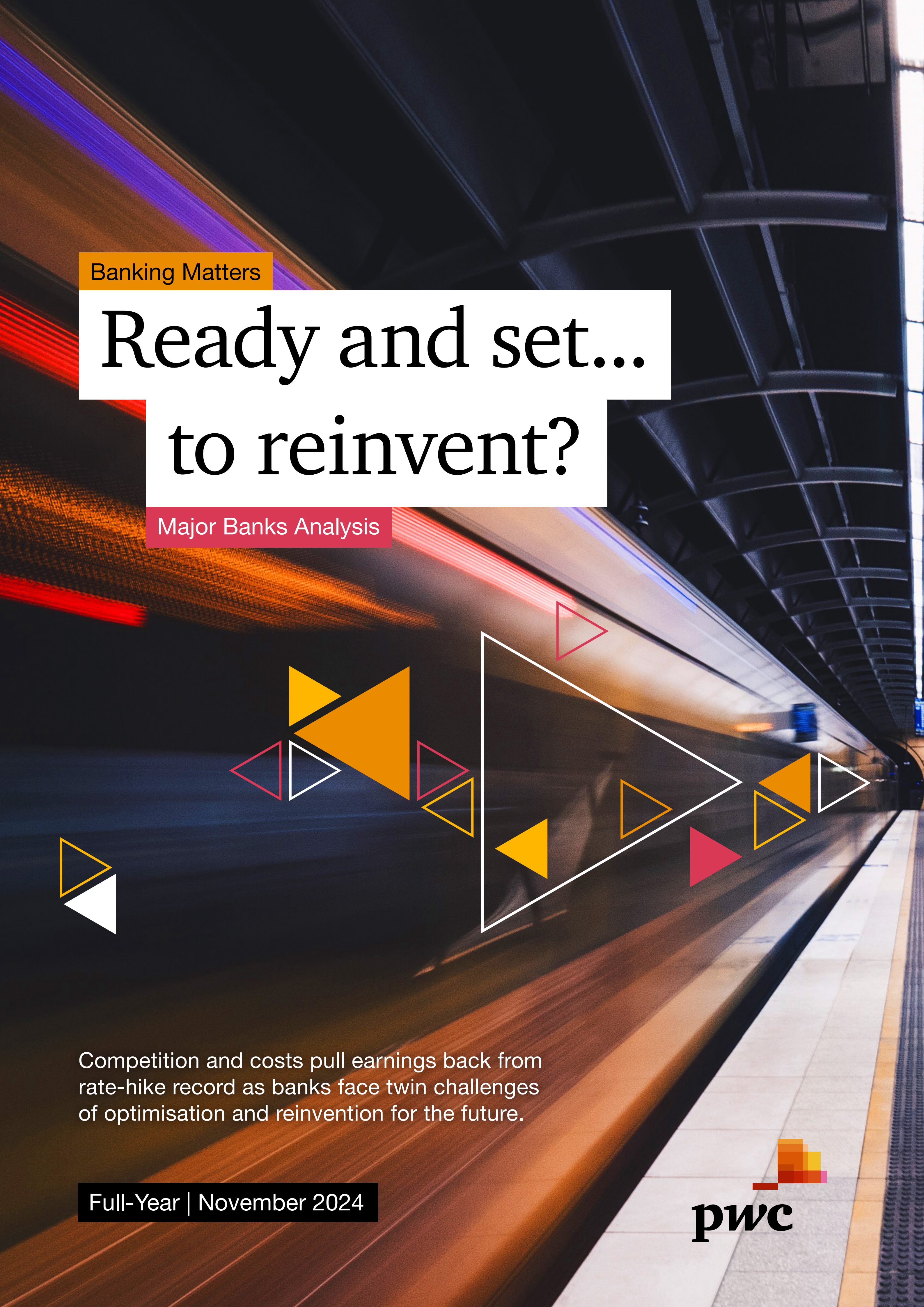


Banking Matters

Ready and set... to reinvent?

Major Banks Analysis

Competition and costs pull earnings back from rate-hike record as banks face twin challenges of optimisation and reinvention for the future.

Full-Year | November 2024

pwc

Earnings and returns

Cash earnings

-5.4% yoy
-1.7% hoh

$30.7bn

Cash earnings fell to $30.7bn ($30.8bn excluding the impact of acquisition notables), which was a drop of 5.4% from the record $32.4bn set last year. NIM decreased over the year, which was not quite offset by increased loan volumes. Operating Expense increases weighed on results, increasing 6.5% to $43bn (exc. notables) – a record high for the banks. Credit expenses were lower on the prior year, with low loss experience continuing to support results. Earnings continued to moderate in 2H24, down 1.7% on 1H24.

Return on equity

-79 bps yoy
-19 bps hoh

11.1%

ROE fell 79bps to 11.1%, down from 11.9% in the prior year (which was a 5 year high). A decrease in cash earnings was the key driver with average equity levels also rising marginally. ROE also continued to moderate into 2H24 (falling 19bps from 1H24).

Revenues

Net interest income (ex notables)

-0.4% yoy
+1.2% hoh

$74.6bn

Increased NIM pressure weighted on Net Interest Income during the period, resulting in a 0.4% decrease to $74.6bn (albeit this falls within our definition of 'flat'). Whilst NIM decreased, NII was supported by an increase in GLAA volumes which helped to mitigate some of the margin pressure. Hoh NII recovered modestly, increasing by 1.2% on 1H24 to close out the year.

Other operating income (ex notables)

+0.4% yoy
-4.6% hoh

$15.4bn

Non-Interest Income rose marginally over the period to $15.4bn (falling within our definition of 'flat'), being an increase of 0.4% year-on-year. Banking fees income remained the biggest contributor, and was also largely flat over the year.

Lending

Net interest margin

-6 bps yoy
+2 bps hoh

1.8%

NIM was down during the year, with strong competition in the mortgage market continuing to put pressure on lending margins. Funding costs also rose, with depositors switching to higher returning products and increases in wholesale funding costs. Increased contributions from capital investments were not enough to offset these headwinds. NIM did improve in 2H24 however, as banks moved to protect margins and described selective action to manage volume/margin tradeoffs.

Lending growth (ex acquisitions)

-131 bps yoy
+248 bps hoh

3.4%

Lending growth remained positive over the period, however at 3.4% (which excludes the impact of acquisitions during the period), this was down 131bps year-on-year. Lending growth did pick up in the second half however, with 2H24 seeing an annualised 248bps increase on 1H24 (also excluding the impact of acquisitions) – with business lending being the fastest growing segment during the period. Lending growth over the year was ~5.6% including the impacts of acquisitions.

Expenses

Operating expenses (ex notables)

+6.5% yoy
+3.0% hoh

$43.2bn

Operating expenses hit a new record high during FY24, closing the year at $43.2bn which was up 6.5% on the prior year. Significant growth in technology spend as well as general inflationary pressure were key drivers of this increase, with the expense-to-income ratio for the year landing at 48% (up from 45% in the prior period, excluding notables). Expense growth continued into 2H24, up another 3% on 1H24.

Expense-to-income ratio (ex notables)

+308 bps yoy
+133 bps hoh

48%

With flat NII and operating expenses up on the prior year, the expense-to-income ratio increased around 308bps from FY23. This represents the highest ETI ratio in the last decade (excluding notables). Growth in 2H24 was more or less in line with 1H24, with higher expenses being offset by higher NII.

Asset quality

Credit impairment expense (ex acquisitions)

-20.4% yoy
-15.7% hoh

$2.2bn

Credit expenses was $2.2bn (which excludes the impact of acquisitions). The key drivers of the expense were a combination of balance sheet growth (and therefore an organic increase in provision) and an increase in Stage 3 individual provisions, with some signs of stress appearing. This is in contrast to the prior year, where the credit impairment expense was driven by changes in future expectations of the outlook. Including the impact of acquisitions, credit expenses were ~$2.5bn

Credit provisions (ex acquisitions)

+2.7% yoy
+0.6% hoh

$21.4bn

Credit provisions were up 2.7% from FY23 (excluding the impact of acquisitions) which we consider 'flat'. The increase reflected an increase in GLAA during the period (which attracts an increase in ECL provision), and increases in stage 3 provisions. This, combined with 90+ DPD indicators increasing over the period suggests borrowers are increasingly becoming distressed – however these levels are still within what the banks describe as their expectations.

Balance sheet

Provision cover

-1 bps yoy
-2 bps hoh

66bps

The provision coverage ratio was broadly flat again at 66bps, with total provisions (up 2.7% to $21.4bn) largely in with growth in GLAA (up 3.4%) over the year.

Core equity T1 (ex acquisitions)

-12 bps yoy
-24 bps hoh

12.4%

CET1 decreased 12bps (which excludes the impact of acquisitions). The impact of acquisitions would have decreased the CET1 level a further 5bps. Total capital levels (including impact of acquisitions) continued to increase, climbing ~2.0%.

Westpac no longer report cash earnings and amounts included above are as reported on a statutory basis, without adjustment. Adjustments have been made for the impacts of the ANZ acquisition of Suncorp Bank where specifically noted.

Executive Summary

1 / Earnings down, though still high, as balance sheet growth and stable credit losses fail to offset margin and cost pressures with Interest Income struggling to keep pace

Australia's major banks reported combined cash earnings of $30.7bn in 2024 – a fall of 5.4% from the record high of $32.4bn set in FY23. The result shows how the tailwind of rising cash-rates that drove record earnings in 2023, rapidly faded as competition and rising costs moderated returns. Net Interest Margin (NIM) fell approximately 6bps year-on-year, albeit with signs that this decrease was arrested through the second half as banks made volume/margin tradeoffs. Margin contractions were partially offset by loan growth which came in at 3.4% on an annualised basis (and approximately 5.6% if including the impact of acquisitions during the year). While mortgage market share fell slightly, business credit growth was again a standout, with overall system business-credit growth of 7.5% (RBA statistics) and with the majors increasing their share. The combination of margin decline and balance-sheet growth saw Net Interest Income more or less flat over the year (down 0.4%).

The other significant driver of the earnings decline was costs, with operating expenses climbing 6.5%, and setting a new record high of $43.2bn (excluding notables). Significant growth in technology spend as well as inflationary pressures for people costs were key drivers of this increase, with the expense-to-income ratio for the year being 48% (up from 45% in the prior period, excluding notables), being the highest in over a decade. Other Operating Income (OOI) was more or less flat over the period, coming in at $15.4bn and representing 17.1% of Total Income (excluding notables).

Return on Equity (RoE) for the year was 11.1% which was down 79bps from the prior year (which was a 5 year high). This is perhaps unsurprising given the drop off in earnings and with elevated capital levels net of share buy-backs completed during the year. Nevertheless, the banks remain around 2.5% short of the 13.6% RoE recorded in FY17 (being the last time RoE exceeded 13%) as long-term structural challenges continue to play out.

Low credit losses supported the results again as bank customers continued to show resilience to a slower economy and sustained higher cost of debt. Credit provisions on the balance sheet rose modestly to $21.4bn (excluding acquisitions), up from $20.9bn in the prior period with overall provision coverage ratio remaining broadly flat at 66bps.

Credit expense was $2.2bn (excluding acquisitions) for the year (which was 20% lower than FY23). The key drivers of the expense were a combination of balance sheet growth (and therefore an organic increase in provision) and an increase in Stage 3 individual provisions. Whilst this suggests further signs of stress appearing, given total provisions represent 2.38 times (excluding acquisitions) current impaired assets, the banks remain well provisioned for the residual uncertainty that the economic cycle brings.

2 / Strategic tensions as banks globally manage near-term performance with longer-term reinvention

The strong but tightening results also demonstrate the strategic tensions facing banks around the world and that in many markets are causing deep reflection on the need for reinvention in the sector. The pinch is how banks manage near-term performance with continuing their response to the longer-term trends that may call for broader reinvention.

In the near-term, banks globally face a squeeze from both ends and as the 'commodity trap' we have proposed continues to bed in. Competition remains intensified within a much more concentrated set of profit pools following decades of simplification and focus, while economic growth (and particularly asset-price appreciation) cannot be relied upon to fuel balance sheet momentum. At the same time, efficiency (costs) has remained structurally stubborn despite high levels of focus and as investment needs from technology and regulation endure, meaning banks around the world have seen no fundamental shift in their costs. In combination, shifts in returns from 'the core' are likely to come from operating discipline and exceptional execution – both likely sources of outperformance in the coming years.

And longer-term (though requiring thinking now), banks also need to respond to system-wide trends that have built, taken hold and are likely to accelerate – in particular the enablement and disruption from technology, shifting customer preferences (a topic we will soon analyse in a global survey of banking customers), regulation and the broader redistribution of value pools as the world that banks serve reconfigures itself.

These twin challenges – completing the optimisation of current business models – through simplification and modernisation – while responding to trends that may call for reinvention are at the heart of what many in global banking are describing in dramatic terms. While the symptoms may not be as acute in Australia and for our major banks, not least due to our market structure and economic strength – we already see them driving deliberate and discerning choices for our banks.

3 / Ready and set... to reinvent

In response, that is why we see, and expect to see more and more, examples of banks, whether large, incumbent or not, considering the scenarios for the industry's future. These banks will make bolder strategic bets on where in the value chain and for which customer segments (be that defined by features or needs) they see genuine advantage and differentiated opportunity for growth.

We will explore these strategic archetypes and how to deliver them in our upcoming global study of Retail and Business banking, including a significant survey of customer and leader views in the sector. Many may seem familiar (below we introduce a selection of them) however creating true differentiated value will require choices on which archetype is best for which business-line (in a portfolio universal bank) and may lead to a choice away from where things sit today.

01 **The Segment Hero**

Focused on sector expertise and superior customer experiences as it manages both financial and non-financial demands (i.e. property management services bundled with build-to-rent mortgage products)

02 **The Distributor**

Drawing on customer data and experience design, the distributor understands what customers want and how to develop appropriate solutions by partnering with servicers

03 **The Factory**

Harnessing cost-efficient operations and balance sheet strength to delivery low cost and reliable products

To be truly transformative, these choices are also likely to mean investment in capabilities that differentiate, which in and of themselves may feel challenging to contemplate during a time of such discipline and execution and improving the core of the business.

For well over a decade, global banking, including in Australia, has been characterised by becoming simpler, safer and more stable – which has served us all incredibly well. While this focus on discipline and execution remains critical, reinvention is likely to see bigger bets on topics such as:

- diversification
- ecosystems
- personalisation
- truly unlocking data
- structural improvement of the cost base

Again, these may not seem novel, but considering the change that might be required, banking leaders may have to hold apparently competing mindsets in tension.

Holding mindsets in tension as banks seek to optimise and reinvent

Focus	Art of possible
Simplify	Diversify and hyper-personalise
Safe and stable	Innovate faster
Drive down cost	Invest for a different future
Reduce change risk	Execute constant change

The good news for the Australian major banks is that their performance and strength represents a coiled spring to deliver on this kind of ambition.

01

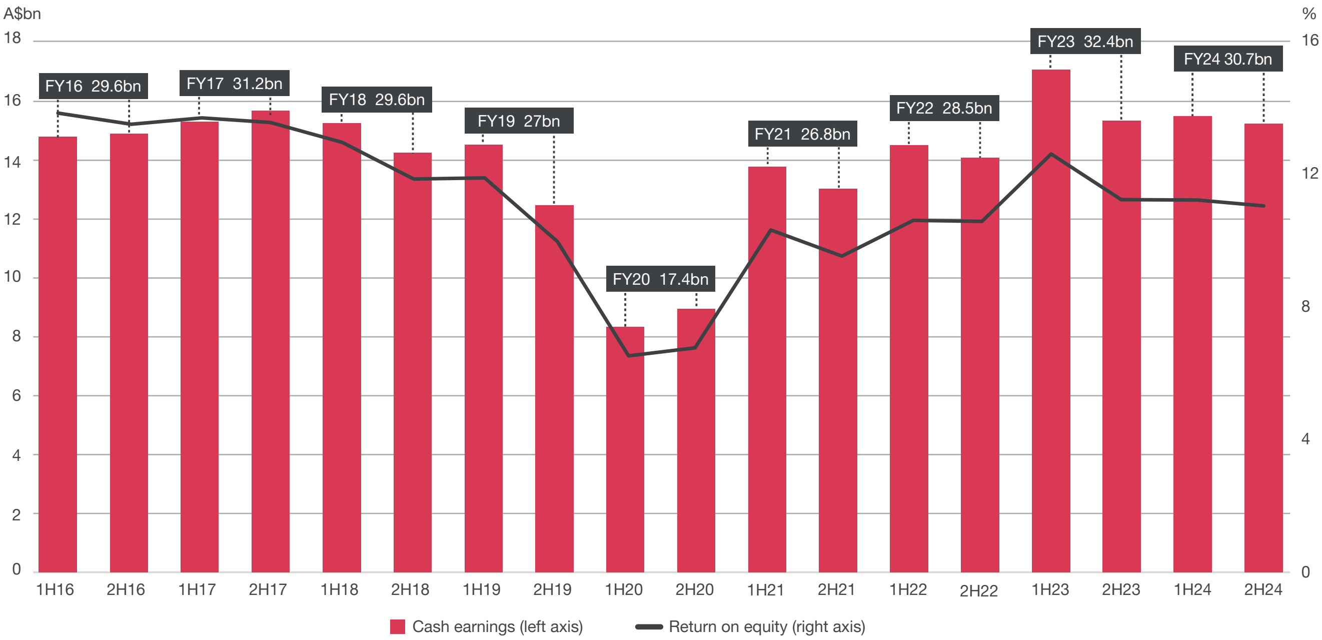
Competition and costs pull earnings back from FY23 rate-hike record

Cash earnings down, tightened by the combined forces of tighter margins and higher expenses

Full-year 2024 earnings at Australia's major banks decreased from the record profits of 2023, coming in at $30.7bn (a 5.4% decrease from the $32.4bn in FY23) as shown in *Figure 1*. Most of last year's outperformance can be attributed to the temporary Net Interest Margin (NIM) spike in the 1H23 earnings, which we separately explore in *Figure 3*. Almost offsetting the decline in NIM over the year, was an increase in loan volumes which provided some support to FY24 earnings – however this was not enough to offset the steady increase in operating expenses. Earnings were also lower half-on-half – down 1.7% on the first half as operating expense continued to bite.

Return on Equity (ROE) for the year was 11.1% which was down 79bps from the prior year (which was a 5 year high). This is perhaps unsurprising given the drop off in earnings and with elevated capital levels net of share buy-backs completed during the year.

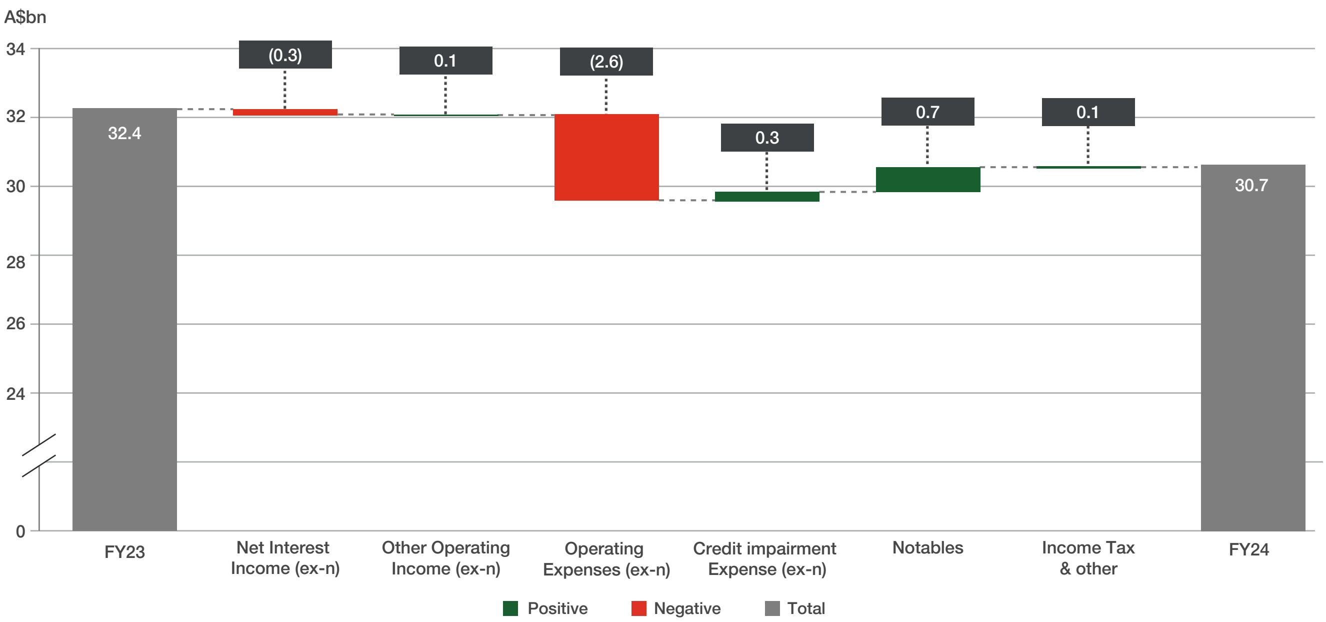
Figure 1 **Earnings down from last year's record high, squeezed by strong competition and higher expenses**



Source: Bank reports, PwC analysis

The key drivers of the decrease in earnings for the year were a continuation of what we observed in 1H24, with operating expenses primarily weighing on the result – as shown in *Figure 2*. Net Interest Income climbed in 2H24 as margins improved slightly, which provided some support to the annual numbers, in contrast to 1H24 where this represented a meaningful decrease. Credit impairment expenses were lower than FY23 (and in 2H24 relative to 1H24), which was accretive to FY24 earnings. Finally, a drop in notables was also observed relative to the prior period which resulted in a benefit in this year's NIM.

Figure 2 **Earnings down with expenses the biggest detractor**



Source: Bank reports, PwC analysis

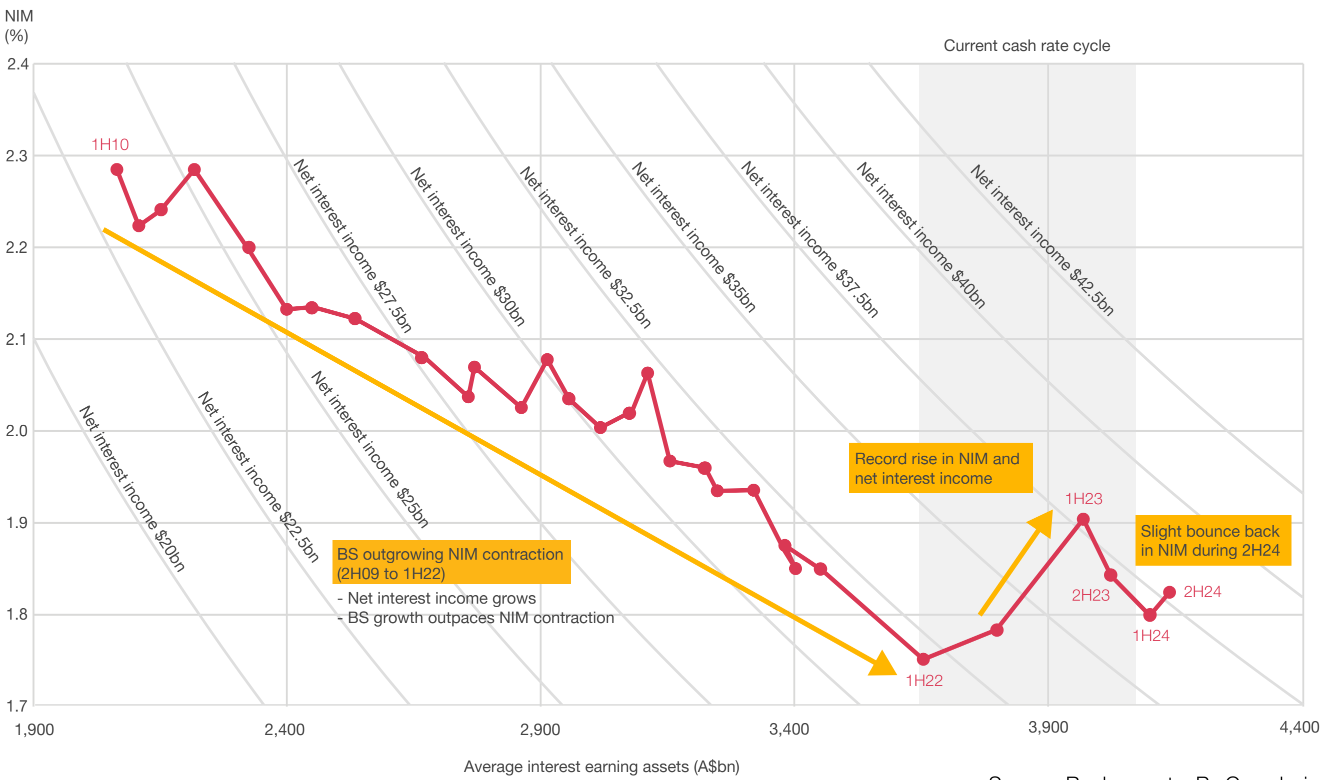
When analysing the change in Net Interest Income (NII) over the year, *Figure 3* provides a useful way of assessing the intersection of the two key drivers – NIM (margin) and Average Interest Earning Assets (lending volume). The solid dots graph the majors over time and moves from 1H10 (top left) to 2H24 (bottom right) – with each dot showing the NIM for the half (y-axis) and the corresponding Average Interest Earning Assets (x-axis). This intersection on the x- and y- axis is the resulting Net Interest Income for the half (denoted by the grey curves).

If we follow the points from top left to bottom right, we see the all too familiar picture of a consistent decrease in NIM (y-axis), however this has been more than offset by the increases in lending volumes (x-axis) – with the net result being a steady increase in Net Interest Income over time despite a structural decline in NIM.

Whilst the start of the Reserve Bank of Australia's (RBA) most recent hiking cycle provided a notable tailwind for NIM (which culminated in the 1H23 high), this has fallen back 6bps over FY24 due to intense competition on lending and deposit margins. The annual movement was largely a reversion back to the long run trend – with increases in volume supporting Net Interest Income despite the contraction in NIM.

Focusing on the half-on-half movement, there was a 2bp increase in 2H24 as many of the majors became more selective with loan pricing. This, combined with a modest increase in lending volume allowed Net Interest Income to increase by 1.2% in the second half.

Figure 3 **NII saw a 1.2% jump in 2H24 – driven by both NIM and volume growth**



Source: Bank reports, PwC analysis

Drilling down further into the changes in NIM over the year, *Figure 4* provides a breakdown of the key movers. Loan pricing was the single largest factor contributing to the year's fall, with significant competition in the mortgage market the key driver. However, the 2H24 results showed that the impact of loan pricing moderated and was almost flat – decreasing only 1bp in the second half.

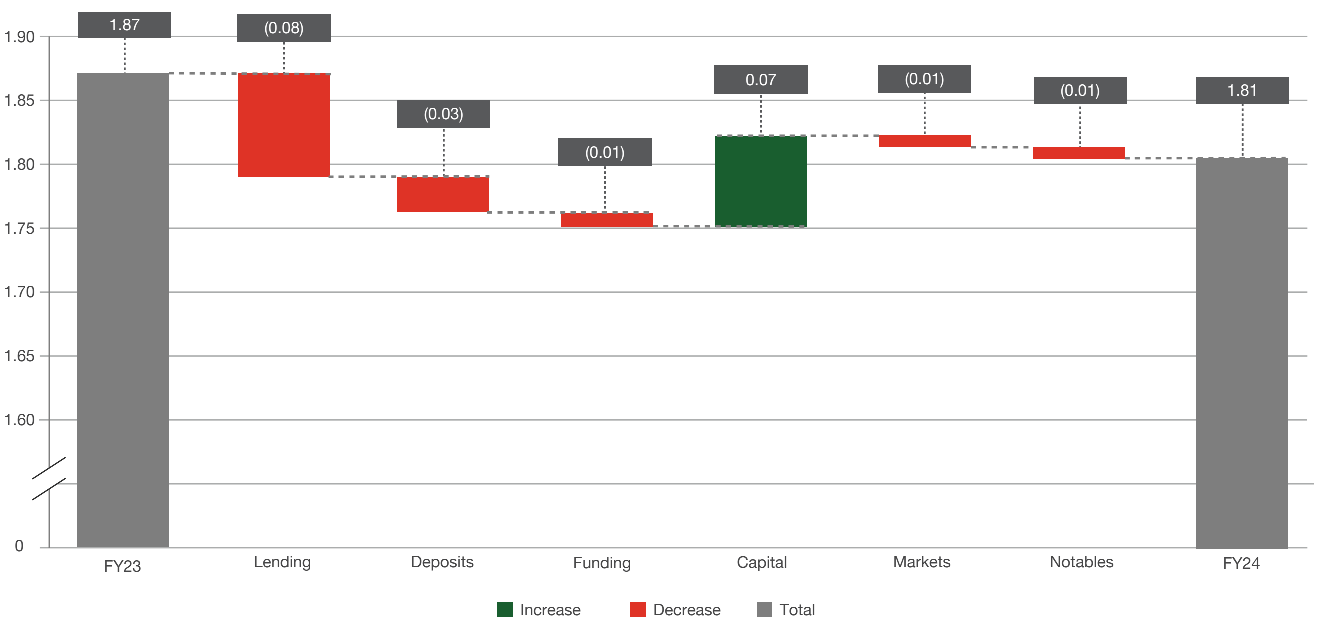
Deposit costs also increased over the period, driven by depositors shifting towards higher returning savings and term deposit products when compared to the prior period. In the midst of a cost-of-living crisis and with term deposit rates now back up to more attractive pre-pandemic levels – perhaps it is unsurprising to see customers shop around to find the best rates.

Funding costs also rose under pressure which included, as some banks called out, the impact of the final refinancing of the RBA's Term Funding Facility (TFF) throughout the year.

The key accretive change during the year was an increase in earnings on the banks' capital investments, primarily as a result of increases in market interest rates – however this was not enough to offset the other declines.

Half-on-half saw a 2bps improvement in NIM which was primarily driven by flatter lending margin changes relative to 1H24 (down closer to ~1bp) while returns on capital remained a positive contributor.

Figure 4 **NIM continues to decrease, with lending and depositor costs the key detractors**



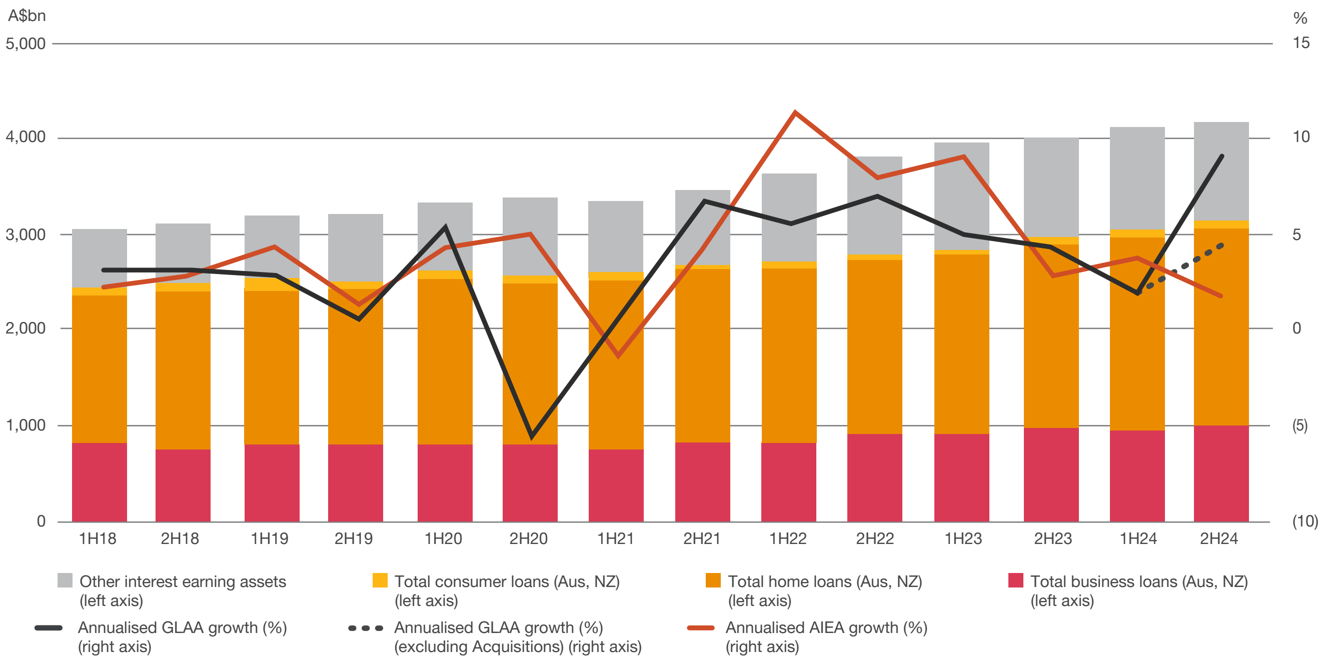
Source: Bank reports, PwC analysis

Lending growth up in the second half, but remains soft compared to recent years

Figure 5 shows the increase in Gross Loans and Advances (GLAA) and Average Interest Earning Assets (AIEA), both of which saw their growth improve during 2H24 after having trended down (albeit remaining positive) from their FY22 peaks.

Business lending continued to grow strongly both at a market level and for the majors with a 6.6% increase on the prior year (with 4.8% of that occurring during 2H24) versus 6.1% for home loans and -14.0% drop for consumer loans. With strong competition in the mortgage market and the more attractive margins on offer in the business channels – this appears to be the natural segment to focus on in the current environment and is certainly reflected in the majors' stated strategies.

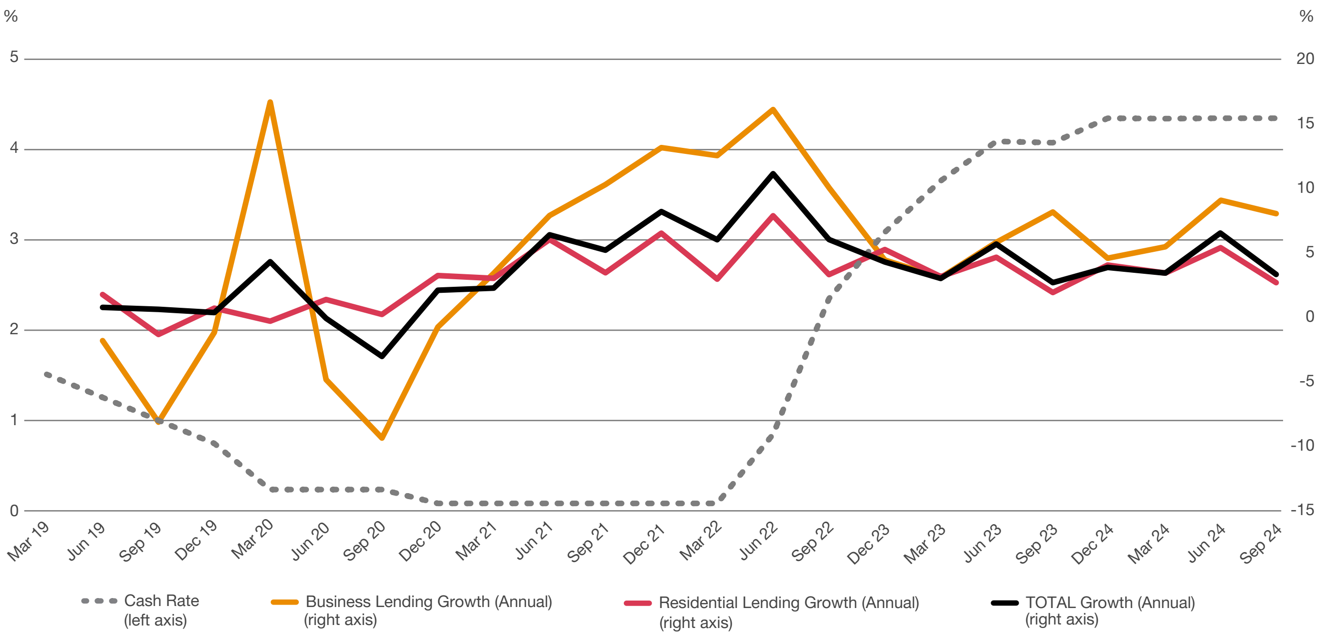
Figure 5 **GLAA growth picks up in 2H24 – coinciding with a pause in the cash rate during 1H24**



Source: Bank reports, PwC analysis

The relative divergence in the business vs residential loan book growth can be seen in *Figure 6*, which is derived from the Australian Prudential Regulation Authority's (APRA) monthly statistics and therefore includes only Australian loans. Whilst growth remained positive across all segments, business lending was the clear outperformer over the year (growing ~7%), with the spread between business and non-business lending widening further in 2H24 to close out the year.

Figure 6 **Business lending growth has outperformed residential lending since ~1H23**

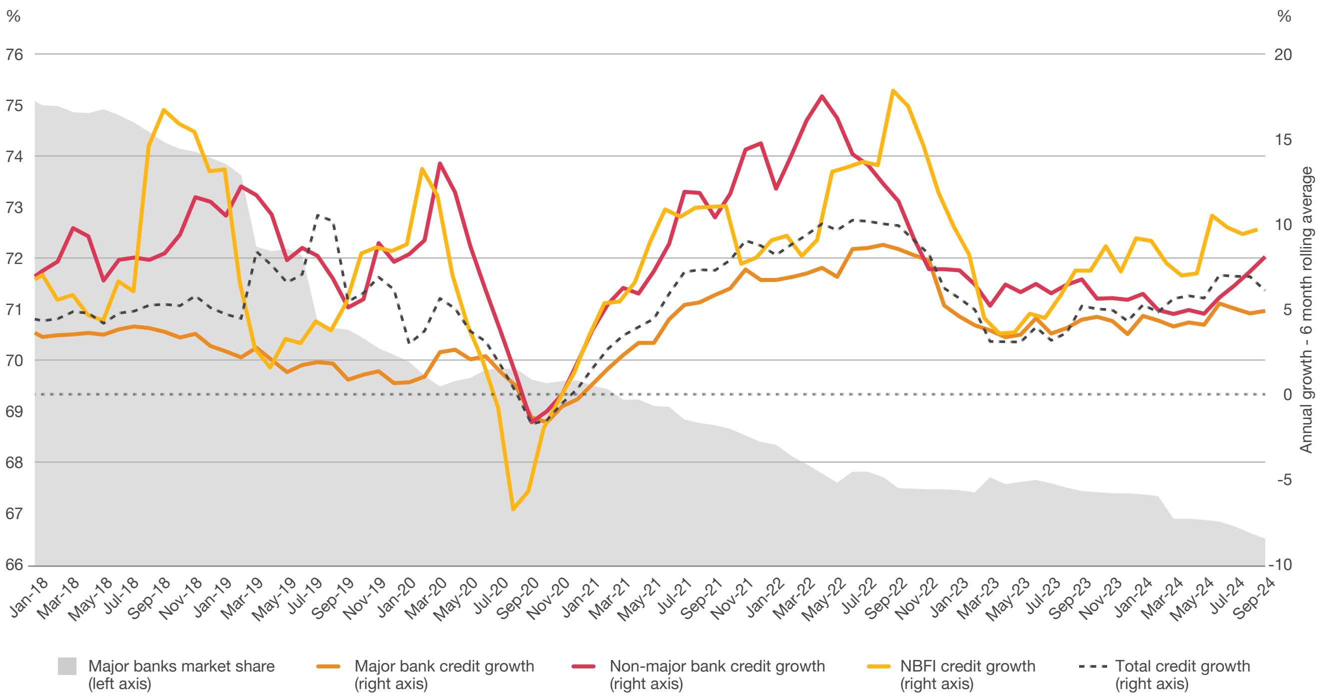


Source: APRA Monthly Banking Statistics, RBA Cash Rate Target, PwC analysis

Despite the majors experiencing GLAA growth over the year (as outlined in the earlier graphs), *Figure 7* shows us that their market share continues in decline after a period of relative stability through FY23. A notable callout in the majors' reporting packs this season has been the increased emphasis on targeting more profitable lending margins, which would intuitively leave the non-majors and non-bank financial institutions (NBFI) to soak up any excess volume.

This appears to be playing out in the lending data, with average annualised credit growth at the majors up 4.9% in the half, well below the non-majors (8.1%) and NBFI (9.7%). The recent increase in NBFI growth is perhaps most notable, with the spread between NBFIs and both the majors/non-majors widening further during the year on an annualised basis.

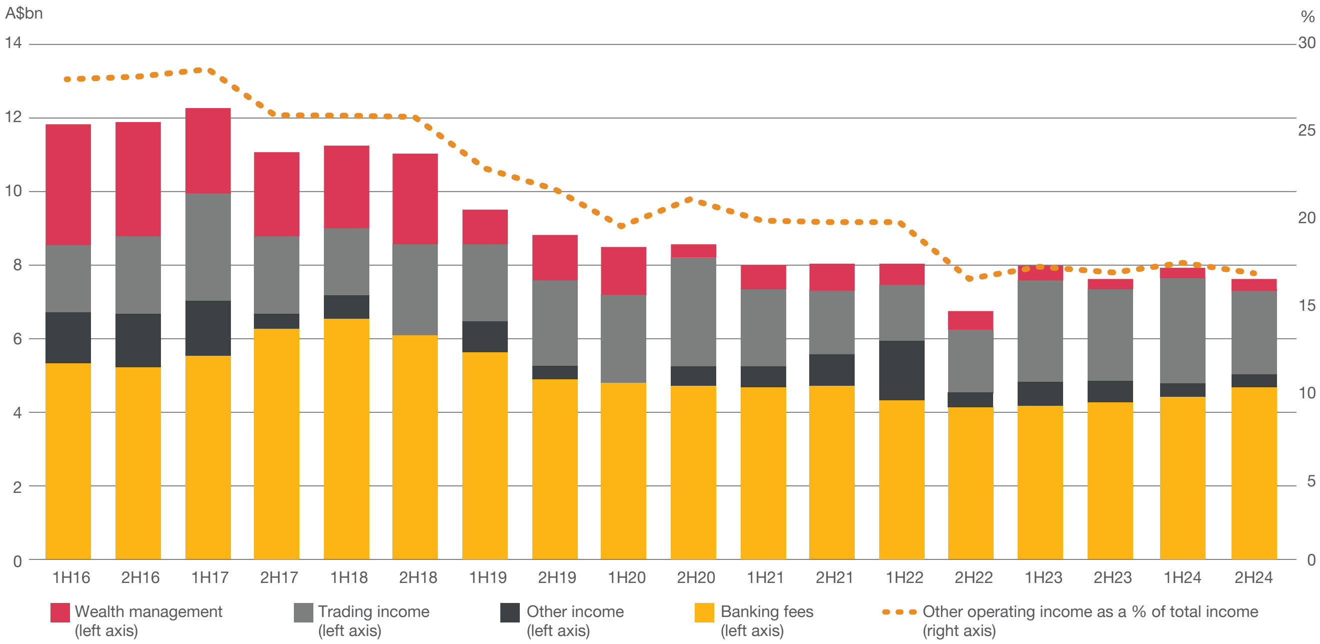
Figure 7 **Majors' market share continues to decline, hitting a new low**



Source: : APRA Monthly Banking Statistics, RBA Financial Aggregates Statistics, PwC analysis

Outside of interest income, 2H24 saw a decline in Other Operating Income (OOI) both in absolute terms and as a percentage of Total income, as shown in *Figure 8*. A 0.8% increase in Banking Fees (which is the largest income type by size) was not enough to offset the 10.8% decline in Trading income in the second half – leading to the half-on-half decline. However looking at the year-on-year movement, the contribution from Other Operating Income was largely flat on the FY23 year.

Figure 8 **OOI largely flat, relative to the prior period**



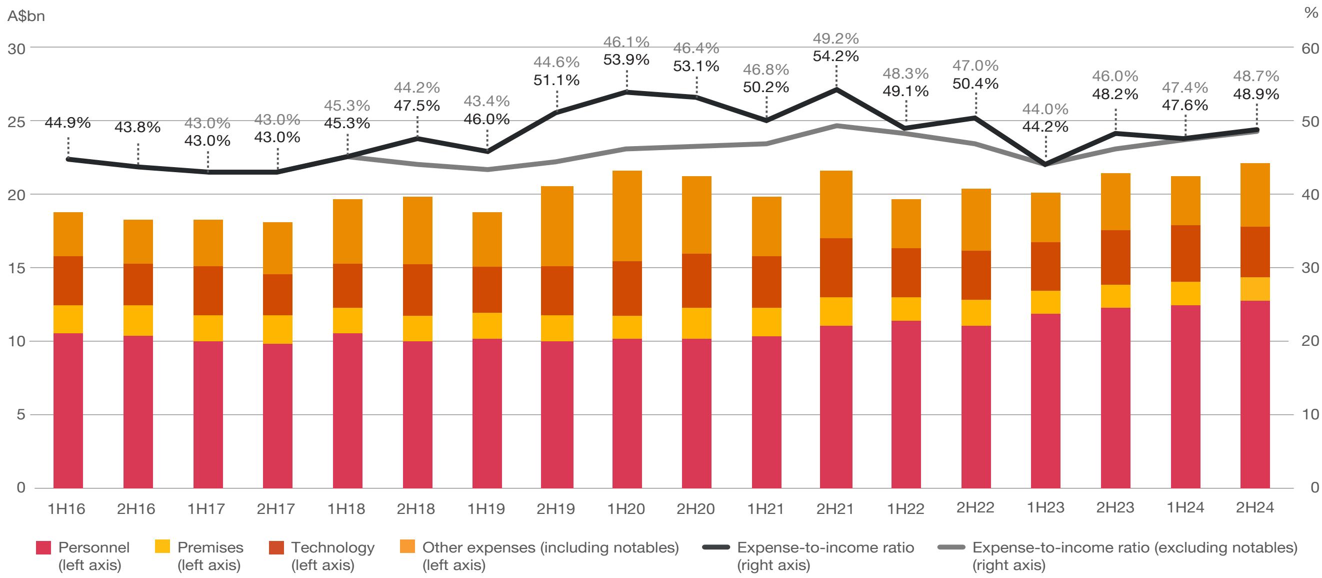
Source: Bank reports, PwC analysis

New record for operating expenses as inflation and investment bites

FY23 was a 3 year high for operating expense, and was eclipsed by FY24 as they continued to increase by 3.9% (or 6.5% excluding notables) – setting a new record high of $43bn. In analysing the half-on-half movements, operating expenses were largely flat in 1H24 (relative to 2H23), with all of the growth coming through in 2H24 where it was up 3.4% from 1H24.

On an annual basis and excluding the impact of notables, the expense-to-income ratio hit a 10-year high (albeit only marginally above FY21) as flat income became even further compressed by growing expenses. The key drivers of this growth over the year were technology spend (14.4% / $1.0b increase) and personnel costs (4.8% / $1.2b increase). With FTE over the period relatively flat (excluding the impact of acquisitions), this increase remained driven by wage inflation for the period.

Figure 9 **Operating Expense hit a record high, with increases in technology spend**



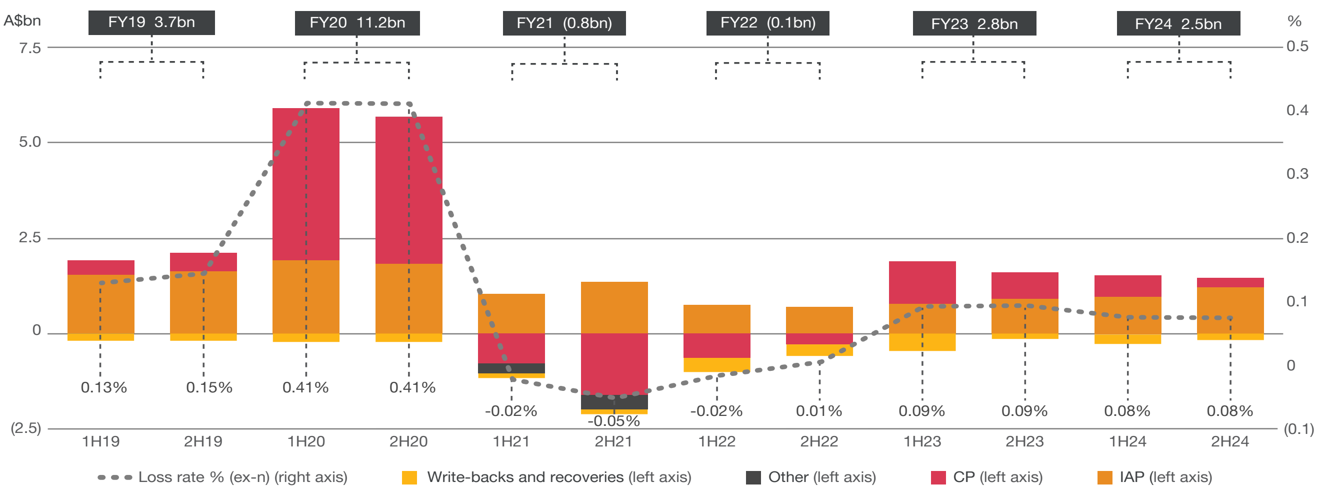
Source: Bank reports, PwC analysis

Credit expenses down slightly, however individual provisions increasing

Credit expenses during the year were $2.5bn ($2.2bn excluding the impact of acquisitions) with the key drivers of the expense being a combination of balance sheet growth (and therefore an organic increase in provision) as well as an increase in individual provisions – indicating some signs of stress are beginning to appear. This is in contrast to FY23, where increases in collective (or modelled) provisions made up the majority of the credit expense.

Borrowers typically move from being modelled as a 'collective' provision to an 'individual' provisions when they enter default or become impaired. The increase in individual provisions is therefore consistent with other arrears indicators – with the banks reporting an increase in 90+ Days Past Due (DPD) indicators over the year as customers deal with cost of living pressure and the ongoing impact of higher interest rates.

Figure 10 **Individual provisions the key drivers of credit expenses during the year**

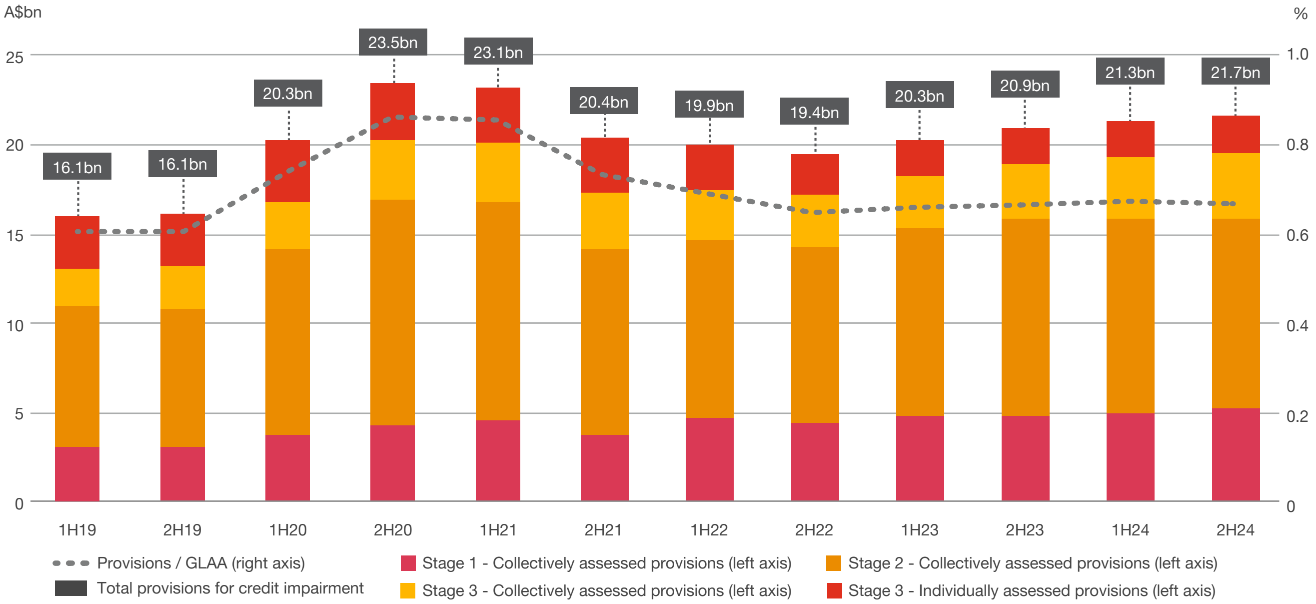


Source: Bank reports, PwC analysis

The balance sheet side of the equation tells a similar story, with a total increase in provisioning up 1.7% from the prior half (or 3.9% from the prior year). The main driver of this growth was from an increase in Stage 3 provisions which were up 7.5% or $0.4bn from 1H24. Stage 1 provisions also increased by 5.6% or $0.3bn over the half, which is the stage where newly originated loans will typically be provided for. The only decrease came from Stage 2 loans which fell by 2.9% or $0.3bn over the half, due to the impact of borrowers moving out of Stage 2 into both Stage 1 and Stage 3 (which was net of an increase due to re-measurement).

The coverage ratio (Provisions / GLAA) remained more or less flat over the period. Whilst Stage 3 loan provisions growth increased in percentage terms, in absolute terms, these still remain low in relative terms when compared to the size of the loan book and did not cause a meaningful move up in the coverage ratio.

Figure 11 **Credit Provisioning up, with decreases in Stage 2 offset by growth in Stage 3 loans**



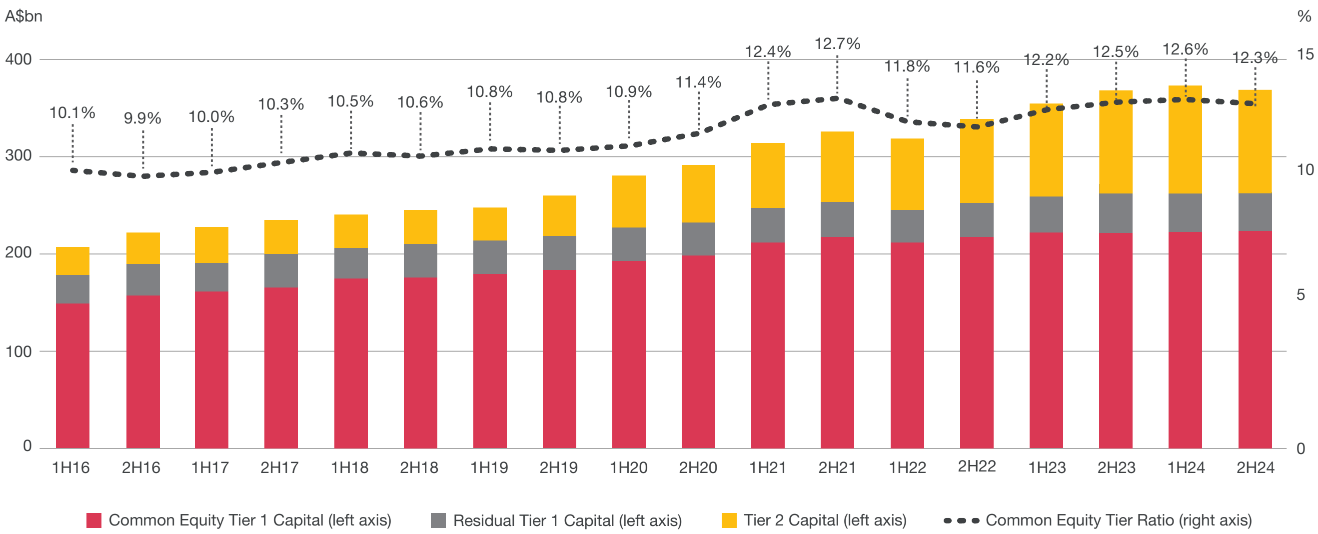
Source: Bank reports, PwC analysis

Capital levels down during the year but remain strong

Total capital was down approximately 0.6% on the prior half, with a decrease of $6bn in Common Equity Tier 1 (CET1) capital a key driver – which also resulted in a drop in the average CET1 ratio from 1H24. A combination of share buy-backs during the period contributed to this fall, as well as the impact of acquisitions which resulted in an increase in required capital deductions between statutory equity and CET1 capital.

With APRA's recently proposed changes to the Additional Tier 1 (AT1) hybrid instruments, over the medium term we would expect to see a decrease in AT1 instruments with a commensurate increase in Tier 2 notes and a marginal increase in CET1 capital. Relative to AT1 instruments, Tier 2 notes typically require a lower return with CET1 capital having a marginally higher return – so on balance the impact to earnings over the medium term should be more or less flat if this reform goes ahead.

Figure 12 **Capital levels down from 1H24, but remain at healthy levels**



Source: Bank reports, PwC analysis

02

Strategic tensions as banks globally manage near-term performance with longer-term reinvention

The strong but tightening results for the majors also continued to demonstrate the strategic tensions that are facing banks around the world and that, in some markets, are causing deep reflection on the need for business model reinvention.

In these markets, and indeed as it has been for some non-major banks in Australia, shareholder sentiment towards the sector indicates concern around the sustainability of business models and value-creation over the longer term. Across the world, a large proportion of listed banks trade at a price-to-book ratio below 1 and at low price/earnings multiples.

While these symptoms are clearly not the case for the Australian majors, the tensions and trends that drive them are by no means contained to other markets and set the scene for the 'Strategic tensions' we have alluded to and that occupy banking boards and executive teams in many markets – including Australia.

To simplify, these tensions exist between the need to complete the optimisation of existing business models, while embarking with purpose on reinvention for the future.

Reminder: Banks around the world grappling with commodity-trap dynamics

To understand these tensions, it is perhaps worth reminding ourselves of the key dynamics that exist today and how we got here. We've described this since 2016 as the 'commodity-trap' facing banking in Australia (and around the world) that has developed and hardened over the last 10-15 years. It is informed today by four consistent themes across most developed banking markets.

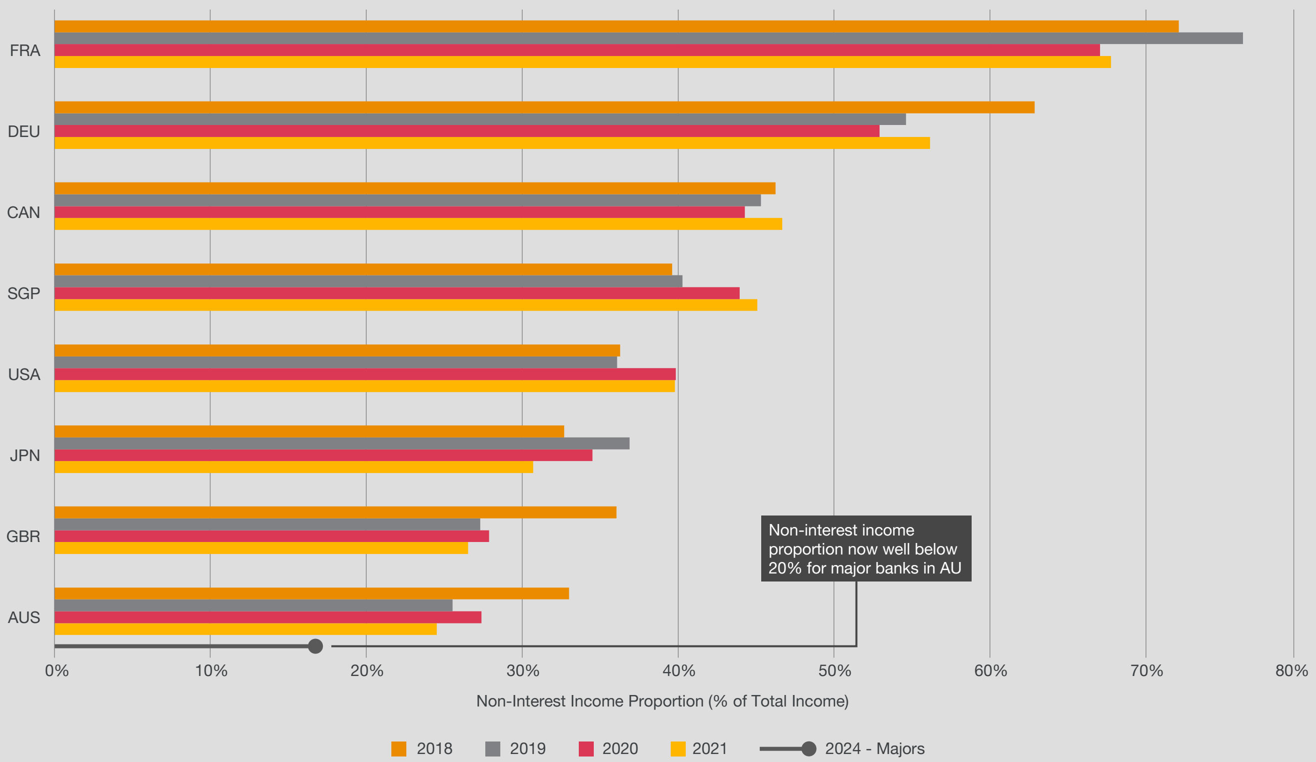
1 / Competition and concentration

The banking system and individual banks, in most markets, have spent years becoming far more focused and simple, offering fewer services, exiting business-lines and geographical locations. This 'return to the core' has been extremely deliberate following the global financial crisis and broader scrutiny on the conduct (and strategic value of) products and services delivered by large, vertically integrated banks.

The result, and no more so than in Australia, is that the industry has become more concentrated, dependent on and highly competitive in the core set of banking products – lending and deposits – and segments – particularly 'retail' banking. Coupling this with the impact of new-entrants, expansion of existing providers seeking to diversify their capital usage and private credit has led to an industry that is highly concentrated in NII and has experienced downward pressure on margins, even as interest rates have risen.

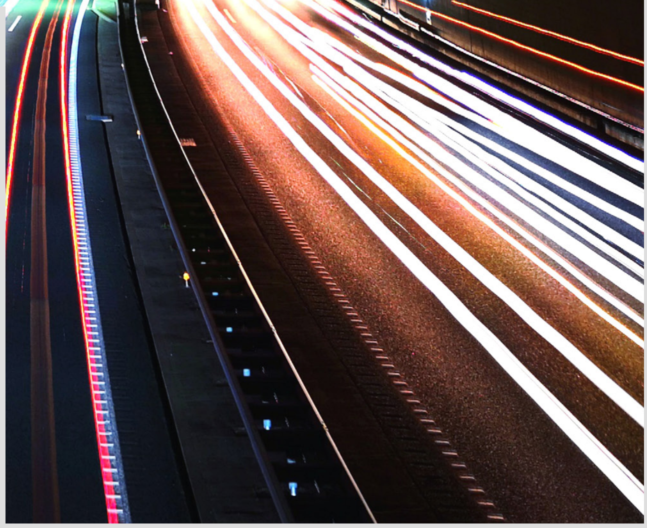
To illustrate (*Figure 13*) in Australia the proportion of non-interest income of banks is amongst the least diversified in the world and is now below 18%. This both explains the extent of competitive pressure and bodes for a future of more diversification-focused decisions – starting with the reallocation of growth investment to business banking.

Figure 13 Australia is one the least diversified banking sectors globally



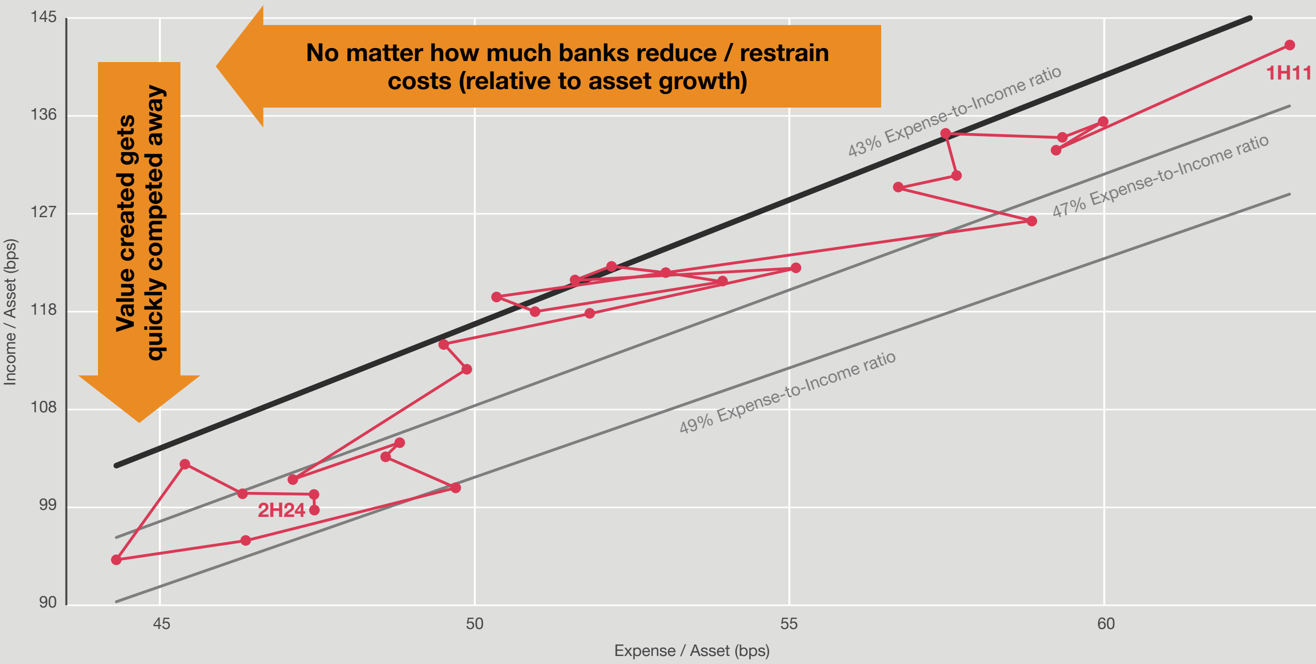
World Bank, PwC Analysis

2 / Structural cost/efficiency challenges



Despite significant focus from banks around the world on cost management and productivity, banks globally largely sit with similar efficiency ratios to those of the last 15 years. The reasons for this are well known and are often-considered structural – regulation, manual processes, technology modernisations. This all indicates the need for banks to both operate ‘at scale’ and reap scale benefits – something that has remained hard to come by. In Australia, this has been compounded by the impact of competition as shown in *Figure 14* – for every dollar saved in efficiency, banks have tended to ‘use’ that to be competitive for customers.

Figure 14 **The banking ‘Commodity Trap’ – cost savings passed to customers**



Source: Major bank financial statements, PwC analysis

3 / Investment needs remain high

While efforts to create efficiency in the 'Business as Usual' side of banking have been hard fought battles, the need for investment is not relenting and is increasingly driven by technology transformation and the enduring cost of regulation. Bank investments continue in technology security, resilience, and customer protection, while also addressing legacy systems and creating modern customer experiences. This year alone, we saw that technology costs increased by more than 8 times any other expense category in the majors.

4 / Stability, safety and risk appetite

Perhaps most interesting of all is the question of 'have banks become too safe?' Following the failings of the global financial crisis, Royal Commission and broader stakeholder scrutiny, the banking sector in Australia has worked exceptionally hard to become safer and more reliable, at the request of regulators and stakeholders. At the same time, we have all experienced a remarkable period of stability in the broader economy, despite shocks of war and pandemics and a rapid rate-tightening - meaning core business performance and particularly credit losses have been remarkably benign.

This has served us all incredibly well, but begs the question, as the banks have expressed in the context of regulation in particular, on whether the banking system – including regulators, shareholders, boards, management have become too accustomed to this stability. At a time where business models may require reinvention, where growth may require new bets and where the economy will need risk capital, there is a reasonable question about how able and ready banks and their stakeholders are to innovate and take (measured) risk. And if they choose not to, the question then arises whether returns can or even should return to higher levels.

Strategic tension: Optimisation and reinvention

> "In the business world, the rearview mirror is always clearer than the windshield."
>
> Warren Buffett

It is the situation described above, when combined with longer-term 'mega trends', that we believe sets the context for a fascinating strategic tension – and one that we think Australian banks are as well positioned as any market to respond to.

This tension is how banks manage near-term performance with continuing their response to the longer-term trends that may call for broader reinvention. Or, as we describe and summarise in *Figure 15*, how banks hold in tension the need to complete the optimisation of their current business models and contemplate reinventing them – ultimately to increase relevance, growth and returns.

On one-hand, the banks already have an ambitious and significant change agenda. This includes the focus on the simplification, modernisation and 'hardening' of their core businesses – technology platforms/consolidation, regulatory change, resilience – to more strategic investment in business priorities and foundations for the future, including acquisitions and commercial-banking investment for instance. These priorities are real, in many cases complex and represent a lot at stake for the banks and are being delivered at the same time as 'the squeeze from both ends' of costs and competition.

In the near-term therefore, it is clear to us that **operating discipline** and **execution excellence** are likely to be features of outperformance.

Figure 15 **Strategic tensions: Optimise and Reinvent**

Complete the optimisation

- Simplify and modernise
- Significant programs
- Squeezed from both ends
- The end of the beginning?

Operating discipline
Execution outperformance

Reinvent for the future

- Technology as enabler and disruptor – compounding
- Customer preference
- Regulation and change in trust
- Value pool redefinition

Choices to differentiate
Investing in capabilities

On the other hand, and in some ways in stark contrast to the tight-ship described above, the banks need to prepare themselves and respond to the impact of longer-term trends that, having been talked about for years, have now hit, are stuck and even accelerating. These are familiar but significant topics including:

01 The exponential and myriad impacts of technology

As an enabler of new customer propositions, accelerant of expectations and source of competition, while at the same time exponentially increasing the art of the possible in business transformation and the holy grail of data. The role of technology companies across bank value chains and value chain power dynamics also warrant interest.

02 Changing customer preferences

Centred around convenience, speed and personalisation (though not always requiring all). From the impact of embedded finance, digitisation of money, 'neo' banks – moving to a more personalised and frictionless customer preference and expectation. But also what Australians need and want as the world changes – particularly in areas such as retirement.

03 Regulation and the changing views of trust

The enduring emphasis on making the regulated sector the 'hardest' , particularly from a resilience, reliability and customer-protection standpoint. This has created not only long-term investment needs, but logical questions on fairness and risk between the regulated and unregulated parts of the system. Customers' centres of trust may also be changing, appearing to value convenience over safety more than we perhaps we expected – a topic we will cover in some depth in a consumer survey of bank customers.

04 Shifting value pools

Where money gets made in banking and who is best placed to 'own' that part of the value chain is also changing. What started as a subject of disintermediation has moved to a far more fundamental assessment of the banking service-set and value pools.

Most interesting of all for us is that these are all deeply interconnected and mutually reinforcing and represent an opportunity and risk of compounding innovation. Which is to say that with each innovation and response (or lack of) the benefit of the next move becomes more and more impactful due to the reinforcing nature of the innovation.

This need to consider reinvention calls for a starkly different emphasis to the 'discipline and execution' of the optimisation imperative – one of bigger choices and investment in truly winning capabilities.

According to Warren Buffet, the clarity of ongoing trends becomes apparent as they continue to shape the future, even if they are less obvious at the outset. With that, we hypothesise that these trends are here to stay, and that banks have reached the end of the beginning. So therefore, the question then becomes:

- What possible paths can they choose, and what capabilities should they nurture to get there?
- Are banking leaders armed with the right mindset to navigate the best path forward?

03

Ready and set… to reinvent

The good news is that, in our view, Australian banks are both ready and set for the reinvention that might be required.

Ultimately, across the globe we expect that to involve much and many more intentional decisions by banks about the different roles that banks choose to play (or archetypes) across their portfolio based on their natural advantages and perspectives on the future. To truly differentiate, that will require investment in new, more transformational capabilities to deliver on that promise.

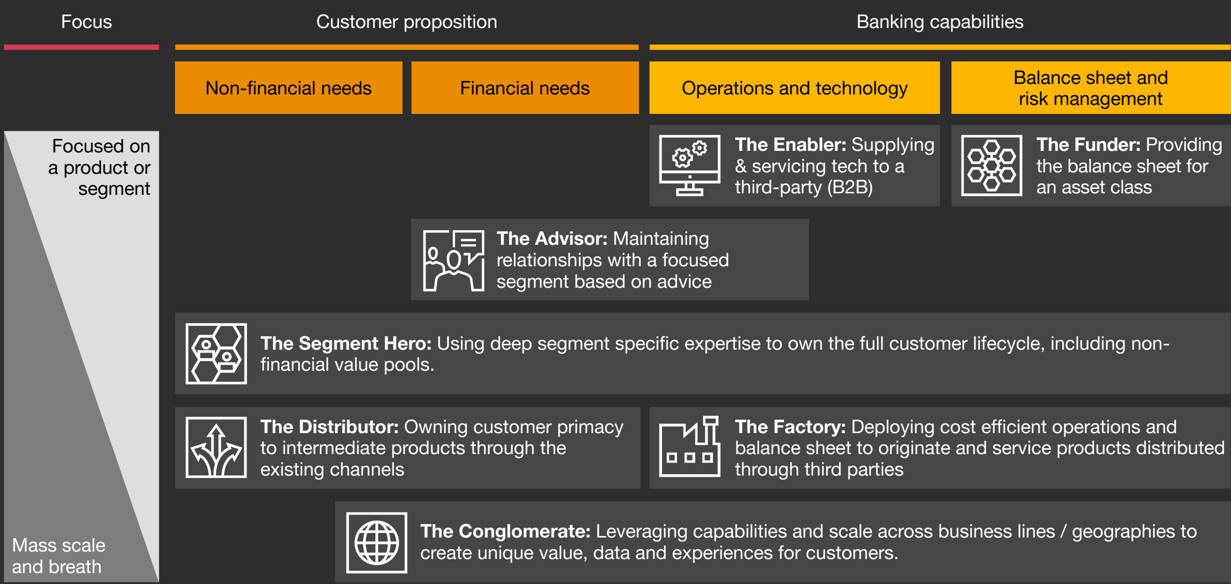
In simplistic terms, we expect banks globally to become more discerning and less vertically integrated as a result. We aren't suggesting a large 'conglomerate' bank will not exist, or that an Australian major will adopt just one archetype. But for winning banks those decisions will be highly conscious and capabilities aligned to deliver – to broaden income streams, create growth and improve/sustain relevance.

From the range of archetypes that could emerge, we've identified seven archetypes of the future. These archetypes are based on considering three dimensions. The first dimension considers the breadth of the customers addressed and the products offered. Some banks will prioritise a particular product or segment while, at the other end of the spectrum, other banks will focus on mass scale and breadth.

The second dimension considers the customer proposition. It considers where the bank delivers and derives value. For example, value may be derived from focussing on meeting the financial needs of the customer. Alternatively, value may be derived from owning the entire customer relationship (i.e. as they are then able to identify all the solutions required – both financial and non-financial).

The final dimension considers where the banking capability resides (i.e. what capability does the bank want to get paid for?) Is the bank's chosen focus on providing the balance sheet and risk management capabilities from which value is derived, or does it also include providing the operational and technology capability?

Figure 16 **New business Archetypes across the banking value chain**



Source: PwC analysis

Our hypothesis is that, while banks may deliver many of these archetypes concurrently, finite resources and investments mean a choice (or two) must be made.

Seven archetypes of the future

01 **The Factory** harnesses cost-efficient operations and balance sheet strength to build and service products which are distributed through third parties.

This model will only be likely for banks that can run products at a consistently lower cost to serve—either due to their scale or their differentiating capabilities. Cost, reliability and flexibility are key differentiators. This is because products are sold through distributors such as brokers, who will have their choice of factories.

02 Drawing on customer data and experience design, **The Distributor** understands what customers want and how to develop appropriate solutions by partnering with manufacturers and servicers.

The Distributor is a viable model for banks and non-banks as it doesn't create and manage the underlying products. Instead, it generates fees as an intermediary. Its key differentiators are customer insight, proposition development and experience management.

03 **The Segment Hero** focuses on sector expertise and superior customer experiences as it manages both financial and non-financial demands in its specialist area. Examples include adding property management to a buy-to-let mortgage offering, industry-specific value-added services alongside merchant acquiring, or equipment management and disposal services alongside asset finance

04 **The Advisor** offers tailored solutions and insights. The differentiators don't just include expertise, but also relationships, impartiality and trust. Technology can help to strengthen customer engagement, understanding and experience, while helping Advisors to compete against traditional distributors such as brokers.

05 **The Enabler** develops and supplies tech solutions to third parties. The Enabler doesn't carry out regulated banking activities or interact with end consumers. Key differentiators include interoperable, scalable and secure solutions.

06 **The Funder** provides the balance sheet for an asset class, often in a niche, specialised or high-risk area. This model focuses on funding for lending, such as via a forward flow or strategic funding arrangement, without providing the technology and operations to originate or service the product. This may be a viable additional archetype for a major bank to adopt alongside other archetypes to deploy spare capital. Key differentiators include capital, liquidity and asset class expertise.

07 **The Conglomerate** draws on its scale, breadth and data-enabled insights from across business lines to create unique value for its customers—whether in the form of lower prices, unique propositions or superior service.

Like the Factory, this model is only likely to be viable for larger banks due to the necessity for scale. But the connectivity of the Conglomerate across brand and product areas marks a shift from the business models employed by major banks today.

The Conglomerate may include several other archetypes within it. We expect the more successful Conglomerates to reconfigure their business units and functional structures, with each unit anchored to a clear purpose and value proposition, underpinned by combinations of common differentiating assets, capabilities and ecosystem relationships.

Investing in differentiating capabilities

Banks that invest in the differentiating capabilities of these archetypes are more likely to see future benefits.

Figure 17 outlines examples of the winning capabilities we see as supporting these archetypes to a greater or lesser extent by archetype.

For example one winning capability that many archetypes are likely to have in common is ecosystem and partnership management.

Ecosystem and partnership management

Maximising the benefits associated with ecosystems and partnerships requires the capability to build and manage strategic relationships and alliances. This involves creating a network of partners that can enhance the bank's offerings, expand their reach, and drive mutual growth. In the digital age, partnerships often entail leveraging each other's technology, data, or services to create an ecosystem where both parties can thrive. The goal is to co-create value, drive innovation, and achieve objectives that would be challenging to accomplish independently.

Given the agility within which the bank would want to add, change or exit partnerships, they will also need to develop the capability to initiate and conclude partnerships with minimal disruption. This includes establishing processes and frameworks for seamless integration and disengagement, ensuring that the bank can adapt quickly to changing circumstances and maintain operational stability throughout the partnership lifecycle.

Figure 17 **Implications for winning capabilities**

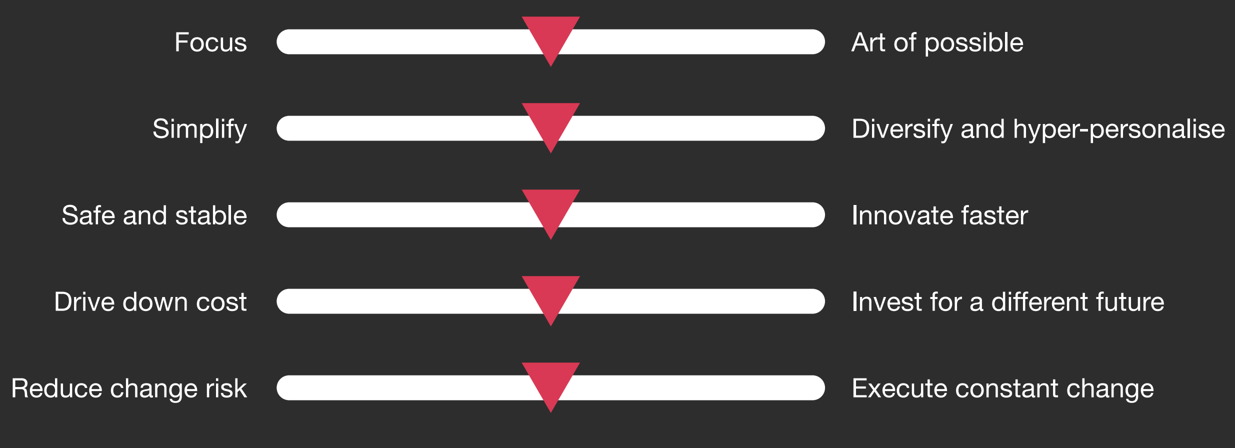
Unifying customer and banker operating model	Structural cost reassessment
Ecosystem and partnership management	Acquisition and integration excellence
Differentiating through resilience and reliability	Skill and work transition
Extracting the data advantage	Leadership in tension

Holding mindsets in tension

Finally, it would be remiss to not recognise that in holding the two sides of the strategic tension, banks and their leaders will also have to hold mindsets in tension – in terms of what is required for optimisation and reinvention.

Put simply, this could be described as ‘keep it tight, but let go’ and is perhaps the most challenging dynamic of all for banks that have worked so hard to get to the position strength and focus today, have so much at stake on existing priorities and, yet, are being called to consider a bigger set of imperatives for their long-term success.

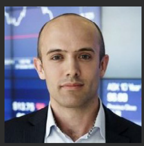
Figure 18 **Holding mindsets in tension as banks seek to optimise and reinvent**



	ANZ			CBA			NAB			WBC		
	FY24	FY23	FY22	FY24	FY23	FY22	FY24	FY23	FY22	FY24	FY23	FY22
Earnings and Returns												
Cash earnings	6,725	7,405	6,515	9,836	10,072	9,595	7,102	7,731	7,104	6,990	7,195	5,276
Cash earnings (incl discontinued operations)	6,725	7,405	6,496	9,847	10,090	9,708	6,960	7,782	6,935	6,990	7,195	5,276
Cash earnings before tax (A+B+C+D)	9,662	10,521	9,200	14,154	14,271	13,618	10,095	10,829	9,897	10,107	10,305	7,874
Core earnings (A)+(B)+(C)	10,068	10,766	8,968	14,956	15,277	13,261	10,823	11,631	10,022	10,644	10,953	8,209
Dividends paid (per cash flow)	5,252	4,380	3,784	7,623	7,117	6,535	4,700	4,339	4,006	5,652	4,504	4,337
Income tax expense	-2,902	-3,219	-2,657	-4,318	-4,097	-4,023	-2,975	-3,093	-2,793	-3,117	-3,277	-2,724
Profit after tax (statutory basis)	6,535	7,098	7,138	9,481	10,090	10,771	6,960	7,414	6,891	6,990	7,195	5,694
Return on average equity (calculated %)	9.6%	10.9%	10.4%	13.6%	13.9%	12.7%	11.6%	12.8%	11.7%	9.8%	10.1%	8.1%
Notable Items												
Notable items (Cash earnings impact)	0	-307	-154	-89	-212	-124	0	0	0	-123	-147	-1,292
Revenues												
Net interest income (A)	16,069	16,574	14,874	22,824	23,056	19,473	16,754	16,807	14,852	18,753	18,317	16,605
Net interest income (excluding notable items)	16,069	16,592	14,874	22,824	23,056	19,473	16,754	16,807	14,852	18,916	18,395	16,606
Net interest margin (NIM) (%)	1.57%	1.70%	1.63%	1.99%	2.07%	3.79%	1.71%	1.74%	1.65%	1.93%	1.95%	1.93%
Non-interest income (B)	4,740	4,331	3,673	4,350	4,079	5,216	3,496	3,847	3,444	2,835	3,328	2,406
Non-interest income (excluding notable items)	4,740	4,338	3,386	4,350	4,079	4,700	3,496	3,847	3,444	2,847	3,110	3,299
Non-interest income as a % of total income (exld. notable items)	23%	21%	19%	16%	15%	19%	17%	19%	19%	13%	14%	17%
Expenses												
Total operating expenses (C)	-10,741	-10,139	-9,579	-12,218	-11,858	-11,428	-9,427	-9,023	-8,274	-10,944	-10,692	-10,802
Expense/income ratio (%)	51.6%	49%	52%	45%	44%	46%	47%	44%	45%	51%	49%	57%
Total operating expenses (excluding notable items)	-10,741	-9,718	-9,170	-12,129	-11,646	-10,788	-9,427	-9,023	-8,274	-10,944	-10,232	-10,181
Expense/income ratio (%) (excluding notable)	51.6%	46%	50%	45%	43%	45%	47%	44%	45%	50%	48%	51%
Total number of full-time equivalent staff	42,370	40,342	39,172	48,887	49,454	48,906	38,996	38,128	35,128	35,240	36,146	37,476
Asset Quality												
Credit impairment expense (D)	-406	-245	232	-802	-1,108	357	-728	-802	-125	-537	-648	-335
Loss rate (%) (credit impairment expense/total GLAA)	-0.05%	-0.03%	0.07%	-0.08%	-0.12%	0.04%	-0.10%	-0.11%	-0.02%	-0.13%	-0.08%	-0.05%
Individual provision funding (exld. write-backs and recoveries)	-465	-476	-520	-397	-470	-321	-863	-560	-402	-423	-197	-220
Collective provision funding	-262	-152	311	-559	-795	506	-92	-469	46	89	-329	27
Gross impaired assets	1,693	1,521	1,445	3,900	3,326	2,951	1,477	1,260	1,029	1,955	1,302	1,514
Gross impaired assets as a % of GLAA	0.21%	0.21%	0.21%	0.41%	0.36%	0.33%	0.20%	0.18%	0.15%	0.24%	0.17%	0.20%
Total provisions for credit impairment	4,555	4,408	4,395	6,135	5,950	5,347	5,921	5,585	5,056	5,084	4,930	4,625
Total provisions for credit impairment as a % of GLAA	0.56%	0.62%	0.65%	0.65%	0.64%	0.60%	0.80%	0.79%	0.74%	0.63%	0.63%	0.62%
Collective provisions	4,247	4,032	3,853	5,423	5,196	4,611	5,165	5,046	4,541	4,548	4,579	4,173
Credit risk weighted assets	361,185	349,041	359,442	370,444	362,869	393,647	350,891	355,554	367,261	345,964	339,758	362,098
Balance sheet												
Total assets	1,229,115	1,105,620	1,085,729	1,254,076	1,252,845	1,215,260	1,080,248	1,059,083	1,055,126	1,077,544	1,029,774	1,014,198
Total average interest earning assets	1,023,616	975,079	910,037	1,144,357	1,111,254	1,026,910	978,741	966,705	900,297	970,055	941,376	886,971
Total average non-interest earnings assets	148,743	138,749	125,932	121,713	122,237	119,775	101,768	103,702	96,278	87,254	81,852	87,792
Gross loans and acceptances (GLAA)	807,057	710,590	673,625	949,948	933,251	884,963	738,206	708,471	687,715	811,335	777,687	743,853
Total liabilities	1,158,487	1,035,626	1,019,328	1,180,988	1,180,790	1,142,422	1,018,035	997,580	996,094	1,005,492	957,235	943,689
Customer deposits	715,211	647,119	620,429	833,725	819,701	777,763	612,796	587,384	566,685	673,615	640,951	612,834
Total equity (excl. minority interests)	69,857	69,495	65,907	73,088	72,000	72,833	61,455	61,154	59,032	71,705	72,495	70,452
Common equity tier 1 ratio (%)	12.2%	13.3%	12.3%	12.3%	12.2%	11.5%	12.4%	12.2%	11.5%	12.5%	12.4%	11.3%
Core equity tier 1 capital	54,469	57,794	55,872	57,691	56,909	57,023	51,139	53,136	51,776	54,648	55,885	53,943
Total risk weighted assets	446,582	433,327	454,718	467,551	467,992	497,892	413,946	435,006	449,918	437,430	451,418	477,620
GLAA / total assets (%)	65.7%	64.3%	62.0%	75.7%	74.5%	72.8%	68.3%	66.9%	65.2%	75.3%	75.5%	73.3%

Where relevant, comparative information in the table has been restated to align with any restated amounts in the annual report.

Contact us



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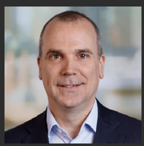

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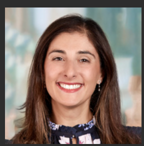

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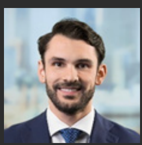

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