

Commonwealth Bank of Australia
March Quarter 2020 Trading Update
13 May 2020

Start of Transcript

Operator: Thank you for standing by and welcome to the Commonwealth Bank of Australia March quarter 2020 trading update conference call. All participants are in a listen only mode. There will be a presentation followed by a question and answer session. If you wish to ask a question you will need to press the star key followed by the number one on your telephone keypad. I would now like to hand the conference over to Melanie Kirk. Please go ahead.

Melanie Kirk: Good morning and thank you for joining us for the Commonwealth Bank of Australia March quarter 2020 trading update call. I'm Melanie Kirk and I'm Head of Investor Relations. On the call today is our CEO, Matt Comyn and our CFO, Alan Docherty. The Bank has lodged a number of announcements with the ASX this morning, including a third quarter trading update presentation. The presentation will be used as the basis of the opening comments from Matt and Alan. Following the opening remarks, there will be time for a few questions. I'll now hand over to Matt.

Matt Comyn: Thanks very much Mel and morning everyone. Unlike normal quarterly results, we put together some additional disclosures for this result which we hope is helpful and as Mel said, Alan and I are happy to take questions at the end of that. I'm not going to refer to all of the slides, but as I go through different parts of the presentation, I'll broadly tell you specifically what slide I'm on.

I think a good place to start is really just on slide 4, if we just look at the significant support that's been put in place really over the last couple of months and the broader impact to try and cushion the blow on the economy. If you look at the load that we've seen, we've received more than a million calls from customers, including an 800% increase in calls to our financial assistance line, huge demand for information, we've had more than four million visits to our CommBank website and we've gone through more than 10 million daily logins to the CommBank app and NetBank. We've provided support to 100,000 businesses and one million personal customers.

From a business perspective, we've auto-enrolled 71,000 small businesses, we've approved more than \$555 million in loans under the government's new SME guarantee scheme and as part of that, making sure that any Commonwealth Bank customer was able to participate in the JobKeeper, we've had 700 people working all over the ANZAC

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weekend and similar numbers in the weekend after that to make sure that we process as many temporary finance facilities for customers as we could.

On the personal side, we've deferred more than 140,000 home loan accounts and this is of course in addition to substantial reductions in fixed rates and also an offer of a term deposit over that period, which was a 70 basis point increase on the cash rate. Across all of that, like other businesses huge disruption and changes to the way people have worked, which we've been able to support our customers throughout and we're particularly pleased from a management perspective to see our employee engagement up 13 percentage points to 81%, which would be the highest result in more than four years.

Now just referring to slide 5 and this will come up more broadly in the deck, as we've thought about various economic scenarios and we've considered a number of different scenarios, both internally and also looked at some of the external data, under any of those scenarios we're expecting a significant contraction in economic activity. We've based a lot of the work that we're going to cover today on the RBA's forecast that came out last Friday.

Clearly there's a lot of uncertainty in the depth and duration of that economic contraction, so we've updated our base case assumption based on their forecasts and then we've run multiple scenarios around that. In the meantime, of course, we're continuing to try and participate as best we can in assisting our customers in the broader economy to restart safely in the coming months, which is clearly going to be a big determinant on both economic activity and future credit losses for us.

As I look at slide 6, from our perspective we're fortunate to be entering a very challenging period in the strongest condition that we've ever been in. Compared to GFC, we're holding three to four times provision levels in liquid assets, our capital ratios are more than double, broadly on a like-for-like basis and as you've seen over many periods, we've continued to increase our level of deposit funding.

We'll talk through how we derive, but as you will have seen, we've taken an additional \$1.5 billion collective provision, taking our total provisions to \$6.4 billion, which gives us a 1.65% provision coverage level to credit risk weighted assets. We've seen a lot of liquidity, particularly in the month of March, so very strong ratios, both deposit funding and stable funding ratios. We'll spend some time on our common equity Tier 1 as Alan walks through that in one of the later slides.

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On slide 7 and pleasingly from our perspective, in addition to operationally performing well, we've continued to execute on our strategy. This morning we announced the divestment of a 55% stake in Colonial First State for \$1.7 billion to KKR. That represents a 15.5 times multiple on pro forma NPAT and a post-gain tax on sale of \$1.5 billion. We expect this will increase our Common Equity Tier 1 by approximately 30 to 40 basis points in the first half of next calendar year.

Turning now to slide 8, I think particularly we've taken some of the good operational momentum from our first half into this quarter. Pleasingly, we were seeing good deposit growth pre-March, but March was a very strong month for us, with deposits up \$10 billion in retail and SME that saw us grow our market share in the month of March and household deposits by more than 20 basis points.

We've seen very strong deposit growth also in the month of April and similarly, the operational performance in home lending has remained very strong. We've continued to grow slightly above market; our operational execution and speedy decision has enabled us to grow faster than system. Somewhat surprisingly, application volumes have remained robust; down during a period of April, but then up quite sharply in May, tracking above the same period last year.

There's obviously been an increase in refinance activity and switching to fixed-term rates and because I think our speedy decision is favourable to competitors, that's enabled us to do well. We've seen a bit of momentum in business lending also during the period.

So overall, our cash NPAT was down 44% to \$1.3 billion, our operating income flat, supported by \$115 million favourable XVA and much higher CommSec trading volumes during the period. Expenses on an underlying basis down 1% and as we look forward into this quarter, we have added a number of customer-facing roles to deal with the significant increase in in-bound customer activity. As you would expect, we've also seen a reduction in annual leave.

Turning to slide 9, we're seeing seasonally higher arrears rates, which are lower year on year. I mean the containment measures really only came into effect in mid-March, so as you would have seen in the underlying loan impairment expense, it was very benign pre that period. We've certainly seen an uptick in arrears, we expect to see that continue particularly in the unsecured book, which as you know, is more sensitive to a fast transmission in terms of an increase in the arrears rate. Troublesome and impaired assets

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were flat at 0.72% of total committed exposures and the loan loss rate, after allowing for the increased provision, is 80 basis points for the quarter.

Turning to slide 10, before I hand over to Alan to talk through some of the methodology in greater detail, I guess the way we've thought about this is over the last couple of months we've been through a number of different scenarios. We've really thought about it both in the context of a bottom-up and top-down approach. When we come through from a bottom-up, we've gone through each of the individual sectors across all of the businesses that we support and looked at individual notching of PD and LGD. Similarly in our retail exposures, we've gone through individual occupation types.

We've then solved from a top-down perspective using a number of different scenarios which we're going to come on to on slide 11. Then we've tried to think through, acknowledging that there is, of course, considerable uncertainty, what we think bottom-up the expected losses will be, as well as the risk weighted asset migration.

Then we've looked at a number of different data points, both domestically and internationally, to try and triangulate to what we believe would be the most appropriate provision, which today we announce is \$1.5 billion. It also positions us with the highest provision coverage ratio in the industry, which we feel is prudent at this point in the cycle, even though we are very comfortable about our overall balance sheet composition going forward.

Maybe on that note I'll hand over to Alan to talk through some of the details.

Alan Docherty: Thank you Matt and good morning all. I'll just walk through our thinking in a bit more detail on loan loss provisioning, the stress testing scenarios and our capital movements in the quarter and then we'll open up for your questions.

On loan loss provision, as Matt has described and you can see on slide 10, we arrived at that going through a granular bottom-up analysis of the likely stress on our retail and non-retail portfolios, which we've then sense checked top down. It's important to stress the starting point for the estimation of the provision of that bottom-up analysis, because that allows for a much more accurate assessment, the likely impact of the particular type of economic stress that you happen to be facing, as opposed to building a provision using blunt economy-wide measures, such as unemployment growth and GDP growth top-down.

So in terms of that bottom-up analysis, for our retail lending portfolios, we conducted analysis of our customer breadth based across a number of dimensions, including their

occupation, where they live, the level of prepayments and the LVR situation. We then identified the likely high risk customer segments who may not have sufficient cash flows to service their loans at the other side of this crisis. From this work we then formed a view on a range of arrears rates and default rates and also the anticipated supply and demand impact on house prices and that helped inform our HPI assumptions for our stress scenarios which I'll come on to shortly.

For the non-retail portfolios, as Matt mentioned, we had some downgrades of the probability default across the whole portfolio and then a more aggressive notching applied to both PDs and loss given default, based on the level of impact that coronavirus is expected to have on the cash flows of each particular industry sector, subsector and also individual institutional clients' cash flows. As you can imagine, we've taken a number of turns at that analysis and we're comfortable with where we've ended up in terms of total loan loss provision of \$6.4 billion.

For a point of reference that \$6.4 billion total loan loss provision, that would be broadly in between the two economic scenarios that we've set out in the following slide. If we turn to that slide, slide 11, as Matt mentioned, we've modelled all sorts of COVID-19 economic stress scenarios over recent weeks, including the Reserve Bank baseline forecasts that were published last Friday. Under the RBA baseline for GDP and unemployment and our expectations around what that would mean for house prices, we could see a 4% increase in credit risk weighted asset intensity, which would drive a 90 basis point CET1 impact. A more prolonged downturn, as you can see, would imply 170 basis point CET1 impact.

We all know there are many unknowns as things stand today, so I don't want to leave you with a false sense of provision around these scenarios. We'll continue to evolve these forecasts as new information continues to flow through. Importantly, under all these forecast stress scenarios, we continue to make a cash profit and generate strong levels of organic capital in each financial year.

As you know, we've also for many years maintained a disciplined approach to managing and allocating our capital across our portfolio of businesses, so we use these stress tests to ensure that we're continually adapting our business settings, making decisions across our retail and non-retail portfolio, with due regard to the need to maintain equilibrium between the needs of all our stakeholders.

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Turning to our capital position at the end of March, it's worth spending a bit of time on slide 12 explaining the various movements here. At the headline level 2 CET1 ratio of 10.7% might be a little lower than some of you may have expected. Firstly, as you know, our March spot position always has a timing difference in major bank peers and that we have just paid a \$3.5 billion interim dividend to our shareholders and we neutralised the interim DRP, which resulted in a 79 basis point distribution of capital.

If we then look at the other moving parts, left to right, capital increased 18 points due to the latest instalment of proceeds from the CommInsure Life divestment, which we received in late March. That was more than offset by increased provisioning in the quarter, mainly in relation to the forward-looking adjustment to loan loss provisioning, which of course does 35 basis points including the non-deductible deferred tax assets associated with these provisions.

The underlying level of organic capital generation was weaker than we'd expected, only 12 points for the quarter. If I break that down, you can see the 51 basis points of cash profit. Credit risk weighted assets were higher. That was in line with our expectations and was primarily due to the strong volume growth in mortgage lending and also the liquidity support that we provided in March to our corporate and institutional clients.

What was unexpected, given the relatively low level of risk we're running in our markets and treasury businesses, was how our traded market risk and interest rates risk models performed. As a result of the pandemic-related market volatility that we experienced in March, the traded market risk model produced a very conservative capital outcome. In addition, the increase in IRRBB was driven by model outputs that reflect their business mix and variable interest rate environment.

This resulted in a 19 basis point decrease in CET1 across these two risk types, which was around four times the level that we observed among peer banks. We expect some of this impact will unwind in the next quarter and we're working towards improving these models during the fourth quarter to ensure that the capital we're carrying better reflects that underlying level of risk.

Lastly, in terms of level 2 capital movements, we've seen a capital impact of 14 basis points on mark-to-market re-valuation of our high quality liquid assets due to widening credit spreads. Pleasingly, we've already seen around half of that impact reverse during the last few weeks, in line with the gradual improvement in credit market conditions. As

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we look ahead, the strong pipeline of announced divestments will drive further inorganic capital generation of between 67 to 77 basis points, which is approximately \$3 billion to \$3.5 billion. We've also maintained a very strong buffer in our level 1 capital ratio, which means we're well placed to absorb the impact of the regulatory ban on dividends from New Zealand banking subsidiaries.

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