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UBS Investment Research

Australian Banking Sector Update

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Competition: Be careful what you wish for

■ Politics and banking don't mix

The Prime Minister & Treasurer have committed to announcing measures to increase Australian banking competition over the next few weeks. This follows the announcement of record profits by the major banks in unison with increases to the mortgage rates above the RBA cycle. In this report we look at: (1) The experiences in the UK following attempts to increase competition in the wake of the Cruickshank Report in 2000; (2) How significant & permanent are the other factors in the banks' interest rate setting (ex RBA); (3) Are banks "gouging" Australians.

■ Increased bank competition - the UK banking experience

Between 1919 and 2000 the five (then four) UK major clearing banks controlled ~85% of the deposit market. However, following the Cruickshank Report into bank competition in 2000 and the substantial increase in funding availability that coincided (via securitisation) the UK banking environment changed substantially. Lending underwriting standards were loosened by newcomers, first in mortgages then in commercial property, leverage increased and asset prices rose sharply. Eventually the large banks followed to protect their position. Then the Global Financial Crisis (GFC) hit. We believe that the short term gains consumers enjoyed from competition appear more than offset by tax payer bail-outs & the recession.

■ RBA monetary policy - is it less effect in a post-GFC environment?

Given Australia's high usage of variable rate mortgages, Monetary Policy has been very effective in managing the economy. However, the extended period of household leveraging above deposit growth means that Australia's reliance on wholesale funding has increased substantially. Prior to the GFC this gap was mainly met through short term wholesale funding in a period of very elastic funding supply. However, post-GFC the banks have both termed out funding and competed aggressively for deposits. But this has coincided with a much steeper/inelastic funding supply curve which has led to substantial increases in bank funding costs. Basel III liquidity requirements will add to overall funding costs and make such changes permanent. As a result Australia must; (1) endure a prolonged period of household deleveraging; (2) accept the inelastic supply of funding is now a key driver in the interest rate settings for depositors and borrowers by the banks over and above the RBA cycle.

■ Are you being "gouged"?

There is a common perception in Australia that the banks are "gouging" customers. We believe that the numbers should be put into perspective. In 2010 revenue growth was the weakest in 8 years. Bank revenue to GDP has been flat since 2001. Revenue on assets earned by the banks is near a 30 year low. ROE of 16% is exactly in line with the 30 year average. 95.4% of bank revenue is re-invested via: employment expenses ($17b); other costs ($13b); tax ($8b); provisions for bad debts ($8b); retained capital to support new lending ($7b); and dividends to Australian superannuants and shareholders ($12b). Banks now employ 174,000 people which exceeds the previous peak in 1996.

This report has been prepared by UBS Securities Australia Ltd

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Competition: The UK experience

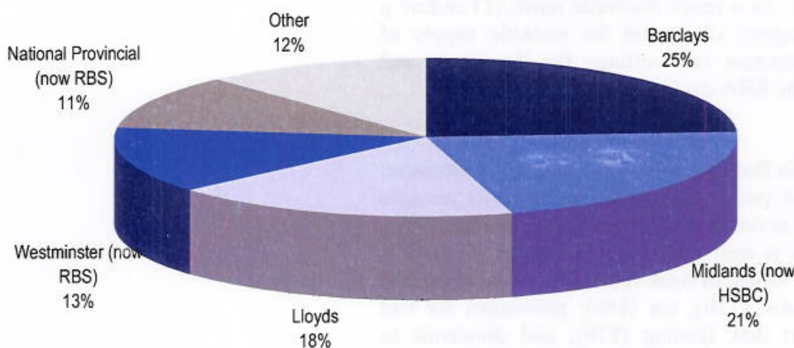
We believe that the current push in Australia to increase competition within the banking sector bears significant resemblance to similar moves in the UK during the late 1990s. Both banking markets had very similar products and legal structure, had a number of stable larger/major banks who dominated market share in key products and generated relatively high levels of profitability. This led to concerns that these organisations were overly profitable and it would be in the public's interest if competition was increased. We believe that the lessons from the UK should not be lost on Australia.

Lessons from the increased banking competition in the UK

The UK banking system had been very stable for an extended period of time. From the 1880s until 1917 the UK banking system went through a period of consolidation between the leading banks. By 1918 a Treasury Committee was established under the Chairmanship of Lord Colwyn to assess whether further such mergers may be "prejudicial to industry and commerce". The Colwyn Report recommended that some measure of Government control was essential and that legislation be passed requiring approval by H.M. Government for future banking amalgamations. Although this legislation was never passed, it became practice in the UK that any banks considering amalgamating would consult the Governor of the Bank of England, who would then consult Treasury before any decision was made.

The stability of the UK banking system can be seen from the 1968 Monopolies Commission report into the Proposed Merger of Barclays, Lloyds and Martins Banks (the report found that a merger between Barclays and Lloyds "may be expected to operate against the public interest"). This report showed that the five leading London Clearing Banks controlled 88.3% of Gross Deposits. Interestingly, these five banks now form parts of the four largest UK banks today.

Chart 1: London Clearing Banks Gross Deposits Market Share, December 1967



Source: Committee of London Clearing Bankers, UBS estimates

The Cruickshank Report

By the mid 1990s there was a growing level of discontent with the UK banks and their profitability. In November 1998 the UK Government commissioned Don Cruickshank to review the UK banking industry including its level of innovation, competition and efficiency. The Cruickshank Report was published in March 2000. Some of the major findings were:

- High profits generated by the UK banks was partially a function of over-charging up to £3-5 billion per annum for services which were to the detriment of personal and SME customers.
- The policy framework for the banks allowed a lower level of competition than other industries. This included regulation that restricted new entrants and the banks' being represented on the Board of the FSA.
- The banks effectively controlled the money transmission system.

The Cruickshank Report recommended:

- To strengthen the policy framework to increase transparency and increase competition in the banking industry. The FSA should assess the level of competition in the banking industry in its Annual Report.
- More information for personal banking customers about their banking options and remedies available to them.
- A monopolies referral for the SME banking market.
- Increased competition in the payments and transmission system.

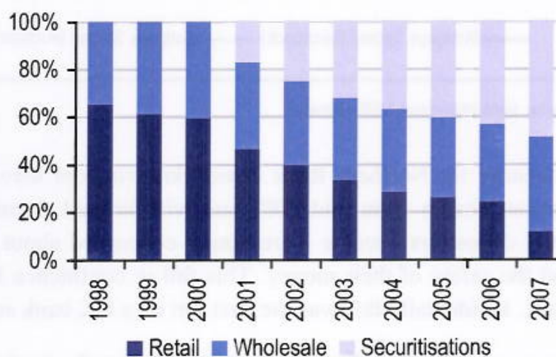
Greater funding availability and increased competition

Through a combination of the implementation of the Cruickshank Report and increased funding availability through securitisation the UK banking markets changed substantially during the 2000s.

Chart 2: Northern Rock Mortgage Lending (£m)

Source: Company data, UBS estimates

Chart 3: Northern Rock Funding Mix



Source: Company data, UBS estimates

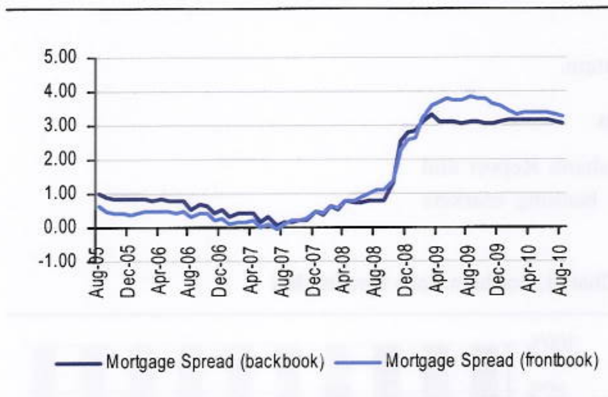
A number of the smaller banks and former building societies began to grow their market share aggressively. Funding was readily available in both the wholesale market and more importantly via securitisation.

Northern Rock was the most high profile bank in this process. In 1998 and 1999 it lent around £3.5b to mortgage customers. However, in 2000 it discovered securitisation as an alternative source of funding and began to grow its balance sheet aggressively. This strategy for balance sheet growth worked particularly well during a period of easy access to funding. By 2006 Northern Rock lent £29b in new mortgages, nearly all of which was funded via securitisation and wholesale sources. To put this into perspective, Northern Rock's mortgage lending flows in 2H06 were greater than its entire mortgage stock in 1999.

Many in the UK were encouraged by the success of Northern Rock. Not only was it increasing the level of competition in the mortgage market and growing much faster than the larger banks, but it was also effective in driving mortgage spreads down. In 2005 UK mortgage spreads (back-book) were around 1%. However, aggressive competition in the mortgage market drove spreads down to around zero in mid-2007, immediately prior to the GFC.

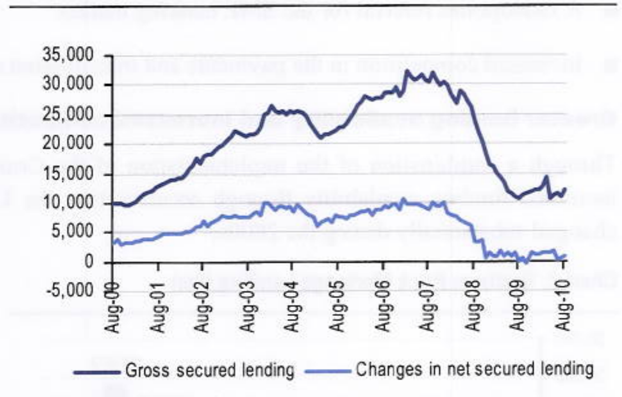
Other UK banks were effectively forced to react to this new competitive threat by also loosening their own credit standards. New "innovative" products such as 110% to 120% Loan to Valuation mortgages were widely available. Other banks also loosened their lending criteria to commercial property (HBOS & the Irish Banks) and other industries. Eventually, the less stringent underwriting standards initiated by the new competitors effected the largest banks which did not want to stand by and watch their century long market shares be taken away.

Chart 4: UK Mortgage Spreads (%)



Source: Bank of England, UBS estimates

Chart 5: Gross and net UK mortgage lending (£m)



Source: Bank of England, UBS estimates

The story for Northern Rock is well known from here. With the securitisation markets frozen from mid 2007 and with limited alternative funding available, retail depositors became increasingly concerned about Northern Rock's health and the safety of their money. This fall in confidence led to a run on Northern Rock. Incidentally this was the first run on a UK bank since the 1880s.

Gross mortgage lending in the UK fell sharply in the months that followed, eventually bottoming two years later down around 65% from the peak. Mortgage spreads also blew out, rising up to around 3% following the collapse of Lehman's and remain at around this level today. Mortgage spreads are now at their long term highs.

Furthermore, the UK government was forced to bail-out a number of its banks via equity investments and the Special Liquidity Scheme. Although H.M. Treasury may eventually make a profit out of these investments, it has placed substantial pressure on the UK fiscal position and economy over the last three years.

In recent weeks the H.M. Treasury has instigated a new Independent Commission on Banking. But this time, in addition to promoting competition, it will also make recommendations on:

- Financial stability;
- Reducing systemic risk in the banking sector;
- Reducing both the likelihood and impact of firm failure;
- Competitiveness of the UK financial services sector and the wider UK economy; and
- Risks to the fiscal position of the Government.

What goes around comes around – lessons for Australia

We believe that the key message of the UK experience is that banking competition for competition's sake can be both dangerous and in the medium term potentially very expensive. We believe that the well managed, well regulated and profitable nature of the Australian banks was one of the primary reasons that the Australian economy survived the GFC as well as it did. It must be remembered that a number of the new entrants and mortgage providers in Australia did not fare so well. This is reflected in their reduced capacity in mortgage finance approvals today.

We believe measures to increase competition such as reduced exit fees or account number portability may help ease some public discontent. However, the non-bank innovators are typically the main proponents of high exit fees and deferred establishment fees.

We are, however, very cautious of any moves which increase funding availability to financial services providers who may not have the same underwriting standards, capitalisation, profitability benchmarks or regulator overview as the banking sector. By regulating the banks you explicitly encourage the growth of the shadow banking system with potentially dire consequences. The Australian economy could see itself walking the same path as the UK a decade earlier.

So, when it comes to measures to increase competition in the Australian banking market, be careful what you wish for.

Banks, the RBA and interest rates in Australia

Over the last twenty years monetary policy in Australia has been an effective economic management tool. The main reason for this is that around 85% of home loan borrowers have had variable rate mortgages which meant that a change in official policy has been efficiently passed through to households.

However, there have been a number of structural movements in the balance sheets of the banks and the Australian economy which have had an impact on monetary policy over time.

For example, the level of mortgage indebtedness has risen sharply over the last twenty years from 16% to 84% of GDP. This higher level of household debt has meant that the RBA has needed smaller changes in monetary policy to have an impact on economic activity, while monetary lag has arguably also reduced. This in itself have given consumers more confidence that interest rates are unlikely to revert to the very high levels seen in the late 1980s and early 1990s, which combined with lower inflation, is one factor which drove up asset prices and mortgage indebtedness.

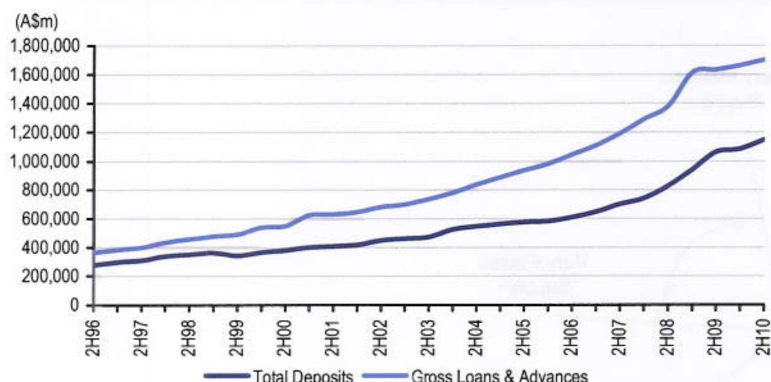
As importantly, there has also been a significant change in the balance sheet of the Australian banks over this period. During the early 1990s when the level of household leverage was significantly lower, the majority of the bank's funding came from deposits. At that time the sector's Loan to Deposit ratio stood at around 130% (excluding institutional Certificates of Deposit). However, given strong credit growth throughout the late 1990s and 2000s the loan to deposit ratio of the banks continued to rise, reaching a peak of 174% in 1H08.

Chart 6: Loan to Deposit ratios of the Major Banks (%)

Source: Company data, UBS estimates.
Note: excludes Certificates of Deposit.

Much of this "loan to deposit gap" was funded through the issue of Bank Bills and other short term wholesale funding instruments.

Chart 7: The wholesale funding gap (total loans less deposits) of the major banks

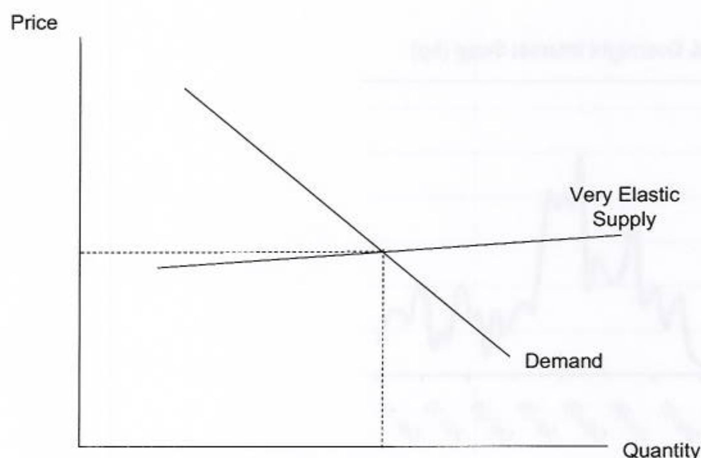


Source: Company data, UBS estimates.
Note: excludes Certificates of Deposit

In FY08 36% of WBC's funding came from wholesale sources with less than one year's duration. At the time this was considered a cheaper and more efficient source of funding which was highly liquid. The spread between bank bills and the Overnight Index Swap (OIS) was very low reflecting minimal credit risk factored into these transactions.

This can be illustrated in Chart 8. Prior to the GFC credit was easily available in large quantities at close to benchmark prices. Effectively, the supply of funding curve for the banks was virtually flat, ie very elastic.

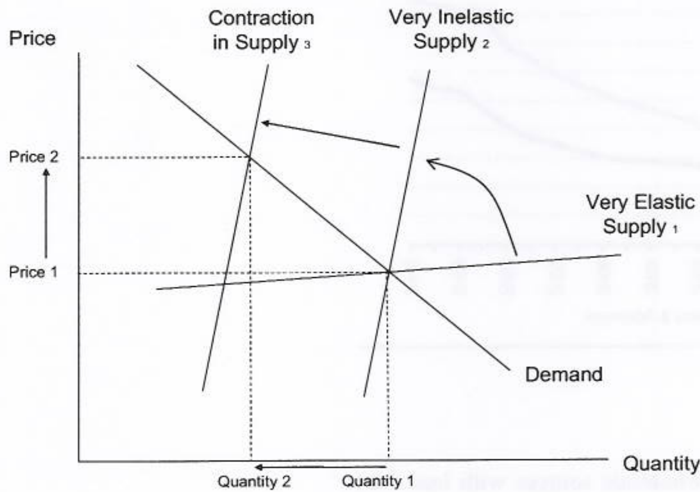
Chart 8: Supply and Demand of Funding prior to the GFC (pre mid-2007)



Source: UBS estimates

However, events changed very quickly with the advent of the Global Financial Crisis in mid to late 2007.

Chart 9: Supply and Demand of Funding during the GFC (from mid-2007)

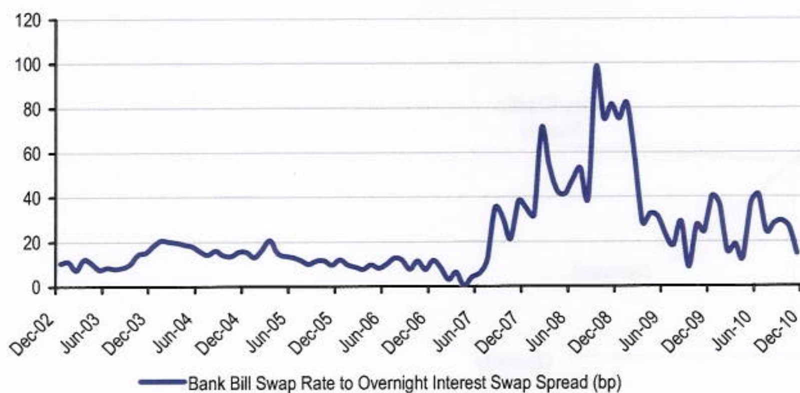


Source: UBS estimates

With concerns rising over potential exposure to sub-prime and other lower grade US mortgage paper, investors became very risk averse. Initially this led to a sharp steepening of the supply of credit curve (ie very inelastic) before the supply effectively dried up (moving to the left).

This placed enormous pressure on banks and financial institutions whose funding was short term as rolling debt became nigh on impossible. High profile victims of this tightening in credit supply include Northern Rock in the UK and RAMS in Australia.

Chart 10: Spread between the Bank Bill Swap Rate & Overnight Interest Swap (bp)

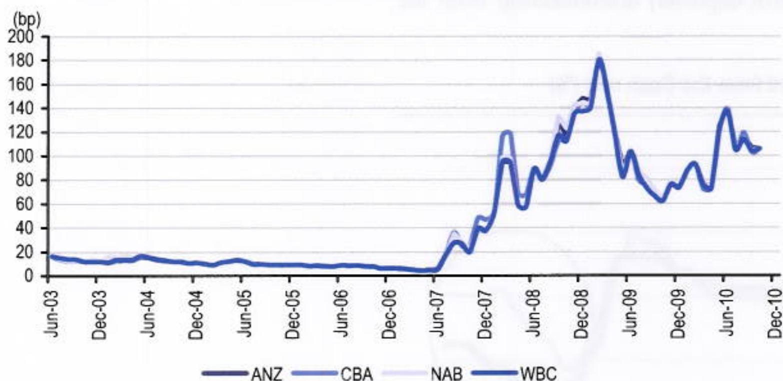


Source: Bloomberg, UBS estimates

It was at this stage that the Australian banks had to further diversify and strengthen their funding sources. The banks began to both increase their

issuance of wholesale term funded debt (generally three or five years duration) and compete more aggressively for deposits. However, with supply of credit still constrained and investors risk averse, the cost of such funding has remained elevated.

Chart 11: 5 Year Senior CDS Spreads for the Major banks (bp)

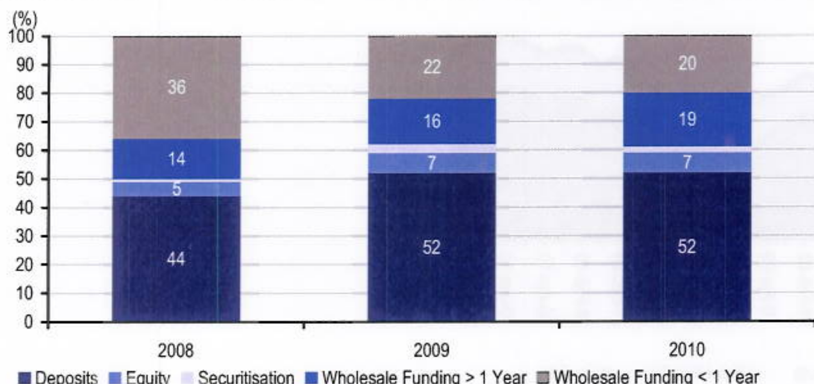


Source: Bloomberg, UBS estimates

This can be illustrated via the Credit Derivative Swap spreads for the major banks. Although this is a quasi insurance product, it provides a good indication of the cost of bank term funding. Prior to the financial crisis the CDS spreads on the major banks reached a low of just 7bp (in June 2007). Effectively the market was factoring in almost no credit risk within the banks, who were able to access wholesale term funding in reasonable size at ~15bp over swap.

However, as the financial crisis peaked in the months following the collapse of Lehman the wholesale funding markets remained effectively closed. When the markets re-opened the major banks were able to access three year wholesale funding (with a Government Guarantee) at a very large cost of over 200bp above the Bank Bill Swap Rate.

Chart 12: WBC Funding Composition (%)

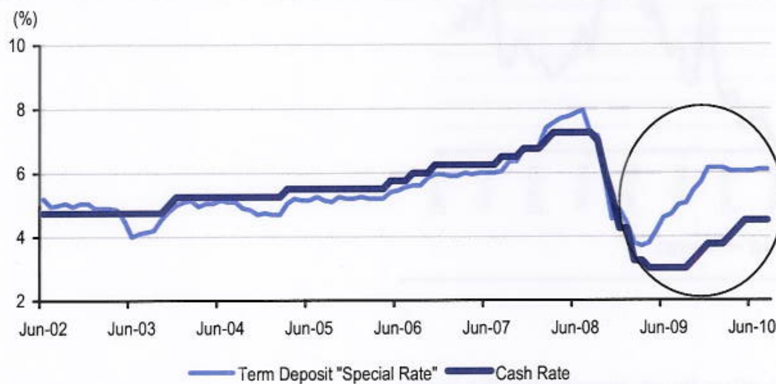


Source: Westpac, UBS estimates

This put the banks in an ugly position of being forced to term out funding and run down their short term funding reliance at significantly higher prices. This lead to a material step-up in the banks' funding costs.

As importantly, banks began to competing fiercely to attract deposits as an alternative "sticky" source of funding. This resulted in the price banks were prepared to pay for deposits (especially term deposits) disconnecting from the RBA Cash rate or any term benchmark.

Chart 13: Term Deposit rates have disconnected from the Cash rate (%)

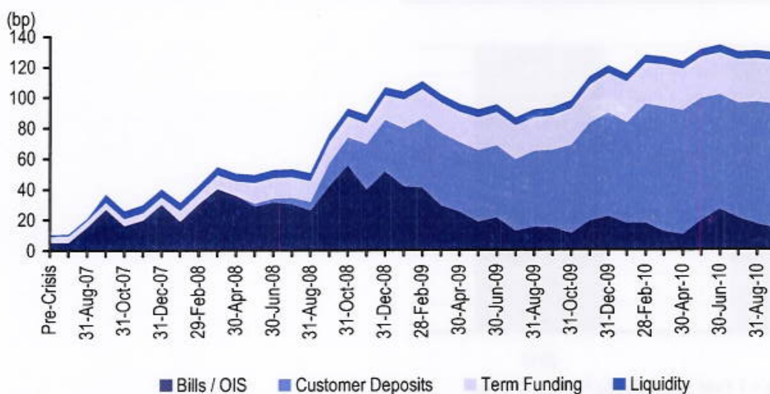


Source: RBA, UBS estimates

No-one can deny that the banks faced intense competition in the deposit market, with savers being thoroughly rewarded for being fiscally prudent via higher interest rates.

Although the very high price level of term deposits has eased somewhat since the beginning of the year (mainly as credit growth has not rebounded and the banks demand for funding has been less than some anticipated) it still remains a substantial headwind for the bank's funding costs.

Chart 14: Increased cost of funding an Australian Variable Rate Mortgage (bp)



Source: NAB.

Note: Funding cost over the RBA Cash Rate

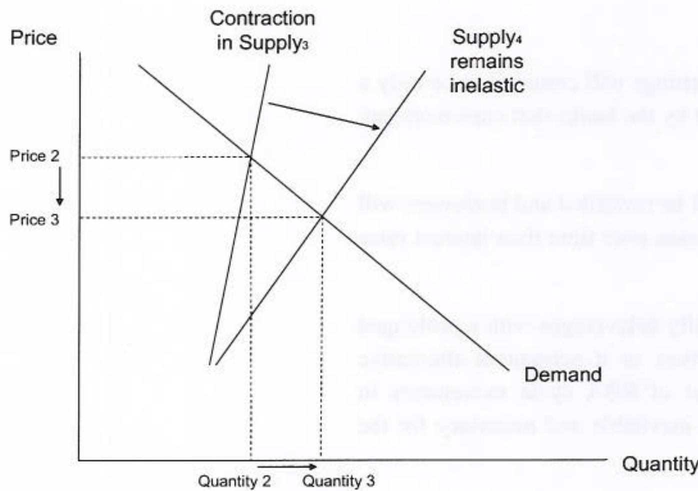
Is this the pain Australian households had to have? A debt hangover.

We believe that the Australian banks and economy could be accused of taking on too much household debt over the last two decades, which was well in excess of the country's internal funding capability. Although this was not as significant an issue prior to the GFC as other sources of funding were cheap and plentiful, once excess liquidity was removed from the system funding costs have risen substantially.

Given the G20's mandate to improve financial stability (Australia is a member of the G20) and the Basel III proposals for stricter capital and liquidity holdings, the major banks are very unlikely to ever to go back to the pre-GFC days of excessive cheap short term liquidity. That is, unless the economy deleverages over time or alternative cheap funding sources become available (covered bonds is one proposal).

Increasing the elasticity of credit supply will be a lengthy process given the more risk averse nature of investors post the GFC and the requirements of the Basel Committee for Bank Supervision (Basel III).

Chart 15: Some easing of supply of credit in recent times

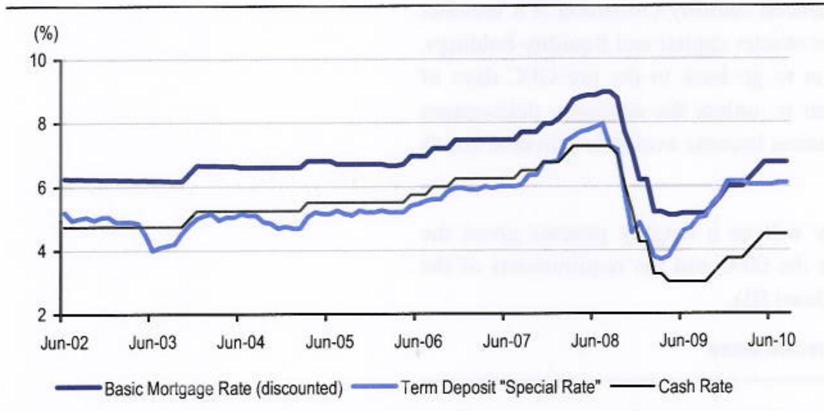


Source: UBS estimates

RBA is now only a factor in setting effective interest rates for households & businesses

As a result regulation and the resulting permanent change in the bank's balance sheet funding structure (more term wholesale funding and expensive retail deposits) we believe that market forces such as the elasticity of supply of credit will be a large a driver of effective interest rates to Australian households and businesses.

Chart 16: Deposit and Mortgage rates have disconnected from the RBA cycle



Source: RBA, UBS estimates

This implies that the RBA's monetary policy settings will continue to be only a factor (albeit significant) in the interest rates set by the banks that customers pay and receive in a post-GFC environment.

In times of inelastic supply of credit, savers will be rewarded and borrowers will be penalised via higher rates. If elasticity increases over time then interest rates may again move closer to the RBA cycle.

Any way we look at it, unless Australia materially deleverages with a prolonged period of weak credit growth or even contraction, or if permanent alternative funding sources can not be found, further out of RBA cycle movements in interest rates for depositors and borrowers are inevitable and necessary for the financial system to function in equilibrium.

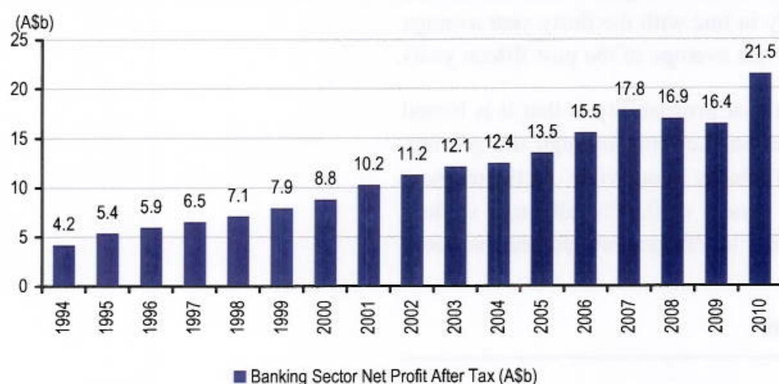
Are you being "gouged"?

Banks are not popular in Australia. They never have been. The general perception is that the banks generate excessive profits by over charging fees and interest, and provide poor levels of service to customers. These attitudes have been reinforced in recent weeks as banks have increased interest rates above movements in the RBA Cash Rate at the same time as they reported record profits. As a result they have been accused of "gouging" customers by the media, while politicians have jumped on the bandwagon also adopting this terminology.

Australia's difficult political environment with a hung Federal Parliament and a minority Labor government has not helped the situation. Many marginal electorates are in mortgage belt regions where discontent with the banks is highest. Easy political points are gained by bank-bashing.

In this section we look at a few statistics on the Australian banks which we believe sheds some light on the arguments that the banks are generating excessive profit and are "gouging" Australia.

Chart 17: Australian Major Banks NPAT (A$b)



Source: Company data, UBS estimates
Note: Pro forma for St George Bank and BankWest

This is probably the most quoted number by people criticising the banks. That they generated over $21b in profit during 2010, up over 30% during the year. Obviously they must be gouging, right?

No doubt the banks are profitable and this has grown. However, the vast majority of the growth during 2010 was purely a result of lower provision charges for bad and doubtful debts as the Australian economy emerges from the GFC.

If we look at the Profit of the banks before charges for bad debts and tax, it fell 0.8% during 2010. This is a fact that has been missed/ignored by many observers (but not shareholders).

In any case, we believe that looking at the profit of the banks in isolation is misleading, these are very big organisations. We believe that it is best to look at the banks Return on Equity and Return on Assets as a measure of profitability.

Chart 18: Australian Banks Return on Equity (%)

Source: Company data, UBS estimates

Return on Equity is the most commonly used measure of profitability of a bank. This measures profit relative to the capital which shareholders have invested in the organisation. On this measure, the Australian bank generated a Return on Equity of 16.1% during 2010. This is exactly in line with the thirty year average for the banking sector, and materially below the average of the past fifteen years.

A weakness of the Return on Equity measure of profitability is that it is biased by the level of gearing within the organisation. Looking through the gearing, Return on Assets is the best measure of profitability in our view. At the moment the Australian banks generate a Return on Assets of 0.91%, although slightly above the thirty year average, it is well below levels generate during the boom years of 1995 to 2007.

Chart 19: Australian Banks Return on Assets (bp)

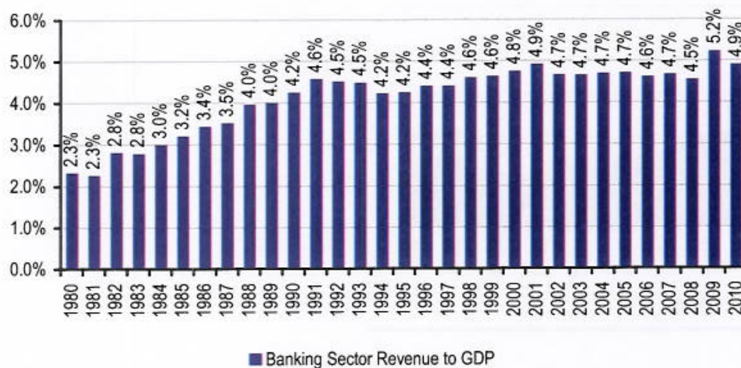
Source: Company data, UBS estimates

Measuring Return on Risk Weighted Assets is an alternative measure. However, there have been substantial changes to the risk weighting methodology in recent years following the adoption of Basel I in 1988 and Basel II in 2007. This makes longer term comparisons difficult. The upcoming adoption of Basel III with further blur these comparisons.

From a customer's perspective, looking at the revenue that the banks are generating is a good way of measuring if they are overcharging. In absolute terms the banks' revenue growth has risen strongly, but then again, so has the Australian economy.

If we look at the banking sector's total revenue to GDP it is currently 4.9%. This is inline with the levels of 2001. In fact, bank revenue to GDP has been between 4% to 5% since 1988. Most of the expansion of the bank's share of GDP occurred in the years immediately following deregulation in 1983. It should also be noted that this relatively flat period of bank's revenue to GDP comes despite the significant increase in leverage in the economy during this time.

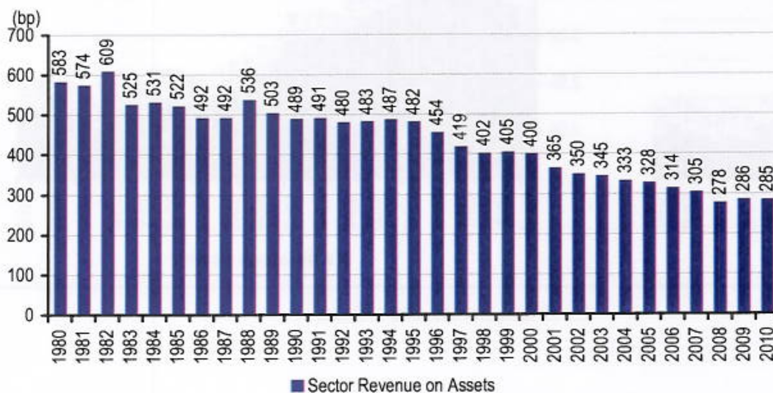
Chart 20: Banking Sector Revenues to GDP (%)



Source: Company data, UBS estimates

If we look at total banking sector revenue on its asset base, this provides an indication of the amount of customers are being charged for their loans, facilities, trading and other assets. We note that total revenue on assets was broadly flat at around 500bp from deregulation in 1983 until around 1994. Since this time it has fallen steadily to current levels of 285bp, slightly off their lows of 278bp seen in 2008.

Chart 21: Banking Sector Revenues to Assets (bp)

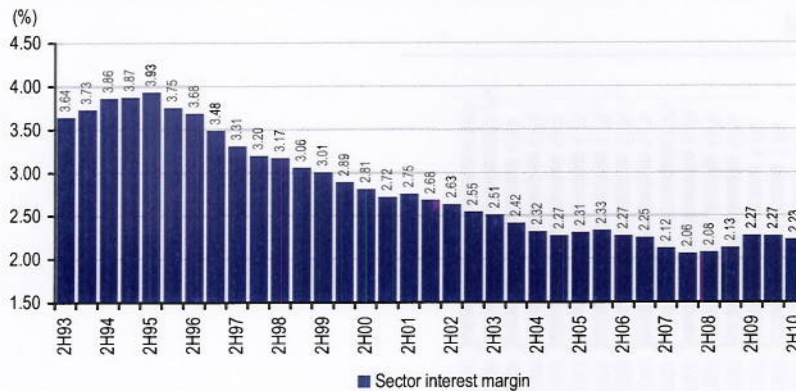


Source: Company data, UBS estimates

There is also substantial focus by politicians, the media and the RBA on the banks' Net Interest Margin, and how it is now above the levels immediately prior to the GFC.

This is correct: the banks' margins are currently at around 2.23% compared to a low of 2.06% in 1H08. But this ignores the most fundamental lesson from the GFC, that risk was significantly underpriced during the mid-2000s. Excess liquidity and miss-pricing of risk is what landed the world into trouble in the first place. This is clearly the wrong benchmark!

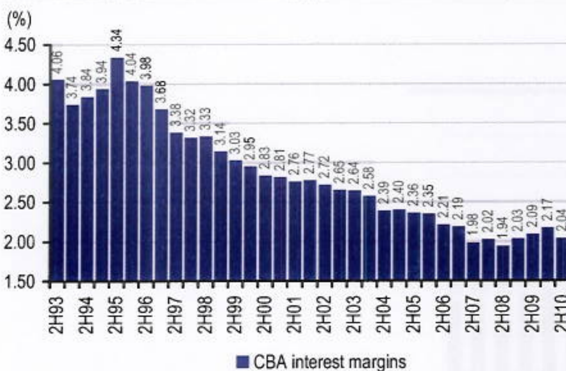
Chart 22: Banking Sector Net Interest Margin (%)



Source: Company data, UBS estimates

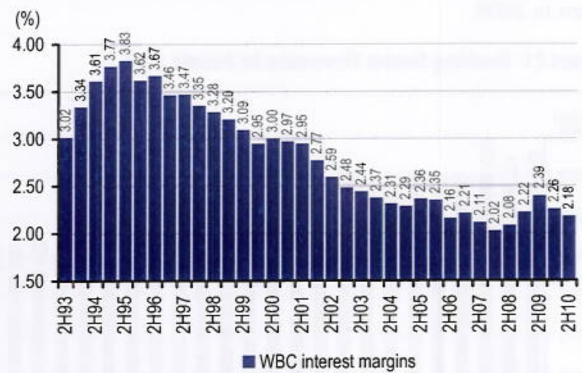
It should also be noted that bank margins have already begun to come down again over the last half year as additional funding costs have not been fully passed through to customers. This is most evident at CBA and WBC who grew their mortgage books fastest during the First Home Owner's Grant period and as a result saw the largest funding task.

Chart 23: CBA Net Interest Margin (%)



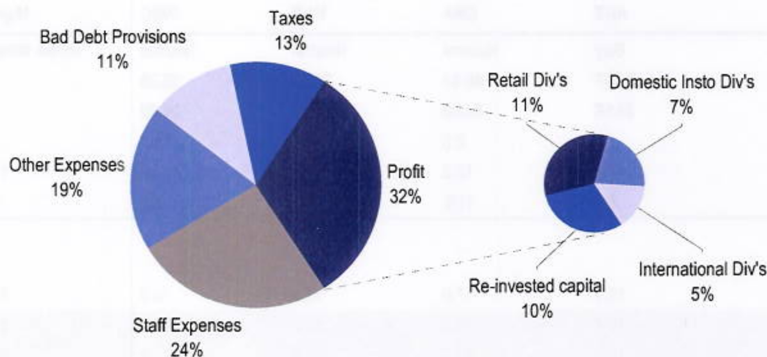
Source: Company data, UBS estimates

Chart 24: WBC Net Interest Margin (%)



Source: Company data, UBS estimates

Chart 25: Where do the banks' revenues go? (2010)

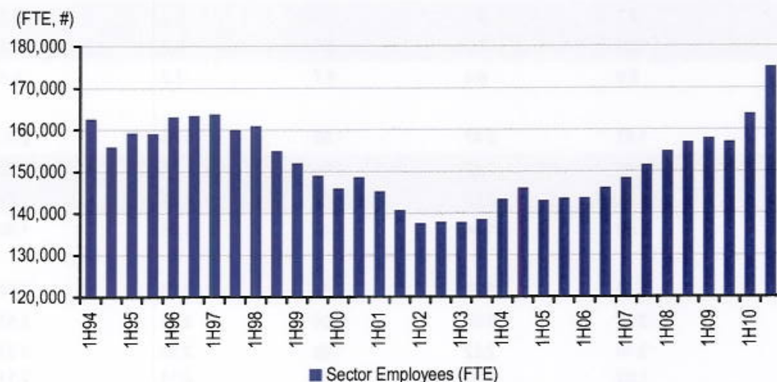


Source: Company data, UBS estimates

A final consideration should be: where does all the revenue go anyway? As a simple breakdown:

- 24% of bank revenue goes to paying its staff. (As an aside, banks now employ 175,000 people, the highest on record, exceeding the 1996 peak.);
- 19% goes to other operating expenses;
- 11% was put away as provisions for Bad and Doubtful Debts;
- 13% went to taxes;
- 10% is retained capital used to grow lending and other assets;
- 11% is paid to retail investors as dividends with a further 7% paid to Australian superannuates and fund investors; and
- Only 5% is paid to overseas investors as dividends.

Chart 26: Total Banking Sector Employees



Source: Company data, UBS estimates

Table 1: Banks Financial Summary

	ANZ	CBA	NAB	WBC	Majors
Rating	**Buy**	**Neutral**	**Neutral**	**Neutral**	**Under Weight**
Share price ($) 08 November 2010	**24.07**	**48.84**	**26.01**	**22.29**	
Price Target ($)	**25.50**	**54.00**	**27.50**	**24.00**	
Implied 2011E Price to Book (x)	1.8	2.3	1.6	1.8	2.0
Implied 2011E PE (%)	11.2	12.3	11.4	11.3	11.7
% Price Upside to Price Target	6%	11%	6%	8%	8%
Valuations					
PE (x)					
2009	15.3	17.0	13.6	14.2	15.2
2010	12.4	12.8	12.2	11.6	12.3
2011E	11.2	12.3	11.4	11.3	11.6
2012E	10.8	11.9	10.6	11.0	11.1
PE Relative to All Industrials (%)					
2009	88	98	79	82	87
2010	82	85	81	77	81
2011E	80	89	82	81	83
2012E	84	92	83	85	87
PE Relative to Major Banks (%)					
2009	100	112	90	94	n.a.
2010	101	105	99	94	n.a.
2011E	96	106	98	98	n.a.
2012E	97	107	95	98	n.a.
Price to Core Earnings (Pre-Prov'n Profit) (x)					
2009	6.9	8.3	5.5	6.6	7.0
2010	7.1	7.5	6.3	6.9	7.0
2011E	6.9	7.8	6.2	7.1	7.1
2012E	6.7	7.6	6.0	6.8	6.8
Diluted EPS growth (%)					
2009	-1.3	-17.7	-16.7	-18.8	-13.9
2010	23.0	32.6	11.7	22.5	23.4
2011E	10.9	4.1	7.4	2.5	6.0
2012E	3.3	3.7	6.9	3.3	4.1
Div Yield (%)					
2009	4.2	4.7	5.6	5.2	4.9
2010	5.2	5.9	5.8	6.2	5.8
2011E	5.8	6.2	6.4	6.9	6.3
2012E	5.9	6.4	6.7	7.2	6.6
Price to Book (x)					
2009	1.91	2.47	1.66	1.89	2.02
2010	1.85	2.22	1.63	1.74	1.89
2011E	1.71	2.09	1.53	1.66	1.77
2012E	1.60	1.94	1.43	1.58	1.66
Price to NTA (x)					
2009	2.18	3.58	2.04	2.83	2.74
2010	2.32	3.06	2.06	2.49	2.53
2011E	2.10	2.82	1.89	2.30	2.33
2012E	1.93	2.55	1.74	2.14	2.13

	ANZ	CBA	NAB	WBC	Majors
Financials					
Cash NPAT (UBS post prefs) ($m)					
2009	3,639	4,348	3,676	4,627	16,290
2010	5,014	6,054	4,543	5,879	21,490
2011E	5,654	6,407	4,948	6,133	23,142
2012E	5,891	6,749	5,369	6,411	24,419
Cash NPAT (Company format) ($m)					
2009	3,772	4,415	3,841	4,627	16,655
2010	5,025	6,101	4,581	5,879	21,586
2011E	5,664	6,453	4,986	6,133	23,236
2012E	5,901	6,795	5,407	6,411	24,513
Cash EPS (fully diluted) (cps)					
2009	158	287	191	157	n.a.
2010	194	380	213	192	n.a.
2011E	215	396	229	197	n.a.
2012E	222	411	245	203	n.a.
Basic EPS (Company format) (cps)					
2009	169	305	200	162	n.a.
2010	199	395	214	198	n.a.
2011E	221	413	230	204	n.a.
2012E	229	429	245	211	n.a.
Dividend (cps)					
2009	102	228	146	116	n.a.
2010	126	290	152	139	n.a.
2011E	139	301	166	154	n.a.
2012E	143	313	175	161	n.a.
Return on Equity (%)					
2009	13.0	15.4	11.6	13.9	13.6
2010	15.5	18.7	13.5	16.2	16.2
2011E	16.4	18.2	14.0	15.8	16.3
2012E	15.8	17.6	14.1	15.5	15.9
Return on Assets (%)					
2009	0.72	0.76	0.59	0.79	0.72
2010	0.95	0.97	0.75	0.99	0.92
2011E	1.02	0.98	0.76	0.99	0.94
2012E	0.98	0.96	0.75	0.98	0.93
Tier 1 (%)					
2009	10.56	8.07	8.96	8.11	8.84
2010	10.10	9.15	8.91	9.09	9.30
2011E	10.30	9.62	9.18	9.47	9.65
2012E	10.77	10.10	9.20	9.89	10.01
Core Tier 1 (%)					
2009	8.96	6.35	6.82	6.57	7.10
2010	8.04	6.86	6.80	7.50	7.26
2011E	8.38	7.41	7.19	7.94	7.69
2012E	8.94	8.00	7.36	8.42	8.12

	ANZ	CBA	NAB	WBC	Majors
Key Earnings Drivers					
Growth in Ave Interest Earning Assets (%)					
2008	17.5	17.9	18.0	20.3	18.3
2009	9.2	23.7	10.4	44.5	20.6
2010	2.7	14.3	-2.3	5.3	4.9
2011E	10.2	5.1	6.0	4.2	6.2
2011E	7.9	5.8	8.2	5.7	6.9
Margins (%)					
2008	2.01	1.98	2.20	2.05	2.06
2009	2.30	2.06	2.16	2.31	2.21
2010	2.46	2.10	2.25	2.22	2.26
2011E	2.42	1.95	2.14	2.13	2.16
2012E	2.33	1.88	2.04	2.07	2.08
Non-Interest Income Growth (%)					
2008	12.3	3.4	-12.5	1.5	0.6
2009	9.1	3.1	14.6	29.3	12.5
2010	9.0	8.4	-8.8	0.4	2.7
2011E	11.1	3.2	11.7	2.0	6.5
2011E	7.1	6.0	9.7	6.3	7.1
Revenue Growth (%)					
2008	9.1	8.2	5.3	9.5	7.8
2009	19.5	17.3	10.1	50.7	22.7
2010	9.8	13.3	-1.3	0.9	5.5
2011E	9.2	-0.2	3.9	0.7	3.2
2012E	5.0	3.6	5.1	4.0	4.4
Cost Growth (%)					
2008	15.0	9.2	-2.0	7.3	6.5
2009	9.0	11.0	6.8	38.2	14.7
2010	12.3	10.6	1.2	3.4	6.7
2011E	15.0	3.1	5.9	4.8	6.9
2012E	6.1	2.0	4.1	1.0	3.3
Cost to Income Ratio (%)					
2008	47.3	48.9	47.3	43.9	46.9
2009	43.2	46.2	45.9	40.2	43.9
2010	44.1	45.1	47.0	41.2	44.3
2011E	46.5	46.6	47.9	42.9	45.9
2012E	47.0	45.9	47.5	41.7	45.4
Core Earnings Growth					
2008	4.3	7.2	12.8	11.3	9.0
2009	28.9	23.3	12.9	60.5	29.8
2010	8.0	15.7	-3.3	-0.8	4.6
2011E	4.7	-2.9	2.2	-2.1	0.2
2012E	4.0	5.0	6.0	6.2	5.3
BDD charge/loans (bp)					
2008	56	25	63	30	44
2009	88	63	89	71	77
2010	50	41	51	30	43
2011E	35	24	38	19	28
2012E	34	23	34	20	27

Source: Company data, UBS estimates

Sector Valuations and Pricing

Chart 27: Sector PE (x)

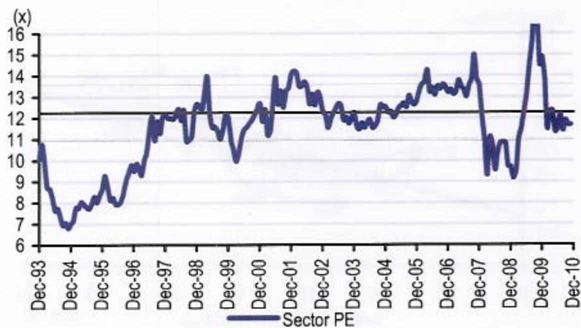


Chart 28:Sector PE Relative to the All Industrials (ex Financials)

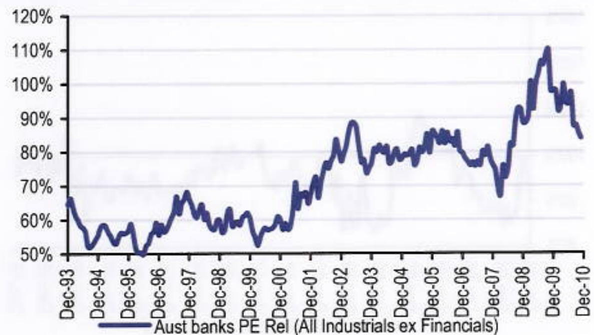


Chart 29:Sector Price to Pre-Provision Profits (x)

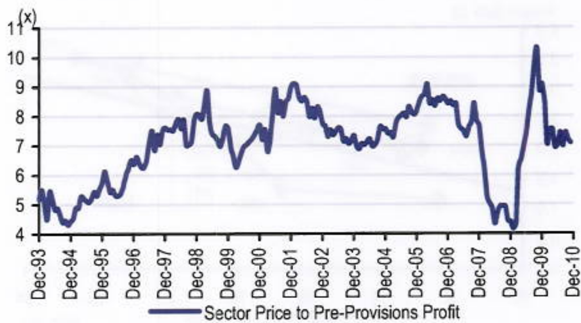


Chart 30: Sector Earnings Yield to Bond Yield (%)

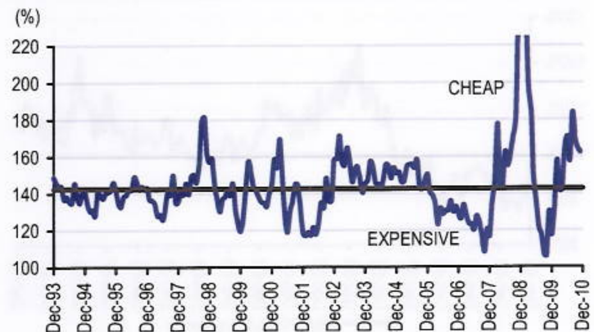


Chart 31: Sector Price to Book Ratio (x)

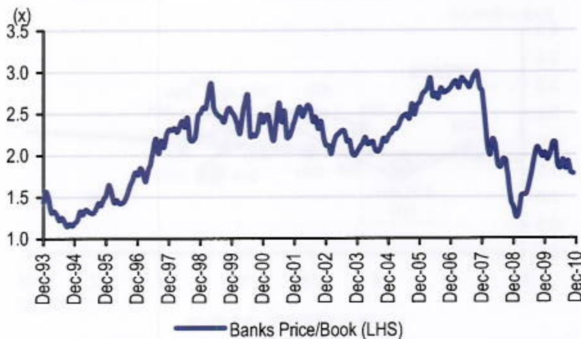


Chart 32: Sector Price to Book (x) vs Return on Equity (%)

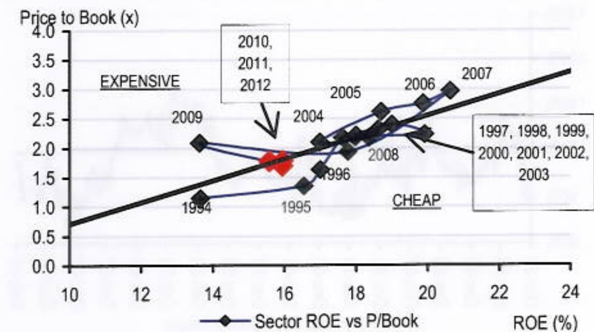


Chart 33: Sector Dividend Yield (%)

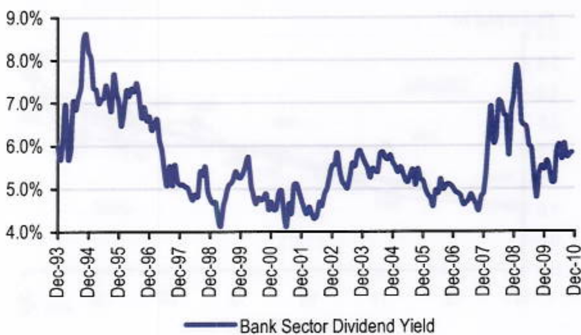
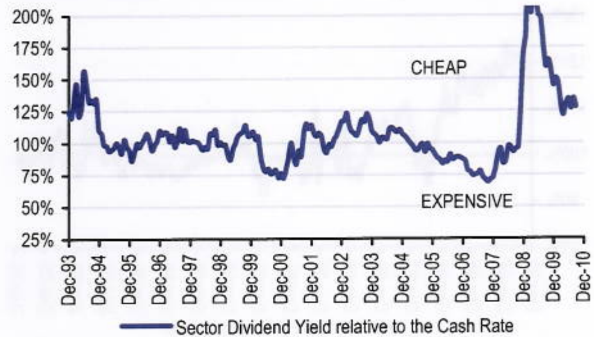


Chart 34: Sector Dividend Yield vs Cash Rate (%)



Source: Company data, UBS estimates

Source: Company data, UBS estimates

Stock Valuations and Pricing

Chart 35: ANZ PE Relative to the Major Banks (%)

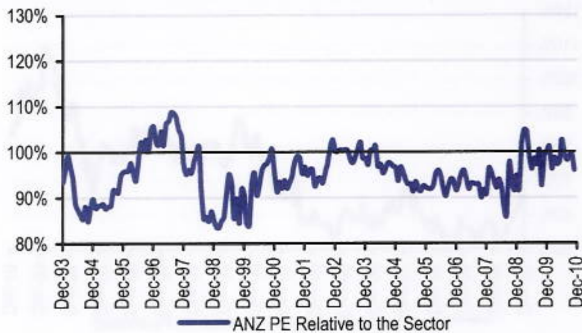


Chart 36: ANZ Price to Book (x) vs Return on Equity (%)

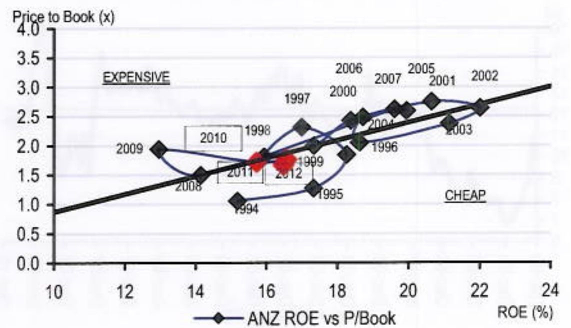


Chart 37: CBA PE Relative to the Major Banks (%)

Chart 38: CBA Price to Book (x) vs Return on Equity (%)

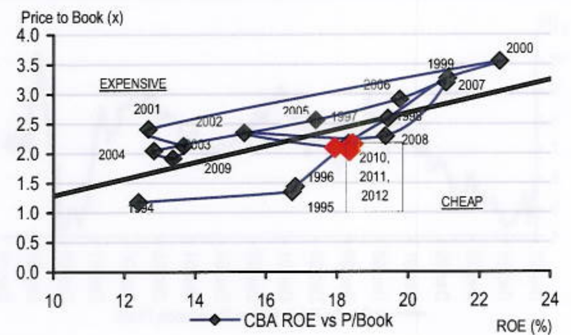


Chart 39: NAB PE Relative to the Major Banks (%)

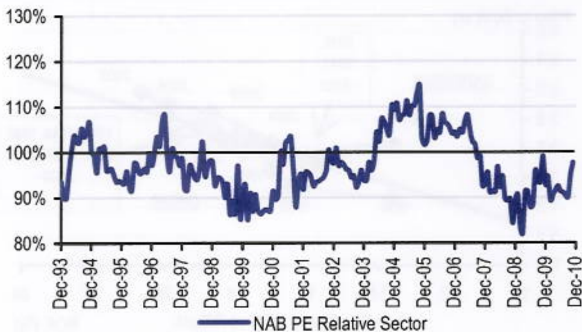


Chart 40: NAB Price to Book (x) vs Return on Equity (%)

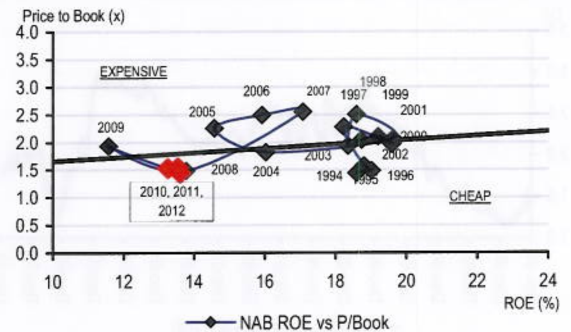


Chart 41: WBC PE Relative to the Major Banks (%)

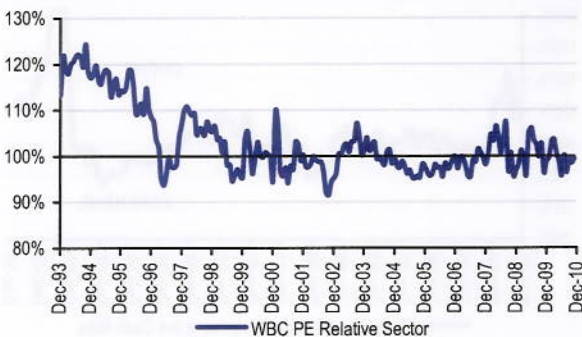
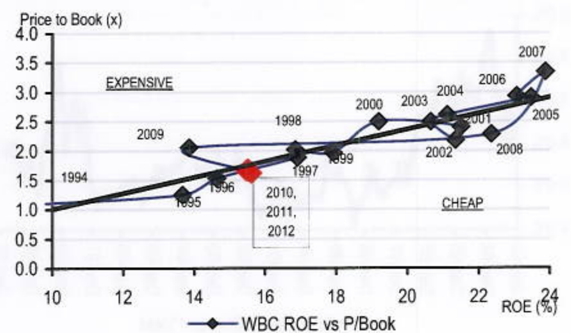


Chart 42: WBC Price to Book (x) vs Return on Equity (%)



Source: Company data, UBS estimates

Source: Company data, UBS estimates

■ Statement of Risk

Australian banks are large, highly leveraged financial institutions operating across a number of markets, and as such are subject to the risk of changes in the general business and economic conditions within these markets. A change in these conditions could include changes in interest rates, inflation, unemployment, monetary supply, exogenous shock, changes in foreign exchange rates, and the health of the general economy. The banks also face the risk of regulatory changes and increased competition which could affect the profitability of the sector. A key risk that financial institutions face is associated with extending credit to other parties. Less favourable business conditions could cause potential losses from loans to increase putting pressure on the group's capital. The bank sector also faces operational risk from operating such large and complex businesses.

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UBS 12-Month Rating	Rating Category	Coverage[1]	IB Services[2]
Buy	Buy	51%	37%
Neutral	Hold/Neutral	40%	33%
Sell	Sell	9%	22%
UBS Short-Term Rating	**Rating Category**	**Coverage[3]**	**IB Services[4]**
Buy	Buy	less than 1%	20%
Sell	Sell	less than 1%	0%

1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category.
4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 30 September 2010.

UBS Investment Research: Global Equity Rating Definitions

UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
Sell	FSR is > 6% below the MRA.
UBS Short-Term Rating	**Definition**
Buy	Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.
Sell	Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).

Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

Short-Term Ratings reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case.

Equity Price Targets have an investment horizon of 12 months.

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UBS Securities Australia Ltd: Jonathan Mott; Chris Williams, CFA; Adam Lee.

Company Disclosures

Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
ANZ Banking Group[2, 4, 5a, 6, 13, 16]	ANZ.AX	Buy	N/A	A$24.07	08 Nov 2010
Commonwealth Bank of Australia[2, 4, 5a, 16]	CBA.AX	Neutral	N/A	A$48.84	08 Nov 2010
National Australia Bank[2, 4, 5a, 13, 16]	NAB.AX	Neutral	N/A	A$26.01	08 Nov 2010
Westpac Banking Corporation[2, 4, 5a, 5b, 6, 13, 16]	WBC.AX	Neutral	N/A	A$22.29	08 Nov 2010

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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13. UBS AG, its affiliates or subsidiaries beneficially owned 1% or more of a class of this company`s common equity securities as of last month`s end (or the prior month`s end if this report is dated less than 10 days after the most recent month`s end).
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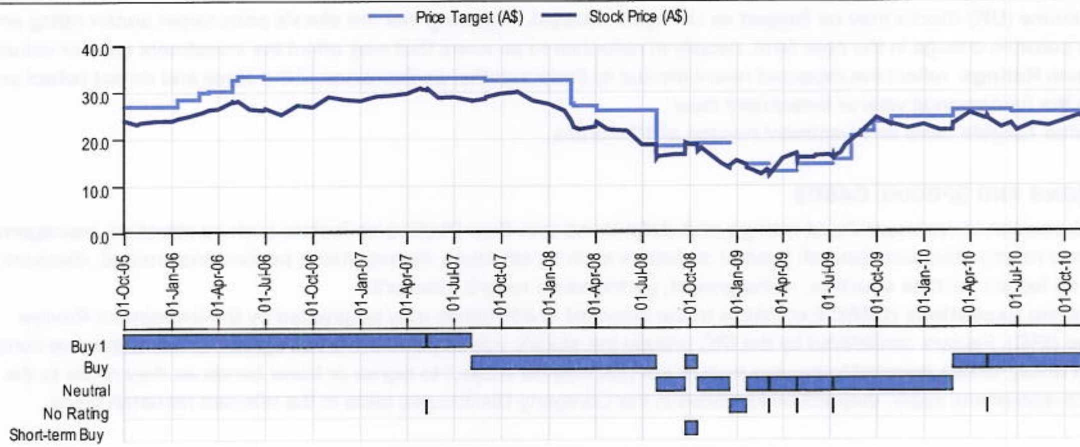
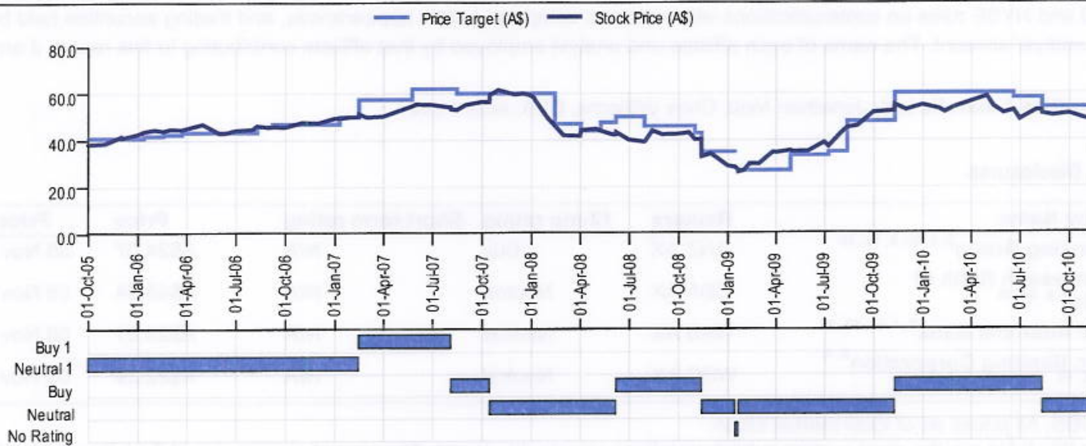
ANZ Banking Group (A$)



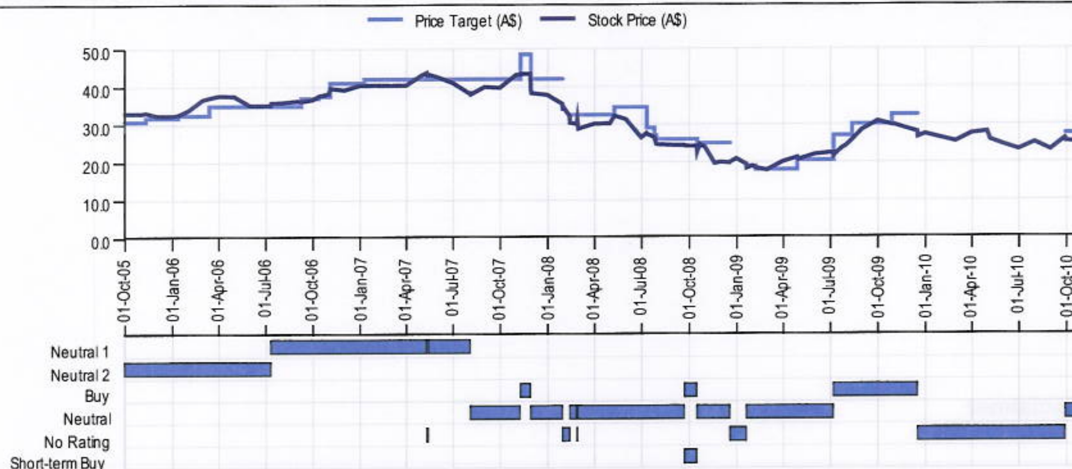
Source: UBS; as of 08 Nov 2010

Commonwealth Bank of Australia (A$)



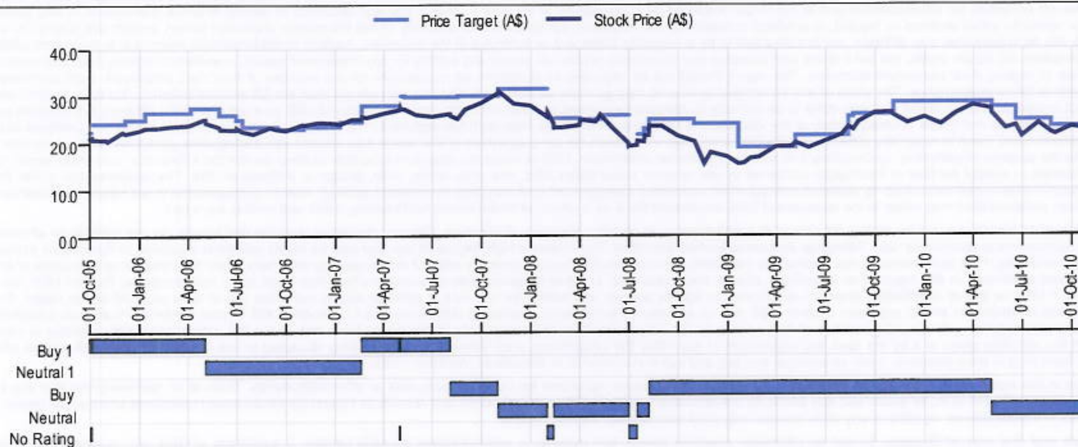
Source: UBS; as of 08 Nov 2010

National Australia Bank (A$)



Source: UBS; as of 08 Nov 2010

Westpac Banking Corporation (A$)



Source: UBS; as of 08 Nov 2010

Note: On August 4, 2007 UBS revised its rating system. (See 'UBS Investment Research: Global Equity Rating Definitions' table for details). From September 9, 2006 through August 3, 2007 the UBS ratings and their definitions were: Buy 1 = FSR is > 6% above the MRA, higher degree of predictability; Buy 2 = FSR is > 6% above the MRA, lower degree of predictability; Neutral 1 = FSR is between -6% and 6% of the MRA, higher degree of predictability; Neutral 2 = FSR is between -6% and 6% of the MRA, lower degree of predictability; Reduce 1 = FSR is > 6% below the MRA, higher degree of predictability; Reduce 2 = FSR is > 6% below the MRA, lower degree of predictability. The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities. From October 13, 2003 through September 8, 2006 the percentage band criteria used in the rating system was 10%.

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UBS Investment Research
Australian Banking Sector Update

Are Credit Unions & Building Societies a viable "fifth pillar"?

24 November 2010

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■ **Government proposals to increase banking competition**

Following increases to standard variable mortgage rates in excess of the RBA Cash rate which coincided with banks reporting record profits, the PM & Treasurer have stated they will announce measures to increase banking competition in coming weeks. Recently the Federal Treasurer Wayne Swan stated "*The Government is determined to see a new pillar in the banking system, particularly based on our mutual sector, based on our credit unions and our building societies.*"

■ **Are Building Societies & Credit Unions a viable alternative to Banks?**

In 1984 Building Societies & Credit Unions (BS & CUs) controlled 36% of the mortgages and 25% of deposits market. However following demutualisations and growth in the banks, this fell to 7% of mortgages & 8% of deposits by 1994. Today this share has slipped to 4% of both mortgages & deposits.

■ **Is providing AOFM (tax payer) support to BS & CU's a good idea?**

(1) To become a credible "fifth pillar" the BS & CUs will need mortgage share of ~10%. This would require ~$90b of additional mortgages over the next four years. Do the BS & CU's have the ability to underwrite, process & service this volume of lending? (2) Do BS & CU's have the capital to support this lending or will the AOFM buy equity tranches? Who will provide the capital? (3) What will be the impact on Regional Banks? (4) Do we actually need additional mortgage capacity when Australia already has expensive housing and very highly geared consumers? (5) What were the lessons from the Global Financial Crisis regarding the provision of cheap funding to small lenders with less sophisticated underwriting capabilities? (6) BS & CU's do not have capabilities to lend to SME's where there have been suggestions of credit rationing. Shouldn't this be the focus of Government policy?

■ **Competition vs Financial Stability, pick your poison**

While the Government is looking at a number of options to increase competition none look ideal: eliminating exit fees – helps majors; account number portability – accelerates bank runs; Aussie Post Bank – logistically challenging; extend AOFM support – weaker underwriting, capital constraints, distorts markets. At the end of the day we do not believe that there is a silver bullet solution (although covered bonds may help in the interim) and Australia must accept that a period of slower credit growth and deleveraging is likely to be both inevitable and healthy.

■ **Banks – large headwinds but valuations becoming less stretched.**

The banks continue to face substantial headwinds including subdued credit growth, funding pressure, ongoing pressure on fees (exit fees & ATM charges next?) and ongoing investments in systems & efficiency. The current regulatory and political headwinds only make matters more difficult, underpinning our underweight sector call. That said, banks have underperformed and valuations now look less stretched at 11.0x (FY11E), 1.7x book & 6.7% dividend yield.

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The Politics of Banking

Unfortunately over the last few months the Australian banks have become political footballs. Political debate around regulation and competition is now a larger driver of bank performance than financial returns. This debate is likely to come to a head in coming weeks with the Australian Prime Minister and Treasurer committed to announcing measures to increase competition within the banking sector during December. This is likely to coincide with additional directions from the BIS and APRA regarding liquidity under the Basel III regime.

While the debate over increasing banking competition has changed tact several times in recent weeks as the Government and Opposition have both attempted to drive the agenda, we believe that recent statements by the Treasurer provide an indication of where its policy is likely to land. On Channel 9's Today show on Sunday 21st November the Treasurer Wayne Swan stated *"The Government is determined to see a new pillar in the banking system, particularly based on our mutual sector, based on our credit unions and our building societies."*

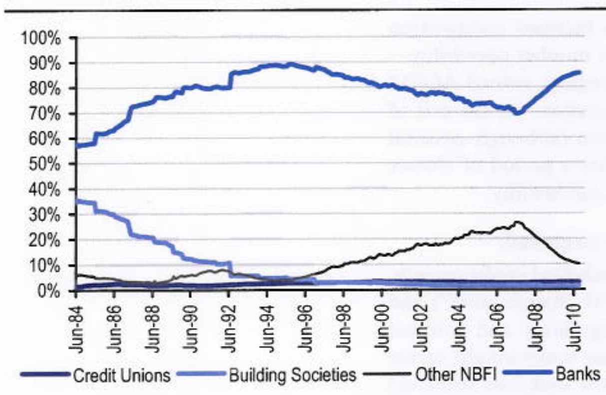
While increased Government support for the mutual Credit Unions and Building Societies is likely to be popular with constituents, we believe that it is both complicated and potentially risky. We believe that a number of issues need to be taken into consideration before the Government moves down this path:

Loss of market share by Building Societies & Credit Unions

Building Societies and Credit Unions held a significant position in the provision of financial services products in Australia for decades. However, over the last thirty years this position has decreased significantly.

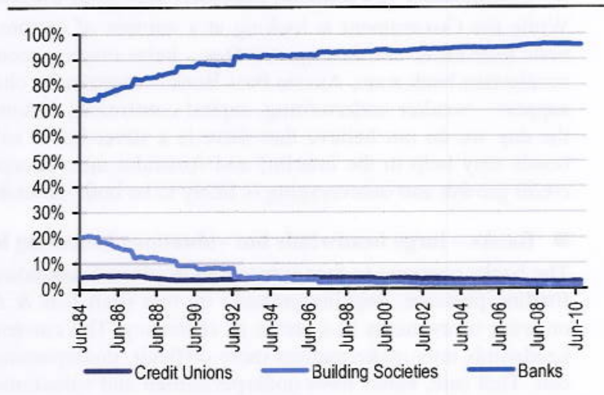
In 1984 Building Societies and Credit Unions controlled around 36% of the mortgage market in Australia and 25% of deposits. Building Societies in particular were significantly larger than today, with 35% share of mortgages.

Chart 1: Market share of Mortgages in Australia (%)



Source: APRA, RBA, UBS estimates

Chart 2: Market share of Deposits in Australia (%)



Source: APRA, RBA, UBS estimates

However, following a series of demutualisations and conversions into banks in the wake of deregulation in 1983, building societies quickly lost share. The high profile collapse of Pyramid Building Society in 1990 also accelerated the demise of building societies. By 1994 building societies' and credit unions' share of

mortgages had fallen to 7%. This trend has continued until today, when building societies and credit unions account for around 4% of system mortgages and deposits.

Do the building societies and credit unions have the capacity to become a "fifth pillar"?

We believe that to be considered a substantial player in the financial services landscape (or a "fifth pillar") the Building Societies and Credit Unions would need to regain market share back to around 8-10%. (This is consistent with the "rule of thumb" of Santander which believes that around 10% share in each market is appropriate to be a material player and provide scale benefits).

RBA data indicates that the mortgage market in Australia is currently $1,142b. We expect mortgage credit to grow at around 6% per annum over the next few years. This implies that in four years the mortgage market will grow to around $1,440b.

If Building Societies and Credit Unions are to reach 10% market share over this period, it would require increasing their total mortgage lending from $50b at present to around $144b, or grow by $94b. Is this logistically possible?

- Do the building societies and credit unions have the ability to process such large volumes of lending?
- Do building societies and credit unions have adequate underwriting capacity or will credit standards be loosened?
- What is the cost of the additional capex required to build systems and facilities with the scale to process such volumes?
- Who would fund this capex?
- Do the building societies and credit unions have the management and board capabilities to take on such a significant role in the financial system?

Capital considerations

Even if the government was prepared to provide Australian Office of Financial Management (AOFM) funding support to the building societies and credit unions to increase their scale, capital remains a big constraint.

At present the Building Societies and Credit Unions are leveraged around 12x. This is consistent with their Prudential Capital Requirements imposed by APRA. If the Building Societies and Credit Unions increased their lending by around $94b as described above, they would need approximately $8b in additional capital to support this growth. This compares to around $5.9b of capital currently in the Building Societies and Credit Unions.

Given retained earnings would be insufficient to generate the quantum of capital we believe that there are two alternatives:

(1) Additional capital contributions from members of the Building Societies and Credit Unions

(2) AOFM support would need to be extended to the non-investment grade and equity tranches of Building Society and Credit Union RMBS issuance. This would comply with the risk transfer requirements by APRA and reduce the capital burden. But this leads to the question of whether tax payer money should be used to acquire lower rated tranches of ADI mortgage securitisation. Is this an appropriate use of tax payers' money?

What is the potential impact on the Regional Banks?

Wayne Swan's comments suggest that support will be provided to the mutual sector, specifically the Building Societies and Credit Unions. But where would this leave the Regional Banks?

Without the same level of tax payer support as the Building Societies and Credit Unions, the regional banks would be at a significant competitive disadvantage. Regional Banks do not have the credit rating to access wholesale markets at the same prices as the majors, while not receiving the same level of government support as the mutuals would leave Regional Banks stuck in the middle.

In addition, the regional banks have benefited from a degree of anti-major bank sentiment in recent years which has helped their growth. If they do not receive the funding benefit of the mutuals their opportunities for growth are likely to be significantly constrained, especially in mortgages.

Is now the right time to be adding additional capacity to the mortgage market?

Stepping back and looking at the big picture, we must ask if now is the right time to be adding new capacity to the mortgage system. It is worth considering:

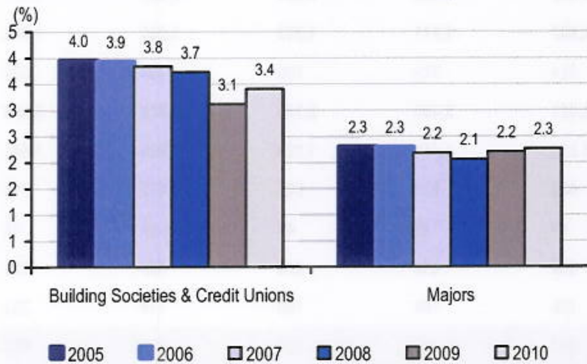
- Mortgage credit has grown at a compound rate of 13.4% for the last 34 years since the latest series of RBA credit statistics began.
- Mortgage credit is currently equivalent to 82% of GDP. This is one of the highest levels in the world.
- Housing affordability is also now approaching record low levels.
- House prices in Australia are expensive under nearly every measure.
- There have been very few stories of applicants with appropriate deposits and credit history being unable to access mortgage funding. This would suggest that there has not been credit rationing in mortgages by the existing players.
- Shouldn't the focus be on increasing funding availability to the SME sector where there has been less competition and arguably more credit constraints in recent times?

What are the lessons learned from the GFC?

Will Australia fall for the same mistakes as seen in other countries whose banking systems performed so poorly in recent times? It must be remembered that there is a clear inverse relationship between competition and financial stability. There was no shortage of mortgage competition in the US and UK between 2000 and 2007. Unfortunately that didn't end too well.

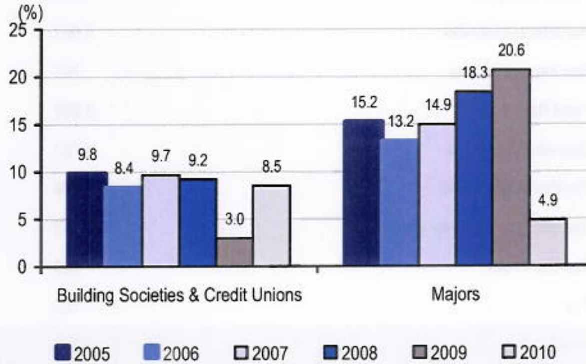
Comparing Building Societies & Credit Unions vs Major Banks

Chart 3: Margins (%)



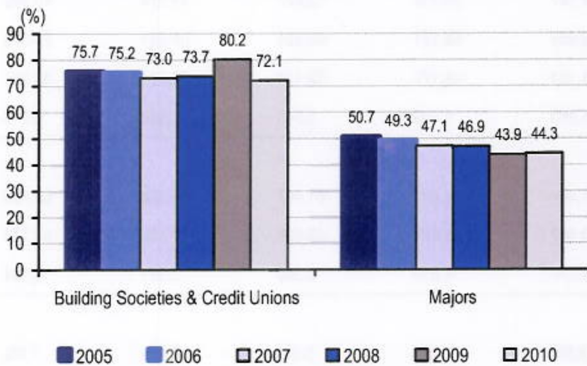
Source: APRA, Company data, UBS estimates

Chart 4: Loan Growth (%)



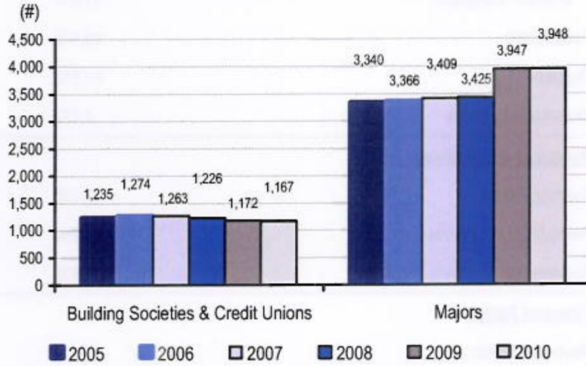
Source: APRA, Company data, UBS estimates

Chart 5: Cost to Income Ratio (%)



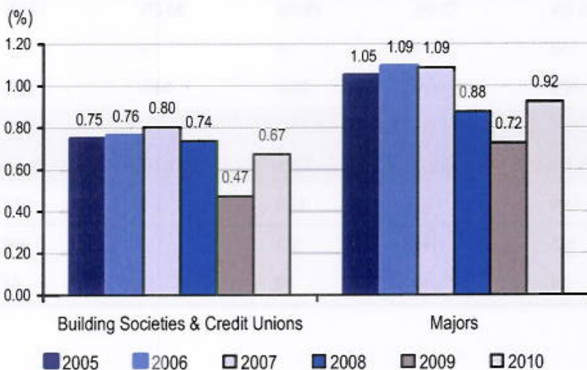
Source: APRA, Company data, UBS estimates

Chart 6: Branch Numbers (#)



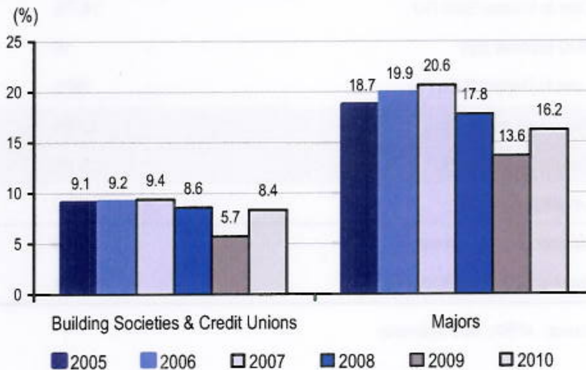
Source: APRA, Company data, UBS est. Note: Majors incl SGB & BWA from 2009.

Chart 7: Return on Assets (%)



Source: APRA, Company data, UBS estimates

Chart 8: Return on Equity (%)



Source: APRA, Company data, UBS estimates

Table 1: Credit Unions and Building Societies Financial Summary (A$m)

Period to June	2005	2006	2007	2008	2009	2010
Interest Income	3,237	3,649	4,098	4,820	4,577	4,239
Interest Expense	1,736	2,042	2,388	3,008	2,982	2,377
Net Interest Income	**1,501**	**1,607**	**1,711**	**1,813**	**1,595**	**1,862**
Non Interest Income	749	824	774	796	783	694
Total Revenue	**2,250**	**2,431**	**2,485**	**2,609**	**2,378**	**2,556**
Operating Expenses	1,703	1,829	1,815	1,923	1,906	1,843
Pre-Provision Profit	**548**	**602**	**670**	**686**	**472**	**713**
Bad and Doubtful Debt expense	38	43	35	46	46	42
Pre-Tax Profit	**509**	**559**	**635**	**640**	**426**	**671**
Tax	152	166	184	190	118	202
NPAT	**357**	**393**	**451**	**450**	**308**	**468**
(growth %)	-	*9.8%*	*14.9%*	*-0.2%*	*-31.6%*	*52.0%*
Spot Balance Sheet						
Loans & Advances	39,808	43,135	47,311	51,668	53,208	57,731
of which mortgages	31,017	34,167	38,105	42,427	44,974	49,485
Total Assets	49,440	53,869	59,121	64,284	67,521	73,079
Deposits	41,519	45,154	48,177	52,174	56,751	60,211
Shareholder's Funds	4,122	4,553	5,100	5,545	5,390	5,916
Average Balance Sheet						
Average Assets	47,728	51,404	56,207	61,167	65,354	69,769
Average Loans & Advances	37,950	40,882	44,534	48,608	51,184	54,774
Average Shareholder's Funds	3,932	4,276	4,810	5,250	5,391	5,604
Financial Ratios						
Revenue Growth	-	8.0%	2.2%	5.0%	-8.8%	7.5%
Costs Growth	-	7.4%	-0.7%	5.9%	-0.9%	-3.3%
Margin (%)	**3.96%**	**3.93%**	**3.84%**	**3.73%**	**3.12%**	**3.40%**
Loan growth	-	8.4%	9.7%	9.2%	3.0%	8.5%
Cost to Income Ratio (%)	75.7%	75.2%	73.0%	73.7%	80.2%	72.1%
BDD expense (bp)	10	10	7	9	9	7
Loan to Deposit Ratio (%)	96%	96%	98%	99%	94%	96%
Return on Assets (bp)	**0.75%**	**0.76%**	**0.80%**	**0.74%**	**0.47%**	**0.67%**
Return on Equity (%)	**9.1%**	**9.2%**	**9.4%**	**8.6%**	**5.7%**	**8.4%**
Leverage Ratio (x)	12.0	11.8	11.6	11.6	12.5	12.4
Number of Credit Unions	164	148	143	133	117	108
Number of Building Societies	14	14	14	12	11	11

Source: APRA, UBS estimates

Table 2: Banks Financial Summary

	ANZ	CBA	NAB	WBC	Majors
Recommendation	**Buy**	**Neutral**	**Neutral**	**Neutral**	**Under Weight**
Share price ($) 24 November 2010	**22.30**	**48.12**	**23.37**	**21.36**	
Price Target ($)	**25.50**	**54.00**	**NA**	**24.00**	
Implied 2011E Price to Book (x)	1.8	2.3	NA	1.8	2.0
Implied 2011E PE (%)	10.4	12.1	NA	10.8	11.2
% Price Upside to Price Target	14%	12%	NA	12%	14%
Valuations					
PE (x)					
2009	14.1	16.8	12.3	13.6	14.4
2010	11.5	12.7	11.0	11.1	11.6
2011E	10.4	12.1	10.2	10.8	11.0
2012E	10.0	11.6	9.6	10.5	10.5
PE Relative to All Industrials (%)					
2009	83	98	72	80	85
2010	78	85	74	75	78
2011E	76	88	74	79	80
2012E	79	91	75	83	83
PE Relative to Major Banks (%)					
2009	98	116	85	95	n.a.
2010	99	109	94	96	n.a.
2011E	94	110	93	99	n.a.
2012E	95	110	91	100	n.a.
Price to Core Earnings (Pre-Prov'n Profit) (x)					
2009	6.4	8.2	5.0	6.3	6.6
2010	6.6	7.4	5.6	6.6	6.6
2011E	6.4	7.7	5.6	6.9	6.7
2012E	6.2	7.4	5.4	6.5	6.5
Diluted EPS growth (%)					
2009	-1.3	-17.7	-16.7	-18.8	-13.9
2010	23.0	32.6	11.7	22.5	23.4
2011E	10.9	4.9	7.4	2.5	6.2
2012E	3.3	4.1	6.9	3.3	4.3
Div Yield (%)					
2009	4.6	4.7	6.2	5.4	5.2
2010	5.7	6.0	6.5	6.5	6.2
2011E	6.2	6.3	7.1	7.2	6.7
2012E	6.4	6.6	7.5	7.5	7.0
Price to Book (x)					
2009	1.77	2.44	1.49	1.81	1.92
2010	1.72	2.18	1.46	1.67	1.79
2011E	1.59	2.06	1.37	1.59	1.69
2012E	1.48	1.91	1.29	1.51	1.58
Price to NTA (x)					
2009	2.02	3.53	1.84	2.71	2.61
2010	2.15	3.02	1.85	2.38	2.41
2011E	1.95	2.78	1.70	2.21	2.21
2012E	1.79	2.50	1.57	2.05	2.02

	ANZ	CBA	NAB	WBC	Majors
Financials					
Cash NPAT (UBS post prefs) ($m)					
2009	3,639	4,348	3,676	4,627	16,290
2010	5,014	6,054	4,543	5,879	21,490
2011E	5,654	6,455	4,948	6,133	23,189
2012E	5,891	6,832	5,369	6,411	24,502
Cash NPAT (Company format) ($m)					
2009	3,772	4,415	3,841	4,627	16,655
2010	5,025	6,101	4,581	5,879	21,586
2011E	5,664	6,501	4,986	6,133	23,283
2012E	5,901	6,878	5,407	6,411	24,596
Cash EPS (fully diluted) (cps)					
2009	158	287	191	157	n.a.
2010	194	380	213	192	n.a.
2011E	215	399	229	197	n.a.
2012E	222	415	245	203	n.a.
Basic EPS (Company format) (cps)					
2009	169	305	200	162	n.a.
2010	199	395	214	198	n.a.
2011E	221	416	230	204	n.a.
2012E	229	434	245	211	n.a.
Dividend (cps)					
2009	102	228	146	116	n.a.
2010	126	290	152	139	n.a.
2011E	139	303	166	154	n.a.
2012E	143	316	175	161	n.a.
Return on Equity (%)					
2009	13.0	15.4	11.6	13.9	13.6
2010	15.5	18.7	13.5	16.2	16.2
2011E	16.4	18.3	14.0	15.8	16.3
2012E	15.8	17.8	14.1	15.5	15.9
Return on Assets (%)					
2009	0.72	0.76	0.59	0.79	0.72
2010	0.95	0.97	0.75	0.99	0.92
2011E	1.02	1.00	0.76	0.99	0.95
2012E	0.98	0.99	0.75	0.98	0.93
Tier 1 (%)					
2009	10.56	8.07	8.96	8.11	8.84
2010	10.10	9.15	8.91	9.09	9.30
2011E	10.30	9.80	9.18	9.47	9.70
2012E	10.77	10.30	9.20	9.89	10.08
Core Tier 1 (%)					
2009	8.96	6.35	6.82	6.57	7.10
2010	8.04	6.86	6.80	7.50	7.26
2011E	8.38	7.55	7.19	7.94	7.72
2012E	8.94	8.16	7.36	8.42	8.16

	ANZ	CBA	NAB	WBC	Majors
Key Earnings Drivers					
Growth in Ave Interest Earning Assets (%)					
2008	17.5	17.9	18.0	20.3	18.3
2009	9.2	23.7	10.4	44.5	20.6
2010	2.7	14.3	-2.3	5.3	4.9
2011E	10.2	3.5	6.0	4.2	5.8
2011E	7.9	5.3	8.2	5.7	6.8
Margins (%)					
2008	2.01	1.98	2.20	2.05	2.06
2009	2.30	2.06	2.16	2.31	2.21
2010	2.46	2.10	2.25	2.22	2.26
2011E	2.42	1.99	2.14	2.13	2.17
2012E	2.33	1.94	2.04	2.07	2.10
Non-Interest Income Growth (%)					
2008	12.3	3.4	-12.5	1.5	0.6
2009	9.1	3.1	14.6	29.3	12.5
2010	9.0	8.4	-8.8	0.4	2.7
2011E	11.1	3.2	11.7	2.0	6.5
2011E	7.1	6.0	9.7	6.3	7.1
Revenue Growth (%)					
2008	9.1	8.2	5.3	9.5	7.8
2009	19.5	17.3	10.1	50.7	22.7
2010	9.8	13.3	-1.3	0.9	5.5
2011E	9.2	0.1	3.9	0.7	3.3
2012E	5.0	3.8	5.1	4.0	4.4
Cost Growth (%)					
2008	15.0	9.2	-2.0	7.3	6.5
2009	9.0	11.0	6.8	38.2	14.7
2010	12.3	10.6	1.2	3.4	6.7
2011E	15.0	3.1	5.9	4.8	6.9
2012E	6.1	2.0	4.1	1.0	3.3
Cost to Income Ratio (%)					
2008	47.3	48.9	47.3	43.9	46.9
2009	43.2	46.2	45.9	40.2	43.9
2010	44.1	45.1	47.0	41.2	44.3
2011E	46.5	46.5	47.9	42.9	45.8
2012E	47.0	45.7	47.5	41.7	45.3
Core Earnings Growth					
2008	4.3	7.2	12.8	11.3	9.0
2009	28.9	23.3	12.9	60.5	29.8
2010	8.0	15.7	-3.3	-0.8	4.6
2011E	4.7	-2.3	2.2	-2.1	0.4
2012E	4.0	5.4	6.0	6.2	5.4
BDD charge/loans (bp)					
2008	56	25	63	30	44
2009	88	63	89	71	77
2010	50	41	51	30	43
2011E	35	24	38	19	28
2012E	34	23	34	20	27

Source: Company data, UBS estimates

Sector Valuations and Pricing

Chart 9: Sector PE (x)

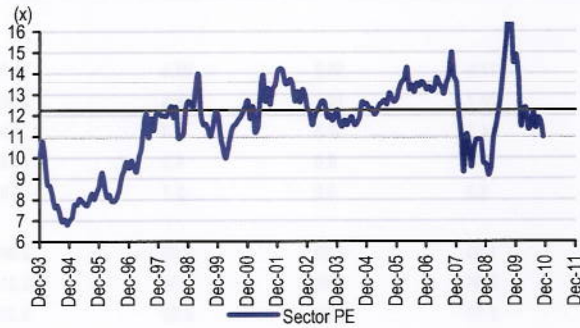


Chart 10:Sector PE Relative to the All Industrials (ex Financials)

Chart 11:Sector Price to Pre-Provision Profits (x)

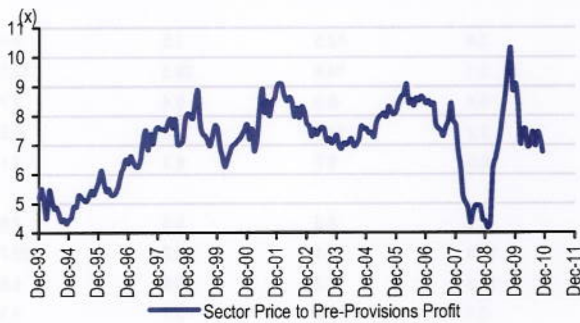


Chart 12: Sector Earnings Yield to Bond Yield (%)

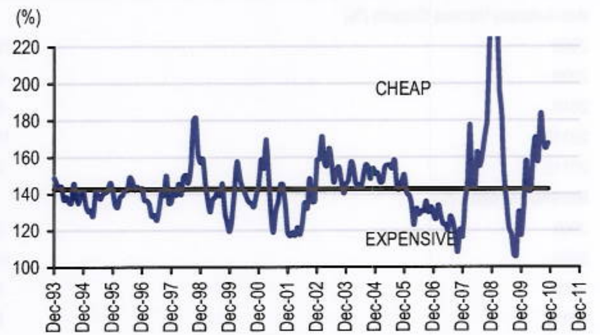


Chart 13: Sector Price to Book Ratio (x)

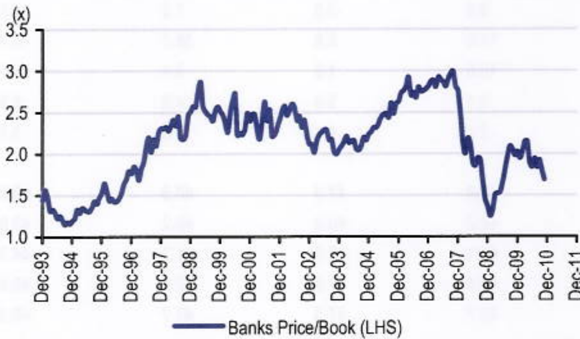


Chart 14: Sector Price to Book (x) vs Return on Equity (%)

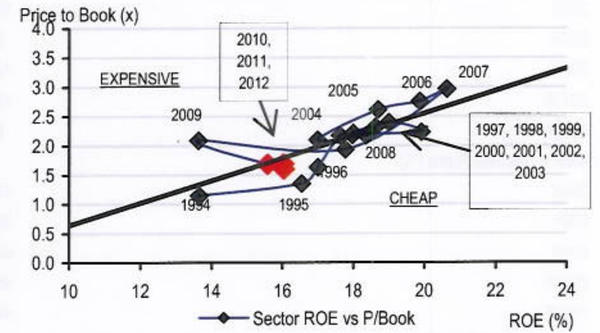
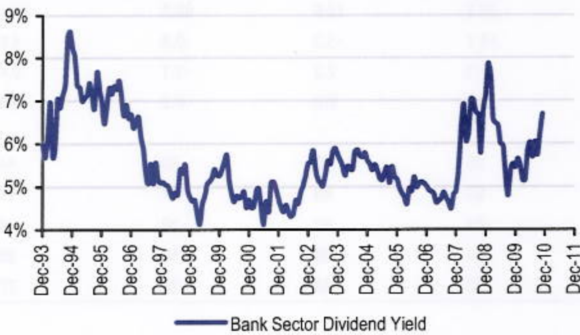


Chart 15: Sector Dividend Yield (%)



Source: Company data, UBS estimates

Chart 16: Sector Dividend Yield vs Cash Rate (%)

Source: Company data, UBS estimates

Stock Valuations and Pricing

Chart 17: ANZ PE Relative to the Major Banks (%)

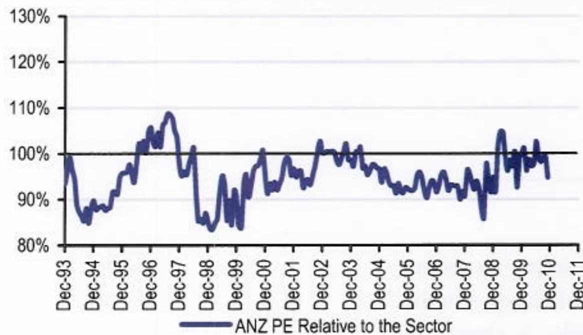


Chart 18: ANZ Price to Book (x) vs Return on Equity (%)

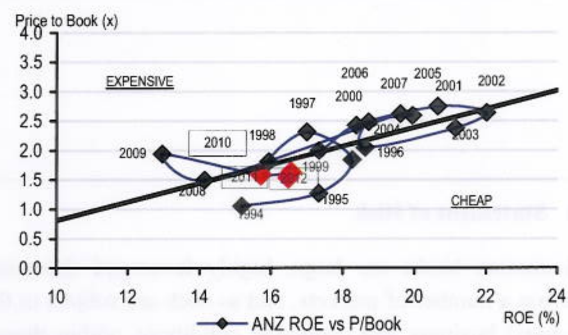


Chart 19: CBA PE Relative to the Major Banks (%)

Chart 20: CBA Price to Book (x) vs Return on Equity (%)

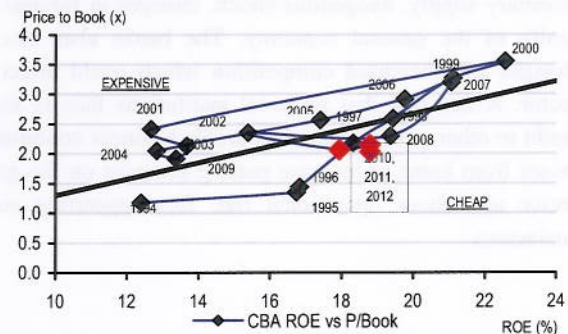


Chart 21: NAB PE Relative to the Major Banks (%)

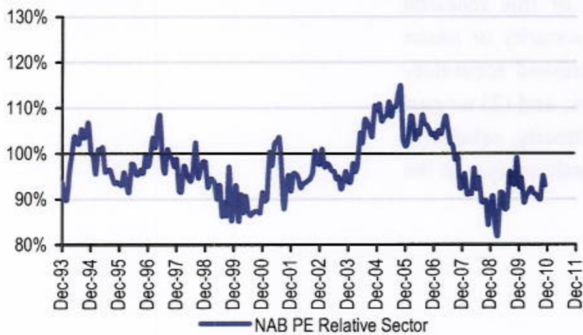


Chart 22: NAB Price to Book (x) vs Return on Equity (%)

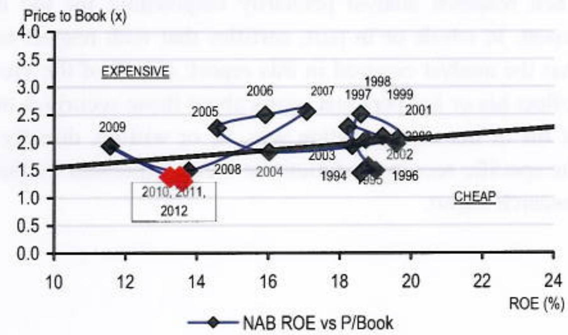


Chart 23: WBC PE Relative to the Major Banks (%)

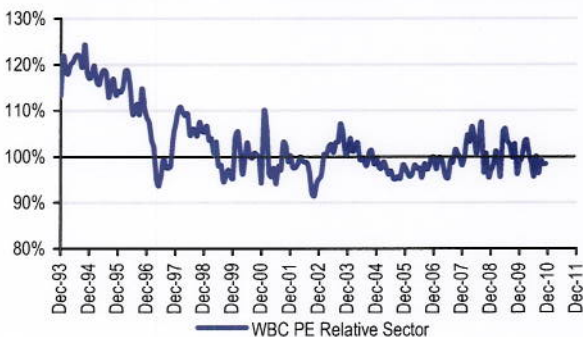
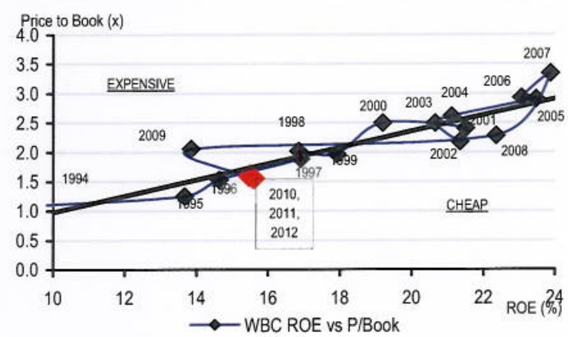


Chart 24: WBC Price to Book (x) vs Return on Equity (%)



Source: Company data, UBS estimates

Source: Company data, UBS estimates

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Australian banks are large, highly leveraged financial institutions operating across a number of markets, and as such are subject to the risk of changes in the general business and economic conditions within these markets. A change in these conditions could include changes in interest rates, inflation, unemployment, monetary supply, exogenous shock, changes in foreign exchange rates, and the health of the general economy. The banks also face the risk of regulatory changes and increased competition which could affect the profitability of the sector. A key risk that financial institutions face is associated with extending credit to other parties. Less favourable business conditions could cause potential losses from loans to increase putting pressure on the group's capital. The bank sector also faces operational risk from operating such large and complex businesses.

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Buy	Buy	51%	37%
Neutral	Hold/Neutral	40%	33%
Sell	Sell	9%	22%
UBS Short-Term Rating	**Rating Category**	**Coverage[3]**	**IB Services[4]**
Buy	Buy	less than 1%	20%
Sell	Sell	less than 1%	0%

1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category.
4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 30 September 2010.

UBS Investment Research: Global Equity Rating Definitions

UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
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Buy	Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.
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Equity Price Targets have an investment horizon of 12 months.

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UBS Securities Australia Ltd: Jonathan Mott; Chris Williams, CFA; Adam Lee.

Company Disclosures

Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
ANZ Banking Group[2, 4, 5a, 6, 13, 16]	ANZ.AX	Buy	N/A	A$22.34	23 Nov 2010
Commonwealth Bank of Australia[2, 4, 5a, 16]	CBA.AX	Neutral	N/A	A$48.18	23 Nov 2010
National Australia Bank[2, 4, 5a, 13, 16]	NAB.AX	Suspended	N/A	A$23.56	23 Nov 2010
Westpac Banking Corporation[2, 4, 5a, 5b, 6, 13, 16]	WBC.AX	Neutral	N/A	A$21.31	23 Nov 2010

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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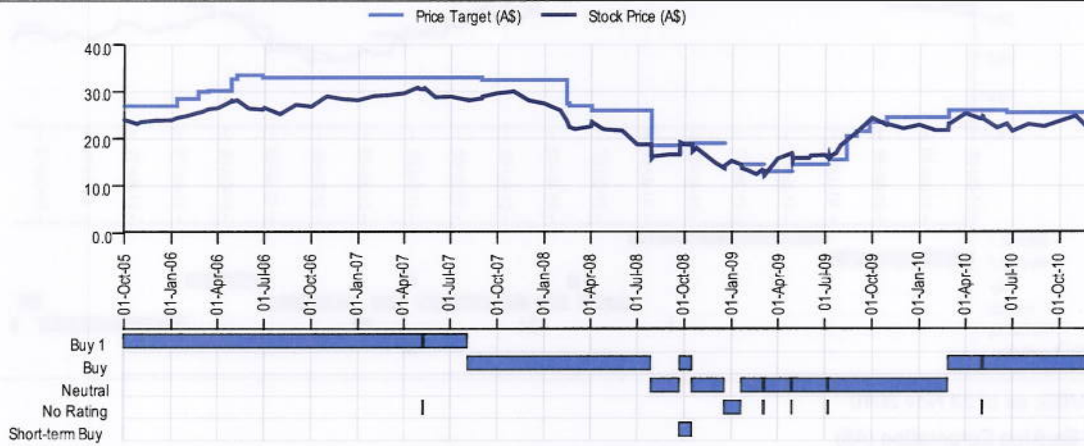
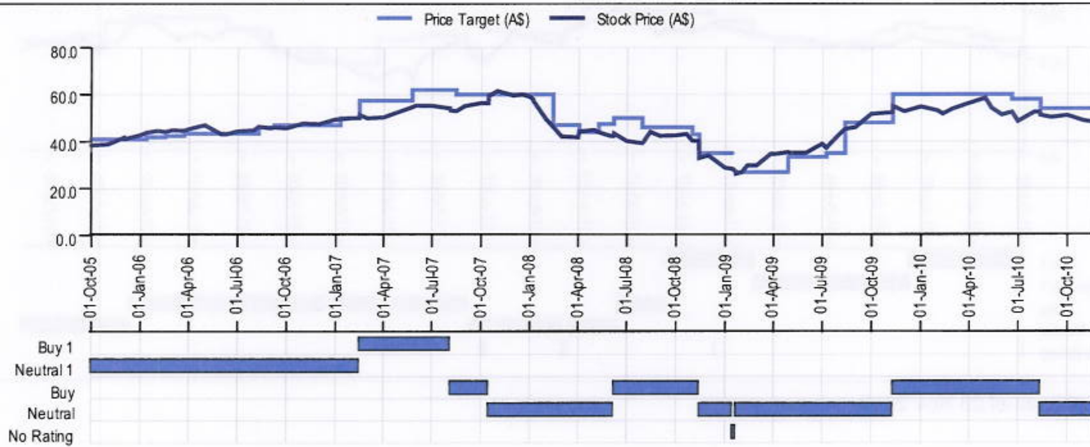


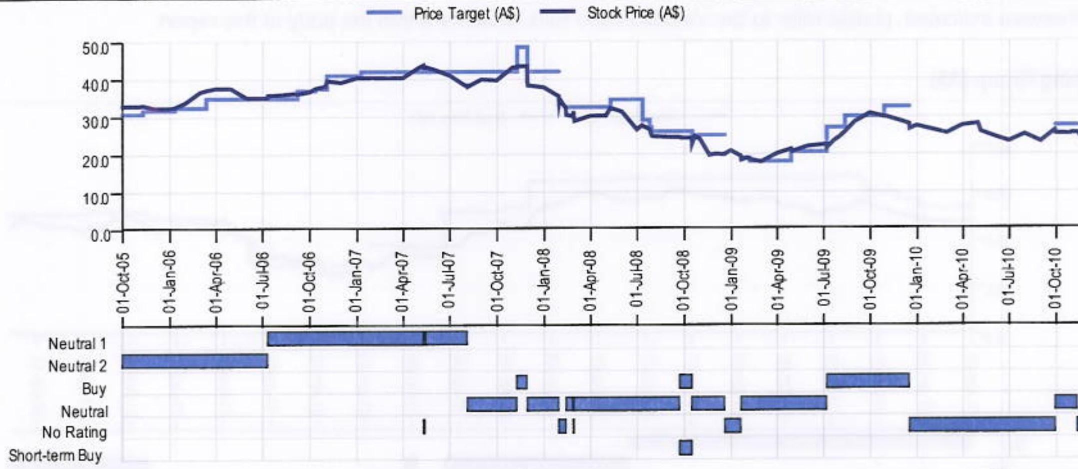
Source: UBS; as of 23 Nov 2010

Commonwealth Bank of Australia (A$)



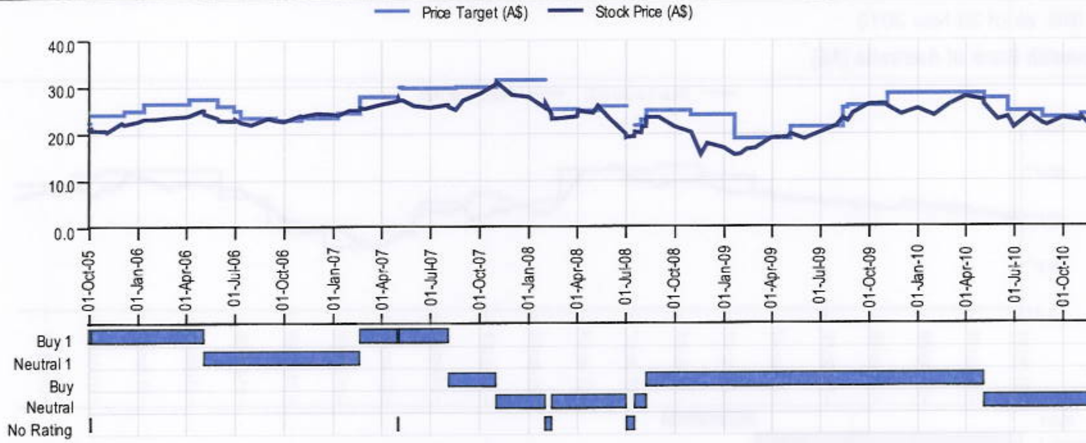
Source: UBS; as of 23 Nov 2010

National Australia Bank (A$)



Source: UBS; as of 23 Nov 2010

Westpac Banking Corporation (A$)



Source: UBS; as of 23 Nov 2010

Note: On August 4, 2007 UBS revised its rating system. (See 'UBS Investment Research: Global Equity Rating Definitions' table for details). From September 9, 2006 through August 3, 2007 the UBS ratings and their definitions were: Buy 1 = FSR is > 6% above the MRA, higher degree of predictability; Buy 2 = FSR is > 6% above the MRA, lower degree of predictability; Neutral 1 = FSR is between -6% and 6% of the MRA, higher degree of predictability; Neutral 2 = FSR is between -6% and 6% of the MRA, lower degree of predictability; Reduce 1 = FSR is > 6% below the MRA, higher degree of predictability; Reduce 2 = FSR is > 6% below the MRA, lower degree of predictability. The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities. From October 13, 2003 through September 8, 2006 the percentage band criteria used in the rating system was 10%.

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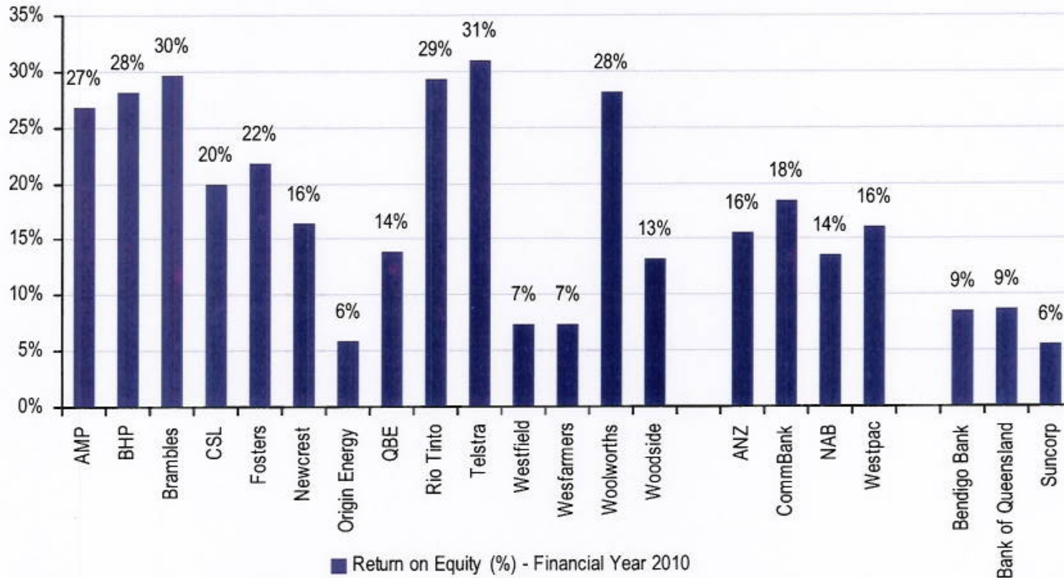
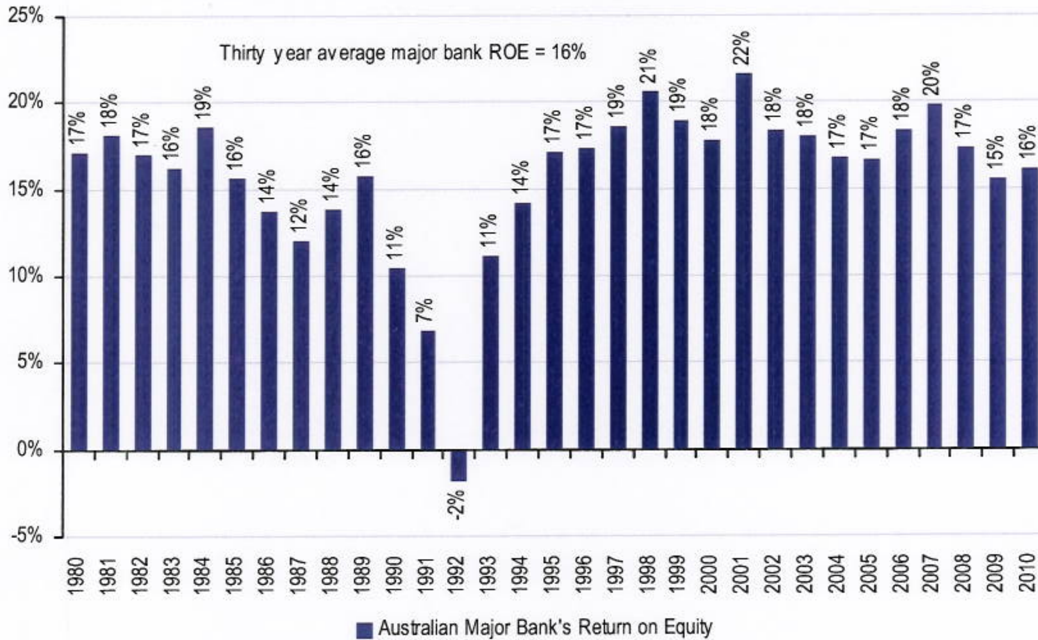
Return on Equity of the Banks compared to other leading Australian Companies – FY10



Source: Company data, UBS estimates

Long Term Return on Equity for the Australian Major Banks



Source: Company data, UBS estimates