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Bank Note$

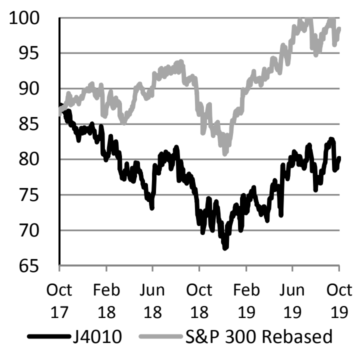
Outside in the cold distance, a wildcat did growl

Stock	Price	Target	Rating
ANZ	$27.83	$29.30	Buy
CBA	$79.31	$86.00	Buy
NAB	$28.45	$30.50	Buy
WBC	$28.94	$30.20	Hold

ASX200 Banks (J4010) Price Performance

	(1m)	(3m)	(12m)
Index (x100)	81.50	79.40	72.19
Absolute (%)	-1.65	0.95	11.04
Rel market (%)	-1.60	1.76	-2.12

Absolute Price



SOURCE: IRESS

Proposed revisions to capital adequacy and measurement of capital (APS 111) manageable for the majors

APRA has growled and launched a review of the capital treatment of ADIs' investments in banking and insurance subsidiaries. Changes are now proposed to APS 111 at Level 1 to increase equity required to support investments in large subsidiaries but reduce that for smaller ones. This is aimed more at the major banks with substantial New Zealand operations. The current Level 1 treatment provides an average uplift of 100bp to the majors' CET1 ratio. This is based on 400% risk weighting of the subsidiary investment after deducting intangibles and APRA believes this capital support may be overstated. APRA is proposing to limit the tangible amount of exposure to an unlisted individual subsidiary to 10% of net Level 1 Group CET1 capital and with amounts over this limit to be "met dollar-for-dollar" (i.e. any investment in excess of this 10% limit will be fully deducted from net Level 1 Group CET1 capital while anything below this limit will be risk weighted at 250%). While there is no impact on the majors' Level 2 CET1 ratio, the Level 1 CET1 impact is estimated (by the majors) as follows: (2) ANZ -75bp although certain management actions would offset much of this; (2) CBA -30bp although announced divestments and regulatory changes would more than offset this; (3) NAB minimal impact; and (4) WBC -40bp although the ratio has since been lifted by 25-30bp through intra-group transactions.

In a nutshell, all the majors appear well placed to weather any capital increase under APRA's proposals (as evidenced by share price reactions today and yesterday). ANZ would have to be the most resilient major purely based on CET1 flexibility (Level 1 and Level 2), followed by CBA, NAB and WBC – that is also reflected in our pecking order.

NAB's Buy rating reinstated

We lowered NAB's rating from Buy to Hold and its price target from $30.80 to $30.20 in our 2 October FY19 result preview note. This was largely based on capital concerns (following nearly $1.2bn after tax charges in 2H19 for customer remediation and software write-downs) that implied the bank is unlikely to achieve APRA's "unquestionably strong" minimum CET1 benchmark of 10.5% by 1 January 2020. NAB has now clarified it expects to achieve this benchmark at both levels and we have revised our FY19 final dividend forecast from 79¢ back to 83¢. As a result, the price target is increased by 1% to $30.50 and NAB's Buy rating is reinstated based on easing capital concerns (although our 2H19 underwritten DRP assumption remains).

Table 1 – Investment summary

	Mkt Cap	Price / Book (x)		PE (x)		Yield		ROE		EPS growth		Price	Last	
	($bn)	2019e	2020e	2019e	2020e	2019e	2020e	2019e	2020e	2019e	2020e	target	price	Rating
MAJORS														
ANZ	78.9	1.3	1.3	11.9	12.0	5.7%	5.7%	11.2%	10.8%	5%	-1%	$29.30	$27.83	Buy
CBA	140.4	2.0	1.9	16.5	16.1	5.4%	5.4%	12.5%	12.3%	-6%	2%	$86.00	$79.31	Buy
NAB	82.0	1.5	1.4	15.7	12.1	5.8%	5.8%	9.9%	12.6%	-14%	29%	$30.50	$28.45	Buy
WBC	101.0	1.5	1.5	14.5	12.8	6.4%	6.2%	10.8%	12.1%	-16%	14%	$30.20	$28.94	Hold

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Outside in the cold distance, a wildcat did growl

Proposed revisions to capital adequacy and measurement of capital (APS 111) manageable for the majors

APRA released a strengthened prudential standard aimed at mitigating contagion risk within banking groups (APS 222) back in August. This largely impacts banks with substantial operations overseas and in particular the major banks' subsidiaries in New Zealand.

As an adjacent issue, APRA has growled again and launched a review of the capital treatment of ADIs' investments in banking and insurance subsidiaries. Changes are now proposed to the prudential standard covering capital adequacy and the measurement of capital (APS 111) at Level 1 that will increase the amount of equity required to support investments in large subsidiaries but reduce that for smaller ones. This is again aimed more at the major banks with substantial New Zealand operations.

To recap, Level 1 includes the parent bank, offshore branches and APRA approved extended licence entities while Level 2 comprises the consolidated banking group excluding the insurance and funds management businesses.

APRA is of the view that no material additional capital is required at the consolidated level although some ADIs may have to raise capital. Regardless, APRA believes there are options available to the major banks to provide for any higher capital requirements including retaining more profits locally (i.e. repatriating less New Zealand dividends back to Australia – no surprises as the majors have been gearing for this possibility since the RBNZ's call for higher capital levels).

The current Level 1 treatment provides an average uplift of 100bp to the majors' CET1 ratio. This is based on 400% risk weighting of the subsidiary investment after deducting intangibles and APRA believes this capital support may be overstated.

As the focus is more on large exposures, APRA is proposing to limit the tangible amount of exposure to an unlisted individual subsidiary to 10% of net Level 1 Group CET1 capital and with amounts over this limit to be "met dollar-for-dollar". In other words, any investment in excess of this 10% limit will be required to be fully deducted from net Level 1 Group CET1 capital. Anything below this 10% limit will be risk weighted at 250% – such that ADIs with investments below this limit will actually gain on the capital front.

The impact as estimated by each of the majors is as follows:

1. **ANZ** – Reduction in Level 1 CET1 ratio of ~$2.5bn or 75bp before offsetting management actions (the bank believes this is an unlikely outcome given post implementation of certain management actions – possibly through intra-group transactions – would lead to a minimal overall impact) with no impact on Level 2 CET1 ratio (~11.5% pro-forma as at 30 June 2019). ANZ's Level 1 outcome was as expected given it is the largest New Zealand bank. However, ANZ has the best CET1 ratio among the majors and is best placed to absorb any higher capital requirements.
2. **CBA** – Reduction in Level 1 CET1 ratio of ~NZ$3.0bn or 30bp (i.e. from 11.2% as at 30 June 2019 to 10.9% before the impact of announced divestments and regulatory changes) with no impact on Level 2 CET1 ratio (pro-forma ~11.8% after announced divestments and regulatory changes). The pro-forma 10.9% Level 1 CET1 ratio

presents a healthy buffer and the bank retains sufficient capacity to meet future regulatory requirements.

3. **NAB** – Minimal impact on Level 1 CET1 ratio (10.6% as at 31 March 2019) and no impact on Level 2 CET1 ratio (10.4% as at 31 March 2019 and 30 June 2019). In addition, replacing the New Zealand bank's AT1 and Tier 2 securities issued to the parent with externally issued instruments over time could reduce overall Level 1 capital requirements. On a positive note, NAB further indicated it expects to achieve APRA's unquestionably strong CET1 benchmark of 10.5% by 1 January 2020.
4. **WBC** – Reduction in Level 1 CET1 ratio of ~$1.6bn or 40bp (i.e. from 10.5% as at 30 June 2019 to 10.1%) with no impact on Level 2 CET1 ratio (10.5% as at 30 June 2019). WBC indicated there has been progress in lifting Level 1 CET1 ratio by 25-30bp since then through intra-group transactions.

In a nutshell, all the majors appear well placed to weather any capital increase under APRA's APS 111 proposals (as evidenced by share price reactions today and yesterday). ANZ would have to be the most resilient major purely based on CET1 flexibility (Level 1 and Level 2), followed by CBA, NAB and WBC – that is also reflected in our pecking order.

Cheat Sheet

Table 2 – Bank Cheat Sheet 1 (S&P 100 only)

		ANZ	CBA	NAB	WBC	SUN	BEN	BOQ	MQG
1	**EaD ($bn) (APRA Table 7d)**								
	Home	377	593	391	562	45	44	30	51
	Other retail	55	42	15	35	0	4	15	11
	Agriculture, forestry & fishing	35	22	45	21	4	6	0	0
	Oil & gas	7	8	7	3	0	0	0	1
	Mining	7	9	2	5	0	0	0	2
	Mining services	2	1	1	2	0	0	0	0
	Other commercial	489	360	396	406	18	8	5	72
	Total	971	1,035	857	1,034	68	62	49	136
	2020e growth (BP)	3%	4%	5%	4%	3%	3%	3%	-
	2021e growth (BP)	3%	4%	6%	4%	3%	4%	3%	-
	Domestic market share (APRA)								
	Home - owner occupied	15%	26%	14%	21%	3%	3%	1%	2%
	Home - investor	14%	24%	18%	29%	2%	2%	2%	3%
	Credit card	18%	27%	13%	23%	0%	1%	0%	1%
	Other consumer	16%	19%	20%	27%	3%	3%	0%	2%
	Wholesale lending (non-financials)	15%	17%	22%	17%	2%	2%	1%	1%
	Mortgage lending by State								
	NSW / ACT	32%	36%	39%	41%	29%	24%	27%	-
	VIC	33%	28%	31%	26%	11%	39%	16%	-
	QLD	16%	19%	16%	17%	48%	15%	43%	-
	WA	13%	11%	9%	9%	7%	9%	10%	-
	SA / other	6%	6%	5%	7%	5%	13%	4%	-
	Total	100%	100%	100%	100%	100%	100%	100%	-
2	**Group funding (ex-SHE)**								
	Customer deposits as % of funding - Term	35%	22%	21%	28%	27%	43%	34%	-
	Customer deposits as % of funding - Other	29%	47%	36%	39%	37%	38%	31%	-
	Other as % of funding	36%	31%	43%	33%	37%	18%	36%	-
	Total	100%	100%	100%	100%	100%	100%	100%	-
	Customer deposits as % of gross loans	80%	76%	70%	71%	66%	84%	68%	-
	Net interest margin	1.79%	2.10%	1.79%	2.12%	1.79%	1.96%	1.94%	-
	NSFR	115%	112%	113%	111%	112%	112%	110%	113%
	Wholesale funding <12 month maturity	25%	14%	17%	14%	12%	8%	14%	-
	2020e w'sale funding requirement ($bn)	23	32	31	30	3	1	1	-
	Liquidity Coverage Ratio (average)	143%	132%	128%	137%	127%	125%	124%	154%
	Domestic market share - deposits (APRA)	13%	24%	17%	21%	2%	2%	2%	3%
3	**Asset quality**								
	Bad debt charge as % of GLA	0.13%	0.16%	0.15%	0.09%	0.02%	0.08%	0.13%	-
	Provisions as % of GLA	0.70%	0.63%	0.66%	0.56%	0.49%	0.58%	0.60%	-
	90 days past due as % of GLA	0.55%	0.44%	0.53%	0.70%	0.93%	0.71%	0.63%	-
	Commercial property exposure	4.3%	6.3%	7.4%	6.4%	4.9%	6.8%	<1.0%	-
	Texas Ratio	8.4%	8.6%	8.2%	9.2%	15.2%	12.5%	10.6%	-
	Institutional loans by risk grade (estimate)								
	AAA to BBB- (investment grade)	78%	67%	76%	61%	-	-	-	-
	Other	22%	33%	24%	39%	-	-	-	-
	Total	100%	100%	100%	100%	-	-	-	-
4	**EaD by industry ($bn)**								
	Agriculture, F&F & mining	49	40	56	19	4	6	-	-
	Construction & property related	70	74	87	91	3	4	-	-
	Entertainment, leisure & tourism	16	6	10	10	1	0	-	-
	Financial	113	69	96	71	2	1	-	-
	Manufacturing	42	15	20	30	0	0	-	-
	Retail	412	635	407	603	45	48	-	-
	Services	13	13	24	35	0	0	-	-
	Sovereign	155	90	62	80	3	0	-	-
	Trade	46	20	32	35	0	1	-	-
	Transport & storage	19	20	23	18	0	0	-	-
	Other	36	53	40	40	8	2	-	-
	Total	971	1,035	857	1,034	68	62	49	136
	Agriculture, F&F & mining	5%	4%	6%	2%	6%	10%	-	-
	Construction & property related	7%	7%	10%	9%	5%	7%	-	-
	Entertainment, leisure & tourism	2%	1%	1%	1%	2%	1%	-	-
	Financial	12%	7%	11%	7%	3%	1%	-	-
	Manufacturing	4%	1%	2%	3%	0%	0%	-	-
	Retail	42%	61%	48%	58%	67%	76%	-	-
	Services	1%	1%	3%	3%	0%	1%	-	-
	Sovereign	16%	9%	7%	8%	5%	0%	-	-
	Trade	5%	2%	4%	3%	0%	1%	-	-
	Transport & storage	2%	2%	3%	2%	0%	0%	-	-
	Other	4%	5%	5%	4%	12%	3%	-	-
	Total	100%	100%	100%	100%	100%	100%	100%	100%
5	**EaD by portfolio ($bn)**								
	Retail	412	635	407	603	45	48	44	61
	Corporate	176	182	137	198	6	0	0	49
	Business / SME	116	59	155	89	11	14	0	16
	Financial	113	69	96	63	2	1	2	8
	Sovereign	155	90	62	80	3	0	3	2
	Total	971	1,035	857	1,034	68	62	49	136
	Retail	42%	61%	48%	58%	67%	76%	90%	45%
	Corporate	18%	18%	16%	19%	9%	0%	0%	36%
	Business / SME	12%	6%	18%	9%	17%	22%	0%	12%
	Financial	12%	7%	11%	6%	3%	1%	3%	6%
	Sovereign	16%	9%	7%	8%	5%	0%	6%	1%
	Total	100%	100%	100%	100%	100%	100%	100%	100%
6	**NPAT by segment**								
	Retail banking	47%	52%	23%	55%	15%	67%	38%	-
	Wholesale banking	53%	44%	74%	55%	15%	33%	62%	-
	Wealth	-1%	2%	3%	-9%	4%	0%	0%	-
	Offshore (ex-New Zealand) & other	1%	3%	0%	0%	66%	0%	0%	-
	Total	100%	100%	100%	100%	100%	100%	100%	-
7	**NPAT by geography**								
	Australia	78%	86%	85%	84%	80%	100%	100%	-
	New Zealand	22%	11%	15%	16%	20%	0%	0%	-
	Other	1%	3%	0%	0%	0%	0%	0%	-
	Total	100%	100%	100%	100%	100%	100%	100%	-
	Bank group cost-to-income ratio	46%	46%	47%	44%	56%	57%	48%	64%
8	**Capital management (last reported)**								
	APRA leverage ratio (>4%) (Tier 1 / EaD)	5.5%	5.6%	5.4%	5.7%	5.4%	6.8%	6.6%	5.3%
	APRA CET1 (>10.5% MTB, >8.5% others)	11.8%	10.7%	10.4%	10.5%	9.3%	8.9%	9.3%	11.4%
	Tier 1	13.8%	12.7%	12.5%	12.7%	11.0%	11.3%	10.9%	13.5%
	International CET1	17.2%	16.2%	14.6%	15.9%	-	-	-	14.3%

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Table 3 – Bank Cheat Sheet 2 (S&P 100 only)

	ANZ	CBA	NAB	WBC	SUN	BEN	BOQ	MQG
9 **Pricing**								
Shareprice	$27.83	$79.31	$28.45	$28.94	$13.33	$11.26	$9.58	$132.17
Price target	$29.30	$86.00	$30.50	$30.20	$14.80	$10.80	$9.70	$140.00
Target PB								
- 2020e	1.3	2.1	1.5	1.6	1.4	0.9	1.0	2.4
- 2021e	1.3	2.1	1.4	1.5	1.4	0.9	0.9	2.3
Target PE								
- 2020e	12.6	17.5	13.0	13.3	13.2	12.7	11.7	16.0
- 2021e	12.5	16.6	12.3	12.8	15.5	12.4	11.3	14.9
Target yield								
- 2020e	5.5%	5.0%	5.4%	6.0%	5.3%	6.5%	7.0%	4.3%
- 2021e	5.5%	5.0%	5.4%	6.0%	5.4%	6.5%	7.0%	4.6%
Expected return	11.0%	13.9%	13.0%	10.6%	16.9%	2.1%	8.4%	10.5%
BP recommendation	Buy	Buy	Buy	Hold	Buy	Hold	Hold	Buy
S&P long term Issuer Credit Rating (ICR)	AA-	AA-	AA-	AA-	A+	BBB+	BBB+	BBB (Bank A)
Moody's long term Issuer Credit Rating (ICR)	Aa3	Aa3	Aa3	Aa3	A1	A3	A3	A3 (Bank A2)
Market capitalisation ($bn)	79	140	82	101	17	6	4	47
TSR								
1 week	3%	1%	1%	2%	-1%	1%	0%	5%
1 month	1%	-3%	-2%	-2%	-3%	-1%	-3%	2%
3 months	3%	1%	6%	5%	5%	2%	4%	4%
1 year	15%	27%	18%	18%	2%	19%	0%	21%
BP estimates								
PB 2018 (x)	1.3	2.1	1.6	1.6	1.2	1.0	1.0	2.6
PB 2019e (x)	1.3	2.0	1.5	1.5	1.3	1.0	1.0	2.6
PB 2020e (x)	1.3	1.9	1.4	1.5	1.3	1.0	1.0	2.3
PB 2021e (x)	1.2	1.9	1.3	1.4	1.3	0.9	0.9	2.2
ROE 2018	11%	14%	12%	13%	8%	8%	10%	17%
ROE 2019e	11%	12%	10%	11%	8%	7%	8%	18%
ROE 2020e	11%	12%	13%	12%	11%	7%	9%	16%
ROE 2021e	11%	13%	13%	12%	9%	8%	9%	16%
NIM 2018	1.87%	2.15%	1.85%	2.22%	1.84%	1.98%	1.98%	-
NIM 2019e	1.79%	2.10%	1.79%	2.10%	1.90%	1.96%	1.93%	-
NIM 2020e	1.75%	2.06%	1.77%	2.07%	1.90%	1.91%	1.92%	-
NIM 2021e	1.73%	2.05%	1.77%	2.08%	1.89%	1.90%	1.92%	-
PE 2018 (x)	12.5	15.5	13.5	12.3	15.6	12.2	10.1	17.4
PE 2019e (x)	11.9	16.5	15.7	14.5	15.5	13.2	12.0	15.0
PE 2020e (x)	12.0	16.1	12.1	12.8	11.9	13.2	11.6	15.1
PE 2021e (x)	11.9	15.3	11.5	12.2	14.0	12.9	11.2	14.1
EPS 2018 (cps)	223	510	210	236	85	92	95	758
EPS 2019e (cps)	234	481	181	199	86	85	80	883
EPS 2020e (cps)	232	492	234	227	112	85	83	876
EPS 2021e (cps)	234	517	247	237	95	87	86	938
EPS growth 2018	-4%	-9%	-16%	-1%	-5%	4%	-3%	15%
EPS growth 2019e	5%	-6%	-14%	-16%	1%	-8%	-15%	17%
EPS growth 2020e	-1%	2%	29%	14%	30%	0%	4%	-1%
EPS growth 2021e	1%	5%	6%	4%	-15%	2%	3%	7%
DPS 2018 (cps)	160	431	198	188	81	70	76	525
DPS 2019e (cps)	160	431	166	184	78	70	68	575
DPS 2020e (cps)	160	431	166	180	78	70	68	601
DPS 2021e (cps)	160	431	166	180	80	70	68	637
Yield 2018	5.7%	5.4%	6.9%	6.5%	6.1%	6.2%	7.9%	4.0%
Yield 2019e	5.7%	5.4%	5.8%	6.4%	5.9%	6.2%	7.1%	4.4%
Yield 2020e	5.7%	5.4%	5.8%	6.2%	5.9%	6.2%	7.1%	4.5%
Yield 2021e	5.7%	5.4%	5.8%	6.2%	6.0%	6.2%	7.1%	4.8%
Payout 2018	72%	80%	94%	80%	86%	76%	81%	69%
Payout 2019e	68%	90%	91%	92%	90%	82%	85%	65%
Payout 2020e	69%	88%	71%	79%	69%	82%	82%	69%
Payout 2021e	68%	83%	67%	76%	84%	80%	79%	68%
BDD as % of GLA 2014	0.19%	0.16%	0.15%	0.11%	0.27%	0.15%	0.22%	-
BDD as % of GLA 2015	0.19%	0.15%	0.14%	0.12%	0.11%	0.12%	0.18%	-
BDD as % of GLA 2016	0.33%	0.18%	0.15%	0.17%	0.03%	0.08%	0.16%	-
BDD as % of GLA 2017	0.21%	0.15%	0.14%	0.13%	0.01%	0.12%	0.11%	-
BDD as % of GLA 2018	0.11%	0.15%	0.13%	0.10%	0.05%	0.11%	0.09%	-
BDD as % of GLA 2019e	0.13%	0.16%	0.15%	0.10%	0.02%	0.08%	0.09%	-
BDD as % of GLA 2020e	0.15%	0.17%	0.18%	0.12%	0.03%	0.09%	0.14%	-
BDD as % of GLA 2021e	0.16%	0.17%	0.19%	0.13%	0.04%	0.09%	0.14%	-
Provisions as % of RWA 2014	1.1%	1.2%	1.0%	1.1%	1.2%	0.9%	1.4%	-
Provisions as % of RWA 2015	1.0%	1.0%	1.0%	0.9%	1.2%	0.9%	1.3%	-
Provisions as % of RWA 2016	1.0%	1.0%	0.9%	0.9%	0.8%	1.0%	1.2%	-
Provisions as % of RWA 2017	1.0%	0.9%	0.9%	0.8%	0.7%	0.7%	1.1%	-
Provisions as % of RWA 2018	0.9%	0.8%	0.9%	0.7%	0.7%	0.8%	0.9%	-
Provisions as % of RWA 2019e	1.1%	1.1%	1.0%	0.9%	0.7%	1.0%	0.9%	-
Provisions as % of RWA 2020e	1.1%	1.1%	1.0%	0.9%	0.7%	1.0%	0.9%	-
Provisions as % of RWA 2021e	1.1%	1.1%	1.0%	0.9%	0.7%	1.0%	0.9%	-
10 **Strategy**								
	Focus on retail and business banking in Australia and New Zealand, and selected institutional markets here and overseas	IT leadership underpinning core retail bank in Australia & NZ	Focus on retail and business (especially agribusiness) banking in Australia and New Zealand	Focus on retail and business banking in Australia and New Zealand, and selected institutional markets here and overseas	More of a GI now with smaller banking component; lately pursuing front end opportunities	Strong retail funding base to provide platform for growth in SME and wealth	Strong retail funding base to support growth in WA and VIC; well capitalised and provisioned	Moving towards annuity-style earnings; leveraged to global growth through asset management and infrastructure
11 **Value proposition**								
	Maximising NIM and ROE through focus markets and cost management, and having the best capital management flexibility in its peer group	Wealth demerger, focus on higher ROE core retail and business banking	Bridge ROE gap with peers; focus on business, SME and retail banking	Significant improvements in core retail banking efficiency and productivity	Surplus capital and BIP cost savings, rate and volume increases	Value add is to buy SUN's Core Bank or regional QLD players such as ABA or MYS	Focused on higher margin leasing and specialty finance businesses; credit systems top notch	Best growth outlook based on infrastructure leverage; return of surplus capital

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

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TS Lim, authoring analyst, holds long positions in ABA, ANZ, BOQ, CBA, CBAPC, MQG, MQGPC, MQGPD and SUN.

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