



BANKING

Major Australian Banks: Half Year 2010

Financial Institutions
Performance Summary

FINANCIAL SERVICES



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At a glance

	ANZ		CBA ¹		NAB		WBC	
	H110	H209	H110	H209	H110	H209	H110	H209
Ranking								
By profit before tax	4	3	1	1	3	4	2	2
By total assets	4	4	2	2	1	1	3	3
By total equity	4	3	3	4	2	1	1	2
By market capitalisation	3	4	1	1	4	3	2	2
By Tier 1 capital ratio	1	1	2	4	3	2	4	3
Profit before tax (\$ million)	2,753	2,276	4,423	3,166	2,840	1,241	4,010	2,995
Profit after tax (\$ million)²	1,925	1,526	2,914	2,150	2,095	(75)	2,875	1,271
Cash profit after tax (\$ million)³	2,298	1,864	2,943	2,402	2,193	1,814	2,983	2,332
Net interest margin (basis points)	243	237	218	216	225	225	227	241
Cost to income ratio (percent)	46.8	44.5	44.7	46.5	45.5	44.5	43.0	42.5
Loan impairment charge (\$ million)⁴	1,062	1,632	1,383	1,443	1,218	1,952	879	1,681
Basic earnings per share – cash basis (cents)	91.3	79.2	191.7	158.5	103.0	90.6	100.8	79.7
Basic earnings per share – statutory basis (cents)	76.8	64.8	190.3	142.2	95.5	(9.9)	97.5	43.5
Return on equity (percent) – cash basis	14.7	12.5	18.5	16.3	12.9	10.9	16.6	13.4
Impaired loans to loans and advances to customers (percent)	1.56	1.30	0.98	0.89	1.44	1.35	0.99	0.90
Collective provision to credit RWA (percent)⁵	1.38	1.32	1.34	1.25	1.00	0.94	1.50	1.42
Total assets (\$ million)	506,708	476,987	625,476	620,372	650,360	654,120	600,775	589,587
Total equity (\$ million)	32,583	32,429	33,583	31,442	38,199	37,835	38,410	36,571
Capital Adequacy Ratios (percent)								
- Total	13.00	13.70	11.63	10.42	12.07	11.48	10.80	10.80
- Tier 1	10.70	10.60	9.10	8.07	9.09	8.96	8.60	8.10
Market capitalisation (\$ million)⁶	64,244	61,081	86,366	78,598	58,378	64,468	82,866	77,200

Summary

The opportunities and challenges ahead

“The mild impact of the global financial crisis in Australia has left Australian banks with strong balance sheets and a strong international reputation.”



Michelle Hinchliffe
Partner, Head of
Financial Services

On an optimistic note...

It would be brave, even foolish, to write a glowingly optimistic overview of the global banking landscape at the moment. The crisis has taught us once again to expect the unexpected. Even though most of the developed nations seem to have emerged from recession, the recovery is still fragile. Economies burdened with excessive debt may face further setbacks before returning to sustained growth. So, confidence has to be tempered with caution but there are grounds for optimism

The more disastrous possible outcomes have been avoided by concerted government action, and the financial sector has been stabilized. We are seeing a return to profitability by most global banks and consumer confidence is improving. Stock markets are recovering their buoyancy, and economic output is generally growing again. However, economic crises caused by failures in financial markets tend to be long-lasting, as do synchronised crises which affect all major economies at the same time. Fundamental imbalances, particularly those between the West and Asia, have not been addressed.

Some mighty challenges remain. Governments haven't even started to tackle the massive public sector debts incurred in fighting the crisis. Fiscal and monetary stimulus needs to be unwound. Unemployment in developed countries is still high compared to before the crisis, with the US jobless rate nearly 10 percent. The IMF estimates that US\$1.5 trillion of banks debts have still to be written off.

But there are some areas where optimism is distinctly justified: rising standards of living in Asia, increasing investment potential and scope for innovation to produce new strategies, products and approaches. This optimism is particularly justified in Australia.

The performance of the majors in 2010 reflects a prudent approach to risk management and a resilient Australian economy. The mild impact of the global financial crisis in Australia has left Australian banks with strong balance sheets and a strong international reputation. They are well capitalised and therefore well poised for organic growth or foreign acquisitions.

“Despite the challenges there are considerable bright spots. Global economic growth is returning, Asian economies are driving ahead and a new world order in financial services is being established”



Andrew Dickinson
Partner, Head of
Banking

Challenges

Credit risk and pricing - Retail and commercial banking faces particular challenges in returning to something like business as usual. Liquidity remains tight, companies and consumers are, correctly, de-leveraging and reducing debt, but savings remain in short supply.

Rebuilding banks' balance sheets and restoring profitability implies bidding up rates in an attempt to attract deposits. But the impact on borrowers is inevitable. Companies and individuals, already weakened by recession, face higher borrowing costs and the prospect of being starved of funding as banks impose tighter credit risk criteria.

Trust - The reputation of the banking industry has been severely damaged. Banks have lost the trust of customers, stakeholders, investors and regulators. Much of this damage has been self-inflicted, the result of greed, fraud, poor management and shortcomings in corporate governance.

A top priority for CEOs is to re-establish relationships of trust. This is not just a matter of good public relations. It's a question of managing the whole of the business to produce the right values, and communicating this to the workforce, clients, shareholders and society at large. In order for the system to work, each player has to trust the other, and trust the system to work.

Remuneration - Remuneration and compensation arrangements in financial services have come in for strong criticism. Some of this is rather unedifying: envy of what can be a high-pay, high-bonus industry. But much of it is justified. Compensation and bonus structures have encouraged excessive risk-taking and excessive short-termism. They have too often looked like one-way bets. Pushed for change by the Financial Stability Board (FSB), the G20 and national authorities, banks now face a delicate balancing act between retaining talent, placating regulators and quieting public outrage.

Enormous regulatory agenda - Defining a new, coherent and consistent global regulatory framework poses an enormous challenge. There is no doubt that the crisis has handed the moral, political and financial high ground to politicians. The G20 has charged the FSB with monitoring and reporting progress on regulatory reforms, and reporting threats to the stability of the global financial system. Tim Geithner, US Treasury Secretary, has described the FSB as a 'fourth pillar' of international cooperation in the new global financial architecture, along with the IMF, World Bank and World Trade Organisation. The list of issues regulators face is extensive: competition regulation; cost of state aid; the 'too big to fail' issue; capital requirements; liquidity; compensation; corporate and investor governance; product regulation.

On top of this, the structure of the global regulatory framework itself needs to change: it clearly proved to be inadequate to prevent the crisis. There is a danger that the scale of the task will prove to be unmanageable, and that

national interests will over-ride the need for a global framework. No-one should underestimate the challenges ahead.

Areas for optimism

Despite the challenges, there are considerable bright spots.

Financial and economic results - Some very favorable results are being published at the moment by banks in the UK, Europe and the US. Although we are a long way from recouping the GDP loss from the recession – and some argue that we will not resume previous levels of growth for many years – the return to economic growth seems to be a world-wide phenomenon.

In the eurozone, the economy is forecast to grow overall by about one percent in 2010, despite continuing weakness in Greece, Spain, Portugal and Ireland. In the US, retail sales are growing; consumer confidence remains fragile, but a robust recovery seems possible.

Growth markets - The major Asian economies are once again driving ahead. China has so far managed to sustain its remarkable rate of growth, but Japan, Singapore and Korea are all also looking more healthy. This will of course be particularly important in the Australian context, where the IMF is now forecasting economic growth of 3% in 2010 and 3.5% in 2011. Asia can not only power a global return to growth but also provide significant opportunities for growth for those companies with the strength and expertise to exploit them.

A new world order - The financial services industry has been through a massive crisis, which has had a major impact on many players and in many markets. The industry must expect higher levels of political and regulatory oversight for years to come, which is understandable given the scale of taxpayer support to the industry globally. But even this, perhaps the biggest cause of current uncertainty, has a very positive implication: it provides the chance to re-invent the regulatory framework to enhance the contribution which financial services can make to growth, wealth creation and prosperity.

Stronger capital and liquidity requirements will ultimately prove to be good for the industry. Competition, regulation and divestments will lead to the entry of new players into the market. Improvements in corporate and investor governance will strengthen the industry. Accounting changes will lead to more simplified, harmonised codes which increased transparency and responsiveness to market needs.

Above all, the world will find ways to reduce systemic risk, and correct the global economic imbalances between West and East. There is no doubt that we are witnessing an historic change here.

The sun may well be rising in the East as usual, and we are well placed in Australia to benefit from this.

Performance of the Australian majors has been underpinned by prudent risk management and strong balance sheets

Profit

The Major Australian banks have demonstrated their resilience and strength in the global market by reporting strong profits for the first half of 2010. While international competitors continue to deal with issues such as government ownership, sovereign debt levels and economic uncertainty, the majors have capitalised on a prudent approach to risk management and a buoyant domestic economy producing statutory profit before tax of \$14.0 billion in H1 2010 compared to \$9.7 billion in H2 2009.

Year	Profit before tax \$ billion	Year	Profit before tax \$ billion
H1 2010	14.0	H2 2007	12.7
H2 2009	9.7	H1 2007	12.7
H1 2009	12.5	H2 2006	11.5
H2 2008	10.2	H1 2006	11.4
H1 2008	12.4	H2 2005	9.8

Key contributors to this result are:

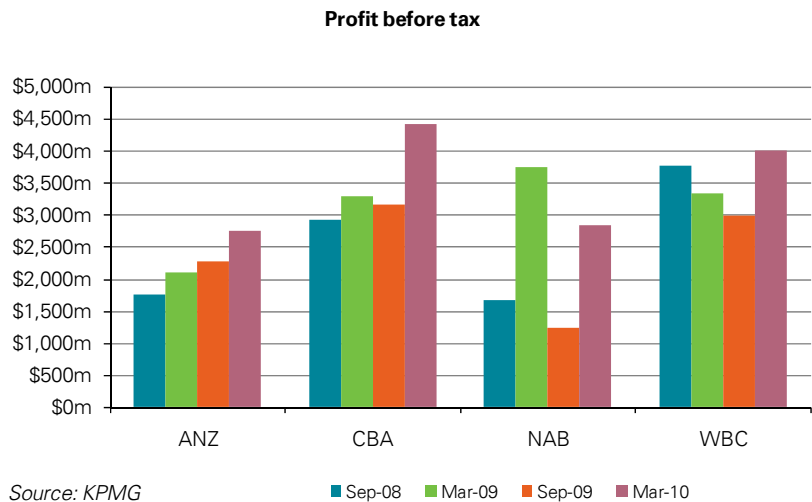
- A reduction in loan impairment charges of 33 percent to \$4.5 billion in H1 2010 compared to \$6.7 billion in H2 2009
- Positive margin impact from the repricing of risk in the commercial and institutional portfolios offset by increased costs of retail deposits and wholesale funding and lower returns on holding increased stocks of liquid assets
- Reduced trading income resulting from lower volatility in fx and interest rate markets
- Increased wealth management income following the improvement in global equity markets
- Reduced retail banking fees following action taken by the majors to reduce the nature and amount of fees charged to customers
- Cost synergies being realised from previous acquisitions and focused cost control

The majors have all signalled a cautious but optimistic outlook for the future. Significant headwinds remain in the form of regulatory change driving higher levels and better quality of capital and liquidity, increasing levels of impaired loans as the impact of the financial crisis works its way through the system; and global uncertainty driven by lower economic growth in the US and Europe as they continue to recover from the financial crisis.

Profit before tax has increased by 44 percent to \$14.0 billion compared to H2 2009

Profit before tax

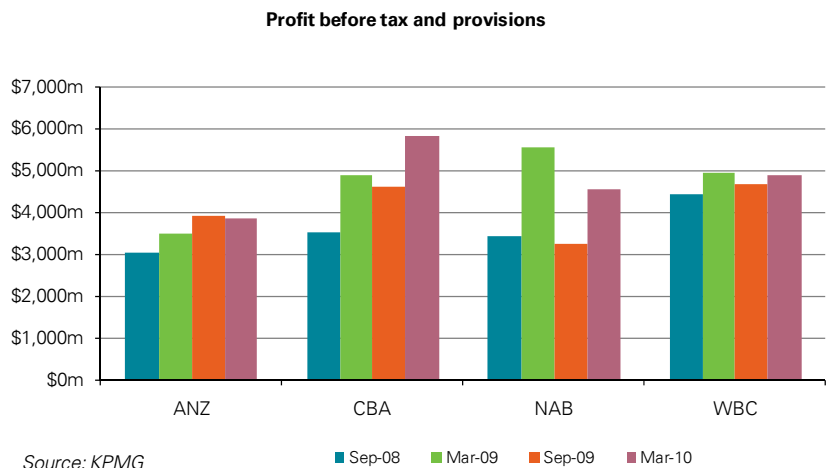
Strong growth in statutory profit before tax was achieved by each of the majors: ANZ – 21%, CBA – 42 %, NAB – 129 % and WBC - 34%. The significant growth in the NAB result is principally due to fair value losses on financial instruments recognised in H2 2009 of \$653 million compared to fair value gains of \$165 million recognised in the current half.



Source: KPMG

Profit before tax and provisions

Profit before tax and provisions increased by 16.1 percent to \$19.1 billion in H1 2010.

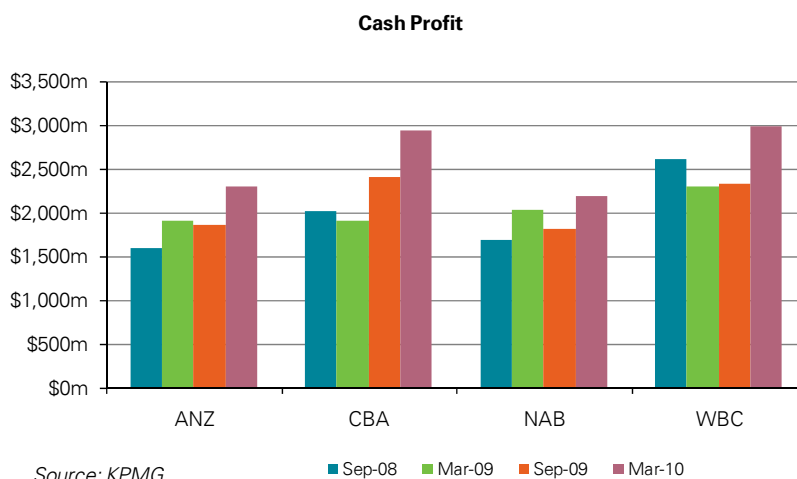


Source: KPMG

During 2009, WBC acquired St George Bank. Unless stated, proforma information provided within the WBC 2009 results has been used, presenting current period and comparative information for the combined entity. ANZ, CBA and NAB have all completed acquisitions in 2009 and 2010, however the impact of these are not as material in the initial period of acquisition and as a consequence, no proforma information is included within this survey.

Cash profit

Using the industry preferred cash profit (after tax) basis, which removes the impact of one off transactions, discontinued operations and accounting volatility, the performance of the majors for H1 2010 was \$10.4 billion compared to \$8.4 billion in H2 2009, representing a 24 percent increase.



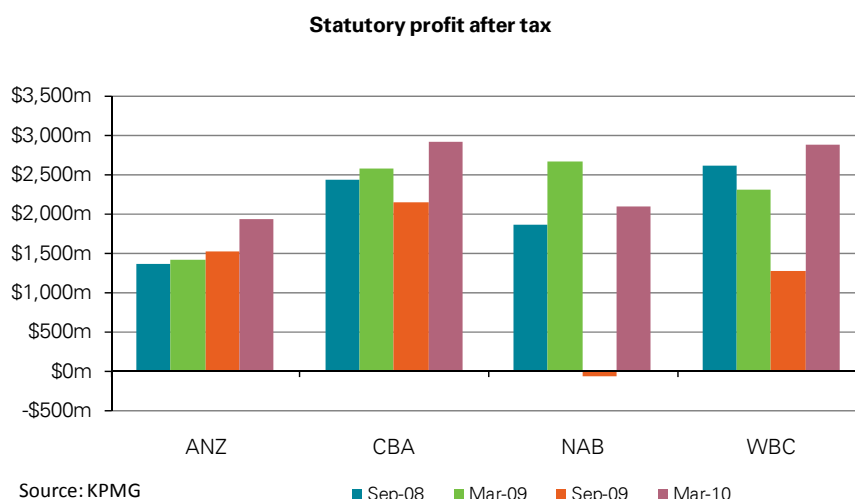
Cash profit growth for each of the majors suggests momentum exists in underlying operations. However, over 75% of the increase half on half relates to movement in loan impairment charges.

	ANZ \$ million	CBA \$ million	NAB \$ million	WBC \$ million
Statutory profit after tax	1,925	2,914	2,095	2,875
Adjustments to statutory profit:				
Tax on NZ conduit transactions	(38)	171	(128)	(106)
Restructuring costs	-	-	67	-
Fair value adjustments	115	(177)	221	26
Treasury shares	52	52	(67)	10
Impact of acquisitions/disposals	297	(17)	64	178
Distributions of other equity	-	-	(103)	-
Other	(53)	-	44	-
Cash profit¹	2,298	2,943	2,193	2,983

¹ ANZ have reported underlying profit in 2010

Statutory profit after tax has increased by 100 percent to \$9.8 billion compared to H2 2009.

Profit after tax



Statutory profit after tax increased from \$4.9 billion in H2 2009 to \$9.8 billion in H1 2010. In H2 2009, following New Zealand High Court rulings, the majors, with the exception of CBA, recorded significant income tax expense relating to certain structured financing transactions in New Zealand totalling \$1.4 billion (ANZ: \$196 million, NAB: \$542 million, WBC: \$703 million).

In addition, NAB recognised a further \$309 million income tax expense in relation to certain structured transactions in Australia.

During H1 2010 these New Zealand transaction disputes were settled resulting in a partial write back to tax expense of \$259 million (ANZ: \$38 million, NAB: \$128 million, WBC: \$95 million (including other adjustments not separately disclosed)).

Included in CBA's tax expense for H1 2010 is an amount of \$171 million related to the tax expense on similar structured finance transactions in New Zealand.

The movements in the effective tax rates shown below are principally due to the provisions and write backs taken against these structured finance transactions.

Effective tax rate	H1 2010	H2 2009	H1 2009
ANZ	30.0%	33.0%	32.5%
CBA	31.8%	31.0%	25.6%
NAB	26.2%	106.9%	28.5%
WBC	27.5%	56.6%	28.5%

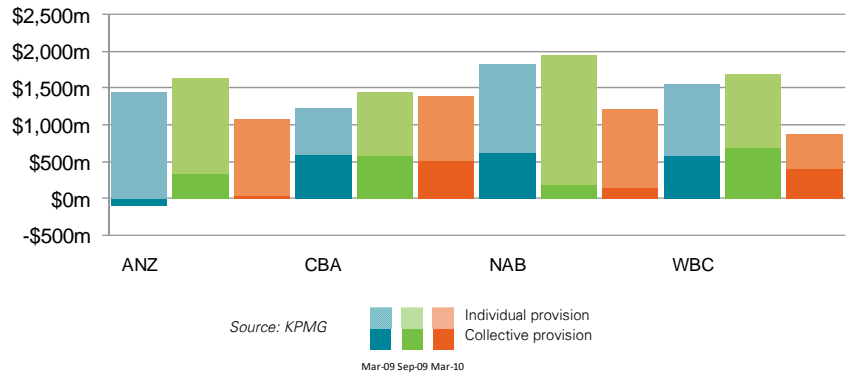
Asset quality

Loan impairment charges have reduced 33 percent following a peak in provisioning in H2 2009.

The loan impairment charge reduced by 33 percent to \$4.5 billion compared to \$6.7 billion in H2 2009. The composition of the impairment charge has migrated from the larger institutional exposures in H2 2009 to the comparatively smaller exposures in the business banking and commercial portfolios in H1 2010.

Year	Impairment charge \$ billion	Year	Impairment charge \$ billion
H1 2010	4.5	H2 2007	1.2
H2 2009	6.7	H1 2007	1.1
H1 2009	6.0	H2 2006	0.9
H2 2008	4.2	H1 2006	0.9
H1 2008	2.8	H2 2005	0.9

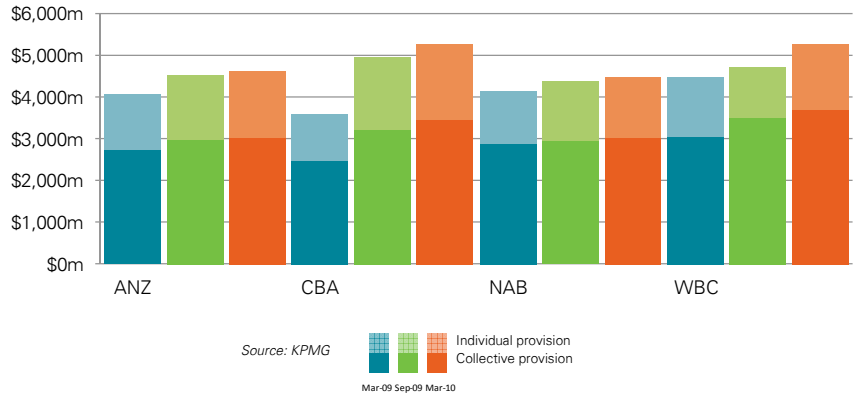
Loan impairment charge



The majors reported a fall in both the collective and individual provision components of the loan impairment charge compared to H2 2009.

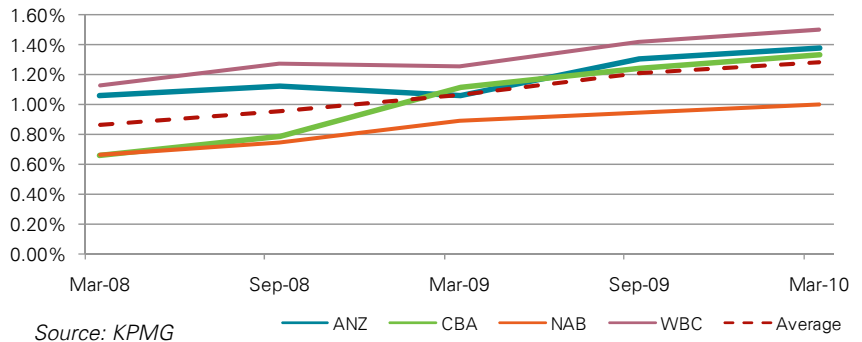
While the loan provisioning charge appears to have peaked in H2 2009, the impact of the financial crisis continues to work its way through the system with impaired loans increasing 14 percent to \$20.0 billion (ANZ – 21%, CBA – 15%, NAB - 7%, WBC – 14%). Each of the majors highlighted ‘troublesome’ sectors: ANZ – agriculture, forestry and fishing and manufacturing; CBA- property and agriculture; NAB – property; and WBC – commercial property.

Balance sheet credit provisions



Although loan impairment charges are declining, the majors continue to caution about future challenges in the quality of lending assets. This is a key factor in the majors holding collective provisions at cyclically high levels with no significant release to date in the overlay components for economic conditions and portfolio concentration. As a result, collective provisions as a percentage of credit risk weighted assets continues to increase with the average ratio for the majors in excess of 1.3 percent.

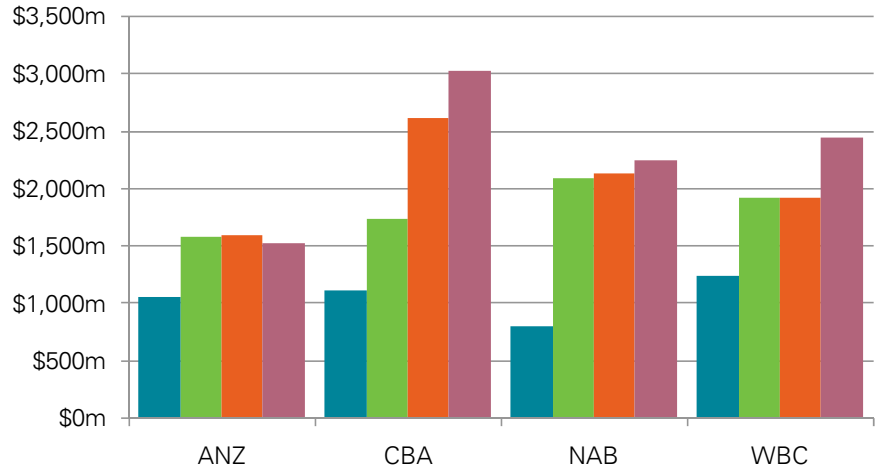
Collective provisions for impairment compared to credit risk weighted assets



Notes:

NAB's collective provision for impairment used in the graph above does not include collective provision allocated to loans and derivatives at fair value.

Accruing loans past due 90 days or more



Source: KPMG

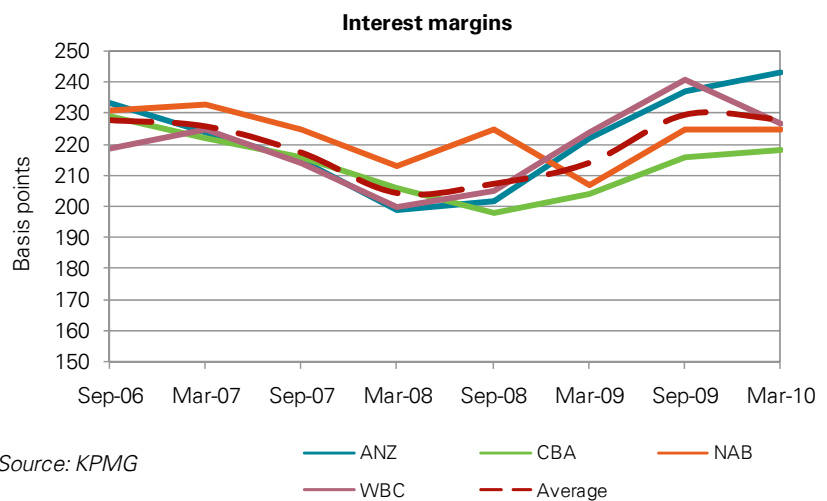
■ Sep-08 ■ Mar-09 ■ Sep-09 ■ Mar-10

Accruing loans past due 90 days continue to trend upwards, driven by delinquencies in mortgages, personal lending and credit cards as well as the middle market sector. Accruing loans past due 90 days at H1 2010 of \$9.2 billion is 11.8 percent higher than H2 2009. Of this increase, CBA's mortgage portfolio contributed \$574 million and WBC's other loan products over \$400 million.



Average net interest margin decreased 2 basis points to 228 basis points. The drivers of margin movement had varying impacts on each of the majors.

The average net interest margin of 228 basis points compares to 230 basis points in H2 2009 (based on statutory net interest income). For the first time in a number of years, the drivers of margin movement had varying impacts on each of the majors. ANZ and CBA reported margin growth of 6 basis points and 2 basis points respectively, while NAB reported a flat margin on a statutory basis. In contrast, WBC reported a fall in margin of 14 basis points.



The key contributor to margin growth for each of the majors was the repricing for risk which commenced in the second half of 2008 and continued through H1 2010, principally in the institutional and commercial portfolio.

A number of factors tempered this growth in margins:

- Intense competition in the retail deposit market continued through H1 2010 driving up the cost of retail deposits
- Wholesale funding costs have increased as term funding matures and is replaced at higher spreads over benchmark rates
- The increase in the level and quality of low yielding liquid assets held by the majors lead to a reduction in the return earned on these assets.

The current period margin was achieved off modest growth in the balance sheet. Loan balances over the last six months have remained relatively constant particularly in the corporate and institutional portfolios as customers have sought to deleverage. This has been offset to some extent by growth in the new homebuyers market which saw WBC and CBA grow their share of this market.

“In the current climate the RBA rate is not as relevant in understanding changes in mortgage rates. We need to understand movements in all interest rates to assess movements in mortgage rates, not just simplistically measure them against RBA rates.”



Andrew Dickinson
Partner, Head of
Banking

The RBA and mortgage interest rates

The current debate around bank interest rate rises ignores the fact that the issue is complex and multi-faceted. The discussion seems to centre on the assumption that any mortgage interest rate rises in excess of RBA's rate increases are unjustified and represent an abuse of the banks' market power. It may be useful to add some facts and context to the debate.

Firstly, we need to consider whether the RBA rate (and movements in it) is relevant when assessing mortgage rates. And why focus only on increased mortgage rates and ignore increased deposit rates?

Additionally, we need to consider whether the increased bank lending rates reflect only the increased cost of funding and if overall interest margins earned by the banks are increasing, is this increased margin appropriate?

It is indisputable that average mortgage interest rates have risen more than RBA rates over recent years. Two years ago average mortgage rates were about 1.9 percent above the RBA rate, a year ago 2.6 percent above, and now 2.9 percent above, a relative increase of 100 basis points.

Historically bank funding costs have largely mirrored movements in the RBA rate. But in the current environment where bank funding costs are more sensitive to credit and liquidity risks this historical relationship is not as relevant.

About 50 percent of banks' funding comes from domestic retail and business deposits, 25 percent from short-term wholesale funding and 25 percent from long-term wholesale funding. Of the 50 percent of banks' balance sheets funded in wholesale markets, about half is sourced domestically and the rest internationally.

Historically, all domestic sources of funding have moved closely in line with RBA rates while international rates may or may not. In recent times, even domestic funding has become more expensive relative to the RBA rate.

By way of example, average bank term deposit rates have historically been about 150 basis points below the RBA rate. However, over the last 18 months they have increased to be almost in line with, and frequently above, the RBA rates.

The wholesale funding rates have also moved relative to RBA rates. Most short-term wholesale funding is based on bank bill rates. These 90-day bank bill rates have historically been about 10 basis points above overnight rates. But over the last two years they have been very volatile, with bill rates reaching as much as 140 basis points over overnight rates in September 2008, and settling recently at about 30 basis points over. Long-term wholesale funding has been even more volatile, with the margin on 3 year AA rated bank bonds being historically around 15 basis points above treasury bonds and now being about 180 basis points above (after peaking at over 240 basis points above in early 2009).

We can see then that the cost of all sources of bank funding, retail and business deposits, short-term and long-term wholesale funding, have significantly increased compared to RBA rates.

Movements in margins will tell us whether increased bank lending rates are reflective only of the increased cost of bank funding.

Average bank interest margins for the current half year were 2.28 percent compared to 2.22 percent for the 2009 year and 2.06 percent last year. But when we take a

longer term view, it is clear that bank margins remain at historically low levels. Margins have decreased every year since bank deregulation in 1985, right up to 2008. In 2004 the margin was 2.41 percent, in 1999 it was 3.08 percent, and in 1994 – the “good old days”, when banks were “responsible” - it was a whopping 3.70 percent. We should also remember that bank margins are reported in total rather than by product such as mortgage loans.

Mortgage loans represent over half of the total bank lending but the margin on the balance, particularly corporate lending, has clearly increased by a lot more than the 16 basis point total increase. This means the margin on mortgages will have increased by a lot less than the average 16 basis points – it is probably flat, and may even be down.

So total interest margins (particularly corporate lending margins) are up on the historical lows of 2008, but in a longer-term context, when looking specifically at mortgage margins, they remain very low.

When assessing whether banks are charging a reasonable margin, we need to remember that one of the criticisms levelled at banks during the GFC was that they were lending too much money too cheaply; with risk not being properly priced. Why wouldn't we expect then, that with a repricing for risk, interest rates should increase?

It would seem hard, following on from the above analysis, to assert that current margins, at 40 percent below the levels of 15-20 years ago, reflect an abuse of market power.

We also need to remember that global economic growth is highly dependent on the availability of bank funding. And the more the banks need to borrow to be able to lend, the more their funding costs will increase as they need to borrow an increasing portion of their book at higher, current, interest rates.

When looking at the facts above, it is hard to be objectively critical of banks for increasing mortgage rates by more than the RBA rate – this is an inevitable outcome of the realities of the world we now live in.

Interest rate adjustments

Basis point movements in RBA and bank mortgage rates during the period since September 2008 were as follows:

Months	RBA	ANZ	CBA	NAB	WBC
October 2008	(100)	(105)	(101)	(100)	(100)
November 2008	(75)	(58)	(58)	(62)	(65)
December 2008	(100)	(83)	(100)	(100)	(80)
February 2009	(100)	(100)	(100)	(100)	(100)
April 2009	(25)	(10)	(10)	-	(10)
June 2009	-	-	10	-	-
October 2009	25	25	25	25	25
November 2009	25	25	25	25	25
December 2009	25	35	37	25	45
March 2010	25	25	25	25	25
April 2010	25	25	25	25	25
May 2010	25	25	25	25	25
Total	(250)	(196)	(197)	(212)	(185)

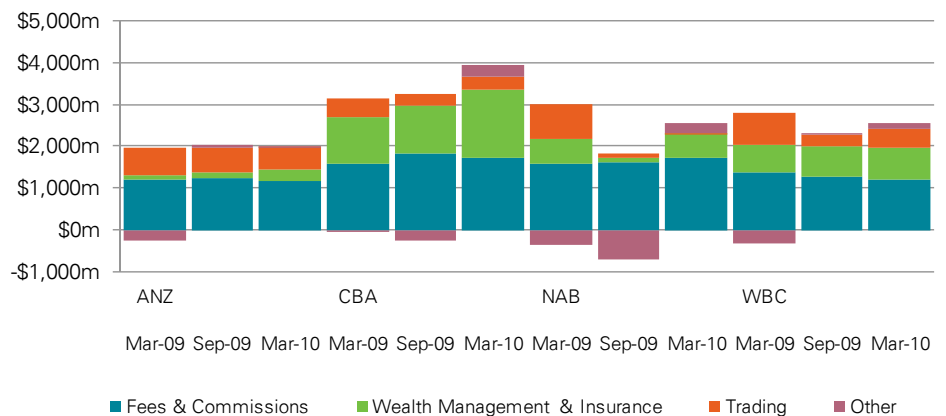
Global markets income fell following reduced volatility in foreign exchange and interest rate markets

Non-interest income

Non-interest income increased modestly over the prior period driven by:

- An increase in wealth management profits (see analysis on page 19)
- Lower global markets income due to reduced market volatility
- A downward trend in fee and commission income
- An increase in fair value movements on financial instruments.

Breakdown of non-interest income



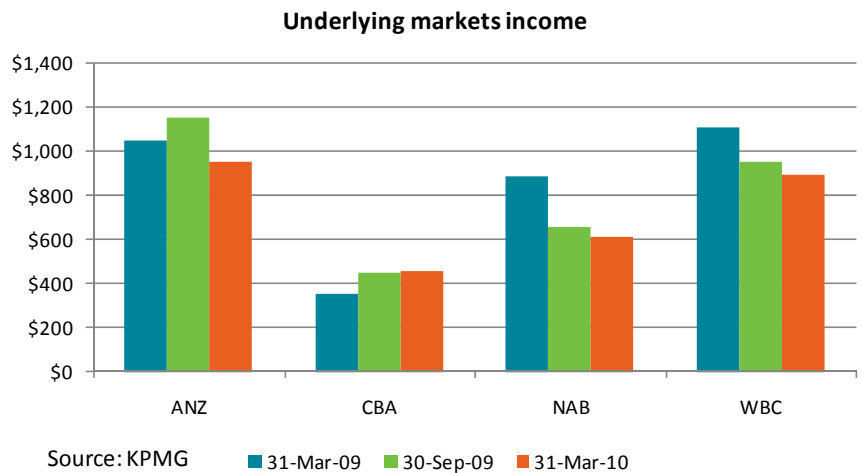
Source: KPMG

Fees & Commissions

The reduction in fees and commission income by each of the majors is the result of removing overdrawn account and exception fees announced during H2 2009. The annualised impact of this is estimated to be in excess of \$150 million for each of the majors.

Global Markets

Global markets results (on an underlying basis) includes both interest income and non interest income components (as reported below by the majors).



The decline in global markets income in H1 2010 is due to:

- Reduced market volatility leading to lower levels of customer hedging activity and reduced trading opportunities
- Tightening of margins across most markets as greater stability returned, reducing the opportunity for earning trading income
- Partially offsetting the above were positive fair value adjustments arising from improved credit spreads in debt markets.



Strong growth was reported across wealth businesses reflecting improved investment markets and increased funds under management

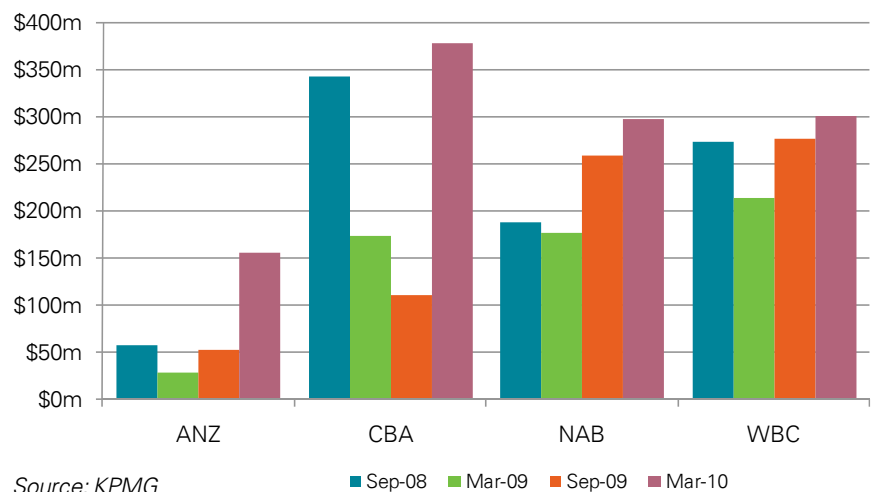
Wealth Management

Wealth management includes income arising from the insurance, investment management and private clients operations of the majors. Wealth management profits for H1 2010 totalled \$1.1 billion compared to \$702 million in H2 2009 representing an increase of 62 percent.

The strong income growth was reported across the majors investment management business reflecting improved investment markets and increased funds under management. Premium growth in insurance operations also contributed to this increase although general insurance results were negatively impacted by increased claims, predominantly from the Melbourne and Perth storms.

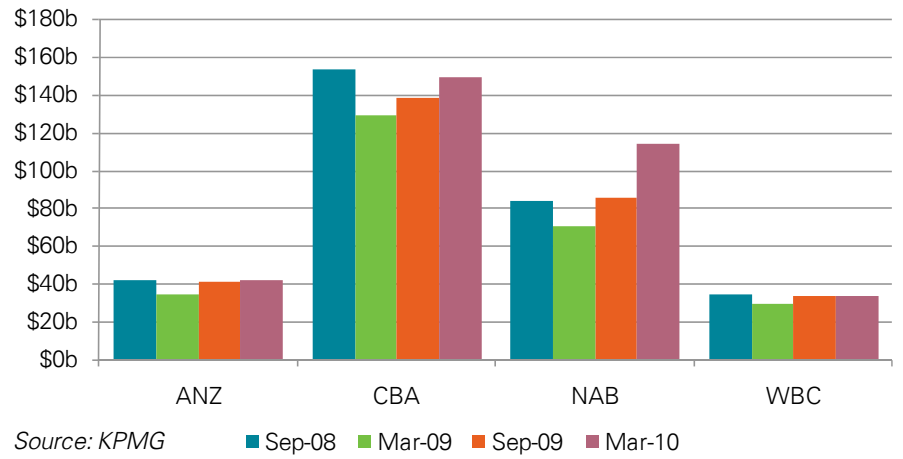
Current period acquisitions also boosted the profits of ANZ following the acquisition of the remaining 51% of the ING joint ventures and NAB with the acquisitions of Aviva and JB Were operations. These acquisitions contributed to an increase in profit of \$61 million and \$67 million respectively.

Wealth management - profit



Index	Performance for 6 months to 31 Mar 2010	Performance for 6 months to 30 Sept 2009	Performance for 12 months to 30 Sept 2009
S&P 500	11%	23%	-9%
Japan TOPIX	8%	13%	-16%
FTSE 100	11%	25%	5%
Hang Seng	1%	41%	16%
S&P/ASX 200	3%	31%	3%

Wealth management - FUM



Note: ANZ Sep 08, Mar 09 and Sep 09 represents INGA FUM at those dates



“The heart of brand value lies in the consumer experience. A successful brand communicates a message of a particular and distinctive value proposition. The consumer engaging with a successful brand understands the promise that it makes, and once committed to a brand, will typically remain loyal to it as long as the promise is satisfied.”



Martin Blake
Partner, Business
Performance Services

Multi-branding in the banking sector: Untapped potential

The normal processes of mergers and acquisitions have been given greater impetus in the banking sector as a result of the financial crisis. Banking assets are changing hands as failing institutions are rescued or wound down; divestments and reconfiguration of the banking industry are being imposed by regulatory authorities. As a result, many banking groups are finding themselves, perhaps without a clearly thought-out prior strategy, owning multiple brands. How to manage these brands, and how to extract greatest shareholder value from them, is a key issue.

Historically, the banking sector has not been especially effective at managing multiple brands within a single group. Other consumer goods and services industries typically have much more sophisticated brand strategies – in many cases identifying their portfolio of brands as their single most valuable strategic asset. By contrast, banks seem to struggle with multiple brands. They tend to succeed only in certain particular circumstances, and otherwise succumb to the temptation to collapse multiple brands under a single umbrella. There are some specific characteristics of banking which mean that sustaining a multi-brand portfolio faces certain challenges. Nevertheless, there is great potential for banks to generate significant value from a multi-brand strategy, which is currently largely untapped.

Our research shows that the evolution of a multi-brand configuration in a banking group is heavily dependent on the company's position in the business growth cycle. Many banks acquiring multiple brands may set out with the intention of maintaining them – and in some cases make promises to regulators, staff and local customers to do so. But integration and cost-reduction programs lead progressively to consolidation of systems, processes and support operations, and from there to 'hollowing out' the distinctive value propositions of different brands. It then becomes increasingly difficult to sustain the case for retaining multiple brands, which are then collapsed. A recent example is the rebranding in the UK of Abbey National, Alliance & Leicester and Bradford & Bingley under the Santander umbrella.

Examples where a multi-brand strategy has been sustained over a significant period of time tend to be found only where specific geographical or consumer segment niches are explicitly targeted: in the UK, again, the Royal Bank of Scotland Group maintains among others the RBS brand (for Scotland and SME customers), NatWest (English consumer operations), Coutts (high net worth individuals and wealth management) and DirectLine (online insurance services). Whether this portfolio can survive the current 84 percent state ownership and eventual attempts to transfer it back to private ownership remains to be seen.

While multi-brand strategies have been proven to generate shareholder value in

other consumer sectors, the general failure of banking to do the same represents a significant loss of potential. The root of the difficulty lies in a failure to sustain brand distinctiveness. Part of this can be traced to a tendency to see the provision of banking as a commodity service. Reinforced by the banks' behavior towards them, consumers respond in a predictable manner: absence of brand loyalty, low perceptions of customer service, frequent brand switching (for example, credit cards and deposits) in search of the lowest commodity price or highest rate.

A significant value opportunity therefore awaits a bank which can successfully offer multi-brand propositions addressing the same customer needs through a single set of channels. Achieving this requires a change in mindset in banks' senior management on how to run the business with distinctive brands, and a focus on brand as the centre of why customers choose to engage, purchase, advocate and support their chosen bank. A clear brand management strategy is essential. Clear profit pool maps and 5-10 year aspirations should be developed for each distinct brand.

Responsibilities for brand development and oversight need to be carefully defined and allocated. Engagement of stakeholders from each business is key to managing multi-brands, maintaining consistency with the brand pyramid and retaining the distinctive personality of each brand. Understanding and aligning staff beliefs and values with the strategy is extremely effective in winning their hearts and minds, and empowering front line staff with insights and information builds their confidence and trust.

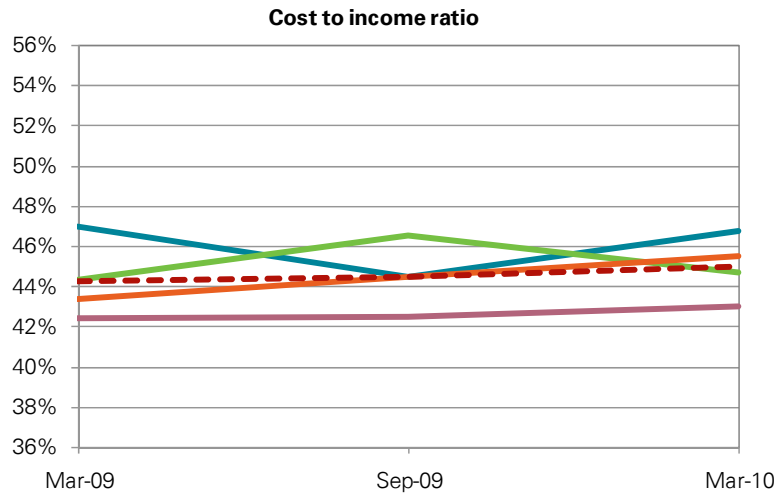
Maintaining a clear view of brand architecture and distinctiveness can help prevent unintentional hollowing out of brands. This also enables a clear view about what to integrate to achieve scale advantage and what is unique and needs to be kept separate. The overall objective is to provide consumers with products and services that are consistent with a distinctive brand promise.

Many other consumer industry sectors have demonstrated the value of successful multi-brand strategies. The opportunity is open for an enterprising banking group to exploit the same potential.

Costs

Average cost to income ratio of 45.0 percent continues to compare favourably with the UK experience where the average ratio for 2009 was 53.8 percent

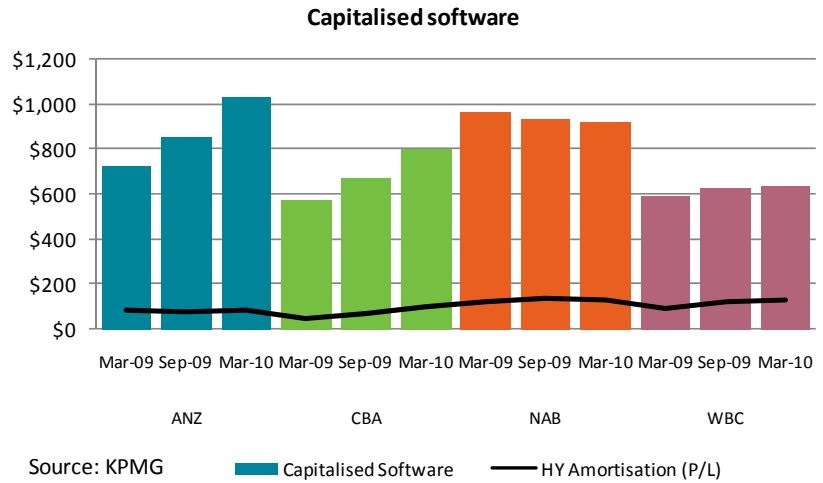
Average cost to income has increased slightly to 45.0 percent from 44.5 percent in H2 2009. Key drivers of this ratio in H1 2010 are lower markets and trading income, increased costs associated with integrating acquired businesses and increased expenditure on IT including amortisation of



Source: KPMG

capitalised software.

The majors have all announced programs of IT investment to support strategic initiatives and improve operating efficiency of existing systems. Net capitalised software has increased by \$300 million or 9.9 percent to \$3.3 billion compared to H2 2009. Amortisation of capitalised software over the same period has increased by 12.0 percent to \$457 million. As the majors continue to invest in IT infrastructure and software and the amortisation charge increases, operational efficiencies from the implementation of enhanced systems will be essential.



Expansion of operations (both organic and via acquisition) contributed to the increased cost base:

- ANZ expanded its distribution network across Asia including increased resources to support the growth agenda. This was in addition to costs incurred in integrating the ING joint ventures
- NAB's Efficiency, Quality and Service agenda resulted in increased costs directed towards improved efficiency and reduced duplication. In addition integration costs were incurred in respect of the Aviva and JB Were acquisitions
- Westpac continued to incur additional costs associated with business restructures and integration of St George.



“There are no single super-systems that can replace all of the key business requirements across a tier 1 bank”



Michael Axarlis
Partner, IT
Advisory

Australian core systems replacement a message from the past

It hasn't been since the late 80's that there has been so much attention on bank's IT systems. Three of the four major Australian trading banks are embarking on a "core systems replacement" (CSR) and over \$2 billion is expected to be spent over the next two years.

Unlike in manufacturing, where the big power-house Enterprise Resource Planning systems (ERP) benefit most if not all of a company's operational, finance and risk system requirements, the definition of what constitutes a CSR for a full service bank varies greatly.

There are no single "super-systems" that can replace all of the key business requirements across a tier 1 bank's retail, wealth management, corporate and business lending, as well as wholesale and investment businesses. This is further complicated by the myriad of channels ranging from teller terminal, web/internet, ATM, POS, call centre operations and the like. For these reasons, comparing the big banks' CSR strategies is subject to a lot of interpretation.

In the late 80's when the major Australian banks' last seriously ventured into this space, comparisons were relatively more straight-forward. Indeed, three of the major Australian Banks compared their CSR projects in the financial press where their CEOs highlighted their respective 'superior' implementation strategies. Tellingly, four years later only one bank had achieved anything near its aims, so it is perhaps not surprising that it has taken 20 years to return to this point.

Today's CSR strategies are much more complicated and banks' CEOs much more sensitised to the enormous difficulties in such major ventures and are indeed alert to the fact that there are no silver bullets. There is considerable analysis espousing the benefits of replacing the base infrastructure with a more modern, service oriented friendly solution which: exploits the benefits of the web; facilitates better straight through processing; affords real-time information and provides a more holistic understanding of the customer.

The finest designs in all fields of endeavour are pointless if they are too complex to assemble, deliver and manage by the resources available. This was a key learning from the late 80's, which should help drive some of the current project decisions. The question remains whether we have learnt from this history.

Capital adequacy

The average Tier 1 ratio of 9.4 percent compares to 8.9 percent at H2 2009

The focus on improving the quantity and quality of capital has continued throughout H1 2010. While the final changes to the Basel 3 requirements are not expected until H2 2010, the majors continue to improve their capital position in order to minimise the impact of transition to the new regulatory requirements.

The average Tier 1 ratio of 9.4 percent at H1 2010 compares to 8.9 percent at H2 2009 and 7.8 percent at H2 2008. Total Tier 1 capital increased from \$104.0 billion in H2 2009 to \$109.0 billion in H1 2010.

	ANZ		CBA		NAB		WBC	
	Mar10	Sep09	Mar10	Sep09	Mar10	Sep09	Mar10	Sep09
Capital Adequacy Ratios (%)								
- Total	13.00	13.70	11.63	10.42	12.07	11.48	10.80	10.80
- Tier 1	10.70	10.60	9.10	8.07	9.09	8.96	8.60	8.10
Tier 1 Capital (\$ million)	26,628	26,619	27,065	23,311	30,252	30,674	25,063	23,416
Total Capital (\$ million)	32,260	34,430	34,594	30,095	40,186	39,317	31,401	31,127
Risk weighted assets (\$ million)	248,961	252,069	297,449	288,836	332,833	342,522	290,097	288,739

The Basel Committee for Banking Supervision (BCBS) announced shortly before Christmas 2009 its proposals for reforming bank regulation in the wake of the global financial crisis. The BCBS aims to raise the quality, consistency and transparency of banks' capital resources. Given APRA's already conservative interpretation of the Basel requirements relative to other jurisdictions, the impact of these proposals is expected to be less in respect of the majors.

The proposal also introduces a leverage ratio to supplement the existing Basel II risk-based framework. This ratio is aimed to help contain the build-up of excessive leverage in the banking system and add additional safeguards against model risk and measurement error.

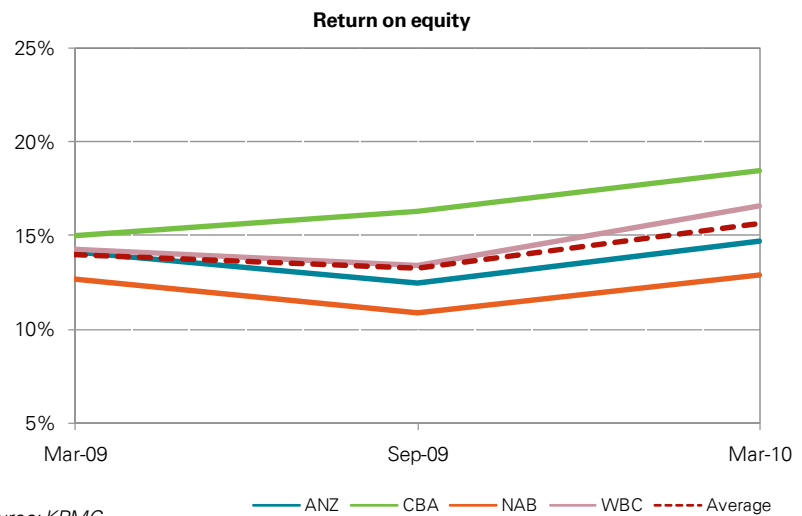
The BCBS is also seeking a global minimum liquidity standard for internationally active banks. It would include a 30-day liquidity coverage ratio underpinned by a longer term structural liquidity ratio.

The BCBS is yet to reveal what the new capital levels should be, however no one doubts the new minimum ratios will be higher than today's levels. Innovative capital instruments such as hybrids will be out and equity will be king.

Return on equity of 15.7 percent is a strong result but well below the levels of over 20 percent achieved in the mid 2000s

Return on equity

The average return on equity increased to 15.7 percent in the first half of 2010 compared to 13.3 percent in H2 2009 and 12.2 percent in H1 2009, reversing the downward trend started in 2007. Reduced impairment charges and increased investment returns have contributed to this result.



Dividends

Each of the majors increased their 2010 interim dividend compared to 2009 interim dividend. ANZ – 13 percent, CBA – 6 percent, NAB – 1.4 percent, WBC – 16 percent. This follows reductions in total dividends by each of the majors in 2009 and reflects increasing confidence in the outlook for 2010.

Market capitalisation

	6 May 10 (\$ million)	31 Mar 10 (\$ million)	30 Sept 09 (\$ million)	31 Mar 09 (\$ million)
ANZ	56,877	64,244	61,081	33,990
CBA	85,443	86,266	78,598	52,252
NAB	54,857	58,378	64,468	38,562
WBC	74,722	82,866	77,200	55,562

Source: Bloomberg

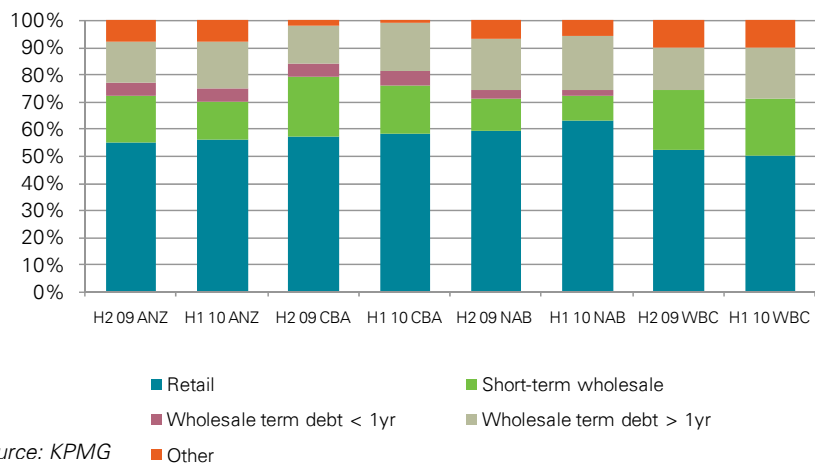
Funding

The funding profile of the majors continued to strengthen during H1 2010

The majors have continued to adopt a disciplined approach to their group funding requirements with the aim of achieving higher quality funding and more liquidity. Key features include:

- Increasing the average tenure of new term issuances which was in excess of five years for H1 2010 compared with approximately four years for 2009 issuances
- Increasing the reliance on customer deposits which are now in excess of 50 percent for each of the majors – ANZ: 56 percent, CBA: 58 percent, NAB: 63 percent and WBC: 50 percent
- Reducing reliance on government guaranteed wholesale debt issuances. The majority of wholesale funding sourced during 2009 was with the government guarantee. As expected, during 2010 this reliance decreased. The Australian government announced the withdrawal of the guarantee scheme for wholesale funding effective 31 March 2010.

Funding profile



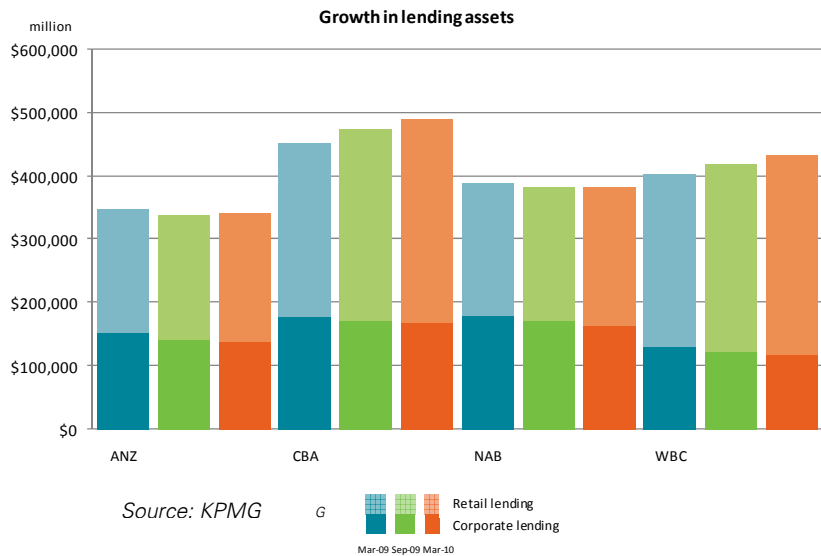
WBC do not disclose a breakdown of their wholesale funding maturity profile. For the purposes of the graph above, all short-term wholesale funding has been allocated to wholesale maturity periods less than 1 year.

Corporate lending assets declined 3 percent while retail lending assets increased 5 percent across the majors

Assets

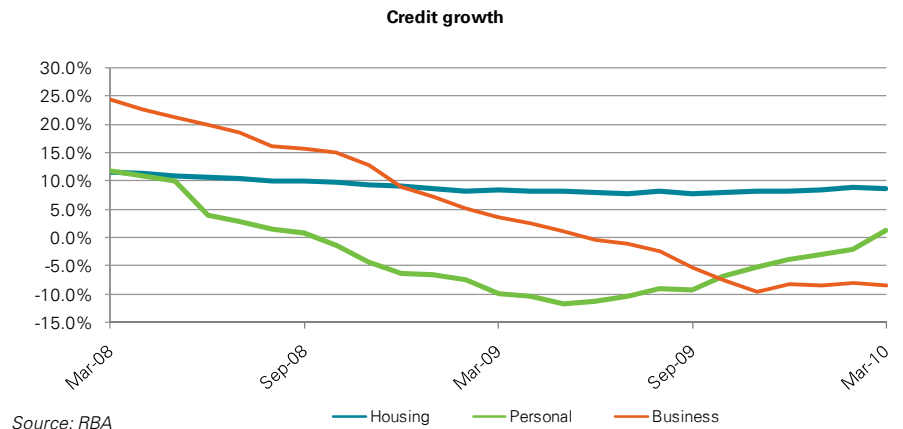
Balance sheet growth has been subdued across each of the majors, driven largely by deleveraging in the corporate sector.

Corporate lending assets have reduced by 3 percent from \$608 billion at H2 2009 to \$589 billion at H1 2010.

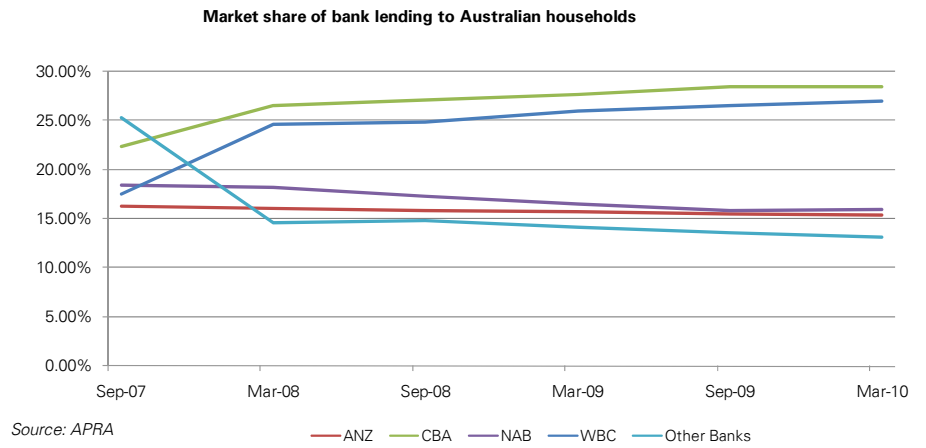


- 1 Lending assets comprises gross loans and advances at each balance sheet date excluding acceptances
- 2 Retail lending assets comprises credit card outstandings and housing loans at each balance sheet date

Retail lending saw improved growth across H1 2010, driven in part by the Governments' incentive to new home buyers during the period. Retail lending assets increased from \$1,005 billion at H2 2009 to \$1,057 billion at H1 2010, representing an increase of 5 percent.



Australian Household Lending



In prior periods, CBA and WBC increased their share of lending to Australian households following acquisitions of Bankwest and St George respectively. Growth in this segment continued for both CBA and WBC in H1 2010 as they took a dominant share of the growth in the first homebuyer’s market.



“While global economic growth remains fragile, the outlook for the second half remains positive for the major Australian banks.”



Ian Pollari Director,
Financial Services

Global outlook

While conditions in the global economy and financial services industry have improved considerably over the past 12 months, significant challenges remain. Despite the continued efforts of governments and central banks, sustained growth remains fragile:

Slow and challenging recovery – While global banks seem to be more confident about the future, and most predict a return to growth, all recognise that recovery will be a slow and challenging process. Considerable uncertainties remain regarding the future of regulation and, in particular, the potential impact of more onerous capital requirements on the range of activities delivered by a full service bank. This will likely mean a re-focus on core banking activities. The intention is that the government stakes in financial institutions, such as Citigroup, RBS and Lloyds will be reduced over time with the aim of delivering profit as value is rebuilt within these organisations. Across Europe, banks which received state aid are beginning, in line with EU requirements, to plan for the carve out of elements of their business to create new competitors. These sales will be paced to reflect the complexities of separation. Almost all banks are divesting non-core businesses to restore their balance sheets.

Economic outlook uncertain - Signs of recovery are now coming through in many parts of the world. Most economies bottomed out around the middle of last year, while the UK finally emerged from recession in the fourth quarter, posting 0.1 per cent growth. Others, such as China and India, saw some dent in their rate of positive growth, but have sailed through the crisis with the help of government assistance. The question is what will happen to economic growth from here? While signs of recovery are coming through, growth is still fragile.

Sovereign debt concerns - National fiscal deficits are a real concern for global markets, which have been heightened by the recent debt problems in Greece, and possibly Spain and Portugal. As a result, interest rates may potentially be forced to rise. While rising interest rates could ease funding problems by giving greater incentives to save, a fall in consumption and rising unemployment, however, would reduce demand for credit and increase impairments. This would, in turn, result in falling asset prices and an adverse wealth effect upon consumers, accentuated if house prices fall. As a result, a double dip recession would become probable. Conversely, if the deficits are reduced too quickly, the reduction in overall demand could potentially also create a double dip recession.

Higher capital levels - Before 2008, bank shares were regarded as a secure source of dividends, but many analysts now assume that some global banks, e.g. Lloyds and RBS will not pay dividends for the immediate years

ahead and that other banks will also need to retain earnings to bring capital up to a much higher level. The recapitalisation of banks started in 2009, but it will take some years to complete. This is important because banks provide the lending required to drive an economic recovery through investment and consumer spending. A tougher capital regime for banks will, therefore, be a drag on economic growth. With additional regulation on the horizon and the inevitability of higher capital requirements under Basel III, banks are still in the process of adjusting to what is now regarded as 'appropriate' capital. It is clear that they will need to hold higher capital against proprietary trading books, but what that level actually is has not yet been defined. A double dip recession would again bring capital ratios under pressure. It would be very bold to assume that there will be no further cash calls in the next three years. Many banks have built their capital base well in 2009, but they will have more to do in 2010. They have also begun the process of funding coming more from retail deposits and being less reliant upon wholesale funds. Banks will continue to need more capital and greater liquidity for the foreseeable future.

Profitability - If the economic recovery continues, then retail and commercial banking profits should slowly climb from the very low profit levels seen in 2009. That said, it seems unlikely that 2007 levels will be seen again for many years. If the economy turns down and unemployment rises then impairments will outweigh widening lending margins and these businesses will, at best, make a negligible return for a number of years. Before the "Credit Crunch", banks were able to obtain wholesale funding at much more attractive rates. Today, they have to tap into the retail savings market, one that has recently become extremely competitive, particularly because when base rates are low, the volume of savings is reduced. The impact on the cost of deposits has been significant with deposit margins much reduced. Asset re-pricing, with credit and liquidity risk more properly priced into products, has, in part, offset these costs. We expect the positive effect of asset re-pricing to continue. The re-pricing of new lending is gradually raising margins impacted by the higher costs of funding in the post credit crunch world. If the global economy recovers gradually, as predicted by most economists, retail banking profits will be expected to grow more rapidly than the economy.

Markets businesses - The outlook for markets businesses is uncertain and with a set of challenges to overcome. Firstly, less volatile market conditions over a prolonged period will dampen levels of business during 2010. Secondly, the withdrawal/suspension of government support schemes around the world, together with rising interest rates, could bring an end to the current period of cheap liquidity. The overall impact of this is hard to predict due to multiple variables that influence the market. Thirdly, regulatory change is occurring on multiple fronts, and presents a significant challenge to the industry. This may lead to changes in business models and the entrance into/exit out of certain businesses, products and markets.

Impairments - Most banks are suggesting that the peak of impairments passed in 2009 and that charges will fall gradually over the next few years. This is dependent upon the prediction that the economy is now climbing slowly back to growth. The scenario of a double dip recession would produce a much less attractive outlook for impairments. Real estate provisions were substantial in 2009 and reflect the underlying weakness of commercial property values. Commercial property underpins much lending to businesses and the weakness in this asset class limits borrowing capacity for the sector. Unsecured impairments rose in many countries in 2009 fuelled by increasing unemployment and substantial falls in house prices were avoided in many instances because of the injection of significant monetary stimuli.

The housing market - House prices will remain a key determinant of mortgage provisions. In previous downturns, continuing employment enabled homeowners to work through the negative equity of their property, in this downturn, house prices have been maintained, and indeed lifted, by monetary stimulus. Although the sharp reduction in interest rates has helped many borrowers cope, unemployment remains the single most important factor in determining provisions. In the scenario of a double dip recession, mortgage provisions would increase sharply which, in turn, could generate significant price falls at a time of rising unemployment. Even in the best scenario of a return to growth, many mortgage payers will be hit hard by increases in base rates as they rise from exceptionally low levels.

Regulatory and political reform - The divestments imposed upon RBS and Lloyds by the European Commission, together with the sale of the good bank within Northern Rock, are designed to create significant new competition in UK. These assets cannot be acquired by the major UK banks and there is some question as to the price that can be achieved from a restricted pool of potential bidders, particularly if the economic outlook deteriorates. Under debate by the US Senate, Citigroup, Bank of America and other financial institutions may also be forced to shrink or divest their businesses in order not to repeat the failings of the financial crisis.

A key driver for regulators and governments is the desire to remove the implied systemic subsidy to the banking sector. The end solution will take many years to build. One key element, however, will be the development of recovery plans which would mean that other stakeholders, such as bondholders, in addition to shareholders, will take some losses in the event of bank failures. The consequences of these changes will be that banks have even higher levels of capital and liquidity buffers. Returns on capital will therefore be below the levels seen pre-2007 for the foreseeable future. One area of uncertainty at the heart of rebuilding strong banks is the valuation of deferred tax assets within Tier 1 capital ratios. If the rules on using deferred tax assets were changed this would have a major impact upon the capitalisation of banks.

Australian outlook

The Australian financial services industry continues to shine on the international stage – with strong profit results, experienced senior management at the helm, bad debts having reached their peak and the availability of funding improving. The following factors are likely to shape their future performance:

Economic recovery – While many countries have had one of their most, if not their most, serious recessions in the post-War period, Australia had arguably one of its mildest economic downturns. Recent measures of consumer and business confidence suggest that Australians are generally quite optimistic about the future and notwithstanding more stringent lending standards; housing lending has remained reasonably strong (mainly driven by first-home buyers). The biggest threats to sustaining our economic recovery lie offshore, with mounting concerns over the sovereign risk of nations in the euro zone, the potential exposure of European banks to this risk and in the event of a default, the negative impact that may have on credit markets globally. Against this setting, the major Australian banks will continue to exercise a degree of caution, however, on balance are well positioned to further consolidate their strong market positions.

Funding – As conditions in global financial markets became less stressed, funding for the major Australian banks improved in the first half of 2009, with access to the market opening and wholesale funding costs falling. In light of these positive developments, the majors significantly reduced their use of the Government guarantee arrangements for wholesale debt and in turn, commenced issuing unguaranteed debt (with the Treasurer announcing that local wholesale guarantee arrangements would close at the end of March 2010). Improved economic conditions could add to funding pressures with a re-emerging supply of global bank debt and global government bond issuance for Australian banks to compete with. In response to this threat, and given their efforts to lengthen the maturity profile of their liabilities, the majors have been proactive in undertaking their future financing requirements earlier than anticipated. Competition in the deposit space, driven by heightened regulatory requirements for sustainable funding sources is likely to continue in 2010 and add to banks' average funding costs relative to the cash rate.

Capital management – The major Australian banks remain well capitalised, with Tier 1 capital ratios rising in the first half of 2010, and according to the RBA, are at their highest levels since the 1980s. The major banks have issued a combined \$37 billion of ordinary equity since the end of 2007, predominantly through new share issuances and dividend reinvestment plans. They have also grown their capital base through organic means, including cuts to dividend payments to shareholders and continued efforts to reduce their risk-

weighted assets, which we expect to continue. The major banks' funding tasks could be made difficult by continued uncertainty surrounding bank liquidity requirements. Recognising the risks from further international volatility and the uncertainty surrounding the outcome of initiatives by global regulators around banking sector capital and liquidity, we expect the major banks to retain their current conservative capital and liquidity settings for the foreseeable future. With new global regulations set to be announced in 2010, higher minimum levels of equity capital are inevitable for the major banks.

Bad debts – As expected, with historically low interest rates, substantial government stimulus support and a stable employment market, growth in bad debt charges moderated for all the major banks. Although the indications are that the level of bad debt charges have peaked, exposures to commercial property continued to deteriorate, with the major banks implementing stricter screening of property borrowers and passing on the higher costs of funds. Over the period, we have also seen the incidence of non-performing business loans become more broadly based. With the RBA's tighter monetary policy forecast to continue in 2010, higher debt-servicing costs will increase pressure on some borrowers, particularly mortgagees and credit card holders. In response, the banks will continue to tighten their loan criteria and invest in evolving their credit risk management policies, practices and processes.

Competition – The Australian Competition and Consumer Commission has expressed concerns over what they see as diminished levels of competition in the industry, hence any future banking acquisitions will likely face significant opposition (as we have recently witnessed with NAB's proposed acquisition of AXA Asia Pacific Holdings). We expect that there might be further consolidation and acquisition activity with the regional banks, building societies and credit unions, as well as in Asia. During the "Credit Crunch", there were fears that many foreign lenders would repatriate capital to their home markets, further diminishing the levels of competition in the market. There has been little evidence of a withdrawal of foreign banks, who on balance have continued to participate in recent syndicated loan deals, and in recent months, increased their overall lending. The majors have continued to drive strong growth in the mortgage market, accounting for around 80 per cent of new owner-occupier loans approvals at the end of 2009.

Regulation – International agencies, led by the G-20, the Financial Stability Board and the Bank for International Settlements, and national governments and prudential regulators are continuing their efforts to improve the regulatory framework in response to the financial crisis. While the major banks and regulatory regime in Australian has been highly resilient compared to our international peers, increased costs of compliance are inevitable. Major global banks, including banks with international operations (such as the Australian major banks) will be impacted by enhancements to capital regulations and strengthening liquidity requirements in particular. To this end, it will be

important that international standard-setters provide scope for some tailoring to national circumstances and that a balance between more regulation and more effective enforcement of existing regulations and standards are achieved. For local banks, the challenge will be how to most efficiently comply with new regulations, whilst simultaneously seeking to capture any performance related benefits through data management efforts, improvements in processes and creating a more robust control environment.

Execution risk – All four of the major banks made substantial acquisitions in 2008/09 and continue to focus on the successful execution of their respective post-merger integration efforts. This activity will need to be maintained for the foreseeable future as they aim to realise the anticipated synergy benefits, successfully manage multiple brands and effectively mitigate the significant IT and operational risks inherent in any large-scale integration programme.

End notes

- ¹ CBA result for 31 December and 30 June.
- ² Profit represents statutory profit attributable to shareholders of the company, except for WBC which is on a Proforma basis.
- ³ ANZ 2010 and 2009 reported on an underlying basis.
- ⁴ Excludes impairment expense arising from available for sale investments (CBA: 2009 (\$2 million); ANZ: 2010 \$20 million).
- ⁵ For NAB, reported collective provision excluding provision for loans and derivatives at fair value has been used to calculate the ratio of collective provisions to credit risk-weighted assets.
- ⁶ Source: Bloomberg as at 31 March 2010 and 30 September 2009.

Michelle Hinchliffe

Head of Financial Services, Australia

Partner

Tel: +61 3 9288 5452

mhinchliffe1@kpmg.com.au

Andrew Dickinson

Head of Banking, Australia

Partner

Tel: +61 2 9335 8952

adickinson@kpmg.com.au

Visit www.fips.kpmg.com.au or call +61 2 9335 7000 to learn more about KPMG's Financial Services practice.

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