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Credit Opinion: Commonwealth Bank of Australia

Global Credit Research - 14 Dec 2014

Sydney, New South Wales, Australia

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Aa2/P-1
Bkd Deposit Note/CD Program -Fgn Curr	(P)Aa2/--
Bkd Deposit Note/CD Program -Dom Curr	(P)Aaa/--
Bank Financial Strength	B-
Baseline Credit Assessment	a1
Adjusted Baseline Credit Assessment	a1
Issuer Rating	Aa2
Senior Unsecured	Aa2
Subordinate -Fgn Curr	A2
Subordinate -Dom Curr	A3 (hyb)
Pref. Stock Non-cumulative -Dom Curr	Baa1 (hyb)
Commercial Paper	P-1
Other Short Term	(P)P-1
ASB Bank Limited	
Outlook	Stable
Bank Deposits	Aa3/P-1
Bank Financial Strength	C+
Baseline Credit Assessment	a2
Adjusted Baseline Credit Assessment	a1
Issuer Rating	Aa3
Senior Unsecured -Dom Curr	Aa3
Subordinate -Dom Curr	A2
Commercial Paper	P-1
Other Short Term	(P)P-1

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Key Indicators

COMMONWEALTH BANK OF AUSTRALIA (Consolidated Financials)[1]

	[2]**6-14**	[2]**6-13**	[3]**6-12**	[3]**6-11**	[3]**6-10**	**Avg.**
Total Assets (AUD million)	**791,406.0**	**753,803.0**	**718,732.0**	**667,899.0**	**646,330.0**	[4]**5.2**
Total Assets (USD million)	**746,968.8**	**689,992.5**	**736,737.9**	**715,049.4**	**545,923.7**	[4]**8.2**
Tangible Common Equity (AUD million)	**41,220.5**	**35,916.7**	**31,863.7**	**28,859.3**	**27,484.9**	[4]**10.7**
Tangible Common Equity (USD million)	**38,906.0**	**32,876.3**	**32,662.0**	**30,896.6**	**23,215.2**	[4]**13.8**
Net Interest Margin (%)	**2.0**	**2.0**	**1.9**	**2.0**	**1.9**	[5]**2.0**

PPI / Average RWA (%)	**4.0**	**3.7**	**3.9**	**3.7**	**3.7**	[6]**3.9**
Net Income / Average RWA (%)	**2.8**	**2.5**	**2.5**	**2.4**	**2.1**	[6]**2.7**
(Market Funds - Liquid Assets) / Total Assets (%)	**15.4**	**16.1**	**17.4**	**20.2**	**24.4**	[5]**18.7**
Core Deposits / Average Gross Loans (%)	**74.3**	**73.2**	**71.5**	**67.5**	**63.9**	[5]**70.1**
Tier 1 Ratio (%)	**11.1**	**10.2**	**10.0**	**10.0**	**9.2**	[6]**10.6**
Tangible Common Equity / RWA (%)	**12.2**	**10.9**	**10.5**	**10.2**	**9.5**	[6]**11.6**
Cost / Income Ratio (%)	**40.0**	**41.0**	**42.1**	**42.6**	**41.5**	[5]**41.4**
Problem Loans / Gross Loans (%)	**0.9**	**1.2**	**1.4**	**1.7**	**1.7**	[5]**1.4**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**10.0**	**12.7**	**15.8**	**20.7**	**20.2**	[5]**15.9**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Moody's Aa2 senior unsecured rating of the Commonwealth Bank of Australia's (CBA) reflects the bank's stable profitability, asset quality and conservative balance sheet. In addition, the Aa2 rating incorporates two notches of uplift over CBA's standalone financial strength of a1, in recognition of the bank's systemic importance and the traditionally supportive approach of Australia's bank supervisors.

CBA's rating remains strongly positioned within its ratings band. We note that the bank's strong credit profile needs to be placed in the context of a broadly supportive but evolving operating environment in Australia. Our central scenario assumes steady economic growth, supported by an accommodative monetary policy. However, the Australian economy is undergoing a period of transition, characterised by subsiding investment in the resources sector, as well as lingering imbalances in the property market. Overall, the bank remains well-positioned for a period of continuing uncertainty with a strong balance sheet, a low-risk loan book, moderating funding costs and a high level of operating efficiency.

(Please select "Read Full Report" for a more in-depth discussion. Note that the Pre-Provision Income / Average RWA and Net income/ Average RWA ratios in the Key Indicators Table are calculated under the Basel III regime as of FY 2013. In Australia, minimum capital requirements under Basel III have been met since 1 January 2013 and there are no transitional arrangements for capital deductions. To calculate the average risk weighted assets for FY 2013 and FY 2014, only reporting period subsequent to 1 January 2013 were used).

Rating Drivers

- A broadly supportive operating environment

- Exceptional franchise value supported by a low-risk housing portfolio

- Bad debt charge at exceptionally low levels, expected to over time revert toward long-term averages

- Improved funding and liquidity profile, but still an area of rating focus

- Healthy capital metrics cushion the bank against an adverse stress

- High probability of systemic support.

Rating Outlook

CBA's ratings have a stable outlook. The outlook reflects the bank's flexibility to absorb potential losses in the event of a sharp deterioration in the operating environment.

What Could Change the Rating - Down

CBA's stable rating outlook is based on our core scenario of resilient economic growth in Australia. An

unexpectedly severe adverse change in economic conditions, leading to an increase in the amount of non-performing loans, would be a negative. The rating would come under downward pressure should the Australian housing market experience any substantial further acceleration in house prices, particularly outside of the core Sydney market, raising the risk of a sharper-than-expected correction.

The rating outlook is also predicated upon a stable funding profile: a reversion toward a greater proportion of confidence-sensitive funding and in particular short-term (<1 year) offshore wholesale debt issuance, not accompanied by a commensurate increase in liquid assets, could result in downward pressure on the rating.

What Could Change the Rating - Up

In light of CBA's already high baseline credit assessment, and the potential for global wholesale funding markets to remain sensitive to reversals in investor confidence, an upgrade does not appear likely in the near term.

DETAILED RATING CONSIDERATIONS

CBA's ratings reflect the following considerations:

A Broadly Supportive Operating Environment

Our baseline scenario for the Australian economy assumes GDP growth of around 3% for 2015. Growth will be underpinned by resources exports, as more production capacity, such as LNG plants, comes online and some activity in the construction sector. While there may be pockets of weakness from lower investment and fiscal spending, low interest rates should support overall private-sector demand.

Threats emanating from house price inflation appear to be moderate at this stage. House price growth experienced in 2013 and 2014 does not appear to be fuelled by excessive credit growth or a significant relaxation of lending standards, albeit the rapid increase in the investor housing segment represents a notable downside risk. In this context, we view the Australian Prudential Regulation Authority's (APRA) announcement in December 2014 that it will tighten its supervision on Australian banks' mortgage lending practices, and investment lending in particular, as a positive.

On balance, we believe this exposes Australian banks to a supportive operating environment over the next 18 months with downside risks for asset quality and profitability metrics.

Exceptional Franchise Value Supporting Strong Profitability

CBA has an entrenched franchise position in the Australian and New Zealand markets as one of Australia's `four pillar' banks (which combined maintain approximately 80% of total resident assets with 22% for CBA; source APRA). Like its peers, CBA took advantage of the global financial crisis to extend its market share in Australia. CBA has looked to further entrench its competitive position through an update of its core IT systems Moreover, Australia's "four pillars" policy, which prohibits the four major banks from merging with each other, lessens the risk of M&A, and allows CBA and its peers to maintain relatively conservative loan underwriting standards and adequate risk-adjusted pricing.

CBA's consequent pricing power has allowed it to maintain strong profitability. In addition, the bank's profitability has been supported by favorable asset quality trends, a change in the bank's portfolio mix towards higher-yielding assets. More recently, competition for less-stable, high cost deposits appears to have attenuated and there is more focus on deposits with more stable characteristics. Deposit competition may continue to constitute a potential source of margin pressure, albeit that CBA has successfully defrayed the margin impact thus far.

The supportive operating environment and strong financial profiles of Australian banks is shifting attention to other sources of risks. In particular, the banks' entrenched profitability could lead to some complacency in regard of operational risks. Similarly, low interest rates may over time couple with relatively low credit growth could incent banks to lower credit standards. We would consider lower lending standards and/or signs of operational complacency to be material medium-term risks. The effectiveness of CBA's risk management in this regard is a key part of its rating assessment.

Bad Debt Charge At Exceptionally Low Levels, Expected To Over Time Revert Toward Long-Term Averages

CBA's asset quality metrics are currently exceptional. In FY 2014 the loan impairment charge reduced to 0.16%, significantly below estimated long-term marrket averages of 0.40-0.45% (source National Australia Bank). Similarly, the bank has reported a reduction in the stock of impaired assets with total problem loans falling to

0.94% of gross loans.

Whilst we see CBA's asset quality performance as a clear positive, its long-term sustainability is doubtful. Its credit metrics currently benefit from cyclical tailwinds associated with low interest rates. As such, we see any further material improvement in asset quality as unlikely. The bank's metrics are underpinned by the following three factors:

1. A material portion of the improvement in credit performance to the lower interest rate environment prevalent during 2013 and 2014. Mortgage interest rates are at currently at multi-decadal lows. In addition Australian borrowers are on average materially ahead of their repayment schedules. Similarly, Australian corporates have been cautious and currently maintain considerable liquidity reserves. Although low interest rates will continue underpinning good asset quality in the short run, the economic transition Australia is undergoing will inevitably create some pockets of weakness and may eventually move credit costs from their current low base. In addition, borrowers will inevitably come under greater stress when interest rates start rising again towards their long-run averages.

2. CBA's asset quality benefits from its focus on the domestic Australian market and on residential mortgage lending, which has continued to perform well. Australian mortgages were ~66% of CBA's gross loans as at June 2014. Our central scenario remains for stability in asset quality in the housing market. We also note loan-to-value ratios of banks' mortgage portfolios are at a cyclical low (the current dynamic average loan-to-value ratio for CBA is 48%). In addition, in Australia, higher loan-to-value exposures are covered by A-rated domestically-incorporated mortgage insurers. That said, household leverage in both Australia and New Zealand is high, and there is potential for a rapid acceleration in house price growth as a result of lower interest rates, creating exposure to external shocks, a rise in interest rates and unemployment.

3. CBA's corporate exposure concentrations are generally of high quality: the majority is either investment grade or well-secured. The portfolio is well diversified by industry. CBA's single borrower concentration is moderately high, reflecting the concentrated nature of its main markets and the small size of corporate bond markets in Australia and New Zealand. Nevertheless, Australian and New Zealand corporate balance sheets are generally in sound shape and high end commercial real estate borrowers have boosted their financial profiles by equity issuance during the crisis.CBA has very little direct exposure to crisis-hit asset classes, including European bank and sovereign securities. In common with other Australian banks, CBA runs a very low level of market risk.

Improved Funding And Liquidity Profile, But Still An Area Of Rating Focus

Australia's major banks, including CBA, have a structural reliance on wholesale funding, with an important offshore component. However, this reliance reduced steadily since the global financial crisis as a result of strong deposit growth and deleveraging by households and the corporate sector. CBA has rebalanced its funding base towards deposits, with deposit funding increasing to 64% as at June 2014. In addition, CBA has continued to increase the tenor of its new wholesale issuance, which has lifted the average tenor of its long-term wholesale portfolio to 3.8 years.

We view the lengthening of wholesale funding tenors to be credit positive, directly addressing the key rating sensitivity of Australian banks, which is their sensitivity to funding market conditions. Similarly, we view the longer-term trend towards increased deposit funding to be broadly favorable: competition for less-stable, high cost deposits appears to have attenuated and there is more focus on deposits with more stable characteristics. We do note however Unlike previous years, in FY 2014 new deposits did not cover new lending in full during the year, reflecting rising lending but moderating deposit growth. So long as the bank maintains a conservative maturity profile, we view a moderate increase in debt funding from current levels to be credit-neutral.

At the same, we note that the bank's wholesale funding task remains relatively large and continues to expose CBA to market conditions. Although not our central scenario, should demand for loans accelerate and deposit growth slow further or reverse, how the bank responds will be a critical rating consideration. Any increase in confidence-sensitive funding - such as short-tenor debt issuance, in particular abroad, or high-yield uninsured deposits - not accompanied by a commensurate increase in liquid assets, would be viewed as rating negative.

Healthy Capital Metrics Cushion The Bank Against An Adverse Stress

CBA's 9.3% Common Equity Tier 1 ratio (on an APRA Basel III basis, equating to 12.1% on a Basel III calculation basis), combined with adequate provisioning, creates a solid cushion to absorb credit losses. Our stress tests indicate that although in a severe recession - equivalent to loss rates observed in the US between 2008-11 - CBA's capital cushion would be materially eroded, it would not fall under the 4.5% headline regulatory minimum

(albeit we note that Australian banks are subject to individual Prudential Capital Ratios set by APRA).

In December 2013, APRA announced its new framework for dealing with domestic systemically important banks (D-SIBs). APRA has identified four Australian D-SIBs, including CBA and the other three Australian major banks. Under the framework, APRA will apply a 1% capital surcharge, known as the higher loss absorbency (HLA) capital requirement, to the four D-SIBs. The HLA requirement must be met from Common Equity Tier 1 (CET 1) capital and will be implemented as an extension of the capital conservation buffer. The new framework will come into effect in January 2016. Given their strong organic capital generation plans, we expect Australian banks, including CBA, to have no difficulty meeting the D-SIB requirements.

In May 2014, CBA and other Australian major banks reported they have been in discussion with APRA regarding APRA's intention to change its rules in relation to the definition of Level 2 groups. As a result, current capital benefits applying to non-recourse debt securities issued by certain Australian banks' wealth management subsidiaries will be phased out. CBA's wealth management subsidiary, Colonial Holding Company Limited, has AUD 2.2 billion of non-recourse debt on issue. We estimate the impact of removing the current capital benefits in respect of this debt will result in a 0.66% reduction in CBA's Common Equity Tier 1 ratio.

APRA has canvassed a transitional period whereby the current capital benefit will be phased out, potentially as debt matures. The transitional arrangements will give the banks time to generate additional Common Equity Tier 1 capital to cover the deductions throughout and after the relief period. CBA's strong profitability, generating significant levels of capital, will enable it to cover its capital needs. In recent years, improvements in the bank's capitalization have been constrained due to high dividend payments and actions taken to neutralize the bank's dividend reinvestment plan. However, CBA retains sufficient flexibility within its capital management actions to reduce the potential capital shortfall either through organic capital generation and/or other mitigating actions.

Potential For Systemic Support Remains Very High

Potential for systemic support remains very high. CBA's Aa2 global-scale local currency deposit and debt ratings incorporate two notches of uplift from the bank's baseline credit assessment of a1, reflecting a high probability that, as a consequence of its size, it would receive systemic support in case of need. At the margin, we also view CBA's position as one of the "four pillars" (the four major banks, which government policy prevents from merging) to increase the potential for support.

Australia is a member of the Financial Stability Board (FSB) and the FSB has highlighted the lack of statutory bail-in in Australia as a gap relative to international standards. The Australian authorities have thus far adopted a cautious and nuanced public stance on creditor bail-in. Treasury has commented that further consideration is warranted, but noted concerns about the workability of bail-in for large institutions. At the same time, while supporting to the objective to minimize the burden of bank resolution costs on tax payers, the RBA has opined that the policy "toolkit" should retain the ability to "take an institution under public ownership before selling it again when the risk appetite of the private sector has returned to more normal levels". In its final report, Australia's Financial System Inquiry has recommended that Australia adopts a loss absorbing capacity and resolution framework. The Inquiry expressed preference for introducing securities with contractual bail-in features, rather than creating a statutory bail-in regime. Increased loss-absorbing requirements could place pressure on ratings uplift attributable to government support, since they reduce the likelihood of bank resolution taking place by way of bail-out and instead imply a higher level of burden sharing with creditors.

The exact resolution mechanisms ultimately adopted in Australia remain to be determined. Accordingly, their impact on bank ratings would depend on the degree to which the positive impact of higher loss-absorption capacity offsets the possible reduction in Moody's support assumption for the banks' senior obligations.

Rating Factors

COMMONWEALTH BANK OF AUSTRALIA

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (50%)						B+	
Factor: Franchise Value						B-	Neutral
Market share and sustainability		x					

Geographical diversification			x				
Earnings stability		x					
Earnings Diversification [2]							
Factor: Risk Positioning						B+	Neutral
Corporate Governance [2]	--	--	--	--	--		
- Ownership and Organizational Complexity	--	--	--	--	--		
- Key Man Risk	--	--	--	--	--		
- Insider and Related-Party Risks	--	--	--	--	--		
Controls and Risk Management		x					
- Risk Management		x					
- Controls		x					
Financial Reporting Transparency		x					
- Global Comparability	x						
- Frequency and Timeliness			x				
- Quality of Financial Information		x					
Credit Risk Concentration	--	--	--	--	--		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
Liquidity Management		x					
Market Risk Appetite	x						
Factor: Operating Environment						A	Neutral
Economic Stability	x						
Integrity and Corruption	x						
Legal System	x						
Financial Factors (50%)						B	
Factor: Profitability						A	Neutral
PPI % Average RWA (Basel III - transitional phase-in)	3.84%						
Net Income % Average RWA (Basel III - transitional phase-in)	2.63%						
Factor: Liquidity						C+	Neutral
(Market Funds - Liquid Assets) % Total Assets				16.29%			
Liquidity Management		x					
Factor: Capital Adequacy						A	Neutral
Tier 1 Ratio (%) (Basel III - transitional phase-in)	10.70%						
Tangible Common Equity % RWA (Basel III - transitional phase-in)	11.57%						
Factor: Efficiency						A	Neutral
Cost / Income Ratio	41.02%						
Factor: Asset Quality						B	Neutral
Problem Loans % Gross Loans		1.16%					
Problem Loans % (Equity + LLR)		12.84%					
Lowest Combined Financial Factor Score (15%)						C+	
Economic Insolvency Override						Neutral	
Aggregate BFSR Score						B	
Aggregate BCA Score						aa3	
Assigned BFSR						B-	
Assigned BCA						a1	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.
[2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.

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