FITCH REVISES CBA OUTLOOK TO NEGATIVE; AFFIRMS RATINGS AT 'AA-'

Fitch Ratings-Sydney-06 May 2018: Fitch Ratings has revised the Outlook on Commonwealth Bank of Australia's (CBA) Long-Term Issuer Default Rating (IDR) to Negative from Stable. At the same time, we have affirmed the IDR at 'AA-'. The agency has taken a similar action on CBA's New Zealand subsidiary, ASB Bank Limited. A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

VIABILITY RATING, IDRS AND SENIOR UNSECURED DEBT

The affirmation of CBA's ratings reflects Fitch's expectation that the bank will maintain its strong franchise and sound financial profile despite negative findings from an independent prudential inquiry into its governance, culture and accountability.

The Outlook has been revised to Negative to reflect CBA's risks in remediating shortcomings in operational risk controls and governance. Management's focus may divert from ongoing operations and a likely cost increase might manifest in a weaker financial profile and franchise. There is also a risk that ongoing inquiries into the sector, including the Royal Commission, identify additional shortcomings. If this occurs, it may leave CBA more susceptible than peers to a weaker operating environment. The current operating environment is challenging for Australian banks, as reflected in Fitch's negative sector outlook.

Fitch revised the Outlook as we believe the initially identified shortcomings of CBA, being risk appetite as well as management and strategy, are more widespread than we had incorporated into the previous assessment of these factors. The final report from the independent prudential inquiry, published 1 May 2018, revealed that CBA's continued financial success led to complacency within the bank.

The timetable to implement the remediation recommendations is unclear. CBA will provide a roadmap to implementing the 35 recommendations to the Australian Prudential Regulation Authority (APRA) within 60 days under an enforceable undertaking provided by the bank in relation to the report. Considerable turnover in senior management and the board could assist the ambitious remediation process. The prudential inquiry report indicated that the task is larger than previous risk management initiatives, yet also acknowledged that board rigour has already shown signs of improvement under the current chair, in place since the beginning of 2017.

APRA imposed an additional operational risk capital charge of AUD1 billion on CBA as a result of the findings of the report. CBA estimates that this would have reduced its end-2017 common equity Tier 1 ratio by about 30bp to 10.1%. This is toward the lower end of domestic peers but manageable for CBA, particularly in light of its profitability. This charge can be reduced or removed if CBA is able to demonstrate to APRA that it has met the undertakings outlined as part of the bank's enforceable undertaking.

SUPPORT RATING AND SUPPORT RATING FLOOR

CBA's Support Rating and Support Rating Floor reflect its systemic importance and an extremely high probability of support from Australian authorities, if needed.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

The ratings of CBA's Tier 2 subordinated debt, both legacy and Basel III-compliant instruments, are notched down one level from the Viability Rating for loss severity. No notching has been applied for non-performance risk.

SUBSIDIARY AND AFFILIATED COMPANY
The Outlook on ASB and its IDRs are aligned with those of CBA to reflect Fitch's view that there continues to be an extremely high likelihood of support from CBA, if required. ASB is a highly integrated and integral part of CBA's business. The possibility of support is reinforced by strong regulatory linkages between Australia and New Zealand banking authorities.

The ratings of senior unsecured debt issued by ASB Finance Limited are aligned with ASB's Long-Term IDR, as ASB guarantees the debt instruments.

RATING SENSITIVITIES
VIABILITY RATING, IDRS AND SENIOR UNSECURED DEBT
CBA's Viability Rating and IDRs may be downgraded if management fails to contain spill-over risks from the required remediation to the ongoing business, resulting in a substantial weakening in its financial profile and franchise. Ratings are also likely to come under pressure if further shortcomings are identified in other areas of CBA's risk controls, such as credit and market risk.

Conversely, the Outlook may be revised to Stable if CBA is able to strengthen its risk framework and controls in line with regulatory requirements and international best practice.

Additional downside rating risks include:
- a sharp deterioration in the operating environment, most likely driven by external factors;
- an ongoing rise in household risks that heightens the banking system's sensitivity to significant asset-quality, profitability or capitalisation deterioration if labour market conditions were to substantially weaken or interest rates rise sharply; and
- deterioration in the funding and liquidity profile as it could leave CBA susceptible to prolonged funding market dislocation.

Increased competition from non-bank lenders, particularly in the digital space, may result in a lower assessment of CBA's company profile, earnings and profitability and, ultimately, ratings, should it emerge. However, we do not expect this to occur within the next two to three years.

SUPPORT RATING AND SUPPORT RATING FLOOR
Fitch does not expect any change to the propensity of authorities to provide support to CBA, despite global regulatory moves to limit implicit government support to banks. However, we expect Australia's resolution framework to be strengthened in the medium term, which could change our assumption around sovereign support. The regulator plans to start consultation on a framework for minimum loss-absorbing capacity and recapitalisation capacity later in 2018. This may prompt a review of Support Ratings and Support Rating Floors across the sector.

A change in the ability of Australian authorities to provide support, which is likely to be reflected in a downgrade of the Australian sovereign (AAA/Stable), may also result in a downgrade of CBA's Support Rating and Support Rating Floor. However, this would not directly affect CBA's IDRs, which are driven by its Viability Rating.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
Subordinated debt instrument ratings are broadly sensitive to the same considerations that might affect CBA's Viability Rating.

SUBSIDIARY AND AFFILIATED COMPANIES

Any change in CBA's ratings is likely to also be reflected in ASB's ratings. The IDRs may be downgraded should Fitch change its view of ASB's role within CBA or if the authorities change their cross-border regulatory approach.

The ratings of the senior unsecured securities issued by ASB Finance are sensitive to the same factors as ASB.

The rating actions are as follows:

Commonwealth Bank of Australia
Long-Term IDR affirmed at 'AA-'; Outlook revised to Negative from Stable
Short-term IDR affirmed at 'F1+'
Viability Rating affirmed at 'aa-'
Support Rating affirmed at '1'
Support Rating Floor affirmed at 'A'
Senior unsecured long-term debt affirmed at 'AA-'
Senior unsecured short-term debt affirmed at 'F1+'
Subordinated debt affirmed at 'A+'

ASB Bank Limited
Long-Term Foreign-Currency IDR affirmed at 'AA-'; Outlook revised to Negative from Stable
Short-Term Foreign-Currency IDR affirmed at 'F1+'
Long-Term Local-Currency IDR affirmed at 'AA-'; Outlook revised to Negative from Stable
Short-Term Local-Currency IDR affirmed at 'F1+'
Support Rating affirmed at '1'

ASB Finance Limited
Senior unsecured long-term debt affirmed at 'AA-'
Senior unsecured short-term debt affirmed at 'F1+'

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Additional information is available on www.fitchratings.com

Applicable Criteria
Bank Rating Criteria (pub. 23 Mar 2018)
https://www.fitchratings.com/site/re/10023430