29 July 2003 Strategy Briefing - Presentation by Marten Touw, Group Treasurer

Title Slide: Capital

Slide 2: Disclaimer
The material that follows is a presentation of general background information about the Bank's activities current at the date of the presentation 29 July 2003. It is information given in summary form and does not purport to be complete. It is not intended to be relied upon as advice to investors or potential investors and does not take into account the investment objectives, financial situation or needs of any particular investor. These should be considered, with or without professional advice when deciding if an investment is appropriate.

Slide 3: Speaker's Notes
Speaker's notes for these presentations are attached below each slide.
To access them, you may need to save the slides in PowerPoint and view/print in "notes view."

Slide 4: Capital requirements must be aligned with business risks
Good evening / good morning as the case may be.

First, let me apologise for not being here in the flesh. By now, the reasons will be obvious to you.

CBA views its capital needs in the context of economic risk. Capital is held against unexpected losses with all business risks quantified at the AA rating level. This concept is applied consistently across the Group and influences the Group's overall strategic thinking and performance management.

The model forming the basis of our calculations of economic risk was implemented 3 years ago in conjunction with Oliver Wyman and has since been refined.

Many other measures of capital adequacy exist including those prescribed by APRA and the various adjusted equity measures used by the rating agencies, investors and analysts.

Slide 5: There are differing perspectives of "capital"
We manage our capital position having regard to the requirements of shareholders, regulators in the form of APRA, Reserve Bank of New Zealand, Financial Services Authority etc and rating agencies. Each of these entities has a perspective based on the level of capital required to support its interests.

While we use our economic equity calculations as the basis for determining whether we are capital adequate and the APRA requirements are well known, the common measure used by rating agencies and analysts is some form of "adjusted equity" - "adjusted common equity"; "adjusted tangible equity"; "core equity"; etc. The numerator in these measures typically includes a range of views on the deductions required for various CBA investments. For the denominator, the assessment of risk is often based on regulatory risk weighted assets and is not aligned to the actual underlying risks in the business. For example, our internal models show an economic equity requirement of less than 0.50% on residential home loans as compared to APRA's current minimum capital requirement of 4%. This causes an immediate tension between analysts' calculations and those used by CBA.

Tier 1 Capital, calculated in accordance with APRA Regulations, includes the tangible component of the investment in life insurance and funds management businesses. Some commentators have referred to this as "double gearing". CBA suggests whether or not this is true is a moot point. We are solving for the question of whether or not we have adequate capital to meet the needs of the regulators (so that we can maintain our banking licence); the rating agencies (so that we can maintain AA- level access to cost effective debt) and shareholders (so that we can meet unexpected losses to the AA level and remain in business). To date, all pronouncements from APRA and the rating agencies confirm CBA is well capitalised.

Slide 6: Capital to protect shareholders' interests
As discussed, CBA has modelled its economic equity attribution process using Oliver Wyman, one of the well known consultants in this field.

Our internal models show CBA is strongly capitalised based on our assessment of the capital required to support the real risks in our businesses.

With respect to Conglomerates:

- APRA has prescribed that CBA will be subject to the Level 3 capital adequacy requirements that form part of the new Conglomerates Regulations that came into effect on 1 July 2003.
- As a result, CBA is required to provide APRA with details of our internal models used for monitoring and measuring capital. This is to satisfy APRA that the CBA conglomerate group (ie banking, life and funds management) has sufficient capital for the risk profile of the group as a whole.

Slide 7: Capital to protect depositors' interests
Our regulator, APRA, has stated that we are well capitalised.

CBA's Tier 1 capital ratio increased from 6.78% at 30 June 2002 to 7.06% at 31 December 2002.

This compares with a decline in Tier 1 Capital for our 3 major peers from September 2002 to March 2003.

Although CBA has a Tier 1 ratio lower than ANZ and NAB, this needs to be analysed in the context of the respective underlying risks in the businesses. CBA believes that the risk in our banking book is lower than our peers: about 60% of CBA's loans and advances are lower risk residential mortgages, compared to approximately 48% for ANZ, 43% for NAB and 53% for WBC.

As a result, if the risk weighting for home loans was reduced from 50% to only 35% (as proposed for the Basel 2 "Standardised Approach"), the positive impact on CBA's Tier 1 capital position would be the largest of the 4 majors. If the Basel 2 Advanced IRB approach was applied, the benefit to CBA would be even greater.

Slide 8: Capital to protect policyholders' interests
APRA sets capital requirements to protect life insurance policyholders, and ASIC sets requirements for funds management companies. Overseas, the local regulators set requirements.

The excess capital across the businesses at 31 December 2002 was $807m.

For regulatory purposes, Deferred Acquisition Costs (DACs) are required to be included in the calculation of Capital Adequacy, at face value – this amounts to approximately $500m for Australian insurance business that is deducted from free equity.

This is a very conservative position as we expect this business to continue on the books for up to 30 years. On an economic basis, we would not write off the entire DAC – accordingly economic equity is less than regulatory capital for this business.

Additionally, there are ways we could reduce the DAC that appears on the balance sheet eg securitisation, financial reinsurance. Without changing the economic risks, the regulatory capital is reduced. We choose not to take this approach because the economic costs do not justify the real benefit.

Of the Australian Insurance required capital of $1.2 bn, approximately 35% is in products that are in run off including "traditional products". These products will release this capital in excess of profits over their remaining lifespan. This capital will be used to fund new business ie to pay for new DACs.

Slide 9: Capital to protect debtholders' interests
CBA's credit rating is not at risk.

You will all be familiar with the fact that credit ratings are determined based on a number of factors.

Moody's have specifically commented that:
"A number of market participants continue to believe that there is a strong correlation between a bank's level of regulatory capital (most often defined by the Tier 1 ratio or an ad-hoc adjusted version of it) and the ratings that these banks get from Moody's. Nevertheless, our analysts continually emphasise that indeed this is not the case with our assessment of bank credit risk."

Source: "Capital Ratios & Moody's Bank Ratings: No direct correlation", Moody's Bank Risk Monitor January 2003 - Issue 2

Slide 10: Proposed changes to the regulatory environment
CONGLOMERATES

As discussed, APRA has designated CBA a "financial conglomerate". Regulations relating to Financial Conglomerates came into effect on 1 July 2003.

Financial conglomerates will have three levels of regulatory capital requirements:

- Level 1 and Level 2 are similar to the previous Stand Alone and Group regulatory capital requirements
- Level 3 is a new requirement from 1 July this year. This derives the aggregate capital requirement for all businesses in the group, whether they be banking, life insurance or funds management businesses.

APRA have said they will use the internal models used by banks that own life insurance companies to determine the capital requirements from 1 July 2003. They have also said they are unlikely to have evaluated the models used by all the banks concerned until June 2004. At present, therefore, we cannot say for certain that our models will meet their requirements but we are confident that this will be the case.

We believe that the 1 July 2003 Conglomerates Regulations should have no material effect on the Group's regulatory capital ratios.

Slide 11: Proposed changes to the regulatory environment
BASEL 2

Under the New Capital Accord, risk weights for credit risk will be based on the credit rating of the counterparty or loss experience on statistically managed portfolios.

CBA's modeling indicates that the capital required for credit risk under Pillar 1 of Basel 2 will be considerably less than at present. Off-setting this will be a new requirement for capital to cover operational risk. In addition, APRA will have new capital requirements under Pillar 2 of Basel 2, which will include capital for business and strategic risk and credit concentration risk. Quantification of the benefits is not possible until APRA releases its "national discretion" requirements under Pillar 2. However, APRA expect that the Pillar 2 capital requirements will substantially reduce the benefits Australian banks are expected to derive under Pillar 1.

The treatment of the deduction for life insurance and funds management companies will change. The deduction for the tangible element will be 50% from tier 1 and 50% from tier 2 (currently it is 100% from total capital).

Overall, we expect Basel 2 will be beneficial to CBA. However, there is still insufficient information on the New Capital Accord for us to provide a definitive answer as to the impact on our capital ratios.

We continue to work with APRA.

Slide 12: Proposed changes to the regulatory environment
IAS

From 1 July 2005 Australian companies will adopt International Financial Reporting Standards.

CBA is preparing for these changes now. At 1 July 2005, we will be required to show 2 years of comparative data and as a result we will need to run 2 sets of accounts for 2003/04 and 2004/05

However, preparing for these new accounting standards is made difficult as the rules are not finalised as yet. There is a lack of clarity over certain details in the Standards.

IAS will have major implications for CBA

- many balance sheet items will be "fair valued"
- most derivatives will be fair valued whilst the hedged item may not
- goodwill accounting
- pension accounting
- insurance contracts
- appraisal value accounting
- impairment recognition and provisioning

securitisation and asset derecognition

CBA's current effort is being applied to minimising profit & loss volatility from changes to the hedging rules. Otherwise, artificial profit volatility of hundreds of millions of dollars could be created from the loss of asymmetric accounting treatment for "internal" deals. However, we are using IAS 39 hedge accounting to match underlying balance sheet items to an external hedge.

The overall impact of the rules and their interpretation by the regulator and rating agencies is unclear. However, the rules make no difference to the Group's economic equity calculations.

Slide 13: Proposed changes to the regulatory environment
CAPITALISED EXPENSES

APRA released guidelines for Capitalised Expenses on the 25th of June 2003.

The guidelines propose that certain capitalised expenses are deducted from Tier 1 capital. These expenses are:

Loan/lease origination fees and commissions paid to originators and brokers
Securitisation establishment costs
Costs associated with debt/capital raisings
Other general asset classifications relating to transformation costs or business development initiatives

Implementation of the proposed guidelines on 1 July 2004 will have only a minor impact on CBA's Tier 1 capital ie less than 6 basis points.

The guidelines continue with the current practice of including software development costs as a Risk Weighted Asset. However, APRA has stated that it "considers it is questionable whether these costs satisfy the recognition requirements for a regulatory asset" and they will continue to monitor the capital treatment of software development costs.

Even if APRA were to require a Tier 1 deduction for capitalised software cost, the impact today for CBA would be less than 15bp. We estimate that this is less than our peers.

Slide 14: Summary
Again, CBA views its capital needs in the context of economic risk.

In determining the capital requirements of CBA, we ensure that we have adequate capital to meet the needs of shareholders (so that we can meet unexpected losses to the AA level and remain in business); the regulators (so that we can maintain our banking license); and the rating agencies (so that we can maintain AA- level access to cost effective debt).

To date, all pronouncements from APRA and the rating agencies confirm CBA is well capitalised.

Slide 15: Title Slide