COMMONWEALTH BANK OF AUSTRALIA
FACT SHEET
FEBRUARY 2024

IAM
INCOME ASSET MANAGEMENT

Commonwealth Bank of Australia

Issuer Outline
Commonwealth Bank of Australia provides banking, life insurance, and related services for individuals, small businesses, and medium-sized commercial enterprises. The Bank offers corporate and general banking, international financing, institutional banking, and stock broking and funds management such as superannuation products.

Sector:	Financial
Sub-Sector:	Banks
Country:	AU
Ownership:	Public

IAM Credit View

Commonwealth Bank of Australia (CBA) continues to grow from strength to strength, emerging as the outperformer of all major Australian banks in FY23 results. Comparatively, the bank has notably ranked first in market capitalisation, net interest margin (NIM), cash profits and total assets owned amidst elevated macro uncertainty and fiercer competition faced in the lending markets. NIM was a positive carry (+18% YoY) as CBA was largely able to guard its dominant share of the residential mortgage (owning 25.8% of market share) and business lending (18.0% of market share) against ANZ, Macquarie Bank and non-bank lenders that aggressively bid for new customers. The competition for new loans was exacerbated by the tactics of undercutting lending rates (unprofitably to below the industry's cost of capital in some cases) as well as increasing cash incentives for refinancing - all at the cost of lenders' top line margins. With the rising pressure on revenue generation, cost discipline is a priority and a competitive differentiator for banks. Efficiency ratio has improved YoY as CBA's cost-to-income ratio fell by 2.8% to 43.5% given higher revenues that outweighed rising costs of salaries and technology spend.

Issuer Credit Rating & Outlook

Agency	Rating	Outlook
S&P	AA-	STABLE
Moody's	Aa3	STABLE
Fitch	A+	STABLE

Key Financials (AUD m)

LTM (31 March)	2024
Net interest income	23,081
Non-interest income	4,336
NPAT	10,090
Gross loans	931,873
Total assets	1,252,845
Customer deposits	864,485
Short- and long-term debt	234,632
Non-performing loans (NPLs) to total loans (%)	0.37
CET 1 ratio (%)	14.50

The broader outlook for mortgage loan demand remains arguably strong considering the relative undersupply of housing stock (including new build pipeline) to accommodate a growing Australian population. An imminent challenge for CBA is managing the growing costs of loan arrears and impairments (realised and unrealised) as inflationary cost pressures continue to test the financial resiliency of consumers and businesses. Loan impairment expense increased by $1,465 million in FY23 and represented ~36bps of CBA's overall loans and advances to customers as of FY23 end, 10-15bps higher than other major banks. As the baseline, CBA is well capitalised considering its conservative buffers in liquidity, capital and funding profile as affirmed by improved capital adequacy ratios and an increased proportion of deposits (+1% to 75%) held by the bank. In contrast, CBA's return on equity fell by 5% to 14% over the last 10 years as the bank had been required to hold a much higher level of capital, which remains its biggest strength, and is reflected in its AA issuer ratings since 1996 at S&P and since 2007 at Moody's.

On a forward-looking basis, CBA is expected to be the most active participant of the capital markets out of the major banks. In terms of debt issuance, the market is likely to see $6 billion of CBA's tier 2 subordinated debt issued over the next 2 years to replace outstanding tier 2 debt. This is on top of upcoming repayments on its borrowing from the Term Funding Facility (TFF) such that $30 billion is payable to Reserve Bank of Australia (RBA) between fiscal 2024 and 2025. This will likely be funded by new senior debt noting that actual issuance amounts rely on the proportion of deposits in CBA's funding profile alongside broader financing requirements for the bank.

Relative value trade opportunities

In FY23, CBA issued ~$35 billion of debt including $4 billion of Additional Tier 1 notes (AT1s) and Tier 2 notes which boosted Tier 1 and Tier 2 capital adequacy ratios by 90bps and 150bps respectively. Of which, the CBA Subordinated 2032 6.86% 10NC5 issue was the last fixed rate paper of 2023 and offered the highest issue yield compared to similar Tier 2 notes by CBA. The paper is consistently well bid by the market and currently boosts a compelling running yield of 6.54%. Comparing the same 10NC5 paper issued by ANZ in second week of 2024 which priced at 5.89% for the fixed rate tranche - the CBA bond stands out considering the higher yielding bond and stronger financial performance of the issuer in FY23.

CBA also issued AT1 bond PERLS XVI which was priced attractively at 3.0%+BBSW3M with current yield to maturity of 6.88% - highest yielding compared to other AT1 paper by major banks. Considering the recent outperformance of the issuer and relative value of the instrument, this issue stands out on the fronts of downside protection and upside returns.

Note: the aforementioned trade opportunities reflect a point-in-time perspective and require reassessment as market movements are linked to the credit cycle and/or idiosyncrasies.

Strengths of CBA

- **Strong capitalisation:** CBA is well-capitalised, with a Common Equity Tier 1 (**CET1**) ratio of 12.2% at 30 June 2023 (+70bps on FY22). The Australian Prudential Regulation Authority (APRA) requires authorised deposit-taking institutions (ADIs) to hold a minimum ratio of Tier 1 capital to risk-weighted assets of 11.75%, with at least 10.25% in the form of CET1 capital (based on minimum prudential requirement of 4.5% plus D-SIBs capital buffer of at least 5.75%).

- **Healthy debt maturity profile supported by strong funding position**: The weighted average term maturity of term funding maturing beyond one year at 30 June 2023 is 5.5 years for the bank, meaning the risk of significant refinancing in a period of potential market dislocation is greatly mitigated. CBA also had an average liquidity coverage ratio (**LCR**) of 131% (+1% from 2022), well-above regulatory minimums (100%) and on par with domestic peers. The funding profile of CBA is heavily skewed towards customer deposit as it is considered the most stable source of funding. The strength of its banking business has ensured the bank to maintain the highest share of stable household deposits in Australia. Customer deposits account for 75% of total funding, with customers continuing to increase retail, business and institutional deposits. Deposit balances is projected to continue growing due to customer preference for term investment products (representing the behaviour of flight for safety in times of uncertainty), and beneficial margins due to the rising rate environment.

- **Sound macro environment and regulatory oversight:** Australian financials, benefit from operating in an economy characterised as having a very high degree of economic resilience with low susceptibility to event risk. The Australian economy rebounded strongly after COVID-19 related disruptions, and while the impacts of the pandemic are largely behind us, it remains that institutional and governance frameworks compare well with overseas jurisdictions, providing an additional level of security, against future uncertainty.

- **Systematic importance to the Australian economy and financial system**: In the unlikely event of a failure, it is expected that the Australian government is more than likely to provide support for a workout solution as CBA holds the largest share of household deposits in Australia, servicing 25% of overall market.

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Weaknesses of CBA

- **Near term debt repayment task of ~A$20bn:** CBA has imminent debt maturities of ~A$20bn to address in FY24, half of which is payable to the RBA Term Funding Facility (TFF). TFF was introduced to provide ultra-low-cost funding (three-year fixed rate of 0.25%) to support the economy during the Covid-19 pandemic. CBA will need to source funding to repay these maturities, and typical funding avenues for the banks include raising new money in wholesale markets and formation of new deposits. Both of which are likely to incur considerably higher funding costs in light of elevated cash rates, impacting profitability adversely.

- **Concentrated revenue stream from banking activities**: CBA continues to divest from non-core operations to focus on banking business in ANZ. Playing to its strength, CBA's skew leaves its earnings more vulnerable to the pressures on lending markets, and households and businesses that are experiencing elevated cost burdens from higher interest rates and inflation. Over the recent years, CBA has partially or fully sold off its general insurance division CommInsure and financial planning arm for instance. Diversity in revenue streams has proven to be an effective hedge particularly in times of market volatility as Macquarie bank has shown.

Risks related to the CBA

- **Deterioration in portfolio credit quality**: Troublesome and impaired assets increased to $7.1 billion from $6.4 billion in FY22, primarily driven by increases in the construction and commercial property sectors. This represents 0.5% of CBA's committed portfolio of assets. Construction saw the highest growth of troubled assets by 1.5% as inflationary pressures and growing interest expense continue to stress on the sector, particularly businesses that were exposed to margin pressures from fixed price contracts. Commercial property was up by less than 1% due to similar reasons alongside vacant offices in lower quality office properties. Retail trade was also a sector that the management is scrutinising due to the higher costs of living affecting discretionary spend. This presents an ongoing challenge for CBA as the full extent of cost pressures and bearish outlook have yet to see an end. A pickup in distressed and defaulted assets will more than likely take a hit on CBA's profit margins alongside a potential downgrade on its issuer and issue ratings due to poorer credit worthiness.

- **Rating downgrades**: Ratings on both issuers and issues can be influenced by factors that do not necessarily reflect the financial strength or credit quality of a specific issuer, such as the Australian sovereign rating, the rating agencies' view on the economic prospects of the country or relative strengths of the regulatory framework. For example, in 2020 both S&P and Moody's placed the ratings on a number of Australian financial institutions, including CBA (S&P only), on negative outlook due to concerns about the economic outlook for Australia.

- **Weakness of the Australian Dollar**: CBA is sensitive to forex movements given its extensive business operations in foreign countries as well as a sizeable holding of foreign investments. Offshore operations hold liquid assets denominated in local currency to meet required regulations as imposed by each jurisdiction's regulator. Foreign revenue will likely be lower once converted back to Australian dollar as the currency appreciates, and reversely return a higher net income in Australia dollar terms if the Australian dollar depreciates against other foreign currencies.

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Risks related to the Instruments (Tier 2) and Additional Tier 1 (AT1)

- **Optional call dependent on regulatory approval:** Tier 2 notes include an early call feature where the face value of the notes may be repaid early in cash from a given date stated in the terms and conditions of the instrument. The optional redemption requires regulatory approval, which may not be provided. In general, regulators are unlikely to provide approval for a Tier 2 instrument to be called if it results in a reduction in the issuer's capitalisation; regulators are unlikely to provide approval for a redemption or resale unless the issuer has, or is expected to, issue an instrument of similar size to replace the instrument subject to that call. To the extent the optional call was expected not to be exercised, it is likely that the price of the notes will be negatively affected, with this negative price movement being potentially material.

- **Conversion or write-down following a Non-Viability Trigger Event:** A Non-Viability Trigger Event occurs when APRA determines conversion to ordinary shares (or write-off) of some or all of an issuer's contingent capital securities (Tier 2 and AT1) is necessary to prevent that financial institution becoming non-viable. Whether a non-viability trigger event will occur is solely at the discretion of APRA. APRA does not define what constitutes a non-viability event and there are currently no precedents under Basel III to determine non-viability. If such an event occurs, the issuer may be required to convert some or all of its Tier 2 notes into ordinary shares. In a more severe scenario, the issuer may be required to write-off the value of these notes. We note that it is expected that the conversion/write-off would be expected to be applied first to AT1 hybrids and only then to Tier 2 if the AT1 conversion/write-off was not sufficient to restore the issuer to a viable position.

- **Capped equity conversion**: Conversion of Tier 2 notes following a non-viability trigger event is subject to a maximum number of shares being issued. As such, if the notes are converted into ordinary shares, the value of ordinary shares an investor receives may be significantly less than the face value of their notes.

- **Subordination**: Tier 2 and AT1 notes are deeply subordinated, and rank ahead only of ordinary shares. AT1 was used recently when international banks (such as Credit Suisse and Silicon Valley Bank) collapsed rather than providing capital support earlier in the crisis.

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Summary Bond Details

ISIN	Issue Amount	Ranking	Coupon	Coupon Frequency	First Call[1]	Maturity Date	Issue Rating (S&P/Moody's/Fitch)
AU3FN0073029	AUD1100m	Subordinated Unsecured Tier 2	3mBBSW + 2.70%	Quarterly	9 January 2027	9 January 2032	BBB+ / Baa1 / A-
AU3CB0293769	AUD900m	Subordinated Unsecured Tier 2	6.860%[2]	Semi-annual	9 January 2027	9 January 2032	BBB+ / Baa1 / A-
AU3CB0297653	AUD1750m	Subordinated Unsecured Tier 2	6.704%[3]	Semi-annual	15 March 2033	15 March 2038	BBB+ / Baa1 / A-
AU3CB0303667	AUD550m	Subordinated Unsecured Tier 2	6.446%[4]	Semi-annual	25 October 2028	25 October 2033	BBB+ / Baa1 / A-
AU3FN0082251	AUD700m	Subordinated Unsecured Tier 2	3mBBSW + 2.05%	Quarterly	25 October 2028	25 October 2033	BBB+ / Baa1 / A-
AU0000028854	AUD1.59bn	Jr Subordinated Additional Tier 1	3mBBSW + 3.70%	Quarterly	26 April 2024	Perpetual	BBB- / - / -
AU0000003832	AUD1.37bn	Jr Subordinated Additional Tier 1	3mBBSW + 3.40%	Quarterly	15 April 2025	Perpetual	BBB- / - / -

[1] Excludes potential terms that would allow the issuer to redeem prior to the maturity date through a make-whole call.
[2] Resets on 9 November 2027 at a rate equal to the 3-month BBSW + 2.70%.
[3] Resets on 15 March 2033 at a rate equal to the 3-month BBSW + 2.45%.
[4] Resets on 25 October 2028 at a rate equal to the 3-month BBSW 2.05%.

Tier 2 Structure

Interest Deferral/Cancellation	Interest is deferrable and cumulative if, prior to the payment of interest, the issuer is not solvent or would not be solvent after payment.
Non-Viability Trigger	Yes, standard Basel III compliant non-viability trigger. If APRA determines the issuer is at risk of becoming non-viable, the terms of the notes indicate that the primary method of loss absorption will be via conversion of the subordinated notes into equity, in-part or in full.

Perpetual Tier 1 (AT1) Structure

Interest Deferral/Cancellation	Interest is deferrable and non-cumulative. Interest payment is optional and, if unpaid, the issuer has no obligation to pay any deferred amounts later. A cancellation of interest does not constitute a default under the Notes for any purpose.
Common Equity Tier 1 Trigger	If a bank determines, or APRA notifies a bank in writing, that the bank's Common Equity Tier 1 ratio is less than or equal to 5.125%, the bank may be required to write-off some or all the face value of the notes or convert some or all of the notes into ordinary shares.
Non-Viability Trigger	If APRA determines that an issuer requires capital support to prevent it from becoming non-viable (a 'non-viability event'), the bank may be required to write-off some or all the face value of the notes or convert some or all of the notes into ordinary shares.
Maturity	The notes do not have a maturity date. This means that the issuer does not have an obligation to repay the principal, although if it elects to do so, it will require APRA approval.

Disclosure

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