

## Issuer Profile:

Positive (2)

## Ticker:

WSTP

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# Westpac Banking Corporation

### Recommendation

- Proceedings against Westpac for breaches of the Anti-Money Laundering and Counter-Terrorism Financing Act add to existing challenges for Westpac's credit profile.
- While the imminent and eventual departure of the CEO and Chairman may placate the market for the time being, the medium-term impact is undoubtedly negative in our view.
- The Positive (2) issuer profile remains for now but the situation remains fluid in our view. What may limit the damage somewhat is Westpac's systemic importance in Australia's financial sector which may result in a harsh, yet balanced outcome for Westpac.
- With a destabilizing period ahead, we see better value in other Tier 2 bonds against the WSTP 4.0% '27c22s for both fundamental and technical reasons and remain mindful of call risk based on reset spreads and rising Tier 2 requirements for Australian banks.

### Relative Value

Comparative AT1s	CET1 Ratio	Call date	Reset Spread	Ask Price	Ask Yield	Spread
WSTP 4.0% '27c22s	10.7%	12/08/22	1.540%	103.67	2.58%	118bps
ANZ 3.75% '27c22s	11.4%	23/03/22	1.372%	103.00	2.41%	102bps
NAB 4.15% '28c23s	10.4%	19/05/23	2.030%	104.50	2.78%	137bps
BNP 4.35% '29c24s	12.0%	22/01/24	2.385%	105.27	2.99%	155bps

*Indicative prices as at 26 November 2019 Source: Bloomberg  
CET1 capital ratios based on latest available quarter*

### Background

- Last Wednesday, Westpac acknowledged the [commencement of civil proceedings and receipt of a statement of claim by Australia's financial crimes regulator \('AUSTRAC'\)](#) for alleged systemic breaches under the Anti-Money Laundering and Counter-Terrorism Financing Act. These proceedings relate to Westpac's self-reported failure to report international funds transfers as required under the act.
- Per Westpac's 2019 Annual Report, these transfers occurred between 2009-2018 and were recurring, low value payments through one Westpac Institutional Bank product made to foreign government pension funds and corporates.
- AUSTRAC has applied to the Federal Court of Australia for civil penalty orders against Westpac with AUSTRAC's filings also detailing additional issues related to customer due diligence processes and an ongoing shortfall in implementation measures to address the issues at hand.

### Key Considerations – the three 'Qs'

- **The Quantity of the problem:** Per AUSTRAC's statement of claim, the proceedings relate to Westpac's self-reported failure to report over 23 million international funds transfers worth AUD11bn as required under the Anti-Money Laundering and Counter-Terrorism Financing Act. According to media reports, this is the largest breach of Australia's Anti-Money Laundering and Counter-Terrorism Financing laws and is much larger than Commonwealth Bank of Australia's 53,000 breaches which resulted in AUD700mn in fines. As per AUSTRAC's Concise Statement, each contravention attracts a civil penalty of AUD17-21mn.

- **The Quality of the reactions:** While the numbers are unprecedented, what is more concerning is the nature of the problem. While the majority of the breaches may be limited to just non-reporting of transactions which is serious in itself, a small number of the payments were indicative of payment patterns for child exploitation with AUSTRAC uncovering that transaction parties for these payments have been charged with child exploitation offences. This more than anything has driven the attitude of investors, regulators, politicians and the public and transformed the implications from these breaches to not only financial but reputational. Language used so far has been direct and forceful of the severity of the breaches and the urgent need for accountability. Language used by AUSTRAC was not subtle and referred to multiple layers of serious short comings with a combination of inadequate systems, potential human failure and a possible lack of urgency by management to address the issues resulting in the scale of the breaches. The implication appears to speak to culture and not just process shortcomings. Opinions have since followed from Australia's Prime Minister, Treasurer, Attorney General and Home Affairs Minister that have only added further pressure to Westpac and its management. Amongst them were comments from Attorney-General Christian Porter, who would have to approve any agreed settlement, telling the Australian Financial Review the alleged offenses were "off the charts."
  
- **The Questions being raised:**
  1. What is the size of any potential fine? Considering the quantity of breaches and the quality of them, the fine will likely be material. According to AUSTRAC, the fine per contravention is AUD17-21mn and considering the volume of breaches, the fine is basically limitless right now. Using Commonwealth Bank of Australia's fine of ~AUD13k per breach for AML issues, it still equates to a significantly large fine. The size will ultimately depend on how the board and management moves forward with their response and today's departure of CEO Brian Hartzler and Chairman Lindsay Maxsted's announcement to bring forward his planned 2020 departure to the first half of next year may go some way in limiting the eventual financial impact. The appointment of current CFO Peter King as interim CEO has been met favourably by the market given his reputation and length of service at Westpac which promotes stability.
  2. What are the implications for management? We have already seen the negative impact on the CEO and Chairman but there is an expectation that it may not end there. This is given that these breaches began in 2013, were highlighted by internal compliance in 2016 and only addressed in 2018. The question still remains on who else may also be held accountable and may influence sentiment more than the measures announced by the board late last week to address the issue that included amongst other things the closure of the affected products, improvement to payment screening processes, investment in improving data sharing to fight financial crime, and the establishment of a new financial crime board sub-committee with the financial crime function reporting directly to the Chief Risk Officer. As evidence of this, the announcement of an as yet to be determined independent expert to conduct an accountability review has been met with suggestions that the need for external experts indicates the board do not know where the accountability lies and how to fix it.
  3. What is the impact on fundamentals? Until there is clarity on any fines, the short term impact may be limited. However, there is potential for a long-lasting impact in our view. The scale and substance of these charges are not just limited to breach of Anti-Money Laundering and Counter-Terrorism Financing laws but the potential social consequences of the breaches which could be as damaging to Westpac's reputation as it could be to Westpac's financial condition. This could ultimately lead to a dispersion in underlying fundamentals between Westpac and Australia's other large banks as a potential fine along with a higher cost of doing business may limit Westpac's future capital generation at a time when [APRA is seeking to increase the loss absorbing capacity for Australia's banks](#). Part of the measures announced by the board late last week included the hiring of an additional 200 people to tackle financial crime and during this week, Australia's other regulators (Australian Securities and Investments Commission (securities regulator) and the Australian Prudential Regulation Authority (prudential

regulator)) launched their own investigations which could result in additional fines and penalties under other legislation. Westpac's share price has fallen around 4% since AUSTRAC's announcement continuing its fall through November (down 12%) however while USD senior and sub CDS has widened, it still remains relatively low compared to values over the past five years.

- **Timing could be everything:** The environment appears conducive right now for a long-lasting negative outcome for Westpac. On the one hand, regulators have a higher willingness and capacity to litigate the banks with a scaling up of resources and higher motivation to actively pursue proceedings against Australia's banks in the shadow of the Royal Commission on misconduct in the Banking industry so as to appear to be enforcing and actioning the outcomes of the Royal Commission through litigation rather than negotiation. Conversely, the banks likely have a reduced willingness to contest any charges given current public perception following the recent Royal Commission. Added to this is the language and contents of AUSTRAC's claims as well as recent statements by senior politicians which effectively forces the court to act forcefully. All these developments highlight the higher scrutiny being placed on Australia's big banks by both regulators and the public. What may limit the impact somewhat is Westpac's systemic importance in Australia's financial sector, its position as the third largest bank by total assets and the government's supportive stance to the sector. This could mean a harsh, yet balanced outcome for Westpac. All up, Westpac is expected to go through a destabilizing period which adds onto already known profitability pressures from lower interest rates, potentially lower credit demand and hence heightened competition as well as pressure on operating costs from other customer remediation and compliance expenses and likely higher technology expenditure. There may also be mounting focus on other banks, both in Australia and abroad with Citibank also indirectly mentioned as a transactional counterparty to the breaches. Citibank however is not named and not under investigation by AUSTRAC for these proceedings.

#### Recent Reports on UBS Group AG from OCBC Credit Research

- [Asian Credit Daily \(26 November 2019\)](#)
- [Asian Credit Daily \(25 November 2019\)](#)
- [Asian Credit Daily \(20 November 2019\)](#)
- [Asian Credit Daily \(4 November 2019\)](#)
- [Asian Credit Daily \(24 October 2019\)](#)

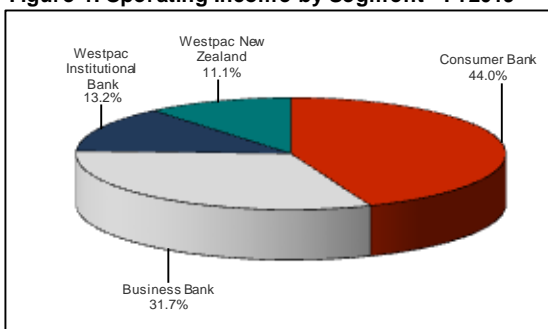
## Westpac Banking Corporation

Table 1: Summary Financials

Year Ended 30th Sep	FY2017	FY2018	FY2019
<b>Income Statement (AUD'mn)</b>			
Net Interest Income	15,516	16,505	16,907
Non Interest Income	6,286	5,502	3,742
Operating Expenses	9,434	9,566	10,106
Pre-Provision Operating Profit	12,368	12,441	10,543
Provisions	853	710	794
Other Income/(Expenses)	0	0	0
PBT	11,515	11,731	9,749
Income Taxes	3,518	3,632	2,959
Net Income to Common Shareholders	7,990	8,095	6,784
<b>Balance Sheet (AUD'mn)</b>			
Total Assets	851,875	879,592	906,626
Total Loans (net)	684,919	709,690	714,770
Total Loans (gross)	687,785	712,504	718,378
Total Allowances	2,866	2,814	3,608
Total NPLs	1,542	1,416	1,763
Total Liabilities	790,533	815,019	841,119
Total Deposits	533,591	559,285	563,247
Total Equity	61,342	64,573	65,507
<b>Key Ratios</b>			
NIM	2.06%	2.13%	2.12%
Cost-income Ratio	43.3%	43.8%	48.9%
LDR	128.4%	126.9%	126.9%
NPL Ratio	0.22%	0.20%	0.25%
Allowance/NPLs	185.9%	198.7%	204.7%
Credit Costs	0.12%	0.10%	0.11%
Equity/Assets	7.20%	7.34%	7.23%
CETier 1 Ratio (Full)	10.6%	10.6%	10.7%
Tier 1 Ratio	12.7%	12.8%	12.8%
Total CAR	14.8%	14.7%	15.6%
ROE	13.77%	13.10%	10.65%
ROA	0.92%	0.92%	0.96%

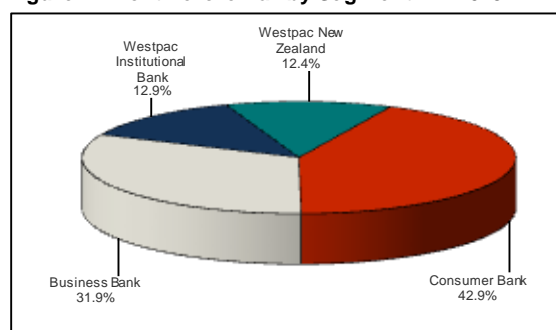
Source: Company

Figure 1: Operating Income by Segment - FY2019



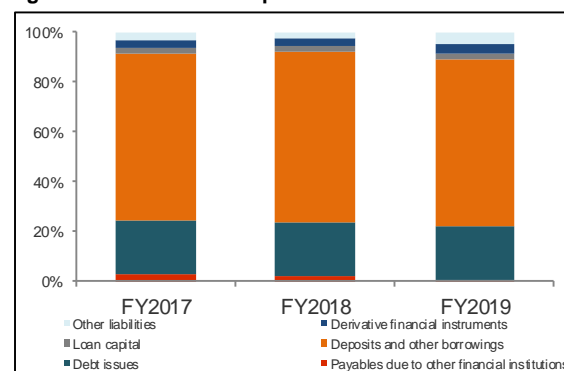
Source: Company | Excludes Group Business

Figure 2: Profit Before Tax by Segment - FY2019



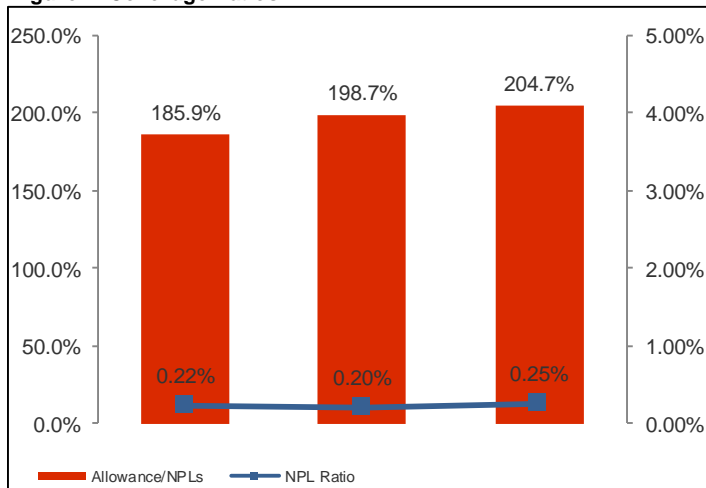
Source: Company | Excludes Group Business

Figure 3: Liabilities Composition



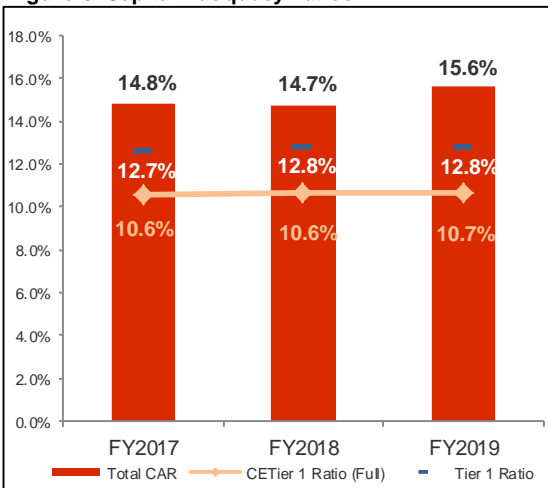
Source: Company

Figure 4: Coverage Ratios



Source: Company, OCBC estimates

Figure 5: Capital Adequacy Ratios



Source: Company

### Explanation of Issuer Profile Rating / Issuer Profile Score

**Positive (“Pos”)** – The issuer’s credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

**Neutral (“N”)** – The issuer’s credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

**Negative (“Neg”)** – The issuer’s credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

**Please note that Bond Recommendations are dependent on a bond’s price, underlying risk free rates and an implied credit spread that reflects the strength of the issuer’s credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.**

### Explanation of Bond Recommendation

**Overweight (“OW”)** – The performance of the issuer’s specific bond is expected to outperform the issuer’s other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

**Neutral (“N”)** – The performance of the issuer’s specific bond is expected to perform in line with the issuer’s other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

**Underweight (“UW”)** – The performance of the issuer’s specific bond is expected to underperform the issuer’s other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

### Other

**Suspension** – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

**Withdrawal (“WD”)** – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

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#### Analyst Declaration

The analyst(s) who wrote this report and/or her or his respective connected persons did not hold financial interests in the above-mentioned issuer or company as at the time of the publication of this report.

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