UBS Conference

Current issues in Financial Management

June 2005

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Australia and New Zealand Banking Group Limited

Current issues in financial management

- Cost of capital
- Measuring performance
  - IFRS
  - EVA
- Approach to acquisitions
- Potential credit issues

A quick recap on the first half – a solid result

Cash EPS*	85.9c	↑	8.9%
NPAT*	$1,492m	↑	13.7%
Interim dividend	51c	↑	8.5%
Net non-accruals	$326m	↓	37%
Net specific provisions	$151m	↓	23%

And

FY05 cash EPS growth likely to be modestly ahead of 8% target

Scorecard

Volume Growth	✓ ✓
Interest Margin	✓
Non Int. Income	X
Expenses	✓
Provisions	✓ ✓
Tax	✓
Cash EPS	✓ ✓

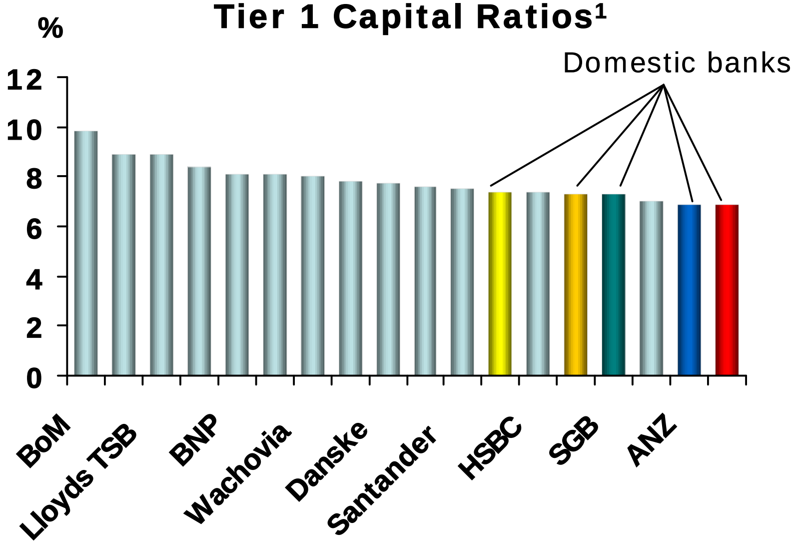
✓ ✓ - Ahead of expectations
✓ - In line with expectations
X – Below expectations

*excluding NZ incremental integration costs and significant items

Capital levels in Australian banks – the "Goldilocks conundrum"

Too little?

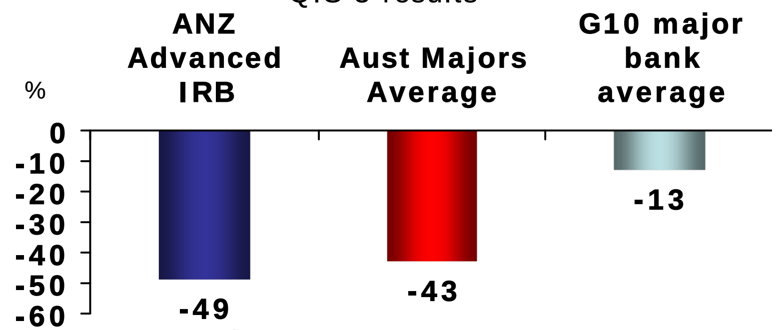
Tier 1 Capital Ratios[1]



Too much?

Change in RWA under Basel II[2]

QIS 3 results



Based on current calculations, implies capital ratios would effectively double under Basel II

Reality

About right!

(but bordering on conservative)

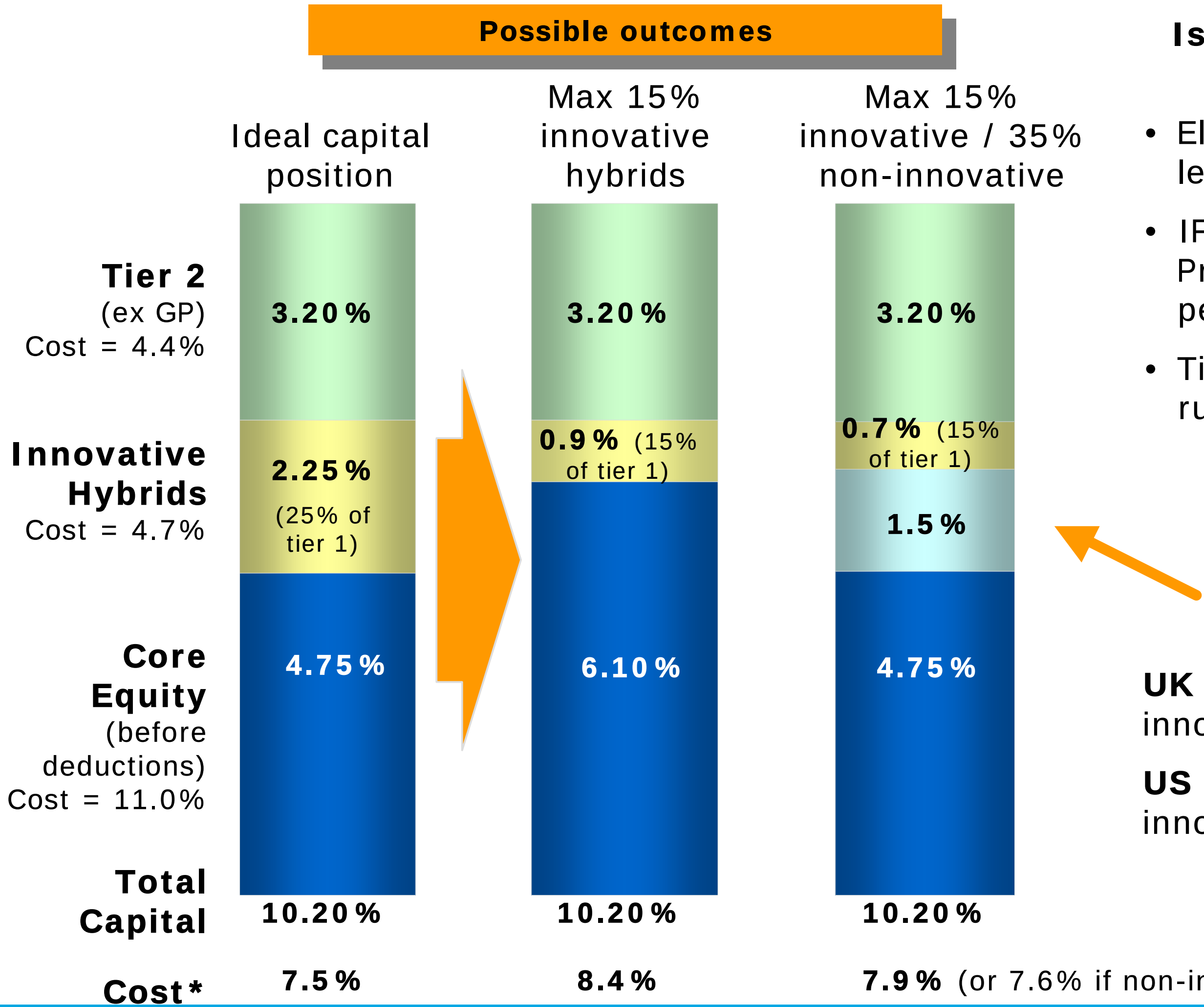
Of only ~30 banks globally with AA category credit rating, **4** are in Australia

1 *Source - Deutsche*

2 *RWA calculations were performed using the capital functions used in QIS 3.0 These may change upon the finalisation of Basel II*

ANZ NOW

Changes to Hybrid rules should include provision for non-innovative instruments



Issues being considered by APRA

- Eligibility of hybrids (types, levels)
- IFRS impacts (Collective Provisions, EMVONA, pensions)
- Tier 1 capital measurement rules

Non-innovative Hybrids

Offshore position

UK – allow up to 50% non-innovative hybrids

US – allow up to 50% non-innovative hybrids

Note: Core equity and innovative hybrids are generally non-tax deductible. Cost is on an after tax basis

Measuring performance under IFRS

Key points

- No change to ANZ's underlying business
- Increased earnings volatility likely under IFRS, driven predominantly by:
  - Provisioning
  - Hedging
- Volatility means very specific guidance no longer possible
- No change in substance of dividend policy, form of policy will need to take into account higher IFRS driven earnings volatility
- First IFRS reporting period for ANZ Group will be six months to 31 March 2006
  - NZ GDS for 3 months to 31 December 2005 will be under IFRS
- IFRS impacts will be clearly disclosed to assist investors in understanding underlying performance

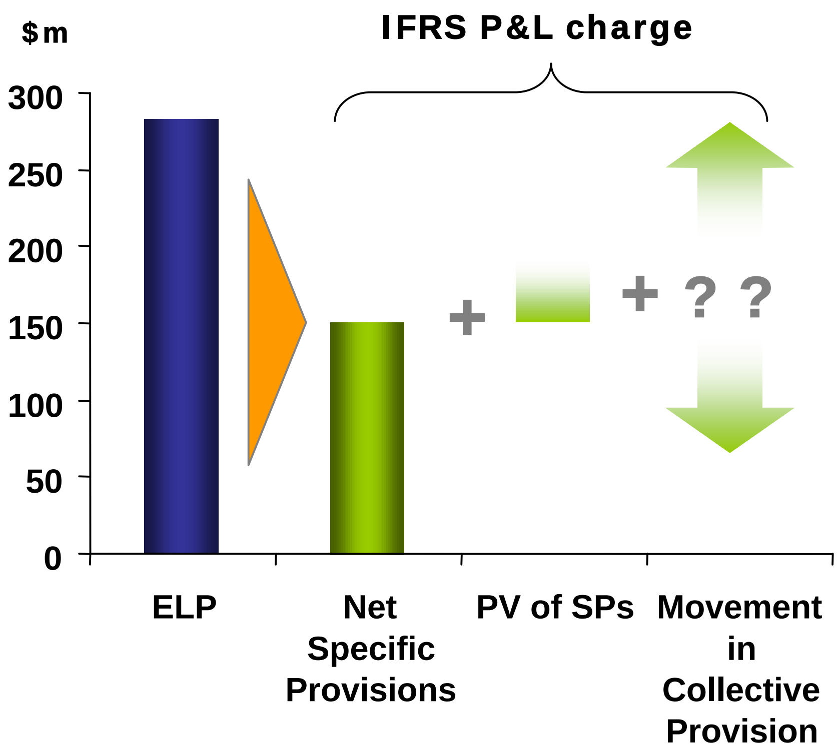
Impact of IFRS on cash EPS

Key Areas	Cash EPS impact	Potential full year impact
Goodwill	n/a	• Goodwill no longer amortised in PAT, no impact on Cash EPS unless there is 'impairment'
Fee Revenue	Small decrease	• Amortisation of fees has small impact on Cash EPS. With fees growing, this slightly lowers (lags) income in each period
Hybrids	n/a	• StEPS reclassified as debt and approximately $60m as interest expense. Impacts PAT only as already 'expensed' in Cash EPS
Share Based Payments	Small decrease	• Recognition of expense for share scheme incentives increases expenses by ~ $50m (<2% Cash EPS)
Financial instruments	Small decrease	• Allowing for bid/offer and credit spread is immaterial
Special Purpose Vehicles	Nil	• Impact of recognition of SPV's for securitisation expected to be immaterial
Hedging	"nil" (volatility)	• Impact uncertain – 'ineffectiveness' of economic hedging disclosed separately to allow this to be backed out of Cash EPS
Post Employment Benefits	n/a	• Movements in defined benefit scheme likely to be booked through Retained Earnings
Provisioning	+ / -	• Specific provisions and movements in Collective Provision charged direct to P&L driving increased earnings volatility

Credit Provisioning greatest area of uncertainty

Significant changes to credit loss provisioning methodology

Based on 1H05



- ELP will be replaced by a charge for:
  - Movements in Specific Provisions (SP),
  - Plus/minus a charge for movements in the Collective Provisions
- SP's determined individually for large loans and on portfolio basis for 'retail' loans
- SP's reflect the loan carrying amount less PV of expected future cash flows.
- All loans not specifically provided for are collectively assessed
- Collective Provisions replaces current general provision, however expected to be smaller on transition
- Collective Provision function of change in:
  - Portfolio size
  - Portfolio mix
  - Risk & cycle outlook

Financial management requires an arsenal of measures – no one measure is enough

EVA^{TM} a powerful management tool, but important to understand limitations

Some key qualities of performance management tools	EVA	NPAT	EPS
Reflects across the cycle credit losses	✓	✗ IFRS	✗ IFRS
Incorporate cost of capital proportional to risk	✓	✗	✗
Recognise benefits of imputation credits	✓	✗	✗
Generally accepted methodology	✓	✓	✓
Takes into account dilution	✓	✗	✓
Encourage longer term decision making	✗	✗	✗
Useful in pricing tools	✓	✓	✗

Important to understand limitations of EVA

- Can encourage growth in low risk, but low ROA categories – important to acknowledge boundary conditions – in particular inability to leverage up very low risk assets at a Group level
- Can encourage short term focus – needs to be balanced with longer term overlay, and/or long term incentive program

High level of acquisition discipline

Our starting point

- Organic growth fundamentally more attractive
  - Generally less costly and lower risk
  - Easiest way is to be positioned in growth areas (products or regions)
- <u>But</u> – attractive opportunities may arise which are capable of generating value for our shareholders (eg NBNZ)
  - It is in shareholders interests that we <u>look</u> at such opportunities

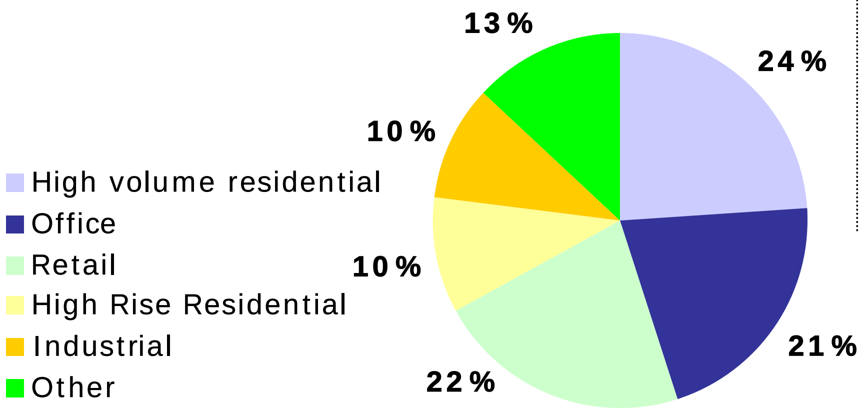
Current position

- Domestic opportunities limited
  - At current prices plus a premium, difficult to establish plausible business case for any domestic bank acquisitions
  - Insurance outside our area of expertise
- Continue to look at small opportunities within Asia/Pacific
  - Low cost option plays
  - Focus on targets where we can add value
  - Continue to be very disciplined

Potential risks we are watching carefully

	Why are we watching?	Current position
Auto sector	Potential upstream impacts from financial difficulties at GM & Ford	• Ford & GM have strong cash positions, but urgent remedial action needed • Component manufacturers tied to fortunes of car makers - small exposure for ANZ
Commercial Property#	Construction costs increasing, development site values falling, spike in settlements over next 12 months	• Total commercial property lending at 8.1% of portfolio, within 10% cap, and relatively constant since Sep-03 • Only one third of commercial property exposure relates to 'development' • Portfolio well secured, with 85% of exposures having security values above loan amount • ~62% of med-high rise residential development lending has >100% pre-sale coverage. A further ~17% has >80% pre-sale coverage. • Underlying demand for ~165,000 pa new residences supports residential market

Real Estate Operators & Developers Lending Purpose*

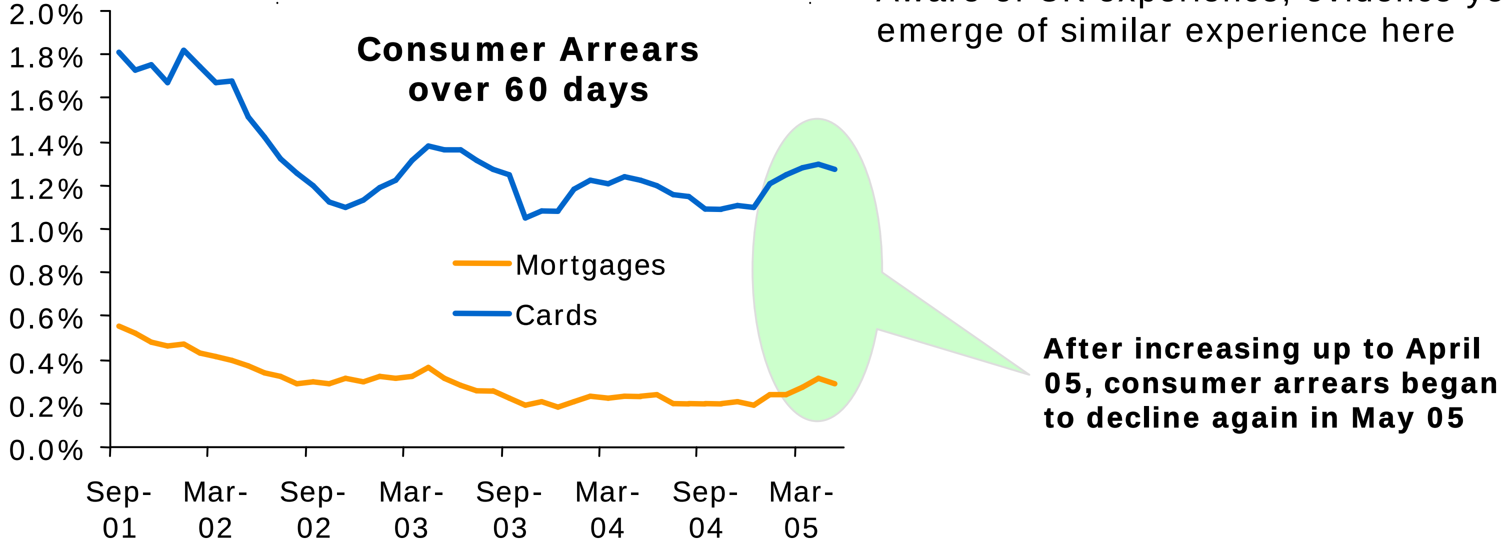


Commercial property refers to lending to Real Estate Operators and Developers – ie excludes lending to consumers

* For Corporate and Institutional Banking in Australia

Potential risks we are watching carefully

	Why are we watching?	Current position
Rural Lending	Impact of drought	• Recent rains have helped significantly • Agri represents ~6% of portfolio, although ~68% of this is in NZ, which has not suffered drought conditions
Consumer Lending	High level of consumer indebtedness by historical standards	• Continuing low unemployment • Interest rates not likely to rise materially • Arrears still well below historical norms • Aware of UK experience, evidence yet to emerge of similar experience here



Summary

- Solid first half, no change in FY05 guidance
- Changes to APRA capital requirements could have a substantial impact on Australian banks
- Introduction of IFRS will add volatility to reported earnings, with no change to underlying cash flows
- ANZ adopts strong financial management disciplines
- High level of acquisition discipline
- Vigilant with respect to potential risk areas

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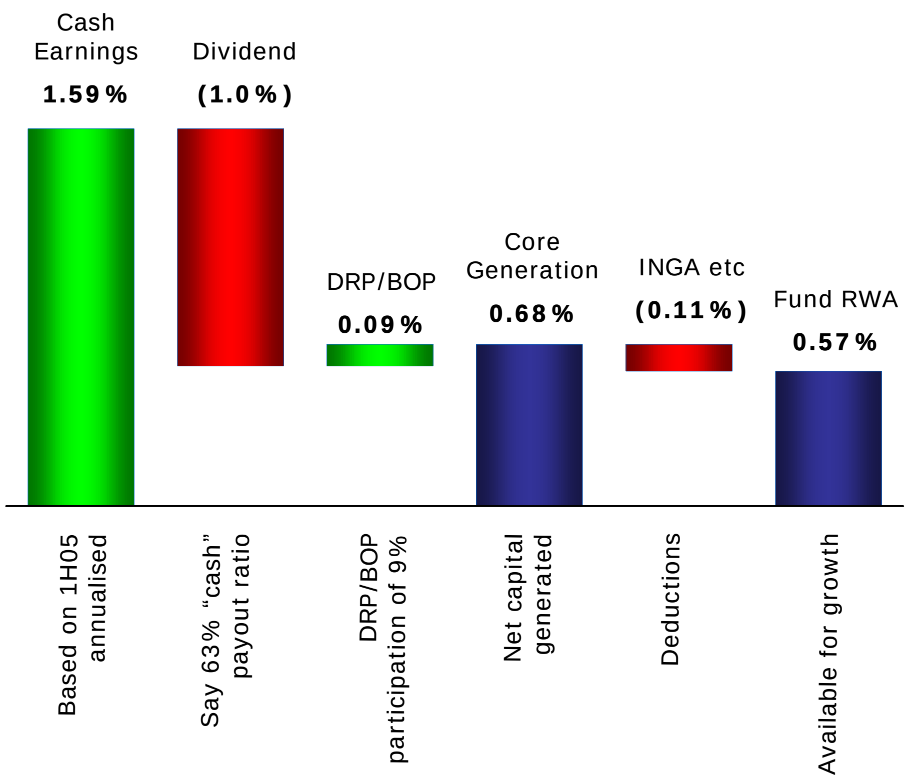
Additional Slides

APRA changes to Hybrid rules could reduce organic funding capacity

Capital Generation & Usage % of RWA



Capital ratio			
RWA growth	ACE mid point 4.75%	15% hybrids 6.09%	0% hybrids 7.00%
7%	0.33%	0.43%	0.49%
8%	0.38%	0.49%	0.56%
9%	0.43%	0.55%	0.63%
10%	0.48%	0.61%	0.70%
11%	0.52%	0.67%	0.77%
12%	0.57%	0.73%	0.84%
13%	0.62%	0.79%	0.91%

Options available for capital generation

- Non innovative hybrids as allowed in other jurisdictions (subject to APRA)
- Uncapped DRP
- Securitisation
- Capital raisings

Implementation of IFRS and Basel II in Australia

- IFRS and Basel 2 are international standards, adopted by countries who wish to further integrate their financial systems into the global market
- Adoption of 'amended' global rules could result in competitive disadvantage for Australian banks – on some issues, there continues to be global diversity rather than global consistency
- Potential adverse outcomes if capital rules vary from those applying to competitors
- Less profitable banks could be encouraged to take greater risks
- Regulators can change capital ratios in response to specific conditions (eg, country economics, bank specific conditions) – this enables the rules for capital to be globally consistent, while enabling the local regulator to respond to local concerns in setting capital levels

Provisioning post IFRS

IFRS Component	Current Equivalent	Balance Sheet Provision	Profit and Loss Impact
Individual provisions	Specific Provision	1	Δ1 = New provisions *(including those provided for and written off in the same period)* ***add*** increases in existing provisions ***less*** write-backs & recoveries
Collective Provisions - long-term historic performance - economic cycle adjustment - model risk and scenario modelling adjustments	ELP less specific provisions	2	Δ2 = Current Period Collective Provision ***less*** Prior Period Collective Provision
TOTAL		**1 + 2**	**Δ1 + Δ2**

Comparison to ELP

	ELP	IFRS
Losses included	• Average one year loss expected to be incurred if the same loan portfolio was held over an economic cycle	• Losses inherent within the Group's existing loan portfolio including: – specifically identified losses on individually significant loans and on a portfolio basis – presently unidentified impaired loans, provision collectively assessed • Collectively assessed losses are based on long term historic portfolio performance adjusted to account for: – current market conditions – model risk & scenario modelling
Discount Rate	• Internal funding rate	• Original Effective Interest Rate (OEIR)
Credit provision on undrawn commitments	• Includes average one year loss on expected drawdowns if the same portfolio was held over an economic cycle	• Includes loss on expected drawdowns over the remaining life of the facility

Determining the Collective Provision

- Collective Provision held for presently unidentified impaired assets
- Period between when event causing impairment occurs, and when impairment identified by lender, is referred to as “emergence period”
- Emergence periods will vary according to the type of loan, and are typically around 18 months
- Methodology for calculating Collective Provision considers all credit exposures for which no SP has been made
- Collective evaluation groups loans according to similar characteristics, such as credit grade, industry, geography
- Collective Provision represents an interim step, made prior to identification of loss on individual asset
- Collective Provision is calculated based on historic loss experience of the portfolio, adjusted for current market conditions (economic cycle adjustments), model risk and scenario modelling
- Movements in Collective Provision will be directionally consistent with leading indicators of credit cycle

Collective Provision treatment in balance sheet

- Excludes provisions for identified impairment - these are specific provisions, and assessed either on an individual or a portfolio basis.
- Basel: a general loan loss reserve, held against presently unidentified losses is eligible for inclusion in Tier 2
- FSA: general/Collective Provisions that a company holds in reserve against losses that have not yet been identified eligible for inclusion in Tier 2
- APRA: draft paper proposed that Collective Provision be ineligible for inclusion in Tier 2; and that a un-distributable reserve, equivalent to the current required minimum general provision, be created from Tier 1 retained earnings to offset
- Constructive dialogue being held with APRA

Net interest margins under IFRS

Reported net interest margin (NIM) is likely to increase slightly under IFRS

IFRS NIM → $\dfrac{\text{Interest earned} - \text{i paid} + \text{yield} + \text{unwind} - \text{StEPS}}{\text{AGAAP IEA} + \text{bills}}$

=

Existing NIM

+

Amortised fee income

+

Impaired assets unwind

-

StEPS distribution reported as interest expense

+

Impact of including Bills in interest earning assets

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