Question and Answer

Melanie Kirk
Head of Investor Relations

[Operator Instructions] We'll take now take our first question from Jon Mott.

Jonathan Mott
UBS Investment Bank, Research Division

Jon Mott from UBS. You talked about a simpler, better bank. But when you look it, the cost base is still $10.5 billion, which it's been growing very rapidly for a number of years. If you exclude the divestments and demergers, which you've called out, obviously, that number's going to change, and you'll provide numbers going forward. And then you do call out on Slide 5, it's the first time we're seeing cost reduction being called out as an actual target. What are we talking about here? Is there a number that you can think about? How far down do you need to get the cost base? And how should we benchmark you on cost reduction?

Matthew Comyn
CEO, MD & Executive Director

Yes, look, obviously, medium, long term, right-sizing the cost base is going to be really important, particularly for the competitive context, which undoubtedly will shift. I think we have to be realistic about what level of cost reduction we'll achieve in the near term. We've called out the $155 million in one-off costs. We've said the underlying $199 million is in the cost base. We called out an investment cost of $1.34 billion. That mix is about 50% regulatory and compliance. We expect, a, that those costs will remain elevated; b, that mix will be about right. And as we deliver both the response to the Prudential Inquiry as well as just strengthen our management of customer and risk outcomes, we do expect to be able to take cost out of the organization. Clearly, that needs to be a focus. I think, again, in the near term, some of the simplification will deliver the majority of those benefits. And then looking forward, we certainly see opportunities around automation, distribution more broadly and really across simplifying in terms of the way the organization works, making it easier to get stuff done.

Jonathan Mott
UBS Investment Bank, Research Division

It's more of a medium-term view, your cost-out?

Matthew Comyn
CEO, MD & Executive Director

Yes. I think it's realistic to assume that there's going to be more cost-out opportunities over the medium term. We expect investment to remain elevated certainly in this financial year, and we do see some benefits that will flow from just some of the simplification and decisions that we're making.

Melanie Kirk
Head of Investor Relations

Great. We'll take the next question from Jarrod Martin.

Jarrod Martin
Crédit Suisse AG, Research Division

Jarrod Martin from Crédit Suisse. Just a question on margins and, in particular, on Slide 20. Is the best way to read this -- you said that the basis risk for every 5 basis points elevated, it's 1 basis point of group NIM. But if I just eyeball that chart, looks to be circa 30 basis points up on where it was earlier this year. And on the previous chart, you've called out 2 basis points from basis risk, which implies 10 of the 30. So if it remains at the current level, is that another 4 basis points of group NIM decline? Is that the best way to read it? Is that -- from a mathematical perspective?

Matthew Comyn
CEO, MD & Executive Director

Yes, I mean, I'll let Alan talk to it as well. I mean the first half, that basis risk was, it's a rolling average over that period, 22 basis points. We see it at 33 in the second half. It's spotting today at about 46. So if you do the maths on that, you can sort of calculate through. I think broadly, your calculation is right.

Alan Docherty
Chief Financial Officer

Yes. I mean, there's a lot of daily volatility, as you know, and that spot basis risk number, I think taking a 3-month rolling average, that's certainly how we look at it. But that's a key sensitivity for us.

Melanie Kirk
Head of Investor Relations

Great. We'll take our next question from Andrew Lyons.

Andrew Lyons
Goldman Sachs Group Inc., Research Division

Andrew Lyons from Goldman. Just a question on the underlying momentum in the business half-over-half. Your preprovision operating profit growth, ex the one-offs that you've called out, was down 7% half-over-half. Even adjusting for the $80 million of hedge restructuring costs and the $51 million of software impairments, half-over-half preprovision operating profit growth was down about 6%. Again, you've talked about some NIM pressures, which we've highlighted, you're still growing below system in mortgages. I guess just in that environment, can you perhaps talk about some of the levers that you can potentially pull to reinvigorate growth in the franchise into FY '19?

Matthew Comyn
CEO, MD & Executive Director

Yes, I mean, because of a number of the factors that you mentioned and another one I'm sure you sometimes get sick of hearing it, but there are 3 fewer days in the second half, so it's worth about $150 million in revenue. The hedge restructure that you mentioned, the impact on basis risk premium and compression on margins, we're calling out as well, certainly, a weaker markets revenue than we'd seen. And we'd certainly -- that will be an area of focus going forward. I'd say both from the Retail Bank's perspective and, look, we've been prepared to grow below system and we're always trying to make the right decisions between pricing for risk as much as getting the volume balance right. That remains a key area of focus. And we saw better momentum in the second half from a commercial lending perspective in our Business and Private Bank which is offset, of course, by the reduction in credit risk-weighted assets in the institutional bank. So I guess it's a combination of a number of those levers, trying to get those settings right to make sure we're delivering the optimal returns.

Melanie Kirk
Head of Investor Relations

Great. We'll take the question from Richard Wiles.

Richard E. Wiles
Morgan Stanley, Research Division

Rich Wiles, Morgan Stanley. So housing loan growth slowed in 2018, largely due to the restrictions on interest-only lending. But on Slide 85, you've outlined 8 ways in which you've tightened lending standards during the 2018 year. I would assume that we haven't seen the full impact of that tightening. So how much do you expect housing loan growth to slow in 2019, particularly given the new restrictions around debt to income and also what you've done on income and expense verification?

Matthew Comyn
CEO, MD & Executive Director

Yes. Look, we're expecting, and I'm sure we'll be precisely incorrect, but we're expecting about 4% credit growth in home lending. I mean, consistent with the remarks from the Chair of APRA, we see the majority of the tightening work is being done, certainly, at the margin and the application of some of those policy changes, there's, certainly, some potential. You mentioned around debt to income, we've included some disclosure in the results today in terms of loan to income. So anything above 4.5 practically we're watching closely. But that flow has been coming down. We certainly don't see any big policy adjustments on the horizon. So we feel like that 4% credit growth, given what we're seeing at the moment in the system, is about right and, of course, it would be a function of outperformance against that system.

Melanie Kirk
Head of Investor Relations

Great. We'll move over to this side of the room and take a question from James Ellis.

James Ellis
BofA Merrill Lynch, Research Division

James Ellis from Merrill Lynch. Can I ask a question in relation to operating cost in slightly different way? So in the second half, the operating cost growth of 4%, that was matched by a 3% increase in the FTE headcount over the same period. So if you think about operating cost going forward, would it be fair to say that a lot of the cost in the second half are pretty much baked in, acknowledging there were some additional capitalized software write-downs which won't occur and that, longer term, these productivity initiatives you get to work on but at least from what we have seen in this result, would it be fair to say second half cost base is pretty much baked in?

Matthew Comyn
CEO, MD & Executive Director

Yes. Look, as we said earlier, we called out the $155 million in one-off. That $199 million that we're seeing on an ongoing basis, a lot of that relates to our investments in regulatory and compliance, particularly around financial crime. That's a big driver of the FTE increase in that second half. We would expect those numbers to remain elevated. But certainly, not the growth of that -- anything like that level of increase. We also see a pickup generally in the second half versus the first half, particularly in terms of just resources associated with projects. And we do have a number of regulatory and compliance projects underway, and that's a function of what you see in our disclosures of higher overall investment spend.

Melanie Kirk
Head of Investor Relations

We'll take the next question from Victor.

Victor German
Macquarie Research

Victor German from Macquarie. 2 questions, if I may. The first one on the 90-day past due. So Alan, you've pointed out that there's been an increase, and persistent increase albeit from lower levels, in terms of housing arrears. Historically, that has been a potential leading indicator, a potential deterioration in credit quality. Just be interested in your observations in terms of how systemic and potential impact on that. And secondly, I know there's been a few questions on the costs already, but I just wanted to maybe have another go. I guess -- we've seen a reasonable increase in FTE numbers, but FTE expense has been pretty flat. So I'm assuming there's been some potential adjustments to short-term incentive pool sort of given some challenges this year. As we go into next year, if performance improves, I'm assuming that will potentially be one of the offsetting factors. But from a medium-term perspective, I'm mindful of the fact that, Matt, you've mentioned that you want to reinvest some of compliance spend to innovation projects. You've never really felt that you've been under-investing in the past. Just if you can elaborate on sort of what exactly you mean by that, that would be very handy.

Matthew Comyn
CEO, MD & Executive Director

Sure. Why don't I let Alan take the cost question, I'll start with home loan arrears. So really 3 factors that we're calling out. The first is just lower growth and so, obviously, it has a denominator effect. We called out pockets of stress, particularly in WA and Northern Territory. And you can see that in the disclosures, a real [pick up] there. I think we're still seeing weakness in WA, less so in mining towns, more so in sort of out of metro and regional areas. We'd like to think that that's stabilized. And then the third factor is we have seen an uptick as customers switch from interest-only on to principal and interest. But what we're seeing consistently certainly to date is with those interest-only cohorts, after a period of time, actually adjust to the new repayment amount and actually fall in line with the performance of the overall cohort. Just maybe one other factor just to call out is we've been looking at that and part of that, of course, is making sure that we're communicating clearly and well in advance to our customers, so we're now writing out them 12 months in advance of that switch. And as we've broken down our book, 79% of customers who are coming to the end of an interest-only period actually have the option to be able to extend by at least 1 year. And so that means they're well inside the maximum 5 year on owner-occupied or the 10-year interest-only period on investor. So I thought maybe that's an additional piece of information worth sharing. But I do think that, that distribution and adjustment is probably smoother than perhaps some people would have otherwise anticipated.

Alan Docherty
Chief Financial Officer

Yes. On cost, yes, you've seen the detail of the operating expense disclosure, there's a reduction, as well as the bonus reduction was also an impact on unvested shares as we announced a few weeks ago. And so you'll see a reduction in the share-based payments expense as well as the bonus reduction. And so all being well in a normal year, you would expect some mean reversion around those line items. On investment spend, for many years, we've had gross investment spend levels of around $1.2 billion. We're now in the $1.3 billion. The proportion of risk and compliance spend, as we've talked about, is elevated and is likely to remain elevated. And you know that our risk and compliance costs tend to have a much higher expense rate relative to productivity and growth initiatives. So I think that combination of elevated growth spend and a lower level of capitalization consistent with the current year is something to expect in the near term.

Melanie Kirk
Head of Investor Relations

We'll take our next question from Andrew Triggs.

Andrew Triggs
JP Morgan Chase & Co, Research Division

It's Andrew Triggs from JPMorgan. Just a couple of questions sort of related to margins. Firstly, on deposits. While you called out an improved retail deposit metrics for the year, for the half, it looked like RBS deposits were flat. We've also noticed that the APRA stats in recent months have seen quite a slowdown in deposits. Just your thoughts on what's happening in the system, whether that's any concern because, obviously, we need to see some deposit spread improvement to help offset some of the asset spread pressures. And then the second question, just any observations you've seen in the home loan market around discounting since some of the smaller banks repriced, please?

Matthew Comyn
CEO, MD & Executive Director

Yes. The second question is easier to answer. I mean pretty intense levels of competition in the home lending market. Look, going back to deposits more broadly, I'd say, I mean, a couple of things, if I broke down our volume performance over the year, it was certainly weaker in the first half but largely associated with 2 months where there was some expensive term deposits that were running off. And so when you adjust for that, basically, we've been flat through the course of the year or there or thereabouts to system. I think it was a standout performance in terms of new transaction accounts, obviously, something we watch very closely. Overall, we've made some pricing decisions more recently, which are being covered on our deposit pricing. As you mentioned, that's one of the ways that we can manage overall margin, notwithstanding there will be compression that will come through from elevated basis risk premium that we discussed earlier.

Melanie Kirk
Head of Investor Relations

We'll take the next question from Brian Johnson.

Brian D. Johnson
CLSA Limited, Research Division

Brian Johnson, CLSA. Two questions if I may. Overnight index swap bad. It's a very illiquid market. What you can see at the moment is a 90-day bank bill rate that's getting better, getting materially better. But the overnight index swap is still elevated, why continue using the overnight index swap at all was the first one. And then the second one is that when we actually have a look at Commonwealth Bank's access to the CLF, it's actually lower than Westpac's despite the fact that you've got more stable deposits. I'm just wondering next month, I would imagine you will find out but probably not tell us straight away what the CLF will be for next year. Could we get a feeling for what is your thoughts on getting more CLF and the capacity to run down the balance sheet liquidity going forward in a relative sense compared to your peers?

Alan Docherty
Chief Financial Officer

Yes. I'll maybe take the CLF component of that question first, Brian, and come back to bills-OIS. The CLF, as you know, we make an annual application to the reserve bank as do all other banks in the industry. The reserve bank will make that determination based on their view of liquidity in the Australian market. We'll be advised of that, and we'll update the market in the next half year result around our level of CLF. On bills-OIS...

Brian D. Johnson
CLSA Limited, Research Division

Are you asking for more, though?

Alan Docherty
Chief Financial Officer

Well, we've made an application, and that's then going to be subject to a determination by the Reserve Bank of Australia.

Brian D. Johnson
CLSA Limited, Research Division

Do you think you'd get your fair share, though?

Alan Docherty
Chief Financial Officer

We make an application every year based on a view of the forecast net cash outflows and our proposed mix of liquid assets, and we're very happy to...

Brian D. Johnson
CLSA Limited, Research Division

Well, sorry to be pointed about this...

Melanie Kirk
Head of Investor Relations

Just wait for the microphone, Brian.

Brian D. Johnson

CLSA Limited, Research Division

But if [you're filling an application] and you're not getting your fair share then, obviously, you're not applying for enough. I'm just trying to get a feeling, is there a positive opportunity there or not?

Alan Docherty
Chief Financial Officer

I mean, you've seen an increase in the CLF in the last financial year, following our application there. We've taken the opportunity through managing our net cash outflows and also that lengthening of the long-term funding that you've seen. You've seen that resulted in a large decrease in net cash outflows and the opportunity to reduce the level of liquid assets held as a numerator while still increasing the liquidity coverage ratio, so we'll continue to use all the levers at our disposal in order to optimize that liquidity coverage ratio as efficiently as possible. On the basis risk question, I mean, we've seen, really coming out of the quarter-end, real elevation in that basis risk level. There isn't a great deal we can do to hedge away that risk. That's a feature of the landscape for the moment. It is really a manifestation of global excess liquidity and that search for yield. And we've seen a lot of foreign banks, offshore investors look for yielding Australian dollar assets and hedge their cross-currency basis risk through short-term Aussie dollar funding. I don't think that feature of the landscape's going to go away anytime soon, so we're closely watching that. But given that's the benchmark rate for all banks funding, there's no real way of escaping the implications of that basis spread.

Melanie Kirk
Head of Investor Relations

We'll take the next question from Brendan.

Brendan Sproules
Citigroup Inc, Research Division

It's Brendan Sproules from Citigroup. I just have 2 questions. Firstly, just on the NIM. To what extent -- the higher New Zealand NIM and also the lower institutional lending, which were positives for the NIM this period, to what extent will they continue into FY '19? And my second question is just on the IB&M division. Obviously, you've reduced the credit risk-weighted assets pretty substantially over the last couple of years. To what extent does that impact your ability to collect trading revenue, especially for hedging for these customers? And secondly, will there be a material reduction in the FTEs that work in that division?

Matthew Comyn
CEO, MD & Executive Director

So why don't I start? I'll answer the institutional question, and I'll hand back to Alan on NIM. Yes, look, there's been a focus on return on risk-weighted assets, and that's seen us reduced our risk-weighted assets overall. Of course, the institutional team is very mindful of making sure that we're retaining the key relationships and making sure that we're getting all of the adjacent opportunities to serve those customers. I think it's fair to say that across all of our businesses, in line with one of the strategic capabilities I called out around cost reduction, we will look for opportunities to make sure that we have optimized ourselves from both a footprint as well as number of FTE that are optimally there to better serve our customers to be able to make sure that we're able to in our priority markets and priority segments and with a particular focus on customers in our home market that we're appropriately set up to be able to do that.

Alan Docherty
Chief Financial Officer

And on the margin point, so aside from -- the institutional lending is, obviously, a function of the reduced exposures and a lower margin segment and that's led to that favorable mix effect, which you can see primarily over the second half of the financial year. On the New Zealand margins, we've seen and you've seen the detail of the divisional profit announcement disclosures from New Zealand. We've seen a lower level of fixed rate home loan breaks, which caused some margin losses, if you like, or depressed margin in the prior period. And so the sort of absence of that level of breaks in the current period has been the main reason for the rebound in margin there in the 6 months.

Melanie Kirk
Head of Investor Relations

We'll now move to the phones. We'll take a call from Azib Khan at Morgans.

Azib Khan
Morgans Financial Limited, Research Division

So a couple of questions on the IB&M division and then 1 question on IFS. On IB&M, so look here, you've reduced your risk-weighted assets by $13 billion in the last year. A fair chunk of that was just in the last quarter. How much more RWA runoff do you anticipate as a result of your optimization initiatives? A second question on IB&M is you've obviously impaired the $51 million of capitalized software because you're bringing in a new institutional lending platform. What will be different about the new platform? And the third question is on IFS. So you've announced the sale of TymeDigital this morning. My understanding is that some of the digital banking capability that was developed by Tyme was being rolled out into your Indonesian and Indian banking operations. So by selling the Tyme business, will you be less committed to your Asian banking operations going forward?

Matthew Comyn
CEO, MD & Executive Director

So why don't I take each of those in turn? So look, on credit risk-weighted assets, as you mentioned, look, that will continue to be a focus going forward. I certainly wouldn't like to provide expectations about that. But the team lead by Andrew now will make sure that's optimized going forward. The $51 million impairment to the institutional lending system, effectively, we made a decision that the system that was in the process of being implemented was not fit-for-purpose, and so we -- it required us to implement a new system which, therefore, triggered the impairment of that $51 million of intangible. And then from an Asian perspective, you shouldn't draw that conclusion. Without going through all of the specifics of the agreement that we're in the process of finalizing with our partner, we will retain the rights to the intellectual property in Indonesia, and we'll remain committed to Indonesia. We've already announced previously an exit of India, of our branch there. That is not a priority market for us. But in Indonesia, in the context of our banking business in PTBC, where we've been there for more than 25 years and we've implemented some of the technology and moving towards more of a digital service offering, that remains a priority for us.

Melanie Kirk
Head of Investor Relations

Great. We'll take another question from Richard Wiles.

Richard E. Wiles
Morgan Stanley, Research Division

Rich Wiles, Morgan Stanley. On Slide 10, you split profit into your core businesses, and the businesses that you intend to demerge or are under review. You're going to lose $250 million of earnings from your life insurance sale. You'll lose $550 million plus from the demerger. So basically there's 7.5% of your earnings that you won't have in the future. Should we expect you to cut the Commonwealth Bank Group dividend by 7.5% to reflect that loss of earnings?

Matthew Comyn
CEO, MD & Executive Director

The 7.5%, the 92.5% that will remain generates the predominance of the organic capital for the organization. I think what you should conclude is there's no change that we're intending to make to our overall dividend policy, which has been in place for many years. It sees us for that an interim of around 70%, which we've had in place, I think, since 2012 and a target range between 70% and 80% throughout that time.

Richard E. Wiles
Morgan Stanley, Research Division

Yes. But if you keep the payout ratio at 75%, it will be 75% on a lesser earnings base, which means the dividend gets cut or that ratio is the same but the dividend gets cut.

Matthew Comyn
CEO, MD & Executive Director

Of course, that depends on a number of different assumptions in terms of the actual performance at that particular point in time. And within that payout range, without going into forecast or projections about what the dividend is, that will be a decision that the board will take at that point in time.

Melanie Kirk
Head of Investor Relations

We'll take a question from Anthony.

Anthony Hoo
Deutsche Bank AG, Research Division

Anthony Hoo from Deutsche Bank. Just a question on the APRA op risk surcharge. Would you be able to give an update on the milestones that you still need to achieve in terms of time frame as well around removing the op risk surcharge?

Matthew Comyn
CEO, MD & Executive Director

Well, as I said earlier, we put in our plan, which APRA has endorsed. I mean it's a multiyear plan, but we certainly intend to make substantial progress over the next 12 months. It's incumbent on us to be able to demonstrate that progress to APRA. And at the appropriate time where we feel like we have a demonstrable amount of progress, we will then make an application for a review of the capital.

Anthony Hoo
Deutsche Bank AG, Research Division

When you said a demonstrable progress, does that mean that progress has to be completed at end of the multiyear period? Or you have to demonstrate you're making good progress and have confidence that you can get to the endpoint but you don't have to get to the end of what is 3 years, 5 years or whatever it is?

Matthew Comyn
CEO, MD & Executive Director

Yes. There's a provision in the Enforceable Undertaking which enables a partial capital reduction, so it's not contingent on full completion of the program. But of course, it is contingent on us being able to demonstrate a significant progress, which is what we are working to do. And at that time, we will then look to make an application and have a discussion with APRA.

Melanie Kirk
Head of Investor Relations

We'll take the next question from Brett.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

Brett Le Mesurier from Shaw and Partners. One of the few bits of good news in your margin in the second half was the business and corporate loans. The average interest rate on that went up by 25 basis points from the first half to the second half. To what extent have the actions that you've taken in the second half been reflected in the 25 points? And to what extent do those actions lead to a further increase in that margin in 2019 financial year?

Alan Docherty
Chief Financial Officer

Yes. The yield increase that you're seeing there, Brett, that's largely a function of the mix change within that line item. So as we've reduced the amount of institutional lending exposures, the mix between those exposures and the rest of the corporate exposures, including the Business and Private bank, give you a favorability in both yield and in NIM.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

Yes. But that mix occurred during the period, right? So by the time you get to the end of the period, that has all taken effect. So you would think that there's something more to come, I was wondering what that would be. Because you didn't make that change at the start of the period.

Alan Docherty
Chief Financial Officer

Yes, for sure. The last quarter, you've seen the reduction in the credit risk-weighted assets as we've disclosed. There will be some flow-on effect into the next financial year.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

Yes. But I was wondering what that increase was.

Alan Docherty
Chief Financial Officer

We don't give guidance at that level of detail, Brett.

Melanie Kirk
Head of Investor Relations

We'll take another question from Brian.

Brian D. Johnson
CLSA Limited, Research Division

Three really quick questions, which you'll be able to answer really quickly. Slide 119, $67.1 billion of online savings -- online deposits. Could we get that split out between the net saver, the GoalSaver and the business bank account because you've changed the price on some of those? The second one is that Commonwealth Bank is a little bit different in that you're providing upfront for the project expenses. I'm sensing that, that will continue that you're expecting more projects going forward. But at some point, you'd think reasonably that they disappear. I'd just be wondering when you think we'd get to this, the end of the forward provisioning on the projects. And then the final one, Matt, when we have a look deep down of what Commonwealth Bank is, your bank makes a hell of a lot of money out of lending on very high ROE home loans in Australia. Can we just get a feeling on the front book price of the home loan right now in this new kind of funding dynamic? Is it still well north of the overall group ROE? And is effectively the strategy about increasing the proportion of the group earnings coming from that? So the deposit split-up, the housing profitability and the project cost.

Matthew Comyn
CEO, MD & Executive Director

Yes. So I was waiting for the list of questions from you, Brian. Maybe David never answered. I thought cost of capital might be on there. I could break out the split of deposits, but I'm not going to. In the context of expenditure on projects, look, I mean, our policy around that is consistent. The regulatory compliance projects get expensed. [Where we see] that there's going to be value created in future periods, then there's capitalization alongside that. And again, I don't really want to be drawn into what the return on equity is currently on mortgages. I mean, they remain a profitable product. In the context of Australian banking, there is intense competition. And as we've seen in various periods, I think the last time, probably 2 years ago, a combination of both elevated basis risk and intense competition saw the reduction in front-book margins quite substantially. So it's contingent, actually, on our overall context of both the input cost from a funding perspective and the competitive intensity. But clearly, for our core franchise, making sure that we're meeting one of their most important decisions and their needs in terms of the context of buying a home is a critical priority for us going forward.

Melanie Kirk
Head of Investor Relations
Fantastic. That now brings us to the end of this briefing. If you have any follow-up, please contact the IR team, but thank you for joining us today.