Question and Answer

Unknown Analyst

It's [indiscernible] from Bell Potter. BOQ has made a good business out of cherry picking the major banks. With a lot of credit unions now trying to become banks, is there a danger of being squeezed in the middle? I mean, is there a danger of them cherry picking you guys around this time?

Ewan Cameron
Former Chief Financial Officer

Look, I think it's fair to say, to date, we still don't see the credit unions or even other regional banks directly competing with us. The majors are still our sweet spot. Customers disaffected with majors continues at a sort of a steady to increasing rate, especially when you consider the pricing advantages that the majors had, despite that, they continue to bleed. So I think it's fair to say the smaller players can feed off the elephants for quite a while yet.

Ben Koo
Goldman Sachs JBWere Pty Ltd, Research Division

It's Ben Koo from Goldman Sachs. Nice to be visiting up here for the first time. Just quickly on the ROE comments that you made and your outlook for that, can you just give a sense -- I was just looking back at that slide where you actually talked to the different business units. And what's a little bit just trying to reconcile in my mind is that you've got here for the businesses like Equipment Finance and the St. Andrew's piece, you've talked about how that's already fully paid back capital that's deployed there, yet the ROE targets for those businesses suggest that it's much higher with the current run rate. And also I want to get a sense of the Banking business as well because the exit margin I'm guessing is higher than what the half was given you paid back the Government Guaranteed Debt now. I just want to get a bit more color around sort of the 4 trends of the Banking business as well?

Ram Kangatharan
Former Chief Operating Officer

Let me the answer the ROE piece and flick you to Ewan for that last part. Now with respect to the ROE, remember, the acquired component of BOQ Finance is CIT. This ROE target is for BOQ Finance, which includes the Equipment Finance division as well as the Debtor Finance piece, which was previously part of Banking. So when you do your ROE comparisons, that's why the acquired businesses are hitting that 35% ROE but when you look at this, the average of that is not going to be 35%, right, it's because of that dilutionary effect of Equipment Finance and Debtor coming into that. In terms of how these divisions are performing right now, we're actually expecting the Insurance ROE to drop from its current levels to that 25% because of the growth profile. So we recognize that right now, we're experience some very extraordinary profits in that division. But as we grow, we wouldn't expect to hold that very high ROE levels. And with BOQ Finance, we closed the financial year '11 results with the 3 divisions or 3 components, which is CIT, Equipment Finance and Debtor Finance together producing a 15% ROE. And as we grow, we expect to maintain that.

Ben Koo
Goldman Sachs JBWere Pty Ltd, Research Division

So the Debtor Finance, that must be then barely making cost of capital right now if the new businesses are blending out, is that right?

Ram Kangatharan
Former Chief Operating Officer

Debtor Finance is very small. The asset base on that is about, I think, $130 million, $120 million? And that's very high ROE business for us. And it's actually performing very well. Equipment Finance if you remember, and if you look back at the financial year '10 results, you'll see that it took a quite a steep dive in returns in financial year '10 because of the delinquency issues that we had, which is why we repositioned that business in financial year '11 and that's involved signing up all of our brokers, 250 brokers onto new agreements, which is also then part of the explanation for the negative $220 million growth in that segment.

Ben Koo
Goldman Sachs JBWere Pty Ltd, Research Division

And just on the Retail bank?

Ram Kangatharan
Former Chief Operating Officer

In terms of our Retail bank, we do expect bad debts to normalize but not back to the 15 to 20 basis points of GLA that we guided back in financial year '09. Our expectation now would be more in the 20 to 25 basis points sort of range out to 2014, and that's really a key driver. And in addition to that, there's the push on low cost sticky deposits to lower the cost of funding and very moderate growth around the 6% sort of mark.

Ben Koo
Goldman Sachs JBWere Pty Ltd, Research Division

Then your exit margin was probably higher than your second half margin because of the Government Guaranteed Debt that was paid off, is that right in your forward thinking?

Ewan Cameron
Former Chief Financial Officer

That's probably down a little bit a couple of basis points just because of the impact of the nonperforming loans over the full half. And then also recently, the impact of the yield curve on the term deposit rates 3 to 6-month deposit rates have put up margins for the recent term deposits over August, since August. Like issuing to 3- to 6-month term deposit have been quite expensive. And so our margin is trailing slightly to 165 at the current point in time. But we do repay $500 million of Government Guaranteed Debt in 2 weeks' time, and that's going to have a positive impact. If we bring it back up, that will also drive down liquidity. We're sitting on excess liquidity right now in order to be able to redeem that. So that will also improve the NIM. And then we're expecting or hoping that retail deposits spreads will start to improve. Certainly there's a lot of speculation around that in the press this week. So we're looking at taking action there to improve our overall NIM.

Charlie Green
Hunter Green Institutional Broking Pty Ltd.

It's Charlie Green here from Hunter Green. Just couldn't find an update on the asset action against your Storm litigation or the OMB activity. Is that being dealt with? Is that history now or is it still ongoing?

Ram Kangatharan
Former Chief Operating Officer

Charlie, look, there is no resolution of the matter but equally, there is nothing new to report. The position that we laid out at the last half is unchanged. These things, as you can expect, they'll take time to sort of meander through.

Charlie Green
Hunter Green Institutional Broking Pty Ltd.

How much time do you think?

Ram Kangatharan
Former Chief Operating Officer

I wish I knew. But our position is unchanged.

Operator

The next question comes from the line of Wes Nason from Citi.

Wes Nason
Citigroup Inc, Research Division

Couple of questions, if I could. I guess, firstly, just a broad question on credit quality. The second half charge is probably a little higher than most people anticipated and you've got arrears as you mentioned, still high, relatively stable for the last quarter or so and of course, the impaired loans. How confident are you that you're going to see material whip-down in the charge in the next half? I know your not giving guidance at this stage, but I just want to get a sense about how you're feeling about the...

Ram Kangatharan
Former Chief Operating Officer

I'll kick it off and let Ewan finish it off. In terms of the guidance for the second half, I think it's fair to say, at the time we gave the guidance, we'd just taken the flood provisions, and there was a $32.5 million balance outstanding at the end of that first half. So in terms of the guidance, it would have included an assumption that as the flood-affected losses came through, that we would work off that overlay. We made the decision not to do that, so we actually preserved the full $32.5 million. But reallocate it to different parts of the collective provision, as Ewan walked through in one of his slides. So that's the guidance piece. In terms of it coming down, look, we're maintaining a cautious outlook, at least until the first half, expecting that run rate in the second half to continue. But obviously, with hope for better.

Ewan Cameron
Former Chief Financial Officer

Nothing really major to add. I think as long as arrears are high, we're concerned about bad debt trends and we wouldn't expect it to reduce rapidly from the level it's at right now. But as we see that recent trend continue, I think we'll start to feel little bit more confident about bad debt coming down. And certainly, if you look at their performance in a year, where a year ago we talked about how we'd increase our focus on collections and it's really paid off this year. We're hoping that that's going to continue in the retail and commercial book over the next 6 to 12 months.

Wes Nason
Citigroup Inc, Research Division

Just one other quick one, if I could. Slide 19, you've got better funding mix and then you've got retail up to 52% and you're targeting 50% number. I mean, what is your view, clearly, where you've got funding is a significant companion of what [indiscernible] are thinking about demand. Do you think that 60% number might be sufficient to put you guys down in a mix for a potential adjustment in the credit rating?

Ram Kangatharan
Former Chief Operating Officer

Yes, Wes, I think what Ewan said was, look, it's strategically important we get to that 60%. When actually look at the mix of retail funding required to fund our growth, we're actually funding more than 100% of our growth with Retail. And with respect to rating agencies, I think the progress that we've shown should be more than sufficient to allay any concerns, because I think they were actually expecting those trends to go the opposite way. So I believe that the progress we've made, if we can continue that, it's going to be viewed favorably.

Operator

The next question comes from the line of Ben Zucker from CBA Equity.

Ben Zucker
Commonwealth Bank of Australia, Research Division

I just want to do a space follow up around that funding issue as well, which obviously ties a lot to margin. And your comment, Ewan, that you made around some of the press and the like. I mean, there's a lot of focus on deposit pricing and I guess I'm just trying to understand, with your goal to get up toward 60% Retail deposit funded, do you see a much flexibility in terms of your pricing policies attracting those deposits?

Ewan Cameron
Former Chief Financial Officer

Well, we are priced above the general market in order to attract the growth because it's been a priority for us to increase that share. And so we anticipate that we'll have to continue to do that over the coming year, paying 10 basis points more than the majors. But our anticipation is that the majors will start to reduce and you already can see some of those trends and several analysts are reporting that over the last couple of weeks. And so as they come down, we'll come down relative to where we are as well.

Ben Zucker
Commonwealth Bank of Australia, Research Division

And in terms of other offerings, online accounts and things like that, I mean what are your thoughts around pricing for that?

Ewan Cameron
Former Chief Financial Officer

We've seen the specials come off. Certainly, we've reduced our rates, the special rates. Our strategy has been to keep that online saver account levels where it's at then actually throughout the year. On a dollar basis, it didn't grow. It didn't shrink, but didn't grow. And all the growth in Retail deposits have come from term deposits, which is a little bit more expensive but it's also more sticky, also helps our net stable funding ratio, which right now based on our interpretation, the guidelines is sitting in the 90s. It's unfortunate that just with the dislocation of the markets and the inversion of the yield curve over August and September, that has ended up being a lot more expensive and it's impacted our short-term NIM. But we think that will correct and having that in term deposit provides the opportunity to start to develop and grow that relationship with the customer and the branch network and there's -- we put in place, over the last year, incentives to do that, so that hopefully we can take that term deposit and turn it into a broader banking relationship and make it a little bit more sticky going forward.

Ben Zucker
Commonwealth Bank of Australia, Research Division

And so on the other side, when you think about line pricing and competition, in some of the comments that were made earlier about what you are and are not participating in. Is that a source of concern to you as well in terms of managing margin going forward? Or how do you think about the asset pricing side here?

Ram Kangatharan
Former Chief Operating Officer

Look, clearly, the industry as a whole, I don't think is going to opt for margin squeezes. So I think you can expect the pricing competition on mortgages to reflect a more normalizing retail and wholesale funding cost scenario. But in terms of where we are not participating, I think we can be competitive on pricing, and you'll see us responding to market conditions with specials, et cetera. That's not an issue. Where the market, I think, is headed, especially with some of the majors announcing for instance LVR increases, et cetera, that's probably the sorts of things that we would not be participating in given what we see as potentially a fairly subdued economic outlook.

Operator

Our next question comes from the line of Victor German from Nomura.

Victor German

Nomura Securities Co. Ltd., Research Division

My question relates to Slide 10 of your presentation on capital and liquidity. I think more or less all banks globally have now started talking on to their Basel III numbers on both of those measures. And today, you've highlighted that you still believe you have excess liquidity. Can you just update us on how those measures might look on the new Basel III requirements as outlined by APRA recently?

Ewan Cameron
Former Chief Financial Officer

Sure. The 2 main adjustments that we expect to impact our capital position are the change in treatment of the dividend. We expect that will increase our overall capital position by 10, 11 basis points. And then the treatment of the investments, the 50-50 move into 100% Tier 1 deduction will reduce Tier 1 by approximately 20 basis points but have no impact in overall capital. So net-net, core Tier 1, Tier 1 will drop by 10, overall capital will increase by 10. On the LCR, given our interpretation of where we think the standards are going to come out and the guidelines aren't going to be released apparently until November. Under the assumption that we'll be able to use the RBA facility, our anticipation is that LCR would currently be in the mid-80s and that stable funding ratio would be in high 90s. But obviously, that's open to review in November.

Victor German
Nomura Securities Co. Ltd., Research Division

So on LCR requirements, how much extra liquidity do you think you will need other than your own?

Ewan Cameron
Former Chief Financial Officer

We haven't calculated that, Victor.

Victor German
Nomura Securities Co. Ltd., Research Division

But then assuming it's going to be higher than your current liquidity position?

Ewan Cameron
Former Chief Financial Officer

Well, potentially, it's more of a mix issue. It just means you have to think about where you put your liquidity, what sort of our instruments, because our liquidity is fairly high and we maintain it higher than everyone else currently.

Victor German
Nomura Securities Co. Ltd., Research Division

And just on the results field, I've noticed that your other income has increased, other banking income, has increase in this half quite substantially. Could you just highlight to us what's driving that increase?

Ewan Cameron
Former Chief Financial Officer

In other income, it's the strong trading performance driven by the excess liquidity we've been carrying. We have carried significant excess liquidity throughout the half, building up to the $555 million repayment or buyback and then we're holding excess liquidity later on for the repayment in October.

Victor German
Nomura Securities Co. Ltd., Research Division

So the $10 million additional revenue impact in other income line is driven by trading, is it?

Ewan Cameron
Former Chief Financial Officer

And mark to markets, yes.

Victor German
Nomura Securities Co. Ltd., Research Division

And we should expected that to reverse in the next half?

Ewan Cameron
Former Chief Financial Officer

I think it was a strong performance. It is quite variable if you look half-and-half, for the last couple of years, is up and down. I think you probably need to take a 2-year, 3-year average for that line.

Operator

Your next question comes from the line of Jon Mott from UBS.

Jonathan Mott
UBS Investment Bank, Research Division

Just 2 quick questions. The first one I'm following on for Victor as before. You mentioned you've been carrying a bit of excess liquids but you'll need those to meet the LCR. Does that mean that you won't be able to continue to run down liquids to fund potential rollout of the Government Guaranteed Debt if the markets remain challenged? And second question is relating to a comment you made on the collective provision. With the collective provision being flat during the half, just by the obvious big increase in 90 days past due, you mentioned apart from the overlays still the change in methodology. Can you elaborate on that change in methodology?

Ewan Cameron
Former Chief Financial Officer

Sure, yes. The rundown on the liquids, I think, I guess, are -- the LCR changes are along several years off and we'll wait on the guidelines before we really say too much about that. In terms of the government guarantee or long-term debt repayments over the coming couple of years, we've got $1 billion next year, that's over a year from today. Depending on our performance in retail deposits, we may look to strategically repay some of that early. Otherwise, we will hold excess liquidity in anticipation of that maturity. And then the next major maturity is a year after that for $675 million, I think, is the outstanding. So we think they're very manageable given we typically carry about $1 billion over the prudential requirements in HQLA at any point in time.

Ram Kangatharan
Former Chief Operating Officer

Jon, I think there's plenty of time before the regulations kick in. And for us, all of our government maturities are inside of that period. So I think we play it by ear. If the opportunity is there, we'll take it.

Jonathan Mott
UBS Investment Bank, Research Division

So really, to that, credit growth remain very benign and deposit growth remain very strong?

Ram Kangatharan
Former Chief Operating Officer

Yes, Jon. I think we don't necessarily think that we're going to be affected by the system flows as much, if you like, because we're such a small player within that. I think what we have proven is that we can effectively compete for deposits. And we also now are increasingly turning our network disciplines towards retaining and growing deposits, in particular, those low costs and stickies. So I think we're gaining greater and greater confidence independent of whatever happens in terms of the larger system flows.

Jonathan Mott
UBS Investment Bank, Research Division

And in terms of methodology that's a fit?

Ewan Cameron
Former Chief Financial Officer

Sure, we've increased or we revised PDs and LGDs that feed into that model. And on the commercial side, we based the collective coverage based on loan quality ratings that we make internally. And we introduce a coverage on better quality loans that would previously not have had any collective coverage and now have coverage. Their loans obviously aren't substandard, but we decided to introduce a coverage of those.

Ram Kangatharan
Former Chief Operating Officer

And Jon, I think Ewan slated out pretty well on Slide 27. If you look at that $32.5 million flood provision that we had at the end of the first half, roughly $18 million went into those product methodology changes, $13 million as property overlay, and I think there's another $2 million still left in the general flood related.

Operator

Your next question comes from the line of David Shi from Morgan Stanley.

David Shi

I have a question with that, the credit quality, the leasing book. In Slide 50, you showed that the leasing have actually up from about $16 million to $28 million. That's about $0.08 up the half and also the SME side was 130, 2 basis points up the portfolio. Can you just provide some commentary regarding what was the main cause of this and also what's the outlook maybe [indiscernible] going forward?

Ewan Cameron
Former Chief Financial Officer

Sure. Yes, obviously, as we reduced arrears, a large proportion of that reduction in arrears comes through the asset management activity to repossess and then sell the underlying collateral. When a loan is in arrears, typically it has up to about 50%, 60% -- when it's in the collective, it has a range about a 25% coverage. When it moves to the specific, typically our loss rates on individual assets increase about 50%. And so as loans are being repossessed, they'll come out of arrears and go into impaired, hence, the increase in impaired over the half is going from $16 million to $28 million. So there's been quite a lot of activity. That's driven the reduction in arrears but it's increased the specific bad debt expense but also offsetting that has reduced the collective provision by $8 million as loans have moved through that process. And so the impaired are relatively high compared to where they were 6 months ago, but that reflects higher repossession or closure activity on those troubled accounts. And you need to look at the specific expense in conjunction with the reduction of the collective. And that's why we put in that set of metrics, the total BDD expense which you can see has dropped from 1.5% a year ago to 60 basis points, which is truly the bad debt performance in the leasing portfolio over the half which is pretty good.

David Shi

In that case, I mean, when do you actively lease back the impaired state?

Ewan Cameron
Former Chief Financial Officer

The impaireds turn over pretty fast in Equipment Finance like it's a 2- to 3-month activity which is very -- it's different from your bigger-ticket commercial accounts, which underlying property can take several months to sell. This stuff tends to be trucks, buses, cars that will go through auctioneer and be sold relatively quickly. So I would expect that the impaired balance come down pretty fast.

Ram Kangatharan
Former Chief Operating Officer

Don't forget, this is a really short-tailed business. Usually, 90 days is a best indicator of what's to come. That's turned down pretty dramatically. You'd expect that to flow through very quickly.

Ewan Cameron
Former Chief Financial Officer

Yes. The reality is like we had doubled the size of this team a year ago. And so over the year, the speed of which they are turning over and dealing with challenged accounts has increased as the amount of arrears has fallen. A year ago, we're sitting on $50 million of exposures over 90 days. At the end of the year, we're setting out with just over $15 million over 90 days. And so that $15 million will be dealt with faster given that we haven't downsized the team.

David Shi

And then, I mean, since a bumpy -- I mean, with that bond, I mean, next for the exit bond, when do you see [indiscernible] the arrears, it has an exit provision against bonds. Do you expect the total BDD transport [indiscernible] to activate the process through 50 basis points or 100?

Ram Kangatharan
Former Chief Operating Officer

This is an area where it's fairly sensitive to the economic cycle. I think the guidance that we've given in the past is we expect to kind of improve the cycle norm in this segment to be around 50, 55. So that's a not an unrealistic number that you've just put up.

Ewan Cameron
Former Chief Financial Officer

I think somewhere between 50 and 100 is a reasonable estimate for next year.

Operator

Your final question comes from the line of from Brett Le Mesurier from BBY.

Brett Le Mesurier
Axiome Equities

A couple of simple questions. What's the average maturity of your wholesale funding?

Ewan Cameron
Former Chief Financial Officer

2.4 -- right about 2.4 years.

Brett Le Mesurier
Axiome Equities

So it doesn't change very much over...

Ewan Cameron
Former Chief Financial Officer

No.

Brett Le Mesurier
Axiome Equities

And then secondly the level of the impaired hasn't really changed much in the -- with respect to the less than $5 million exposures. I presume a good chunk of them coming through the commercial portfolio, possibly more than through the Leasing portfolio, would that be correct?

Ram Kangatharan
Former Chief Operating Officer

Absolutely. When we're talking order of magnitude, right? The impaireds leasing is 28 at Slide 50 where we just went through.

Ewan Cameron
Former Chief Financial Officer

Yes, that has been probably about 20% from leasing. Housing, I've seen an increase in the rest, would be Commercial and you probably picked that up from some of the trends there.

Brett Le Mesurier
Axiome Equities

Right. So you said that you tied your credit floor in to the leasing portfolio. I didn't hear whether or not you've done that for the commercial portfolio as well.

Ram Kangatharan
Former Chief Operating Officer

Yes, Brett. So with leasing portfolio, we said in financial year '10 that we were taking specific steps with respect to certain security types, et cetera, and that's all done. And we've also resigned 250 brokers on new agreements where it's not just a volume-based, incentive-based contract, it's actually also incorporates asset quality metrics. With respect to our commercial portfolio, we have put a large focus on not increasing dramatically the large exposures of our new customers in that property segment. And you can see that in the results. Our property exposures, we've actually proactively run off where we've felt uncomfortable. So it's a combination of both appetite in that segment but also proactively moving some of the exposures.

Brett Le Mesurier
Axiome Equities

What was the proportion of the commercial portfolio that was represented by property?

Ram Kangatharan
Former Chief Operating Officer

I think you got the chart in one of the Ewan slides. Slide -- you're making me do your work.

Ewan Cameron
Former Chief Financial Officer

It's just under 50%.

Brett Le Mesurier
Axiome Equities

Right. So we can expect that to contract?

Ram Kangatharan
Former Chief Operating Officer

Yes. Okay, I think we're up on our time. Is there any questions outstanding or...

Caroline Dunworth Daffy
Former Head of Corporate Affairs

No.

Ram Kangatharan
Former Chief Operating Officer
Okay. So I'm sorry, we're done. Please call Ewan if you've got any difficult questions. And thanks very much for coming -- attending this call. Thanks very much. Cheers.