Question and Answer

Andrew Bowden
Head of Investor Relations

Okay. I think I saw Victor's hand up first, so we'll start off there. We'll just keep it to a couple of questions, Victor, won't we?

Victor German
Macquarie Research

All right. I'll just start with one. Just interested in your thoughts around the macro prudential changes, particularly around interest only. As you highlighted, you're in mid-40s, even though flows is -- in that product is slowing, which is good. But see, with 30% limit, given your exposure or you'll be awaiting to invest this segment, which is traditionally higher interest-only component, how do you think those changes will flow through to Westpac? And will it have a bigger adverse impact relative to peers?

Brian Charles Hartzer
MD, CEO & Director

Well, the starting point, Victor, is that, if you think about the drivers of why the regulators are focusing on this, I think it's important to remember, the governor of the Reserve Bank really clarified this last week, that the main concern is about, in the event of higher interest rates, in the event of challenges to economic growth, how do we make sure that consumers have the flexibility to spend? So it's more about the impact of consumer spending on economic growth than it is about the quality of the balance sheet. So from a risk point of view, we feel quite comfortable. The actions that we've taken on restructuring the way we price the different loans -- loan categories has already had an effect. As Peter said, we're already getting pretty close to the 30% flow level that's required based on the most recent application volume, so we're comfortable we can get there. We -- I equate this to the investment property growth cap that we faced last year. We had similar questions, we got there. I'm confident we'll get there on this one as well. In terms of the impact on us, I think we'll have to see. But if you bear in mind, it's not really about a different product, it's really about a feature of the loan that gets written. And that's going to be a consistent tilt across the market. So it's not obvious to me why there would be any significant impact on us out of it that would be disproportionate.

Victor German
Macquarie Research

So you think you'd be able to grow broadly in line with system?

Peter Francis King
Chief Financial Officer

Yes, Victor, the only other point I'd make is a lot of the behavior in interest only, when you look at the product with the offset that most people take, is they actually look like P&I loans for a big part of the portfolio. So I think what we're going to see is the market will move to more P&I, and there's less choice for customers in the market is the end result. So I actually think we'll probably see a little bit of a slowdown in offset account growth, which -- partly funds the -- what happens in terms of market dynamics. And just to give you a stat, already like 1/4 of the IPL book is principal and interests, so it's not like that whole book is interest only, So we do -- but we do have a lot of behavior the -- on the interest-only ones that look like P&I.

Andrew Bowden
Head of Investor Relations

Jon?

Jonathan Mott

UBS Investment Bank, Research Division

Jon Mott from UBS. Just a question, and I think you kind of go through it in Slide 23, which is the bad debt charges held pretty low because you had some good write-backs and recoveries coming through. With a lot of money flowing around now and credit spreads coming in, a lot of people trying to chase distressed debt, do you think this would be an ongoing feature, where you can continue to exit a lot of the -- what you have left of your impaired assets to hold that charge low? Or is this kind of a one-off period where you just had a couple of good exits? And I think you called out New Zealand. And if this doesn't repeat, you'd expect that impairment charge to start bouncing back from here?

Peter Francis King
Chief Financial Officer

Yes, well, I think certainly, we are seeing some companies still being able to either raise equity or refinance, and that's given a good outcome from our perspective, and when we saw that again in the half, particularly with that New Zealand exposure. We see opportunities, I think, all the time. So I think interest rates are still low. There's still plenty of cash in the world, so there's opportunities. I say all the time that they'll probably reduce over time, but there's nothing that says they won't continue for a little while longer, I think. And so it really depend on customer-by-customer situations and whether the buyers can see value in the particular assets.

Brian Charles Hartzer
MD, CEO & Director

This may be a gratuitous comment, but the fact that the book is so clean that a couple of names here and there can move the percentages, I think, really emphasizes the point that Peter is making, as it tends to be about an individual situation and not an overall portfolio, just because the stock of these things is so small.

Andrew Bowden
Head of Investor Relations

Andrew?

Andrew Triggs
Deutsche Bank AG, Research Division

It's Andrew Triggs from Deutsche Bank. Just a question on the margin slide, the waterfall chart. Just perhaps your thoughts on why deposit spread pressure was a little bit more than you saw at the peers. You mentioned very strong growth in term deposits, but that was -- term deposit pricing was a feature -- or repricing was a feature of all banks late last year. And just a follow-up then on some of the sort of future trajectories, some of those bars in the waterfall chart, please, around, yes, whether deposits are still a drag next half or actually tailwind. And also, what's going on in terms of short term with U.S. commercial credit spreads having appeared to turn quite a bit?

Peter Francis King
Chief Financial Officer

Yes. So on the customer deposits, the 3/4 of that move was term deposits. We had a lot of customers take that 1 year, 3% offer, so that was -- and so I think we had more than peers. So that's predominantly the reason that our trend is a little bit different, I think. So that means August, September, October type time is when they tend to run off. So probably later in the half, more in next half, should market rates stay where they are. Then on wholesale funding, I think you're right, the -- our U.S. CP spreads are down, but that's a 12-month issuance, so it takes a while for that to flow through. Unsecured spreads have been pretty good. But one of the things I highlighted was we've done more Tier 1 and Tier 2 issuance in the last 12 months. For Tier 1, it's the full period impact to something we did last half; and Tier 2, we've just been steadily building that ratio. So the ratio is where we needed to be now, so it's just a matter of rolling the book. So as usual in wholesale funding, lots of moving bits.

Andrew Triggs

Deutsche Bank AG, Research Division

Okay. Can I just ask a follow-up on S&P's RAC ratio, where do you think you are today? With the very capital performance, do you think you're above the 10%? And do you think that's a metric that APRA will pay much attention to?

Peter Francis King
Chief Financial Officer

Well, our calculations, were just slightly below 10%. We think we're 9.9%. And certainly, with APRA's comments, they've said they'll look at stress testing, they'll look at alternate measures of capital, such as S&P and their ratios, plus the international comparable ratio, so we have to wait. I don't think you'll have to wait too long, and we'll hear something from them. And it would be nice to end of the year with a bit of clarity on capital.

Andrew Bowden
Head of Investor Relations

Jarrod.

Jarrod Martin
Crédit Suisse AG, Research Division

Jarrod Martin from Credit Suisse. Brian, Peter, you point out that your capital ratio is within the top 5 of comparable companies at 10%. That sits 100 basis points above the midpoint of your target range, yet you've decided to put a 1.5% discount on the DRP. Is that to say that you think that whatever capital changes are coming through are ultimately, in excess of 100 basis points, and therefore, any changes you would slip below the range? There seems to be a disconnect between you're saying that you are in the top 5 of comparable companies, but you're putting a discount on DRP.

Peter Francis King
Chief Financial Officer

I'll just -- I use the word prudent, that's how we're thinking about it. Unfortunately, we don't have the clarity on where we're going to lend up -- end up, but we just thought we'd get a little bit on board this time given we -- there's some uncertainty. Prudent is the word and how we feel about it.

Brian Charles Hartzer
MD, CEO & Director

It's also consistent with the remarks that have been made by the regulators about the direction of travel on capital. So you're right that it's above our target range, but we also have an expectation that there'll be adjustments in the way that gets calculated over time. So I echo the point, it just seemed like the sensible thing to do. We'll have more clarity in the next 6 months.

Andrew Bowden
Head of Investor Relations

Richard?

Richard E. Wiles
Morgan Stanley, Research Division

Richard Wiles, Morgan Stanley. Brian, can you give us an update in your confidence of achieving the 40% cost-to-income target. And Peter, you mentioned that there would be 2 announcements from APRA, one on unquestionably strong and one on product capital requirements. Does that mean you think the first announcement will be on the level of capital, and the second announcement will be on risk weightings? Is that how you're thinking about it?

Brian Charles Hartzer
MD, CEO & Director

Well, if I start with the first one, Richard, yes, we're still very confident about getting below 40%. The timing of that is going to depend a little bit on what the revenue outlook looks like, obviously. But when we look at the opportunity and the cost of distribution, the cost of our internal processes and overheads, the cost of our core infrastructure, the trajectory that we're on in terms of adopting digital and upgrading our various systems, the implementation of straight-through processes, we can see very big step changes to come in the next couple of years. So we do feel quite confident about that.

Peter Francis King
Chief Financial Officer

And on the second question, discussion paper, I think soon on probably the level of all the discussion paper on unquestionably strong, which will probably include the level of capital. And in the -- where it goes, will be later in the year is my best understanding of how the year will unfold.

Andrew Bowden
Head of Investor Relations

Brian?

Brian D. Johnson
CLSA Limited, Research Division

Brian Johnson, CLSA. I had 2 questions, if I may. The first one is, when we have a look at Slide 79, we can see WA, the arrears rate, going up. You're saying that it hasn't yet basically reached the peak. We can see house prices are down. Could I get a feeling on how much collective provisioning, in basis points, you're carrying in respect of just that portfolio? And if you are doing IFRS 9, how much more provisioning would you basically carry in respect to that portfolio, if you're know? And then the second one, just going back to Richard's question. Is what you're implying today is that unquestionably strong and whatever they do on housing, the housing bit is additive?

Peter Francis King
Chief Financial Officer

Just answering that, no, I'm just saying there'll be a conversation on -- there'll be a discussion paper on unquestionably strong, but it won't help us understand which products are moving in terms of capital requirements, that will be -- that will come later in the year, so not additive.

Brian Charles Hartzer
MD, CEO & Director

For at least the components of it...

Peter Francis King
Chief Financial Officer

Yes, the components of how that is allocated to a product come -- the detail comes later in the year. And then on WA, I haven't -- the way it works is we pick up the provisioning through the delinquency buckets and experience. So we've already got that in the numbers. And we've also got mining overlays for particular sectors that include mortgages, Brian, so I haven't got the...

Brian D. Johnson
CLSA Limited, Research Division

But it's just that it strikes me...

Peter Francis King
Chief Financial Officer

Yes.

Brian D. Johnson
CLSA Limited, Research Division

Being 3 months in arrears is a long time in an environment where the value of the collateral is actually falling, and you're saying it. Could you give us a feeling as to how much collective provisioning that you've got in respect to that book?

Peter Francis King
Chief Financial Officer

We've picked it up through the economic overlays 12 months ago, Brian. It's how we've dealt with it.

Brian D. Johnson
CLSA Limited, Research Division

But like that it only declined by $11 million over this half year?

Peter Francis King
Chief Financial Officer

Yes, we still got $390-odd million of overlays, with much -- with a big chunk of that related to the mining sectors -- mining areas, sorry.

Andrew Bowden
Head of Investor Relations

We'll take questions on the phone. One, from Matthew Wilson, please?

Matthew Wilson
JCP Investment Partners Limited

Loan-to-income profile by value of the mortgage book?

Peter Francis King
Chief Financial Officer

Sorry, Matt, could you repeat that?

Matthew Wilson
JCP Investment Partners Limited

Sure. Could you talk through the loan-to-income profile by value of the mortgage book?

Peter Francis King
Chief Financial Officer

I think the way -- the metric that we watch closely internally is actually the proportion of borrowers who require 30% of repayments. That's sort of the leverage metric that we look at, and that's running and has run for the last 12 to 18 months around 10% of the portfolios operating 30% or above. So that's the leverage ratio that we look at internally.

Matthew Wilson
JCP Investment Partners Limited

Okay. And then secondly, any change of thought on providing warehouse facilities to non-bank financings given the recent events in Canada?

Peter Francis King
Chief Financial Officer

Given recent events in Canada? Well, I think Australia is a very different market to Canada in terms of warehouses. And certainly, we apply similar, if not tighter standards on our warehouses, than we do for our mortgages. So no, there's no change in strategy from our perspective in our warehouse business.

Matthew Wilson
JCP Investment Partners Limited

And what is the warehouse's outstanding?

Peter Francis King
Chief Financial Officer

It's around $10 billion.

Matthew Wilson
JCP Investment Partners Limited

$10 billion. Okay.

Andrew Bowden
Head of Investor Relations

We'll take a question from Craig Williams, please.

Craig Anthony Williams
Citigroup Inc, Research Division

Your capital position does look unquestionably strong and, as you noted, top 5 banks in the world. And Peter, you've called out capital generation of 44 basis points this half, as the result highlighted. So with respect to the DRP take-up again, I'm sorry to labor on this point, do you not think that you're building capital sufficiently quickly to meet the likely timing of regulators' additional requirements, and is there not merit in protecting sort of return on equity and facing pressure on the payout ratio by managing capital build more slowly?

Peter Francis King
Chief Financial Officer

I think I'd come back to the point about being prudent. So we'll have -- I think we'll have a general direction in a couple of months, once APRA puts out its discussion paper. So we just literally thought about getting a little bit on board as part of this process, so I wouldn't read anything more into it than that.

Brian Charles Hartzer
MD, CEO & Director

The mood music is pretty clear out of the regulators on this, so it felt like the prudent thing to do.

Craig Anthony Williams
Citigroup Inc, Research Division

Yes, but I would've thought the direction of your capital build is also pretty clear, heading the same direction as where with the regulators are assuming things.

Peter Francis King
Chief Financial Officer

Yes, I would highlight, though, that while we're doing a great job on the unused limits, and we've pulled back in some of the low-return businesses, that can't go on forever. We will start growing again. There will be growth in risk-weighted assets. So we did a great job -- I think we did a great job this half. But when growth comes back, you'll get -- you won't get as much capital generation coming through.

Craig Anthony Williams
Citigroup Inc, Research Division

Okay. And if I could ask a question with respect to New Zealand, please. It looks like a pretty challenging time for your New Zealand franchise and, probably in fairness to New Zealand business, probably often doesn't make the highlight reels at Westpac results time. But 22 basis points NIM decay, a notable volatility in the term deposit book, and the provisioning cupboard probably looks relatively empty after a net write-back through the P&L this period. So I think you called out that David has a sort of plan of attack for restoring operational performance in that business. Could you enunciate on that a little bit, please?

Peter Francis King
Chief Financial Officer

Well, I think the piece that we would like to have done better is the negotiation of some pretty hot competition in the deposit market, with a couple of peers looking to pay down in a group lending post the APRA restrictions on in-group funding. I just think we didn't manage that deposit book as well as what we could have. So I won't go into the things that we're doing moving forward, but we'll be managing all parts of our balance sheet to improve that NIM performance.

Brian Charles Hartzer
MD, CEO & Director

And from a credit point of view, the dairy outlook is reasonably positive, so we feel pretty good about the quality of the credit book there.

Andrew Bowden
Head of Investor Relations

Okay, Scott?

Scott Robert Manning
JP Morgan Chase & Co, Research Division

Scott Manning from JPMorgan. Just referring to Slide 77, where you're looking at the proportion of drawdowns of LVR origination by LVR band. There's been a bit of a drift up in 80 to 90, 90 to 95. Just interested, given -- typically, if you do see assets -- asset prices are being elevated in the commercial property book, you'd try and originate a higher proportion at lower LVRs, whereas if you call in close to the top of the marketing house prices, just interested why you're actually growing above the average of a book in these high LVR segments, noting that these disclosures also exclude [rems], which is primarily first timer and high LVR based.

Peter Francis King
Chief Financial Officer

Sorry, Scott, which -- what are you looking at there?

Scott Robert Manning
JP Morgan Chase & Co, Research Division

Slide 77, the 1H17 drawdowns versus the portfolio at origination.

Peter Francis King
Chief Financial Officer

Yes, I wouldn't put that down to anything in particular, Scott.

Scott Robert Manning
JP Morgan Chase & Co, Research Division

Well, I mean, the fact is that you are originating a higher proportion in the back book and high LVR loans when asset values are stalling, so I'm interested in what risk settings that you are applying to actually get that result.

Peter Francis King
Chief Financial Officer

Yes. I think the risk settings are unchanged. In fact, they're actually tightened because we've got higher buffers, we've got higher discounting of income. It will just be a skew between owner-occupied and investor that will really drive that.

Scott Robert Manning
JP Morgan Chase & Co, Research Division

Okay. And secondly, on the cost outlook, so trying to get below 2%, flat this period. Is there any reason why we've waited until now to drive flat costs? I mean, is this something that could be readily achievable in the outlook that you're -- actually, the settings that you're trying to generate for the business. Is there any reason why you can't continue to do flat costs?

Peter Francis King
Chief Financial Officer

Yes, well, there's really 3 drivers of the cost base. So the first is -- so the operating cost bucket offset by productivity, and we're still driving that bucket as hard as we can and as fast as we can. Then the other pieces are investment and regulatory costs. So the investment, as I said, will really depend on the speed of the outlook of revenues. So if we see revenue a bit stronger, we might invest a bit faster. And then regulatory, I think there's just a lot of regulatory activity at the moment in all parts of the portfolio, so that can be lower or higher. But we'll continue to give you a bit of a line of sight on what happens each 6 months on that one.

Brian Charles Hartzer
MD, CEO & Director

I think the point here is that we're solving for positive jaws, essentially. So we've got an agenda of investments we want to make. And then when I talk about the balance between long term and current period earnings, we're really managing around the jaws. And so if we think the revenue environment's a bit better, we'll invest a bit faster. If we think it's a bit softer, we'll slow down.

Andrew Bowden
Head of Investor Relations

I'll take a question from Azib on the phone.

Azib Khan
CIMB Research

Your commentary in the [foreday] regarding NIM movement from the prior period, can you talk about the impact of asset repricing being partly offset by competition. Now you reduced your front book discounting in the half. So I'm just trying to understand, is that competition a reference to the difference between the front book spread and the back book spread in the mortgage book? Or were you seeing intensified competition in areas outside of housing?

Peter Francis King
Chief Financial Officer

No, it was mainly a reference to the housing market where the discount -- even though we dropped our -- or lowered our discounts in the half, that was still slightly above the back book, so I think about that as competition.

Brett Le Mesurier

It's Brett Le Mesurier from Velocity Trade. A couple of questions in relation to the Institutional business. How much further do you think you need to shrink your Institutional loan book? And half your deposit growth has come from the Institutional business? Do you think the shrinkage there is a limit to the extent where you can shrink your loans in the Institutional business without affecting your deposit growth?

Peter Francis King
Chief Financial Officer

Well, I think our settings in the Institutional Bank aren't just shrink the book. They are to be targeted on relationships over time and the ones that we can get the best relationships. So we don't have an absolute target for WIB. We have expectations on customers and from the ones that we've had long relationships with, we support. So that's how we think about the Institutional Bank. Then on deposits, we have the strongest franchise with the governments, particularly banking some of the big state governments. And that's seen as generate some good deposit flow this time. So I think working capital grew well outside of that, but we had some good flows in the government relationships as well.

Brett Le Mesurier

Brian, on Adani, is that giving you grief?

Brian Charles Hartzer
MD, CEO & Director

I don't know what you mean by that. We -- our policy is pretty clear. We've had a strong position on climate change for a long period of time. We put our climate position statement out back in 2008, and we update it every 3 years. And it was time to do that. We've been working on that for 18 months. Inevitably, it was going to attract some attention, which it has, but we feel very comfortable with where we landed.

Andrew Bowden
Head of Investor Relations

Just one last from Brian.

Brian D. Johnson
CLSA Limited, Research Division

Brian Johnson, CLSA. Peter, in the available-for-sale investments reserve, you can see a revaluation up with something like $160 million, which quite prudently, I would suggest, you haven't basically realized or not transferred it into the P&L. But can I just confirm, if that had been realized, all you're really doing is just stripping earnings from the future. As you reinvest at a higher rate, you get a lower return going forward. And then in a related issue, is it given we had a positive revaluation, could you explain to us why the interest rate risk in the banking book on Page 43 has gone up so much if the revaluation is suggesting the embedded gain didn't decline?

Peter Francis King
Chief Financial Officer

Yes. So firstly, on the available-for-sale reserves, Treasury itself had a pretty -- a good half, but it was flat half-on-half in terms of what was booked in the P&L, so we're pleased with the Treasury result. But as you highlighted, there's another $160 million of value they credit in the liquids portfolio that's in reserves, so not in the P&L. So that -- it's pretty good half in the Treasury, with not all of it in the P&L. I wouldn't characterize it as raiding future profits. I think that is true mark-to-market movements, and we'll manage that portfolio based on extracting value for shareholders. If we have to sell some of them, that means, under the accounting standards, that you crystallize the profit, we will do that if that's the right thing to do. So that's how I think about that book. In relation to the interest rate risk in the banking book, risk-weighted assets, they're not really linked, Brian. So the reason that they went up so much was, predominantly, the profit in the banking book reduced because of interest rate moves in the half. So we had interest rates coming back up. That reduced attractive value in a mark-to-market sense, so not related to the AFS profit.

Andrew Bowden
Head of Investor Relations
Well, with that, thank you all very much for attending, and good morning.