Question and Answer

Analyst

Just a question, David, in regards to that last comment you made, just any solutions that you suggest the government adopt to cancel some of those powers of the big four.

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

Look, I think the government are working on a whole number of initiatives at the moment, including the RMBS markets, the potential for a covert bond market and so forth. And I think they're positive steps. They'll certainly help position. But if you look at over the last 12 months, it's very hard to restore the competitive nature of this marketplace when the two largest regional banks have disappeared. Three of the major non-bank lenders have disappeared. So I think a lot of damage has been done. All I'm suggesting is to restore healthy competition. We don't need all that power controlled by four. And I think some of the initiatives that are being proposed will certainly assist in funding and assist in, perhaps, changing the debt profiles of the banks, et cetera. Let's do make it more competitive in terms of pricing, and that's what we need to look at.

Analyst

The first one is ROE targets and the cost ratios, is that inclusive of the pending CIT deal? And also the second question is can you give any firm numbers on St Andrew's, I mean, the earnings trajectory?

Ram Kangatharan
Former Chief Operating Officer

I think it is[ph] , on both of that, I'm going to disappoint you. Look, CIT is still in due diligence, so it may or may not happen. So we're certainly not counting on that. With respect to St Andrew's, as we said at the time of the announcement, it doesn't have a material impact in financial year '10, and we'll give far more detail when we come to our full year results.

Analyst

Ram, I think this is a question for you. The operating cost, a lot of the reduction there is the employee cost. Where were most of those gains made? And were they through process efficiency or a part of the business constraint at the moment?

Ram Kangatharan
Former Chief Operating Officer

As part of Project Pathways, we announced a number of initiatives. Some of it was process oriented, but a lot of it was also about how we went to market and how the organization was structured. So if you remember at that time, we announced that business banking and retail banking was coming together under a sort of a single leadership structure. We also said that we're taking some action on discretionary cost, which will bring discipline back into the organization in terms of lower-growth environment. So if you look at the trends across all of those five expense categories, with the exception of administrative, which is purely due to some legal expenses in the half, they all show that the disciplines we had second half '09 versus first half have been maintained through into the first half of this year.

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

So I think we also muscled up a bit in terms of the quality of our people.

Analyst

In Western Australia, [indiscernible] some good business opportunities going forward there?

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

Yes, my gut, Tim, is that we'll see a two-speed economy again. I think, a few of the heavy investment in gas and coal and iron ore, first, it's certainly starting to return to what, I'll call, more normal. Our business there, as Ram suggested, was hamstrung a bit because almost 60% of our business was coming through third-party brokers, and we stopped that overnight. So we are backfilling for a lot of that. But now I'm confident, Western Australia is an economy that we want to invest in and grow.

Analyst

And just on that question, Victoria, what was the exceptional growth there that...

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

Look, I think, and I mentioned that the bill could be at our board meeting [ph](50:27). Victoria right throughout the GFC was probably one of our best performing business areas. Victoria's population growth is expanding. The industry, generally, has done well. And certainly, housing hasn't slowed like it had in some other areas. So we've got more branches in Victoria. But it's seen as a key growth area for us, and we're in the process of opening new branches as we talk. If anything they lack is that they don't have a promising team this year. I think we've got to take some calls in the State.

Analyst

Just on your ROE target, one of the drivers is a permanent margin. I'm just wondering some key factors behind that? What's going to drive that?

Ram Kangatharan
Former Chief Operating Officer

So we've flagged for some time that in terms of our margin expansion strategy, the Equipment Finance business is pretty key to that. The front book margins on that business are running about 3%, whilst the back book is still around 2%, 2.1%. So there's natural accretion in margin on the back of that. There's still some repricing opportunities in our Commercial portfolio that we're still working through. And with the majority of the portfolio, that's the mortgages, which is about 72% of the book, we're really, I guess, hostage to the competitive moves. And we have seen the majors trying to recapture some margin on that front. And so as and when they do, we'll think about doing the same.

Analyst

Can I get your views on commercial property outlook in Queensland?

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

Look, a lot of the lending players have sort of disappeared, and that's because a couple of the major lenders were banks that no longer exist in true form, and some core pulled back a lot from property lending. But my gut feel is that there's a lot of property being held by banks and liquidized that potentially will come into the market at some stage and potentially will have an adverse impact on valuations. But we're not seeing any of that today.

Operator

Our next question comes from the line of Victor German from Deutsche Bank.

Victor German
Deutsche Bank AG, Research Division

Firstly, on bad debts, you're guiding for, obviously, peaking bad debts in 2010. Have we already peaked in first half? Or are you expecting further increases in that charge in the second half?

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

Look, all the indications are that we've seen and we're seeing an improvement flowing into the beginning of the second half in terms of the past dues. Ram mentioned the 30-day-plus number is actually on the improved. Interest rate movements have definitely had, I think, some impact, but our housing performance has been very strong. So you never say never, but I'm hopeful that what we've experienced to date is our bad-debt period.

Victor German
Deutsche Bank AG, Research Division

So you're actually expecting -- actually, it's from you indicated you're seeing today for bad debt charge in second half to improve?

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

We already expect to be in a better position than we were in the first half.

Victor German
Deutsche Bank AG, Research Division

Just secondly on margins, continue from the previous question. It appears that most of the margin benefit, as you've highlighted, came from additional capital that you raised in the previous half, as well as you're not participating in retail deposit space, which is obviously very competitive. It's probably not necessary to position as you can stay out for a while and you have to re-enter that market in the near term. And it appears also that spreads in lending products are now beginning to contract as well. Is your positive view on margins purely as a result of just attracting a different mix of business? Or is it something that we are missing?

Ram Kangatharan
Former Chief Operating Officer

I think the way you need to think about it is to look at the liquidity that we are carrying. So there's a chart that David went through that showed 18.6% liquidity. That is clearly a massive buffer if you think about our organic growth rate of roughly about $1.6 billion in our half. That gives you almost complete coverage from the excess liquidity itself. So I don't agree with what you said about having shortly to go back into the market aggressively. The collection of retail deposits, it's not something where you can be schizophrenic about. But at the same time, you can be disciplined about the pricing approach to that market. So I think what we're saying is the liquidity buffer that we've built up, which is clearly diluting our results for the half, also then affords us the opportunity to be more disciplined in the second half about chasing retail money.

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

And I don't think you should assume that margins are actually coming down in the industry. You got nice small businesses, most property player will -- they'll tell you margins are going up.

Victor German
Deutsche Bank AG, Research Division

And you still have some benefits from revising the debt book, is that what you're saying?

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

Yes, definitely.

Victor German

Deutsche Bank AG, Research Division

And just lastly on capital, after the raise, and I think your capital position was around 9.6%, or from organic growth, it has reduced. You're now looking for where you acquired the business and you're looking to acquire another business. What does that leave you in terms of capital in second half? And if you are successful in making that acquisition in this half, does that mean you will need to come back to the market and look to raise more capital?

Ram Kangatharan
Former Chief Operating Officer

Yes. Look, I think we can pretty clearly guide you on -- if you look at our risk-weighted assets at about $17.6 billion, each percentage point is about $176 million of equity, right. We are not going to use up that much, so not even a percentage point, in our bolt-on acquisition strategy. So when we say, the bolt-on acquisition strategy is within our existing capital footprint, it's not going to have a material impact with respect to the capital adequacy levels that we have today.

Victor German
Deutsche Bank AG, Research Division

But you're still chewing some equity as you're growing, and plus that you're saying you may use up to 1%, that leaves you, of course, to 8%, which is significantly low were major banks are sitting.

Ram Kangatharan
Former Chief Operating Officer

But don't forget, the acquisitions are actually targeting the reduction in the capital intensity of the business. So you can't just say it's just going to eat up capital and then you just stay down there. Those businesses we are acquiring are actually designed to then increase the organic capital generation of the business. So you can't just say, "Well, it's going to eat away your capital, and then you're going to come back to the market and raise more capital." Those acquisitions will actually then start to give you a way forward, where you can actually accelerate your growth and not have your capital go down as you accelerate growth.

Victor German
Deutsche Bank AG, Research Division

Right, so at this stage, you're not looking to underwrite the second half dividend?

Ram Kangatharan
Former Chief Operating Officer

No, not at this point.

Operator

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

Wes Nason
Citigroup Inc, Research Division

Firstly, just on the loan growth and, I guess, mixed impacts or, I guess, medium term, when you're going up, obviously, your commercial leasing book outgrow your housing loans in the last half, which is sort of counter the way where the system sort of wins, I guess. But the mix is -- so you're paying sort of 70% loans, 70% housing over the last couple of years. I mean, are you looking for that to change, I should say, to potentially, I guess, ramp up in the Leasing and Commercial business? Can you give us any sense of where that mix mark gets to?

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

Wes, firstly, the reason that we grew our leasing book apart from good origination model is that several players left the market, and you know who they are, and a large one here in Queensland. So we were naturally going to get more in that area. Look, we see our business shifting towards a good mix between retail, which I'll call the housing loan side of our business, Consumer Finance and leasing still out there to finance. So we've always said around about a 70-30 split. I think you'll see that over time, it probably change a bit to a 60-40 split. But our emphasis on growth is in the Consumer Finance area, in the leasing area and in the data finance area. We'll continue to grow our branch footprint, which we call our organic growth and that's, obviously, heavily directed towards housing finance and to SME to our day-to-day lending. There are strategic opportunities lie in those former areas.

Wes Nason
Citigroup Inc, Research Division

Just on the NIM target, 175 bps, you mentioned liquidity, you've got a lot at the moment. Ram, perhaps this one is for you, have you -- if you can sort of throw any impacts of the liquidity reforms that are coming and how that plays into that number?

Ram Kangatharan
Former Chief Operating Officer

So in terms of the reforms that, at least, in terms of discussion papers that are circulating, it's more around the types of instruments that you get to count in your liquidity book. I think what you can assume is that in terms of carrying 18.6% liquidity, which I haven't checked this, but I don't think there's a single bank in Australia that's carrying that sort of liquidity at the moment, it's not about the absolute level. The absolute level is where we've built that buffer. In terms of all of the other discussions on types of instruments and yield of those instruments, we'll have to figure that out as we go. But I think, generally, you can expect anything that comes out not to be too far from where we are today, where the yield on the liquidity portfolio is so low compared to your cost of equity and your cost of funds.

Wes Nason
Citigroup Inc, Research Division

A bit of a specific, in lending expense line, because non-lending loss, I think it was $5.8 million versus $1.6 million on the pcp, could you just give us a quick comment about what that was?

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

That's a big fraud.

Ram Kangatharan
Former Chief Operating Officer

There was a fraud item. And, Wes, you'll be happy to know, I didn't normalize it out of the results. And look, it's in the normal course of our business, and we've fixed up the issues.

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

But it will be the subject for our ongoing investigation, externally. So you may see some of that come back.

Operator

The next question comes from the line of Matthew Davison from Merrill Lynch.

Matthew Davison
BofA Merrill Lynch, Research Division

Just a few questions on the revenue outlook, again. Firstly, just on non-interest income, are there any areas of upside that you can flag from the existing business? Or do we really need to wait the acquisitions on that front? The second one was just on the deposit environment and if the current, I guess, situation in the marketplace persist, do you think you can get to the NIM that's consistent with the 15% ROE rate?

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

On both camps, yes. Otherwise, we wouldn't have said it. But in terms of the non-interest income, obviously, we had pretty significant headwinds, with the exception fee issue and the ATM falling off last year. And that's where we're focusing very clearly on identifying opportunities for growth in that sector. St Andrew's is a good start for that. It's a business that we have been one of their largest customers over a number years. It's an opportunity to cross sell into our existing customer base. It's an opportunity to grow the B2B business model outside of the existing customers that they have. So I'm quite confident that we have identified opportunities in that non-interest income area that will help us get towards that target. And clearly, we've set on that Page 35, in terms of our pathway to that return on equity, that we've made some assumptions in there, and we'll stick by those assumptions as we have everything else we have said.

Ram Kangatharan
Former Chief Operating Officer

Matthew, just to give you a bit of detail on that first question you asked. In terms of the base business outside of the ATM direct charging impact that we flagged, in terms of our base business with respect to loan maintenance fees or even just transaction fees outside of that ATM fees and account keeping fees, they're all growing in line with our customer acquisition and asset growth. It's just that the headwinds from ATM direct charging and possibly exception fees when we get to aligning on that, we flagged at the end of '09, were going to be significant headwind. So the way you should think about is we have these two items that are big lumpy headwinds, but the rest of the business in terms of that non-interest income continues to operate in line with growth.

Matthew Davison
BofA Merrill Lynch, Research Division

Can I just clarify David's comments on the margin outlook. If we saw an improvement in deposit spreads out there in the marketplace, would that represent upside for the 1.75% that you're targeting there?

Ram Kangatharan
Former Chief Operating Officer

If you saw a material improvement on that, and as I said, we do have excess liquidity that we're going to run down first, right? So once we eat through the excess liquidity and start relying on retail funding to fund the incremental growth, that'll be a big part of that NIM improvement.

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

Plus the mix of our business is changing as well, so that will be an added benefit towards that NIM improvement.

Operator

The next question comes from the line of Jonathan Mott from UBS.

Jonathan Mott
UBS Investment Bank, Research Division

I just had a question on deposits, if you look at Page 22 of the profit announcement, we saw that the actual deposits actually fell by a bit and a half and turned deposits to current assets to stay the same, so not large. I know now you're starting back from competition to some extent. I also wanted to tie that in to the slowdown in the deposits with a comment that Ram made, which was that you're switching between retail and wholesale and you're going to be a bit more nimble with that. As the competition comes and goes, you're going in and out of the market, how will that impact your ability to get to that net stable funding ratio being proposed by us, who are involved?

Ram Kangatharan
Former Chief Operating Officer

Look, that's a good point. Look, that's why we've made the point that in the Retail segment, we're not suggesting we're going to be sort of pushing buttons every other month on whether we want Retail or Wholesale. I'm not suggesting that at all. I think what we've said is that we've demonstrated the capability of the network in financial year '09 to gather retail deposits, at the time when market said the network just can't address the liability side of the balance sheet. So those disciplines are in place. Going forward, what we're saying is that we don't need to be desperate, if you like, in terms of pricing in the Retail market, which is the message we send at the end of '09, and we just want to maintain that stance. And the liquidity buffer that we have, I think, allows us to write through this period when all the different institutions are trying to figure out what is the level of retail deposits they need to get too, how do they compete for it, et cetera. So the market will settle down as we go through this period where the guarantees have been withdrawn, each institution figures out how to compete, which niche segments to address, et cetera, et cetera.

Jonathan Mott
UBS Investment Bank, Research Division

And just another question on the 15% ROE target. To get there, it would really imply that you're not going to pay a goodwill for any M&A, which that really that's just not gotten away. Is that we're seeing there in your future acquisitions of CIT or anything else will be out of the book value.

Ram Kangatharan
Former Chief Operating Officer

I think you can assume that we are stingy.

Jonathan Mott
UBS Investment Bank, Research Division

Is that a yes?

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

Take it as you like it, Jonathan.

Operator

The next question comes from the line of Brian Johnson from CLSA.

Brian D. Johnson
CLSA Limited, Research Division

My question is for Ram. Ram, if I have a look at the net interest income slide on Page 11, it's all before the cost of the payment that you're paying out to the third party?

Ram Kangatharan
Former Chief Operating Officer

That's correct.

Brian D. Johnson
CLSA Limited, Research Division

If I have a look at the margin that's actually going to ordinary shareholders, which is on Page 16 of the result, we got a slightly with different picture. We actually get that the margin went from 159 to 165 of the front page, so that's up six basis points. But on this slide, I'm saying that the free float impact was eight. And then when you have a look at the spread, it actually went down from 140 to 130, that's sequential half-on-half. Can you just reconcile for us the bullish commentary on margin versus the fact that the bps retained actually went down? And then if I could, if we're now going to have a look at the liquidity slide on Page 15, it's talking about, well -- the slide before 12, if you have a look there, the short-term Wholesale liquidity is actually gone in the period from 13% to 16%. If we're going to have a look at the extended duration slide, it's after the $1 billion issued that we actually did in March, which I'm kind of taking implies that your average duration actually shrank during the period. Could you reconcile all those observations, please?

Ram Kangatharan
Former Chief Operating Officer

So I'll try to be thorough on all the things that you just said, Brian. Look, in terms of the net interest margin piece that you raised first, I specifically mentioned on that slide, that is the gross NIM impact that we're showing you to show you the kind of the end customer base margin that we're achieving, because that part of it is pretty much about how we compete, what's our value proposition and what sells in the marketplace. The second component which is the amount that we shared with our owner-managers is very much about the internal arrangement that we have with a very important stakeholder, our owner-managers. And the point that we made was that through the global financial crisis, we've actually not only shared our margins with the owner-managers, we've actually protected them so that in a lower growth environment, those owner-managers continue to have viable businesses that continue to grow income, et cetera, et cetera. So your point about what goes to the shareholders is absolutely right, but I think what we are flagging here is that we've gone through the crisis in good shape, we've expanded margin at the top end to the customer, we've got all of the leaders available to us to now reaccelerate growth. And as we do that, that share, that natural share to the owner-managers as a percentage of the total business, will start to equalize down again.

Brian D. Johnson
CLSA Limited, Research Division

And that is inherent in the 1.75% prediction?

Ram Kangatharan
Former Chief Operating Officer

That's right. The 1.75% should be read as the net margin prediction. So right now, we're at 1.65%. That's still 10 bps higher by financial year '12.

Brian D. Johnson
CLSA Limited, Research Division

And Ram, can you give us your feeling in the second half of '09, the brokers for the OMB has got 26 bps first half, and it's up to 32. Can you give us your feeling on what is the expectation on that number going forward?

Ram Kangatharan
Former Chief Operating Officer

Look, I'd expect that number to stabilize around these half levels. And then when we get to financial year '12, you will start to see that share, I said, decline as the non-owner-managed component, if you like, of the business starts to increase. And if you look at our bolt-on acquisition strategy, you can pretty clearly see that some of that is going to happen because these are broader businesses than just a BOQ footprint.

Brian D. Johnson
CLSA Limited, Research Division

And the liquidity one, Ram, what about the liquidity you've seen over the average of it if we excluded that post-down date bond issue?

Ram Kangatharan

Former Chief Operating Officer

We actually showed that in the slide, Brian. So if you look at David's section, we actually -- I don't know whether you could read that in the slide there, but the liquidity is 18.6%, with the $1 billion issue. And if you exclude it, I think it's 16.0%.

Brian D. Johnson
CLSA Limited, Research Division

I supposed what I'm interested is the weighted average maturity, the one from 2.4% down to 1.8% of Slide 15, whether they'll still decline had it not been for that bond issue. I'm suspecting it probably wouldn't based on the slide?

Ram Kangatharan
Former Chief Operating Officer

No, I think if you do the math, and I love to sit here and count all of the bus and added together, but even if you exclude that $1 billion, I think you'll find that the average maturity is still going to be higher versus where we started in the GFC.

Brian D. Johnson
CLSA Limited, Research Division

So over this period where it's lengthened from one point -- okay, so you're saying that's still the number. Ram, if you can come back to me on that number when you do worked it out, it would be very appreciated.

Ram Kangatharan
Former Chief Operating Officer

What? The maturity number?

Brian D. Johnson
CLSA Limited, Research Division

Yes.

Ram Kangatharan
Former Chief Operating Officer

I think you can do that, Brian. You get paid a lot of money for that.

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director

Very hard priority for Ram. Brian, I'm sure you're capable of doing it yourself.

Operator

The last question comes from the line of Brett Le Mesurier from Axiome Equities.

Brett Le Mesurier
Axiome Equities Pty Limited

The payments, the hard payments to third parties, were they were actual payments? Or they were contractual?

Ram Kangatharan
Former Chief Operating Officer

No, they're based on assets and liabilities and we set in place incentive mechanisms, so it's not just lump sum extra assure payments. They're basically part of a program of managing the network. So they're consistent with, if you like, a fair and transparent pricing and margin sharing arrangement we have across the network.

Brett Le Mesurier
Axiome Equities Pty Limited

What guidance do you have on the expense composition? The cost-to-income ratio, were you looking at the actual one you reported or you normalize them? Or in other words, when you say, 47% in FY '10, are you talking about a normalized 47%? Or are you talking about actual?

Ram Kangatharan
Former Chief Operating Officer

Brett, it's always been normalized. And that chart that David put up in his section is the chart that we used when we actually gave the guidance, and you'll notice the words and the picture are exactly the same except we are tracking lower.

Brett Le Mesurier
Axiome Equities Pty Limited

Right, so you're actually talking about potentially 49% normalized cost-to-income ratio in the second half?

Ram Kangatharan
Former Chief Operating Officer

No. As I said, they're in creed what we said about our commitment as a forecast of where the cost-to-income ratio is going to come. What we're saying is we're not going to commit the organization to a lower commitment on the cost-to-income ratio than what we've already done. I will stick to 47% for financial year '10 and 45% for '11.

David Paul Liddy
Former Chief Executive Officer, Managing Director and Executive Non-Independent Director
Okay. Thanks very much, everyone. I think that concludes questions from online. Thanks very much everyone for joining us and those offline, and we're available to take questions on the phones from there on. Okay, thank you.