Question and Answer

Jill Craig
Former Group General Manager, Investor Relations

Thanks, Shayne. Thanks, Mike. Procedure for Q&A is we will go to questions in the -- in the room here in Melbourne first. I'll then throw it to Sydney. We'll then go to the web and the phone. If you could please wait for a microphone and let us know who you are when you get the microphone, that will be great. We'll go to Craig Williams first. Thanks, Ben.

Craig Anthony Williams
Citigroup Inc, Research Division

My rough calc sort of suggested return on risk-weighted assets in the Australian Division about 2.3% annualized. In APEA, about 1.2%. I think cash profit growth was 9% in the Australian geography and APEA, up 4% year-on-year. So while the group has done a good job of establishing its position in Asia with a suitable risk profile, it simply isn't as attractive a profit profile as the domestic market is. So should the group's focus be as much about growth in APEA when the returns on capital are so much lower?

Michael Roger Pearson Smith
Former Non-Executive Advisor

Well, I think it's the overall mix, Craig, as we talked about many times. And I think that the growth potential is obviously APEA in terms of the significant growth that is possible. And whilst the Australian business is a great business and certainly that Commercial business in particular is one that we are very keen to grow and invest in, the growth is always going to be lower than it's possible elsewhere. In terms of the risk weighting as well, I think that Asia will continue to go through a cycle where we're seeing the risk reward a little lower than we would see here in Australia. Although there has been increased competition in the Australian market, which has been a little bit disruptive, often from international banks. But whilst the world is flushed with liquidity from the various easing measures that have taken place and particularly in the U.S. but now with Japan as well, there has been a bit of pressure on margin. We're now seeing that stabilized though. The other thing is, of course, within Asia, we took a very, very considered opinion to move our assets to short-term trade finance primarily. That is always going to produce a lower return. But, of course, it's much lower risk and it doesn't carry any of the funding risk, so it's much easier to fund. And that was a very deliberate strategy.

Shayne Cary Elliott
CEO & Executive Director

I might just add a few comments. I mean, certainly, we can create shareholder value in 2 ways: by generating better returns but also by generating growth. As long as that growth is through generating -- driving growth at a high level of return than our cost of capital, both creating value. And so the Asia strategy is really about driving that growth and that's why we've said our focus here, we've got growth, we've got momentum and all the underlying drivers here are very positive. And our focus is to make sure that we get commensurate returns from it and that's been the focus here. On Australia and New Zealand, we've got terrific returns. And what we're asking the business here is to focus a little bit more on growth so that we can drive value from both.

Jill Craig
Former Group General Manager, Investor Relations

Okay. Any more questions from the floor? It looks like it's over to you, Graham. Thanks.

Graham Kennedy Hodges
Former Deputy Chief Executive Officer

Okay, Jill, we've got 5 or 6 hands up here, so we'll cut through them quickly. So, Mike, we'll just start here.

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Jarrod Martin
Crédit Suisse AG, Research Division

Jarrod Martin from Credit Suisse. Can I just ask a question on the dividend -- the commitment to increase payout ratio in the near term to the upper end of the range. What's the commitment in terms of franking considering your large exposure to New Zealand and non-Australian earnings and whether that means that you'll be able to frank that dividend fully going forward as well?

Michael Roger Pearson Smith
Former Non-Executive Advisor

Yes, the view is that we have sufficient franking credit for the foreseeable future. That's your question, Jarrod?

Jonathan Mott
UBS Investment Bank, Research Division

Jon Mott from UBS. Good question on the Global Markets revenue, which was obviously very strong during the half. And you flagged that at the quarter as well. But when you look through the detail, it looks like it was really driven by the trading in the balance sheet side, with the Global Market sales actually down 8% versus PCP. I just wanted to get a feel for that, the trading and balance sheet side, how much of that was due to CVA, DVA and movements in credit spreads as credit spreads rally globally. And do you basically need this environment of a rallying credit spreads to continue to sustain the global market revenue at this level?

Shayne Cary Elliott
CEO & Executive Director

Okay. I'll answer that one. That a good question. The piece about DVA ,CVA was almost no impact, so it wasn't really that. If you kind of decompose what happened in markets here, yes, there has been a benefit from the reduction in credit spreads. But if you think about our business model, when credit spreads reduce, we get the impact on our lending book through NIM compression. And that comes from an accrual basis in our books. The opposite to that is when, in our liquidity books, we get a mark-to-market gain. So it's a natural balance that we have within our business. If margins were to expand on the credit side, we wouldn't have the gains on our liquidity book, but our lending books would look a whole lot better. Now, there's a slight -- there's a timing issue because one's on an accrual basis, one is mark-to-market. But I think that reflects decent balance within the book, Jonathan. The other question in terms of trading and sales. At the end of the day, our trading businesses here within ANZ are almost all driven off customer flow. The amount of trading that we do that is really prop-driven is almost non- -- it's very, very small. So all of that trading position is really just reflecting as we do customer positions, they generate positions in various books and the traders trade their way out of it. So it's all ultimately relating that to customer business.

James Freeman
Deutsche Bank AG, Research Division

It's James Freeman from Deutsche Bank. Just wanted to ask on the cost side of the equation, a very good performance clearly in the first half of the year. Just any indication or some color around the momentum flowing in from the New Zealand simplification but also from the hub side. Certainly, our analysis suggests there is strong momentum running through. But just interested why you haven't actually changed your cost to income target by 2014 given you're 140 basis points into it?

Michael Roger Pearson Smith
Former Non-Executive Advisor

Well, we're along the road, James. I don't want to get too excited. But I think when we've made that target, we'll put out another one. The issue with New Zealand, yes, I still think there's -- as I say, there's gas in the tank there. There's further opportunity in New Zealand as we move to the one system and really make the best of that and indeed the one brand. But the real standout here is the hub strategy and

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that is really beginning to return some of the investment that we've made in it. And, again, I think that the potential here is enormous. I mean, this has not been easy to do. And here, I have to really thank all the staff who've been involved around the group in making this possible because it has been a tough strategy to manage. But it is really working for us. It provides us flexibility. It provides us with a capability in terms of capacity. It allows standardization, improvement in control. For example, money-laundering, anti-money laundering, this sort of issue is much easier when you have this sort of standardization. So still a lot to do, but we're seeing the benefits and that momentum will be continued.

Richard E. Wiles
Morgan Stanley, Research Division

It's Rich Wiles from Morgan Stanley. Can I just focus on revenue for a moment? In Australia, the revenue was up 2% half-on-half despite the benefits of high [indiscernible] pricing, which appear to be coming to an end. The IIB revenue was down 5% if you take out the markets income and New Zealand was down 2% half-on-half. Mike, I wonder if you could comment on your expectations for the pickup in revenue in the second half and what you think might drive that?

Michael Roger Pearson Smith
Former Non-Executive Advisor

Well, I think revenue will continue to grow. I mean, overall, it's growing about 3% per annum. And I think it's done that for the last year, Shayne, isn't it? About half on half on half for the last 2 years.

Shayne Cary Elliott
CEO & Executive Director

Yes.

Michael Roger Pearson Smith
Former Non-Executive Advisor

And so I think there will still be reasonable growth. But as Shayne mentioned earlier, when you have a reduction in interest rates as we have, then, of course, you're going to have this squeeze in your lending margin in terms of the loan books. That's somewhat offset by markets. So to extract markets or liquidity books from markets is actually not very sensible. So again, you got to look at this in the totality because our business mix and the way we run the bank is a whole. We don't just look at the individual businesses and say, well, they're up today, down tomorrow. You've got to look at it at what is compensating for this. So the outlook I still think is pretty good. I think that whilst we are still in a low-growth environment, if you compare it to precrisis in Australia and New Zealand, certainly, the growth is there. And you look at the Commercial growth over the year and also the mortgage growth over the year, those have both been above system and I think are looking good for the second half. And in Asia, things are still moving very well.

Shayne Cary Elliott
CEO & Executive Director

And I might just add a few comments on that. I mean, first of all, the growth in Australia is actually solid. Half of that revenue growth is actually coming from volume, from market share growth, both in Retail and Commercial. There's a small impact on margins. And that has been a consistent story within the Australia division, as I mentioned, consecutive quarters of slow but steady share growth, which is absolutely on strategy and the right thing to do. And we expect that to continue. And in IIB, I don't understand why we're taking our markets from [indiscernible]. Markets is an essential part of the strategy, particularly in Asia. We don't want to build a business in Asia that's built on lending. It is about intimidating trading capital flows. And the way we participate in that is by doing foreign exchange and servicing those needs of our customers. So it's an essential part of the strategy and markets revenue will be a key driver of growth, particularly in Asia. So I think the underlying drivers in IIB are very encouraging. More customers, more places, more debt for the relationship across the board. New Zealand revenue is harder. I mean, obviously, we already -- we start in a very dominant position in a reasonably low-growth economy. So it is a bit more of a difficult position and that is why the focus on New Zealand has been our productivity. I think David

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and the team there are focused on building profitable share growth, but their primary objective is around productivity for exactly that reason.

Michael Wiblin
Macquarie Research

I'm Mike Wiblin from Macquarie. Look, just on the funding structure, you're seeing some of the smoke clear in wholesale markets. Obviously, that's the counterpoint to the competition, the asset side you're talking about there. You do have the lowest funding gap of your piece that's shown on Page 46. I mean, is there an opportunity to push a little more into wholesale markets? You use that channel just a little bit more given that, I would say, is looking a little bit up -- a few more raises [indiscernible].

Michael Roger Pearson Smith
Former Non-Executive Advisor

Yes, until Spain falls over or Portugal goes the way of Greece or -- there are so many unknowns out there. Credit markets are in much better shape than they were, but we're not out of the woods yet. And I think it's prudent to maintain that core deposit ratio and continue to improve that core deposit ratio. And the Basel III, of course, we are rewarded for that as well. And I think an increased dependence on wholesale markets is not necessarily a good thing. I think that we have an ability to probably do maybe $5 more in that space -- sorry, $5 billion. Minus, plus, a billion here or there. That's -- but I'm -- but I wouldn't want to push it much more than that. But it does -- you're right, it does provide us with the degree of flexibility and optionality.

Victor German
Nomura Securities Co. Ltd., Research Division

Victor German from Nomura. Two questions, if I may. One, just a clarification on DRP. Some of your peers are looking to neutralize their DRPs. Be interested to hear your views on that. And secondly, on the margins, if my memory serves me right, at the quarter, you suggested that margins in Institutionals were down about 10 basis points excluding markets. And now it appears that they're down 12 for the full half. So it looks like the run rate had slowed to around 4, 5 basis points in the quarter. Just interested in your observation, what do you expect those trends for the next half? And more broadly, you suggested that you're expecting margins slightly lower for the group. If you could just give us sort of some sort of reconciliation how that you come to that on a business-by-business level?

Michael Roger Pearson Smith
Former Non-Executive Advisor

Okay, do you want to...

Shayne Cary Elliott
CEO & Executive Director

I'll start with that one then. I'll start on the margins and Mike can answer the DRP. You're right, we did suggest that the IIB margin contraction would slow dramatically and it did. So the contraction over the half was around 14 points, thereabouts. 2/3 of that -- and again, going back to what drove that. One is just competition, pricing on lines and things like that. Actually, that wasn't loans -- it wasn't a big driver. 2/3 of the compression was driven by like the absolute -- a lower level of absolute interest rates, which means the capital that we invest and the value that we drive from lower interest-bearing deposits reduced. So it's really kind of an environmental factor. Why do we -- what do we think going forward? Actually, it's always very difficult to predict an institution in terms of loan margins. But the market today would suggest that margin pressure has eased and it's stabilizing. And as I mentioned in my notes, we think that the kind of mix of our business, market pressure, et cetera, will be a net 0 for the group. The only exposure that we really have on a margins basis is that impact of lower interest rates. Now interest rates aren't necessarily falling further. But in the second half, you're going to have a whole half of lower interest rates versus the first half, the weighted average is a little bit higher because they were actually reducing during the half, if that makes sense. So what I'm saying is on balance, rates will be a little bit lower in the second half on average. And that will drive a slight deterioration in our margins at a group

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level. We're talking about a basis point or 2 at a group level. And that will be felt -- just to reconcile, most of that gets felt in Institutional as a division basis. Why? Because Institutional is the most capital-intensive business and therefore, low returns on capital affect Institutional more than they do, say, the Australia division. I mean all divisions will suffer from that, but at a differing rate. Want to try the DRP?

Michael Roger Pearson Smith
Former Non-Executive Advisor

Yes, in terms of the DRP, as you've seen, we've maintained the DRP but with a 0 discount rate. Now whether or not we wish to neutralize that, those are options available to us, we haven't made a decision on that yet.

Victor German
Nomura Securities Co. Ltd., Research Division

So, sorry, that's including this dividend?

Michael Roger Pearson Smith
Former Non-Executive Advisor

Yes.

Brett Le Mesurier
Asia Pacific Prudential Securities Pty Ltd., Research Division

Brett Le Mesurier from BBY. A question, Shayne, on the RoE on the APEA business. It looks like from your disclosure to the ROE for the first half '13 was 10%. When I calculate that on the basis of your cash profits of $460 million, your risk-weighted asset is about $80 billion and about $3 billion of capital invested in associates, so you've got about $9 billion of capital invested in the business. You commented that you would be happy growing that business as long as your RoE exceeded your cost of capital. Since the RoE is 10%, are you happy that, that exceeds your cost of capital?

Shayne Cary Elliott
CEO & Executive Director

Well, it's a -- the APEA business isn't a business in itself. It's a portfolio of businesses. So some of those businesses have higher returns, some of them have lower. What we've been talking about in terms of capital efficiency is being much more proactive in terms of increasing our capital allocation, if you will, to those businesses that can produce decent returns to shareholders. So we don't think about APEA as a whole. We think about it in its component parts. There are parts of APEA, for example, parts of the Institutional business which have very, very healthy RoEs and continue to grow and we're very happy with that. There are other parts of APEA that have very early stage investments for us. I mean, we can't expect to have RoEs on day 1 when you open a new market or launch a new business. And so we give those businesses some time to establish themselves. Now our responsibility is to make sure that those businesses with low RoE, whether they're in APEA or Australia for that matter, have a credible path to a decent sustainable RoE in the medium term that will produce value for shareholders. And that's how we approach our capital allocation.

Brett Le Mesurier
Asia Pacific Prudential Securities Pty Ltd., Research Division

The second question in APEA geography, it also refers to non-lending assets increasing from $66 billion to $81 billion in the half. Can you comment on what that refers to?

Michael Roger Pearson Smith
Former Non-Executive Advisor

Not really sure. I think -- normally, I think that'll be -- do you have an idea, Shayne?

Shayne Cary Elliott
CEO & Executive Director

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[indiscernible]

Michael Roger Pearson Smith
Former Non-Executive Advisor

Just -- yes. Well, we'll get back to you on that one, Brett, later today.

Shayne Cary Elliott
CEO & Executive Director

It will be [indiscernible].

Michael Roger Pearson Smith
Former Non-Executive Advisor

It will be [indiscernible] markets, exactly. It's probably just liquidity or something.

Brian D. Johnson
CLSA Limited, Research Division

Brian Johnson, CLSA. I was just wondering if I could bring together 2 questions that I'm still a bit confused about. If you have a look at the capital regime that we face going forward in the next quarter, the dividend comes out. In this quarter, we basically saw $400 million increase in the nonrecourse debt funding of the life company, which may disappear with the financial conglomerates proposal. In New Zealand, we've got basically a much tighter tax regime under thin capitalization rules. On top of that, we've seen the Agri risk weighting increase. We also see a proposal to increase the risk weighting on high LVR home loans, which the reserve bank of New Zealand, if you run through the numbers, would means you'd have to spit $250 million of capital into there. We see Basel having released a paper saying that the financial market's capital adequacy arguably is increasing. And in this result, we see the minority interest treatment in Asia becoming a full Tier 1 deduction. I was just wondering if we could get some clarity on, if you were to get a perfect storm and these things all head the other way, how committed would you be to the higher payout ratio target or would we, in fact, see DRP underwriting start to come back through the other way? And conversely, if we roll forward, basically the targeted payout ratio and the full franking that you're very comfortable with now, 30% potentially from APEA, 20% from New Zealand is 50%, that means 50% of the tax payments in Australia. How can you fully frank basically the dividend payout ratio if in fact with the 2017 mix target we're talking about? So capital intensity with all those things and the franking.

Michael Roger Pearson Smith
Former Non-Executive Advisor

All right. Well, thanks, Brian. I mean, we know what we know and we don't want to know what we don't know in terms of the regulatory environment and what is going to happen and what isn't. All I would say is that our capital position right now is pretty strong. And in terms of a global comparison to peer banks around the world, we are in as good, if not better, position than anyone else. Now under the APRA guidelines, as you know, if we fully harmonize our capital position, we're some 2% over the APRA requirement, which is a very considerable buffer. So I honestly don't know how this will all pan out. We have been basically building our capital position over the last 5 years. We've been ahead of that curve. We're comfortable where we are at the moment. There are options available to us. But right now, I don't see that there is any need to have immediate reaction to it. I feel that in terms of how we manage the business and how we manage our capital position and indeed our liquidity position, that's what we're paid to do. And certainly, I think you would say that the track record on getting that one right and getting -- and having the appropriate amount of liquidity and indeed our capital over the last 5 years has been sound. So yes, we will watch and we'll be careful and basically position ourselves as new regulation comes out or as we're required to do for whole additional capital.

Scott Robert Manning
JP Morgan Chase & Co, Research Division

Scott Manning from JPMorgan. Just with the uplift in the payout ratio, trying to get a better understanding of the drivers in the sustainability. To what extent is there been a review of the current capital that has

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been deployed and looking for opportunities to improve the efficiency of capital risk currently deployed relative to trying to deploy the incremental dollar of capital and get a better return on that? Just trying to get a better understanding whether you're trying to release capital from your existing operations to redeploy or whether it's more of an incremental process.

Shayne Cary Elliott
CEO & Executive Director

I guess it's both, Scott. I mean, we talked about last year our focus on capital efficiency. And that is about more proactively managing the capital that we already have allocated within our businesses and generating better returns from that. So across the whole bank, we have a desire to be more capital efficient. So that is from our existing operations, making sure that, that capital is deployed to get the best possible outcome and to create long-term value for shareholders, but also around the incremental use of it. I mean, I don't know that the DPO -- the payout ratio is really reflecting that the business that we have today has reached new level of maturity. We're getting dividends, if you will, and sustainability. Where we're getting dividends back, if you will, from the investments we've made in the past. It's only reasonable, therefore, that we can increase the amount of dividend that we pay to shareholders as a result. But fundamentally, it doesn't change the fact that we're a growth story. We will continue to have a lower payout ratio than some of our peers because we have things to do with our capital in terms of creating long-term value for shareholders.

Jill Craig
Former Group General Manager, Investor Relations

Any more from the floor in Sydney, Graham?

Graham Kennedy Hodges
Former Deputy Chief Executive Officer

Yes, Jill. Yes, we've just got 2 more questions coming here. Scott?

Scott Robert Manning
JP Morgan Chase & Co, Research Division

Sorry, it's still Scott, just following on with the RoEs in the Asian business. Does that then necessitate half the capital that's currently being deployed in the partnerships getting reallocated or rotated into other opportunities?

Michael Roger Pearson Smith
Former Non-Executive Advisor

Look, I think the treatment under Basel III, or under APRA's definition of Basel III, with regard to partnerships is something that we have to look at. The dilutive impact at the moment at group level is still very small. And it does bring into question, though, the strategic logic of, one, doing this sort of deal; and, two, maintaining it. And as I've always been very clear about, my view is that you enter into this sort of deal only if you see a route to control unless there are regulatory restrictions around the requirement where you're holding is capped, for example, in Malaysia and China. But where there isn't a regulatory requirement or there isn't a route to control, then you would have to say you have to ask the strategic question as to whether or not these investments are withholding. And as we saw with our stake in Sacombank in Vietnam, we sold that last year.

Brian D. Johnson
CLSA Limited, Research Division

It's Brian Johnson from CLSA again. Shayne, could I have an answer on that franking question? It's been asked about 3 different ways today, which is, if you get to the target mix in 2017, where we're getting 50% of the earnings offshore, 50% of the tax paid in Australia, how do you frank what's now become a 70% dividend payout ratio?

Michael Roger Pearson Smith

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Former Non-Executive Advisor

I mean, as I say, we have to manage the business appropriately and maybe the business will have to be restructured, Brian, at that time.

Shayne Cary Elliott
CEO & Executive Director

I think the answer to that, Brian, though, is that's a problem we look forward to having. I mean, if you're telling me that the way that problem comes about is that our business in Asia is so wildly successful that it's generating equal profits through Australia and New Zealand, bring it on. I mean, that's a problem I'll happily deal with.

Graham Kennedy Hodges
Former Deputy Chief Executive Officer

So back from Sydney, now to you, Jill.

Jill Craig
Former Group General Manager, Investor Relations

Thanks, Graham. I believe we have 2 questions on the phone. If we can go to the first of those, please.

Operator

Your first question today comes from Andrew Lyons from Goldman Sachs.

Andrew Lyons
RBS Strategy

Just a question around Slide 101 of the chart pack and IIB return on equity, specifically Global Markets. There was always an expectation that, that would fall under the introduction of Basel III. And I'm just wanting to get some sort of a feel against your expectations, how is the fall, the actual fall in the return on equity in the Global Markets business compare to that. And just any commentary that you might be able to make around the opportunities to optimize the capital base to get that RoE higher again?

Shayne Cary Elliott
CEO & Executive Director

So I don't think there were any particular surprises in terms of the RoE impact or the capital impact of the Basel III on markets. We always knew that was coming. I mean, I think the point to note is that it's still a very healthy return on a Basel III basis. And in terms of opportunity, there's absolutely opportunities to do better both in the markets business but across the business overall. I mean, we've only really just started this intense focus on capital efficiency. It's always been part of the business, but it's been more intense recently with increased levels of capital. And that will continue and we're confident that through just better management, more focus, being more proactive around it, we can drive greater efficiency and therefore, better RoE outcome over the medium term.

Operator

The next question comes from T.S. Lim from Bell Potter Securities.

T.S. Lim
Bell Potter Securities Limited, Research Division

I just want to get a feel for your assessment of sovereign risks in Asia given your larger presence than the other major banks. I mean, has this actually gone up with some elections coming through in some of the countries?

Michael Roger Pearson Smith
Former Non-Executive Advisor

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Sorry, were we talking about -- T.S., were you talking about sovereign risk of Malaysia in particular or...

T.S. Lim
Bell Potter Securities Limited, Research Division

Oh, sovereign risk generally up in Asia.

Michael Roger Pearson Smith
Former Non-Executive Advisor

Up in Asia. Yes, look, I think sovereign risk is an issue, globally is an issue. And indeed, you've seen comments in the press about Australia as well. I actually still believe that the Australian country risk is one of the strongest in the world and will continue to be so. And at the end of the day, I guess it's all relative, isn't it? If there are -- if everybody is downgraded and you look at where Europe is now sitting and, well, indeed, most of the West, who would've thought that any of those countries would not have been AAA 5 years ago, 6 years ago. So in terms of the country risk in Asia, I'm not too worried. I think that most of those countries now have gotten much stronger economies. They're much more diverse and they're probably more politically stable than they have been through much of their history. So I actually feel that, overall, it's not something that we would be unduly worried about.

Jill Craig
Former Group General Manager, Investor Relations

Thanks. Any remaining questions on the phone?

Operator

There are no further questions at this time.

Jill Craig
Former Group General Manager, Investor Relations

Okay. Any last questions on the floor here in Melbourne? It doesn't look like anyone's tapping. No?

Okay. With that, I'll hand over to you to close. Thanks, Mike.

Michael Roger Pearson Smith
Former Non-Executive Advisor
Okay. Thank you very much, Jill. Again, I'd just like to thank you for attending today. And indeed, if you would like to follow up on any particular questions, please do so and Jill will field that. So many thanks indeed.

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