Question and Answer

Andrew Bowden
Head of Investor Relations

Just start with Andrew Triggs.

Andrew Triggs
JP Morgan Chase & Co, Research Division

Andrew Triggs from JP Morgan. Just in terms of the interest only the book. The statement of -- the RBA statement of monetary policy out last week, I guess, gave some confidence from liaison with the banks having impact of the role of interest only book wouldn't have too great an impact on credit quality. It concluded that the share of borrowers that wouldn't be able to deal with the increased repayments was small and also noted that the -- that it had noted a reduction in the unscheduled principle repayments largely offsetting the increase in scheduled principle repayments. Could you try to please talk about what experience you're seeing so far on interest only role and in that context the increase that we've seen in arrears rates whether that -- any of that is due to the conversion to P&I?

Peter Francis King
Chief Financial Officer

Interesting, we're seeing very similar points the RBA made the. So if I think about the movement, its 10 percentage points down. It's quite big. The other feature that doesn't probably come out as quickly is repayments and refinancing have doubled at the same time. So we've had new flow down. We've had proactive switching, and then we've had repayment, and that's really what's driven the faster decline in the book in half compared to the previous half. And then when we flick through and look at the credit performance and the delinquencies, actually we're tracking through that particular cohort. We're not seeing major issues in that flow through at all.

Andrew Triggs
JP Morgan Chase & Co, Research Division

I think there was a rise in New South Wales ATT arrears, was any of that down to --

Peter Francis King
Chief Financial Officer

I mean, we're now through -- if you look at the -- so the last couple years hardships might have been a bit of an issue, but it's normally -- it's pretty much worked through. Its normal seasonal stuff now, so it's not -- there's not anything in there that we particularly call out.

Andrew Bowden
Head of Investor Relations

Victor?

Victor German
Commonwealth Bank of Australia, Research Division

Thank you, Andrew. Victor German from Macquarie. 2 questions if I could. First one on capital and one on mortgages. On capital, APRA has given, I guess, guidance that 10.5% is the right level and that -- given that guidance probably close to a year ago now. This year it looks like through your modeling changes you're effectively taking about 50 basis point hit on capital. I'd just be interested in your observations how that relates to original comment that 10.5% for the industry is broadly lower at level. And secondly, whether we should expect any modeling changes from sort of second half of '19 -- sorry, second half of '18? And secondly, Peter, you've -- I think you said that DTI is around 20% in terms of flow. I think APRA also has made some observations around the limits that they want to put on those numbers going forward. How are you thinking that will play out for you guys given that you've got bigger proportion of your book in investor and whether you think there might be any differentiation between investor book on DTI and on occupy lines?

Peter Francis King
Chief Financial Officer

So on capital, you're right. Yes, APRA said if you're 10.5% -- yes, that's where you need to be. When we looked at our book, our mortgage risk quotes were little bit low and our APRAs was little low, so we're dealing with that. We could have -- on APRAs we could have rebuilt the advanced model and then thrown it out in 2019, so we decided not to do that and just put an overlay on it. On mortgages, we -- we're the effectively the last bank to do the PD changes, so that will flow through in the second half. So nothing else that I need to highlight in terms of those changes. They were the 2 areas that we're a bit under. On the DTI, I think this will be an evolutionary process. So as all the banks report their information, we'll then have to go through a process where it's standardized. There's a lot of questions on methodology still to be worked through and then we will set our appetite and run to it. I think APRA hasn't come out with hard limits, because everyone does differently and we'll work through that in the second half.

Victor German
Commonwealth Bank of Australia, Research Division

Just to clarify on capital. So once you've put those changes through, is 10.5% the right level for you going forward and you're not expecting massive changes from there onwards.

Peter Francis King
Chief Financial Officer

For us.

Andrew Bowden
Head of Investor Relations

Jarrod?

Jarrod Martin
Crédit Suisse AG, Research Division

Jarrod Martin from Credit Suisse. A couple of questions around the Royal Commission. First of all, just the mechanics of the expenses. I think, Peter, you mentioned $50 million to $60 million total cost. For Royal Commission you've booked $34 million in this half. Should we think the remainder is booked in the second half or is it spread out over a couple of periods? And then how does that link in with the top end of 2% to 3% expense growth range? Then secondly, a more broader question. 3 of your competitors, Brian, have all but exiting wealth management, notwithstanding Westpac did the IPO of BTIM a number of years back. Does the changes in the Royal Commission mean that you'll strategically look at BT and whether you should be the owner of it and/or if you do retain it, do the returns of that business ultimately creep lower over the medium term because of what's coming out of the Royal Commission.

Peter Francis King
Chief Financial Officer

So Jarrod on the cost piece, the best way to think about it is, we will take as much as we can this year. So we want to try and deal with the Royal Commission cost this year, so that's how I'm thinking about it right now.

Jarrod Martin
Crédit Suisse AG, Research Division

So the 3% -- the top end of the 2% to 3%, is that --

Peter Francis King
Chief Financial Officer

And then -- so that will be within our underlying cost growth, if you like, and within the 2% to 3% bucket. I only think that's outside is the goodwill write off for Hastings.

Brian Charles Hartzer
MD, CEO & Director

And Jarrod, with respect to wealth, the way we think about this is that, we're trying to help customers through their financial lives. We've been conscious of the need to minimizes or eliminate clear conflicts of interests where we can and the ownership of the actual active asset manager we concluded that manufacturing a product really didn't make sense in the overall context, which is why we sold down BTIM. And, in fact, BTIM has rebranded itself as of today to be called Pendal which really shows that it is now quite separate from us. But longer term, we think that customers continue to want and need advice particularly as the population ages. How advice gets managed is an ongoing challenge for the industry, not just banks. And we think, as I said in my remarks, that the position we've built with Panorama, which is essentially an open architecture administration platform that makes it really convenient for people to manage their money and link it in with internet banking. We think that's a very sensible place and there is a stark distinction now beginning to be drawn between where we sit and where others sit. From a return point of view the growth is still good and the platform is very efficient, so we think it's attractive.

Andrew Bowden
Head of Investor Relations

Jon?

Jonathan Mott
UBS Investment Bank, Research Division

Jon Mott from UBS. I've got a question about the APRA targeted review, which was released by the Royal Commission. Now, I acknowledge that it's a tougher test than the current rules and obviously asset quality is very good at this stage of the cycle which you'd expect for all the banks. But if you go through PwC found that 8 of the 10 control objectives were inefficient or ineffective. Wayne Byres described to you as a significant outlier. And your board paper said that Westpac's performance in the targeted review was poor, but absolutely and relative to peers. Now I know you've said that the file that's up there with 420 files and that isn't exact, but obviously PwC described it as a representative sample. And some of the things that came out of here that 29% of the files didn't actually check the payslips, 86% of the customers had monthly living expenses equal to HEM and only 1% of customers had a monthly living expense more than 50% of their income. Now, they're quite unusual statistics. So question, are you satisfied with these results and what more needs to be done to fix up the mortgage process?

Brian Charles Hartzer
MD, CEO & Director

It's a pretty broad ranging question. Let me just tell you about the file first. One of the challenges is the scope of work that PwC was asked to do. So they only took account of information on the credit file, which is very important, because they did not look at all the information that was available to the banker when they made the decision. And so when I said that the file was incomplete, it did not have all the information that was available. So bring that to life, there was a loan where the banker had taken it -- had received a previous application very close to it. They verified the income here. It wasn't on the new loan application, so PwC filed it. Absolutely, didn't put any income in and that's why I said its incomplete. In a lot of cases, the loan that was being refinanced was also included in the file, so that's how you got such high D-to-I numbers on the file, because it was a double count. And so the challenge with this is context. Now we took it seriously. We had a look at the 38 loans, went back and had someone -- the person that approved it go through it. And all but one case they didn't stack up. We then subsequently did another dive of 3x the number files and no new issues have come up. Now in terms of the control environment, the standard was complete inaccurate. So if I give you an example of some of the challenges there. There is no positive credit bureau in Australia, so you cannot ever get complete and accurate on the whole of customer debt. It's coming, but not for a while. If you look at marital status, if you look at dependents, again, there is no central source, so PwC said you can never get it. So there's a difference between the theoretical concept of complete and accurate and what's possible in the current infrastructure. So we did take this seriously, we did look at it and we're comfortable with our standards.

Andrew Bowden
Head of Investor Relations

Andrew?

Andrew Lyons
Goldman Sachs Group Inc., Research Division

Thanks. Andrew Lyons from Goldmans. Just a question on your capital position and payout ratio, you're organic capital generation in the half is pretty solid, but you noted some one-off model changes which did impact reported numbers and that will to some extent continue into the second half. And also, in dividend considerations, note your surplus franking credit whose value, I guess, now faces some political uncertainty. Just in light of all of that and particularly having your payout ratio back within your sustainable range, how you're thinking about balancing your capital position, your dividend payout ratio and those surplus franking credits?

Peter Francis King
Chief Financial Officer

Well, I think our preference for returning capital to shareholders will always be with -- through dividends with franking credits attached and that will remain the case until we have less frank credits. We are aware of the changes that you have pointed to and we'll be considering them in any future decisions that we think about.

Andrew Bowden
Head of Investor Relations

Brian?

Brian D. Johnson
CLSA Limited, Research Division

Brian Johnson, CLSA. Just an observation, I don't know how anyone can be confident that they know the loan-to-income ratio, the debt-to-income ratio for all those reasons you just pointed out. So there is a flipside on that, until we actually have full credit reporting we don't know. We do know there's a great [indiscernible], so with that kind of answer, we expect the other way as well. But I'd 2 questions if I may. First one is that when we have a look at where this result beat, it's on the margin and it's on the financial -- it's on the market side that went through the net interest income. Can we get a feeling of the opportunities that you sighted that actually drove that and their ability to replicate that in the second half? And the second one, I agree with you that the RBA official cash flow rate ain't going up any time soon, but I'd interested in your view on what happens if it was to go up. Is Westpac basically more vulnerable the most because you do have a geared housing loans in there?

Peter Francis King
Chief Financial Officer

So I'll touch on treasury. I'm really pleased with the treasury result this half, because I think they took advantage of both credit spread movements and particular the short term interest right movements in the U.S. and Australia. In terms of any 6 month period, difficult to say what the opportunity is going to be, but I'm confident that the team is competent enough, and can manage risk well enough that I can maximize the opportunities whatever they are. Now, I think, we started this year thinking that there was going to be no opportunities and the first half has probably thrown up a few more than what we thought, so we'll see. In relation to the -- sort of the mortgage quality, I think one of things I'd highlight, which I don't think is well understood is some of the change we made back in 2015. So particularly the income adjusted HEM. So HEM -- and HEM is not the same across all the bank, I should say. HEM is a 3 dimensional spreadsheet that takes account of income, takes account of number of dependents, location, categories of expenses and then you've got to average it up to whatever number you're going to put in your serviceability. So if you take -- at the moment you take the case that someone at $120,000 has got $44,000 HEM that we use, I just think there's a misunderstanding about what we use and how to compare it, because I can solve some of those problems by dropping the HEM, but that's not the right thing to do. Other banks use different HEMs.

Brian D. Johnson
CLSA Limited, Research Division

There is a vulnerability --

Peter Francis King
Chief Financial Officer

And I think it's any different to any other bank.

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

Brett Le Mesurier from Shaw and Partners. Brian you said that you are targeting cost-to-income ratio below 40%. To be at 40% now you'd need your revenue to be 4% higher given your expense level. So that means going forward you need cumulative revenue higher than your expense growth. Given that credit growth is slowing, it seems like it's going to take quite a few years to achieve that 40% target or get below it. Is that how you see it?

Brian Charles Hartzer
MD, CEO & Director

Well I think it's fair to say that -- clearly there's a revenue and a cost dynamic on this and over the last couple years we've had a couple of unexpected negatives on the revenue side where we've had to adjust down fees and various things like that. We've also had a much bigger increase in compliance costs than we expected. But I think with some of the compliance costs -- part of what we've had to do is throw people at issues where new regulations came in. Over time we expect automation to allow us to unwind a fair amount of that as we go back and reengineer these processes. And then the investment -- the increases in costs that we're getting as I said in my remarks, so really about investing in the platforms that we can start to take cost down. And if I give you -- try to bring that to life for you. If you take cloud computing, which is going to save us a ton of money over time on data storage, so in the last few weeks our second site for -- what we call our hybrid cloud environment went live. That means we can now provision data storage to projects about 3x -- sorry 30x faster than we used to and it costs about a 1/3 as much. And so we can now start the process of migrating our data storage into that private cloud environment. But to do that we have to make significant investments and we will start to get a step change on data storage costs, for example. So there's a whole bunch of things that are in the works that will begin to allow us to step our cost down over time and we obviously are trying to do that in a measured balanced way, so we can continue to grow share, continue to grow revenue and those 2 dynamics together should contribute.

Andrew Bowden
Head of Investor Relations

We'd take couple of questions from the phone. Matthew Wilson.

Matthew Wilson
JCP Investment Partners Limited

You know you added color on the APRA targeted review, you're really just highlighting industry issue, which all banks confront. The question is why was Westpac so far behinds peers, with the controlled environment and how do you reconcile that controlled fire outcome with your technology narrative?

Peter Francis King
Chief Financial Officer

Matt, I think as we -- we've always obviously had a good look at the 4 targeted reviews and its difficult, so I'm not sure that the standards were exactly the same. Now that's our assessment. Our approach has been to dig deeper to make sure that we're comfortable, we did. We've done not only the 38 that filed, but another much deeper review. And then looking forward the Customer Service Hub rollout with focus on mortgages is a critical capability for the company to not only improve the processes for the customer, but to improve the data capture and therefore the risk processes that look around mortgage applications. So that was something that we started a couple years because we wanted to improve it. I think it's -- in hindsight a good thing that we did started a couple years ago.

Andrew Bowden
Head of Investor Relations

I'll take another one from the phone from Richard Wiles.

Richard E. Wiles
Morgan Stanley, Research Division

Brian, in 2015 in your strategy update you said that you would target a cost-to-income ratio below 40% within 3 years. Today you targeting sub 40% and I think you said in the presentation just saying that would be over the next 2 year. I understand from your response to Brett's question that you think you've got some emerging cost opportunities which leads me 2 question. Firstly, does the 2% to 3% cost growth guidance remain appropriate beyond the current year? And secondly, do you think the $1.3 billion of annual investment spend finds about the right level or is there actually an opportunity for that investment spend to come down as you start to automate some of the processes that you just mentioned?

Brian Charles Hartzer
MD, CEO & Director

Thanks Richard. Well, as I said -- I think just to reiterate what I said to Brett. We have had a bunch of negative revenue headwinds and then increased compliance and risk costs that we weren't expecting which is why this is taking a bit longer than we would have liked. The 2% to 3% is pitched around the idea of what we think the revenue environment generally is going to look like. And obviously this year, as Peter said, we've got the one-off on the Royal Commission cost. In the future, we will continue to manage the company in the same way, which is, we will be looking to offset ongoing expenses with productivity. We expect that over the next sort of while to start to ramp up. And then the amount of investment that we -- the speed of investment is somewhat influenced by what we think the revenue environment is going to look like. So there is an opportunity to adjust. I think the current level of spending on investment is about right for the agenda that we've got. It will continue like that for a couple of years and then I would expect it will begin to ramp down as we deliver on some of these big projects.

Andrew Bowden
Head of Investor Relations

Anthony.

Anthony Hoo
Deutsche Bank AG, Research Division

Anthony Hoo at Deutsche Bank. Just couple of questions. Firstly, just on your credit quality. You mentioned before the increased overlays. Can you give us some insight into your thinking in terms of the outlook. I think some of the peers -- there were some divergent trends in terms of their movement in the overlays in the most recent result. And then secondly, following up on the questioning around the PwC report. You said you have done further reviews of the [Westfield] loan book. Can you comment on how extensive this review has been. And your interaction with the regulator, has there been any link to the increase in mortgage changes risk weight et cetera.

Peter Francis King
Chief Financial Officer

Okay. So -- I mean, the way to think about the overlays is, they were basically held. They were up $12 million in the half, so nothing -- to me it's just normal movement as we update our overlays. There is nothing that went up and down in a big way. Then on the PwC, the second review that we did was 1,300 files. It was -- and as I said it didn't throw out any new issues. So that was that was positive. I wouldn't link the changes in the mortgage risk weights with the targeted review. They are different process. It's the PD modeling in the mortgage, risk weighted asset calculation that is being reviewed.

Andrew Bowden
Head of Investor Relations
And with that -- that's thank you very much. No, let see, if we will -- thanks for coming.