Question and Answer

Travis Crouch
Chief Financial Officer

Thanks, Mike. We might just take questions here in Melbourne before we go to the phones.

Ian Rogers

So it's Ian Rogers from Banking Day. So look, to the extent that, that portfolio is the Murray lead [ph] and there's a leveling of the playing field, as you would call it, are you anticipating that smaller banks will have a reduction in risk weightings? Or the large banks will have an increase in their risk weightings?

Michael John Hirst
Former MD, CEO & Director

Look, I think there isn't room to move in the existing regulation to lower risk weight -- risk weightings for the smaller banks. So I think it's pretty well accepted across the industry that there will be an increase in risk weightings for those on the advanced model. Now, with any luck that will be us as well. It's the increase in that and the gap between the small and large that's, I guess, the most interesting.

Travis Crouch
Chief Financial Officer

Thanks, Mike. We might go to the phones now for questions.

Operator

[Operator Instructions] Your first question comes from the line of Jon Mott from UBS.

Jonathan Mott
UBS Investment Bank, Research Division

Two quick questions, if I could. One on the margin and just the impact of very low interest rates that you've called out. I just wanted to get a feel for the impact that you'd expect to see if we do see there maybe another 25 basis points rate cut coming through. Have you got a hedging portfolio, which would offset that? Or otherwise, what would be the margin impact of lower rates coming through over the next 6 and 12 months? And secondly, just on Homesafe. Obviously, another strong result. It's almost 10% of pretax profit is now coming from that business. It's been a great little returner, but probably maxing out on the returns it can generate, is it time to look at it to dispose of that asset and book a good gain?

Michael John Hirst
Former MD, CEO & Director

Why don't I start with the Homesafe one, and Richard can deal with the margin. Yes, look, it has been a great returner for us. The -- whether or not we necessarily want to get rid of those particular assets or things, probably it would be a moot point, we want to see that product continue to grow. We'd like to think that other people would identify the fact that it's been a good returner and look to come in and support the portfolio. I think we're a bit ambivalent about whether or not we sell our assets to do that or whether or not we fund new assets from other investors coming in. We're very comfortable with the risk as a percentage of our total capital base. Obviously, in this sort of environment a product like this is, is just all the more important for the aging population. So we'll see where that goes.

Jonathan Mott
UBS Investment Bank, Research Division

Don't you think that will do on someone else's balance sheet?

Michael John Hirst
Former MD, CEO & Director

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How to be good to be able to bring other people into support that.

Jonathan Mott
UBS Investment Bank, Research Division

Okay. And on the margin?

Richard Fennell
Executive of Customer Banking

Yes. John, in relation to the way we hedge, look, we obviously hedge the majority of our interest rate risk. However, we don't hedge completely all interest rate risk. And the reality is each month, they -- well, every day the positions move as our asset and liability positions move. What we look at with some of these issues is trying to match out any significant risk. But at times -- actually, holding -- there's no real value in hedging out some of the short-term risk. So if the market, for example, is already pricing in 25 basis points for the next RBA meeting or potentially higher and our internal view is that the worst case is 25 basis points to actually hedge out that risk for the next month, it doesn't -- it wouldn't make any economic impact at all. So look, the lower absolute rates do have an impact with -- on our business if nothing else in relation to the capital we hold, where obviously we're not able to generate as significant a return from that capital in the assets that's invested in. But yes, look, we actively hedge the amount of interest rate risk we're carrying at any point in time, there is, given our view of future interest rates as a bank versus where the -- what the market is pricing in. But the reality is lower interest rates, assuming they are fully passed on in asset markets, which going on the last move there a couple of weeks ago they have been, they do have a negative impact from a margin perspective.

Jonathan Mott
UBS Investment Bank, Research Division

How significant is that? Can you give us a basis point estimate on what it will be if rates get cut again?

Richard Fennell
Executive of Customer Banking

No, because it depends on exactly our hedging position. So I know what the last one impact is, but I'm not going to disclose it. What may happen with the next one, again, will depend if and when it happens and exactly what our hedging position is at the time. It's not an exact number for each move.

Operator

You next question comes from the line of Ed Henning from CLSA.

Edmund Anthony Biddulph Henning
CLSA Limited, Research Division

Just on capital. Previously, you guys have indicated around kind of the 8% mark as kind of where your goal is. Recently, peers and Regional Banks, Suncorp's saying they target 8.5% to 9%. You guys are kind of 8%, 14%. You've got the big capitalized software hit, which will show impact capital next period. Are you guys -- you say you've got a strong capital position, but are you guys happy where it is at the moment and obviously there are some headwinds coming?

Richard Fennell
Executive of Customer Banking

Yes. Ed, the capitalized software, the expenses that have been -- that haven't gone through that balance are already a deduction from capital. So that's built into that price, even though they haven't transferred to that capitalized software balance as capitalized expenses, they are already a deduction from capital, so there's no significant hit on that. Look, we certainly believe, given the risk we carry in our balance sheet, anywhere north of 8% in core equity Tier 1 is a strong capital position. Obviously, we're not carrying the additional 1% charge for being a domestically significant bank, or systemically important bank. We think we're domestically significant. The -- but the other thing that needs to be taken into account is the

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relativity of the risk weightings. And as we move closer to advanced accreditation, we'll see how that plays out from a core equity Tier 1 perspective if and when we get there.

Edmund Anthony Biddulph Henning
CLSA Limited, Research Division

Suncorp is in the same boat as you guys, and they're saying 8.5% to 9%, and they're pushing for advance as well?

Richard Fennell
Executive of Customer Banking

Well, you'd have to ask them why they think they need that much.

Michael John Hirst
Former MD, CEO & Director

Well, I think, one of the things you've got to look at, too, Ed, is just how much you've had to draw on capital over the last few years and we haven't had anywhere near the credit issues that Suncorp's had.

Edmund Anthony Biddulph Henning
CLSA Limited, Research Division

Okay, that's fine. Just on credit, just a second question on Great Southern. Your provisioning for Great Southern fell during the period by about 20%, but yet the loans or the arrears actually went up and the loans didn't fall nearly by that much. Was it just a specific provision that you've written off in that book? Or what actually happened there?

Richard Fennell
Executive of Customer Banking

Yes. That was just specifics reducing, the collective provision stayed at the same level, Ed. And it was one that we'd previously provided for being written off.

Operator

Your next question comes from the line of Mike Wiblin from Macquarie.

Michael Wiblin
Macquarie Research

Look, just a question around third party. Can you talk a little bit about the margin decline there? You sort of talked about competition and pay down, but the book seems quite flat, so obviously the margin is getting hit. So what's going on there? And are there any opportunities to, I guess, further adjust the cost base there, given that the business is under pressure?

Richard Fennell
Executive of Customer Banking

Yes. Mike, there's a number of contributors to that net margin decline. We've seen a significant increase in the proportion of loans being written as fixed rate loans and they have been, over the last 12 months, probably at a lower margin than variable rate loans. Having said that, variable rate loans are also under significant margin pressure. That third-party business, with broker channel if you like, is really where the competition is hottest because the reality is, other than price, there's very limited levers to pull to attract customers there. I mean, obviously, you need to provide a good service proposition to your partners, the brokers and mortgage managers, that's important. But price is an important part of the equation there. The other thing that is having any impact in our margin is the continued amortization of our low-dock book, which is at a significant margin premium, and that's now down to I think around 3% of our total portfolio. So as that runs off as well, that has an impact in margin. From a cost perspective, there are pretty limited direct costs in our third-party business. It's a low-FTE business. There's obviously costs in relation to technology and the like that you need to continue to invest in to stay relevant. And

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unfortunately, over the last 10 years, we've probably under-invested there and we're playing a bit of catch-up in that space. But also, it's a variable cost business. So if you write less loans, you incur less cost reprocessing and obviously through the commissions you incur as well. We do know that this is one of those areas where the level-playing field really has an impact. So if we can get on to that level-playing field with our value proposition to our mortgage broker partners and mortgage manager partners, we're confident that this business can start to grow again at a good level of return. We've got a -- we're probably going to have to battle our way through to that point, given the current level of competition.

Operator

You next question comes from the line of Andrew Triggs from Deutsche Bank.

Andrew Triggs
Deutsche Bank AG, Research Division

Just a question really around your investment program and specifically how you think you might keep to your positive -- flat to positive, given Homesafe accrual normalizing in the future periods. And also, while you're waiting for advanced accreditation, how you think you might manage that margin volume trade-off? You've elected for margin to this point, but as the cost growth picks that up -- sorry, it jacks up, do you need to do a bit more around volume?

Richard Fennell
Executive of Customer Banking

Yes. Look, we've got a very strong cost focus within the business from a BAU operating cost perspective. And we -- I guess, look at it a little differently around the investments we make and we look at that from a perspective of the investments that we have to make either for regulatory purposes or to stay relevant and up to speed with the competition. And then the other investments that we choose to make and can afford to make. The reality is, this Basel II program as it's winding down now although we've been capitalizing significant cost there, there are other costs that are being expensed straight to the bottom line and those will start to ease up. But this industry, as a whole, is an industry where you need to continue to invest, particularly from a technology perspective to stay relevant and never more so than now, with the speed of technology change. So we stay focused on costs. You're right to point out, if we do see any parts of our business start to generate reduced revenue, whether that be Homesafe or any other part of the business, we need to respond to that. And we stayed pretty hard in our focus on costs and we monitor them closely and try to make sure that we're only spending what we can readily afford to spend.

Andrew Triggs
Deutsche Bank AG, Research Division

Richard, in terms of your productivity program, I mean how far do you think you're through that? Are you -- have you seen easy wins in that space? Or just trying to get a sense on the trajectory on -- I know you don't split it out, but where you are in your productivity programs?

Michael John Hirst
Former MD, CEO & Director

No. Look, it's actually embedding a continuous improvement culture that is the key thing that we're trying to do, and we are seeing -- I think, that's starting to emerge. And I would be very hopeful that the efficiency continues to build for us. But what we are doing is we're taking resources that we free up and putting them into new investment opportunities. And so whilst the overall cost base probably won't change, the direction that, that cost base is aimed at will alter as we move forward. But the amount of efficiency that we're building, particularly through the retail networks, are really encouraging.

Operator

Our next question comes from the line of Scott Manning from JPMorgan.

Scott Robert Manning
JP Morgan Chase & Co, Research Division

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I've got 2 questions, one on Homesafe and one on the Community Banking deposits. So firstly, on Homesafe. Can you just remind us of what you expect that "normal run rate" to be if you have inflation like house prices? I thought from memory, it was somewhere around maybe $8 million to $10.5 million?

Richard Fennell
Executive of Customer Banking

In relation to inflation on house prices, depending what assumption you make. But one way to think about it, Scott, would be, okay, we've got a $450 million portfolio, multiply that by whatever percentage you would like per half, and then add a bit over $1 million a month in the discount we're recognizing. So I'm -- I'll let you make your own assessment on what you think a sustainable housing price inflation level is. I've got feeling you won't build into it the historical residential real estate housing inflation rate for Sydney and Melbourne, which, if you go back to the last roughly 30 years, it's about 7%. But I'll let you make your own decision on what number you put in there, but that's the way to work the maths.

Scott Robert Manning
JP Morgan Chase & Co, Research Division

Okay. And so in that context, how are you thinking about the earnings risk in the business when house prices inevitably do start to drift a bit more sideways and what that means for your payout ratio or your capital position? Because it looks to me like the ongoing strength in the Homesafe portfolio is the key driver of the dividend growth at the moment.

Richard Fennell
Executive of Customer Banking

From a capital position perspective, the unrealized gains, which are the mark-to-market value of that portfolio is not brought to account through our capital. So if we were to include, if we're allowed to include those unrealized gains that would increase our capital position significantly. So from a -- and so from a dividend perspective, I don't see that as a short-term risk because as those contracts complete and we realize those gains then that feeds through to our capital position, so -- however, from an earnings perspective -- look, if it does start to drift sideways and let's assume it was pretty much flat with the downturn probably just below $10 million a half rather than sort of $25 million to $30 million a half, that means we would be looking to generate income elsewhere or manage our cost base to ensure we could continue to deliver returns whilst maintain our dividend profile.

Scott Robert Manning
JP Morgan Chase & Co, Research Division

Okay. And then the second one on the Community Banking, the big deposit base there. Can you just talk us through what's been happening with deposit spreads? It looks like across the industry, spreads improved quite significantly in the back half of last year, but what the outlook is now for reduced rates moving forward and whether there's any prospects of potentially renegotiating the profit-share again with the community banks, given the change in the landscape?

Michael John Hirst
Former MD, CEO & Director

Look, I think, Scott, the keeping with what's happening in the deposit market at the moment is that, with return deposit rates where they are, people aren't valuing the fact that they get a higher rate for locking their funds up. So the flexibility that's provided by the differential between the medium rate at call accounts and term deposits is such that we're seeing a lot flow into at call. So it's potentially at a higher margin. We saw that through the GFC as well. So the question will be -- I think, there's a different motivation during the GFC, and that was the -- and there was some uncertainty around the security of banks generally on a global basis. But equally, there was some utility around having funds available should things turn around that probably hasn't happened, it's fair to say. But now with the markets running the way they are, with property prices running the way they are, then perhaps people are thinking about that -- needing that flexibility. In respect of the community banks, I don't think we'll be looking to renegotiate the margin the way it exists at the moment. But what we are doing is working with the community

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banks to move to a model that is more resilient as things change, and right now fixed rates or fixed-rate products in the community bank earn a margin, whereas I think what we'll be looking to do in the near term is change that to a margin-share basis because we'll be applying fund transfer pricing right across the business.

Operator

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

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

A couple of questions on Great Southern. Can you tell us how many people you've got in dedicated to the Great Southern recovery actions at the moment within Bendigo?

Michael John Hirst
Former MD, CEO & Director

I think it's to the tune of 15 or 20.

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

And do you expect the costs associated with any legal action to be treated as specific guidance?

Michael John Hirst
Former MD, CEO & Director

They've already been expensed.

Richard Fennell
Executive of Customer Banking

And in this last half, Brett, there was, I think, a couple of million dollars and that was around the finalization of the court case. The more significant costs were covered through insurance, but there was a shortfall there, which we put through as a specific item this last half year, costs going forward, including any legal costs relating to recovering these amounts, at this stage we would expect just to carry those through our normal P&L.

Michael John Hirst
Former MD, CEO & Director

Yes. But just having said that though, because nobody opted out of the class action, all those people are covered by the settlement. Because it's a quarter approved settlement, if we have to go to court to get the monies back then it's likely that they'd be liable for 100% of their costs and that's something that the class action lawyers have pointed out to all of those borrowers.

Operator

Your next question comes from the line of Craig Williams from Citigroup.

Craig Anthony Williams
Citigroup Inc, Research Division

I'm just wondering whether or not in considering your position on capital, whether you've done any exercise on benchmarking your capital levels with, say, the major banks and where you think you might sit in terms of this question of unquestionably strong. Certainly the S&P RAC ratio, which is some sort of measure of harmonized capital would see you, I think, sitting above the majors on that measure. But how do you think about this issue?

Michael John Hirst
Former MD, CEO & Director

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I think there's 2 things, Craig, one is using that RAC ratio we are well above the majors, so that would indicate to us that there's room to move, especially given we're not at the receipt D-SIB, so there's some additional room to move there. The other thing is that the -- any of the modeling that you do under Basel II has to reflect the complexity of the business. So the things that we're doing would suggest that we run a reasonably straightforward business and that the numbers that are coming out in respect of risk for us are supporting that fact. So it's really hard to know how it all comes out. At the end of the day, it's a negotiation process as you work your way through with APRA. We do know that you can't get more than 10% relief straight upfront, so that is probably a consideration that would put a floor under anything that you might be thinking.

Operator

Your next question comes from the line of Shaun Drummond from Fairfax Media.

Shaun Drummond

Yes. With the cut following on from the advanced accreditation once you actually achieve that and given that the risk weights are going up, what do you expect the actual difference to be realistically from your present position from risk weights? And one additional question, I mean, what are you going to do with that extra capital once you have it? Do you need to make further reasonably large acquisitions to maintain growth like Rural Finance? Or quite bigger than that?

Michael John Hirst
Former MD, CEO & Director

So I think the first thing to say, Shaun, is that we don't know what the outcome might be. The best we can do is take a line through those banks that are already on advanced accreditation. You can see through that analysis, that they're more -- you sit somewhere between 15% and 17%, we're currently at 39%. There's going to be a bit of an increase in capital for operational risk out of the advanced method, interest rate risk in the banking book, et cetera, although we wouldn't expect that to be significant. Then to overlay, on the top of that, the FSI considerations in the Basel, let's call them Basel IV for the want of a better name, considerations. So it's very difficult to be able to predict exactly what it might look like. We do know though, as I said in answering Craig's question, that we're not going to get anything more than a 10%, [indiscernible] should that come along. In respect of what we might do with that, we'll apply that to the opportunities that are before us and we're moving into a market where interest rates are very low, funding is readily available, capital is readily available, but generally, these are good portent of M&A activity. Surprisingly, we haven't seen a lot of it over the last year or so. So who knows, we might be in a market that's got a completely different mindset around that. We're very open to having discussions, and we do have lots of discussions with lots of different people. The alliance bank model, whilst on an M&A model, is something that allows us to continue to grow our business inorganically whilst allowing the mutuals and the credit unions to be able to continue with they do best, which is serve their customers and their communities. So I think there's good upside for us to apply the capital that might be released, and we look forward to seeing what those opportunities might be. Do you want me to comment on the Queensland banks? I'm not going to.

Operator

[Operator Instructions] It appears to be no questions at this time.

Travis Crouch
Chief Financial Officer
Okay. Thanks for that. So that brings us to a close for our half-year results presentation. Thanks to Mike and Richard, for those who joined us here in Melbourne and to those of you on the phone. Thank you, and have a good day.

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