Question and Answer

Daniel Ryan
Former Head of Investor Relations

Thank you, George. We'll start with questions from analysts and investors in the room, then take some questions on the phone. [Operator Instructions] For those in the room, please raise your hand. If you'd like to ask a question, wait for the microphone, name your -- state your name and organization. And let's begin with [John] in the middle here. Okay.

Unknown Analyst

Just trying to place a few things in account in there, George. It's obviously a challenging time to start. But you said it's going to take time, fundamental investment is required. You're trying to build a new digital bank for Virgin Money. It's coming through. The underlying earnings outlook is challenging. And I think on Slide 39, you've got a list of potential headwinds that come through, which is in title and a page long. The DRP participation was lower, and you want to maintain a strong balance sheet as you go through this whole transition program. So with all that in mind, I can understand where you want to get to, and you're going to provide more information coming out in February about what you want to get to, but should we be thinking next year is going to be even more challenging than this year? Should we expect, if you want a strong balance sheet, you're going to have to cut the dividend again next year to maintain the capital to get through this transition phase?

George Frazis
MD, CEO & Director

Thanks, [John]. And I'll let Matt kind of add to that. I mean the starting point is that our objective is to return to sustainable and profitable growth. And the objective of that is, for us, to be organically generating capital in the medium to long term. So that's the strategy we want to embark on, and that's what we will be presenting back to the market in February. There is actually no doubt one of my key focuses is to make sure we maintain a strong balance sheet, and that's going to be taking a lot of my attention leading up to February. At this stage, we remain on track and are comfortable with our unquestionably strong for FY 2020. But as I said, this is going to be an area of focus. I'll hand over to Matt to kind of add to that.

Matthew Baxby
Former Chief Financial Officer

Yes. I think probably, the points I'd add, obviously, February is critical in terms of laying out the business strategy and the needs of the business. But I think also, this half, which we called out, was impacted by a number of more volatile items, which resulted in more of a [calm down than] we'd ordinarily expect. There's obviously levers available in terms of managing capital carefully. They include, and George mentioned a couple of them, continuing to optimize risk-weighted assets; obviously, looking closely at the operating model, the mix of growth that we drive. I think they are all factors that contribute to that. But as I've said, I think the February strategy session is critical for the shape of the business.

Daniel Ryan
Former Head of Investor Relations

Yes. Pass across to Andrew.

Andrew Triggs
JP Morgan Chase & Co, Research Division

Andrew Triggs from JPMorgan. Just a question on the BOQ retail part of the bank. We've had a lot of focus in recent years on the niche segments. But the -- of the $31 billion mortgage book, the vast majority of that remains in BOQ Retail. So George, maybe some initial thoughts from you on what you think needs to be done to turnaround momentum in that part of the business? And I note that I think there's another 5 --

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another 5 reduction in the number of branches during the half, so that's been a long-term decline, partly intentional, but obviously, a lot of that unintentional. So what needs to be done outside of Virgin Money to improve the retail offering?

George Frazis
MD, CEO & Director

Thanks, Andrew. And the standpoint is, I'm 6 weeks into this role. So obviously, I am looking at all parts of our business in detail but, it's fair to say, when it comes to retail banking and business banking, this is something I've got a lot of experience in. So my initial observations on the retail bank are that there are a number of opportunities for us that we can actually improve our performance. My sense is that probably the critical thing is our onerous mortgage lending processes. So we've gone to the extreme in terms of conservatism, in terms of how we conduct those. So there is opportunity for us to streamline those. There are some improvements that we've already made, but we've got a long way to go on that. So that's going to be one of my key focuses going forward.

The other thing is, we haven't quite got the trade-off between our volume and price rates are being much more commercial and really being careful about the decisions we make on a daily, weekly basis. And again, this is something that I've got a lot of experience in. And Andrew, you did mention the other critical point is, for us to grow in our retail bank, we need to make sure distribution is optimized and performing. So a reduction of that capacity is not the right way to approach it, not until we actually get productivity up, and also our digital offering, which is another avenue that our customers have when it comes to distribution.

Matthew Baxby
Former Chief Financial Officer

Probably the one thing I'd add to that was, one of the things we called out in the first half was the removal of the regulatory overhang as we move through the Royal Commission, and then the need to simplify the commission model. And as we called out, that's something the team have worked hard on over the last 6 months with a view to rolling that out in the first half of FY '20. So that's simpler, ensures there's alignment of interest. I think that's a key factor, key ingredient as well.

George Frazis
MD, CEO & Director

Yes, actually -- maybe I should add to that. It's a good point, Matt. In the sense that if you look at our Owner Manager Branch network and, again, it's early days for me. But my initial observations and a good example of that, if you look at Frank, who runs our Bourke Street, the Owner Manager there. Now he's well-established in that community, really has good contacts with the business and the commercial community, provides great service to his customers. So we have got a point of differentiation that could be really -- that's going to be valuable for us. And how we incentivize him, how do we make sure that the alignment between the customer outcomes, what BOQ requires and also the Owner Manager is going to be something that we can tap into.

James Ellis
BofA Merrill Lynch, Research Division

It's James Ellis from Bank of America. Just to unpack a bit more the guidance statement for fiscal '20 of an expectation broadly in line for revenues and bad debt. On the revenue side, we've probably got at least one more cash rate cut coming through. Noninterest income continues to struggle to find a floor and there's -- as we've discussed in the room, not a lot of momentum in the mortgage book. So just wondering, how do we square that off? Why would revenues be broadly in line as opposed to lower? And then similarly with the bad debt charge, if the bad debt charge for fiscal '19 had upward pressure from accounting changes and risk model changes, which are presumably not going to be recurrent in the next year, why would bad debt charges not be lower as opposed to broadly in line?

George Frazis
MD, CEO & Director

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James, thanks for that. I'll -- maybe I'll touch on the revenue, and you can add to both of them if you want, Matt. Following the outcome, I mean, the key driver in terms of our revenue performance was, one, what was our asset growth. And you'll have to say, given the improvements that we are going to put in place in terms of particularly our mortgage processes and our lending process, in general, our sense is that we've got some leeway to actually increase our growth. That's not going to come at the expense of margin. It really is all about service improvement and improving that time to the right decision for our customers. So that's the starting point. There will be some degradation in margin. There's some tailwinds and headwinds. We've broken that up, and Matt can sort of touch on that more broadly. So in line, revenue is taking those 2 and looking at the balanced outcome for FY '20. But Matt, do you want to...

Matthew Baxby
Former Chief Financial Officer

Yes. Well, there's probably not a great deal to add beyond the moving parts that we called out in the presentation. There's obviously -- there's a continuing front-to-back book. We've got some pricing benefits that are sort of locked in and flowing through FY '20.

I think hedging costs, I think, probably where we're maybe a little bit different to some others in the industry is the rolling hedging program that we have there. So I called out a couple of the data points in terms of the step down from first half to the second half in basis. That's an enduring benefit that flows through the first half of '20, which gives us some margin support.

And then the unknown, as ever, is funding costs. I think in the second half of '19, we did see elevated costs associated with a bit of a repositioning of the balance sheet. So built some momentum in, obviously, deposits lengthened the portfolio tenor in wholesale. And we think, as I said, I think it will continue to be a headwind, maybe a bit less.

I think in terms of your question on provisioning, part of the reason we called out the moving parts on provisioning is to try and give the market clarity as to what led to the loan impairment result in the second half. I think that was an important part. And they were the right prudent steps to ensure that we’ve built resilience. I think the second part of that is, obviously, a couple of those specific provisions. They were onetime large exposures. They happen from time to time. Again, that was the driver of the loan impairment expense in the second half.

In terms of the outlook being in line, I think the way we look at that is, obviously, there is an uncertain economic outlook. We're confident in the quality of the underlying portfolio. The AASB 9 has shown there's volatility in model outcomes. And so I think that's -- there's a degree of conservatism in that. But I think it's probably the right shape of what FY '20 is likely to look like.

Andrei Stadnik
Morgan Stanley, Research Division

Andrei Stadnik from Morgan Stanley. Look, I just wanted to ask around the growth in mortgages in this half -- second half of '19. It seems as though there was quite a substantial pickup in the growth of interest-only has gone from about 16% to 24% of new flows. It's a -- kind of 2 parts to that. Do you think -- firstly, do you think you can increase that further because that is a higher-margin business? And then secondly, in this half, it seems that the increase in interest-only was actually on owner-occupiers because overall mix shift went towards owner-occupiers. So like, are you comfortable with lending to owner-occupiers on interest-only?

George Frazis
MD, CEO & Director

Okay. So maybe I'll take that. Again, just starting off in terms of mortgages, I think there's opportunity for us to actually improve our performance in terms of mortgage volume growth. And again, not at the expense of margin but improving our processes. In terms of interest-only, if you look at the book that we've got in interest-only, we're really comfortable with where that's at, and I think there's opportunity for us to grow in that. You're right in the sense that if we think about our go-forward focus on where we see opportunity for that to grow, it is more on the investor space rather than the owner-occupier. And there's

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going to be really good reasons why we're saying yes to interest-only for owner-occupiers and there are situations where that makes sense. So the go-forward position for us will be there is opportunities in interest-only. It will be primarily in investors.

Daniel Ryan
Former Head of Investor Relations

I think, Andrei, there was a note, too, that we did reclassify some construction lines into interest-only, which -- and so the increase wasn't quite as big as you flagged it.

Brendan Sproules
Citigroup Inc, Research Division

It's Brendan Sproules from Citigroup. I just got a couple of questions on a couple of business lines that are growing at the moment. So firstly, on BOQ Finance, that does say that business has been growing but it does seem to be chewing up quite a bit of risk-weighted asset growth. And as we saw this year, quite a bit of collective provision. There doesn't seem to be much coming through on the revenue line as we see in the disclosures around the business bank. Could you maybe talk about the type of returns that you're generating on that new business? My second question is on the BOQ Specialist. Business inflows or growth on Page 18 show that mortgages are kind of 5 or 6x the volume, I guess, on business lending within that channel. Is that the right sort of mix that you would expect from that business looking forward?

George Frazis
MD, CEO & Director

So maybe I'll touch on the BOQ Finance first and let you add to it, and then we'll go back to the BOQ Specialist. Standpoint, from my perspective, if I look at that business from what I've seen in being there for 6 weeks is that this is an attractive business that we've done pretty well in. So again, it kind of shows that if we've got a clear value proposition for customers, we can grow successfully. So that, I'm comfortable with that business, I'm comfortable with us growing that business. Obviously, with the change in the provisions, that has changed the collective provision, and we need to think through the right pricing and margin management on that business. And I would say more generally, our approach to better making that trade-off between margin and volume is going to be a focus, particularly in the short term for us. That does not mean that we won't continue to go after growth on BOQ Finance. Do you want to add anything to that, Matt?

Matthew Baxby
Former Chief Financial Officer

Yes, probably just the absolute focus on maintaining risk savings in that portfolio. What led to the growth, and I mentioned this in my presentation was the customer proposition absolutely lining up with a market need. And the team took some great steps to ensure that there was a true partnership with our customers and our brokers. That resonated well. And I think it's a really good demonstration of when we can line up behind the market in a particular target niche that we can generate good growth. And that wasn't at the expense of margin in that particular business line. Yes, there was a bit of collective that came with it because of the nature of the model, but that's likely to sort of settle down, I think, over the next few periods but, yes, comfortable with the return profile there.

George Frazis
MD, CEO & Director

If I look at BOQ Specialist, I'll say, that's an example of what we need to do more of. Effectively, what you've got is an absolute focus on the customer segments. So as a smaller player in the market, we're not going to win by being generalists. It is all about specialization. And the critical success around that is how good our bankers are and how good our credit people are working side-by-side to make sure they're delivering on a value proposition to the customers that is really compelling. Within that whole model, it's all about how do we meet the broader needs of that segment. So we're indifferent to if it's their personal needs or assisting them to finance their practice. It is all about being responsive to all the needs of that segment. And that's an example of a successful strategy that we need to expand on.

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Brian D. Johnson
Jefferies LLC, Research Division

Brian Johnson, Jefferies. I had 2 questions. The first one is, if we look at this concept that you see an opportunity to ramp up the housing volume growth, but we've got front book prices below back book, you're saying there's an opportunity in interest-only. But if we have a look at the most recent cuts, they're far bigger in interest-only than they actually are on P&I. Housing has got a lower margin than business loan. How can that possibly not basically come at the expense of margin?

And the second one is, unfortunately, banking is very much a scale game. And when you move into the digital space as a small bank, you probably just do not have as much investment power as basically some of the major banks. Looking at it, not to be too rude about it, but the operational execution for many years has probably not -- has probably been lacking. I'd just be intrigued if you could explain why we should suddenly be so confident that this digital bank that we rebuild under Virgin will work.

George Frazis
MD, CEO & Director

Thanks, Brian, and congratulations on your new role. Look, if I take the housing volume first, the critical thing in terms of the way we're going to approach growing housing is definitely not on margins. So -- and we've seen the impact in terms of the front book, back book. We've shown the half-on-half impact of that which is around about 4 basis points per half. That will continue. So that dynamic is not going to change. And in terms of how we priced on interest-only, if you think about the margin, the return that we get on interest-only, particularly on investors, that is a very attractive segment compared to the rest of the portfolio. So we chose to pass on that full rate as a result of that.

If I look at the digital bank and Virgin Money, there's 2 things I would say. Firstly, on the blue side, so on the BOQ side, we have already launched a new mobile banking app for BOQ Specialist. So we've shown under this new platform we're capable of executing and delivering. This is into a segment that is growing, so we'll support that growth. And as I said, it includes Apple Pay. So it's quite a strong proposition for that segment.

On Virgin Money, the difference I see on Virgin Money is that starting point is that business has a really clear understanding of what's required for their customer segment to develop something that's appealing. So the first thing I would say is that what's been designed is based on real clarity on what the customers need.

If you think about what's happening with technology going forward, if we’re doing this some 6 years ago, it would have cost us 4x the amount and taken us twice as long. So new technology in terms of cloud-based approach, which is what we're taking on this, and not customizing is what's going to reduce the execution risk on that. Now we've got a program in place over the next 12 months to deliver on that. The stage 1 of that, which is a proof-of-concept has been very successful.

Edmund Anthony Biddulph Henning
CLSA Limited, Research Division

It's Ed Henning from CLSA. Just looking at the capital consumption, reducing ROE, you've talked today about repricing potentially in leasing. Are there any other segments that you're looking at through your business that you're worried about the returns on. It's been dragging, obviously, the capital consumption and the falling ROE?

George Frazis
MD, CEO & Director

So I'll -- maybe I'll start and then let you, Matt, add to that. Same point, I would say, is that our objective in terms of the growth going forward is to rebalance between the finance business and the bank itself. That's not to say that we're not comfortable with the growth on the finance side, but we definitely have to start improving our growth rates on the retail and the business bank in general. Can I hand over to you?

Matthew Baxby

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Former Chief Financial Officer

Yes. There was a little bit of noise in what led to a step-up in risk-weighted asset growth beyond just pure bringing in, for instance, commercial and BOQ Finance customers on the balance sheet. So traded market risk, a bit of noise on securitization and some off-balance sheet items. So I think if you look back half-on-half over the periods, it was a step-up in terms of the drag, from risk-weighted asset growth as a result of a number of those moving parts. I think the return profile across our product lines, as George has called out, there's always opportunity. I think what's dragging returns around is structurally getting the cost base to where it needs to be to service the business that we've got. And one of the reasons George has called out as a priority simplifying our business, addressing costs, launching an operating model reviews to achieve exactly that.

George Frazis
MD, CEO & Director

And Ed, sorry, there was one more thing I wanted to add which slipped my mind. We are looking at what's the appropriate pricing for all of our business banking products. And in fact, that's an exercise across the board.

Edmund Anthony Biddulph Henning
CLSA Limited, Research Division

And just one clarification. In the last 2 halves, you've adjusted your models for the collective provisioning for AASB 9. Are all those reviews now finished? Have you gone through all your products essentially?

Matthew Baxby
Former Chief Financial Officer

Yes. So I think it's important just to call out the different aspects of those model adjustments. So there's obviously a transitional adjustment on the implementation of AASB 9, I called that to stop on 1 September. I think the second half is much more around continuing to improve the model. And in particular, things like loss given default rates that we've observed in our vendor finance portfolio, ensuring that they're lined up to the model. I think in respect to the agribusiness, given the conditions that we're operating in, that was really around adding some additional resilience. But that's a relatively small part of our overall commercial portfolio. I think it's less than 5%. So it's small. But again, I guess, it demonstrates a prudent approach.

Daniel Ryan
Former Head of Investor Relations

Okay. We'll go to our first question on the phones.

Operator

Your first question from the phone today comes from the line of Victor German from Macquarie.

Victor German
Macquarie Research

George, I appreciate it's only 6 weeks in your seat. But throughout the presentation, you talked about improving customer offering and customer proposition. And obviously, in your previous role, you would have had a view on the issue around front-to-back book. For BOQ, that issue has been arguably bigger than for peers and probably resulted in flow of volume growth in that channel as well. Just be interested in your observations on how you're thinking you can manage this without significantly impacting shareholders.

And second question on credit quality. In the past, BOQ has consistently told us that you have very strong focus on credit quality. And it appears that in the retail channel, it certainly holds true. But the increase in impaired assets that we've seen in this half kind of potentially suggest that you've taken a little bit more risk than probably market expected in channels outside of retail. Is that something that you need

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to review and potentially tighten risk standards, which will impact your growth going forward in channels outside of retail?

George Frazis
MD, CEO & Director

Thanks, Victor. I might take the first one and hand over to Matt for the second one. If I think about the 2 key impacts in terms of our mortgage growth, it's not been about our pricing. It's been about our onerous processes. So to be frank, we would be close to the slowest to market when it comes to providing a decision to customers. As you can imagine, particularly on the broker channel, that has a huge impact in terms of how successful you can be on that or not. And it impacts your customers more generally. So that's why one of my key priorities for short-term and medium-term improvements is to actually streamline that process. And there's many opportunities and I've got experience having done that. And so that's going to be our objective. On margin, we -- the other thing I said is a key priority, short to medium term is for us to maximize and manage that margin carefully so we optimize revenue. So that will be our approach.

Matthew Baxby
Former Chief Financial Officer

And Victor, on your question on credit quality, I think the starting point is all of our portfolios continue to perform as expected and we're comfortable with those. And in terms of what led to the result in terms of the lift in impaired assets, it was 2 single name exposures, $40 million. So that almost represents the entirety of that step up. During the presentation, we included some material around provision coverage. We're comfortable that we're fully covered there and it is the right level of focus on those connections.

George Frazis
MD, CEO & Director

The only other thing to add to that, if you look at those 2 exposures, there were very specific circumstances that related to those point.

Victor German
Macquarie Research

Sorry, George, just if I could just follow-up on your earlier response. I appreciate -- completely appreciate around the time of approving application, that's what's driving the flow. But I just still -- if I can push my luck and just get your thoughts on this issue, that has -- this week been -- or last week, I should say, been pointed by the [indiscernible]. Looking into this front-to-back book issue of mortgages, it has been something that's been fairly large for BOQ historically. Like, do you think you can manage margins given everything that's going on in the regulatory space?

George Frazis
MD, CEO & Director

So Victor, as you said, it's 6 weeks in. So that is something I'm going to be looking at in a lot of detail. The thing I would state is our view is that we have had a migration from back to front book. So we're dealing with customers all the time in terms of dealing with that. That has impacted our margin previously. Our view is that it will continue impacting our margin. The way we're looking at optimizing margin, this is something we're carefully looking at to make sure that basically, we're doing the right thing by all of our customers. As you would expect, many of our customers are on discounts. We -- this is something we're going to carefully navigate through. But our starting point is that we've got to return to profitable and sustainable growth. We want to do that through service as opposed to through price, and we'll have to manage the price issues over time.

Operator

Your next question on the line comes from Andrew Lyons from Goldman Sachs.

Andrew Lyons

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Goldman Sachs Group Inc., Research Division

Just a follow-up on James' question on your broadly flat revenue guidance in FY '20. You provided some great detail on net interest income, but noninterest income looks to have some reasonable headwinds heading into FY '20. Just dealing with each of them, firstly, fees have continued to step lower and even annualized in the second half outcome you've got a couple of million dollars headwind there. Secondly, you've had your best half in trading income in the second half since the first half '17. And thirdly, your insurance income remains under structural pressure and like fees, even if you just annualize the second half outcome, there's another couple of million dollar headwind there. So just wondering, are there any offsets to these -- to this headwind?

Matthew Baxby
Former Chief Financial Officer

Yes, thanks for your question. I think it is important to call out what some of the elements that led to an adjustment in noninterest income. So you've called out St. Andrew's. I think we've provided clarity in terms of what we think the shape of that line is likely to be through FY '20. I think there were a number of other sort of one-offs in terms of the transition -- the transition into AASB 15, some changes around the equipment sales income and BOQ Finance business, and also the migration to a new merchant arrangement. As we said, we think that's now fully embedded in the number that we printed in the second half.

In terms of offsets to that, I think it's obviously one of the things the team is working through in terms of the segment-by-segment review. But Virgin Money is making a greater and greater contribution to that line over time. They saw a good step-up in income from their partnership-related business during the half. And then we've also talked in previous periods about the opportunity in financial markets. That's an area we've invested in the last couple of years. And in terms of the outlook, I think, meeting more needs of those SME and commercial customers through financial markets business is important, too.

Operator

Your next question comes from the line of Josh Freiman from Macquarie.

Joshua Freiman
Macquarie Research

So just a bit of an extension to Victor's question, I noticed you guys mentioned that you're expecting the front-to-back book impact to continue moving forward. I think it's about 4 basis points. I just wanted to double check if you guys were willing to provide the quantum of the current front-to-back book gap? And in addition, second part, if there's any change in the average duration of the mortgage book?

George Frazis
MD, CEO & Director

In terms of disclosure, as I said, we've given the impact previously. Our view is that, that impact will continue over the next 12 months. Look, we're probably not going to disclose any more than that in terms of the average duration.

Matthew Baxby
Former Chief Financial Officer

Yes, yes. So maybe just to add to the sort of margin part, what -- part of the reason that George mentioned that it is obviously the front-to-back book element, obviously, transparent around that. Just an average rate across the portfolio, given the way segmentation across the home loan portfolio, has emerged, there's obviously different price points across all of those. So I think that's probably a bit less meaningful.

In terms of average duration on the home loan portfolio, we actually saw in the half an extension of the average tenor of our mortgage portfolio. So contributors to that could be maybe a perception that credit's been a bit more difficult to get. It's potentially one driver, a slightly less certain economic outlook. And

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we've only, in recent months, seen the housing market begin to show signs of life. So we have seen duration extend slightly. And yes, that's one we'll continue to monitor closely.

Joshua Freiman
Macquarie Research

Sorry, just on the extension of duration, is the average duration around 5 years or...

Matthew Baxby
Former Chief Financial Officer

Longer than that, actually.

Joshua Freiman
Macquarie Research

A bit longer?

Matthew Baxby
Former Chief Financial Officer

Yes.

Operator

Your next question comes from the line of Richard Wiles from Morgan Stanley.

Richard E. Wiles
Morgan Stanley, Research Division

I've got 2 questions on your approach to capital management. Firstly, today, you flagged higher capitalized software, the impact of AASB 16. You expect loan growth to improve next year but earnings to be lower, and you've also talked about the Virgin investment that you intend to make. So if we put all those things together, it suggests that your common equity ratio will hit below 9%. Could you remind us of your targets for common equity Tier 1? And can you explain why you're not topping up the capital as well as cutting the dividend today?

Secondly, on the dividend, you've cut it. It seems to be that you've decided to keep the payout ratio steady at 82%. Is that too high for a bank with an ROE of around 8.5%? Is there any strong reason why the payout ratio shouldn't be 70% or below?

George Frazis
MD, CEO & Director

What if I start and then hand over to Matt and I'll take those questions in reverse? Again, if we think about the dividend decision, that's something that the Board takes every reporting period and a number of factors are taken into account. The Board has taken a prudent action, as I said, to keep the payout ratio the same. We are going through a full strategic review. The objective is to get this bank back to a sustainable and profitable growth. We'll have more detail around that once we complete that review.

In terms of our capital target, our starting point is that, as I said, a key objective of mine is to make -- ensure we've got a strong balance sheet. It is going to take quite a bit of focus of mine and attention. At this stage, where we stand is that we are well-placed. We're unquestionably strong so we're comfortable with our position. But Matt, over to you there.

Matthew Baxby
Former Chief Financial Officer

Yes. I think, Richard, during the presentation, we called out some of the volatility that led to the print of CET1 in the second half. We called out the known items in terms of the investment in Virgin and the accounting standard change. And also, as George mentioned, how we're placed against it is unquestionably strong. And the levers we have available to continue to manage capital. I think, obviously,

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February is critical in terms of the team coming back with the business strategy. And that will provide clarity, I think, in terms of the outlook. And the Board obviously consider a range of factors in setting the dividend each half and will continue to do so based on the shape of the business that is in front of them.

George Frazis
MD, CEO & Director

And Richard, the only other thing to add, obviously, when we're looking at growth, we're very conscious of the risk-weighted asset impact of that. So -- and that will form part of our strategy in terms of where we want to grow.

Richard E. Wiles
Morgan Stanley, Research Division

Just a follow-up regarding capital. There's a slide in here. I can't find which one it is for the moment, but it shows that in your -- in this half, you had 7 basis points of capital usage. And I acknowledge that you didn't quite get the DRP participation that you expected. But going forward, you expect earnings to decline, that's your guidance. You've also said today you expect to get some volume growth. Those 2 things together mean that your organic capital generation will weaken. Then you've got software capitalized balances going up, you've got an 8 basis point hit from AASB 16. You've said you're going to make this investment in Virgin Money. All of those things suggest that the payout ratio will be low -- sorry, the capital ratio will be lower. And I acknowledge you've got the strategic review coming up and that you'll make some decisions on the back of that. But what's the capital you're targeting? Is that -- do you just need to be above 8.5% or do you need a buffer?

George Frazis
MD, CEO & Director

Well the same point is our first position, are we well-positioned for unquestionably strong? And our view is we are. In terms of the buffer going forward, that will depend somewhat on the realignment of risk-weighted assets that we'll get clarity from APRA at some point. And also, we'll have to take into account our ability to organically grow our capital. The thing to note is that our earnings forecast is for in-line FY '19 results and not a reduction in total earnings. And our views in terms of that mix of risk-weighted assets, we'll be tilting it more to the lower end of the risk-weighted asset products as opposed to what we've achieved in the last 12 months. Matt, on the...

Matthew Baxby
Former Chief Financial Officer

No. I think that says it all. Yes.

Operator

Your next question comes from the line of T.S. Lim from Bell Potter.

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

A question for George. I guess you have sat at the bank to some extent. Can you briefly tell us what BOQ's competitive advantages are?

George Frazis
MD, CEO & Director

Thanks, T.S. Again, it's 6 weeks in, but I have to say I'm pleased in terms of what I see as a fundamentally sound business. And what we've also shown is examples of how we can really differentiate. I've touched on those, for a bank our size, being all things to all players is not going to be the way we're going to win. It's all about really specializing and going after niche segments where we can provide a compelling and differentiated offering. Examples of that are Virgin Money Australia. So that is attracting a

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younger aspirational customer base, which is really a valuable approach to have in terms of increasing the customer franchise going forward.

Again, on the BOQ Specialist side, we've shown that when we go deep down segments with specialized bankers and credit people, we can be really successful. So that's going to be our approach. There are some fundamental things we have to fix, as I said, like processes that will help our performance. The other thing I would say is that I think our OMB model potentially has -- and I think strongly has the opportunity for us to differentiate. And it is all about making sure that we're leveraging the strong relationships those OMB managers have with both commercial customers, business customers and retail customers.

Operator

Your next question comes from the line of Azib Khan from Morgans Financial.

Azib Khan
Morgans Financial Limited, Research Division

A couple of questions from me. So firstly, I have to follow-up on Richard's question about the CET1 ratio. So George, I mean, you're clearly emphasizing that one of your focuses going forward will be balance sheet strength. BOQ's CET1 ratio has trended down from about 9.4% 2 years ago to now a touch over 9%. At the interim result, CET1 target range of 8.25% to 9.5% was laid out. And correct me if I'm wrong, but it looks like that target range has now been dropped or it's disappeared. So can you please tell us how low the Board is comfortable with the CET1 ratio dropping to? I acknowledge you're saying that you're well-placed for unquestionably strong, but in light of that, can you confirm that you're operating on the basis that you're down questionably strong benchmark for BOQ is 8.5%? More importantly, what I'd really like to know here is how low is the Board comfortable with the CET1 ratio dropping to? So that's the first question.

The second question is about business simplification going forward. You said you'll look to simplify and reduce the number of products on offer. George, do you see potential for banking fee income to be rebased to a lower level as a result of this? And the second part on simplifying your business, George, you've said you'll embark on an end-to-end mortgage lending transformation program. You're obviously coming across from Westpac's retail bank. Westpac at the moment is in the process of digitizing its end-to-end mortgage origination process, which they hope to complete by the end of next year. Do you have a similar transformation in mind for BOQ? And how long do you think that will take? And again, I know you're only in the job for 6 weeks but I think this will be an area where you've got some very good foresight.

George Frazis
MD, CEO & Director

Yes. So if I touch on both of those. The same point is, as I said, we're comfortable that we're well-positioned in terms of unquestionably strong. There's no doubt the next 12 months is going to be a transition period. And we'll be looking at how we approach in terms of our buffers. During that transition period, after developing our strategy, we're comfortable that we will be unquestionably strong. At this stage, there isn't a target that the Board has set, but through that strategic review, we'll be looking at where our target range will be in terms of capital.

In terms of simplifying the business, if I think about the noninterest income fees, effectively, a lot of the rebasing in our business has already occurred. So our expectation is that -- that we'll get some growth out of that but not significant growth. But in terms of the drag, it's had, it's unlikely to continue going forward.

On mortgages, the digital transformation of mortgages is important. So it's all about saying how do you actually create an end-to-end process that's streamlined. I'll have to say, we're in the position right now where there's a whole lot of improvements that we can achieve that don't require digital transformation of our mortgage process. So what we're going after initially will be all the low-hanging fruit which will then start providing results for our customer experience fairly quickly.

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Matthew Baxby
Former Chief Financial Officer

Probably the only thing I'd add, you mentioned 8.25% to 9.5%, but that is set out in our Pillar 3 as the management-endorsed capital range. I guess the moving parts are when they -- when APRA released their unquestionably strong discussion paper back in 2017, they talked about 50 basis points of additional capital beyond prudential limits. I guess the uncertainty for the industry has been how are they likely to calibrate risk-weighted asset in the run into 2022. So I think across the industry, that's what's created a little bit of uncertainty as to where is the precise landing zone.

I think probably the part I'd emphasize is that there were some things that contribute to a step down in CET1 in the second half. We talked about some of the levers that are available to us to manage capital organically. And George has said that balance strength is a key priority with a Strategy Day coming up at the end of February.

Operator

Your final question today comes from the line of Brett Le Mesurier from Shaw and Partners.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

A couple of questions on expenses. What do you think the average life of your current software -- capitalized software expenses is going to be?

Matthew Baxby
Former Chief Financial Officer

I'll take that, Brett. So it obviously varies. We do a case-by-case analysis of each asset based on its expected useful life. I think like everyone, things like digital assets that have a shorter life because they're more likely to cycle through is obviously shorter. But we are investing in, for instance, the core banking platform that will have a longer useful life. So it's probably not that meaningful for me to just give you an average across the range. I gave pretty strong indication of what we saw the amortization uplift into the first half of '20 likely to be if that's sort of where your question was going. So I think that should be relatively clear.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

My question's really going to what happens after that because if you're looking at 232 capitalized software assets and that's growing and you've got an average life of, say, 3 years, then your amortization charge is heading to 80 -- $80 million per year and it was $40 million this year. So it looks to me like the $10 million to $15 million is just the first step on the way to a more painful journey.

Matthew Baxby
Former Chief Financial Officer

You're right. The intangible asset balance is going up. I think an assumption around a 3-year life across that whole portfolio that I mentioned is too short. So it would be spread over a longer useful life of class of assets that we have there.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

Yes. On the comment you made before about the regulatory uplift, you said it was going to be $10 million in the first half and then $10 million in the second half. Does that mean increase of $10 million from second half '19, first half '20 and then $20 million increase from second half '19 to second half '20?

Matthew Baxby
Former Chief Financial Officer

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I think the way to think about it is for the second half of '19, we had $7 million of regulatory uplift. I think back that out to an underlying cost base and grow that by $10 million per half. So $10 million in the first half for RAC and $10 million in the second half for RAC.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

So increments of $10 million in each half.

Matthew Baxby
Former Chief Financial Officer

$10 million over the top of that underlying expense base.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

Right. So by the time you get the years' time, you're increased by $20 million relative from the start of the year.

George Frazis
MD, CEO & Director

No. You go through the $7 million.

Daniel Ryan
Former Head of Investor Relations

It doesn't go up...

Matthew Baxby
Former Chief Financial Officer

It doesn't go up twice, no. It's $10 million exactly.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

Okay. Good. And just related to that, are you going to have any more regulatory expenses not included in your cash items? Or is this a consolidation of the regulatory expenses that you haven't included in your cash expenses?

Matthew Baxby
Former Chief Financial Officer

Well, I think the non-cash items are obviously assessed each period. The point of having some noncash items is to ensure comparability between periods. This period had the tail end of the external legal costs associated with the Royal Commission are the true onetime regulatory cost aspects. Introduction of BEAR as an example. But I would expect that to begin -- that to be tailing off, as we've called that pretty transparently, through operating expense is what the RAC uplift is likely to be.

Daniel Ryan
Former Head of Investor Relations

Okay. That was the last question on the phone. So one final question in the room.

Brian D. Johnson
Jefferies LLC, Research Division

Brian Johnson, Jefferies. George, you've been in the gig for 6 weeks. Is this your result or will we basically get your real view at the update in '20? Like the past and new CEO, I'd be hammering everything, but it seems to kind of self-hammered it. If you have a look at basically a lot of the narrative there today, and it's not lost on me, George, that you did say under pressure, then you said earning's flat, but Slide 33

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clearly says next year's earnings expectation is down. But I'm trying to get a feel George, is whether we get a new CEO coming through at the -- in February '20, is that when -- is that what you're accountable beyond that point? Or is it because you're sitting here in front of us today, is this your result?

George Frazis
MD, CEO & Director

Yes. Brian, the starting point is if you look at the outlook I've provided, that is our expected BAU outlook for the year. As I said, it's 6 weeks into the business. We are going to do a full strategic review. I'm looking at every part of the business. We will come back in February in terms of what the strategy go-forward position will be. That will have some input -- impact on 2020, but the majority of the impact will be in the following years after that.

Daniel Ryan
Former Head of Investor Relations

Okay. That brings an end to today's briefing. Thanks for joining us.

George Frazis
MD, CEO & Director
Thank you.

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