Question and Answer

Caroline Dunworth Daffy
Former Head of Corporate Affairs

Any questions from the floor first? No questions. Mary, we'll go to the phone.

Operator

Your first question comes from the line of Jonathan Mott from UBS.

Jonathan Mott
UBS Investment Bank, Research Division

I had a question on Page 22 on payday pricing, and you've got a pretty good slide on there. My question really regards with pricing differential you have with some major banks at the moment. And as you highlighted it, there's a 159 basis point spread versus where the yield curve is at the moment. I wanted to get a feel on the ability to get the pricing down over the next while and the retention rates you should expect, especially given what you saw or in the promo websaver with quite a bit of

money flying out.

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

Yes, thanks, Jonathan. I'm glad you liked the slide. It's -- it all depends. This is a point-of-time chart. There are periods of time where we can actually relax going into it. One of the things that we are mindful of is the balance between the retail funding targets we do have in the longevity. And what you've seen is that we're actually putting a lot of value in getting a longevity into the deposit ratio. So we have been paying up a little bit more for the duration, and we have taken a strategic decision to actually relax the websaver side of things. It's not a hard-and-fast rule that you can do, and it relies very much on some of the competitor information and some of the stickiness we can get of our customer base. Ewan, do want to add anything to that?

Ewan Cameron
Former Chief Financial Officer

Nothing. I think you're right, Stuart. I think we're -- typically, we tend to pay like 10 basis points over and above, because what we're trying to do is grow well above system because it's very important for us to reach that target.

Jonathan Mott
UBS Investment Bank, Research Division

And so just following on from that, you're sort of mentioning that there's been a pressure coming through with the hedging cost as well. If the RBA does cut you'd you expect to see the ability to pass most of that through the depositors as well?

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

I think we'd have to wait and see, Jonathan. I'm not going to signal price at this point in time.

Operator

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

Matthew Davison
BofA Merrill Lynch, Research Division

A question for Stuart just on, I guess, the asset quality review and what you discovered in the whole process. I mean going back to January, you viewed the bank as pretty well capitalized. So clearly, you uncovered some pretty nasty practices. I'm just interested what really shocked you during that review period, was it the assumptions around realization values? Or was it just how much the market had moved in the last 6 months? And what confidence does it give you around that this skills in the bank to then embark on a snake-growth strategy going forward?

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

Yes, I'll try and deal with them. If I miss any, I'm sure you'll let me know. We're in -- the way of process is more that the market have moved quite dramatically in the period of time. And we also -- we were seeing some realizations of property coming through, which actually were outside what we would call the normal distribution of outcomes. And that caused me to-- and the management team to sit down and say, "Well, let's have a look at what we actually do have on our books." So we looked very closely at the impaired loans in our books and did a very sort of mark-to-market approach to them. And typically we'd be looking at valuations, which were probably between 1 to 3 years old. And with our geographical dispersion towards Southeast Queensland, a one year in property in Southeast Queensland is a very long time. And we found that even since the balance date of August the market had probably gapped another 10% to 15%. And what it caused us to look at is what really is the provisioning that we should use, and we put in place a collective provision to actually look at the-- some of, perhaps, the model weaknesses that we did find, which is the model wasn't as dynamic given the rapid shifts in property prices that we had seen. Moving into, I suppose more of what gives me confidence that we can grow the SME, we're not taking a broad-brush approach to it. We have brought some new people in to look at the strategy. We're focusing on niches of opportunity, and we are reviewing just the -- some of the lending practices just to make sure that we are air-tighting them. And that's not saying there's anything wrong with them, but it's a useful time to have a review of them, given the result that we've just had in the environment we find ourselves in.

Operator

Your next question comes from the line of James Ellis from Crédit Suisse.

James Ellis
Crédit Suisse AG, Research Division

I'm just wondering if you could just talk about cost growth given obviously was a good outcome with flat costs sequentially in the half but you've had a headcount growth of 3% over the same period. And you've also called out implicitly for the IT reinvestment, which presumably put upward pressure on cost going forward?

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

Yes, I mean, I'm not going to fill in the model for you, James. But what we've always tried to do is keep our cost growth pretty much in line with inflation, as you've seen over a period of time. One of the main reasons we're running on the efficiency program and riding hard on that is to make sure that we are creating room for investment as well as both on an IT basis, which really isn't coming through too strongly, but probably moreso on a personnel basis is to make sure that we have the capacity to increase the front-line staff as and when we move into some of these strategies. So I suppose the way to answer that is we have a very strong focus on what the bottom line is and the mix between income and expenses.

Operator

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

Wes Nason
Citigroup Inc, Research Division

Can I ask you, Ewan, just a quick question on the fee income? I know you kept fees down on the PCP, and I guess perhaps provided the share of fees you're paying to the LNB in full and certainly the commission. I guess that your commission base seems to be falling as well. Can you provide some observations on, I guess, what's going on there?

Ewan Cameron
Former Chief Financial Officer

The primary driver in the reduction in fee income is the result of industry movement towards fee free accounts, which we have a day-to-day account which we launched mid last financial year. And so that's -- there's been some leakage in fee income as a result of that. And the formulas around how we share the income with the owner management doesn't change in the last year, so it's just the dynamic of that. We have been trying to concentrate on trying to grow some other fees, for example, FX income which is up in the half. So we're pleased by that trend and we hope that will continue.

Operator

Your next question comes from the line of George Liondis from Australian Financial Review.

George Liondis

Stuart, look at -- obviously, interest rates are the topical issue at the moment. I'm just wondering, given what you've said about funding costs, where you expect interest rates to go? Do we -- should we expect to see more out-of-cycle moves by banks, including Bank of Queensland, even before the next RBA meeting or assuming the RBA cuts in May?

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

Thanks, George, and that's an easy one to go through. We've actually pretty much moved at the time the RBA makes their announcement. We believe our customers understand that the RBA reviews rates and movements around that time are understood. I think there's still a bit of a difficulty in the -- with a lot of our -- certainly our customers understanding the right moves out of -- what we call, out of cycle. We certainly don't have any plans to move that way, unless there's any major shocks that would occur. I think it's a very -- as you probably see in the presentation, I think it's a very difficult path trying to understand what to do with rates when you've got a 2-speed economy, the carbon tax is probably about to be introduced, unemployment still at fairly low level. I think it's a very hard position for the RBA to be in, and we just have to look at what we can do at the time of the RBA moving the rates. But we're always trying to do the right thing by our customers, which is why we've always been very early out in trying to get clarity to them as soon as we can.

Operator

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

Andrew Triggs
Deutsche Bank AG, Research Division

My question was just around the margin outlook. And particularly given that you'll have some housing reprocessing in the second half and you also mentioned the repayment to the government-guaranteed debt. Just on the public side of the equation, how much of -- or do you think the deterioration in deposit spreads that you've seen has fully flowed through the margin? Or do you expect some continued drag from that in this half?

Ewan Cameron
Former Chief Financial Officer

There will be some drag continuing, but a lot of it has already come in because the predominant issuance of term deposits had been in the 6-month to 9-month range, and that has those higher rates had really kind of come into place since August last year. And so all of it has come through already. We obviously have the benefit coming up this year from the government-guaranteed repayment. Current rates in the market in the U.S. means it won't be as great as we are hoping for, but there will be some benefit. Additionally, you've got 10 basis points repricing that went through in March, and we also have the benefit of the capital raising. So all those things are-- roughly offset each other, so it really depends on what happens with the yield curve.

Operator

Your next question comes from the line of Campbell Dawson [ph] from S.J. Investment Management. [ph]

Unknown Analyst

A [indiscernible] are a big chunk of your Tier 1 capital and they operate that in December, I think. Can you give any indication or you've any idea what you'll be doing with it?

Ewan Cameron
Former Chief Financial Officer

Sir, can you repeat the question?

Unknown Analyst

The [indiscernible] are a big chunk of your Tier 1 capital and they operate that in December. Can you give an indication of whether you would paying it or reissuing or what you're going to be doing with it?

Ewan Cameron
Former Chief Financial Officer

Well, we'll be with them to continue with that instrument. And in some form, it may need some potential tweaks in reissuance and refinancing towards the end of the year. But our expectations is we continue with some sort of hybrid Tier 1 instrument.

Operator

Your next question comes from the line of David Shi from Morgan Stanley.

David F. Shi
Morgan Stanley, Research Division

You mentioned in one of your slides that you aim to offer value for money to your customers. I just wanted to get a comment on when do you aim decide to SBR versus your peers going forward higher considering that your current price cap is higher and in line with Westpac?

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

Sorry, the line is pretty bad. I couldn't actually understand a word. Could you -- would you like to try and repeat it?

[Technical Difficulty]

David F. Shi
Morgan Stanley, Research Division

One of your slides, you mentioned that you aim to offer value for money to your customers. So I just wanted to get a comment from you, if possible, on where you aim to price your home loans SBR versus your peers going forward, considering your currently at your higher end in line with Westpac.

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

Yes, the value for money is actually not just based on price. What we are actually very good, if you look at the perhaps the owner-management model that we run, the fact is you can walk in today and open an account with an owner-manager in one of our branches. And you can go to their branch for the next 5 years and still deal with the same person who actually gets to know you, your family, your friends. And for that level of service, which you'll see in the community every day, it's not necessarily the absolute prize which drives the purchase decision. It's the extent that the relationship has managed. Now, we probably haven't been strong in communicating that value equation in the past. But the aim that we have here is to actually represent the value that we do present to customers over a long period of time, not just through Day 1. And through that, we think by getting to the client, getting more of the client's needs satisfied, we can actually gain more value when compared to the peers.

Ewan Cameron
Former Chief Financial Officer

The other thing to bear in mind, David, is that not many customers in Australia peers pay a standard variable rate. And you have to look at the current discounts or package discounts on offer, where we compare quite favorably with the major banks currently at an all-in price.

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

I was wondering what was important to you, your target of growing loans above system, or the 63% retail funding target?

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

Brett, I don't think it's an either-or type equation. We have a view that we want to get to the 63%. But we also have an understanding that we don't want to open the gates and grow at such rate that we're getting out of sync. So it's a very balanced approach. I don't think you'll see massive discount pricing, much as I don't think you want to see massive discount pricing to achieve loan growth.

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

Right, so you wouldn't expect, then, if you're achieving loan growth ahead of the system that you would have substantial NIM decline?

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

We wouldn't expect to be putting ourselves into a detrimental funding position.

Operator

Your next question comes from the line of Charlie Green from Hunter Green.

Charlie Green
Hunter Green Institutional Broking Pty Ltd.

Just on Slide 43, you made a reference to a compelling alternative to the majors. Can you just flush out where you think the compelling aspects might arise from?

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

Yes. Well, part of challenge is what I've already described with the unique operating model that we do have, where we have longevity in relationships with our customers. And the staff that exist, that deal with on of the retail level is actually very significantly solid that we don't have to reintroduce ourselves every time a customer walks through the door. We also look at service and not just the latest product sheet that we're trying to push. It's very much about talking to the customer, not putting them under pressure to deal with us and making a difference at the very elementary level of a relationship. At the other levels, and perhaps some of the newer segments we're looking at, for instance, when I looked at agri, which we've mentioned, we actually can target the customers that we do want to deal with because we aren't actually having to deal with a large back book and work out how to reduce the cost to serve to a number of clients, because we can actually choose where we want to go because we don't actually have large market shares in that. And while we're not quite there yet, one of the things we do have to get better at is absolute speed to market and we're not there. But I think once we get there, we will be making quite a demonstrable difference.

Charlie Green
Hunter Green Institutional Broking Pty Ltd.

I guess my point is you could have been wearing a St. George Bank hat and made the same comment--like, isn't everyone going the same way?

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

Yes, but I've only got one business card where it says BOQ, not Westpac and St. George. We are independent and we are very local. I don't think St. George could say that they have managers in place in their branches for 8 to 10 years, and the staff at a consistent for 5 to 7 years. I don't think they could do that. Certainly in some of the areas, they can do. But a lot of this is also down to the ability to execute, and I believe with the team we have, we do have an advantage to that.

Operator

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

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

This is question for Stuart. You probably have time to talk to the owner-managers since you were there. Is there still strong interest in running a franchise? And also, is there room for you to increase more corporate branches?

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

I would say that the demand for owner-managers isn't as strong as it has been. But having said that, we've just opened 3 or 4 in the last 2 weeks, so there is a demand there. I think the conditions are a little bit tougher than 3 or 4 years ago where it was a lot different, but we still have good demand. In terms of the corporate branches, we will look at corporate branches where it make sense. We do want to grow both sites, and we will open some corporate branches in those areas where perhaps where we see some value in a very high traffic, higher rental which makes it more economic for us to do it as a brand inflation.

Operator

Your final question comes from the line of Ben Zucker from Commonwealth Bank Australia.

Ben Zucker
Commonwealth Bank of Australia, Research Division

Stuart, really I guess a little bit of a related question to what you were just asked. But I just want to understand a bit better your thinking about the use of mortgage brokers and what you think, I guess, the spectrum is around how strongly or not you may choose to embrace that channel? And then what does it mean in terms of the change or mix of distribution when you look at the OMB franchise, how much more you feel that is and the growth opportunity for it, which you were sort of briefly touching on?

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

Yes, sure, Ben. The mortgage broker channel is an interesting one because 40% of home-loan clients choose to use a broker rather than use a bank as their first point of call. So it is -- it's a big part of the market. It's a growing part of the market. One of the reasons that we've -- haven't quite targeted it but we've mentioned it because there are opportunities to use that channel to move into graphical spaces that we're not. And with the owner-managers, they are originating and they are still -- most of them are still growing quite strongly. So it's not a conflict issue to the degree that we're operating in different spaces. And as I said before, we're very mindful of the funding constraints we do and also the relationships we do have with our owner-managers. So it's a balanced approach to it. And if you believe what some analysts are saying, the mortgage broker market isn't actually economic and it's one of the things we do have to look at as well as the economics of the whole transaction.

Caroline Dunworth Daffy
Former Head of Corporate Affairs

Stuart, we have one more question from the floor.

John Clifford

Stuart, John Clifford, RBS Morgans. Just a question around the Slide 46 that ran through the points of presence in the Queensland and WA, et cetera, and then your retail market share in each of those. That looks like you're underperforming, in terms of market share, the points of presence. So does that infer that you're in less or more populated in less-populated areas? Or how should we read that?

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

I read it more simplistically than that. There is an opportunity that we haven't actually been able to realize, and I don't think we've actually looked at the stats as-- sort of as simply as that and say there's opportunity. Now where we can realize the full opportunity, part of the reason might be what you said, we might be in the wrong spot. But we know that with our own owner-managers when they're performing very well, they are growing at a rate above the system, and that much we do know. So if we can get it right, the opportunity is not actually just to grow to our share, but actually grow through our share, which we do see what other banks in these markets have shares greater than their distribution base, and that's really what we want to get to.

Anthony Marx

Stuart, it's Anthony Marx with The Courier-Mail. I wondered if you could respond to some pretty harsh criticism that was leveled by Morningstar following the profit guidance and capital-raising announcement. They described the bad debts as "Liddie's legacy," that was their words. And they said this, "the increase in bad debts in emergency capital issue raise serious questions concerning previous senior management and the board." And they continued, "the news of massive disappointment and a worrying legacy of the business model established by the previous long-standing CEO." I wondered if you could respond to their comments?

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

It sounds quite personal, but I'll go back to the way we came to where we were, which is the moves in the market were actually quite extreme. And the policies we had in place at the time involved holding valuations on file, which is quite prudent across most Australia as most Australian banks would do, or up to 2 years of values to be current. And usually a 2-year valuation appearance if you're in Sydney or Melbourne would be quite appropriate. What we found, with the exposures we had in Southeast Queensland, particularly the market was moving at a much greater rate than that. In fact, we've seen falls over the last 12 months, which are very strong double-digit. I don't think -- I think that's a faculty of the -- that's an outcome of the environment and we've reacted to the environment in a pretty strong and prudent way. I think it's -- a part of it is the factor of where we actually reside, and the skew of our book which is up 70%, mortgages and 60% into Queensland. That's an outcome, and what we've tried to do is position the bank strongly for the future and this is very much about looking forward.

Caroline Dunworth Daffy
Former Head of Corporate Affairs

I think that's it.

Stuart Ian Grimshaw
Former Chief Executive Officer, Managing Director and Executive Director

Thank you.

Caroline Dunworth Daffy
Former Head of Corporate Affairs
Thank you.