Question and Answer

Operator

[Operator Instructions] Your first question comes from Victor German with Macquarie Group.

Victor German
Macquarie Research

A couple of questions from me, if possible. The first one is on margins. You've talked about improving the operating environment, and also, we're obviously seeing exit margin, which is significantly stronger than what you reported in the half. Anything that you can maybe highlight to us as to what we should think about in looking for margin trends into next half and why we shouldn't expect margins to go up by 5, 6 basis points in the half?

Richard Fennell
Executive of Customer Banking

Victor, look, that exit margin, certainly, we will be doing our best to try and hold that as close as possible to that. But trying to put a forecast on that when we are in such a dynamic environment right now is fraught with danger. I know that's a job that you have to do in your role, but as we sit here with 2% to 3% market share, needing to respond to the market dynamics out there, and not all of those market dynamics are visible, getting a good read on front book discounting is something that is very hard to do prospectively. Really, it's a retrospective -- it's retrospective information. So look, we are hopeful that we can keep our margin certainly toward that sort of number, but -- and look, 1 month into this new year, that's something that is -- has been achieved in the first month. But beyond that, really, it is such a dynamic environment. Our Pricing Committee meets every couple of weeks, and it is -- there is not a Pricing Committee meeting that I can recall in the last probably 6 or 12 months where we haven't been tweaking prices on one or both sides of the balance sheet as we respond to the movements in the competitive environment.

Victor German
Macquarie Research

But ex the competitive environment, there's nothing volatile that we should think of in the margin?

Michael John Hirst
Former MD, CEO & Director

I don't think there's anything that we know as of today that we'd expect -- that would make us think that there's going to be volatility in the margin. The -- I guess, one of the unknowns is what APRA is going to do with the risk weights and how granular that's going to be across the different product offerings that we have and where we can play in that space because we understand that we have to be competitive in our pricing, albeit we think the value proposition we have allows us to charge a premium, which these results reflect.

Victor German
Macquarie Research

Okay, thank you. The second question just on capital. So you've obviously invested quite a lot of money into getting advanced accreditation. With the latest paper from APRA it looks like, as an advanced bank, you will need to have some buffers. Just kind of your thinking to the extent, I appreciate there are still unknowns in terms of what APRA's going to do on capital, but to what extent, once you actually achieve that advanced accreditation, you may need to hold more capital, and relative to where you actually currently stand. And maybe I'll just ask my last question while I'm sort of talking, just on the Keystart portfolio. I appreciate that the trends that you're seeing in WA are similar in Keystart to the rest of the portfolio but given the high gearing in that portfolio, do you think that -- should losses start to materialize, losses within that portfolio, will be higher than the rest of your book?

Michael John Hirst
Former MD, CEO & Director

Well, I'll take the advanced accreditation one and Richard can work through the Keystart one. The one thing I would say, though, the Keystart portfolio arrears are significantly lower than that in the third-party channel. So it kind of sits at the average between the 2 channels. On the advanced accreditation pressure, you're right, Victor. We don't know probably the other half of what we need to know, which is what's going to happen with the risk weights. The -- I think the market's take on what APRA put out was that standardized would be at 8.5%, IRRB at 9.5% and IRRB with DCC at 10.5%. I think that's, from the discussions I have, probably a simplistic view of how it might pan out. And I think APRA's view is that they still want there to be incentive in the system for people to move from standardized to advanced. So once they put out the risk weights or it may be at the same time even, I'm sure you'll see some comments around how they're going to maintain that incentive. So it's not obvious to me that it's as straightforward as 10.5%, 9.5%, 8.5%. There seems to me to be some flexibility built in that to encourage organizations to improve their risk processes. And that is a fundamental part of what APRA have always said, they're measured by incentives to do that. So I'm not sure we can give you any more information other than to say APRA will announce those things down the track. But they are -- have been very firm with me that there is to be incentive remaining in the system.

Richard Fennell
Executive of Customer Banking

Victor, on Keystart, you're right. Those -- that portfolio is relatively high, LVR. However, it is also relatively low average value of lending per loan. When we bought the book, it had significant seasoning. And one of the things that attracted us to the book was the very thorough loan origination process in place, which is a sort of loan origination process that is more consistent with what you'd see from a branch network rather than through a third-party network. So look, the performance of that portfolio from a credit perspective is well within the originally modeled expectations. So we're certainly very comfortable with the way that's performing today and hopeful it will continue to perform well, but part of that will be driven a little bit by the Western Australia economy.

Victor German
Macquarie Research

And sorry, Mike, just so I'm clear on your response. Until you get advanced accreditation kind of sorted, is the target for you or you will be targeting an 8.5% core Tier 1 on your current basis? Is that kind of the idea behind it?

Michael John Hirst
Former MD, CEO & Director

Well, I think, Victor, it depends when you want to know about that target. So right now, we're a standardized bank, and we're operating on the basis that we need to be at 8.5% by 2020. And so we'll continue to do that. Now it's a little premature, I think, for us to make any decision about what that might look like on an advanced basis, especially given we're only going to have to wait a few months to find out how that might play out. So I think we'd just rather focus on being standardized. We have got 3 years to get to 8.5%; we're at 8.27% effectively. In a few months' time we'll know a bit more about advanced and we'll be making some decisions on the back of that.

Operator

Your next question comes from Anthony Hoo with Deutsche bank.

Anthony Hoo
Deutsche Bank AG, Research Division

Just a couple of questions. Firstly, just on the margin, I see that the share of third-party increased slightly by 2 basis points half-and-half. Just wondering , what were the key drivers there? And in terms of the outlook going forward, are there any drivers that we should know about that might change that?

Michael John Hirst
Former MD, CEO & Director

Sorry, Anthony, you only faded in at the start. So we missed a fair bit of the question. Do you mind repeating it?

Anthony Hoo
Nomura Securities Co. Ltd., Research Division

Yes, so my question -- first question was around the margin. I see that the share of margin paid through third parties increased by 2 basis points half-and-half. So I'm just wondering, were there any specific drivers in the half? And then also, looking forward, are there any changes, any drivers, that we should know about?

Michael John Hirst
Former MD, CEO & Director

Okay, as the margin has expanded given our model of sharing 50/50 with those Community Banks that bring in a fair bit of the business, it is -- it's just the way the math works that we would expect to see an increase in that margin share component. That is arguably exacerbated a little because the Community Bank branches tend to grow faster than our company owned branches. So you combine margin expansion with more volume through that channel, and you see that increase in margin share. In the same way if margin was to go backwards, then they would share some of that pain and you wouldn't see that same growth. Looking forward, I'm not aware of anything structurally that I can see that is going to have an impact on our margin. The key fact, as always, will be the competitive dynamics. And as we try and deliver growth on an ongoing basis at profitable prices, where can we set our price to make sure that's achievable.

Anthony Hoo
Deutsche Bank AG, Research Division

And just another question, so, a quick one, just in terms of the trading book income. I know that the second half was a lot lower than the first half, which is expected. But even against PCP, it was also quite a lot lower. Just wondering any specific factors in the half to influence that? Do you consider this more normal?

Richard Fennell
Executive of Customer Banking

Look, versus PCP, the PCP had a cash rate reduction in May, which the way we were positioned through our trading book with those May and August cash rate reductions, that did have positive impacts. So the 2 previous halves to this one were impacted by those cash rate reductions. Looking forward, I would have thought that the most recent half is probably a better guide than those 2 previous halves. But only time will tell.

Operator

Your next question comes from Jon Mott with UBS Investment Bank.

Jonathan Mott
UBS Investment Bank, Research Division

Question, if I can, all the way in the appendix on Slide 38 where you go through the approvals coming through. I remember last half, there was quite a lot of excitement, the hurdles had really started to pick up and now it has come back quite sharply over the last 6 month period, and you can see kind of that's the way that had been for the half before that. Can you just elaborate. If all the pullbacks are due to the investment property and you're having to pull your investment property back a bit, that follows onto the next part of question, which is, really the value proposition. You said you have to balance NIM versus growth. NIM margins obviously expanded a lot if you factor in the repricing that came through in July and into August, the NIM should be up again from the exit margin level. Have you effectively gone too far on

NIM? And do you need to pass some of that through to your customers to get the volumes unoccupied and principal interests up again?

Michael John Hirst
Former MD, CEO & Director

Yes, I think that's a reasonable question to unload. The APRA caps on investor and interest-only have had an impact, there's no doubt about that. The -- why that that's worked through leaves you with a pretty sort of blunt instrument really, which is around price, and you can't afford to try and do it with a scalpel because if you miss, the penalty's pretty severe. It would be like going into an operation to have your right leg amputated and they take your left off as well. So you've -- we've really got to try and work through the nuance of all that. The other thing that's been happening a little bit too is a trade-off between fee income and margin through some of this origination space. And how that works in that owner-occupied PNI space is a little different to how it might work in the investor space. So we're learning a little bit as we go along in this environment. But I think the amount of inquiry that we're seeing would suggest we haven't gone too far. But I don't think you know until you've done it.

Operator

Your next question comes from Ed Henning with CLSA.

Edmund Anthony Biddulph Henning
CLSA Limited, Research Division

A couple of questions from me. Just the first one on the amortization profile, and obviously, legging up next year. So with Basel II, the coming on potentially a little bit later in the year, we have another leg up in '19, on the amortization charge?

Richard Fennell
Executive of Customer Banking

Yes, good question, Ed. We really need to wait. And I know this won't help answer the question particularly well from your perspective, but we really need to wait until we see what the implications of the new risk weights coming out are to understand what that might mean for our treatment and the appropriate amortization life of the investment we've made in Basel II. So look, I expect if things play out the way we hope, which is there is appropriate incentives still there to move to advanced accreditation, then the way you are talking with a bit of -- some pickup in 2018 and then maybe another increase to some degree in 2019 may well be the way that plays out. But there are, I guess, a number of questions we've got that we want to get clarity on from those releases due from APRA in the next couple of months. Until we get that, it's really hard to be more definitive.

Edmund Anthony Biddulph Henning
CLSA Limited, Research Division

And just on the extra $10 million uplift you're talking about from $20 million to $30 million in '18, how much of that is included for the Basel II stuff or not much?

Richard Fennell
Executive of Customer Banking

Not much of that is Basel II. Most of that relates to the other additions that we've brought in, in FY '17.

Edmund Anthony Biddulph Henning
CLSA Limited, Research Division

Okay. And just kind of circling back to the questions on capital, and I know it's difficult to answer, but you've been talking that you're comfortable to achieve kind of the standardized 8.5% by 2020. Mike's mentioned that hopefully there is still an incentive there and from all the conversations you've had with APRA there should be an incentive to move to advanced accreditation. So if you move to advance on the things we know today, do you guys see yourself having excess capital or do you guys just see yourself having enough for a little bit of growth there? And that's it.

Michael John Hirst
Former MD, CEO & Director

I really don't think we can answer that Ed until we see what the risk weights are. So if you want to assume that the risk weights don't change, which I think would be a poor assumption, then there'd be a little bit there for growth. But I don't think there's any way that they're going to be the same as they are today.

Edmund Anthony Biddulph Henning
CLSA Limited, Research Division

Okay. And just one final one, while I've got it. Just back on to Great Southern. You guys looks like you've increased your collective provision a little bit there, obviously, that the books come down substantially. Is that just due to the kind of ramp that's left? I know you kind of said you're comfortable with things tracking pain down as expected but just one is the increase in the collective provision. Is it just to be more conservative or is it just a ramp of the portfolio coming through?

Richard Fennell
Executive of Customer Banking

Yes, the collective is actually flat from December, Ed, and percentage-wise, it is up because the portfolio is obviously paying back. But we didn't adjust the collective from where we were at December. It was really about taking a conservative position. Say in effect, we've increased the overlay there by the maths that we use to work out that collective provision, and that would have suggested we should reduce it, but we just used, I guess, some judgment that as we get to the ramp of what's left there, eventually we'll end up with some messy ones that are going to be really hard to collect. So we just took a conservative position now. That doesn't mean that in the next half or either the next several halves, we won't be reducing that collective further. It's just the opposition we chose to take this time.

Operator

Your next question comes from Craig Williams with Citibank.

Craig Anthony Williams
Citigroup Inc, Research Division

Banks have repriced mortgages, I think, something like 8 waves in the past 2 years but it sort of barely made any improvement in net interest margins at an industry level though there is some good signs emerging in your results this half. Can the sector you think afford to sort of continue to drink from the mortgage repricing well? Given the political pressures associated with compliance problems as well as sort of public disgruntlement with the extent of repricing, which has occurred in recent times?

Michael John Hirst
Former MD, CEO & Director

That's a good question, Craig. I think the repricing that's been seen in the industry in the last little bit is as a result of APRA's intervention in the market, which is essentially, I guess, the regulators jointly with the RBA trying to slow down the credit that's flowing to housing without really trying to slow down the credit availability in the broader economy because we've obviously not done investment to increase GDP, et cetera. So it's an interesting situation when you've got the government, et cetera rightly in some cases concerned about the cultural issues that might be happening across big business generally, not just in banking, and yet at the same time, the regulatory intervention forces you to do things that you're being pilloried for. So it's an unusual time, I'll certainly say that, but I think it's a time where consumers are looking for things other than just price. There's things other than price coming into consideration these days.

Operator

Your next question comes from David Spotswood with Shaw and Partners.

David Spotswood
Shaw and Partners Limited, Research Division

I guess, just want to go back to the question on the exit NIM of 2.34%. I mean, in mid-July I think on the 14th of July, you repriced up interest-only investor lending about 40 basis points. So the 2.34%, I mean, presumably, there is -- that's not a fully loaded number for the recent rate increases?

Richard Fennell
Executive of Customer Banking

Yes, that's right, David. That will provide some support going forward, which will help to offset the challenge I've been calling out for several years on the front book discounting versus the back book amortization. But absolutely, that most recent repricing does provide some support.

Operator

Your next question comes from Ashley Dalziell with Goldman Sachs.

Ashley Dalziell
Goldman Sachs Group Inc., Research Division

Just picking up on one of the previous questions around the outlook for mortgage credit growth. I suppose with what you can see today in terms of the step down in approvals and also a bit of extra work to come on in the investor and interest-only regulation, would a flat half-on-half mortgage balance type outcome be realistic from where we stand, or are you expecting to be able to achieve some growth in that second half?

Michael John Hirst
Former MD, CEO & Director

Well, I think, it's a bit difficult to call out too much, Ash, because we're 6 weeks in and everyone is still trying to adjust to meet the September requirements of APRA. So it's hard to know where the flow's going to head to some degree. And don't forget part of what's happening here is that the regulators trying to slow down the growth in house prices, and if there's a low growth in house prices, then there's, I guess, less people buying properties. And so less opportunities to take on new business because we know that when people want to change their bank, is they generally need a trigger point to make that happen. They either want to borrow more money or they're changing house or they're doing something along those lines. There's some other event that makes them seek out alternative financing. So it's hard to know what the industry growth rate's going to be as we go through this period of adjustment. Throw the risk weights on top of that and who knows where that goes.

Ashley Dalziell
Goldman Sachs Group Inc., Research Division

Okay.

Richard Fennell
Executive of Customer Banking

And having said that, Ashley, I mean we -- our intention is to continue to grow the business. Our -- and if you see the investor credit chart there, it -- we are certainly not looking for that to drop back down to 0. So we would expect to try and maintain that comfortably below the 10% but certainly, well above 0. So we will look for growth in the investor space. The challenge for us and I think most institutions is right now pulling back those interest-only flows, which you can see there historically have been above 40%. And we've got to get them sub 30% in a hurry and that's going to impact, certainly, the September quarter growth numbers right across the industry. So it will be interesting to see where system growth ends up, particularly in this half year.

Michael John Hirst

Former MD, CEO & Director

The conundrum in all that, of course, is that interest-only is predominantly what investors want because the tax regime is such that many people try and maximize the deduction that they can get. So it's as we've said, it's a little unclear as to how all that plays out.

Ashley Dalziell
Goldman Sachs Group Inc., Research Division

I just had a second question coming back to trading income. I think at the last result, you had told us -- flagged under a waning environment where we don't have the reduction in the cash rate or any material step change in cash rate expectations it would be very hard to earn anything at that line so the $7 million outcome I suppose is probably better than you had expected. And just thinking from here, I mean, if we do get another environment like we've just had with no cash rate shift, are we supposed to be thinking about that as being flat or closer to the $7 million that you've delivered today?

Richard Fennell
Executive of Customer Banking

So look, I won't bother checking the transcript, but I think my intention last time would have been probably to say that certainly we wouldn't expect the sort of contribution that we'd seen in the first half with no interest rate reductions. Certainly, I have a slightly greater expectation than 0 from our team that manages the trading book. So I would have thought -- I'd be hoping what's going to be north of 0. And -- but it's not going to be -- I'd be very, very surprised if it's anywhere near the $15 million we saw during half year where there are interest rate reductions. We are at 7, we're at 5, some other number, it is -- it's very hard to tell because this is driven by how you position that trading book, how you think the market will play out. But then the big one that you can't predict is how that the market will actually play out and what that means for the value of those assets you're holding in your trading book.

Operator

Your next question comes from Richard Wiles with Morgan Stanley.

Richard E. Wiles
Morgan Stanley, Research Division

I have 2 questions. Firstly, are you able to give us some indication of how much switching is going on from interest-only to PNI? And where the switching just relates to owner-occupied loans or whether investors are switching as well? And second question, on Slide 38, you say that 45% of your mortgage borrowers are ahead of the minimum repayment schedule. At Comm Bank's result last week, they said 77% of their borrows were ahead of schedule. I'm just wondering if that's a like-for-like comparison, and if there is a reason why half of your borrowers would be ahead of schedule.

Michael John Hirst
Former MD, CEO & Director

So I think we don't have a huge -- when you talk about the swap from interest-only to investors, you mean in the new flows we're seeing or do you mean amongst their book?

Richard E. Wiles
Morgan Stanley, Research Division

Mainly I thought it might come only in the back book, so where borrowers are saying their right...

Michael John Hirst
Former MD, CEO & Director

We haven't seen very much changing at all in the back book. One of the things that I suppose people need to think about going forward is if the risk weights change dramatically relative interest-only to PNI investor to owner-occupied is that going to provide incentive for people to want to encourage that behavior. There will be a trade-off there that I think we'll need to think about, but right now, we're not seeing our customers initiating that change themselves. In respect of the change -- the difference between us and CBA, we haven't included the amounts that are held in offset accounts which is pretty significant. So if we were to do that exercise, I imagine we'd get closer to where CBA are at.

Richard E. Wiles
Morgan Stanley, Research Division

Yes, I'm not sure that it's that significant. I mean each of the major banks Mike, have said that offset accounts are less than 10% of their total loan portfolio. So I'm not sure of exact number for you. I think you have disclosed it, but even if it's 10% of the book that's been offset, that only accounts for 10% of the 30% difference between your customers and CBA's customers.

Michael John Hirst
Former MD, CEO & Director

You can't sit there and say it's only 10% and it doesn't account for 3 months worth of payments. Those 2 numbers aren't correlated.

Richard Fennell
Executive of Customer Banking

There's $3.4 billion in those offset accounts, Richard. And what -- the assumption that if that's 10% or it's a bit less than 10% of the overall mortgage portfolio, so let's take a number and say it's roughly 7.5% or something like that. To say that's only 7.5% of the borrowers, that means those people have 100% of their mortgage offset by the offset account. Now we know that the amount people hold in offset accounts tends to be a relatively small fraction of the overall amount they borrowed. So I would be surprised if we weren't up around that same percentage, and maybe even higher when you look at that sort of percentage. 45% of home loan customers being ahead, excluding offset accounts, given the prevalence of those accounts, is actually a surprisingly high number.

Richard E. Wiles
Morgan Stanley, Research Division

I just find it surprising that more customers aren't ahead of their repayments given that interest rates are at record lows.

Richard Fennell
Executive of Customer Banking

If you hold an offset account, then the question in my mind is why would -- most borrowers would say why would I put more into the mortgage when I can just put it into the offset account with the complete flexibility that, that brings with the same impact of putting it into the mortgage. So it really is up to the customer's choice. It has exactly the same impact on their mortgage.

Michael John Hirst
Former MD, CEO & Director

I think there's a flip side in thinking about the question you're asking, and that is are we seeing any more stress come through at the mortgage help center in respect of our customers, and the answer to that's no.

Richard E. Wiles
Morgan Stanley, Research Division

Yes, but rates haven't -- rates are only just starting to go up.

Michael John Hirst
Former MD, CEO & Director

Yes, that's true. But rates -- interest rates won't climb significantly in the market, unless we see inflationary pressure. Historically in Australia, inflationary pressure has been driven by wage inflation. We are not seeing any wage inflation. But if we did, then people's capacity to pay would increase at the same time that the interest rates are going up.

Richard E. Wiles
Morgan Stanley, Research Division

Okay, could I just ask one final question? I take your point about the dollar value of the offset accounts may be not being the best way to measure who's paying in advance. Can you tell us how many of your customers or what proportion of your customers actually have offset accounts? Would it be a large proportion of the 45% who are not paying in advance?

Michael John Hirst
Former MD, CEO & Director

The numbers is in our third-party mortgage area, but we'll find out and let you know.

Operator

Your next question comes from T.S. Lim with Bell Potter.

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

What's your long-term view on ROE and the bad debt charge?

Richard Fennell
Executive of Customer Banking

I'll go to the second element first, TS. Look, ex Great Southern, our bad doubtful debt charge is 8 basis points. As I mentioned, I'm hoping that the contribution from Great Southern will -- we're hoping will pass the peak. So hopefully, we can get back down towards that 8 basis points overall. It's the bad and doubtful charge from our mortgage business remains very low in the retail business. It's at 2 basis points, the provisions going through that part of the business. And I think the loss rates is at 1 basis point. So what we do know is from time to time, you do suffer losses in business lending whether that be agribusiness or SME business lending, but they're harder to predict. But as I said, ex Great Southern, somewhere around that 8 basis points is probably somewhere -- a level that -- I mean, we're never comfortable with any losses, but it's probably reasonable to expect. As far as ROE is concerned, it's an interesting dynamic as we -- I mean, on the back of what was announced very recently with unquestionably strong -- with APRA expecting standardized banks on average to need to increase 50 basis points to their core equity Tier 1, as we assume that we will need to add roughly 50 basis points, and we've gone a fair bit of the way to doing that in this last half, that will have some impact in holding back the growth in ROE. Having said that, a lot of the work we've done around advanced accreditation has really helped us to understand the sort of returns on a risk-adjusted basis we are generating at a much more granular level, which is now fading through into making sure that we're getting appropriate turns from the new business we write. So the reality is we are looking to drive our returns on capital higher like all banks at the moment, where there's new rules coming through. It might be some delay before that really starts to have a meaningful impact on those ROE or ROTE numbers.

Operator

There are no further questions at this time. I'll now hand back to Mr. Hirst for closing remarks.

Michael John Hirst
Former MD, CEO & Director
Thanks very much, everybody, for your attendance, questions and interest today. We look forward to seeing you all as we go around this week, and talk about what is a really interesting time in banking. Thanks very much.