Question and Answer

Tanny Mangos
General Manager of Corporate Affairs & Investor Relations

Thank you, Anthony, and I see hands up already. I'm sure there's a lot of keen people to ask questions. But can I please ask that only analysts and investors ask questions? And also, given the heightened interest in -- and the number of questions you want to ask, can I just limit it to 2? For those in the room, please wait for the microphone, state your name and the organization you're from.

So we'll start with -- here in the front of the room. Thank you.

Jonathan Mott
UBS Investment Bank, Research Division

I'm Jon Mott from UBS. Anthony, I got a question -- or I'm just going to comment. Obviously, one of the big headwinds you faced is the ongoing runoff as the Owner-Managed Branch, minus $700 million in mortgages this half, and it looks like it's accelerating. You made some comments on that, and you said you're coming up with more clarity. And I just want to get a bit more detail on this. So from FY '20, you're changing the value proposition so it's going to be better for the Owner-Managers and it's going to be aligned with the shareholders.

So can you give us a bit more information on what you're proposing to do there, how it's going to change it? Will you be able to retain and attract more of the Owner-Managers back into the -- into this business model? And do you actually think it can stem the outflow which is being a huge drag on the business?

Anthony Rose
Interim CEO & COO

The clarity that Hayne has now provided I think is a real benefit for us in being able to address this issue going forward. The -- we all understand that the -- our frontline staff need to be Sedgwick compliant. That's irrespective of whether they sit in the corporate branch network or our franchise channel. But the way in which we share the returns from the portfolios with our franchisees is available to us without Sedgwick restrictions. We'd probably moved to a path that had added some complexity and volatility in the model of our remuneration structure with a franchise network that has created some degree of uncertainty. And as I've talked about earlier, the regulatory uncertainty of the changes in the broker remuneration model and how that might flow into our model had also been an overhang for that clarity.

The value share arrangement that we're talking about and we're in discussions with the franchisee advisory board at the moment, on what that would look like will be much more a value share, so aligned to footings, aligned to activity, aligned to growth and momentum, that we think will be simpler and easier for both the franchisees to understand but also allow us to align the shareholder interest with -- and customer interests to the outcomes for the Owner-Managers.

Now we will obviously be able to talk more fulsomely about that later in the year when that will come into operation sort of 1 September for the 2020 financial year.

Jonathan Mott
UBS Investment Bank, Research Division

And is this for all existing OMBs or we roll onto this as you see contract expires?

Anthony Rose
Interim CEO & COO

So the thinking at the moment is we would move this to the new model. The flexibility of the new scorecard model that we moved to some time ago allows us to amend the framework in the way that we're contemplating.

Jonathan Mott
UBS Investment Bank, Research Division

Can you give us a bit more detail? So how do you split? Like, so is it now more is going to the Owner-Managers so that they can stay in business and make money? And how does it change? Because you haven't this given as much detail on how you're actually going to remunerate them better to keep them attractive to stay in the business or attract new people in.

Anthony Rose
Interim CEO & COO

We have a balanced scorecard that's in place today that has measures that drive off a range of different metrics across a points-based system that, depending upon business flow and activity, has created volatility in earnings stream for the network. We think the model will move to -- going forward will be better aligned to the additional momentum that they can drive in their business, which they do, relative to what we would see out of a traditional corporate-owned branch network. And really sharing that upside in the outcome in a way that's much more transparent and simple for everybody to understand.

James Ellis
BofA Merrill Lynch, Research Division

James Ellis from Bank of America Merrill Lynch. Just 2 questions here. Staying particularly around capital implied, that the capitalized software balance was going to rise for some time. Just whether you could give us a sense as to when and what level that's going to peak out at. And then just secondly on St Andrew's, now that the transaction is canceled, it's not going to be complete, just what are the strategic considerations around it given it does appear to be a stranded asset at the moment?

Matthew Baxby
Chief Financial Officer

So I'll handle the first and might hand to Anthony for the second. I think, as we called out, on any measure, BOQ is in a strong capital position in terms of its CET1. In the last couple of periods, we've talked about the foundational investment that we've needed to make, and as I said, it's reflected in the rise in the asset balance. We spend in terms of our core portfolio between $60 million and $70 million of CapEx per year. That's partly to keep the lights on and continue to function and partly to pursue the things we think are most important from a strategy point of view.

At the end of the last half, we talked about the accelerated investment program, and that was in the order of 7-or-so basis points of CET1, about $20 million, and that was progressively going to roll through '19 and into '20. So that's the profile that we're working on. Obviously, that throws off a larger tail of amortization. But at the same time, we're investing in programs of work that either generate additional revenue, make us more efficient, ensure we meet our regulatory obligations so we consider them to be must-do investments.

Tanny Mangos
General Manager of Corporate Affairs & Investor Relations

I think we have some questions here in the front -- I'm sorry.

Anthony Rose
Interim CEO & COO

Sorry, just the second part of the question on St Andrew's. St Andrew's remains focused on delivering for its customers and our corporate partners. It's actually onboarded a number of additional partner relationships with some of the smaller ADIs very recently, and we've had some really good success in that business. I think, as Matt mentioned, we are continuing to look at the strategic alternatives that we've got in that business.

Andrei Stadnik
Morgan Stanley, Research Division

Andrei Stadnik from Morgan Stanley. Can I ask 2 questions, please? Firstly, around the earnings outlook you've given, can I clarify directionally what it is saying when you're saying 2H '19 earnings unlikely to improve on 1 half? Are you saying it is most likely to be flat? Or are you saying it could be flat or down?

Anthony Rose
Interim CEO & COO

Look, there's a lot of moving parts at the moment in this environment. So it's -- and we've got quite an exercise that we've outlined today that we will be going through quite forensically. The objective obviously is to lift return on tangible equity from the levels that it is at the moment. And I think the right way that shareholders will want us focused on that exercise is what is the sort of long-term recurring return on tangible equity profile as we go through that process. That's the focus that we will have. They may well be some shorter-term noise in the context of working through that transition. So other than the guidance we've given, that's pretty much the best we can provide for you at the moment.

Andrei Stadnik
Morgan Stanley, Research Division

And the second question, just in terms of thinking about your opportunity to grow the mortgage book in the second half, what are some of the opportunities there? And can BOQ move closer towards system?

Anthony Rose
Interim CEO & COO

Look, there are parts of the business, BOQ Specialist and Virgin, which continue to drive good growth. We've talked about the challenges in the Retail Bank. The end-to-end lending transformation in mortgages as well as the digital offering are obviously 2 big elements. The Owner-Manager franchise network and regenerating that with a new model, we think, will make a material difference, but I don't think any of these are very short term. They are things we think we can materially change of the dial over the next 12 months. That's -- we do see that upside in momentum beyond that. But it's not an -- immediate. Is there anything else you thought...

Matthew Baxby
Chief Financial Officer

I think Anthony called out pretty directly the 2 or 3 constraints that we've seen in the Retail Bank. I think one in particular to draw on is we were early adopters of the requirements around responsible lending. And there's still is inconsistency in the market in terms of how those standards apply. And what we're focused on are the things within our control. And the things within our control our how we enhance our process, really put the customer lens over the top of how those standards are applied. And we think that creates -- that will create opportunity for us.

Edmund Anthony Biddulph Henning
CLSA Limited, Research Division

It's Ed Henning from CLSA. Just following up on the cost and the amortization going forward. You touched on some of the regulatory cost rolling off. You've talked about some of the cloud investment. I'd imagine that -- can you just confirm that will be reinvested back in the business? Any benefits from that? But also, just the amortization profile next year, how long do these assets amortize over? Is it 5 years? Is it 10 years?

Matthew Baxby
Chief Financial Officer

Yes. Well, the amortization, it's asset by asset. But generally, it's a period of around 5 years in terms of the amortization profile. As we called out, they're must-do investments. They advance us in terms of efficiency and strategically positioning the business, but they do throw a tail of amortization off. The exercise Anthony called out is absolutely partly about how we get the top line moving. But it's also efficiency and simplification. And I think that's where a real opportunity is for us to offset some of the lifted amortization through next year. But yes, we would see that as a headwind into FY '20 without mitigating action.

Edmund Anthony Biddulph Henning
CLSA Limited, Research Division

There will hopefully be some offsets that'll -- that offset some of that amortization going forward in '20 and '21.

Matthew Baxby
Chief Financial Officer

Well, that's absolutely what we are pursuing, yes.

Anthony Rose
Interim CEO & COO

And the plan would be that we've made a commitment across board and management by the end of the year we would be articulating the output of all of this work that we're doing, and we'll be in a much better position to provide guidance as to what we think the 2020 cost number will look like, whether we were allocating those resources and where we believe the customer value propositions are that we can win in a lot greater degree of granularity and detail.

Edmund Anthony Biddulph Henning
CLSA Limited, Research Division

And just the second one. Just on the guidance and the collective provision with the step-up due to the accounting change, what have you assumed in the guidance going forward? Obviously, that steps back. Or are you assuming things to deteriorate from here?

Matthew Baxby
Chief Financial Officer

I think we've called out the component parts of the impact of transitioning to AASB 9. There's obviously the one-off in terms of the model adjustments which we flagged at the end of the last half. And I think the other thing we flagged at the end of last half was volatility that we were going to see from the model, and really, that's what's played through this half. I think there will be a transitional element to this because if you take as an example BOQ Finance obviously saw strong growth in the half, but with that growth comes the booking of an impairment expense. So as the model begins to apply to that new business, we will see the step-up. But over time, that should normalize because they'll see portfolios runoff and you just see the benefit of that. So I think some really volatility for us but, obviously, one that we monitor really closely.
I think one of the points I did make was around the strength of the underlying portfolio in terms of asset quality. I think that's something that gives us a lot of confidence.

Andrew Triggs
JP Morgan Chase & Co, Research Division

It's Andrew Triggs from JPMorgan. Two questions please. Firstly, on the NIM. The third-party cost, whilst there's been some, obviously, volatility due to the weighted average life of loans in the broker channel, the drag on the NIM now at 34 basis points has been growing despite the fact that, that the channel has been disappointing from a loan origination perspective. How do we reconcile that? Is it perhaps the balanced scorecard making an impact from the deposit gathering side of things?

Matthew Baxby
Chief Financial Officer

Sorry, Andrew, can you just clarify your question?

Andrew Triggs
JP Morgan Chase & Co, Research Division

You'd be sitting on a 34 basis point drag on the group NIM from the third-party cost element, and I would expect that perhaps given the Owner-Managed Branches have struggled to -- from a loan origination perspective. So it's surprising to see the share or margin actually increase over time.

Matthew Baxby
Chief Financial Officer

So maybe just to clarify, the third-party cost element, the additional basis was more down to additional brokerage than it was Owner-Manager cost. So we did see strong broker originations as an example through Virgin Money. That's what led to that slight uplift. And all things being equal, we expect that element of net interest margin to be pretty stable from here.

Anthony Rose
Interim CEO & COO

And we're paying commissions through that line on both our Owner-Manager network and our broker network. And there's been a higher mix of flow through those channels than there has been in our corporate branch network where we obviously don't pay it. And you're still going to write 20% of your balance sheet just to stand still in the mortgage space, as you know.

Andrew Triggs
JP Morgan Chase & Co, Research Division

And then the second question just around -- you mentioned the new Fast Track Saver product, pretty high interest rate on that product relative to the Bonus Interest Saver Account (sic) [Bonus Interest Savings Account], just your thinking around the pricing of that product. I mean, the fear, I guess, is that while last period you showed some good development from a transactional account perspective, just a question whether that's a price-led offering which may well get good flows in the door but at some expense to the margin.

Anthony Rose
Interim CEO & COO

The proposition is linked to transaction balance as well together with the higher saving piece. So it is a broader piece. It is also a reflection of the fact that we have not traditionally resonated well with that customer cohort, at the younger end. And it is a way of attracting those customers, acquiring those customers earlier in their life cycle when you actually have an opportunity to do so. And so there is a bit of an investment in the future in that strategy, there's no doubt.

As to your comment on the transaction account, yes, I think increasingly the capability gap that we've got in our digital asset and mobile banking offering is increasingly impacting our propensity to attract and grow customer balances in the transaction space. And as we talked about, we're steering into that as quickly as we possibly can.

I will add, we have been trying to move very fast on this, but the core infrastructure modernization that I talked about is a very critical foundational piece for the maturity of this business. I mean, those that remember in 2012, if you can go back that far, we had $15 million of investment spend in technology per annum, and we only had $40-odd million of capitalized software, which does show a more paper-based organization as you would remember. We have had to lift capability a lot over that time period. And actually, having the clarity of that new modern platform from which we can now design and build these digital solution for our customers has been a key dependency for us. And we're now starting to break some of those chains in unleashing where we could take the organization forward.

Tanny Mangos
General Manager of Corporate Affairs & Investor Relations

We'll just take one more question from the room before we go to phones.

Anthony Hoo
Deutsche Bank AG, Research Division

Anthony Hoo at Deutsche Bank. Just question around outlook. You've talked about initiatives for long-term value creation. So in reference to the dividend reduction, should be expecting a significant investment program on top of the 7 basis points that you mentioned last half for digital?

Anthony Rose
Interim CEO & COO

Well, the program that we called out in the accelerated investment is about delivering the digital offering. So there's nothing over and above that at the moment. The Virgin piece is probably the element there. We do think that the opportunity we've got there is real. And -- but we also think that we're capable of financing that within our existing capital resources. We still do consider ourselves to be quite very well capitalized. We think there's a little bit of room to move below the current level of CET1 that we have today to accommodate whatever might emerge as the opportunity for us in the Virgin Money business.

Tanny Mangos
General Manager of Corporate Affairs & Investor Relations

Okay. We'll take some calls. So...

Operator

Next question is from Brendan Sproules from Citi.

Brendan Sproules
Citigroup Inc, Research Division

It's Brendan from Citigroup here. I just have a question on the regulatory cost that you've highlighted in the second half. Is this going to be a permanent change to your risk management capability and therefore an ongoing cost in the organization? Or is this more project related in terms of adjusting your current systems?

Matthew Baxby
Chief Financial Officer

As Anthony called out, I think, very clearly in his presentation, the Royal Commission outcomes changed the game in a lot of ways in terms of the standards required across the industry. And I guess we're foreshadowing that we've spent -- we expect our expense base to increase certainly in the second half and called out the 2 elements of that, one being more likely to be recurring. And that's more around strengthening 3 lines of defense, ensuring that all aspects of our business are compliant.

Alongside that, we do think this is a wave of activity that's going to be required, certainly, in the next half and into FY '20, which is more focused in lifting standards quickly and remediating any of their processes there. So we think that's the right way to think about it is, yes, there's an element that's recurring which is a result of standards just being lifted, and there's also an element of us staring into some things we need to address quickly and moving on those.

Anthony Rose
Interim CEO & COO

I'd probably just add. I think the industry, and that's participants and regulators, operated in an environment of best endeavors in meeting customer expectations and outcomes. And that's clearly not been enough, and that's been demonstrated out of Hayne. And we are now in a show me how you can positively attest to meeting those standards and that they are effective and embedded. And that is quite a significant shift. We will need to be smart in the way we shift the organizational focus to address that because if you're going to lay a further regulation on top of whatever exists today, what you don't want to do is damage that customer experience. And I think the way we're going have to think about that is starting with the customer outcome lens as the absolute anchor point for the way in which we deliver against those expectations and reimagine what that customer experience can look like.

Operator

Next telephone question is from Victor German from Macquarie.

Victor German
Macquarie Research

I was hoping to just follow up on a couple of questions on margins, actually. So the first one relates that issue that has been an ongoing issue on front to back book. And Matt, you've highlighted that you expect that number to reduce going forward. Just interested if you can maybe perhaps elaborate a little bit on that, whether it's driven by the gap between your front book and back book closing? Or is it because the loan life is increasing? Just some more clarity on that will be useful.

Second on BBSW, I think you mentioned that you expect that to be a 1 basis point benefit. Looking where the numbers -- or looking where the spread is now, I would've thought it should be bigger benefit, but just reconciling whether you're just not expecting that full benefit to sort of play out or where your sort of assumptions are on that. And just a point of clarity whether that 1.1 basis point benefit is incorporated in your guidance for second half.

And lastly, I know there's been 2 questions on this third-party impact on margin, and we've seen an increase this half. As we see more growth from Virgin, I mean, should we be assuming that, that number will continue to grow? And in light of some of the changes you're anticipating in 2020, is that number likely to grow over time?

Matthew Baxby
Chief Financial Officer

Great. Glad I brought my pen so I can write the question down. I'll pick each of those off. So the first on front to back book. We did call out that we think that the impact through the second half should be less. That's predominantly a result of the higher mix of Commercial business starting to flow through our portfolio at higher margin. And then as a result, yes, as we've called out, we saw good growth in BOQ Finance, but that wasn't at the expense of new business margins. And the net result of that is the portfolio weights more towards Commercial that sustains the margin.

In the second, on basis, yes, we called out a 1 basis point impact, I think. Basis has been volatile. And if I look at the half on half period, first half '18, basis was 23 basis points, first half of '19 that we booked around 46, currently sitting at 28. So there's some fairly large volatility there. I think -- we obviously run hedging programs that smoothed some of that volatility, that rolling hedging program that we have. But the net result of that is that it typically takes longer for basis to roll through the hedges and impact our P&L directly. So that's why we're calling out a slightly lesser impact in the second half than if we were unhedged. But we would expect that to roll through FY '20 as the lower basis gets factored into the hedges from there.

The third point on third-party cost, as I said, I think we called out the moving parts in terms of third-party cost and how it impacts margin. We wouldn't expect a significant lift in those costs. The mix of originations that we do can vary a little bit half on half. And we saw a particularly strong result from Virgin in this half at the same time as some of the flow through our Owner-Manager network backing off a little bit more in our corporate network. So overall, we think, period on period, it should be pretty stable.

Victor German
Macquarie Research

Sorry, Matt. Just so I'm 100% clear, so the front to back book is, for the mortgages, did you expect to be 4 to 5 basis points like -- as you have experienced in the past and the difference is the mix impact. Is that how I should be reading your response?

Anthony Rose
Interim CEO & COO

We think it'll be slightly lesser than the periods that we've seen previously, and it's predominantly down to Commercial mix.

Operator

Next question is from Brett Le Mesurier from Shaw and Partners.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

So I've noticed that the amortization of intangible assets for your IT expenses has been falling, the $22 million in the February '18 half, $21 million in August '18 half, $19 million in the most recent half, while the balance of your IT intangible assets has been increasing. Can you reconcile those 2 trends please?

Matthew Baxby
Chief Financial Officer

Yes. So in terms of the amortization that was booked in first half '19, that benefited from the write-down -- or the reassessment of useful life of assets. So that provided a bit of air cover there. But obviously, the other factor that goes into the amount of the amortization charge is the point at which assets move from being under construction to completed and, as a result, throwing amortization off. We have got some large programs of work that Anthony has called out that are in -- progressing through and being delivered. A good example is the infrastructure modernization. As that completes, it moves through to amortization. But in terms of the trends you've called out particularly between '18 and the first half of '19 is more down to the adjustment of useful life that we saw at the end of '18.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

So that $19 million in the February '19 half, that really relates to the $111 million software intangible asset balance. And doesn't include the $69 million assets under construction, that's there in August '18, is that correct?

Matthew Baxby
Chief Financial Officer

Yes. Correct.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

Therefore, the amount of the rest of the balance that is going to be subject amortization is going to be twice the level than the amortization currently applied to, and that's why the increase period in amortization is so important for you to keep the amortization charges down. That's the correct interpretation?

Matthew Baxby
Chief Financial Officer

Yes.

Anthony Rose
Interim CEO & COO

I'm not sure exactly what you mean by the increasing period. I mean, the other way to look at it is, the charges around the $40-odd million mark at the moment that we talked about a $65 million sort of circa spend. So you will see convergence from -- on an annual basis, you will see convergence between those 2 numbers with the additional overlay that the accelerated investment spend bucket of around $20 million will be sort of an additional wave to put on top of that. But that's the expectation.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

You used to amortize them over about 3 years. That's what it looks like and you're increasing it to 5. That's what -- really what I meant. So 5 -- the increase from 3 to 5 takes into account a very large increase in the balance of your intangible assets. So the total amortization charge doesn't change very much.

Anthony Rose
Interim CEO & COO

It's probably one best to take off-line. We haven't made any -- so 5's been relatively standard for most of our investment pipeline. There might be a couple where we've taken a slightly longer approach given the nature of the importance of the asset. And -- but again, I think best taken off-line to get to the crux of the key issue you got.

Tanny Mangos
General Manager of Corporate Affairs & Investor Relations

We've got one last question on the phones.

Operator

And the last question is from as Azib Khan from Morgans Financial.

Azib Khan
Morgans Financial Limited, Research Division

A couple of questions for me. So I note that the board has now set the CET1 ratio target range to be 8.25% to 9.5%. Does this mean you formed a view that the unquestionably strong benchmark for standardized banks is 8.25%? And the second question is, it's more related to AASB 9. Is it fair to say that under AASB 9, your credit impairment expense will be more sensitive to growth in BOQ Finance given that BOQ Finance comes with a higher regulatory expected loss? And would that influenced how you think about growing that portfolio?

Anthony Rose
Interim CEO & COO

I might take the first one. The -- there has been that increase. Obviously, the 8.25% at the bottom end of the range, obviously, the new risk-weighted asset framework needs to roll out that APRA has under development at the moment. The -- I wouldn't read into that number at the moment as the level at which we would be comfortable operating at over a longer-term period, at the 9.26% that we've printed, I think we'd be quite comfortable to see that if we needed to trend down towards the 9% area, we would be very comfortable with that sort of profile whilst the regulatory uncertainties to the new framework remains outstanding.

Matthew Baxby
Chief Financial Officer

Yes. And then on the collective -- probably a few things I'd call out. One is obviously in terms of model outcomes, we tend to see more volatility. But a few of the factors that feed into that, one is the general economic outlook. We've obviously seen some house price deterioration. That throws some outcomes out in terms of an increasing collective. Yes, in terms of new business that's being written, BOQ Finance as I called out, saw a disproportionately higher amount of collective attached to the business. But the other point I made was that, yes, that's true, as that new business is booked, but we also get the benefit of the young ones on that as it matures. So I think there's a few different moving parts to the collective provision. Bottom line is there's more volatility there.

Tanny Mangos
General Manager of Corporate Affairs & Investor Relations

Okay. Do we have any final questions in the room?
Okay, that wraps up the briefing. Thank you, everyone, for attending.