Question and Answer

Operator

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

Jonathan Mott
UBS Investment Bank, Research Division

The question is about the SME segment in business. The last couple of months, we've been seeing business credit growth pick up. I think you mentioned that was mainly coming through the institutional side. Can you just mention what's going on in the SME space there as well? And also, following up, at the first half results, you said that SME fattened [ph] up with their charges, fell quite substantially in that half. Are we now seeing those SMEs who fattened [ph] up their charges revert to a more normal level? Is that what you're saying?

Cameron Anthony Clyne
Former Executive Director

I'll take the one on credit growth, Jon, then Mark can deal with the B&DD. I think we're cautious on the uptick in credit growth because we'd had many, many false starts on that. It is more institutional at this point in time, so it's showing up there. I mean, I think the confidence impacts and -- I haven't seen our latest monthly survey. That will be coming out 11/30, but I think confidence has been subdued and still mainly SME credit growth is still pretty weak, but the uptick has been institutional. But we've seen many false starts and so we're not quite prepared to say the funnel is unclogging. Mark, do you want to pick up the B&DD trend?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

The SME B&DD, if you go -- I've looked back over the last 7 quarters, and the B&DDs that we've incurred in this quarter are pretty much banging in the middle of the average over the last 7 quarters. So it's what we said before, there's a little bit of volatility around the average, but it's just pretty sticky at a level that's elevated to what we had pre-crisis.

Operator

Your next question comes from the line of Jarrod Martin from Credit Suisse.

Jarrod Martin
Crédit Suisse AG, Research Division

Cameron and Mark, just a question on the revenue side. You said that overall revenue was down 1% on the quarterly average of the first half. I wonder if you could give a bit more color around the mix of the revenue between net interest income and noninterest income, whether both were down or which was up, et cetera?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

I'll just have to quickly look that versus the averages. So the NII is slightly down, the OOI is pretty flat. And on the NII side, of course, it's just the sort of lag effect of cost of funds and how that finds its way through into product pricing.

Jarrod Martin
Crédit Suisse AG, Research Division

And to -- as we said, at this point in time, the prep [ph] rate pricing matched the increase in cost of funds?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Well, it has in this quarter. That's probably a coincidence because different products are at different points in the repricing cycle. But the customer NIM was virtually flat in this period. So you'd have to say that worked out. But we have instituted some repricing in this quarter, where we didn't get the full quarter effect, and so we will probably get about a $60 million revenue uptick in the fourth quarter relative to the third from the repricing we've already done. But on the other hand, who knows exactly what's going to happen to short-term wholesale or more importantly, customer deposit cost.

Operator

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

Richard E. Wiles
Morgan Stanley, Research Division

Cameron, you recently said that the Australian economy was a 10-speed economy rather than 2-speed economy. I'm wondering if you can comment on the credit quality trends that you're seeing in some of the problem industries? I'm also interested in some comment around the watched lines within the Business Bank. You said that watch lines increased quarter-on-quarter for the group as a whole. Could you give some color on watched loans in the business bank, please?

Cameron Anthony Clyne
Former Executive Director

Certainly. I think we still stand by our assessment that if you look at the underlying fundamentals of the economy, there's much more nuance in the 2 speeds that are commonly referred to, which has always been the case through any sort of transition. Having said that, just because they're from the fundamental side, doesn't make people believe it and that's why we've got confidence in business activity levels relatively low. But I think if you look at the sectors that we're experiencing, however, I think they still remain if you think through the sectoral areas, there's still elements of discretionary retail, travel manufacturing, and export-oriented industries are the other ones where we're still seeing more watch being developed [ph] geographically, things still to be Queensland, and to a lesser degree, Victoria, where there's manufacturing and they're the sort of geographic in the industry trends and they've remained pretty consistent. On the asset quality indicator, watched loans, the asset [ph] quality indicators have been broadly stable during the quarter. Watched loans actually deteriorated a little bit, they're materially below levels 12 months ago. So there was -- there has been a slight uptick. I mean it's still below where we were a year ago.

Richard E. Wiles
Morgan Stanley, Research Division

Cameron, can you just clarify that's watched loans within the Australian Business Bank as opposed to similar trends in the Australian Business Bank as you've seen at the group level?

Cameron Anthony Clyne
Former Executive Director

Yes, that will be Australian Business Bank. Yes.

Operator

Your next question comes from the line of Victor German from Nomura.

Victor German
Nomura Securities Co. Ltd., Research Division

My question also relates -- sort of 2 questions, if I can, on the Business Bank side. Firstly, relating to the credit quality, would it be fair to assume that predominant deterioration that you've seen or uptick in bad debts was in the higher and of that business space?

Cameron Anthony Clyne
Former Executive Director

Yes, that's correct.

Victor German
Nomura Securities Co. Ltd., Research Division

Okay. And second question on the funding, you've increased your liquidity margin in February, which presume, should have given you a little bit of headroom and you've increased it more recently again. I'm just wondering is it just the quarterly volatility that's moving the business margin around or are there any specific funding pressures that you can highlight that we should be aware of?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Yes. Only 1/3 of the business book is captured by that liquidity margin, so that obviously doesn't deal with the entire funding process across the book. And we've seen now abiding in the competition the deposits. So I think when you look at the fact that deals are only 1/3 of the book and deposits are still running quite strongly, that deals to some of the lag in the revenue benefit from that.

Victor German
Nomura Securities Co. Ltd., Research Division

But you do see it as a lag? And you expect recovering that margin?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Well, to the extent it only deals with 1/3 of the book. But of course, we don't know what's going to happen on deposit pricing. And obviously, that's been an area of intense competition and is likely to remain so. But there is always going to be lag, I mean, just amid supplies include a repricing that we do in the Personal Bank as well, it doesn't always -- it can be a little bit lumpy because you can get the repricing either, which are front loads or back loads of the revenue, depending on when it's done. Now I would just stress, the repricing on the business book, just the liquidity margin repricing does only deal with 1/3 of the book.

Operator

Next question comes from the line of Andrew Lyons of Royal Bank of Scotland.

Andrew Lyons
RBS Strategy

I just -- on your stable funding index that was flat in the quarter at 85%. Can you perhaps just provide a bit of an update on how much you think additional funding will be required by yourselves for the new regulatory regime? And if this the case, when you expect to actually start funding for this? And just where you think your starting position is, compared to your peers, better, in line, or worse?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Well, stable funding is the old metric and SFI is the new metric. Coincidentally, because they're completely different calculations, they're almost the same number. So that gives you a sense of the journey. Now NAB's probably come from having a stable funding ratio somewhere in the high 50s early last decade. So a lot has been done already to bring it up to 85%. So it's not a question of getting started. We're already a long way along the journey. So basically the challenge is equivalent to about 15% or so of the lending book which needs to be moved to what the regulators regard as a more stable basis, which is going to be sticky customer or term wholesale.

Cameron Anthony Clyne
Former Executive Director

I would -- I mean, obviously, the -- that's a target that has to be progressively worked through till 2018. As to how we compare to peers, I'll let others make that assessment. I can make an assessment, you probably would not believe my assessment, so I'll let you do the numbers. But the -- we think we're okay. But I would say that everybody's net stable funding ratio at the moment is going to be flatted by a lot of money in deposits with weak equity markets and subdued credit growth. So if you make an assumption that we might actually see a more buoyant economic environment sometime between now and 2018, you're lucky to see some of those deposits flow back out to equity markets and some increase in credit growth. So that will make the task harder, but be harder for everyone in the sector. So I think we're mindful of that as well as we sort of think about how we have to track through 2018. We can't assume this current operating environment is going to be there.

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

But absent a big upswing in credit which the banks participate in, i's a manageable challenge between now and 2018, but it needs to get done.

Operator

The next question comes from the line of Matthew Davidson from Merrill Lynch.

Matthew Davison
BofA Merrill Lynch, Research Division

My question on costs. You've highlighted the 3% fall in the past 2 years, and again, this quarter. I'm just interested if you could talk about the impact of average headcount this quarter. Obviously, the 12 months to March, you took out nearly 2,000 FTEs. So interested whether what we're looking at is really a roll-through of that impact or whether you found additional savings in FTEs or in non-personnel [ph] costs this quarter that can go forward?

Cameron Anthony Clyne
Former Executive Director

It's really both. I mean, we are continuing to focus on efficiency. What we're very conscious of is there's a lot in the external environment we can't control. We can't control this in our efficiency and productivity. So in this environment, we continue to work very hard on it. We're not it any way constraining our investment because we recognize that it will be a short-term decision. In fact, we're quite pleased and will be pleased and you'll hear more over these coming months about it that a lot of foundation work in the technology space, a lot of the customer applications are going to come online in coming months, which is -- we're very encouraged by. So we're not cutting the investment but I think if you look at the challenging economic environment, we have to control what we can control. One of those things is productivity and we continue to work hard at it.

Matthew Davison
BofA Merrill Lynch, Research Division

And just to expand on that. So the FTE account, this quarter, is it continuing for fall?

Cameron Anthony Clyne
Former Executive Director

Yes.

Operator

Your next question comes from the line of Brian Johnson from CLSA.

Brian D. Johnson
CLSA Limited, Research Division

I'll go ahead with 3 quick questions, if I may. Mark, if you have a look in the first half, one of the big contributors to the margin fall was the United Kingdom as you rolled off wholesale funding replacement with more expensive term deposits given the rating downgrade. Is this really just the full period impact of this flowing into this quarter?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Yes, there will have been some additional contribution from the U.K. But -- I mean, that's in the customer component, and the customer component's been relatively stable. So it hasn't been enough to really move the dial.

Brian D. Johnson
CLSA Limited, Research Division

So the customer's NIM has been flat at the group level in Australia and in the U.K.?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

It's been flat at the group level, not necessarily in NIM [ph] .

Brian D. Johnson
CLSA Limited, Research Division

Okay. Mark, I just wanted to confirm, the second one is, the repricing that you've seen at the home loan book and the business book, if you think about, for example, the business book at the end of February and then again at the end of July, does -- the problem I face, does this grant a positive NIM dynamic going forward?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Well, it does on the revenue side. But you've got quite substantial headwinds from the deposit pricing and who knows exactly what the future holds on that front.

Brian D. Johnson
CLSA Limited, Research Division

I suppose, Mark, what I'm trying to get my head around is that we know there's a lag between repricing the loans and the cost of funds always rising. That I'm assuming was the net negative during this quarter as it was the quarter before. But do we just see a reversal of that half-half in the next 2 quarters?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

No. It's pretty much flat in this quarter because we had some repricing in the prior quarters so we got the full effect of that this quarter. And some of the repricing done in this quarter was done partway through. So, for example, there was a May increase in the SVR. So it really -- it swings in roundabouts. It just happened to have turned out flat in this quarter.

Brian D. Johnson
CLSA Limited, Research Division

Mark, just the final one. If you have a look at NAB's level of cost on liquidity, which is really what diluted margin, it was far higher than your peers at FY '11. It was still higher than the peers at first half '12 but it had declined. What's been the direction of the cost on liquidity spot at the end of the quarter and also the average out in the quarter?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

It was up at the end of June, because we had a number of maturities coming in July, so it doesn't constitute a new ceiling that we intend to stay at. So it'll probably -- so you'll see quite a high quarter number for end of June and it will probably settle down to a lower number at September.

Brian D. Johnson
CLSA Limited, Research Division

So, Mark, would I be right in suspecting this cash in government bonds as both credit and NIM headwind over this quarter, but that would decline in the next quarter, but not [ph] the average?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Yes, at the margin.

Operator

The next question comes from the line of Craig Williams from Citi.

Craig Anthony Williams
Citigroup Inc., Research Division

It's Craig Williams here. A couple of point of clarification. You've made the statement today on the call that you fully funded the balance sheet this quarter with deposits, yet I note through the transcript that stable funding index was unchanged at 85% and you've raised about $12 billion from what we can reconcile with term funding this quarter, which is quite strong. So has the balance sheet been fully funded with deposits? Because I would have anticipated, given the level of the term wholesale funding you've done in this period, that the stable funding index might have increased over the quarter, this period?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

The -- Oh, I see what you're saying. The stable funding is flat at 85%. The underlying customer funding is actually up. It went up from 65% to 67%. But not all customer deposits are recourse, so we haven't made a big deal of that, because it does include some SFI deposits and things like that. But in fact, in this quarter, I think we have something like $8 billion of surplus deposits. So we've more than, more than funded the growth in assets with deposits through this period. Quite what the term funding issuance is relative to term funding redemptions, I'd have to go and check. That might explain why the SFI has been flat.

Craig Anthony Williams
Citigroup Inc., Research Division

Okay. And just the earlier comments about the risk of outflows of deposits to equity markets. A bit confused trying to reconcile that because doesn't -- don't balances just transfer from a depositor to the seller of equities within the system in a falling exchange rate environment?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Right. I suppose so.

Craig Anthony Williams
Citigroup Inc., Research Division

So they may change even from one institution to another but your overall system deposits don't change, correct?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Yes. The bigger threat might not be on the retail side. It might be on the business side because I think a larger proportion at any time in history of corporate assets are sitting in cash on corporate balance sheets. So as you see business confidence recover, as well as an upswing in demand for credit, you might well have outflows that's not necessarily 0.

Operator

The next question comes from the line of James Freeman from Deutsche Bank.

James Freeman
Deutsche Bank AG, Research Division

Mark, just a quick question. Just want to get an idea on the trading revenues. You mentioned they're down. Just an idea as to how much they're down. The reason I asked, obviously, customer margin was flat, you've got some lending growth, but your revenue growth tends to be falling. I'm just trying to reconcile that. Obviously, you're trading numbers are going to be a component of this.

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Yes. If you take customer revenue and risk revenue, so the total revenue in the wholesale business. It's probably off a little under 5% or something like that. So it's still quite strong, it's just not as strong as the run rate in the first half.

Operator

And your next question comes from the line of Mike Wiblin from Macquarie Bank.

Michael Wiblin
Macquarie Research

My question was really just around the 3 areas you called out for revenue weakness, U.K., lower markets and SGA. I mean, is there anything that's more or less important in that list? I mean, can you give us an ordering. Because I would have thought the SGAs running off and revenue being down a little bit is actually a positive thing in that sense?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Yes, well SGA is tiny, it's almost at the bottom, not -- being worth talking about. I think, while, it is tiny, we have to be fair [ph] . So it's revenue in the third quarter was $8 million. Now it's smaller than the first half run rate, which was like 44 but that's -- we haven't got mark-to-market gains and we've had substantial runoff and those things. So -- but that's what we always wanted it to be. We wanted it to disappear and we're just about at that point, I think. Markets I've already told you, and I was just checking, U.K. is dissimilar revenue softness to the markets business.

Michael Wiblin
Macquarie Research

And then just on costs. I mean, they've come to the party again. Obviously fantastic cost performance, really, over the last couple of years. I mean, how much more can you squeeze on lending, that side [ph]?

Cameron Anthony Clyne
Former Executive Director

Well, we just got -- there was a balancing act there. And I think, what's pleased us is that we've addressed these costs, we've also have record levels of customer satisfaction employing [indiscernible] because we're trying to get out in a sustainable way not in a short-term way. But we have to balance it off with the investment. We -- it's always very tempting to cut in your investment when you're faced with challenging environments. But then, unfortunately, there's been decision that have been taken by many organizations in the past, and just quite bigger headwinds in the future. So I think the longer we have a subdued environment, the harder it gets, but we feel we've got an obligation to continue to grow productivity. And we'll continue to do it. And as long as we've got that stark engagement and our customer satisfaction improving, we think we're getting at it in the right way. And obviously it gets harder.

Operator

The next question comes from the line of Ben Zucker from CBA Equities.

Ben Zucker
Commonwealth Bank of Australia, Research Division

Just a question, I guess, to clarify a little bit more about your thoughts on the funding side and how you're seeing the pressures there, particularly around the margin, if you like? I'm wondering if you could just talk a bit about that competition in deposits comment that you made from a large end of town, small end of town business side, as well as retail and where is the pressure there? And then lastly, I guess in the context of your good progress on stable or wholesale funding, deposits growth outstripping loan growth, how much longer do you remain or do you expect conditions to remain very competitive on that deposit side, if those conditions remain, that is of low loan growth?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

I think the strongest competition on deposit is on the retail side because under Basel III, they're the valuable deposits. And the bigger the party you're dealing with becomes, the more regulated supply headcount of that. So I think coming back to that earlier point about NSFR, which is 2018, as that start to come over the horizon, people are going to have to position their book to emphasize the retail side. And so I see competition -- and we talked earlier in the call about how if there was a big upswing in demand for credit, it would be difficult to reconcile going with that demand and accommodating in, and at the same time, meeting the NSFR backlog challenge. So I think competition, particularly on the retail side, is here for the next 5 years while everyone gets positioned for it. I don't see it letting up. That doesn't necessarily mean it's going to go to ever and ever higher prices. One of the benefits of the fact that we have taken the price so high relative to the official cash rate is that it is actually growing the pie. But I don't see that everyone is suddenly going to relax on this front. I think it's at least a 5-year journey.

Ben Zucker
Commonwealth Bank of Australia, Research Division

And in terms of managing customer margin and your comments about flat; I mean, is flat the aspiration, if you like, kind of like the positive jaws [ph] or what do you...

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Well, we don't really manage to the margin. It's sort of an interim indicator. We're managing to an ROE, which means we're going to healthy business and a healthy banking sector. So as part of that, the more efficient we get on the cost side, the more we can share some of that with customers and so the margin is really an outcome rather than something you manage directly to. But the safer we make the banking system, the more expensive credit needs to be, so we should unashamedly incorporate those costs into product price.

Operator

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

Scott Robert Manning
JPMorgan Chase & Co, Research Division

I had 2 questions. Firstly, just on capital. You mentioned you were well-advanced in meeting the requirements of the new regime. I just wanted to confirm that meant that you're still on track to convert those $1.1 billion of hybrids that you referred to at the half? And secondly, for the U.K. provisioning, where do you see a greater concentration or focus? In the commercial real estate book or in just the vanilla business book, given the broader economic conditions there?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Okay. The likelihood is we will -- the hybrids, we'll make decisions in conjunction with the regulator as we go along. But certainly, the first tranche, which is $600 million will get converted before the year ended. All of, I think, in absolute EPS of course. And a combination of those and capital generation of the business should put us within fine to fluid [ph] , we think, we need to go on capital ratios and so we'll take the pressure off our dividend and our DRP and allow us to increase effectively the cash dividend going forward. So it's good actually to see what we think is the line on that stuff, and converting these hybrids will accelerate that. So that's not necessarily a bad thing. On the U.K., we have seen an increase in delinquency in the U.K. CRE. But our provisioning still looks good and the bad debt expense coming out in the CRE in the last quarter actually fell relative to the first half run rate. So that says that, that worsening in delinquency was anticipated in our provisioning. And in fact, the average credit quality across the rest of the business book, excluding the CRE, improved in the quarter.

Operator

Your next question comes from Brett Le Measurier BBY.

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

A couple of questions. You mentioned that risk-weighted assets dropped to the loan growth and methodology changes. So both those were leading to the increase?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Yes, they both contributed. The second one, the regulatory one, relates to regulator views on counter-party credit and things like that and markets trading and that sort of end. And dealing with other FIs. So there's been some increase -- there's been a premium put on risk rates of other banks, for example, because of these correlation effects within the industry. So I think they pretty much contributed evenly to the increase in RWA's, those two things.

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

Can you give the percentage increase in risk-weighted assets in the quarter, as such?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

I think there's an RCR report coming out the next 24 hours. So you can pick up all the details.

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

Now from what you were talking about with your target capital, it sounds like you're heading towards the Core Equity Tier 1 ratios about 8% on the Basel III, is that right?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

Yes, we haven't got a board-approved target yet. But when I've talked about in the past, I've said that we want to get ourselves somewhere into the 8%, 8.25% range and we'll see where regulators settle and where our peers settle and then make a recommendation to our board. So we don't have a hard number but that's sort of our interim target.

Brett Le Mesurier

Asia Pacific Prudential Securities Pty Ltd., Research Division

And lastly, it sounds like the lower markets income hit the net interest income line. Is that correct?

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

It does randomly find its way to NII and OOI and I haven't actually tracked it for the quarter what it's now in there. But Ross is nodding at me, so I think you might be right.

Operator

[Operator Instructions] The next question comes from TS Lim from Bell Potter Securities.

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

Just in terms of NAB Wealth. Are you able to retain your financial advisors because in the first half, you guys lost about 6% of them? And the second question is, the lower funds under management. Is it both due to negative flows and also negative investment earnings?

Cameron Anthony Clyne
Former Executive Director

Mark can look on the slides. On the advisers, I mean, we've been pretty happy with advisor retention. We obviously still been acquiring some advisors out of some other institutions. But still a lot of advisors are leaving the industry. And I can tell you on this call, it hasn't been the most pleasant financial planning environment for the last 4 years. So, a lot of that just relates to a net outflow of advisors leaving the industry, but we've been pretty happy with our retention and our attraction in the sector.

Mark Andrew Joiner
Former Executive Director of Finance and Executive Director

And on the fund side, the sum at the end of the quarter was 122 against an average of 124 in the first half. And I don't know the extent to which that is negative net flows versus markets movements. But I think there probably was small negative net flows in the quarter.

Operator

We have no further questions on the line at this time.

Cameron Anthony Clyne
Former Executive Director

All right. We'll close the call at that point. Thanks very much for joining.

Operator
That does conclude our conference for today. Thank you for participating. You may all disconnect.