Question and Answer

Andrew Lyons
Goldman Sachs Group Inc., Research Division

Andrew Lyons from Goldman Sachs. Just 2 questions, if I could. First, so just on the IFRS 9 adoption and the 25 basis point capital hit. Would've expected more of a buffer from the [JR] sale and the regulatory expected loss. Can you maybe just talk through the workings of that and if there is any offset from -- as far as the capital impact is concerned? And then just a second question on the margin/volume trade-off in the Retail Bank. You've had 10 basis points of NIM expansion in RBS versus continued subsystem growth albeit, I think, the quality of that growth has continued to improve with a proprietary channel. Can you maybe just think about is there a need now to perhaps reinvest some of that margin strength back into volumes?

Ian Mark Narev
Former Executive

Well, let me address the second point first, then Rob, you can talk about the IFRS matter. I do think it's really important to take, again, a sort of a 5- or 6-year view of that volume/margin balance. And the reality is certainly over the time I've been at the bank and been sitting here, every so often we have one of these periods where people say, "You seem to be growing too fast. Aren't you thinking enough about margin?" and then later, "You seem to not be growing fast enough. Are you overdoing margin?" And the answer is, always, it's a balance. We've been in a period particularly over the last year where there's been macroprudential limits, a lot of different forces at work in the market. And right across the bank, Matt and his team, Adam and the business bank, Kelly, Rowan Munchenberg and Bankwest and then through to ASB have just kept thinking about that trade-off. I can even repeat what we've said before is we don't sort of work the hard lines of the level of market share. We won't drop below or above every time we're achieving this balance. And I think the really important observation is the one that you've made is that there's a real focus on the quality of the growth in the business, and that's a combination of margin, of channel and of credit quality.

Robert Dharshan Jesudason
Former Group Executive, Financial Services & CFO

Yes, on your question, I mean, there are 2 major impacts through the adoption of IFRS 9. One is the lifetime expected losses on stage 2 loans and also these forward-looking macroeconomic factors. And depending on the balance of that, that's how it flows through into your increased provisioning, and then obviously the impact on capital.

Melanie Kirk

We'll take the next question from Craig Williams.

Craig Anthony Williams
Citigroup Inc, Research Division

Craig Williams from Citi. I have 2 questions as well. Is it reasonable to assume that the $200 million in regulatory costs that were incurred in first half '18 would otherwise sort of likely have been ordinarily spent on the business in terms of efficiency or growth initiative? Is that sort of the message you're trying to say by saying this is part of your -- the underlying expense profile of the business? And the second question, you've talked about a reliable estimate on the legal fine. What sort of factors are being considered in determining this number, please?

Ian Mark Narev
Former Executive

So on the 2 questions, I don't think we're calling it out in underlying because we said otherwise it would've been spent on something else. I think we are saying that for a period for us because, as I've said at the start, some of this is undoubtedly unique to us but also for the banking system, there is going to be a certain level of this kind of expense which we expect it to be around for a while in one way, shape or form. We have really done our best as a CBA over time not to let regulatory and compliance spend crowd out good, productive innovation investment and other investment. But the reality is there's only so much people can get done, and the constraint's been historically less about the money and much more about the fact that we just want to make sure that we embed the change through the investments, whether it's regulatory and compliance or a new customer experience. In terms of the second question, the accounting standard really requires us to do a couple of different things. Number one is form a view on where the money is going to go -- likely to go out the door as a result of this event. And the moment we filed our statement of defense, and clearly as we've said all along, there are a bunch of things in there which we didn't do well enough, we've reached the conclusion it's going to cost us some money. The standard then is can you make a reliable estimate, and in doing that, we take into account everything we know at the time. And obviously, the big part of that is what our lawyers are telling us is what they would expect to be what a court will determine as the civil penalty if this reaches a conclusion and that's the basis of the judgment call.

Melanie Kirk

We'll take the next question from Jon Mott.

Jonathan Mott
UBS Investment Bank, Research Division

Jon Mott from UBS. My question is to Matt. So I've actually had this question before in the last couple of years, but it's getting a bit more extreme. If you look at the NIM in the Retail Bank, you just cracked through 3%, 3.01%, and in absolute terms, that's the highest NIM you've ever recorded in the Retail Bank, including before the financial crisis when rates were above 7%. If you back out given, again, these are risk weights and you can apply some other capital deductions, it implies the ROE is north of 30% in that business. So the question then becomes, are these returns of 30% ROE and above 3% NIM appropriate for the largest retail bank in Australia? Is it balancing the shareholders versus the other stakeholders? And second question, and this goes back to what you're just commenting on, the potential provision for the fine. Have you had discussions with AUSTRAC or any other counterparties? Or is the -- that based on your own lawyer's advice?

Ian Mark Narev
Former Executive

The -- let me answer the second question first, then Matt can take the first one. I'm not going to comment any further on what discussions we've done with AUSTRAC. We have done what we're required to do, which is take into account everything we know and make a reasonable estimate.

Matthew Comyn
CEO, MD & Executive Director

Yes, thanks, Jon. So on the first question on margin. So clearly, in the period, there were a number of things that were very favorably. One, of course, the interest rate, rate pricing in home lending for both the May and July flowing through, very good conditions from a funding perspective. As you look, I guess, back, clearly there's been quite a bit of expansion on the asset side of the book. I think also when we talk about how we've actually positioned and the selectiveness of the growth, one of the things that we did when the interest-only cap came out was we basically moved early to make sure we were well underneath that. I think we can safely say we overshot based on where the market came. So we thought it was actually quite challenging to get to sub 30% when the limit came out initially, but we ended up in the low 20%. So actually that's why we grew below system. And so some of that was selective and some of that was actually also just a function of the competitive dynamics of the market. I think overall, looking forward and even if you look at the results more broadly, we're seeing the major banks losing share at the moment. There's a lot of competition in the home lending market. We're seeing the regionals growing at 1.5x system and, of course, the non-bank financial institutions. So the volume -- the question on volume margin is something that we spend a lot of attention on, trying to adjust for the appropriate conditions, ranges, stakeholders, as you pointed out, and trying to get that balance right.

Ian Mark Narev
Former Executive

Yes, the other thing I'd say on this topic in general, and our investors and analysts have quite rightly talked a lot about the current environment, the characteristics of the current environment, and I just think people need to be very careful about drawing return extrapolations from the environment we're in at the moment. Whatever they are, the environment we're at the moment is one of very strong organic capital generation, very good credit quality, et cetera, and those things are going to move and banks must manage themselves through this cycle.

Melanie Kirk

We'll take the next question from Jarrod Martin.

Jarrod Martin
Crédit Suisse AG, Research Division

Jarrod Martin from Crédit Suisse. No surprise I'm going to talk about volume/margin trade-off as well. But look, we can understand on the asset side of the balance sheet with macroprudential. That seems reasonable in terms of managing that. But the liability side of the balance sheet, household deposits are high quality, and you're also growing at 75% of system in household deposits. I'm just wondering whether it's convenient to talk about the macroprudential as being the reason for the subsystem growth versus there is issues in the franchise from a momentum perspective. So that's first question. Second question, just some clarification around the $200 million provision for costs, et cetera. Could you confirm that, that does not include any estimate of ultimately what remediation actions will come out of some of the reviews either from ASIC or from APRA? It is purely just your legal or -- and project costs?

Ian Mark Narev
Former Executive

Look, on the 2 questions, first of all, yes, we like household deposits and we like transaction accounts and we like them for a couple of reasons. Number one, that's why we're here; and number two, they're very good for funding purposes. They also have a cost. And exactly the same principles that apply over time when trading our volume and margin on the ASIC side, apply on the liability side. I have seen absolutely no evidence of any fact that suggests that the deposit growth was as a result of anything other than our volume/margin trade-off, and we can't see any evidence of that anywhere else in the business. Secondly, good question on the $200 million. Clearly, in any regulatory proceeding, if we're talking about the APRA inquiry or the Royal Commission, et cetera, there is a wide range of potential outcomes. We have discussions about some of the things that we think might come out of it. We've been having that for a while. We've done our best to get going on a few things that we think are going to make the bank a better bank anyway. So we haven't sat down and taken a provision for absolutely every outcome we think might be likely. What we have talked about is some of the things we think might be most likely to come out of those and, in particular, where we think they're good business anyway, gone on and done them.

Melanie Kirk

We'll take the next question from Brian Johnson.

Brian D. Johnson
CLSA Limited, Research Division

I have 2 questions. The first one, on the $350 million post-tax provision for AUSTRAC, I, for the life of me, can't believe that wouldn't be tax deductible. Is that because it's really $350 million after tax and you don't want to get the bad press? Or is there genuinely -- so it's really $500 million? Or is it genuinely because it would not be tax deductible?

Robert Dharshan Jesudason

Former Group Executive, Financial Services & CFO

No.

Ian Mark Narev
Former Executive

No. It's $375 million, and it's not tax deductible.

Brian D. Johnson
CLSA Limited, Research Division

Okay. The second question is -- great questions from everyone else about the Retail Banking business. But just on the institutional banking business, we've seen the margin continuing to come down. We have quite a big specific loan loss on a U.K. exposure. I'm just wondering, a, could you give us an explanation for why Commonwealth Bank of Australia has such a big, chunky exposure to something in the United Kingdom that is troublesome? And the other one is, fantastic message on discipline today, Ian. But when you have a look at that business when you actually normalize everything, is there some kind of review you should be undertaking on the positioning in the institutional bank?

Ian Mark Narev
Former Executive

Well, look, Brian, the dynamics of the institutional banking business are different from in the other parts of the portfolio. And there's no doubt that particularly at this point in the cycle and probably at most points through the cycle, it's got different return dynamics than from, example, the Retail Bank. But I'd say a couple things. Number one, it is a critical part of what we do and why we're here, and we have clients who want to do business outside Australia and we have overseas clients who have a connection with Australia. We want to be in a position to serve them. Number two, I'd say particularly in the last couple of years under Kelly's watch, the trajectory of that business has been repeatedly getting smaller. We've been cutting risk-weighted assets. We've been selling down some exposures. We've raised the bar on the volume/margin trade-off. So the trajectory of that business is actually to keep it because we believe in it. It's an important part of what we do, but really have it coming smaller for some of the dynamics you've talked about. A couple of years ago, we had one big period. There were privatizations, et cetera, big period of activity in Australia. We did grow the balance sheet. A lot of people are calling out the fact that the strategy seemed to have changed. We said it hasn't. There was one period of a lot of activity. At every half since then, you've seen of anything the direction be contracting the businesses. It's for a number of different reasons. So we're committed to it, but it's getting smaller.

Brian D. Johnson
CLSA Limited, Research Division

And Ian, some [indiscernible] exposure [indiscernible]...

Ian Mark Narev
Former Executive

Well, I'm not going to go into individual exposures, Brian, except to say in any business, in an institutional banking business, you're going to get some lumpy exposures. The question we always ask ourselves is -- we go back and ask ourselves: why was the decision made? And in certain cases we get lumpy exposure, you find that's a legacy exposure that wouldn't have been originated according to the strategy or the standards today.

Melanie Kirk

Great. We'll take the next question from Victor.

Victor German
Macquarie Research

Victor German from Macquarie. Just actually following up on Brian's question. Appreciate that you don't like to comment on specific clients, but assuming that this is no longer a client, perhaps you will be able to provide us some commentary. But maybe just even a abroad comment. Assuming you have an exposure, which senior debt is currently trading at 2 cents on the dollar, would it be fair for us to assume that all provisions for that exposure would have already been taken? Or do we need to sort of be concerning ourselves for the next half?

Ian Mark Narev
Former Executive

No, I think under that hypothetical, you could assume all provisions have been taken. The other thing I'd say is, look, provisioning is a science but with judgment. And what you can see from what Rob said last time, one of the reasons why the period-on-period, half-on-half institutional banking LIE is so far up is because of write-backs in the previous time. Now this is no guarantee that we'll always get it perfect in the future, but the pattern, the track record of the Commonwealth Bank in some -- over some period of time is take a provision hard, take it early. We don't always do that perfectly, but you can be assured that will be the case, more often than not.

Victor German
Macquarie Research

And second question for Rob, you've sort of alluded to, and I think Ian alluded it as well, but productivity improvement is something that you're really focusing on. Clearly this half you've had lots of moving parts. You've had taken provisions. Your compliance spend has gone up and when -- certainly, when we look at your compliance spend, it's -- looks like it's tracking at a pretty elevated level, frankly. I mean, at what point do you think you'll actually kind of get through, through that hump? And also, even taking out some of these additional overlays and provisions, cost growth is still sort of a couple of percent. One of your peers is targeting flat costs on sort of a 2-year, 3-year view. Are you able to give us some indication of what you think that trajectory might look for CBA in the future?

Robert Dharshan Jesudason
Former Group Executive, Financial Services & CFO

No, we're -- I'm not going to give you a forecast. But what I would say is, look, we've got to manage the short term, and in the short term, we've got some remediation spend. And that's why when we look at it as a business, we do strip it out and look at: are we delivering underlying productivity? But medium term, we all understand the sort of structural change happening in financial services, and that's going to lead to lower cost base. And what we're trying to do is balance investment in technology to digitize -- to drive digitization of the customer experience and to service customers. The sort of short-term pressure is on remediation and compliance spend and deliver ongoing productivity.

Melanie Kirk

We're just going to shift to the phones quickly, and we have Matthew Wilson from JCP on the line.

Matthew Wilson
JCP Investment Partners Limited

Two questions, if I may. Firstly, the Bankwest half-on-half performance outlined on Page 71 looks remarkable for a challenged economy. You had revenue growth up 5% half-on-half on 3% asset growth. You combine that with the 5% cut to costs. Can you explain the magic there? And then secondly, further to Craig and Jon's questions on AUSTRAC, it seems your reliable estimate therefore doesn't include any assessment of potential U.S. action where you find they're typically more serious and in the billions. Or is it just the classic low-ball first offer?

Ian Mark Narev
Former Executive

Look, on the first point of new south -- Western Australia net from a macroeconomic positions had its challenges, Bankwest, I think, adjusted to that market pretty effectively on the revenue line, took the right decisions in terms of risk appetite, et cetera, and is now in a position to be able to support the economy as it starts to turn. And so revenue growth's picked up a little bit. Bankwest, by design, does a little bit more in the broker channel than the Commonwealth Bank does. That's fine, and its overall volumes have been doing okay. Its LIE, as we've said consistently because of its history, has managed itself pretty well through the difficulties of the Western Australian economy. And it's continued to look for ways for harnessing some of the productivity benefits of closer alignment with the Commonwealth Bank, particularly on some of the middle and back office aspect of its operations. So that explains the performance. Number two, the provisions that we've got and we're required to make are always regarding everything we know and all things that we can take into account of and that's all in that provision.

Robert Dharshan Jesudason
Former Group Executive, Financial Services & CFO

Sorry, I'll just add one point, Matt, on the Bankwest performance. You have to remember it's a national business, so there's growth in the East Coast as well. It's not just Western Australia.

Melanie Kirk

We'll take another call from the phone. We'll take a call from Frank at Merrill Lynch.

Frank Podrug
BofA Merrill Lynch, Research Division

A couple of questions. Firstly, Rob, you called out portfolio optimization as one of the 3 areas of focus. Where do you see the greatest opportunities and how meaningful are they? And secondly, one for Ian. Just came to get your reflections on, a, what industry developments most surprised you during your tenure as CEO? And secondly, putting your management consulting hat back on, what's the greatest opportunity and threat for banks in the next 5 years?

Ian Mark Narev
Former Executive

I'll let Rob answer this first question and by then you'll hopefully have forgotten you asked the second one.

Robert Dharshan Jesudason
Former Group Executive, Financial Services & CFO

So on portfolio optimization, I mean, 6 months ago, we said big focus in the institutional bank on credit risk weights. But we said that trajectory will slow because in the first 6 months that you implement a strategy, they're sort of more low-hanging fruit and over periods, that closes out. And you've seen smaller impact in this 6 months than the first 6 months. For any substantive reduction in risk weights now, you're really talking about lower assets. So that's a strategic decision for Kelly and the team around client activity. You've seen in the last 6 months, in particular, there've been a series of asset sales as well particularly in IFS, but there are now announcements in wealth. And again, what we've announced is basically what we're focused on. So there's nothing more at the moment that -- in terms of divestments.

Ian Mark Narev
Former Executive

Look, in all seriousness on the [thing], I think the big change in the financial services industry over the recent period has just been we've needed to adjust just to much different scrutiny and expectations. The levers you use to look at to decide whether the bank was going well, which were much more the aggregate level, we've needed to realize that even when things are going extremely well in all sorts of dimensions at the aggregate level, there can be aspects of what's going on within the business that can weaken it. And I would say that would be the big change. It's something I think our people might argue we were too slow to learn, and if we were, I'd certainly take accountability for that. But I can tell you what, we've learned the lesson. And on that note, I think the biggest opportunity of the Commonwealth Bank's better management. So we'll see how we go.

Melanie Kirk

Great. We'll take the next question from Richard Wiles.

Richard E. Wiles
Morgan Stanley, Research Division

Rich Wiles, Morgan Stanley. A couple of questions. Firstly, on Slide 12 you mentioned the APRA inquiry and also the Royal Commission. You don't include the Productivity inquiry in sort of competition in financial services, and you also met the ACCC inquiry into mortgage pricing. I'm wondering if that means you think they provide less risk to the bank or there's less likely that -- it's less likely that you'll need to respond to those inquiries. And is that -- are those inquiries affecting your current pricing and tactics in the mortgage market?

Ian Mark Narev
Former Executive

The -- good question. The reason they're not on Page 12 is the intention of Page 12 was really to show the link between the things going on in the regulatory compliance world and the things we're specifically putting aside money for, investing for. To the point I said before, it's not presupposing outcomes from any regulatory inquiry, and we certainly are taking both the Productivity Commission's work and the ACCC's work extremely seriously. I mean, obviously, we know what we've been doing. We have a high degree of confidence in what we've been doing, but we just need to be very thoughtful and very careful. We do, as I said before, whether it's these regulatory interactions, whether it's broader inquiries across the industry, we spend a lot of time talking about what might come out of those inquiries not because we're trying to predict what it would be, but because part of it is actually challenging ourselves to see where areas of the business, to the point I said before about the changes, where we feel we haven't paid enough attention and we need to do more. Now areas like the ACCC inquiry, I've already said we're very, very comfortable with the practices that we've got, but we've learned in the past that inquiries take their own turns and we need to be wary of it.

Richard E. Wiles
Morgan Stanley, Research Division

And just my second question relates to cost. Rob, you said you obviously need to manage, I mean, the short term and take into account the remediation and other compliance costs. In this half, on an underlying basis, you delivered positive jaws. That was obviously helped by the margin expansion on the back of rate pricing. Do you remain committed to that philosophy around targeting positive jaws between revenue and cost growth?

Robert Dharshan Jesudason
Former Group Executive, Financial Services & CFO

Yes, I mean, we've had that philosophy for now nearly a decade, and we are committed to it and we manage the business on an underlying basis to deliver.

Melanie Kirk

We'll take the next question from Andrew Triggs.

Andrew Triggs
JP Morgan Chase & Co, Research Division

Andrew Triggs from JPMorgan. Just a couple of questions, please. The first one, just the replicating portfolio, how much of a drag was that on margins this half? And do you expect similar for the next little while? And second question around interest-only switching. You gave some very good disclosure around a bit of a slowdown in switching in the December quarter. You did see, I think, a 6 percentage point reduction in the amount of the book in that space. Where do you think this might end up? And I see that maturities are very heavily weighted towards 2018.

Ian Mark Narev
Former Executive

Well, let me answer the second question, and Rob can talk about our old friend, the replicating portfolio. I mean, I think given what's been going on in the market and the questions we've got, it was very important for us to be very clear about what the activity actually is. And you can see in the materials the split between people coming to the end of interest-only and people who've made the election to switch, both of which are dynamics which will continue, to some extent, into the future. We've taken a pretty conservative approach to keeping within the cap for various reasons, and we probably remain pretty conservative. But I think there's credit there for people who want to do that kind of borrowing. The key thing for us is to make sure within all the regulatory requirements, we're very focused on the best product for the customer and for the needs of their customer at any period of time. And beyond that, that will be determined by customer preference.

Robert Dharshan Jesudason
Former Group Executive, Financial Services & CFO

On the replicating portfolio, there's nothing really exciting to say. As rates come in and the rates of sort of volatility or decline in rates stabilized, the impact gets smaller and smaller. So it's quite a small impact in this half.

Melanie Kirk

We'll take a question from David Ellis.

David Ellis
Morningstar Inc., Research Division

David Ellis from Morningstar. I've got another question or a follow-up question on home loan interest-only switching and then that's Slide 76. What are the potential risks around the credit risk, loan loss risk around interest-only loans expiring and borrowers moving to P&I? And secondly, when you look at both customer-initiated and interest-only expiries, what potential negative impact is there on margins from moving from a higher interest rate, interest-only loan to a lower interest rate P&I?

Ian Mark Narev
Former Executive

Well, on the credit risk, the first thing to bear in mind is that when customers are taking out interest-only loan, your ability to service the loan is tested as if they were paying back principal. Now clearly over, and particularly, a 5-year life in interest-only loan, people circumstances can change, as all of our circumstances do. But that lets you know that the vast majority of people are able to service the loan on the restructured basis where they're paying off principal interest. We've said for some period of time though that for some families, where a payment increases, that's obviously less money for something else. And an important part of our responsibility, again, is to do what we can with the regulatory guidelines to help people translate the budgeting and lifestyle, all those sorts of things. But the credit quality aspect of that is not an immediate concern. In terms of margin, clearly, if you've got a trend where you're doing less of a higher-margin business and more of a lower-margin business, that will have some mix effect. But again, in this environment and based on what we're here to do, what we will set out to do is give the right product with the right structure to the right customer and see where that gets us.

Melanie Kirk

We're going to move back to the phones and take a call from Azib Khan at Morgans.

Azib Khan
Morgans Financial Limited, Research Division

Ian, look, in terms of asset sales and divestments, you made the comment that you're looking to optimize the portfolio to suit the times. From that perspective, how much sense does it make to keep the Australian general insurance business and the Indonesian life insurance business? I've also got a question for Rob on the market income. Now Rob, look, I understand the law of volatility plays a big part in the movement in that income, but the sales component is also a function of volatility. That's holding up pretty well, so that's been flat from TCP. It's the trading component that's really just dropping. Is there something other than volatility that's also playing the part on that trading side? E.g., has there been a change in the composition of liquid assets? Or are you adopting more conservative trading positions? And if I can, just one more quick one for Rob. Of that incremental $200 million expense provision, how much of that relates to the Royal Commission?

Ian Mark Narev
Former Executive

So on the portfolio to start with, look, clearly, any further portfolio decisions from here will be up to Matt and the board and others to work through. What you can see here is a high degree of commitment and diligence towards assessing the portfolio and where it doesn't make sense to own something, selling it. You go back 4, 5 years, there are all these things being written that Commonwealth Bank would probably be on an M&A binge and the answer was we were because we've sold a whole lot of stuff. And I'm sure that the discipline of assessing businesses, et cetera, will continue, but a lot of the obvious work has now been done. Rob, you can answer to your questions.

Robert Dharshan Jesudason
Former Group Executive, Financial Services & CFO

On the $200 million provision, we don't break it down any further, but you're right in saying that it includes a portion of that for the Royal Commission. In terms of the trading activity, it's nothing to really do with our liquids position. It's trading activity in the institutional bank. Kelly, is there anything you'd like to add?

Kelly Bayer Rosmarin
Former Group Executive of Institutional Banking & Markets

Yes, I think what was characteristic in the previous period were the results were very high, which was true of many banks. It's just having a portfolio that's naturally in fixed income quite long on bonds. And with -- in that period, you saw credit spreads timing and that was favorable.

Melanie Kirk
Great. Well, that now brings the briefing to an end. Thank you very much for attending. If you've got any further questions, please come back to the IR team and we'll help you. Thank you.