# Question and Answer

**Tanny Mangos**
*General Manager of Corporate Affairs & Investor Relations*

Thank you, Jon. We'll begin by taking questions from analysts and investors only. For those in the room, and for the purposes of those listening and watching the webcast, can I just ask you to state your name and organization you represent. So we'll begin in the room. Let's start here in the front, please.

**Andrei Stadnik**
*Morgan Stanley, Research Division*

It's Andrei Stadnik from Morgan Stanley. Could I just ask about margins and switching from interest only? Are you seeing something that would suggest about 25% switching from interest only into P&I? And have you considered that in the 1H '18 margin commentary you've just provided?

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

So we only put through our changes to interest only a month or so ago. And it's very early days yet on the switching. We have seen some switching. We did also plan for switching and further discounts. But the rate that we're seeing is probably less than what we had expected.

**Anthony Rose**
*Executive Officer*

It's probably a bit early to make that call at the moment. We just need a little bit more time and I think we need to continue to watch. And I think that we did call out that we are watching that element closely and that will have an impact potentially on the front-to-back book dynamic.

**Andrei Stadnik**
*Morgan Stanley, Research Division*

And second question then. You said you may accelerate the digital transformation. What kind of investment return hurdles will you be considering in terms of evaluating whether you should accelerate that?

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

We're in a very strong position. Our capital position allows us to actually grow risk-weighted assets, which we would like to do -- to continue to do. We also -- and I talked about this in the past, the last few years. We have to get rid of our fax machines, which we've done. But we do want to be contemporary with our digital offering. We're not going to disclose what the individual hurdle rates are. But customers dictate how they want to deal with banks, and it is important that we continue on our journey to digitize the bank. There are 2 benefits for that. Obviously, we maintain our customer base and grow our customer base, but we're also mindful that the investments we make, shareholders get the return.

**Tanny Mangos**
*General Manager of Corporate Affairs & Investor Relations*

I think I've got a question here in front.

**Jonathan Mott**
*UBS Investment Bank, Research Division*

Jon Mott from UBS. Just following up on the digital transformation. To me, that just sounds like stay in business CapEx. Every bank in Australia has to do that and there's no competitive advantage for this kind of investment. Second, you have to assume that all the benefits that you expect is just going to get computed away as all the other players go through. So I'll ask a question on that. How much do you expect you'll need to spend in costs assuming that there's no revenue benefit? How much will the digital transformation spend?

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

I'll let Anthony talk about the cost side. But I will take -- one point of differentiation, Jon, with your comment is that we touched on it briefly in our opening remarks. We are spending money on our treasury back office and systems. And also, we're spending money on our digital FX offering. Now BOQ has this customer base in BOQ Finance, great customer base in BOQ business, a great customer base in BOQ Specialist and a very strongly growing customer base in Virgin. And now I'm an old foreign exchange trader, and we really believe that, that investment will generate some very good returns for the bank but also for consumers as well because that's an area where the Big 4 banks have had it to themselves for a considerable period of time. So it's not just stay in business. It's also to create business and to support our businesses.

**Jonathan Mott**
*UBS Investment Bank, Research Division*

One follow-up question then comes through. The choice of a special dividend rather than increasing the ordinary, can you just run through why that is the case given that you are in a stronger capital position compared to your new target? You're going to get 25 to -- 20, 25 basis points additional benefit coming through. Why don't you have the confidence to move the ordinary dividend up rather than a special?

**Anthony Rose**
*Executive Officer*

Well, I think the guidance that we've given previously is we expected our ordinary dividend growth to mirror our EPS growth, and I think that probably answers it.

**Tanny Mangos**
*General Manager of Corporate Affairs & Investor Relations*

Okay. We've just got -- on my left.

**Victor German**
*Macquarie Research*

It's Victor German from Macquarie. First, I just wanted to clarify a couple of points. With respect to switching, is that included in the numbers that you were talking about earlier, Anthony, when you were talking about the impact from front-to-back book sort of similar rate? Was that inclusive of that or not?

**Anthony Rose**
*Executive Officer*

Look, the 4 basis point contraction that we had in this half, I think, you'll find the comment I made is we expect the front-to-back book dynamic to continue. I think -- and I made specific mention that we are that switching in the context of that front-to-back book dynamic. So we're providing additional area of focus for the market. It will be a factor in where that number lands, and we haven't given any specific target on the aggregate of that position.

**Victor German**
*Macquarie Research*

I appreciate it, but you're saying that it's tracking a little bit better than your expectation.

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

I didn't say that. Well, I did say it's too early to say what the real trend will be, but it's a little better than what we thought it would be. But you shouldn't read anything into that because consumers -- and this is talked about daily in the press, and we've only had our change in for a short period of time.

**Victor German**
*Macquarie Research*

No, I appreciate that. I'm not trying to kind of get a number off you. I'm just trying to understand, is that number -- whatever the outcome will be, is that included in the that 4 basis point or not? Is it outside?

**Anthony Rose**
*Executive Officer*

I haven't -- there was no intention to provide a definitive number about what front-to-back book dynamic will be in the next half.

**Victor German**
*Macquarie Research*

Okay. And then just other point of clarification. Obviously, the business that you sold presumably delivered some earnings. What should we be taking out for the benefit that you were getting from that business?

**Anthony Rose**
*Executive Officer*

Yes. The $16 million really reflects future earnings. It would have been generated off that portfolio. The -- because the book only started in 2015, you haven't had any maturity of those customers through to the end of their lease term after which you would get the asset realization revenues or the inertia income, which is effectively the bring-forward that reflects that $16 million. So the earnings that have come through in this period reflects the portfolio of a little under $100 million, and that's the net interest income on that portfolio.

**Victor German**
*Macquarie Research*

Immaterial.

**Anthony Rose**
*Executive Officer*

Okay. Immaterial on the other income.

**Tanny Mangos**
*General Manager of Corporate Affairs & Investor Relations*

I'll ask everyone to limit their questions to 2, please, because we've got a lot of questions on the phone as well. Sorry.

**Victor German**
*Macquarie Research*

Okay. Sorry, that was just a clarification. Now comes just one question. In terms of volume growth that we're seeing, obviously, we've seen improvement in the half, which is kind of what you've guided. But one of the channels that's still struggling is BOQ channel. Just interested in your observation as to how you expect that to go in the next half and whether you actually expect to see that channel to deliver growth.

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

So our Owner-Manager channel is the backbone of the bank. And an Owner-Manager Branch, as I've said at previous results presentations, will outperform a corporate branch of a Big 4 bank day in and day out. They live and they can breathe their community. We're seeing growing confidence coming back into our

Owner-Manager network. And also, which is really pleasing, we run a balanced scorecard for our Owner-Managers, which is really important that they are serving the needs of all of our customers in the right way. And we've got close to 80% of our Owner-Managers on that new balanced scorecard. We're already starting to see some changes, particularly around deposit gathering. We've recently put foreign exchange on the balanced scorecard, and we've seen a good increase in foreign exchange needs for serving their customers. What is also pleasing about longer term for BOQ is this business is materially different to where it was 5 years, which was a monoline distributor of mortgages. We now have Virgin Money that has delivered $700 million of mortgage growth in a very short period of time. We will add further products to that. We have BOQ Specialist that we acquired in 2014 that had -- that was sending their mortgages off to other banks. We've grown that from 0 to $3.9 billion. We've also backed with the broker channel, and there's no doubt we've had teething problems in the past with the brokers. But we are working really, really hard with that important channel to make sure that we can deliver on their expectations as well. So from my perspective, we have some really solid foundational avenues of growth across a range of great brands.

**Anthony Rose**
*Executive Officer*

And I would also just add to that, that you've also got to look at the deposit side of the equation as well. And it is, as Jon say, the lifeblood of a branch -- of a bank is the deposit gathering capability of the branch network.

**Tanny Mangos**
*General Manager of Corporate Affairs & Investor Relations*

Okay. I might just take one more question from the room and then we'll go to the phones. Just here in the front, please.

**Anthony Hoo**
*Deutsche Bank AG, Research Division*

It's Anthony Hoo at Deutsche Bank. Just a question on noninterest income. You've alluded to pressure as customers go to its low fee products. Can you talk a bit about the outlook for this and how you're positioned in terms of -- given the broader environment, including political factors, seem to be pushing the broader sector again? There seems to be a renewed pressure against fees and the like. So can you comment how you're positioned and what you think the trends are?

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

The trend is pretty clear. It's -- there is a lot of discussion in the community around where banking fees may go, and we quickly made the changes to our ATM fees, which Anthony spoke about.

**Anthony Rose**
*Executive Officer*

Look, I think the areas that we're focused on in trying to ameliorate those headwinds in extension of our capabilities to our existing customer base, and Jon mentioned the foreign exchange capability that we expect to deliver over the course of the next financial year, that we do see opportunities in that space. So that's the other levers, I suppose, that we're pulling that we haven't had penetration in that we arguably should have within our existing customer base.

**Anthony Hoo**
*Deutsche Bank AG, Research Division*

But if we exclude the sort of mitigation options that you are pursuing in terms of existing products, do you think there's still a lot more fat to go through in terms of the fees? Or do you think you're largely done or...

**Jon Earle Sutton**

*Former MD, CEO & Executive Director*

I think from our perspective is we do absolutely remain competitive, and the industry -- this is an industry comment. The industry comment is facing pressure across a range of fees.

**Tanny Mangos**
*General Manager of Corporate Affairs & Investor Relations*

Okay. We'll take a question from the phones.

**Operator**

Your first question comes from the line of Craig Williams from Citi.

**Craig Anthony Williams**
*Citigroup Inc, Research Division*

I suppose it's somewhat a bit of a follow-up from Anthony's line of questioning. I mean, you talked about macro prudential policy slowing credit, mortgage repricing looks challenging from here, and the industry is giving away sort of extraneous fees at present, sort of paints a backdrop of a challenging revenue outlook. Does that revenue backdrop, therefore, signal that yourself and the industry needs to take a much more aggressive focus on the cost base of your business?

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

I'll address that in 2 ways, Craig. I think from our perspective is that we've got these lines of businesses that are growing as well. So if you have a mortgage market or credit system growth that is slowing, what is really pleasing and what we are seeing is that our niche strategy, particularly in our commercial bank and the niche businesses that we're targeting, has good growth. And when I think about the commercial bank, not only on the Business Bank side, not only is it just the straight lending, but it's also leveraging BOQ Specialist for leasing. It's also meeting all the needs of the medical professionals that we service through BOQ Specialist. BOQ Finance has a huge customer base that we barely touch other than the one product of leasing. So for me, that gives me some comfort about against a slowing mortgage market. On the cost side, we've been really clear about our guidance on cost, and we've been really pleased on what we've delivered this year. But we will still continue to have a laser-like forensic focus on our costs to find additional headroom to make the investments to grow this business.

**Tanny Mangos**
*General Manager of Corporate Affairs & Investor Relations*

We'll take another question from the phone.

**Operator**

Your next question comes from Frank Podrug from Merrill Lynch.

**Frank Podrug**
*BofA Merrill Lynch, Research Division*

A couple of questions from me. First is your attitude towards future covered bond issuance as part of the funding strategy. So you're well under the limit. Such funding is typically longer tenor and cheaper than unsecured wholesale funding given its nature. So where do you see that going?

**Anthony Rose**
*Executive Officer*

Yes. So we just completed our first inaugural issue earlier this half. Over time, we do see that program maturing. So we'll probably have 3 to 4 transactions out across a duration curve in full maturity. Obviously, that will take us several years to put into place. But there is definitely an opportunity there. I suppose the thing I would call out is our thinking at the moment in that space is that we are able to attract an investor base in offshore markets, and we went to Europe in our inaugural deal, that we simply couldn't attract off our unsecured balance sheet. And whilst you pay a little bit for the cost of bringing that back onshore and you're getting that effectively -- you're seeing your unsecured domestic credit curve roughly, we see that as a pretty important avenue to allow us to continue to grow over the longer term without putting any pressure on any of our domestic funding capacity. So I think that's an important thing to call out.

**Frank Podrug**
*BofA Merrill Lynch, Research Division*

Okay. And second question. So I know you've had a couple of it already, but the path to achieving sub-inflation expense growth given you had a 4% sequential increase in your FTE, you're continuing to invest. Where do you see the offsets coming from?

**Anthony Rose**
*Executive Officer*

We have some cyclicality, as you will see, in our half-on-half profile. First half expenses do tend to be lower. There's a little bit of annual leave timing accrual piece impact and that sort of thing. And so -- and we continue to extract efficiencies in the way we operate. So we've had some benefits on the other side of the ledger, but yes, I think you'll see that cyclicality pretty consistently.

**Tanny Mangos**
*General Manager of Corporate Affairs & Investor Relations*

Okay. We'll take another question from the floor here in the front. We've got Richard.

**Richard E. Wiles**
*Morgan Stanley, Research Division*

Rich Wiles, Morgan Stanley. A couple of questions, Jon. Firstly, you chose to do a special dividend, which I think uses about 10 basis points of capital. You've got 20 to 25 coming in the next half. So why not do a sort of $80 million, $100 million buyback, lower the share count, improve a future ROE rather than doing a special dividend? And second question, on the ATMs, I'm wondering how much it costs you to run you're network. And is there any reason why you wouldn't just close it down and let your customers use major banking networks in the future?

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

I'll deal with ATM piece. We have a lot -- our ATMs are -- they're near our branches. We're also part of the redi network. We're also in a lot of regional areas as well, Richard, and I think that would be not a great idea to be shutting your ATM network down in regional areas. And being a person that grew up in a regional area, I think it's very important that they actually have access to ATMs. But certainly, we made some changes to our ATMs fleet last year in that they're much more contemporary, which also gave us some significant savings on the way we operate that fleet. I'm going to pass to Anthony on the capital question, but we did look at many different options on -- and we arrived where we arrived at.

**Anthony Rose**
*Executive Officer*

I mean, I think the overarching conclusion is that the special dividend profile liberates franking credits out of the organization that otherwise wouldn't -- otherwise would be trapped within the organization. And whilst that's not necessarily the preferred outcome for every investor across the register, certainly, the -- all of the discussions that we've had about the payout ratio profile that we've had in the past has, on balance, pointed us towards that direction. We're also conscious that in the steps that we've taken that the board announced today, we -- a lot of the changes that we're talking about coming in, that 20 to 25 basis points is a 1 January first half impact. And so we just wanted to be, again, conservative in the way that we manage that profile over the next 3 or 4 months.

**Tanny Mangos**

*General Manager of Corporate Affairs & Investor Relations*

I think, Ed, you had a question.

**Edmund Anthony Biddulph Henning**
*CLSA Limited, Research Division*

It's Ed Henning from CLSA. A couple from me. Firstly, if you look at your home loan and you're still obviously well below system and you talked about some of the things you are doing. Can you just run us through kind of how you're going to get out the system early? You said, Jon, you're doing 28% through the brokers. Your peers are much higher than that. Is there any still to go on the transformation of your lending process to kind of help that get through? That's the first one.

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

We've rolled out a new lending process, particularly right through BOQ and the BOQ broker network. We are now actively looking at putting that through Virgin, and we will look at that over time for BOQ Specialist. There's no doubt that the macro prudential changes have started to slow credit growth. We still maintain our credit settings, and it will take us time to gradually build back the reward system. But it's really important that brands, such as BOQ, Virgin, have strong resonance and they do attract a materially different customer to what we actually have at BOQ, and we'll continue to grow the Virgin brand. And BOQ Specialist still remains an engine of growth for us, particularly in mortgages. And if you look at the other banks, they're probably doing 50% through brokers. Combined with Virgin and BOQ, we're at 28% at the moment and there is scope for us to further increase there.

**Edmund Anthony Biddulph Henning**
*CLSA Limited, Research Division*

And is there -- and you talked about there's -- you don't think there's any more bottlenecks in the broker channel as a process, you're now happy with it. Is there any further tinkering you need to do to improve that to get the brokers to push your brand more?

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

Well, there's a number of ways to get brokers to push your brand.

**Edmund Anthony Biddulph Henning**
*CLSA Limited, Research Division*

Other than price?

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

And we're not going to go and pull the price lever, and we're very mindful of both sides of the balance sheet and particularly on deposit sides and the NIM on deposits and the NIM on acquisition price. Now what I will say on acquisition pricing, it has become pretty competitive over the last few weeks. But with brokers, it's constantly about serving their needs, listening to what they need and what they want. And we've got good, experienced people on the ground that are talking to brokers day in and day out. Will we always get it right? Probably not, but we are in a much better position with our centralized mortgage hub that have got the risk teams together, the validation teams together to get a quicker "time to yes" to take those home loan customers off the market.

**Edmund Anthony Biddulph Henning**
*CLSA Limited, Research Division*

And just a second one. You talked about the potential investment in technology. What do you guys still need to do to catch up to peers or take over some peers?

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

Have you ever used the BOQ app?

**Edmund Anthony Biddulph Henning**
*CLSA Limited, Research Division*

No, I haven't.

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

I've got 3 sons that have used the BOQ app, and we need to make it more contemporary. And it's -- and that's where we want to go. So we will continue to make those investments that are needed to get us closer to our customers, and that's what our customers expect and demand from banks.

**Anthony Rose**
*Executive Officer*

As we talked about in the strategy briefing that we had here a couple of months back, a lot of the technology architecture that we're moving towards, a lot of institutions in our space have moved on to a much more dynamic infrastructure environment with the use of cloud. We're really just in the early phases of thinking through our path in that regard, and there are a lot of opportunities to modernize our network. We did talk at that day about simplifying the organization such that we can on board and change on board new capability and fulfillment from outside of the organization to assist us in becoming genuinely nimble, and we do see that's the prize for the organization.

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

A tangible example of that is at the moment, if we wanted to do some testing on a new Virgin deposit product, the ability for us to put up a test server and pull it down as and when we need it is fairly limited, which really delays our time to market. So some of the changes in investments we are making will allow us to have that greater agility to get to market much quicker with changes to pricing or changes to products or launch new products, which is incredibly important.

**Tanny Mangos**
*General Manager of Corporate Affairs & Investor Relations*

Okay. I might take some calls from the phone again.

**Operator**

Your next question comes from the line of Ashley Dalziell from Goldman Sachs.

**Ashley Dalziell**
*Goldman Sachs Group Inc., Research Division*

Just firstly, on the margin, just wanted to clarify what's sort of going on with hedging cost stuff that you called out of plus 1 basis point tailwind going into the first half of '18, coming off a neutral sort of impact in the second half of '17. If I just look at what's occurred through FY '16, hedging cost or basis risk knocked about 5 bps off your margin. And I think we all use sort of a cash bill spread as a proxy for what's going on there. And that's tightened up quite materially just in the last few months, probably back to where it was before it drove that 5 bps headwind to your margin in '16. So why aren't you a bit more confident on that driver of your NIM into the next half?

**Anthony Rose**
*Executive Officer*

Look, I think we've called out -- so cash bills does bounce around a bit, but it has been in the sort of 23s area at the moment. There's probably about a 5, 6 basis point impact on the cost of those individual hedges, so spread across the totality of the balance sheet. That equates to about 1 basis point in our expectation over the FY '18 year.

**Ashley Dalziell**
*Goldman Sachs Group Inc., Research Division*

Okay. And can I just ask a follow-up question on the investment that you're talking around on digital transformation? Can I just confirm that that's sort of completely separate to any investment that might be required if you do decide to push for advanced accreditation?

**Anthony Rose**
*Executive Officer*

Look, I think there could be some overlap in that regard. I think, however, until we understand exactly what the risk weighting framework we will be operating in when the Basel rules get finalized and APRA determines how they will apply them in Australia, the residual size of that prize, I think, as we've talked about the past, is still uncertain. And APRA's recent unquestionably strong guidance has probably given some clarity that the size of the prize that might have been there previously is certainly not going to be as large going forward. So I suspect that's probably a later-stage element of our transformation program should that be the path we choose to go down.

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

And I just want to reiterate, too. Everything we've been doing in our risk management and our risk management process is our model development, all of those things, lay great foundational stones to allow us if we want to make that decision to go to advanced accreditation. And we continue on that journey.

**Tanny Mangos**
*General Manager of Corporate Affairs & Investor Relations*

I think we have one last question on the phone.

**Operator**

Your last question comes from Brett Le Mesurier from Velocity Trade.

**Brett Le Mesurier**

I think you mentioned that you thought funding costs would have a positive influence in the first half of '18. And I presume that the TD rates form a large portion of that. Would that be correct?

**Anthony Rose**
*Executive Officer*

Yes.

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

Yes.

**Brett Le Mesurier**

So why do you have that view when your TD rate -- 3, 4 months TD rates are higher than they were? In the second half of '17, they were 2.25, 2.25%, according to your website. And then they increased at the end of August to 2.4% and then 2.35% at the moment.

**Anthony Rose**
*Executive Officer*

Look, across the total portfolio, we are seeing the average portfolio spread reducing based upon the prevailing rates that we've got in the market at the moment based upon the duration mix that we're seeing come through our customers.

**Brett Le Mesurier**

What proportion of your TD is at 3 to 4...

**Anthony Rose**
*Executive Officer*

Sorry, Brett, you just cut out at the start of that.

**Brett Le Mesurier**

So what proportion of your TD is at 3- to 4-month duration?

**Anthony Rose**
*Executive Officer*

Look, based upon the latest data, I'll have to come back to you because it does move around a bit. So I'll be happy to catch to that after the session today.

**Tanny Mangos**
*General Manager of Corporate Affairs & Investor Relations*

Okay, just back on to the floor. Another question from Richard. Okay, come here first. And then Richard, you can be the last question.

**Unknown Analyst**

I just wanted to ask a question around loan to income ratio. So NAB recently said they're going to cap at about 8x loan to income for new applications. Can you comment like what is roughly the average for your current book? And then if you were to cap it at 8x, what kind of an impact could that have on volumes?

**Jon Earle Sutton**
*Former MD, CEO & Executive Director*

I'm very well aware of the recent research reports that have been released on this topic. And what I will say is that we always take our lending and -- responsible lending responsibilities extraordinarily seriously. We've been on the record in the past saying that we are a bank that validates 100% of all the mortgage flow that goes through this place, and we'll continue to do so. These are dynamic in nature, but we do take a conservative approach.

**Anthony Rose**
*Executive Officer*

Yes, we have -- what I would also add is through all of this cycle, we have tested serviceability pace based upon the residual P&I term of a mortgage. So we excluded the interest-only portion of the term. We stress-tested all mortgage rates, not just the ones that would be to our institution but all borrowing across the board with the relevant buffer levels above APRA's minimum requirements. And it's very clear, as we've seen changes more recently come through the broker instructions from some of our competitors, that many other institutions haven't been following that practice. And those settings have been in place for us for the last couple of years and beyond in relation to the serviceability on a P&I term that was part of the new risk appetite setting framework.

**Tanny Mangos**
*General Manager of Corporate Affairs & Investor Relations*
Okay. That brings the briefing to an end. Thank you so much for joining us.