Question and Answer

Operator

[Operator Instructions] The first question comes from Victor German, Macquarie Bank.

Victor German
Macquarie Research

Just 2 questions if I could. The first one is, I'm looking at notable items in this quarter and it looks like there is about $100 million in that line relating to sort of the weighted -- you described it in the past, risk and compliance expense. So in addition to remediation expenses, risk and compliance looks like it's still elevated by $100 million. Just would like to maybe get a little bit of your thoughts in terms of where that number is likely to settle? And do you think you're kind of likely to see that number moderate going forward? And then I have just maybe a second question on revenue.

Alan Docherty
Chief Financial Officer

Yes. Victor, it's Alan here. On the notable item disclosure, you can see on Page 6 of the ASX trading update, we've shown the line items that applied in our previous disclosures in that regard, and those line items are consistent as we look at the current quarter. So I think the number you're quoting have risk and compliance uplift and customer remediation of $111 million was the quarterly average of the 2 quarters in the first half of this financial year. And so the -- if you look into the current third quarter, you'd see consistent items around the mortgage broking -- consolidation that we continue to classify within that line item. And in addition, the new customer remediation that we flagged in today's announcement.

I think as we talked about at the half, we see, excluding that customer remediation, some aspects of the risk and compliance uplift are likely to persist into the -- certainly into the medium term, including the uplift work that we're conducting in response to the remedial action plan through the risk outcomes program, and also the uplift work that we've been conducting in financial trade and compliance and our financial trade and operations center. So we see that level of risk and compliance uplift persisting over the short to medium term, obviously, in the third quarter. You're also seeing the additional impost of the new customer remediation provisions.

Victor German
Macquarie Research

Great. And maybe just, Alan, if I could follow-up on the income as well. So I'm just looking at that Slide 5. And I just wanted to make sure that I'm reading it correctly. So effectively, what I think you were telling us is that this additional increase in this income that's on due to initiatives, all that for the duties in 2019 is about $140 million and we should see a similar reduction in 2019. Is that kind of the way I should read it? So you're thinking $275 million, the total annualized number is $415 million. So kind of the headwind into next year is around another $140 million?

Alan Docherty
Chief Financial Officer

Yes. That's right, Victor. And would show on the -- you can see on the bottom right of Slide 5, we've tried to split that up across the Retail Bank, the business bank and the Wealth Management division. So you can see a divisional level that most of that headwind is in relation to the flagged repricing changes and Colonial First State as well as the new Protecting Your Super legislation, which will be effective from 1 July this year in the Retail Bank, as Matt mentioned, where it sort of changes the credit card interest result from treasury reforms that were enacted on 1 January. We'll see the full run rate of that come through and to the annualized total next year as well as the changes that was flagged to the provision -- to the fees on CFT customers that we've organized. So those 2 items are the majority of that difference in the Retail Bank column between the FY '19 forecast and the assumed annualized total going forward.

Victor German
Macquarie Research

Any chance you can split it between interest income and non-interest income, that $415 million?

Alan Docherty
Chief Financial Officer

I mean, that's something we can certainly look at doing as we look to June disclosures. The vast majority, other than the credit card interest, are going to be in the other banking and common non-interest income line to funds management. There are some impacts on the interest income, principally being the credit card interest change, but happy to provide that line item split. That's helpful moving forward.

Operator

Your next question comes from Jonathan Mott, UBS.

Jonathan Mott
UBS Investment Bank, Research Division

Just a quick follow-up on the interest rates on the credit card. Is there any prospect that there'll be remediation for the changes in that you're charging customers less now than you have in the past? Is there any prospect that they can now then come back down the track and say actually you've been overcharging interest? I just wanted to quickly touch on that so we're not looking on a new avenue for remediation on credit cards. And secondly, just on the provisions. Just checking that there was no overlay or other kind of releases that came through during this half? And whether you'll be looking to release any overlays that you might have that the other banks have looked like they've started to release during the -- their recent results.

Alan Docherty
Chief Financial Officer

I mean -- so to answer your first question, Jonathan, those legislative changes are prospective from 1 January and that will be consistent with other providers of credit cards. So we don't see that as a specific issue in terms of remediation. In terms of the provisions, no. The only adjustments that we've made, other than the natural -- the natural attrition and provisions as we work through some of the legacy remediation issues. We -- there's no overlays or other adjustments released within that -- those provisional numbers, that's the gross provisioning in the quarter.

Matthew Comyn
CEO, MD & Executive Director

Yes. Maybe if I just add on the interest rate calculation on credit cards up until 1 January this year, the way it was calculated here is quite consistent with other markets. I understand it's entirely consistent with the U.S., U.K. et cetera, but it was a change, effectively, the way that all banks need to calculate the interest rate and that the timing of that from 1 January, the full year impact is approximately $52 million for us.

Jonathan Mott
UBS Investment Bank, Research Division

Yes. And so you will be reviewing your CPs again, is there anything that you would -- you'd expect to come out in the full year? Any overlays that you think are in mining's being called out? Are there other things we need to think about that could release and offset some of the deterioration in the asset quality to keep the impairment charges a bit lower?

Alan Docherty
Chief Financial Officer

I mean we look at our loan impairment provisions on a monthly basis and as far as you know, under the new accounting rules are the combination of what we currently see in the market, in the macroeconomic environment as well as multiple economic scenarios, that might change. We'll continue to monitor that on a monthly basis. But I wouldn't be flagging new changes in that regard today.

Operator

Your next question comes from Brian Johnson, CLSA.

Brian D. Johnson
CLSA Limited, Research Division

Two, if I may. The first one, just on the replicating portfolio. Could we get a feeling on how big the replicating portfolio is in respect to the deposits, is in respect to the shareholder funds and does it 100% cover those 2 items? And the second one is the slide where you've described the New Zealand core equity Tier 1 shortfall. Can I check whether that's been calculated at a core equity Tier 1 at 14.5%? Or are you allowing some buffer?

Alan Docherty
Chief Financial Officer

Brian, so possibly on replicating, as you know, we've got the largest share of household deposits in the Australian banking system. So as you'd expect, that means we've got a large amount of non-rate sensitive deposits. For many years, we've taken the approach of conservatively hedging the interest rate risk on those deposits over a long investment term tractor in order to provide that relative stability of earnings and margins during a -- on a falling rate cycle. So those -- that non-rate sensitive deposit portfolio that we invest over that term is approximately $70 billion. And for many years, we've had an investment term on that providing a 5-year tractor rate on that portfolio of deposits. So that obviously softens the impact of rate cut through a rate-cutting cycle. However, in absolute terms, the cost of the results and will earn interest earnings as you go through a rate-cutting cycle. On equity, we've got a core equity balance use of around $45 billion.

Brian D. Johnson
CLSA Limited, Research Division

So Alan, just to confirm, so on the deposits, you're running a 5-year tractor now? And on the shareholder funds, a 3-year tractor?

Alan Docherty
Chief Financial Officer

Yes. On shareholder funds, as we talked about at the December result, to the extent that you hold a longer investment term on your equity balance, these attracts that higher capital charge from interest rate risk in the banking books. So as we talked about the half year result, we are looking at the capital and of course the cost of capital relative to the earnings protection that you get, given where we are at the rate cycle and past the cost-benefit test. So you'll have a shorter investment term on the equity.

Brian D. Johnson
CLSA Limited, Research Division

And the second question was on the New Zealand capital. Are you using -- with the capital shortfall that you've disclosed today, is that based on 14.5% or some buffer over and above that for the core ratio?

Alan Docherty
Chief Financial Officer

Yes. So that's based on -- so that -- we wanted to provide a current estimate of -- that's total Tier 1 capital requirement, which ESB would need to hold under the draft proposals. That impact, as we've mentioned, of course, dependent on the size and composition of the ESB balance sheet, that they have implementation and how that changes through any transition period. Also, the finalization of the requirements post the consultation period.

Brian D. Johnson

CLSA Limited, Research Division

And Alan, does it include a buffer? Or is it right at the cusp of the BNZ proposal?

Alan Docherty
Chief Financial Officer

Well, we've said approximately, $3 billion, so that would include any assessment that we made, around the level of buffer that we may or may not hold, only to see the final form of those rules before we finalize that exact level of dollar capital that we hold.

Brian D. Johnson
CLSA Limited, Research Division

Alan, I'm interpreting that as saying it does include a buffer.

Alan Docherty
Chief Financial Officer

That's your interpretation, Brian.

Operator

Your next question comes from Jarrod Martin, Credit Suisse.

Jarrod Martin
Crédit Suisse AG, Research Division

Can we go back to the non-interest income, and the better customer outcomes that you've detailed here of $415 million? Are there other areas that you are looking at so that, potentially, we come to FY '20 and you've got a whole range of additional initiatives that could say that $415 million as an annualized impact increase?

Matthew Comyn
CEO, MD & Executive Director

Yes. Thanks, Jarrod. Look, we've done a really detailed but review of products and the way we currently go to market, and some of that's led to the increased provisions on the remediation side and some of that's led to the changes we've made around net interest income as part of the better customer outcomes. So we feel like we've thoroughly reviewed those, so there's certainly no more that we're intending to bring in the near-term, but obviously recognize that it's a competitive market, and over time, there will be changes to rates and fees.

Jarrod Martin
Crédit Suisse AG, Research Division

And then, secondly, just on net interest margin. You said that the drivers were similar to the first half. If you could -- a bit more color on that, home loans versus business loans, the switching front -- front book versus back books, some more color around that?

Alan Docherty
Chief Financial Officer

Yes. I mean we don't provide specific waterfall disclosure on the net interest margin at the quarter, as Jarrod, as you know. But yes, we thought we'd provide a bit of additional color in the ASX release, particularly that when you back out the 2 calendar days given the February month falling in a third quarter, the net interest income's relatively flat after adjusting for that. And we've called out the margins have experienced a slight reduction in the quarter. I think in terms of the themes underpinning that slight reduction in margin, they're very similar to those we discussed at the December half year. So we've got the benefit of the SVR repricing, obviously, and the full impact of that in the quarter as opposed to the average of the prior 2 halves, offset by ongoing home loan switching behavior, which we continue to see. The lower credit card revolve rate that we called out, and also the lower replicating portfolio benefit continued to be margin themes that we're seeing in the third quarter. One we saw that is basis risk, and on a rolling average basis, the basis risk is actually slightly higher than the third quarter than the average of the 2 past quarters, notwithstanding the fact that our spot levels basis risk have obviously moderated in recent weeks.

Operator

Your next question comes from James Ellis, Bank of America Merrill Lynch.

James Ellis
BofA Merrill Lynch, Research Division

Just 2 questions. Just the shrinkage in your institutional portfolio in the third quarter. Just wondering whether you think that's now ended or that's going to continue? And secondly, on customer remediation statements, you come across as cautiously optimistic that we've broken the back of the customer remediation. Just wondering does that not have any bearing on the NewCo transaction? Or are there other considerations to see if that prevents that transaction from still going ahead?

Matthew Comyn
CEO, MD & Executive Director

Yes. So why don't I start on both of those. I mean on the institutional portfolio, I mean there's going to be progress obviously on the optimization of the existing clients and that's been a big part of the reduction on risk-weighted assets. I guess the only thing I'd note is the competitive context remains very intense and we're very focused on ensuring that business is run from an optimal capital and return perspective. So it's going to be subject a little bit in terms of risk-weighted asset growth and in terms of the competitive context, but we do feel like we've dealt with a lot of the client-related optimization over the last couple of years.

Secondly, on the customer remediation. I mean our focus has been, of course, to then provide fully for aligned. We've done a very thorough review in the business bank where if there's some additional provisions that we've taken in this period. We've also taken some additional provisions related to the wealth business, again trying to provide for all currently known banking and wealth remediation issues. That's clearly larger than what's related to NewCo. But consistent with the announcement that we made when we deferred NewCo, we said that our priority needed to be on ensuring that we'd remediated all customer issues, and there's a large amount of effort that's underway to ensure that occurs as quickly as possible.

Operator

Your next question comes from Andrew Triggs, JPMorgan.

Andrew Triggs
JP Morgan Chase & Co, Research Division

Just a question to follow on, on the non-interest income line and the fee caps to date. Just in terms of -- you can see from that Slide 5 that most of the changes have impacted the Retail Bank to this point. The business and private bank has had a much more limited impact. Just your thoughts on resilience of the non-interest income line in the business bank. That's the first question. And then, just the second question around basis risk. Just to clarify, what delay does the impact of movements in BBSW-OIS set to come through? Is it with a 3-month delay on the spot pricing?

Alan Docherty
Chief Financial Officer

Yes, Andrew. On the basis risk point, yes. Because of the timing of repricing of the wholesale debt, the -- if you use the 3-month rolling average, that's usually a pretty good proxy for the felt effect, if you like, if the basis risk changes on bank funding costs. So yes, a 3-month rolling average basis is a pretty good proxy for how that debt turns over.

Matthew Comyn
CEO, MD & Executive Director

Yes. And on the business side, I mean within the disclosures that we're providing, there's been some slight changes to few fees, and particularly, our thinking around sort of monthly account keeping fees on the business products. But you're right. The majority of the changes have either impacted retail, obviously, just given the scale of the business there. And then, we've already covered some of the changes we've made on the fee side, in Wealth Management, both in Advice and on the CFS platform business.

Operator

Your next question comes from Brett Le Mesurier.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

A couple of questions. Firstly, looking at the Pillar 3. It looks like all your improved deposit funding is coming from less stable deposits, which I assume are term deposits. There's hardly any growth in stable deposits. Can you comment on how difficult it is to increase your transaction and savings account deposits at the moment?

Alan Docherty
Chief Financial Officer

I mean we're comfortable with the growth on transaction deposits over the year. On the quarter, you tend to see some seasonality in the level of transaction deposit growth. But yes, we're comfortable with the overall household deposit growth in the period as we've disclosed.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

What extent is the increased use of term deposits affecting your margin?

Alan Docherty
Chief Financial Officer

There's no particular thematic, as I look at the margin change over the -- either over the half or over this quarter. I think given the slower asset growth and the banking system, that often has the effect of those less intensity on the liability side of the balance sheet. So I think we've seen that more broadly so there's some impact to that in there, but it's not one of the major themes in terms of our NIM -- how our NIMs behaving at the moment.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

And lastly, while your -- since your income is down and your expenses are up in the quarter, how far has it pushed out your expectation of achieving a 40% cost to income ratio?

Matthew Comyn
CEO, MD & Executive Director

Yes. I mean as we said at the half, we're still committed to structurally lowering our cost base and believe that's critical to ensure we remain competitive over the long-term. I mean a couple of things. One, we want to make sure we do that in a sustainable way that doesn't damage our franchise strength or our operating momentum. And two, as this quarter and the last half has highlighted, we've got a number of near-term headwinds on -- in the context of elevated risk and compliance spend, which we think is critical. So I think of course, we've done and we continue to do a lot of detailed work around how we'll adjust that cost base over time. But that certainly feels more like a medium-term ambition than in the near-term.

Operator

Your next participant is Anthony Hoo, Deutsche Bank.

Anthony Hoo
Deutsche Bank AG, Research Division

Can I ask 2 questions? Firstly, on your disclosures around remediation cost in your ASX release on Page 3. For the wealth portion, you've told us $459 million. Are you able to tell us how much of that was in relation to the CommInsure Life insurance issues?

Matthew Comyn
CEO, MD & Executive Director

No. I mean I don't have the breakdown of that total $459 million in front of me in terms of year-to-date. I mean there was some of that $72 million in the quarter was included within life insurance.

Alan Docherty
Chief Financial Officer

So you mean the discontinued life insurance, Anthony?

Anthony Hoo
Deutsche Bank AG, Research Division

Yes.

Alan Docherty
Chief Financial Officer

So we've called out the $740 million of new remediation, that $704 million of that is in our continuing operation. So that was a $10 million remediation related to our discontinued businesses, including the CommInsure Life business.

Anthony Hoo
Deutsche Bank AG, Research Division

Okay. But we don't know historically how much was in life on a cumulative basis?

Matthew Comyn
CEO, MD & Executive Director

No. I don't have that.

Anthony Hoo
Deutsche Bank AG, Research Division

Okay. Just a second question, just on your CP coverage. Your CP includes an amount, which has been assigned to impaired assets. At the half, at the December results, so I'm assuming this is still the case. So that impaired asset provision was obviously

included in your IP to G&A coverage ratio. So it seems like there's an element of double-counting there. Is that still the case in the latest numbers?

Alan Docherty
Chief Financial Officer

Sorry, Anthony. Can you clarify the first part?

Anthony Hoo
Deutsche Bank AG, Research Division

Well, your collective provision of 105, I think it was, basis points, or 103 at December half, includes a portion, which has been assigned to impaired assets. So when you report at the December half, I think it was 33% coverage impaired assets to G&A. So IP to G&A coverage ratio of 33% which seems that there's a bit of double-counting going on.

Alan Docherty
Chief Financial Officer

No. I mean I think the -- so the collective provision -- are you looking at the reconciliation between the new AASB 9 staging? Of the loans in our portfolio and the collective provision?

Anthony Hoo
Deutsche Bank AG, Research Division

Not the reconciliation. Just in terms of provision coverage as they stand at the current point in time.

Alan Docherty
Chief Financial Officer

They're very small, they're very small component of the collective provision related to very small assets, was a shortfall between the present value of

expected recoveries and the load outstanding. But no, the collective provision, coverage ratio is an accurate reflection of the CP coverage we've got across the portfolio.

Operator

Your next question comes from Richard Wiles, Morgan Stanley.

Richard E. Wiles
Morgan Stanley, Research Division

Matt, thanks for your comments around the timing of your lower absolute cost base aspiration. I'm wondering if you could also provide some more detailed comments on costs. Specifically, the media reported plans to reduce headcount by 10,000 to 12,000 and also close 300 branches. Given this is the first time you've had the opportunity to address the investment community on this issue, can you provide any comments on medium-term plans around how you're thinking about headcount, how you're thinking about branches? Or any other key drivers of your cost base?

Matthew Comyn
CEO, MD & Executive Director

Sure. I mean it's fair to say that some of that media reporting was certainly a surprise for me. The divestments that we've announced, there's more than 4,000 employees that are part of that. Beyond that specifically, and clearly as we think long-term of our cost base, and we have some elevated numbers of employees that are dealing with other remediation or specifically with regulatory and compliance projects. We expect those to reduce over time. As it relates to branches, I mean we maintain the largest branch network. We believe that, that's an important strategic asset clearly over time, but the number of branches and the size of those branches has reduced and is likely to continue to reduce. But certainly, we're not contemplating any sort of large-scale branch reduction in the near-term.

And if you look at the way we've managed our physical footprint over the last few years, it's been fairly modest in terms of those branch reductions. And really in line with what we're seeing in terms of customer preferences changing. We believe the branch network enables us to gather deposits very well across the entire retail and business bank. And we also think it's a critical element of being able to serve our customers directly for their home loan needs.

Operator

Your next question comes from Azib Khan, Morgans.

Azib Khan
Morgans Financial Limited, Research Division

A couple of questions for me related to the other program costs shown on Slide 6. That's a pretty chunky number in the quarter of $156 million. Can you please tell me how much of that $156 million relates to the implementation of Royal Commission recommendations? Also, second question on that is how far are you through the implementation of the recommendations? And have you provisioned for remaining implementation?

Matthew Comyn
CEO, MD & Executive Director

Yes. On the first part of the question, we don't break out the specifics between the program costs that we anticipate just with the Royal Commission. As you would see across a range of different either customer remediation or as I've said in the opening comments, we've got sort of 400 people working on the customer remediation program. We've got a number of other people working on resolving projects and issues around that. Some of those projects obviously require resources in the near-term. So I haven't broken that out specifically for the Royal Commission.

In the context of how many of the recommendations we've implemented, I'm trying to recall the specifics of the breakdown in March. But I'd say we have completed sort of half a dozen or so, and we're on track with the ones that we had previously provided before my appearance at the House of Representatives in March. And I anticipate giving a further update at the full year results in August.

Azib Khan
Morgans Financial Limited, Research Division

Have you provisioned for the program costs associated with the remainder of the implementation?

Alan Docherty
Chief Financial Officer

Yes. We've provided for the implementation costs attached to the Royal Commission recommendations in that $156 million.

Operator

Thank you. There are no further questions at this time. I will now hand the conference back to Melanie Kirk for closing remarks.

Melanie Kirk
Head of Investor Relations
Thank you for joining us on the conference today. If you have follow-up questions, please reach out to the Investor Relations team. Thank you.