Question and Answer

Andrew Bowden
Head of Investor Relations

Jarrod in the front there.

Jarrod Martin
Crédit Suisse AG, Research Division

Jarrod Martin from Crédit Suisse. A question on capital and dividend. So your capital position is unquestionably strong, 10.64%. You rightly highlight that 27 basis points of organic capital generation and obviously offset by the major items. You wouldn't be expecting those major items to be as big in the second half? Or maybe you should comment if you are. So there should be some organic capital generation. And that core equity Tier 1 should push closer to 11%. So I'm curious about your decision to put a discount on the DRP. Are we effectively saying that 10.5% is no longer the unquestionably strong level, it needs to be 11%, 11.5% to get ahead of potential changes?

Brian Charles Hartzer
MD, CEO & Director

Do you want to have a go at that?

Peter Francis King
Chief Financial Officer

Yes. No, no, I think -- Jarrod, I think the short answer is it was about capital management. And if I look into the second half, we know we've got a new model for derivatives coming in and that's a 20 basis point headwind. That's the 1st of July. So that's our estimate for that. We also know that APRA will make, hopefully, some announcements on the final capital rules. And that's why we thought we wanted some additional flexibility on capital because we're getting closer to the hard date for APRA's requirements and we wanted some flexibility in terms of that piece. In terms of the second half, we will see that and we'll see earnings and we can make decisions again at the full year.

Andrew Bowden
Head of Investor Relations

Andrew?

Andrew Triggs
JP Morgan Chase & Co, Research Division

Andrew Triggs from JPMorgan. Just a question on deposits. It was a reasonably good...

Peter Francis King
Chief Financial Officer

On what, sorry, Andrew?

Andrew Triggs
JP Morgan Chase & Co, Research Division

On deposits. It was a good half there with the basis point tailwind to the margin. Just 2 questions there. Firstly, in the short term whether you think you can still leak out deposit spread benefits into the second half? And then the sort of more -- sort of medium-term question. How far do you think cash rates would need to fall before you start to find it difficult to reprice deposits sufficiently when you start sort of meeting that lower bound on deposits on at least, say, your online saving portfolio, where there's a 50 basis point base rate, but most customers would be on a sort of retention price north of 2%?

Peter Francis King

Chief Financial Officer

Yes. Andrew, I think on margins -- so I'll just highlight -- one thing I was highlighting is there's been big moves. So the short-term rates are down, the 3-year rate is down. They are very important rates for us in terms of the margin. One will help, one won't help in terms of that.

In terms of your question on where does -- where the interest rates -- I think you've answered it, because some of those products are at 50 basis points. So if you're getting down to that level, you're at 0, then you're starting to get a floor under some of your deposit price.

Andrew Bowden
Head of Investor Relations

Jon?

Jonathan Mott
UBS Investment Bank, Research Division

Jon Mott from UBS. Just following up on the comment you just had then on the tradeoff between BBSW and also the 3-year going the opposite direction. I think previously you said that every 5 basis point movement in BBSW adds 1 to NIM. So you get a lot more leverage from that than you would given the hedge on the tracker from the 3-year. So effectively, if rates aren't moved, I would have thought the benefit that you get from the BBSW will be much larger than the offset from the tracker. Just clarify that? And so another, yes, just as a follow on. The other question I had was, on Slide 18, you talked a bit more about the run-off in the portfolio. I just wanted to get a feel for, is the run-off falling because less people are refinancing externally. So you're seeing less new volume, but also less run-off from refi? Or is it actually that as people are going I/O to P&I, they're just finding it a little bit harder, it's not paying down the loan faster as to moving...

Peter Francis King
Chief Financial Officer

So on the run-off, it's less sales of property. That's the big move.

Jonathan Mott
UBS Investment Bank, Research Division

Less turnover?

Peter Francis King
Chief Financial Officer

Less turnover in the market. So you get it on the new lending side, you get it on the run-off side. So that's -- on margins, so a couple of things. The exit margin is about flat with the half. So that gives you a sense of where we're at right now. And then I think the piece -- so you spoke about short-term housing cost. You spoke about the 3-year swap rate. Competition and switching within the mortgage portfolio. So you put all those things together -- I just think you focused on 2 of the issues, not the third one.

Jonathan Mott
UBS Investment Bank, Research Division

So that would mean if rates get cut, then you lose the BBSW benefit, NIM will come down substantially?

Peter Francis King
Chief Financial Officer

No, I'm not giving you a forecast for NIM. I'm just saying there's a third driver in it.

Jonathan Mott
UBS Investment Bank, Research Division

Okay. Hypothetically speaking, that would be a...

Peter Francis King
Chief Financial Officer

Up to you to model.

Jonathan Mott
UBS Investment Bank, Research Division

Easy.

Andrew Bowden
Head of Investor Relations

Victor?

Victor German
Macquarie Research

Victor German from Macquarie. Two related questions, one on expenses. Brian, you talked about some of the initiatives that you're putting in. And obviously, we have guidance for this year, but just interested in the observations. If challenging revenue environment continues -- and you're getting lots of questions on low interest rates and all that sort of stuff that does to revenue. Just in terms of your thoughts on expenses as we go out into 2020, '21. One of your peers obviously is talking about significant reduction in the expense space?

And second related question on dividends. I appreciate that this year lots of volatility. But on an underlying basis, earnings are down 1% and dividend is flat. You're issuing more shares. And that's obviously continued to put pressure on your payout ratio. How you're thinking about dividend more broadly? Is it you're trying to sort of return as much franking credits to your shareholders and that's the key driver? Or do you think as we go out 2, 3 years, you will be able to get into a more reasonable payout ratio because either revenue improves or you'll be able to do a lot more on costs?

Brian Charles Hartzer
MD, CEO & Director

Well, I might take the cost and you can comment on the dividend side. So when we're thinking about the cost issue, as I said in my remarks, cost is an enormous priority at the moment given the environment. I think one thing to remember about our position is, this isn't a new thing for us. We've been focused on productivity for multiple years. It's embedded in the way that we run the company in terms of internal productivity targets every year. That's why our starting position from a cost to income ratio point of view has been strong relative to some of our peers.

The balance that we're striking is, we've set the target around $400 million in productivity improvement. That's an increase on what we did in the previous years. But I'm not going to sacrifice compliance or risk management in this environment and I'm not going to sacrifice the long-term simplification and modernization of the underlying platform.

So we have some flexibility in terms of the timing of our investments, but we are driving through a program that is all about driving that cost to income ratio down below 40%, which is still our target.

Victor German
Macquarie Research

Sorry, Brian, just if I can push my luck up. Completely appreciate. And shareholders would certainly not want you to sacrifice that investment. One of the things that's difficult for us is how far progressed are you? I mean are we -- is it still another 2, 3 years of further investment or we're getting towards the end of that?

Brian Charles Hartzer
MD, CEO & Director

Well, we'll probably maintain this level of investment for a couple more years. The modernization of our platforms is a big program. But as you can see from the result this half, we're starting to see real benefits coming out of that.

Peter Francis King
Chief Financial Officer

Victor, on the payout ratio, I think the important thing for this period was we looked through the major provision. So that's the first thing. But when you then look at it, it was an 80% payout ratio versus we think 70% to 75% in the medium term, and that's why we've had the DRP issuing shares. We were hopeful that over time the earnings growth would pull that ratio down. The new information this time is RBNZ. So we're going to have to stand back once we know what RBNZ is actually doing and look at the settings of the company.

Andrew Bowden
Head of Investor Relations

Andrew?

Andrew Lyons
Goldman Sachs Group Inc., Research Division

Andrew Lyons from Goldman. Like your peers, your fee fell somewhat in the half. And while you did provide a lot of disclosure around this ahead of the result, these headwinds did seem more significant than expectations in both banking and wealth management. Just with this in mind, can you perhaps talk about -- a bit about the trajectory for fees in both banking and wealth going forward?

Peter Francis King
Chief Financial Officer

Yes. So I think yes, the biggest impact -- putting aside Hastings, which I think everyone knew about, the biggest impact was insurance. So we had a $94 million increase in claims. If you go and have a look at the BT section, which shows cash earnings by division, our insurance provision basically made no money. So we paid all revenue out in claims, which is good for customers but wasn't great for shareholders.

Putting that to one side, we've got the reset of the business. So we've dealt with the grandfathering piece, that's in run rate. Then we've got the platforms reprice to come through. I said that's -- that was about [8.5]. We're probably about a quarter of the way through in terms of that impact. And then on the banking side, we did well. Probably a few headwinds in Business Bank mostly related to merchants. And then the cards piece was moving around mainly because of customer activity. So they did less on FX in particular.

Andrew Bowden
Head of Investor Relations

Brian?

Brian D. Johnson
CLSA Limited, Research Division

Brian Johnson, CLSA. I had 2 questions if I may. The first one is that we've seen the DRP discount 1.5%. We know that APS 180 sucks about 20 basis points out. Where does this -- and on RBNZ your commentary today is that we'll wait and see how we respond, but I think -- which is kind of telling us you're going to reprice up. But the other issue that's kind of floating around there is we're yet to get APRA's response to basically bail. And prima facie, you guys would appear to have a low risk-weighting than your peers, but probably a more capital-intensive book. Could we get some feel about whether this captures that potential risk?

And then the second one is you're saying today that you expect property prices to fall for a few more months. But we do know that your existing book has got a little bit of negative equity. Could you -- and

I'm sure you've got this number and I'm sure you probably won't answer, but could you share with us -- if you're going to talk it, you may as well explain it. But could you just explain for us the sensitivity on that negative equity book because presumably there's some kind of cliff effect at some point? So could you just give us some guidance? It either alarm us or make us feel better with some kind of sensitivity on the negative equity piece?

Peter Francis King
Chief Financial Officer

So on your risk-weighted asset question, I think you've hit -- you've picked all the areas. In relation to APRA's upcoming likely announcement on final bail rules, we know that some parts of the mortgage portfolio get high capital. I don't know how much. So I can't sit here and say I know. So we thought about that. That was part of the decision in terms of the 1.5% for the discount for the DRP. But you've got the right thematics.

In terms of the impact of lower property prices on capital, given we've got an LGD that's fixed at 20%, that's where you'd naturally have it flying through. It's not that big at this point.

Brian Charles Hartzer
MD, CEO & Director

And you've got -- you've seen in the chart that we gave you the breakdown of the ranges of over 100% dynamic, 90% to 100%. So you can kind of look at that piece and make a judgment.

Brian D. Johnson
CLSA Limited, Research Division

Sorry, my question wasn't about the capital. I was just wondering could you -- it was just the dynamics of what happens to that dynamic negative equity. If you can give us just a range of property prices, so we can look at whether there lies a concern or not.

Brian Charles Hartzer
MD, CEO & Director

We're not overly concerned.

Brian D. Johnson
CLSA Limited, Research Division

Could you share with us the dynamics of how you get to your lack of concern?

Peter Francis King
Chief Financial Officer

That's not in the pack, so we'll think about it in the future.

Brian D. Johnson
CLSA Limited, Research Division

Okay.

Brian Charles Hartzer
MD, CEO & Director

But there is quite -- if you look in the back, there is quite a lot of breakdown of the portfolio on a number of areas. And we do that because we think that if you look at the components of that, you'll see that it's a pretty high quality book.

Andrew Bowden
Head of Investor Relations

Okay, Brett.

Brett Le Mesurier
Shaw and Partners Limited, Research Division

Brett Le Mesurier from Shaw and Partners. A question on your impaired. So your disclosure on impaired shows the portfolio of managed impaired increasing from about $400 million at the end of September to about $700 million at the end of March. Can you comment on the factors that created that?

Peter Francis King
Chief Financial Officer

Yes, I think part of it's our transition to AASB 9. So we've applied a new framework or methodology in the small business where we pick up the facility, not the loan, and some data improvement in mortgages. That's about 1/2 the increase. And then the other 1/2 is the mortgage delinquencies increasing. That's the biggest factors. So about 1/2 related to methodology changes, 1/2 related to the economics.

Andrew Bowden
Head of Investor Relations

We'll take a call from the phone from Matthew Wilson.

Matthew Wilson
Deutsche Bank AG, Research Division

My question has been answered.

Andrew Bowden
Head of Investor Relations

Okay. Next one on the phone is Azib.

Azib Khan
Morgans Financial Limited, Research Division

Another question from to me about the lower run-off coming through the home loan portfolio. So Peter, have you increased -- have you lengthened the loan life assumptions in accounting for the deferred acquisition costs associated with mortgages?

Peter Francis King
Chief Financial Officer

No, we look at those every 6 months. It hasn't moved. So we need to...

Azib Khan
Morgans Financial Limited, Research Division

And just one more question from me if that's okay. So if I take a look at the interest on the flows, that's remained pretty stable from the last half despite APRA now lifting the cap, the 30% cap. So the 19% that the flows running at, at the moment, is that more driven by your risk appetite or by lack of demand?

Brian Charles Hartzer
MD, CEO & Director

I'd say it's driven by pricing and flowing into customer demand.

Andrew Bowden
Head of Investor Relations

Okay. I think he is done. Richard?

Richard E. Wiles
Morgan Stanley, Research Division

Rich Wiles, Morgan Stanley. I've got a couple of questions. Firstly, on Slide 109 you said there's a potential 20 basis point impact on group capital from New Zealand. Can you explain how you get to that given it's $3.5 billion to $4 billion within the New Zealand entity?

Second question. Brain, when you announced 14 basis points standard variable right rate pricing back in September, you said that funding costs would remain high for the foreseeable future. That doesn't seem to have continued to play out as you expected. So could you talk about some of the factors that you would take into account when thinking about pricing of your standard variable rates?

Brian Charles Hartzer
MD, CEO & Director

Do I take the first one?

Peter Francis King
Chief Financial Officer

Yes, you do that.

Brian Charles Hartzer
MD, CEO & Director

Okay. Well, I'm not going to talk about obviously what pricing changes we may or may not make. As a general point, on your thing about the elevated costs there, we had watched the BBSW move for -- around 6 months we had warned that cost. There are swings and roundabouts. Those numbers can be relatively volatile. So we don't like to make a lot of changes if we can help it. But at a certain point, you come to a conclusion. There are, as Peter said in his presentation, a number of different factors moving in opposite directions at the moment. As a general statement, we manage the overall net interest margin of the company, and so we think about the funding costs and the mix of funding as well as the mix and demand of loans. There is a variety of different product categories within that, that the mix shifts can change. And so we're thinking about that the whole time. And obviously, competition is a really important element as well.

Peter Francis King
Chief Financial Officer

And Richard, on the first one. That's a net impact, so that's the gross impact of the capital after -- and then after we've taken some actions to implement it. I would say that that is based on current APRA rules. It's quite important that's above that. But it's a net impact.

Richard E. Wiles
Morgan Stanley, Research Division

So that's not assuming any change to the size of the balance sheet in New Zealand or any change on repricing?

Peter Francis King
Chief Financial Officer

No. So it's that...

Richard E. Wiles
Morgan Stanley, Research Division

You're just saying that net impact at the group level would just be 20 basis points?

Peter Francis King
Chief Financial Officer

Based on the rule -- APRA rules today and based on that estimate of capital, that's a net impact.

Andrew Bowden

Head of Investor Relations

We'll take a call from the phone. It's from Brendan.

Brendan Sproules
Citigroup Inc, Research Division

I just got a couple of questions on the treasury result in this half, just referring to Slide 20. Treasury had probably one of the weakest results on the slide there, but obviously the markets, non-customer actually had a better half. Could you maybe talk about how they manage risk differently between those two given they're obviously facing the same market conditions? And my second question is that the volatility that we're getting there, the revenue from treasury seems to have picked up since 2017. Has there been changes in the way -- or the risk taking activities within that division?

Peter Francis King
Chief Financial Officer

Yes. I should just say on treasury, the result was lower, but I'm actually okay with that. To me the way that we run treasury is you take risk when it makes sense. So that's important context. Brendan, while we put them together as risk income, they're really different businesses. So WIB is there to support customer flow and interest rates, FX in particular, and it runs the book. Treasury is there to manage long-term structural mismatch in the balance sheet. So treasury's major risk areas are Australian and U.S. interest rates related to the group's house of funding and the balance sheet mismatch in Australia. So they're quite different businesses.

I'd just say on the treasury performance, it's been a flattening of the yield curve and less opportunities because less volatility. And then over the last sort of 5 years as we move the liquids book to being government and semi-government debt, it has provided less opportunities. So they leveraged the opportunities back in '16 and '17 and early '18 pretty well. It's been a tougher period for them more recently with some of the changes in the markets.

Andrew Bowden
Head of Investor Relations
And with that, we're done. Thank you very much, and good morning.