Start of Transcript

Introduction

Melanie Kirk: Hello and welcome to the Commonwealth Bank of Australia's Results Briefing for the half year ended 31 December 2021. I am Melanie Kirk and I am Head of Investor Relations. Thank you for joining us for this virtual briefing. We are coming to you from Sydney that is currently subject to COVID-19 health restrictions. We are complying with the New South Wales safety requirements as well as our own strict safety standards.

For this briefing we will have presentations from our CEO, Matt Comyn, with an update on the business and an overview of the result, our CFO, Alan Docherty, will provide the details of the financial results and then Matt will provide an outlook and summary. The presentations will be followed by the opportunity for analysts and investors to ask questions.

I will now hand over to Matt. Thank you, Matt.

CEO Presentation

Matt Comyn: Well, thanks very much Mel and good morning, everyone. It's great to be joining you today and while we are again meeting virtually, there are many signs that we can be much more optimistic about 2022. We have continued to support our customers and communities over the past six months and will continue to do so as the economy recovers.

Overall, the Bank has delivered strong financial performance despite the low rate environment. Our continued customer focus and disciplined operational execution is reflected in a very strong volume growth for the half. We have continued to strengthen our balance sheet and are today announcing a $3 billion dividend of $1.75 per share, plus a $2 billion on-market buyback, adding to the $12 billion returned to shareholders in the past 12 months. We have also been focused on our strategic agenda building further differentiation with a strong pipeline of new products and services.

Now, turning to our results. Statutory net profit was $4.7 billion. Cash profit was also $4.7 billion, up 23% due to above system growth, lower collective provisions from an improvement in the economic outlook and a reduction in remediation expenses. Operating performance was $6.6 billion, up 4%. This good operating performance and our strong capital position has allowed the Board to declare a $1.75 dividend for the half, fully franked, with the dividend reinvestment plan to be fully neutralised.

Now, looking at the results in some more detail. Operating income was 2% up for the half with strong core volume growth continuing to offset lower rates which has impacted the net interest margin. Operating expenses were flat with lower remediation costs offsetting increases relating to volume growth and increased investment spend.

Loan impairment expenses were significantly lower on the prior corresponding period driven by lower collective provisions reflecting an improvement in economic conditions and sound portfolio credit quality. This combination of 4% growth in operating performance and lower loan impairment expenses resulted in cash profit up 23% on the same period last year.

Over the past three years we have been prepared to invest to strengthen our franchise to deliver strong operational execution and strong above system volume growth. One measure of that franchise strength has been a growth in transaction banking relationships and balances. We have seen transaction balances across our Australia and New Zealand businesses grow 70% from $189 billion to $317 billion over the past three years and in the past six months we have delivered the strongest volume growth ever in aggregate across our core product areas.

Transaction balances are up 22% year on year with more than 197,000 new business transaction accounts opened in the past 12 months, bringing the total to one million business accounts. Business lending was up 12.5% growing at 1.7 times system over the past 12 months with margins stable in the half and up over the past 12 months.

Home lending's new fundings were up 45% to a record first half of $94 billion with 58% originated through our proprietary channels. CBA now accounts for 35% of proprietary originated home loans in Australia. This strong growth has been achieved despite a very competitive home loan market. We have taken a range of actions on both sides of the balance sheet over the past three years to manage margins in this historically low interest rate environment. Despite continued action, margins in the half were impacted by increases in the swap rate and switching to lower margin fixed rate loans. Alan will step you through our margin outcomes and outlook in more detail shortly.

Volume growth continues to be delivered through customer focus and disciplined execution. Our business and institutional franchises have retained their number 1 Net

Promoter Score positions and despite our consumer NPS being at the highest level since tracking began in July 2015, we are very focused on increasing our absolute NPS score and regaining the number one position.

Our mobile banking app still leads the market and we continue to see it as enabling us to move beyond customer service to redefining and extending the relationship we have with our customers. Digitisation and technology help to drive strong operational performance in both home and business lending. 65% of home loan applications are auto decisioned the same day and 80% of referred applications are also decisioned the same day. In business lending we are now executing 90% of documents digitally leading to faster funding while focusing on simplifying processes has seen a nearly 33% reduction in annual review times.

A highlight of the result is our continued capital and balance sheet strength. Our disciplined and balanced approach to capital optimises growth, reinvestment, shareholder returns and flexibility. Consistent balance sheet discipline has allowed us to return excess capital to our shareholders and lower our share count while remaining strongly capitalised and provisioned. Our balance sheet remains strong with 73% deposit funding. We have seen troublesome and impaired assets reduced by $680 million in the half.

We are well provisioned with total provisions of $5.9 billion, substantially higher than our central economic scenario. Following the successful completion of our $6 billion off-market share buyback, our common equity tier 1 capital ratio is 11.8%, which is 18.4% on an internationally comparable basis.

Our strong capital position with a surplus of currently almost $6 billion continues to create flexibility to support our customers and manage ongoing uncertainty. It also allows us to return a portion of that excess to our shareholders via an on-market buyback of up to $2 billion commencing after we complete the dividend reinvestment neutralisation. Following completion of this buyback, we will have a surplus of almost $4 billion and this strong residual capital surplus provides us with flexibility to consider further capital management initiatives.

Last year we refreshed our strategy to set a more ambitious agenda to build tomorrow's bank today for our customers. We remain focused on four strategic priorities: Leadership in Australia's economy recovery and transition; Reimagined products and services; Global best digital experiences and technology; and Simpler, better foundations. I will spend a few moments sharing our progress on each of these.

Throughout the half we have continued to support both households and small businesses. The most significant initiative over the past couple of years has been the deferral of 163,000 home loans and over 80,000 business loans for our customers which we have been managing very well. The vast majority of customers use the deferral period to get ahead on their loans and as a result we have seen a low level of arrears.

Our customer engagement engine has been critical in helping prompt customers into and out of these deferral arrangements. It has also helped customers initiate 1.8 million claims and access over $500 million in entitlements through Benefits finder as well as help contact 1.8 million customers regarding natural disasters.

We have also helped households with $186 billion in new lending, and we remain focused on building Australia's future economy.

We're ranked number 1 in Australian debt capital markets and have supported businesses with $60 billion in new lending, including 60% of all loans written under the third SME Loan Guarantee Scheme.

Our second strategic priority is to reimagine our products and services. We're looking to create a more differentiated proposition for both our retail and business customers through a combination of new products, partnerships and investments.

We're focusing that activity around 5 areas. We're differentiating our home loan proposition, offering access to additional services like broadband, energy, green loans and property management to drive greater consideration and engagement.

Given high demand across younger consumers, we're focused on bringing investing into the CommBank app, making it simpler and easier for our customers to invest in small increments across a range of asset classes.

Everyday banking remains critical for consumers and business customers and we're looking at a range of ways to make it easier for customers to manage uneven income and uneven expense profiles.

Another particular area of focus is connecting our almost one million business customers with our 11 million retail customers to bring unique deals and offers to save people money, while at the same time, bringing incremental growth to CBA business customers.

We also remain focused on carbon and helping our customers navigate the path to a low carbon future whether that be through financing the transition or providing tools for customers to buy or sell carbon offsets.

A few recent examples of new products we're bringing to market include StepPay, Doshii and our new payments terminal. We're pleased with the early progress of StepPay. Our interest free buy now, pay later card has more than 150,000 customers in its first four months since launch and has now processed two million transactions. At one quarter of the cost for the average merchant, StepPay allows customers to activate and originate in minutes.

Last year, we announced the acquisition of Doshii which looks to simplify the process of taking a hospitality venue online. This has obviously been particularly important for restaurants during COVID as home delivery has grown substantially. In 2021, Doshii doubled its customer base, facilitated over 170 million orders and almost trebled its venue coverage to 70% of the market.

In last October, we began replacing our smart terminal fleet with a new point of sale device. This device is already being used by more than 2200 business customers of which 60% are new to Bank. We are also now piloting live in market our fully mobile mini pay tap and pay reader which will be rolled out this year.

We've made several minority equity investments in the half primarily to secure exclusivity with key strategic partners. In November, we announced an exclusive partnership and minority stake in H2O.ai, a global leader in artificial intelligence. AI is a key area of focus for us and we are increasingly using this technology to drive value whether that be delivering on our aspiration to be one of the highest quality, lowest cost sources of sales leads to merchant customers or improving home loan customer engagement and retention or driving higher engagement and better customer outcomes in our app.

We've partnered with both Gemini and Chainalysis and late last year, launched a small pilot allowing customers the ability to buy, sell or hold crypto assets through the CommBank app. Through our venture arm x15, we've signed exclusive partnerships with two exciting Australian start-ups focused on the home where we are very focused on differentiating our offer.

We've made a small investment in Different which is digitising the property management space and using digital tools to make life easier for both investment property owners and tenants. Last week, we announced an investment alongside Square Peg in OwnHome which is a very interesting model to help customers get into their own home sooner. We also now own just under 24% of PEXA having invested $200 million in the half with PEXA now representing 91% of CBA's home loan settlements.

Our third strategic priority is global best digital experiences and technology. Our mobile app consistently ranks number one in the Asia Pacific region and in the top handful globally in the annual Forester Survey. We're continuing to use technology to build deeper, trusted relationships with our 7.5 million digitally active customers and 6.6 million app users.

We're integrating more and more services into the CommBank app including shopping services and investing products so that the app sits at the trusted centre of our customers' financial lives. Our customer engagement engine allows us to orchestrate relevant and personalised experiences across this growing set of products and services supported by over 400 machine learning models running across 157 billion data points.

We're seeing a steady increase in the way and frequency that our customers are engaging with our app. For example, with 1.9 million monthly engaged users on the recently launched *For You* section of the app where customers can access deals and offers. This is fundamental to the strength of the franchise and being the primary holder of transaction balances and lending relationships for our customers.

Our fourth strategic priority is simpler, better foundations reflecting our focus on creating a simpler, better bank. We've made further progress simplifying the business with the completion of the sale of 55% of Colonial First State to KKR. During the half, we also completed our Remedial Action Plan to improve governance, culture and accountability across the organisation. While the program of work is now complete, we also know there is still more work for us to do and we're very focused on both sustaining the progress and continuously improving and strengthening the changes that we have made.

We continue our long-term focus on discipline and balance capital management that optimises growth, reinvestment, shareholder returns and flexibility. Of course, our people are central to everything we do and their positivity and pride in the organisation is reflected in strong ongoing employee engagement at 80%. I'll now hand to Alan to take you through the result in a bit more detail.

CFO Presentation

Alan Docherty: Well, thank you Matt and good morning to everyone who has dialled in. I'll provide some more detail on the financial results and also take the opportunity to provide further colour on our outlook for net interest margin as well as our considerations around the dividend and capital management.

To summarise, the financial results reflect how we are navigating the low rate environment and our consistent disciplined operational execution. You can again see the results of the good work of our people reflected in market share gains across all core products, improved revenue momentum and growth in pre-provision operating profits. This has provided us with a platform to reinvest in and strengthen our franchise, increase our interim dividend and also continue to gradually return excess capital to our shareholders.

The financial performance in this last six month period has been pleasing and we believe our strategy represents the optimal long-term approach to build on our existing competitive advantages. However, we do need to remain mindful of near-term profitability headwinds. In particular, net interest margins have reduced over the last six months and the outlook for margins will remain pressured until we see a rising cash rate environment. This is a key dynamic as we look ahead and I will spend some time on this topic a little later in the presentation.

Now onto the detail. Statutory profits from continuing operations were $4.7 billion for the six month period. Non-cash items within continuing operations were relatively minor this period and so continuing cash profits were also $4.7 billion. As Matt has mentioned, that cash profit is up 23% on the same half last year with operating income growth of 2%, operating expenses down slightly, good growth and pre-provision profits of approximately 4% and a loan impairment benefit during the period which drives the remainder of that large positive variance in cash profit.

Looking firstly at operating income. Both net interest income and other banking income increased over the prior comparative half due to another strong period of volume driven growth in home loans, business lending and deposit revenues in both Australia and New Zealand. Other banking income also benefited from the non-recurrence of aircraft impairments in the prior comparative half and higher profits from our minority investments.

Insurance income fell this period due to the impact of storm related weather events in October last year. Revenue growth was moderated by a decline in net interest margins over the period and it's worthwhile going into more detail on the next few slides on firstly, the key margin movements that we've seen over the last six months. Secondly, zooming out and looking at how margins have performed over the last three years and finally, walk through what we might expect as we look to the future.

Over the most recent six months, underlying margins decreased nine basis points. The dilutive effect of higher liquids drove a further eight basis point reduction in headline margin. Though as you know, that has little to no impact on net interest income. On the left hand of the chart, fixed home loan pricing changes contributed two basis points of margin decline with long-term swap rates rising faster than fixed rate repricing during the last six months.

A further four basis points of margin decline was due to customers switching from variable to fixed rate home loans during another period of historically low rates. Three basis points of the underlying margin decline was driven by continued competitive pressure for standard variable rate home loans. Deposit repricing and mix delivered three basis points of benefit and the impact of lower tractor rates on deposit and equity hedges were the main components of the residual three points of decline.

Now, before I provide some forward looking considerations on margin, I think it will be useful to provide some broader context around the various moving parts over the last three years during a period of unusually low rates. The most significant driver of margin reduction over the three year period has been the impact of falling cash rates on our portfolio of low rate deposits.

To limit the earnings volatility through a rates cycle, we hedged some of those deposits through a replicating portfolio and you can see in the first two bars on the left that the 140 basis points and cash rate cuts led to a net 15 basis point reduction in our net interest margin. To put that into context, 15 basis points of margin is the equivalent of a reduction in net interest income of $1.4 billion per year.

The next item is the Group's equity hedge. As three year swap rates fell, this led to an eight basis point reduction in margin. If we look at fixed rate home loans, the biggest margin impact has been the 12 basis point mix change caused by customers switching as fixed rate pricing fell below variable rate for an extended period of time. A competitive environment for standard variable rate home loans has driven a 13 basis point reduction so a consistent trend of three to four points of margin contraction per year for each of the last three years.

Against these margin headwinds, we've seen the partially offsetting benefits of both lower wholesale funding costs and also significant management repricing actions on both sides of the balance sheet. Now as you know, all of this occurred in a three year period of both falling overnight cash rates and falling long-term swap rates.

If we now look ahead to the remainder of this financial year and beyond. Long-term swap rates have risen significantly and there is broad agreement on the likelihood of RBA cash rate rises, but with differences of opinion on the expected timing. That has implications for the trajectory of our net interest margins. The first and most obvious point to make is that until there is a rise in cash rates, our margins will remain under pressure and that's highly likely to be the situation in the second half of the current financial year.

Looking at each of the key drivers on this slide, the first two drivers are expected to be broadly neutral in the second half. This is because our portfolio of low-rate deposits has already borne the full impact of falling cash rates and the earnings on the equity hedge take some time to reflect the benefits of the higher level of the three-year swap rate.

On fixed rate home lending, we still expect to see a few more months of margin pressure from both pricing and mix effects. On fixed rate pricing, despite leading the market with five separate rate increases since October, this has only partly offset the margin pressure from rising long-term swap rates. As a result, new business margins on fixed rate home loans are lower now than they were in the first quarter of this financial year.

On fixed rate mix, we experienced very strong December quarter new business volumes and we also have the usual funding lag for pre-Christmas applications that settle over the next few months. Taking these two factors together, we expect the portfolio mix of lower margin fixed rate home loans to peak during the second half of this financial year.

On standard variable rate home loans, it would surprise no one that we would expect to see continued price competition. And all the other key margin drivers, we expect to be broadly neutral or offsetting over the course of the next six months.

If we look further ahead and consider what might change in a rising cash rate environment, there are a few important points to note. Firstly, the low-rate deposit balances that experienced such a large headwind from falling cash rates would be expected to generate a strong tailwind as rates rise. We have approximately $170 billion of low-rate deposit balances that are insensitive to rising rates and we would expect this portfolio to deliver four basis points of margin benefit over time for every 25 basis point increase in the cash rate.

On the equity hedge, if three-year swap rates remain at current levels, then we would expect to see a gradual benefit to our margins as the tractor rate increases. On the fixed home loan portfolio mix, as rates normalise we would expect to see a reversal of the situation over the last three years and a decreasing proportion of fixed rate home loans after reaching a peak in the coming months. Lastly, you would naturally expect a rising rate environment to result in higher wholesale funding costs.

Now that's a little more detail on the margin outlook than we usually provide, but given the number of moving parts and the historically unique inflection point that we have reached on interest rates, I hope that provides some useful transparency around how we're thinking about it.

Turning now to operating expenses, they were down slightly on the comparative period. Pleasingly remediation costs decreased $149 million. Excluding that, underlying costs were up 2.7%, investment spend was up slightly higher, up $24 million or 0.5% as we continue to invest in the long-term health of the franchise.

As you can see, volume-related costs increased 1.4% over the same half last year, reflecting continued strength and new original flows in both the retail and business bank. Lastly, our ongoing business simplification initiatives resulted in incremental productivity savings of $92 million, which helped offset other inflationary cost increases.

Turning to our balance sheet settings and looking firstly at credit risk, loan impairments was again a benefit to P&L in the current half with another benign period for both consumer arrears and another significant reduction in corporate troublesome exposures during the half. These strong portfolio trends, along with an improved macroeconomic outlook, have resulted in a further reduction to our loan loss provisions with collected provisions down $250 million to $5 billion.

As you can see on the right-hand side of this slide, well expected credit losses under a central economic scenario have significantly reduced over the past 12 months. We've continued to exercise caution around the level of provisioning and retained significant provisioning coverage. This is in recognition of the continuing uncertainty from both the pandemic and also forward-looking adjustments for the potential impact of higher inflation and interest rates on our customers and the economy.

Our balance sheet funding settings remain very strong with a customer deposit ratio remaining at 73%, continued low levels of short-term wholesale funding and we continue to conservatively manage our liquidity coverage ratio and net stable funding ratio as we manage the withdrawal of the committed liquidity facility over the course of the next 12 months.

On capital, we've delivered a common equity tier 1 ratio of 11.8% which is down 130 basis points over the last six months due to the successful completion of our $6 billion off-market buyback in October. Capital generation was flat over the six-month period with the benefit of the Colonial First State divestment and higher retained profits offset by increases in risk-weighted assets.

The increase in credit risk-weighted assets was a function of continued strong volume growth in home and business lending and strengthening portfolio credit quality. Interest rate risk in the banking book also increased significantly over the half due to the sharp increase in swap rates that occurred in the final calendar quarter of 2021.

The Board continues to take a disciplined and balanced approach to the consideration of capital management activities. We will continue to reinvest between 20% and 30% of our cash profits into the retained earnings that support our long-term growth. We continue to invest in innovative products, services and partnerships in support of our strategy.

We will aim to continue to pay strong and sustainable dividends and to return excess capital in a manner which lowers our share count and supports shareholders' long-term return on equity and dividend-per-share outcomes. Finally, we will continue to hold strong levels of capital above APRA's requirements in order to remain resilient to potential future stress events.

The interim dividend of $1.75 represents a $0.25 increase on the equivalent period last year and a normalised payout ratio of 70% in line with our longstanding dividend policy. Given our very strong capital position, the Board have also decided to again neutralise the DRP in respect of the interim dividend.

Our capital surplus is currently almost $6 billion above the unquestionably strong benchmark. We are well placed to continue to support our customers and manage ongoing uncertainties, while also returning a portion of that excess to our shareholders via a $2 billion on-market buyback of shares. This would see us with a residual pro forma capital surplus of approximately $4 billion, providing the Board with the flexibility to consider further capital management initiatives.

I'll now hand back to Matt who will take you through the outlook and a closing summary. Thank you.

CEO Outlook and closing summary

Matt Comyn: Thanks very much, Alan. Despite some challenges from the pandemic, the Australian economy is looking strong against a number of metrics. In December 2021, we saw the unemployment rate drop to 4.2%, the lowest in 13 years with underemployment at historic lows and the participation rate looking very strong.

Australian households have now accumulated $240 billion of additional savings and income growth has remained robust. The impact of Omicron on the economy and spending has been more modest than expected, with spending slowing only marginally. Non-mining investment is strong, confidence has held up reasonably well and both exports and infrastructure investment are providing good support.

We expect this strong economic momentum to carry through to at least the end of 2023 and are feeling very positive about the outlook for the Australian economy over this period. We've seen house price growth slowing and expect only modest increases this year before the peak is reached and prices start to settle.

Globally we see growth moderating this year after the sharp recovery in 2021. A big thematic for the year is likely to be rising inflation and tightening monetary policy by some of the world's major central banks, especially the US Federal Reserve. Inflation is well above target in the US, UK, New Zealand and Canada and each of these central banks have started tightening monetary policy.

However, the inflationary risk does not appear as extreme in Australia, but our economists do expect underlying inflation in Australia to average 3% to 3.5% in 2022, which is above the top end of the RBA's target range. As a result of the inflation outlook and the improving labour market, the RBA will tomorrow conclude its bond purchase program. Our economics team expect the first interest rate increase from the RBA in August this year, followed by a gradual and modest tightening cycle. Despite this, we see strong underlying momentum in Australia and are upbeat on the outlook through to the end of 2023.

So in summary, we've delivered a strong result in a low-rate environment. Our continued customer focus and discipline operational execution is reflected in our volume growth for the half. We've continued to strengthen our balance sheet, enabling us to pay a $3 billion dividend to shareholders this half and plan to commence an on-market buyback of a further $2 billion.

Now looking ahead, we'll continue to focus on our operational and strategic execution and we believe that our balance sheet is extremely well positioned for anticipating a change in the interest rate cycle. We'll continue to invest to differentiate our product offering to our retail and business customers and extend our digital leadership, as well as continuing to support our customers as the economy continues to rebound.

I'll now hand over to Mel to go through the questions.

Q&A

Melanie Kirk: Great, thank you Matt. For this briefing we will be taking questions from analysts and investors. We'll announce the question and then your phone line will open. Please state your name and the organisation that you represent. And to allow as many as possible to ask questions, please limit your questions to no more than two questions.

The first call comes from Richard Wiles.

Richard Wiles: (Morgan Stanley, Analyst) Good morning Matt, good morning Alan. I've got a couple of questions relating to slide 25 on the future margin considerations. Thanks for the detail. On the second-half margin you're clearly saying the margin will be down. Do you think the lending headwinds will ease even though that downward pressure will continue?

Then on the medium term, why has the impact of price competition on SVR home loans not negative? Have you just left that blank because you're not allowed to talk about future pricing?

Matt Comyn: Firstly, morning Richard, why don't I start and then Alan, you take it from there? Look, as you said Richard, what we've tried to do is provide as much information and disclosure as possible to try and help our investors and analysts understand what's going on. There's a number of different dynamics, as we pointed out as you can see in the first half, some of which of those are going to continue.

I mean I think particularly what we saw when we called out was high switching to lower margin fixed-rate home loans and we saw that at about 47% of flow over the half; the portfolio is now at 38%. Clearly we expect that to moderate, but moderate gradually over the period of the next six months, probably towards an average of 30% or so of fixed rate flows in the second half. So there will be some, I guess, continuation of that.

Then look, specifically and Alan should talk to this, it's probably – we didn't specifically exclude it for any other reason than often in a rising rate environment we anticipate there might be stronger competition in liabilities. We think we've got a very good deposit gathering franchise. As you would have seen over a long period of time, often as competition intensifies on one side of the balance sheet, perhaps it eases or moderates on the other side. You could easily also try and extend some sort of continuation.

But as you said, there's challenges in the second half. We'll continue to do everything we can as we've tried to do so over the last three years to moderate that impact and then clearly, as Alan stepped through, there's a number of positives over the medium term.

Alan Docherty: Yes and then maybe just to add briefly to that, one of the things that we wanted to make sure that we got across was that there was very strong volumes written in that December quarter in particular. So in terms of that mix effect on the home loan portfolio and the switching that we've seen in that period, we expect that to have a full six-month effect of that in the second half of the financial year. So I thought that was an important dynamic to in particular call out.

Yes, on the right-hand side of that page, I mean it's really – there aren't things we expect to change in many respects, we're in a competitive environment, I don't expect that to change, so that's another consideration.

Richard Wiles: (Morgan Stanley, Analyst) So the standard variable rate should still be red in the medium term? It's been red for years. You're not suggesting that suddenly, as the interest rate environment changes, that inflection point you talked about, you're not suggesting that suddenly front book versus back book competition disappears?

Alan Docherty: No.

Matt Comyn: Yes, it's hard to see that reversing, Richard and you'd expect it to remain competitive.

Richard Wiles: (Morgan Stanley, Analyst) Okay. Yes. Sounds like it should have been red too.

Matt Comyn: Perhaps.

Richard Wiles: (Morgan Stanley, Analyst) Thank you.

Matt Comyn: Thank you.

Melanie Kirk: Thank you, Richard. The next question comes from Andrew Triggs.

Andrew Triggs: (J.P. Morgan, Analyst) Thank you Mel, morning Matt and Alan. First question, just a follow-up on Richard's question, on that same slide there, the other one at the bottom for the second half 2022, broadly neutral and offsetting, do we read that – we can read that one of two ways, either that the funding cost tailwinds are negligible or that there's still a liquidity drag which is offsetting those funding cost benefits that are still coming through.

Also on the medium-term considerations, you called out the benefit on the transaction account portfolio from rising rates. Just interested if there's an additional benefit to be had there from the benefit from free funds.

Alan Docherty: Thanks Andrew. So on the first point on the other broadly neutral/offsetting, yes, there is a number of moving parts in there and you've touched on a couple of the important ones. One is funding costs and you've seen that we've been active, more active in the long-term debt markets over recent weeks and we expect that will continue, so you would expect to see higher wholesale funding costs as we move forward.

Liquids, I mean the committed liquidity facility, we're going to see that wind down over the course of the next 12 months, so again you would expect to see a rise in liquids costs. On the other side of the ledger, you'd expect to see continued positive mix changes from continued very strong growth in at-call transaction deposits that we see some funding mixed benefits rising from that.

As activity rebounds and consumer spending increases, which is our expectation over the next 12 months, you might see a reversal of the unfavourable mix effect that we've seen on lower consumer finance balances over the last two or three years. So when we take all those things together, we expect either individually neutral or broadly offsetting is the best way to describe how we think about that over the course of the next six months in particular.

On your second question, Andrew, that was whether there was a benefit of free funds in addition. Effectively what I'm describing there is the benefit of free funds effect from the rate insensitive deposits, so you'd see that manifest both through the low-rate deposits; we've netted that off against the assumed switching that you might see to higher deposit products during a rising rate environment. The other dynamic there is the equity balances, which obviously behave like rate insensitive deposits, so that's the second item. So really those first two items are the benefit of free funding.

Andrew Triggs: (J.P. Morgan, Analyst) Thanks Alan. Just second question on the other operating income line, it was stronger again than what was a strong previous half. Noted a couple of call outs there around the AIA milestone payment and also higher treasury income, what should we expect for this line going forward please? I know it's hard to call out a normal half.

Alan Docherty: Yes, this is on the other-other income?

Andrew Triggs: (J.P. Morgan, Analyst) Yes.

Alan Docherty: Yes, there's been a few moving parts in there. I mean I think I'd say that we've had a number of movements with another banking income and we've had, for example, lower trading income in the current half versus the same half last year. You will recall we had very favourable trading conditions in the prior comparative period due to opportunities we had in a precious metals commodities business. So there's been a headwind on the trading income side.

You've also seen headwinds on, for example, merchants income because there's been less activity. We've had lockdown restrictions; we've provided fee waivers to many of our merchant customers. So there's a number of offsetting headwinds. Yes, we've had some tailwinds as well, but I think if you stand back from it and look at the other operating income, the net driver underlying all of that has been very strong growth in volume-related fees across home lending, business lending and deposits. So the underlying franchise momentum's been strong there.

Other other income, yes, that was a higher than normal half but there was offsetting headwinds and other line items. So I think when you take it together, that was a strong period that we were very pleased with the volume performance.

Andrew Triggs: (J.P. Morgan, Analyst) Thanks, Alan.

Melanie Kirk: Thank you, Andrew. The next question comes from Bryan Johnson.

Brian Johnson: (Jefferies, Analyst) Thank you for the opportunity to ask some questions and congratulations on clearly what is a great result. Alan, two questions from me. The first one is, the interest rate risk in the Banking book, unsurprisingly, kind of thumped you during the period.

Can I just get a feel? The move in bond rates that we've actually seen subsequently, should we be kind of thinking in this environment that you get a similar hit on the capital for the interest rate risk in the Banking book in the next half year?

Alan Docherty: Yes, thanks, Brian. Yes, certainly swap rates have continued to increase. I wouldn't - they haven't increased as much as the - I mean, that was a - there was a big rate spike at the end of October as you'll recall. That was a much larger impact relatively than the rate increases we've seen since the end of the calendar year.

I mean, there's sort of two opposing dynamics going on there. You obviously have to marked to market. The fact that you've got your equity invested over a three year tractor against a notional one year tractor. So in periods of rising rates, that leads to higher interest rate risk in the Banking book.

That embedded loss, if you like, amortises over a period. So you'll see the sort of amortisation effect of that embedded loss over the course of the next couple of years. Against that, we need to watch what happens with two and three-year swap rates. So as you say, they've increased a little since the end of the year. That will provide an opposing headwind on IRRBB.

So yes, I mean it's certainly a little higher now than it was at the end of the year but it was a very big move that we'd seen in that final calendar quarter so not of this same order of magnitude.

Brian Johnson: (Jefferies, Analyst) The next one is for Matt and I've got a hold back a sense of glee as I ask this question. Just if we have a look at the collapse of a lot of the buy now, pay later valuations. In the previous half, you had marked to market the stake in Klarna up to what you thought the market value would be.

It didn't go through cash earnings, went through the statement of comprehensive income. Can we just find out - and I'm sure it's here somewhere in the text but I haven't seen it yet. Could you just run us through what you've done with the Klarna valuation if anything in this half year?

Matt Comyn: Yes, sure BJ.

Brian Johnson: (Jefferies, Analyst) And what is it held at?

Matt Comyn: Yes, so - I think there's a very modest movement. So you're right, we'd marked it up not through cash. I think probably trying to take a relatively conservative view and hence when we did the revaluation it was a pretty sort of modest movement.

As we've seen their performance globally, it's continued to be very strong so I think we're not - we still believe that business will perform well both domestically and internationally but as I recall, there's a pretty modest - maybe like $100 million or so reduction in their carrying value on books.

Alan Docherty: Yes, you've…

Brian Johnson: (Jefferies, Analyst) So Matt, it will - when we get to the IPO, basically the big impact of it is that if you're to sell down, it releases capital. That's the impact of it rather than a cash earnings impact?

Matt Comyn: That's right.

Brian Johnson: (Jefferies, Analyst) Or does it go back through the cash earnings?

Matt Comyn: No, it'd go through capital.

Brian Johnson: (Jefferies, Analyst) Okay, thank you and what is the hold - what is the value now, Matt?

Matt Comyn: Two point - where does it say that?

Alan Docherty: Yes, it's the - you'll find the - in the page 106 of the profit announcement, Brian, is probably the best place to see the net loss on investment securities. So that's $84 million after tax. That's the after tax effect of the revaluation of Klarna.

So we have reduced the multiple that we're carrying that at, although the underlying business has generated much stronger global revenues over the past six month period and so that's moderated the net impact. So yes, at Matt says, about $100 million net reduction on the very large increase that we booked at June.

Brian Johnson: (Jefferies, Analyst) Thank you very much.

Melanie Kirk: Thank you, Brian. The next question comes from John Mott.

Jonathan Mott: (Barrenjoey, Analyst) Yes, hi guys. Sorry to harp on about the margin but it's probably worth going into, especially given that you did call out more headwind than tailwinds for the margin last half and I don't think anyone expected it to be down as sharply as it was.

If you look at the second quarter, you can estimate that the margin was down about six basis points down to about 189. Obviously you've called out more of these headwinds. Do you anticipate that the margin will continue to decline at the same rate through the third and fourth quarter of this year?

So ongoing margin decline from a lower starting point or would you expect this margin headwind to basically be in that third quarter number - sorry, in the second quarter number just given the movement through the period that you had in that first half? And there's a second question.

Alan Docherty: Yes, so we haven't provided the quarterly breakdown but as you say, you can infer based on the Q1 update and the half year margins that we've published today that the number that you quoted for the second quarter is - I think that's in the ballpark of what we've seen.

Now, we've called out what we expect to be the key headwinds over the course of the second half so the fixed home loan portfolio mix is a really key one. So you can see in our disclosures that the stock mix of fixed home loans is 38% for the Group.

Now, we've seen as I mentioned, very strong December quarter volumes but given the repricing that's been underway over the past few months, we're starting to see the new business flows start to significantly reduce. We expect for that to continue to reduce over the course of the next few months but the averaging effect of those loans that we wrote towards the end of the calendar year, you're going to see a full six month impact of that.

So I would expect that that 38% average mix number to continue to increase over the course of the next few months but we wouldn't see an accelerating trend of margin reduction to your point around - against what we've seen in that second quarter.

Matt Comyn: Yes, John, I guess the only thing I'd add that I think Alan touched on, obviously with swap rates moving very sharply and particularly in October and notwithstanding that we'd done five of the most - maybe the sixth most recently on 4th Feb we saw two basis points, we weren't keeping pace with the swap rates.

So that's probably the other variable is you'd think most of the volatility in swaps has come through but that'd be the other factor as well but not - it's hard to see that accelerating, certainly.

Jonathan Mott: (Barrenjoey, Analyst) Thank you and the second question, on slide 40, which you always put this in which is your MFI share across all the different age brackets. You can see there in the key market, which is 25 to 34 year olds, that you've seen a further slip in your MFI share over the last 12 months or so.

These are the people who are probably the most digitally savvy of all your customers and really should be benefiting from a lot of the investment that you've got going through. Is this really that you're losing out to the brokers as these people are - this age demographic are moving into the housing market? Or is it that really, they're just a lot more price sensitive and their investment in technology is secondary to price?

Matt Comyn: John, look, thanks for the question. As you know, we've been I think publishing this report - the MFI share over the last eight - seven or eight years. So depending on the time series and there's a number of different areas where we've increased but you're quite right when we look at 25 to 34 and you look after that 12 month period.

As always with a survey which is directionally accurate but maybe precisely inaccurate, it's hard to get perfect causality. There's a few things that we're definitely looking at very closely. (1) I know we've mentioned this before but we definitely think the number has - the fact that there have been no migrants into the country has hurt us a bit. We typically get about 45% or so share of new migrant accounts.

We look at our growth in transaction account numbers and balances and engagement with both the app and we certainly take some positive signs from that. But I guess more importantly and we look at strategically as you alluded to, we do think that customers increasingly will obviously - not only around price, we still believe that there's - people have a preference to consolidate with convenience but we think it's really important that we can differentiate our offering.

A lot of the investments that we're making, as you rightly indicated, both in terms of helping customers track and manage their spend, getting a differentiated proposition and value created in our home buying experience in our everyday banking and payments and shopping.

So I mean, we'll continue to watch it closely. We think there's a variety of factors. We're certainly investing against those. It's not clear that it's just price. I think there's perhaps customers have more relationships at that stage than perhaps they did a decade or so ago.

As we see particularly that main relationship with the transaction account, we feel that we're just as relevant but obviously we want to make sure that we're broadening and deepening our relationships with customers across the board.

Jonathan Mott: (Barrenjoey, Analyst) Thank you.

Melanie Kirk: Thank you, John. The next question comes from Victor German.

Victor German: (Macquarie, Analyst) Thank you, Mel. Well it's two questions from me. One of them was hoping to just clarify it, Alan, and I appreciate there's some moving parts with the other operating income but it looks like you've booked Treasury income in the other other income line.

I'm not sure if you can give us what that contribution was but maybe at least you can give us some colour in terms of how this half compares to the average of last three halves? Or sorry, last three years? I think that would be helpful.

Then the second question is on costs. I guess from a short-term perspective, if I look at the second quarter cost number, it's about $100 million down on first quarter. Do you think that's kind of the right run rate for us to think about as we go into second half? Or we've - just managing leave balances and things like that, that have impacted it?

Then from a longer term perspective, Matt, would be really interested in your views. We've seen some results from the US banks that are looking to increase their investment stance substantially over the medium-term.

You've been investing quite significantly in your business for a while now. With the change in the interest rate environment and potentially there becoming more of a tailwind rather than headwind, do you see the need to invest more in the business and is there a capacity to invest more? Or do you feel your current investment spend is broadly right and you're already there? You don't need to increase it from here? Thank you.

Matt Comyn: No problem. Do you - why don't we start with the third and…

Alan Docherty: Okay.

Matt Comyn: …we'll go in reverse order, Alan? If that works for you? So yes, Victor, obviously watched the international results closely. No plans and Al and I have been through this in some detail.

If we look at our investment spend, we've increased it quite significantly over the last few years. We think that investment in the franchise and in our offering has paid off and we see that reflected in higher volume costs.

We're certainly stabilising the investment spend at this point in time. We'll continue to reconsider that over time but at the moment, we feel like we've got a good pipeline of new products and services.

We're still spending a lot in our regulatory spend but that's coming down. We think there's opportunities still to invest in greater digitisation to help with the medium-term cost outlook.

Alan Docherty: On your first two questions, Victor, on other income, no, I mean Treasury performed okay. It wasn't a large - it wasn't a material impact in the half. Against the sequential half, you'll recall that there was some - we sold some - or we bought back some debt in the second half which caused a loss in other income.

So you've got non-recurrence of that loss which is the reason for the callout for Treasury income on the sequential half. But no, it's not a material driver in the current half.

On the second quarter operating expenses, I mean one of the good things under the same quarter was a lot of our people took a well-deserved break. So the annual leave costs of the provision increased that we called out in the first quarter.

We had a partial reversal of that in the second quarter so that was probably the key driver there as a temporary tailwind which reversed the headwind in the first quarter. So we're not baking that in, in terms of the second half.

Victor German: (Macquarie, Analyst) So is the first quarter a better guide for underlying costs or second quarter? Or an average of the two?

Alan Docherty: Sorry?

Victor German: (Macquarie, Analyst) So is - what's the better guide for the run rate? Is it the second - first quarter or second quarter or kind of the average of the two?

Alan Docherty: Yes, I think if you take the average of the two because the annual leave swing factor was a big swing between 1Q and 2Q.

Victor German: (Macquarie, Analyst) Understood. Thank you.

Melanie Kirk: Thank you, Victor. The next question comes from Jarrod Martin.

Jarrod Martin: (Credit Suisse, Analyst) Thanks, Mel. Thanks, Matt, and Alan. Look, Alan, you're probably going to regret putting slide 25 in the pack but it is very useful. Just one question on the medium-term impacts, and particularly around the unwind of the TFF. You've got $50 billion of TFF, current three to five-year swap rates just above two, so let's call it a 2% differential between the current funding rate of 10 basis points, which equates to - and keeping the numbers simple here - $1 billion of increased net interest expense or 10 basis points on margin.

Is it fair to say that the first couple of rate rises, the benefits are likely to be offset by the fact that you've got to refinance the TFF, and you need probably three or four rate rises before you get some real benefit coming through?

Alan Docherty: It depends on the timing of the rate rises, as you know, Jarrod, so you - I mean based - and there's lots of differences of opinion there, I don't want to add mine to the mix. You can model out those changes and cash rate at the time and when they come through. The TFF unwind, the question there is what's the funding mix that replaces the TFF. To the extent it's a straight swap of long-term wholesale funding for TFF then yes, you're going to have a significant cost headwind, as we've called out.

There's also we've got continued strong franchise growth in deposits and so dependent on the mix of transactions, savings and term deposits, that could offset some of that TFF unwind. We're also running historically, as you can see, very low levels of short-term wholesale funding. Again, there's a decision to make around the short versus long-run wholesale funding mix and then within that the tenor of the short-term wholesale funding that we run at.

I wouldn't say it's as simple as taking the TFF and applying the differential to the current long-term rate but certainly it's a headwind over the next two to three years, and that's the reason we called it out. I'm very happy to provide this level of granularity around how we're thinking about it because I think it's helpful to investors and to the market around how we are thinking about it, so hopefully I don't ever regret the transparency.

Jarrod Martin: (Credit Suisse, Analyst) Cheers, Alan.

Melanie Kirk: Thanks, Jarrod. The next question comes from Brendan Sproules.

Brendan Sproules: (Citi, Analyst) Thanks, Mel. Good morning, gentlemen. I've just got a couple of questions, firstly on slide 26 and your operating expenses. The number of FTEs that you've had to add to the business in the half is quite high. Is there a chance as volumes slow that you can - you'll get a reversal of that in the sense that some of these additional staff costs are temporary? And then I have a second question.

Matt Comyn: Thanks, Brendan. I think there's a number of different categories that contributed to the higher FTE. Some of that was related to, as you said, operational volumes. We've added home lenders, business lenders, but there's also a number of FTE that have come on, additional financial crimes operations, quite a significant number so they're clearly unlikely to reverse in the near term, additional FTE, which is supporting the higher, changed investment spend.

It's certainly something we're cognisant of the operating income environment that we're in; some of the challenges in the near term, perhaps over the medium term are certainly looking rosier. So, as we're cognisant of that overall environment but it's not like we could reduce or choose to reduce the FTE in the non-operational areas. We've certainly, as we have shown, been prepared to invest and we think that's going to recur in terms of higher volume growth over time.

Brendan Sproules: (Citi, Analyst) Thank you. The second question is just on slide 77. I've got a question about ASB. It's a very strong performance with 22% NPAT. I was wondering if you could help me understand how mortgage volumes in that business in the last few months have been going. You've had a number of changes with the higher swap rates that you show here on the - and the higher fixed rate costs, but also you've had changes in legislation in New Zealand and you've also had the central bank put in some LVR restrictions. I wonder if you can comment on your home loan volumes in recent months and also to what extent is the combination of those changes impacting borrowing capacity for your New Zealand borrowers.

Matt Comyn: Yes, happy to. If you took a 12-month view, clearly lending volumes have been very strong, but you're quite right. I think there's a number of different factors that have come together that are - you're dampening volumes and in some cases our appetite as well, and so that's I guess a combination as you said of further restrictions, the CCCFA changes, which are equivalent to responsible lending in Australia, substantially similar. There's some slight differences in terms of the implementation around categorisation and of course then the phased changes to the tax framework in New Zealand, which I think comes in over either four or five years. We definitely think that that's going to have an impact on volumes and credit growth and housing in New Zealand.

Given the strength of the housing market both from a price as well as credit growth perspective, we don't think that's a bad thing at this point in the cycle. I think it's, all things being considered, a good thing for it to moderate over time. I guess as we've seen in Australia when you have a multitude of factors that come together in a relatively short period of time, that can also cause some short-term disruption and issues and that's certainly been one of our observations of New Zealand in recent times.

Brendan Sproules: (Citi, Analyst) Sorry, do you just have a view on how much borrowing capacity has been impacted, because in Australia obviously when responsible lending through the Royal Commission changed there was quite an impact on borrowing capacity. Are you expecting a similar outcome in New Zealand from the combination of changes that have happened there?

Matt Comyn: Yes. They're directionally similar but perhaps not to the same magnitude. I think even if you look back on the experience in Australia, it probably varied by institution, both the change impact and the reduction in the borrowing capacity. It depends a little bit on the relative starting point of the institution but there's no question the combination of those factors in implementation and as we saw here, there's more friction and steps going into the process. It's definitely caused us some short-term disruption, you would expect moderate borrowing capacity, but all things being equal that's the desired impact provided it doesn't go too far.

Brendan Sproules: (Citi, Analyst) Thank you.

Melanie Kirk: Thanks, Brendan. We'll have to take the final question from Andrew Lyons. Andrew.

Andrew Lyons: (Goldman Sachs, Analyst) Thanks, Mel. Morning, Matt and Alan. Just a question on the composition of your costs which were very well managed in the half and particularly in the second quarter, as was noted. Not surprisingly, you've seen a material uplift in your staff expenses, as you've pointed out, but against that your occupancy and other expenses were both down about 15% each half-over-half and on PCP, and your IT expenses were down about 5%. So, just two questions.

Firstly, can you perhaps just talk to the sustainability of the cost reductions across those items, and then secondly, just whether your ongoing simplification initiatives can drive these costs lower further or will they need to be more focused on staff expenses from here.

Matt Comyn: Why don't I start and, Alan, you add to it. One of the things I could have mentioned to Brendan's question in terms of higher FTE was we've taken on higher in some areas IT run staff and so some of that we're in-sourcing activities that we'd previously outsourced. Specifically, as you said, there's a reduction in property and occupancy. The most substantial component of that was - as we've now completed, albeit in a largely remote environment, the shift to South Eveleigh. We exited our corporate location in Parramatta.

There's other contributing factors: lower capital works over the period which wouldn't come as a surprise, a slight reduction in the branch network, a slight reduction in our ATM network. Clearly, FTE overall will be a considerable driver of our operational expense going forward and we're just getting that balance right between optimising where we think the activities should sit, bringing some from a partnership or an external partner, bringing those in-house. Investing in volume and better revenue performance, higher change but also, as I said earlier, cognisant of the overall income environment that we're operating in.

Alan Docherty: Yes. Just very briefly to add. We were pleased with the ongoing simplification. We budgeted to increase staff in the areas that Matt mentioned. We're really pleased to add staff to help with the operational volumes because they've been so strong, and then the simplification program, yes, so the consolidation of commercial offices which are seen across both here domestically and internationally.

We've continued with that program so that's a sustainable recurring source of cost benefit in terms of the saves that have been made there. We continue to pursue a number of other productivity initiatives across both FTE and non-FTE line items. So, yes, pleased that that's helped offset a number of those inflationary cost increases that we've seen over the past 12 months.

Andrew Lyons: (Goldman Sachs, Analyst) Thank you.

Melanie Kirk: Thank you, Andrew, and thank you, everyone, for joining us for this briefing. Please follow up with the Investor Relations team if you have further questions. Thank you for joining us.

End of Transcript