BOQ GROUP

BOQ 1H23 Half Year Results Announcement

Thursday, 20 April 2023

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Racheal Kellaway, Chief Financial Officer
Tanya Aaskov, General Manager Investor Relations

Transcript:

Tanya Aaskov: Good morning everyone and welcome to BOQ's results presentation for the half year ended 28 February 2023. My name is Tanya Aaskov and I am the General Manager of Investor Relations. Before we begin, I would like to acknowledge the traditional custodians of the land upon which we are meeting today, the Gadigal people and recognise Elders past, present and emerging.

Thank you for taking the time to join us this morning. With me is Patrick Allaway, Managing Director and CEO and Racheal Kellaway, our Chief Financial Officer. We are also joined in the room by BOQ's Executive Team and Senior Management. This morning we will be providing you with an overview of our half year results. Patrick will provide you with an update on our strategy. Racheal will speak to our financial results before Patrick closes with a summary and outlook for the second half. Following the briefing, there will be an opportunity for questions and answers. I will now hand over to Patrick.

Patrick Allaway: Thank you Tanya and good morning everyone and thank you for joining us. As Tanya mentioned, I am joined this morning by Racheal and other members of the Executive Team and our Senior Leaders.

Moving to slide 8, key messages to leave you with. BOQ is in a strong financial position as we enter this more challenging economic environment. We are well positioned to continue to invest in our transformation to deliver a stronger and simpler low cost digitally enabled bank. We have made progress since announcing our strategy in 2020 across digitisation, improving our strategic position through the ME Bank acquisition, achieving gross across our brands and strengthening our financial resilience. We detailed at the December AGM that we would be prioritising, strengthening and simplifying BOQ whilst optimising returns providing stronger foundations for our target state digital and data led bank.

Our brands target specific customer segments across retail and business providing differentiated value propositions in the market and diversification across our portfolio. We have high conviction that our transformation strategy will address our structural challenges as a smaller bank. Through our targeted customer value proposition, lowering cost of funding through a broader digital deposit base and simplifying and automating our business to materially decrease our operating costs. BOQ's asset quality remains sound with a well-diversified and collateralised book with prudent risk settings. Our purpose and values will lead our behaviour in delivering this strategy and improved outcomes for our customers, people and shareholders.

Looking at slide 9 for our financial performance for the half. Our statutory net profit after tax for the half was $4 million which included two one off non-cash items, a $60 million provision for the integrated risk program and a $200 impairment for goodwill which we announced last Friday. We delivered $256 million of cash earnings after tax. This was supported by a margin tailwind which has materially reduced over the last two months of the half, with heightened mortgage and deposit competition.

The margin uplift was offset by 7% growth in expenses. We know this is unsustainable and we will address expense growth through our simplification program which I will talk to shortly. CET1 at 10.71% is an increase of 114 basis points from the prior half and includes the benefit received from the implementation of Basel III. Our spot liquidation coverage ratio was 143%. We will be retaining the high capital buffer with our revised CET1 target range between 10.25% and 10.75%.

The Board has determined to pay an interim dividend of $0.20 per share. On the reported cash earnings result the dividend payout ratio was 51%. This dividend represents a 61% payout after the one-off provision for the risk program is included. Racheal Kellaway, our CFO, will provide more context to our financial results shortly.

Turning now to slide 10 for a review of the Retail Bank. Improving our customer experience as we progress work on the digital bank has been a focus of our retail transformation this half. Housing lending was broadly flat as we tempered growth while competition remains heightened. We have seen $2 billion growth in customer deposits and 110,000 deposit customers on the new digital platform. We now have $3.8 billion in deposits on the new platform.

We have been proactive in our customer contact given the sharp increase to interest rates. A large portion of these customers have never before experienced interest rate rises. For our customers whose fixed rates are due to mature within the next 12 months, we are contacting them to offer support in preparation for this change.

Turning now to slide 11 for an overview of the Business Bank. Our Business Bank performance and associated high return on equity is a key strength of BOQ. The refocus on SME business has seen pleasing returns and quality growth. The Business Bank has driven efficiency evidenced by a low cost to income ratio of 40.2% this half and improved risk adjusted returns. The Business banking book is well collateralised with limited cashflow lending and diversity across industries.

We have made significant progress in our transformation as detailed on slide 12, enhancing our customer value proposition and experience. We improved our strategic position through the ME acquisition and are in our final year of its standalone integration program. Our digital platform is delivering results with increased customer numbers and more of them calling BOQ their main finance institution. We now have over 170,000 customers on the new platform.

We have improved Group customer NPS and employee engagement scores on the prior comparative periods but recognise we have more work to do. We have strengthened our financial resilience with strong capital and liquidity buffers and we intend to retain our capital buffer given our transformation journey and as we are entering a more challenging economic cycle.

Moving to slide 14, we are committed to our purpose as announced at the full year of building social capital through banking. This is our guiding principle, our why for being in business. The values which underpin this purpose are more important than ever and they inform how we will transform our Bank while providing best in class experiences for our customers and our people.

We have taken a pause to reflect on how far we have come and what is most critical to success in the next stage of our transformation. We are taking an even more holistic and integrated approach to the transformation program to deliver a stronger, more resilient bank, with a simplified structure, reduced duplication and increased productivity.

A digital bank that can grow its scale and optimise for sustainable profits and returns. We have a clear set of capabilities to achieve these outcomes and with a now proven and experienced team delivering the digital bank. Our existing strong relationships through our community anchored owner managers and our specialist bankers will be complemented by our digital bank.

Now I'll talk to strengthening BOQ on slide 15. As we announced last week and further to the 2022 results and the AGM in December last year, there is work required to uplift our operational resilience and risk culture. We have now scoped, costed and commenced a clear program of work supported by a robust governance structure and independent assurance to deliver sustainable embedment of this uplift across our three lines of defence.

This integrated risk program is a $60 million investment in strengthening the Bank. This program will include improvement across our systems, processes, risk and compliance outcomes including AML. Our risk culture plays an important role in delivering on this program. We believe risk is everyone's business and this is being further embedded across the Group led from the top.

Our most recent engagement survey showed our people feel increasingly safe to speak up with an improvement to 78%. This will be an ongoing focus of the Group.

Slide 16 sets out our simplification of BOQ. Simplifying our complex operating model is no small task but we have already seen the benefits of improving processes, reducing the number of products and decommissioning redundant technologies. The next phase in this simplification is to align the structure of our organisation to our target customer segments and business model reducing duplication through an integrated model and leveraging the automation of processes.

We are consolidating our suppliers and property footprint and are making clear decisions about non-core activities, such as the sale of our New Zealand Asset Finance Business. This simplification program will address cost inflation and we will provide a more detailed update to the market in the second half providing productivity targets. We anticipate material cost benefits will start to be realised in FY24.

Now I'll talk to digitising BOQ as outlined on slide 17. We are on track against our digitisation roadmap. We know from data globally that simple and targeted digital models are not only levelling the playing field, but enabling smaller players to outperform the big banks. One initiative we have accelerated in our digitisation is the build out and migration of ME Bank customers onto the new digital platform which will provide current and new ME customers with the best digital experience possible from transaction accounts to mortgages. It also enables us to decommission redundant systems earlier to provide an early proof point in FY25 of a digital low-cost scalable national brand and operating model.

Turning now to optimising BOQ on slide 18. BOQ has strong foundations to further optimise with a quality asset book, a strong 149-year heritage and a portfolio of quality brands with deep customer relationships in targeted segments. We anticipate material performance uplift from FY25. We remain committed to achieving the target cost to income ratio of below 50% with an ROE of over 9.25% by FY26. These targets are supported by a robust financial model and clear transformation plan which assumes normalisation of highly competitive market conditions.

I will now talk to building a sustainable business on slide 19. Our purpose and values will enable us to support our customers while they are facing escalating cost of living or rising costs in their businesses and higher interest rates. Our owner managers have deep ties to their communities giving these relationship-based customers the backing of a national bank, local knowledge and a banker who is a true partner. Our community partners provide support to some of the most vulnerable Australians, and we are proud to continue this important work.

Our people are core to our business and customer proposition, and we are building a future fit organisation that is agile with curious bankers. An engaged and diverse workforce with inclusive leaders is paramount to creating value for our people, customers and shareholders. We have clear environmental targets that overlay our strategy and are committed to the transition to a low-carbon economy and will reduce our scope 1 and scope 2 emissions by 90% and scope 3 by FY30.

I will now hand over to Racheal to provide more detail on the financial results. Over to you Racheal.

Racheal Kellaway: Thank you Patrick and good morning, everyone. I will talk to the non-cash items in more detail on the following slide. Starting with cash earnings and looking in detail at the Group financial performance, we delivered a 10% improvement to underlying profit on the prior comparative period. This was driven by 9% total income growth partially offset by a 7% increase in operating expenses. We delivered on our commitment to positive jaws in a period which saw strong revenue growth, partly being offset by cost pressures including the impacts of inflation and our investment in technology.

Cash earnings have declined 4% to $256 million compared to the prior comparative period due to there being a loan impairment credit in the same period last year. Loan impairment expense for the half was $34 million being a return to a more normalised long-term level. Cash earnings improved 7% on the prior half, again showing positive jaws with 6% income growth and 4% cost growth.

As Patrick noted earlier and as detailed in our ASX release last week, we have impaired goodwill by $200 million and have raised a $42 million after tax provision in the half for our integrated risk program. We are on track and in our final year to integrate ME Bank with $13 million after tax of integration costs in the half. The impact of these items resulted in a statutory profit of $4 million.

Key elements of income are outlined on slide 23. Total income of $902 million increased 9% against the prior corresponding period and 6% half on half. NIM improved to 1.79% in the half, but through the period we saw NIM moderate. We have slowed growth in the balance sheet through the half.

On mortgages, competition intensified. We made the deliberate decision to slow our growth and focus on where we could achieve appropriate returns. On business lending, while we observed a slowdown in the system, our growth remained positive and pleasingly was underpinned by our focus on SME which grew 7% for the half. Total business lending grew $509 million.

As expected, we saw NIM improvement from the rising cash rate environment and continued benefit on our capital and low-cost deposits. NIM improvement of four basis points in the half included a 2 basis point reduction relating to a reclassification of ME fee income. This has no impact on earnings. Excluding this, our underlying in period NIM improvement was six basis points.

Unpacking the key elements of NIM in more detail. Asset pricing and mix resulted in an adverse impact of 12 basis points. Within this, seven basis points was driving by retention discounting as we focused on our existing customer base against a backdrop of increased acquisition competition across the industry. The impact from front to back book compression was 6 basis points in the half, 5 basis points in housing and one basis point in business lending. Whilst this is still a drag on margin, it is an improvement compared to the last half.

Funding costs benefited NIM by 24 basis points. This benefit came from the management of at-call savings margins. We also saw a 5 basis point benefit from term deposits, which as we noted at the full year are priced off the BBSW and were again an attractive source of funding in this period. We flagged at the full year we have seen the cost of wholesale funding increase and this was a negative 3 basis point impact on margin.

The replicating portfolio benefited from a rising rate environment contributing a 7 basis point increase to NIM from capital and low-cost deposits. We held higher levels of liquids as we handed back the Committed Liquidity Facility and commenced replacement of the Term Funding Facility.

We strategically took advantage of favourable investor appetite in the early months of this calendar year. This reduced NIM by 9 basis points in the half and was a prudent decision given pressure on funding markets. Finally, we saw a 3 basis point impact on NIM from third party costs.

Turning to the outlook on NIM and whilst we saw margins increase in the half, continued industry-wide pressure on mortgages, particularly retention discounting and the impacts on funding costs as banks looked to replace the TFF has meant that we expect a decline in NIM in the second half.

We will continue to focus on growing in higher returning segments and optimising our portfolio mix. Funding costs will become a drag on margins. We are seeing high levels of competition on deposits and expect wholesale funding costs to increase. There will be a continued benefit from the replicating portfolio.

We will see ongoing impacts on liquidity as we continue to strengthen the financial resilience of the Bank and take advantage of opportunities to pre-fund the TFF replacement when they arise.

Due to the high levels of re-financing activity in the industry, portfolio duration may shorten in the second half and we will see the start of customers moving off fixed rate loans. The effect of this will largely be seen in FY24.

Turning now to non-interest income on slide 26. Non-interest income of $70 million for the half was a decrease of $20 million on the prior comparative period and a small increase on 2H22 reflecting the non-recurrence of large one-off items that were called out in the first half of last year.

Operating expenses increased 7% against the prior corresponding period, totalling $495 million for the half. The primary driver of the uplift was inflation coupled with $11 million of higher costs related to technology costs and pro-active customer contact. We have delivered $13 million in annualised synergies in the half and are on track to deliver our target of $70 million to $80 million by FY23. This is the final year of the program and the final year we will report on its separately.

Looking to the second half, we expect ongoing inflation and continued costs relating to maintaining legacy systems while building the digital bank. In addition to that and in order to progress our strategic objectives relating to digitisation at pace, we anticipate expense uplift and FTE growth related to investment spend in the second half.

As Patrick noted earlier, we have a strategic program in place to simplify the Bank. We are not content with our cost base and the program will reduce duplication, optimise our operating model and is focused firmly on delivering our cost-to-income target.

Turning to our ongoing investment in transformation on slide 28. Included in our investment spend this half is the cost of the integrated risk program. There has been a step-down in integration costs as noted at the full year. Our investment has been focussed on our retail digital transformation and the delivery of our data capabilities. Later this month, we are launching the first phase of ME digital deposits on the same core platform as the myBOQ and VMA brands. This is a major milestone in digitising our Bank.

Turning now to provisioning and loan impairment expense on slide 29. Whilst we have started to see a small increase in arrears across the housing and business portfolios, this is off a very low base and remains under long-term historical averages. We have been prudent on provisioning and have $313 million in total provisions. The portfolio is well placed with customers having high levels of household savings and repayment buffers.

Loan impairment expense was $34 million for the half, reflecting a more normalised long-term level. Impaired assets reduced again in the half to finish at $133 million. We are confident in the quality of our portfolio which has seen five consecutive halves of reduced exposure in high DTI and high LVR bands. Both measures are stronger than industry averages and mean we have more resilience to higher interest rates and lower house prices.

Our business lending portfolio has significantly less unsecured lending comparative to industry and is well-diversified by geography, size and asset class. However, we also understand that some of our customers are or will face challenging financial times with higher interest rates and higher cost of living impacts. We are and will continue to support them through this.

Moving on to funding and liquidity on slide 30. Over the half, our CLF was handed back and we pre-funded the first tranches of the replacement of the TFF. We did this strategically, taking advantage of favourable wholesale spreads.

Our liquidity portfolio contains a diverse mix of high-quality liquid assets and our spot LCR was 143% for the half and operated higher than this on average, particularly in the second quarter. We have a diverse pool of long-term unsecured and secured debt programs which allow us to take advantage of opportunities in a competitive wholesale market.

Our customer deposits have grown 12.3% against the prior corresponding period. We attracted over 76,000 new customers in the half with a 4% growth in customers who consider BOQ their main financial institution. The average age of new-to-Bank customers on the myBOQ platform is 32, compared to an average of 45 on BOQ legacy platforms. This reflects our digital strategy which provides an attractive customer proposition.

Pleasingly, our loan-to-deposit ratio improved to 80%, an increase of 6 basis points to the prior comparative period. Along with our new retail customers, we have also built on our platform arrangements which support a stable funding position.

Within our customer deposits, we saw a continued shift in customers moving from transaction accounts to savings and term deposit products as customers sought yield in a higher interest rate environment. So, whilst our total transaction balance reduced, we experienced strong growth in the number of customers transacting with us on that digital bank.

This is the first period reporting under Basel III and we are pleased that this framework gave us a positive impact of 120 basis points following the reduction in risk weighted assets of $5 billion. We have a new target range of 10.25% to 10.75% under this new framework. This is prudent in an uncertain economic climate and we continue to invest in strengthening and transforming the Bank. At the end of the half, we are in a strong capital position and are at the top end of our new range with CET1 of 10.71%.

In summary, BOQ has delivered a half year result with a 10% increase to underlying profit. We delivered on our commitment to positive jaws and have been disciplined in our deployment of capital in an intensely competitive environment. We have recognised the need to invest in our financial and operational resilience, including raising a provision for our integrated risk program.

This is our final year of what was an ambitious integration. We are on track to deliver what we promised we would with $70 million to $80 million in annual synergies to be delivered in the full year. We have bolstered our capital and liquidity position and are confident in the quality of our credit portfolio. I will now pass back to Patrick for some closing remarks and the outlook for the full year.

Patrick Allaway: Thank you, Racheal. Moving to slide 34 for outlook. The Australian economy is resilient, supported by low unemployment, stable growth in order books and strong terms of trade. The Australian banking system and robust regulatory environment supports stability following recent US bank failures and developments in Europe.

Economic growth is expected to slow in the second half and into 2024 due to elevated inflation and the recent rapid rise in interest rates. We expect ongoing industry headwinds in the six months ahead with current mortgage competition intensity expected to continue and deposit competition escalated through Term Funding Facility re-financing. We anticipate margin pressure through this period which reaffirms our need for disciplined execution of our strategic priorities to transform to a scalable low-cost Bank with strong foundations.

As Racheal said, we strategically reduced high DTI and high LVR lending which supports strong customer cash buffers and reduced our exposure to property price reductions. We're expecting to see increased impairment expense below the industry longer term average as a result of sustained higher inflation and the interest rate environment.

Our share price is trading at a material discount to book value and at relatively low price to earnings multiple which is not reflective of the material investment being made in the transformation of BOQ. Current industry headwinds will require medium-term view of benefits.

In summary, BOQ is in a strong position. We've strengthened capital liquidity ratios, supported by sound asset quality with prudent risk settings. We've delivered another half of positive jaws and improved NIM through the period. With heightened mortgage and deposit competition, NIM has come under pressure in the last two months of the half. We're pleased to have delivered an uplift of 10% in underlying profit over the period.

Our digitisation is well progressed. We have seen strong performance in our digital deposits franchise and are on track to deliver digital mortgages in FY24 and a full ME migration to the new digital platform in FY25. We acknowledge many of our customers are feeling the impacts from higher inflation and cash rates. We are proactively engaging with them and are here to provide our customers and our people with support through this uncertain time.

We are investing in the uplift of our operational resilience, risk culture and the simplification of the Bank. As we progress through these programs, we will see a stronger BOQ emerge, optimised to take advantage of opportunities to generate ongoing value for our shareholders. We have high conviction in our strategy and the investment we are making in strengthening, digitising and simplifying BOQ will deliver optimisation of earnings and a material uplift in enterprise value. Thank you for your time this morning, I will now hand back to Tanya to open for questions.

Tanya Aaskov: Thanks, Patrick. So, we'll now move to questions on the phone. If you could please limit your questions to two per person. Of course, Management will be happy to take any further questions that you may have on the results later in the day. Thank you, Operator.

Operator: Thank you. If you would like to ask a question, please press star one on your telephone and wait for your name to be announced. If you'd like to cancel your request, please press star two. If you are on a speaker phone, please pick up the handset to ask your question. Again, we do ask that you please limit your questions to two per person. Your first question comes from Matt Dunger from Bank of America. Please, go ahead.

Matt Dunger: (Bank of America, Analyst) Yes, thank you very much for taking my question. If I just kick off, you're flagging an increased deposit competition. In this environment, why are you looking to grow deposits as opposed to looking to funding markets? So are they open at the moment to BOQ?

Patrick Allaway: Thanks for that, Matt. So deposit markets have been cheaper for us. We also have been in the blackout period leading up to results so we haven't been able to access wholesale markets. We will continue to access both wholesale markets and the deposit markets but as we said, our liquidity build and optimisation of our funding mix has really been to support the hand back of the CLF and the replacement of the TFF, of which we've had 23% payback of that in April. We think it's appropriate to access a higher deposit ratio to loans during this period to support those strong liquidity buffers.

Matt Dunger: (Bank of America, Analyst) Thank you very much and if I could just follow up and ask if you're able to quantify? You called out the impacts of the shift to term deposits versus at-call. Are you able to quantify that?

Patrick Allaway: I might just go to Racheal for that.

Racheal Kellaway: So Matt, what you can see in our margin walk there is that we've seen still the benefits, actually, of term deposits through this period. I called out that actually, they're still priced relatively favourable from a - because they're priced off the BBSW. So it's still a benefit in terms of TDs.

Now, what we're seeing in market now is, because of that heightened competition, TD prices are going up. As Patrick outlined, we'll always just look to optimise funding costs across a broad range of areas which include wholesale markets and also retail deposits within our savings, term deposits and the developments through our digital assets which we're seeing some more customers moving onto as well from a transaction perspective.

Matt Dunger: (Bank of America, Analyst) Okay, thank you very much.

Operator: Thank you. Your next question comes from Andrew Lyons from Goldman Sachs. Please go ahead.

Andrew Lyons: (Goldman Sachs, Analyst) Thanks and good morning. Just two questions for me. Firstly just on your NIM. At your FY22 result in October last year, Management commentary on the NIM at the time was pretty bullish talking to an exit NIM that was well in excess of the 1.81% delivered in the fourth quarter.

Despite this, today you've delivered a NIM that's averaged over the half just 1.79% and noted that NIMs did peak in October '22 which mathematically would imply the exit NIM this half must have been significantly below the reported half NIM. Therefore, I guess just consistent with the commentary from last half, can you perhaps provide some commentary around the second quarter '23 NIM and the extent to which the exit NIM was below the half average?

Patrick Allaway: So, I might make some comments just on the first part of your question and then come to the second part. So industry headwinds have escalated across the industry and clearly BOQ has a higher cost of funding. So both of those are impacting the tailwind that we had from them coming into the half. As Racheal had said, that tailwind peaked in October.

The outlook in terms of where NIM is, we are not going to speculate on. We don't give an outlook for NIM. What we do know is that - and what we have said is that NIM compression will continue with heightened competition both across mortgages and deposits impacting NIM. There are a number of moving parts in relation to that and it would not be appropriate for us to make any further comments at this stage as to where NIM is.

Andrew Lyons: (Goldman Sachs, Analyst) Patrick, I can certainly understand why you don't want to make commentary around the outlook but would you be prepared to perhaps talk to where the second quarter '23 actual NIM was and where maybe the exit NIM was versus that second quarter actual NIM?

Patrick Allaway: No because as I said, we said it's peaked. We said it has compressed in the second quarter. There are industry factors impacting that and you'll continue to see NIM pressure into the second half.

Andrew Lyons: (Goldman Sachs, Analyst) Okay, appreciate that. Then just a second question on expenses. Slide 28 highlights that the $60 million integrated risk program provision has been treated within your broader investment spend. Despite this, total investment spend for the half only increased by about $6 million which implies the underlying investment spend actually fell by $54 million half-over-half, which is nearly by a third.

I understand there's a number of moving parts in that but I guess the question is, why isn't Management reducing the underlying investment spend of the business to such a large extent in light of the need to more broadly digitise the business, which you've spoken about and if that's not the case, why was the

$60 million charge taken below the line and not treated as ordinary OpEx?

Patrick Allaway: So Racheal will respond to your question.

Racheal Kellaway: So look, the first thing I'd say is that one of the more material drivers of the reduction in investment spend, if you exclude the integrated risk program, is that we are in the final year of the ME Bank integration. So close to $30 million of that reduction relates to integration coming to an end.

The second thing I'd say is, we did actually have a couple of large programs complete in the period and so through that, the team has re-set the transformation roadmap and we think that this is a sustainable level of investment for the business going forward whilst not putting at risk any of our objectives around digitisation, strengthening and simplifying. Particularly not putting at risk any of our financial targets like the ROE and CTI targets we've put out.

Andrew Lyons: (Goldman Sachs, Analyst) Great, so just to confirm that what we should be thinking about on investment spend should be the first half level less the $60 million of IRP?

Racheal Kellaway: That's about - that's close to where we think we'll be running through the next couple of halves. Correct.

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

Operator: Thank you. Your next question comes from John Storey from UBS. Please, go ahead.

John Storey: (UBS, Analyst) Thanks very much and good morning, Racheal and Patrick. Great presentation. Just two questions on my side. The first one is just around asset quality. One of the things we note is that your 30-day plus arrears have kicked up quite substantially with - certainly on a half on half basis. Just wanted to get sense for what that trend looks like in March and I guess the early parts of April in terms of some of those arrears converting or have the backlog - or has the backlog cleared there?

Then just a second one is really just around volume growth expectations. New business applications, we noted are down about 30% so just wanted to get your sense around the trade-off between volume growth and pricing?

Patrick Kellaway: So John, I might respond to the second part of your question and then I'll go to Racheal to respond to the first part of your question.

So as we said in the presentation, we're very focussed on allocating our capital appropriately to get appropriate returns and as we've also said, there's the mortgage market in particular is very competitive at the moment and we do not want to write business below our cost to capital, so we're very focused on quality growth and we are retaining capital and allocating capital to business bank opportunities, which we've seen growth in, in the first half. But we'll also retain our capital position because we do expect the market to rationalise and we anticipate that we will get appropriate returns on that. So we will sit this out.

We have seen system growth obviously decline as well, so the market is obviously increasingly competitive for a much smaller market share than we've had previously and our view is that we are not going to participate in an irrational market.

Racheal Kellaway: John, just to the question around arrears, we're certainly very alert to the fact that arrears are ticking up, but we're not at this point alarmed. They have continued to slightly increase again post the end of February. Look they're coming off a very low base, is the first point and still very much below historical averages. If I think about the level of provisioning we hold, we're confident that that provision level takes into account a number of forward-looking scenarios that have a wide range of potential outcomes and so that link between arrears and suitability of the level of provision we have we think is still quite strong.

John Storey: (UBS, Analyst): Great, thanks very much.

Operator: Thank you. Your next question comes from Richard Wiles from Morgan Stanley. Please go ahead.

Richard Wiles: (Morgan Stanley, Analyst) Good morning everyone. I have two questions. Firstly on expenses, Patrick when will you actually reduce the cost base? Does your comment that you anticipate material cost benefits in FY24 mean that costs will fall in that year or is cost reduction more of a medium-term target?

Secondly, I'd like to just get some clarity on some of your outlook commentary and guidance. I know you're not commenting on run rate margins at the moment, but certainly looks like the margin at the end of the quarter was close to 1.7% and you've flagged further pressure to come. So given that margin pressure, are you on track for positive Jaws in the full year 2023, which was guidance at the start of the year and can you achieve your FY26 ROE and cost to income targets if margins don't expand from current levels?

Patrick Allaway: So thank you Richard for your question. So firstly on expenses, we continue to operate the old Bank whilst we're building the new Bank, with dual system costs, until we decommission legacy. So that is causing cost escalation at the moment and as we said, most of that expense growth is being driven by running dual systems but also inflation, investment and amortisation and they've been partially offset by productivity and synergies.

We are not comfortable with the expense growth that we've had in the first half and we're addressing it.

As we've said, we're addressing it through a simplification program. A considerable amount of work has been done on that program. We will come back to the market in the second half to provide you with an update on the target productivity benefits from that program. But as I said in the commentary, we do not expect that to materially reduce costs in the second half. We see cost escalation in the second half and that we're driving for the material productivity benefits to start from FY24, so just to clarify that.

You had a question in relation to outlook of positive jaws in the second half. Clearly with those statements achieving positive Jaws will be difficult. I'll leave it at that. In terms of the confidence of reducing our CTI targets and the return on equity targets that we've outlined for FY26, we have high conviction in the transformation program that we're on and the simplification program that we've commenced.

The simplification program further complements that transformation program, so we're taking much larger steps around simplification and productivity than we previously had to achieve those targets, but certainly those targets do assume and we qualified that, you would have seen in the presentation pack, that they do assume that market competition rationalises and that NIM normalises.

Richard Wiles: (Morgan Stanley, Analyst) Thanks Patrick.

Operator: Thank you. Your next question comes from Jonathan Mott from Barrenjoey. Please go ahead.

Jonathan Mott: (Barrenjoey, Analyst) Thank you, Patrick. I've got a question just on volumes as well and we did see the sharp reduction across all the channels coming through over the last half and your comments that you want to be rational and not compete in this environment, I can understand where you're coming from. But my concern with it comes with what then happens to the owner-managed branches, because these are franchisees. Franchisees are effectively paid to grow their business and build a book over time and really grow their business and yes, there is some payout when margins rise over a period of time, but that will evaporate going forward over the next period or two.

But if the competition remains for an extended period of time and the market can remain irrational for an extended period of time, how do you keep the franchisees? How do you keep them motivated when they can see very little opportunity for growing their own business over a period of time?

Patrick Allaway: Thanks for that Jonathan, we've given that a lot of thought and there's other aspects of the business that are important to them. Obviously we're growing deposits and owner-manager branches play an important part in growing those deposits and benefit from that. We are increasingly also, as we grow our focus on small to medium-sized business in the core centres of our owner-managers, where they're located, we see an increasing opportunity to leverage their strong relationship in their communities to growing our SME business.

You would have seen very strong growth in the first half across our SME business and we're getting strong returns from that. So there are opportunities for the owner-manager network to benefit from the products and services that we're offering.

Jonathan Mott: (Barrenjoey, Analyst) So the OMBs have to effectively move from being more of a mortgage focus to an SME focus, which is actually a very, very different business. Do they have the capability and the skillset to be business bankers?

Patrick Allaway: Absolutely. We've got some exceptional bankers that have been in their communities dealing with local businesses for the past 20 years of their time, in 15 to 20 years of their time in the business. We are seeking to leverage that capability more strongly. They're very supported by our specialist business bankers and in fact we're even thinking about whether we put business bankers in some of those owner-manager branches. So it's a core part of our strategy of growing our relationship bank and supporting the communities and the businesses in the communities in which we operate.

Jonathan Mott: (Barrenjoey, Analyst) Thank you. A follow-up question if I could and this probably goes to you, Racheal. You talk about retention discounting costing seven basis points in the period, yes that'd probably be for a lot of the banks a bigger drag than the front book/back book, but can you give us a feel for how far through the repricing you are? I know it's a dynamic situation, not statically [stuck] from one point, but are there still a large number of customers who are on old pricing and this is going to be an ongoing drag for a period of time? So even if mortgage competition eases, you still get that ongoing amortisation of high margin mortgages rolling off, how far through that process are you?

Patrick Allaway: I'll pass that onto Racheal, thank you.

Racheal Kellaway: Thanks Jon, it's a good question. We do expect that to continue to be a drag over the next period at least. 70% of our portfolio is variable and of that, about one third has accessed a discount. So we're probably about a third of the way through. It's unlikely that all customers will get to a discounted position, but we do have a little bit to go, I think, particularly through the second half.

Jonathan Mott: (Barrenjoey, Analyst) Thank you.

Operator: Thank you. Your next question comes from Josh Freiman from Macquarie. Please go ahead.

Joshua Freiman: (Macquarie Group, Analyst) Hey guys, thanks for the opportunity to ask a couple of questions. Maybe the first just on that mortgage competition, just continuing from Motty's question, I'm conscious recently major banks have been attempting to raise their front book variable rates and I'm sure that's probably because they've seen competition on both sides of the balance sheet and we've all seen sub economic front book rates on mortgages. But I just want to ask, have you guys actually seen any noticeable change in the intensity of front book mortgage competition there off the back of that?

Patrick Allaway: Racheal will respond to that, thank you, Josh.

Racheal Kellaway: Yes, look Josh, there's some very early signs of easing on that front to back book pricing, I'd say, but it's so early and probably so immaterial at this point that we aren't currently forecasting any material shift in that.

Joshua Freiman: (Macquarie Group, Analyst) Perfect, thank you. Second question from me, just on the growth of your myBOQ new system deposits, I'm conscious the deposit costs to savings and at-call accounts on the legacy system is really different to that on the myBOQ system, which is obviously significantly higher. If I look at your deposit base, it appears to be split 95% of your deposits in your legacy system, versus 5% in the new myBOQ equivalent.

I guess as you migrate customers, I assume that imposts of moving accounts to be considerably more attractive deposit accounts will be materially lower than it is now, so I guess what plans do you have in plans to mitigate this deposit shift margin impost over the medium term, or is that impost to margin something you have dealt into your budgets and plans?

Patrick Allaway: So we certainly are offering an attractive deposit rate on new banking apps to our customers and we see that as a very important service to our customer base. As we shift customers onto the platform, we're actually looking for more transactional sticky accounts, which is really, really important to us, so this is not just a deposit base. Obviously in the current higher interest rate environment we are seeing customers moving out of transaction accounts to higher-yielding deposit products, but our view is that we will actually have a good mix across both. We're going to have a much lower cost platform in terms of servicing customers and we think the net benefits will actually provide and prove returns for BOQ.

Joshua Freiman: (Macquarie Group, Analyst) Okay, so just to follow up on that, you don't see any risk of your existing legacy deposits shifting into materially higher costs once they've been transferred to the new platform?

Patrick Allaway: No, we don't.

Joshua Freiman: (Macquarie Group, Analyst) Understood.

Operator: Thank you. Your next question comes from Andrew Triggs from J.P. Morgan. Please go ahead.

Andrew Triggs: (J.P. Morgan, Analyst) Thanks and good morning Patrick and Racheal. A couple of questions from me too please. First one, could you help with splitting out the nine-basis-point liquidity headwind to NIM between the CLF replacement and TFF prefunding? My assumption is that the NIM pressure from CLF replacement is roughly neutral to revenue, but TFF prefunding is not.

Also on that prefunding element, how much of the TFF have you actually prefunded to date and the TFF does roll over in the next few halves, so do you expect to remain prefunded fully throughout the next three halves, then perhaps there's a tailwind at the end of that period when you let LCRs and NSRs run down post TFF maturity?

Patrick Allaway: So I'll hand over to Racheal to that and I might make some comments after Racheal.

Racheal Kellaway: Sure, thanks Patrick. So the liquidity impact will continue to be a drag through the second half and a large portion of our TFF rolls off in FY24. But in terms of how much we've funded at the moment, we've got about $1.2 billion in FY23 of the TFF rolling off. We're about $1 billion of the way through that, so that's a real positive from our perspective and you're right, of the nine basis points, most of that impact relates to the cost of the TFF replacement, the holding of liquidity as the TFF moves into our LCR window and there is a small component relating to the CLF.

Patrick Allaway: So I might just make some other comments in relation to that. We think it's appropriate through this period to hold higher liquidity buffers that is impacting them, but it's appropriate given the scale of the tasks for the market at the moment, with both the CLF runoff and the TFF runoff. So just to give you some numbers, CLF was $243 billion. The TFF across the industry was $188 billion. Now the size of that funding task for the industry is very large and we think it's appropriate to just compromise on NIM in the interim to ensure that we have really strong liquidity buffers through this period.

Andrew Triggs: (J.P. Morgan, Analyst) Thank you and second question just around the potential shortening of average life of mortgage loans, just interested in how far through this review you are and maybe if you could provide some sort of sensitivity analysis on potential changes to NIM if it were to be shortened.

Racheal Kellaway: Sure. So I mean we're seeing gradual month-by-month reductions, which you would expect given particularly the high levels of fixed-rate mortgages that were written across the industry. There could be a couple of basis points' impact to margin if we have to – if we find ourselves in a position where we have to reduce that weighted average life and bring forward some of the acquisition costs for those customers.

Andrew Triggs: (J.P. Morgan, Analyst) Racheal, thanks for that and can you comment at all on retention rates you're seeing on your book, particularly on fixed-rate maturities please?

Racheal Kellaway: We're not really at the point where we're seeing many fixed-rate customers roll off, so the vast majority of those fixed-rate customers will start to roll in FY24.

Patrick Allaway: I will say that we are very focused on customer retention of existing customers and supporting existing customers over growing new customers at this highly competitive time.

Andrew Triggs: (J.P. Morgan, Analyst) So to read between the lines there, retention rates haven't really moved to date, but there's obviously a big – the bulk of fixed-rate rolls is still to come.

Racheal Kellaway: Correct, yes. I mean the shortening has been happening over a number of periods. You want to observe a number of halves where you're seeing a shortening before you make any changes to your weighted average life, so it's not just driven off the fixed-rate maturities.

Andrew Triggs: (J.P. Morgan, Analyst) Thank you.

Operator: Thank you. Your next question comes from Brett Le Mesurier from Perpetual. Please go ahead.

Brett Le Mesurier: (Perpetual, Analyst) Thanks very much. How do you determine your [funding] costs when calculating ROE on mortgages?

Racheal Kellaway: I'm sorry…

Patrick Allaway: Sorry, I didn't hear your question Brett, could you just repeat that, sorry?

Brett Le Mesurier: (Perpetual, Analyst) How do you [inaudible] calculating mortgages.

Patrick Allaway: Again, so the line's not very clear. Try that again.

Brett Le Mesurier: (Perpetual, Analyst) How do you determine your funding costs when calculating the ROE on mortgages?

Racheal Kellaway: So we have an internal FTP process that helps us understand at any given time what the acquisition cost would be, so the funding costs for any new loan and that's how we determine the ROE. We look at a portfolio view of returns on a portfolio, on a mortgage portfolio and we also look at acquisition returns.

Brett Le Mesurier: (Perpetual, Analyst) So it's a combination of retail, your current retail and [unclear] funding costs?

Racheal Kellaway: Correct, yes, yes.

Brett Le Mesurier: (Perpetual, Analyst) Do you use your average cost to income ratio across the Bank when you're working this out?

Racheal Kellaway: Look we've got a number of different ways we look at cost allocations, if that's where you're heading and part of that we look at the marginal cost of acquiring a new customer, as well as looking at the average cost of how many customers we have and the cost to maintain that customer base and service those customers that we do have.

Brett Le Mesurier: (Perpetual, Analyst) So would it be fair to conclude that you use cost to income ratio lower than the average across the Bank?

Racheal Kellaway: We allocate all costs when we look at that analysis, so we don't use a lower cost to income total, no.

Brett Le Mesurier: (Perpetual, Analyst) ROE target in FY26, is that going to allow you to meet your cost to capital?

Patrick Allaway: Yes.

Brett Le Mesurier: (Perpetual, Analyst) [Inaudible].

Patrick Allaway: You're cutting out on us quite a lot, so it's quite hard to hear you.

Brett Le Mesurier: (Perpetual, Analyst) Given that your ROE at the moment is about 8.5%, can you tell us which products are actually meeting your cost to capital?

Patrick Allaway: I don't think we'll go into that detail here on the call. Certainly we can come back to you on that when we catch up.

Operator: Thank you. Your next question comes from Ed Henning form CLSA. Please go ahead.

Ed Henning: (CLSA, Analyst) Hi, I've got a couple of questions. Firstly, can you just clarify, you said positive Jaws is going to be hard in the second half, but have you walked away from your guidance for the full year for positive Jaws?

Patrick Allaway: With current industry headwinds and where we're currently trading, we are not holding to the positive Jaws guidance.

Ed Henning: (CLSA, Analyst) Okay, thanks for that clarification. Then just a couple of questions, previously the BOQ teams talked about the home loan brands targeting different segments of the market, can you just talk about the competition in this different segments? Is any brand seeing more competition and more margin pressure than the other or are they all just seeing equal margin pressure to think about on the mortgage side?

Patrick Allaway: Yes, so we have very differentiated value propositions across our brands and our customer segments. But it would be fair to say that across the whole industry we're seeing very similar headwinds.

Ed Henning: (CLSA, Analyst) Okay. Then just one more, while you've given some details for the cost simplification program, you've given a digital strategy, an operating model and it's been talked about before, do you not know the cost of this at the moment or are you just seeing potentially to get more costs out or the inflationary pressure is kind of holding you back from putting out some cost targets now. I'm just trying to figure out why, with the plans in place, why are you not giving us more detail now until the second half?

Patrick Allaway: We had a clear investment roadmap which we very much understand the costs on. We haven't disclosed our future investment program to the market and we don't think it's appropriate to do that. With regard to the simplification program, this is a newer initiative, so we have had ongoing productivity benefits of about $30 million over the last couple of years.

Given where our cost pressure is at the moment and we have said to you that it's unacceptable and we are not comfortable with the expense growth in the business, we initiated at the beginning of this calendar year a material program of work to look at how we could more simplify the Bank and get more productivity benefits.

That work is not complete. We know where we will be targeting those expenses. We have more work to do and we will come back in the second half as we have said to give a very clear outlook at to those productivity benefits. The reason we are not disclosing today is we are not ready but we certainly are giving you a very strong heads up that we are addressing our expense inflation. We are not comfortable with it and we are going to take material measures to drive productivity benefits.

Ed Henning: (CLSA, Analyst) No, that's clear. Thank you very much.

Operator: Thank you. Your next question comes from Nathan Lead from Morgans Financial. Please go ahead.

Nathan Lead: (Morgans Financial, Analyst) Thanks for your presentation. A first question from me is the New Zealand asset sale that you're looking to complete. Just plans for what you are going to do with that capital, impact on earnings, impact on regulatory ratios please.

Patrick Allaway: We have no plans for that capital at this stage. It will benefit our capital position and that sale is not complete. We are in the final stages of moving towards the sale process but it's not capital that we're banking today and it's something that we will certainly take into account in the future.

As we have said, we want to hold high capital buffers. We are allocating our capital appropriately across both growth in the portfolio but also the investment in our digital transformation, as well as ensuring that we have got our capital buffers through the cycle.

Nathan Lead: (Morgans Financial, Analyst) A second question from me. If you just describe the duration of your investment securities portfolio and just remind us how you go about the interest rate risk management on that please.

Racheal Kellaway: Those securities are all fully hedged, so we hedge all the interest rate risk. There's a small component of credit risk but in terms of interest rate risk, all fully hedged and we mark to market those securities. We take a mixed view on duration of that and so some of those securities you will see invested out beyond five years and some of them will be invested at shorter terms depending primarily on the returns we can get.

Nathan Lead: (Morgans Financial, Analyst) Yes. Thank you.

Operator: Thank you. Your next question comes from Azib Khan from E&P. Please go ahead.

Azib Khan: (E&P, Analyst) Thank you very much. A first question on margins and then a second question on costs. On margin if I take a look at deposit tailwinds outside of the replicating portfolio there was a 25bps benefit from savings and TDs in first half 2023 and there was an 11bps benefit from savings and TDs in second half 2022, so a 36bps benefit all up across the two halves which has been generated by savings and TD rates, lagging interest rate rises.

You're today calling out that, or you've mentioned that deposit competition escalated in the second quarter and is likely to continue and if I take a look at your savings deposit rates and carded TD rates in the market they're very attractive and sitting above the cash rate. Can we expect that 36 basis points of NIM benefits that came across the last two halves to now start dissipating?

Racheal Kellaway: Yes, Azib, we are forecasting that that will turn into a headwind.

Azib Khan: (E&P, Analyst) So, Racheal, will that 36 disappear plus more? Is that how we think about it?

Racheal Kellaway: No, we will keep the 36. It will just turn into a headwind in the second half. We expect to see some benefits flow through particularly on the savings side but we are seeing some headwinds on term deposits. You can see the graph that we put in the back of the pack that talks about where the BBSW has gone, but also more importantly the fact that there is a lot of competition across the industry for term deposits at the moment, so there's margin compression on term deposits.

Then the last factor really is the fact that we have seen customers moving funds from lower yielding products up into those higher yielding accounts, so a mix shift will be a drag going through to the second half as well.

Azib Khan: (E&P, Analyst) Can I take your point there on savings deposits Racheal to mean that on average your savings deposit rate rises are still lagging cash rate rises?

Racheal Kellaway: Correct, yes, so still that benefit coming through.

Azib Khan: (E&P, Analyst) Okay, thank you and the second question on costs. I understand you will provide details on the simplification program in the next half, but is that program likely to come with restructuring provisions?

Patrick Allaway: We are not going to comment on that at this stage. As you take out material productivity you would expect that there are going to be restructuring costs associated with that, but as I said, we will come back to you. We will not be doing this and not investing in it unless it produces sustainable long term productivity benefits. If there are restructuring costs, they will certainly be justified by the investment case of the long-term benefits for BOQ.

Azib Khan: (E&P, Analyst) Thank you.

Operator: Thank you. Your next question comes from Brendan Sproules from Citi. Please go ahead.

Brendan Sproules: (Citi, Analyst) Good morning. I've just got a couple of questions. Firstly, on asset quality. Slide 29 shows that the big change in asset quality this period was a kick up in the 90 days past due in your asset finance position. Has that really been due to some of the issues that we are seeing in the construction industry or is there a more broader trend there that you could point us to?

Racheal Kellaway: Hi Brendan. So, there's a couple of things. I mean the first point I would make is that the asset finance portfolio is relatively small, so $6.7 billion there. What we have seen in that is some exposure to construction, so we have seen some stress caused by supply chain issues so that's caused a small uptick in arrears and we are monitoring that very closely. We are very well diversified by both customer size and geography in asset finance and we have not had direct exposure to any of the recent large companies that have gone into liquidation but we are certainly very alert to how that portfolio is performing.

Brendan Sproules: (Citi, Analyst) Okay, thank you. Then just my second question is just on obviously the work around the AML processes that you're upgrading. I do know from the materials that you've mentioned that you may be subject to potential fines or penalties, that could be a possibility. Is that sort of - what brought about that disclosure that you put in today and is that telling us that down the track there is going to be some kind of - there's been some kind of breach of your systems over the last little bit?

Patrick Allaway: Thank you for that question. As you know, we have continued to demonstrate that we have very strong practice in our disclosure. If we had something to disclose in relation to fines or enforceable undertakings or future action, we would disclose that and that would actually be a requirement of us. We have been very transparent and clear in our communication over the past six months on our need to strengthen operational risk and resilience. It is appropriate in our financial accounts to call out the risks associated with not complying with regulatory requirements and that's been called out appropriately.

Brendan Sproules: (Citi, Analyst) Okay, thank you.

Operator: Thank you. As there are no further questions at this time I will now hand back to Miss Aaskov for any closing remarks.

Tanya Aaskov: Thank you for joining us today. Of course, management will be happy to take any further questions that you may have on results later in the day. Thank you.

End of Transcript