Commonwealth Bank of Australia

Transcript – 2020 Half Year Results Briefing

For the half year ended 31 December 2019

12 February 2020

View webcast: https://edge.media-server.com/mmc/p/8q7cmptv

Introduction

Melanie KIRK: Hello and welcome to the Commonwealth Bank of Australia's results presentation for the half year ended 31 December 2019. I am Melanie Kirk and I am Head of Investor Relations. Thank you for joining us. Today we will have, during this briefing, presentations from our CEO, Matt Comyn, giving an overview of the financial results and an update on the business. Our CFO, Alan Docherty, will provide details of the financial result and Matt will provide an outlook and summary. The presentations will be followed by the opportunity for questions and answers. I will now hand over to Matt. Thank you Matt.

Presentation from Matt Comyn

Matt COMYN: Thanks very much, Mel, and morning everybody. I think the result overall, from my perspective, good operational execution across the business as underpinned a solid result in the period. We are pretty pleased overall with the progress that we are making in a number of areas, both strategically as well as the day-to-day challenges. I feel like the business is well positioned and we are going to talk through some of the areas and give a bit of an update on some of the areas where we are investing. And of course, it has been front and centre for us recently, it has been how we have been supporting our customers and communities, particularly in the tragic bushfires recently.

So a couple of things in the way we can now, using our technology, particularly our Customer Engagement Engine, it enables us to actually reach a couple of hundred thousand of our customers. We can build Next Best Conversation and deploy that out to contact all of those customers in 150 postcodes within a couple of hours, to make sure that they know about all of the availability of support and help via our emergency assistance package. We can also make sure that any customers who are calling us in those affected areas, in our contact centres, who are coming into branch, we can be having very personalised conversations and supporting them through such a difficult time.

From our perspective as well, we have been very fortunate to use our technology, but again, really benefiting from the generosity of our customers who have contributed more than $4.5 million which we have donated to the Australian Red Cross. The Commonwealth Bank also announced that we would be dollar matching any of our customer donations or employee donations. We expect to contribute more than $10 million as part of that via either our community grants or some tailored donations, including the purchase of Shane Warne's baggy green. And we feel like this is, of course, a critical part of what we stand for as an organisation, supporting our customers in real times of need and making sure that we are there to help in the rebuild and the recovery efforts.

Now, turning to the result, the statutory profit up 34% was assisted by the $1.7 billion of gain on sale of CFSGAM. The cash net profit after tax of $4.5 billion was down 4.3%. A couple of things are really driving that in particular, the $83 million of bushfire related claims. We took $100 million provision as well for drought and bushfire during the period and the flow through of previously announced changes, particularly to non-interest income, which I will talk about in a little bit more detail. I think one of the highlights of the result has been overall just the strength of the balance sheet in a number of different ways, but clearly our Level 2 Common Equity Tier 1, at 11.7% is very strong. It has enabled us to declare today a fully franked $2.00 interim dividend and also that we will be neutralising the dividend reinvestment program.

Let me just talking through the result again, in a little bit more detail. Net interest income was up 1.7%. During the period we had strong volume growth across a number of our core business lines at deposit and transaction banking, performance was very good again. Home lending, which I am going to talk to subsequently was a strong performance and business lending up 3%. Our net interest margin was stable during the period. Of course, the headwinds from lower interest rates was offset in this particular period by a sharp reduction in basis risk or that cash bill spread. We had about a 23 basis point improvement during the period. Alan is going to talk obviously about the net interest margin movements as well as some of the outlook elements for that as well.

And overall, as I mentioned, particularly in our non-interest income, in Q3 last year, we talked about improvements to customer outcomes. We called out, at that stage, the $275 million in FY19 would grow to $415 million in FY20. We saw that, so we have seen that sort of $207 million of impact in the half and we believe now we have sort of stabilised our non-interest income. We expect to see some modest growth from here, mainly volume related.

Turning now to expenses, I think we have better momentum in the half around our cost savings program. Alan will talk to that in a little bit more detail at $222 million, so increasing momentum, but clearly much more to do here, offset by wage inflation of 2.5%, an uptick in amortisation for the period delivering that overall operating expense growth of 2.6%.

Our loan impairment up 12.5% is really a function of the $100 million provision that I mentioned around bushfires and droughts. I think most pleasingly when we look at the particularly the arrears performance across our consumer portfolios are all down across the period and a stabilisation of our troublesome and impaired assets in our business and corporate bank. So overall, as I said, that delivers a cash net profit of down 4.3%.

A couple of other things maybe just worth calling out, we look at MFI share very closely, both in terms of some of the published surveys, but really what we can see in terms of the engagement that we are having with our customers. We have seen a continuing and strong uptick now, particularly for some of our younger customers who are choosing us as their main financial institution. We see that in the context of them using our transaction account as their primary transaction account, either with salary credits or you can see the bill payments coming in and out. We think that is obviously at the heart of our overall business. It is a function or reflection, I think, of our everyday banking proposition and our continued investments in digital.

As I have already mentioned, I think very good volume growth across the period there. In particular, we were pleased to see deposit funding now at 71% as a function of that strong transaction and deposit performance. That is broadly up 14 percentage points over the last decade. And again, the very strong Common Equity Tier 1 and a pro forma of 12.2% has enabled that interim dividend and a payout ratio of 79%.

So I thought I would spend a little bit of time just on home lending in a few areas. So particular our system, lending growth at 1.5 times, it is probably slightly above that. There has been a bit of restatements and noise during the period, so we sort of estimate that that is right. It is obviously unusual given our size to be growing above system at that level. We have seen good, strong fundings growth, particularly in owner/occupier and principal and interest. We have seen a slight uptick in average borrowing size, which is really a reflection of an increased number of loan applications that have come through in Sydney and Melbourne. And as I mentioned, the improved arrears performance I think has been very good when we have tried to deconstruct what is driving that, we think about 60% of that performance is due to portfolio quality and the other 40% is really a function of we called out that we had added extra resources into our teams that are managing our financial assistance areas and I think that has clearly paid a strong return.

I did want to spend a few minutes just talking about, there has been a lot of enquiry understandably around this sort of differential between the front book and the back book and maybe just to try and help dimension it upfront. Generally, where there is a lot of enquiry, it is looking at the level of discounting, particularly off the standard variable rate product. So that is about 60% of our loans. So you would have to exclude fixed rate loans and other basic products, which for us we have an extra product which I think is priced around sort of life of loan, 332. So if you think about sort of the 60% of our loans, one of the ways that we have looked at it, is really looking at the spot level of discounting in a particular month and then comparing that against the average over the whole book.

When we looked at that in August, just to give you a sense of what that differential is and how it moves around, that was 21 basis points. So that was 18 basis points for owner/occupier and clearly slightly higher for investor. When we looked again at that spot level of discounting versus the average of the book, in December it had improved to, well it had increased rather than improved to 26 basis points. There is clearly quite a bit of volatility in and around what level of pricing is going on in the market. It gives you a sense of the level of competition and in particular, there are obviously a number of new entrants, but it is increasing levels of competition, really over the last decade in home lending. There is also, from my perspective, I think a number of factors that explain price differences in the context of loan sizes, how funding costs which print at the time of origination change over time, LVRs, borrower and risk characteristics. But clearly I think this is an issue that is going to continue to gain attention. It is something that we have been focused on for some time. I mentioned here we have repriced approximately $130 billion over the last three years, just trying to manage that differential. And we think it is really important that that there is an adequate gap that also aligns with those borrow and security characteristics rather than per se, tenure. But we recognise it is an area of ongoing scrutiny. And as mentioned there, we anticipate the ACCC Interim Report will come out at the end of March.

So turning briefly just to talk about some of the highlights against some of our key areas of focus. I think we have made good progress around divestments, particularly the completion of the sale of CFSGAM. I have mentioned the cost savings momentum of $222 million in the half. Remediation continues to be a big focus, making sure that we are refunding our customers as quickly as possible. There is another $100 million that we have refunded to customers in the six months. If I look at the remaining balance sheet provision, which is broadly $900 million, almost 60% of that relates to aligned advice, which is probably the key area of uncertainty in the context of completion and timeframe. But we have a large team very focused on making sure we complete that remediation.

We also this morning put out the Remedial Action Plan, the update from Promontory who is our independent expert. It shows that we have completed 62% of the milestones. We feel like we are on track making good progress. I think the other thing I would say is that we still feel like there is more work to do. Some of the hardest milestones are ahead of us, and we have set ourselves a higher standard from where we are today in terms of the management of non-financial risk. So it continues to be a real area of focus. And of course, getting on and implementing all of the 23 applicable recommendations from the Royal Commission.

I am going to talk in a couple of subsequent slides. More about digital and technology, clearly that has been an area of focus and investment for us. We are seeing very strong engagement with customers, more than seven million customers using us digitally. Almost six million customers regularly on a monthly basis using our mobile banking app. That is a huge focus for us both strategically and the way we think about the future of the organisation. And we have also enhanced both our product offering and we have seen some improvements in our Net Promoter Scores across all of our businesses. But we also recognise, again, there is much more to do on a go-forward basis.

Just briefly, a couple of the new products that we put in market. We really wanted to strengthen our FX proposition. We released a World Debit Card and now an Ultimate Rewards Card to strengthen again our value proposition in the cards market. The feedback so far from customers pretty early on in the launch has been very positive.

We again looked at our pricing in the context of fee structure for particularly digital accounts for businesses. We have repriced that. We have seen strong volume growth in our business customer accounts as well as transaction balances. And later this month we will be bringing out a new product which will be new to the Australian market for all of our home lending customers, who will receive 12 months of cover should they suffer a permanent illness or death.

Moving on, as I mentioned, a huge part of our focus has been continuing to make sure we have got the best digital experience in market, bar none. We continue to focus on using our Customer Engagement Engine, which I have spoken about before, making sure that we are delivering nudges and tools to help our customers manage their overall financial wellbeing. We have also rolled out a new rewards proposition to reward loyalty of our customers. We have got about 100 different offers that are live at the moment. We have had 200,000 redemptions from our customers within the app, and we plan to continue to expand and enhance that program.

And as you would expect, just the safety and security of our customers' information is of critical importance to us. Unfortunately, we have seen an increase in scams in particular in Australia in recent times. We have built out a dedicated team that is working around preventing and detecting scams, and of course, fraud. We have held more than 1,000 educational sessions around the country with our customers to help better inform them. I think it is another just good example of where we are using technology to increase engagement, deliver better outcomes for our customers in terms of avoidance of those scams, but also, of course, reducing fraud losses.

Again, I would like to spend just a couple of minutes, and maybe just give a broader sense of how we are thinking about technology. Yes, digital is an incredibly important part of it, but actually our ambitions are really making sure that we have a modernised, real time and very resilient top to bottom technology stack. I think we come from an advantage position. We have got a strong history of leadership in this area and some very good assets that we are going to build upon.

When we think about it more broadly, there are a number of different focuses here. First and foremost is really just continuing the modernisation theme that the Bank has been investing in for more than a decade. When we look at the overall systems landscape, an easy way to think about it is we have got too many applications running on too much infrastructure. We have got about 3,500 applications. We want to take that footprint down by 25%. Those simplifications obviously deliver some real benefits. We have got a big cloud or public cloud migration underway. We have got about 25% of that footprint in the public cloud. We would like to get that about 95%.

Of course, that comes with lower costs to run, lower costs to compute, but also improvements around resilience. Given the amount that our customers are engaging with us digitally and just a reliance on our systems, it is just critical that we have an incredibly high level of availability and resilience. And of course, there is some engineering that we need to make sure that we are building into the way we develop, run and deploy our software.

Digitisation, obviously a big theme for us and many other institutions. Maybe a few quick focus points for us. Home lending, 80% of our home lending now is digital end-to-end using PEXA on the back end. We want to continue to invest and particularly our business underwriting process, Business Express, at the moment that is unsecured. We would like to really improve both speed to decision and fulfillment process of business lending. And our Institutional Bank, big investments actually in the underpinning infrastructure and systems, everything from the KYC onboarding process to the institutional lending system.

On data, if you look at any of the issues that we have had in regulatory and compliance, data quality and reconciliation and lineage has often been at the centre of a number of those. Actually improving the data quality at source is a really important priority for us. We are making, as you know, big investments in areas like financial crime. One of those elements is making sure that, as I said, we have got high quality at source, and we have got complete coverage, accurate data with high quality lineage. It is not only about, of course, making sure that we are meeting any of our regulatory and compliance obligations. We see that as a foundational asset, that we come again from a very strong starting position, that we will be able to build upon and build differentiated customer experiences, that will help in engagement and retention.

And of course, we need the best people, so best people internally. We also want to work with the best partners, both domestically and locally. And overall execution here is a high area, I think, of value creation for the Group, for our customers, for our shareholders. It is going to be a really important area for us to actually execute incredibly well. And we want to build differentiated experiences relative to our competitors that are hard to replicate at a lower risk, lower cost, much greater velocity than we currently build software, and at a higher level of security.

Just touching briefly now on a couple of things more recently. I think everybody knows the investments that we have made previously in businesses such as PEXA. Beem It now is scaled to more than a million customers. A couple of weeks ago, slightly less than two weeks ago, we announced our 50/50 joint venture partnership with Klarna. We are pleased with the progress. We have not really started to promote that at all. We have had about 25,000 registrations in less than two weeks. We have exceeded that, continue to grow about a quarter of those from what we can see, are existing Commonwealth Bank customers, which is probably slightly lower than we had otherwise anticipated. We had Appliances Online announced yesterday as our first merchant partner, Australia Post, will be announcing another merchant partnership today. We want to continue to build on a number of merchant partnerships in time to come.

And of course, X15, which was only last week, we just see that as another way that we want to just invest in increasing the innovation and particularly the velocity of innovation. Some of that we want to do inside the Group. We also want to find ways that we can build out ventures and just increase again the pace of technology improvement and the differentiated experiences that we can deliver for our customers.

On that point, I am going to hand over to Alan who is going to talk through the result in more detail.

Presentation from Alan Docherty

Alan DOCHERTY: Thank you, Matt. Good morning. I will step through our half year outcomes in some more detail. But I wanted to start by giving you a sense about how we think about our current operating context, what actions we are taking in response, and how that manifests in the outcomes that we deliver for our shareholders.

As we enter a new decade, it is clearly going to be very different to the last one. Interest rates in Australia are likely to remain at historical lows for an extended period of time. Household income growth remains subdued and constrained consumer spending weighs on businesses' appetite to invest. We are adapting our business in support of the objectives that we share with our regulators. The financial wellbeing of our customers is best served by a stable, fair, efficient and safe banking industry, and we are mindful of our responsibilities in that regard. And all of this adds up to pressure on our earnings.

In response to that new context, we are both focused on building upon our franchise strengths, and also building the new disciplines that we will need in order to deliver strong shareholder outcomes over the next decade. As I step through the result in more detail, you will see both the impact of the changed context and also the outcomes achieved from how we have responded in terms of operational execution, how we are managing our balance sheet, the progress that we are making on cost and capital disciplines, and how we are seeking to underpin consistent returns for our shareholders over coming years.

Let me start off as usual with the reconciliation of total statutory profits to cash profits from continuing operations. Statutory profits were $6.2 billion for the six month period, much higher than normal due to the one-off gain on the sale of Global Asset Management. All of the usual adjustments apply in arriving at our cash profits from continuing operations of $4.5 billion, though it is worth noting that the cash profits from our discontinued operations have now virtually all been divested away during the half. And so we are now in the position that the cash used to pay our dividends is generated from the cash profits of our continuing operations. As Matt has described, those cash profits are 4% lower on the prior comparative half with operating income flat, costs up 2.6%, and loan impairments up 12.5%.

Decomposing operating income, you can see that net interest income that reflects the core of our franchise increased by $159 million, and that was offset by derivative volatility within other banking income. The repricing that we flagged last year in our Colonial First State funds management business, and higher general insurance losses booked in the current half due to the bushfires.

If we look more closely at the components of net interest income, you can see that home loan volumes continue to grow above system, and transaction deposit growth remains robust and reflective of our franchise strength and the quality of our digital platforms. Business lending across Australia and New Zealand grew 3% on average, with domestic growth a little below system due to a spike in run-offs in the December month. Institutional lending balances were 9% lower on average on the same half last year due to the reduction in spot exposures that we have seen during the 2019 financial year, with institutional lending increasing slightly over the past six months.

Net interest margins were stable at a headline level, and if we unpack that over the past six months, you can see that there was some large offsetting swings due to the recent volatility in interest rates. Firstly, asset pricing contributed five basis points due to repricing of home loan, business lending and consumer finance portfolios, and the timing benefits associated with the July and October cash rate cuts.

Competition within home lending remains intense, costing us two basis points of margin in the period, and that level of margin pressure has been consistent now for each of the past four halves. Deposit margins were impacted by the cash rate reductions, costing us four basis points, and that is net of a three basis point benefit from a replicating portfolio deposit hedge. Portfolio mix improved one basis point as customer deposits grew to 71% of our funding base. Basis risk spreads fell back in line with post-GFC norms, giving us a one off tailwind of four basis points, and earnings on our Australian capital balances and the New Zealand fell in response to lower interest rates in both countries. Looking ahead, we expect the previously announced cash rate reductions to impact on net interest margin by four basis points over the full year ending June 2020, and by a further four basis points in the following financial year.

Operating expenses increased 2.6% on the prior comparative half. Changes in notable items were broadly offsetting across those two periods, although I wanted to highlight a few noteworthy items within those categories. Firstly, custom remediation charges were minimal during the current half, with no new issues identified. The major remaining uncertainty within customer remediation relates to the ongoing service fees charged by our aligned adviser groups. We raised the $534 million dollar provision for that matter in the prior financial year, and that remains our best estimate pending finalisation of our remediation methodology.

Secondly, the cost of running our major risk and compliance programs to enhance our non-financial risk capabilities has plateaued. Those costs have stabilised at around $200 million per half for two consecutive halves, an increase of $34 million on the same half last year. These elevated risk and compliance costs will continue to be borne over the medium term.

Pleasingly, we benefited from a one-off reduction in expenses during the period. That was partly due to the release of the historical provision following resolution of a longstanding matter, and partly due to the realisation of one-off rebates. Those benefits were offset in the period by an accelerated amortisation of software balances as we adjusted our amortisation methodology to better reflect the faster pace of technological change.

Growth and underlying staff and IT costs outweighed the additional savings realised from business simplification. This was the softest aspect of our financial performance in the half, albeit we were encouraged by the growing momentum and cost reduction achieved over the past three halves with $222 million of cost savings realised during the last six months, doubled the rate of savings achieved during the prior half.

Turning to our balance sheet settings and looking firstly at credit risk, the loan loss rate for the Group was slightly higher at 17 basis points due to the extra provisioning for drought and bushfire affected customers. At a divisional level, loan loss rates reduced in the Retail Bank due to lower arrears across home loan, personal loan and credit card products. Loan loss rates increased in the Business Bank due to higher collective provisioning for regional customers, and the agriculture discretionary retail and construction sectors. There were some small movements off a low base in both IB&M and ASB.

Troublesome and impaired assets were flat on the prior half at $7.8 billion with lower corporate impaired assets offset by higher troublesome assets due to the downgrade of a small number of large exposures across different sectors. And if we look more closely at consumer credit quality, you can see a consistent trend of improved consumer arrears across all products compared with both the prior half and the prior comparative period. Notwithstanding that, we have continued to adopt a conservative approach to provisioning, and have increased both consumer and corporate collective provisions as we continue to make forward looking adjustments for the potential deterioration in macroeconomic conditions.

On wholesale funding, we further extended the maturity profile of our long term debt issuance. Market conditions have been favourable and we have taken the opportunity to issue debt of longer tenure, to further reduce future refinancing risk and also make good progress against the new requirements for total loss absorbing capital.

On capital, we have delivered the level two Common Equity Tier 1 capital ratio of 11.7%. This represents a significant surplus above APRA's unquestionably strong capital benchmark, and we now expect pro forma capital of 12.2% as we finalise our remaining divestments.

During the half, capital generated from divestments totalled 83 basis points, and we have delivered 37 basis points of organic capital despite the elevated payout ratio, due to lower credit risk weighted assets from improved retail portfolio credit quality, and lower traded market risk capital from modelling improvements.

As we are the first major bank to report under the unquestionably strong requirement, we wanted to provide you with some more clarity on our capital targets. We manage our capital at both a level one parent entity and level two banking group basis. Both capital measures are required to be "unquestionably strong". However, as we have higher level one capital, our key binding constraint is currently level two capital.

Our target in line with APRA's expectations is to remain at or above the 10.5% "unquestionably strong" benchmark for the majority of each year, so for seven months or more of each year. As you can see, we intend to manage our capital levels on the basis that we dip below 10.5% following the declaration of the interim and final dividends, spending the rest of the year at or above 10.5%. We will manage our capital settings on a conservative basis. Our strong franchise capital generation and DRP mechanism provides us with the added flexibility to ensure we remain well capitalised at all times.

Our surplus capital position provides us with the opportunity to consider capital management initiatives. We have today announced our third successive of DRP neutralisation, which involves a $500 million on-market share buyback. Following that and subject to prevailing operating conditions, the Board will consider future capital management initiatives to lower share count and underpin dividends. We are targeting a gradual return to a 70 to 80% full year payout ratio, and we are comfortable that the top end of that range we can continue to generate organic capital and excess franking credits.

Finally, we are prepared for a range of possible macroeconomic outcomes. Should operating conditions deteriorate, we have a number of capital management tools available to ensure we remain unquestionably strong, and our Board will continue to reassess the sustainable level of the dividend at each reporting period.

Matt will take you through the outlook and a closing summary.

Matt COMYN: Thanks very much Alan. I mean, overall, in terms of economic outlook, we still remain optimistic and confident about the fundamentals for the Australian economy. We continue to see obviously growth in population, government is in a very strong fiscal position. Trade notwithstanding, outlook maybe for some softness on commodity prices, we see continued underpinnings from investments in infrastructure. We have seen an improvement in the housing market. We believe that is going to continue. Supply has been well absorbed. Today we are probably likely to see a slight uptick in construction in the back half.

Notwithstanding that, of course, there are some near-term uncertainties and risks. In particular, obviously, on the back of the bushfire, coronavirus, we do see a softening in this particular quarter and the next one, but we believe the growth outlook and trajectory for the second half of this calendar year is still quite strong. I mean, from our perspective, we are very focused, of course, on supporting our customers, doing all that we can to facilitate economic growth. Clearly, the housing market has been strong. We would also like to continue to lend into the business market in particular to help support and facilitate increased investment for many of our small to medium enterprises.

Of course, we are going to continue to invest in innovation and growth. We are investing at the moment approximately $1.3 billion. Obviously a huge proportion of that is within IT, if there are opportunities for us to invest that efficiently, get a good return in the future, we will certainly look to be prepared to do so.

Just a very quick summary. As I said, I think some of the most pleasing elements, just a good momentum in operational execution, growth in some of the metrics that really matter from our perspective, in terms of MFI share, customer engagement, good tran banking performance, a good performance in a couple of our key businesses like home lending. Certainly some areas for us to improve. Margin overall has been, as Alan said, stable. We feel like better momentum and costs, but clearly much more to do there. Pleasing from a credit quality perspective overall. Very strong balance sheet and capital position, and hopefully just an increasing velocity of improvement in customer experience related to our technology and the way we serve our customers. Look forward to your questions.

Q&A

Melanie KIRK: Great. Thank you, Matt. For this briefing we will be taking questions from analysts and investors. We will be starting in the room and then we will move to the phones. To ensure everyone can hear you, please wait for the microphone, state your name and the organisation you represent. And to give everyone an opportunity, please limit your questions to no more than two questions. We will take the first question from Jon.

Jon MOTT: Thank you, Jon Mott from UBS. With the NIM, you called out a number of moving parts. But one you didn't really mention was during the period, the July and October rate cut. You held on to the mortgage rate reductions for a period of about three weeks on each occasion. So your funding costs, a lot of our deposit costs fell, but you actually got an elevated NIM for six of the 26 weeks in that period. Can you tell us how much that elevated NIM for almost, what's that, almost a fifth of the period helped your margin during the period?

And going forward, do you think it's appropriate that you hold on to mortgage rate cuts for a period of three weeks given your technology investment? I'm sure you can change rates a bit faster than that. Do you think you can in future commit to passing rate cuts on by the RBA faster to your customer base?

Matt COMYN: Yes, Jon, let me start, and if Alan wants to add anything more specific, I mean, you are quite right in the context of when there are rate changes and the timing of those rate changes. From our perspective, the timeframe that we applied there is consistent with the rate changes that we have made in the past. And I accept the question about whether it could be done with greater speed and urgency. It is also given there have been a number of problems in and around fee and interest accuracy, it is a large scale technology change as well. So we want to make sure we do that with quality.

So we have tried to keep a very consistent timeframe. In previous instances where rates have actually been going up, we have given customers extensive notice, so there is some benefit. I think Alan alluded to that, and you are right, in the period there is some benefit, of course from both the pricing changes and the timing of those.

Jon MOTT: So will you be able to do that faster going forward?

Matt COMYN: Well, Jon, I think it is one of those things that we will continue to monitor on an ongoing basis.

Melanie KIRK: We will take the next question from Richard.

Richard WILES: Good morning, Richard Wiles, Morgan Stanley. A couple of questions. Firstly, on expenses, you're clearly doing more on the cost savings. Good progress this year versus last year. But your costs are still growing around 3% per annum. So what's happening with your ambition to lower the absolute cost base? Is that a realistic target? And when could we expect that to actually happen?

Second question's on capital. Even if you exclude the pending proceeds from insurance, you got about a $5 billion excess above your 10.5% target. Is an off-market buyback the most likely form of capital management given that it distributes franking credits and it lowers the share count, which are two of the things you've flagged as important for your shareholders?

Matt COMYN: Sure. So look on costs, I would say better progress, but clearly a lot more to do. And increasing momentum, and that will continue to be a focus for us going forward. In terms of our aspiration, it is unchanged. It is literally 12 months ago since we talked about that. I remember the day after we said sub 40% cost-to-income the RBA neutralised the rate stance and we had three rate cuts. So I see the perils of providing guidance specifically. But we recognised that is such is life. It is still realistic. It is clearly more challenging than it was 12 months ago. I mean, ultimately, we are going to make the best decisions that we can for the long term of the Group. I realise it is not particularly helpful, but we still say that is a medium term objective.

What you should expect from us and what we certainly intend to deliver is increasing momentum in that particular expense reductions. We meet as a management team on a weekly basis. It is a huge focus. There are obviously a number of other things that we are working on, and we need to get better at it. At least for this period it was better than it has been in prior periods.

On capital, clearly I am not going to foreshadow either size or particular type. But I mean, what we have tried to do, and feel free to add in Alan, we provided additional disclosure in terms in the way we are thinking about unquestionably strong. It enables obviously you to be able to try and calculate what you think that level of surplus capital would be. Of course there's future divestments that are coming. We have said obviously the Board is actively considering that. And one of those considerations is we have surplus franking credits. And so we have provided additional disclosure both at the size of the surplus franking credits and the franking credits for tax purposes as well. So there is not really much more we can say at this point in time, but I think it probably is hopefully helpful in the context of you being able to calculate it.

Alan DOCHERTY: And I mean our immediate focus from a capital management perspective, is this neutralisation of the DRP, so that is going to involve an on-market share buyback during February and March. So that is a near-term focus. We have also flagged that we are expecting to receive some further divestment proceeds to the third quarter of this financial year. So in the near term, that is our focus, and as Matt says,the Board will continue to consider the future of capital management.

Richard WILES: The $500 million of DRP neutralisation, I mean, it's small [inaudible] compared with the $5 billion of excess that you've got. And just to be clear, you've clarified today that the target is 10.5. You don't think you need to run with a buffer above that? My maths is correct, isn't it? $5 billion in surplus above 10.5?

Matt COMYN: You could calculate it. It is a relatively easy calculation. I mean, what Alan said is that we are going to run above 10.5 for the majority of the year. So that is at least seven months, so you can calculate how far above that is, across the period. And the timing and size, yes, $500 million in the context of the number that you are putting forward. But that is what is immediately ahead of us, so over that mid-February into March. We will be on market purchasing shares. But at this stage, it is under active consideration, and certainly the flexibility that we have got enables us to think about that in the near term.

Melanie KIRK: Great. We will take the next question from Jarrod.

Jarrod MARTIN: Jarrod Martin from Credit Suisse. Can we just get back to the margin slide? A bit of clarification. If I take in the blue box in the top right hand corner, the second half margin down five basis points, that sort of implies 206. Then if I use the second line in that with a full year 20 margin down four basis points, that implies 206 for the for the full year, which implies a second half margin below 206. There seems to be a disconnect between what you're saying around second half, using either the top line or the second line.

Alan DOCHERTY: No, no. So what we are providing there is the flow on effect of the previously announced cash rate reductions, including the lower swap rates and the impact that has on the unwind of our replicating portfolio and equity hedges. I am not trying to predict an absolute net interest margin number between periods. It is the flow on effect and how that unwinds between one half and a financial year.

Melanie KIRK: Great. We will take the next question from Victor, thank you.

Victor GERMAN: Thank you, Victor German, Macquarie Bank. Matt, if I was just able to follow on from your comment around non-interest income that you feel like you've reached the floor and you can grow from here, and appreciate, thank you for all the disclosure you've provided. I'd just be interested in perhaps a little bit of further colour in terms of why you think that is the case. I appreciate that you've obviously done a lot of rebasing, but there is still presumably underlying pressure in that line item. And I know your quite good disclosure actually on deposit fees, that you still have about $400 million per year contribution, just interested in the sustainability of that.

And then the second question, it's quite unusual for one of the major banks to sustainably deliver superior growth in mortgages relative to three other peers. But just interested in your observation as to why do you think you were able to do that, and how sustainable is that?

Matt COMYN: Sure. Yes, I mean, in the non-interest income line, I said modest growth. I think that is right. And of course that considers all things being equal. So it is not to say that there will not be changes in the competitive context, et cetera. But in the work that we did last year, we looked top to bottom across our business and made some decisions about what products we would no longer offer, how we wanted to charge for those. We introduced a number of alerting features to help our customers understand what they were being charged and when, which had a direct impact. We forecast at that time that 275 would grow to 415, we have seen that flow through. And we feel like there are some modest growth opportunities which are really just a function of growth from here.

Of course, as you go over into the medium and long term, is there potentially downward pressure on interchange rates? Are there potentially downward pressure on other fee types? Absolutely. But we would consider, at least from what we can see, we believe there are still modest opportunities from here.

And to your second question, yes, look, I mean, given our size, you are right, it is unusual, not seen it before since the GFC. It surprised us that it persisted. I cannot speak for all of the other institutions. I feel we have had a good start to the year. I felt good about January/February. But we would not expect our system performance or volume performance in home lending to persist at these levels.

And I think the main driver, sorry, to come back to the other part of your question, has really been we have been very consistent around operational execution and turnaround times. Obviously, one of the other competitors gave a briefing yesterday. Similarly, we have seen they have done a very good job around operational execution, and there has been obviously greater variance in the market. And so those that have been consistent in particular have been rewarded because others have not. And so particularly in the broker market, that is where flow has shifted between institutions, which is always the case, brokers will move to institutions where they know they can get speed to decision and same day or within 48 hours versus perhaps waiting much longer than that.

Victor GERMAN: Sorry, just one thing on that. Some of your competitors mentioned that perhaps you haven't implemented some of the changes and been delayed on that. Are you able to just confirm that that is not the case and you've implemented everything that you needed to implement into processing?

Matt COMYN: Yes, that is not the case. Yes, I have heard those suggestions. And no, that is not right.

Melanie KIRK: We will take the next question from Matt Wilson.

Matt WILSON: Good morning, Matt Wilson, Evans & Partners. You talked about the front book, back book issue in your mortgage book. Can you add some colour to the [inertia] rents that exist in your deposit book? And then secondly, you've gone from spending $750 million a year on productivity and growth initiatives to now only $300 million a year, yet you aspire to maintain your technology, edge et cetera. Now, can you talk about the issues that have constrained the investment there?

Matt COMYN: Yes. I think, why don't I come back to the deposits, or maybe Alan if you want to take it. I mean on the productivity and tech side matter, I think it is a really, really important question, the way we think about it. Of that $1.3 billion, basically $1 billion of that is tech spend. We have got 5,500 people working on projects. Clearly we would like more of them against productivity and growth. We have had a big regulatory agenda. I mean, financial crime is a good example. We have got more than 1,000 people across our financial crimes team. We are spending $200 million circa cash investment in that area.

And it was one of the points that I was trying to make is that, yes, absolutely, we see that as regulatory and compliance. And when we deem something as regulatory and compliance, it also triggers a slightly different accounting treatment. We will expense a much greater proportion of that over a shorter timeframe. But we have also, the way we are trying to pivot that spend is making sure that where we are building sustainable assets, which do not just deliver benefits in the context of say financial crime per se, but also have additional benefits in the context of having high quality at-source information, which you can flow throughout the organisation reliably and reconcile, it is valuable.

Absolutely, would I like to be, once we have got to the level of management of non-financial risk that we think when we should be delivering, move more of that investment into productivity and growth. Absolutely. And the second part of that equation is would we be prepared to invest more into our technology because we see it as the heart of our competitive advantage? Yes, we would. The binding constraint for us at the moment is not so much trying to constrain the financial envelope. It is all about actually access to high quality resources. And even on the portfolio that we have got at the moment, we feel like we are not executing optimally. And we want to make sure that for every dollar that we are spending, that we are getting a good and efficient return on that. And so to the extent that we are, obviously we are working hard on strengthening that, we feel that there are good opportunities to scale that, and we would be prepared to do that.

You want to talk on the deposits?

Alan DOCHERTY: Yes, sure. So yes, on deposits, obviously we called out during the time of the last cash rate reduction was around a $160 billion dollars of deposits that we could not reprice due to the low levels of interest rates. One of the interesting things, though, that you have seen in this result is given the really strong growth in both transaction and savings deposits, you have seen a substitution effect between term deposits, your obviously higher yielding and lower margin, and lower yielding and higher margin transaction and savings accounts as customers increasingly value the convenience and functionality of the transaction at-call online accounts. And so that is one of the reasons our net interest margin has held up pretty well over the past six months. Our substituted both more expensive, less expensive forms of deposit funding, that has also allowed us to retire some expensive wholesale funding during the period.

And so yes, deposit pricing is going to continue to be an issue in a lower rate environment, but we have seen some pleasing momentum and underlying customer deposit growth.

Matt WILSON: I actually didn't mean that they were in the deposit book. There would be instances where your back book in deposits are earning much less than what the current rate would be if they are a new-to-bank customer today. This is something the FCA is currently investigating in the UK. Given the nature of our policy development, we'll probably copy them. Can you comment on that one?

Matt COMYN: Yeah, look I understand your question Matt. I think one of the issues for banking, as it is for every other industry is, to what extent is it acceptable to have promotional offers, rates to attract new customers. In any highly competitive market and industry, competitors will compete for new customers. Now, that has to be done in a way which is not unfair to existing customers and of course, does not come up with your second order effects.

I think in deposits, there has certainly been less attention on that as an issue and hence why I focused more today in and around home lending, that is another area that we look at. It is probably, I think overall at an industry level, it has probably reduced. There are a relatively small number of products where there is a pricing construct that is quite different. And yes, you are right, any of those regulatory environments, we watch closely. There will be a focus in a number of these areas, but I think as much around awareness, as there is a focus around sort of vulnerability of customers, we have got a lot of work underway there and so we try to as best we can, understand and get ahead of those sorts of trends.

Melanie KIRK: I will take my next question from Andrew Triggs.

Andrew TRIGGS: Thank you, Andrew Triggs from JP Morgan. Just following up from your comment there, Alan, on the substitution effect, do you see this is a long life in tailwind coming halves or is it sort of mostly been achieved in his half? And the follow-up question just on term deposit pricing. From what we can see, it hasn't led to a lot of pulling down of rates in the term deposit market. Is that something that you would naturally expect to follow later on?

Alan DOCHERTY: Yeah. I mean, if you have a look at the average balance sheet disclosure, you will see the felt effect in the net interest margins during the current half. And so yes, I am not viewing it as a tailwind in the future periods. We did well in the current half on that basis. And sorry, your second question?

Andrew TRIGGS: Just whether that substituted effect then leads to better spreads on term deposits for the Bank, as in there's less money chasing term deposits, can you pull those lower?

Matt COMYN: Yes, I think what we have seen, particularly if you look at just TD pricing, last year, when rates moved and the yield curve moved, that put a lot of pressure on TD margins. They really contracted. I think you have seen, as a function of that, TD prices moved down over the course of calendar 2019 and the customer forum that I had in Brisbane, it would have been 70% of the customers there were asking about their TD pricing, not their home loan pricing. So I think for customers out there, they are feeling the impacts of the low interest rate environment quite sharply. So I think we are very conscious of that.

If you look at TD pricing, it has come down quite substantially across the market as you would expect it to given rates. A little bit of substitution out of TDs, not much though in terms of our customers chasing know other sort of high yielding investments, equities, et cetera, maybe at the margin, a little bit of that, probably less mix shifting between transactions and savings accounts, given a low rate environment, probably overall it helps the transaction balance growth.

Melanie KIRK: We will take the next question from Andrew Lyons.

Andrew LYONS: Thanks Andrew Lyons from Goldmans. Just two questions. Firstly, your IB&M NIM was down 10 basis points in the half. I just wondered, just how much of that related to portfolio optimisation that you are doing within that division versus the broader competitive market? And then secondly, you've also spoken about being relatively underweight in commercial banking and the business lending within the Business and Private Bank went backwards in the half. Could you perhaps just talk about strategies you have to rectify the market position and what the competitive environment looks like in that space?

Alan DOCHERTY: Yes, in terms of the institutional banking margins, we have seen a couple of things in there. So firstly, that lower earnings on our equity, we transmit that to each of the business units and you see that manifest in the IB&M results, or that is certainly in there. We have also got a bit of a switch of revenue between P&L line items in this period. So we have got lower yields on some of our commodities' financing income, and that is offset by some stronger performance from a mark-to-market perspective that you see come through other banking income, so you see a bit of a gross up of a netting between net interest income and other banking, particularly in this current period.

Matt COMYN: And in commercial lending in particular, I mean nothing untoward, there is probably just a higher level of runoff particularly in the last couple of months. I think we would describe, I mean our overall business lending is okay. Clearly our aspiration would be slightly stronger performance there. I think look, it is a combination of I think we can improve our offering. I talked a bit about Business Express and just faster speed to decision turnaround time, particularly for sort of sub-million dollar loans. There are a number of things that we are working on and we will continue to.

We have got a very good customer base and deposit franchise in business lending. We have historically not been able to convert that into the commercial lending opportunities that would otherwise be there and obviously it is going to be a very competitive context in that particular area as well.

Melanie KIRK: I will take the next question from Brendan.

Brendan SPROULES: Hi, it's Brendan Sproules from Citi. I just wanted to ask about your consumer finance revenue volumes and margins this particular period. Just the volumes have been falling for a number of periods and obviously you are now investing in Klarna, but you've also launched a debit card which I imagine somewhat competes with credit cards. So just the outlook for volumes, but also what sort of pricing initiatives did you take that revenue obviously grew even though volumes fall and have you sort of included that in your forward margin guidance when you talk about sort of announced repricing or is that something different?

Matt COMYN: So let me talk about consumer finance. You are quite right, I think it is one of the sort of softer areas of performance and maybe I will just talk about it in a couple of different ways. So I mean, if you look at cards business and both of them have been strong contributors to profit and profit after capital. A number of different changes, I think there is a structural shift that continues away from credit to debit. I think buy now, pay later is an element of that, but frankly, that was under way before then. A number of regulatory changes domestically in the context of both no longer able to offer credit limit increases. We used to run, for example, our cards business, a pretty conservative line assignment and credit limit worked very effectively, we think for both customers as well as overall returns. Obviously changes around responsible lending, particularly the amount of repayment that you need to include in the application process.

So there are a number of things that have tightened, interchange has come down. So I think the proposition in Australia, vis-a-vis other markets, is cards actually are not falling substantially in a market like the US, for example, have a much higher interchange. So the Ultimate Rewards Card, we want to have a better product available for transactors. We think the structural shift there in the context of debit over credit, Klarna is part of that. But there is, I think, more to it. And then on, so I see it as demand and supply. And then on personal loans, more of a bias towards tightening a combination of both the, probably the regulatory settings, it has similar application rates, but actually our approval rate is quite well down.

One of the things that we are thinking about in the context of that is our overall pricing strategy, as you would expect. We see that as an area of real focus, it has been a real strength for the best part of a decade and in the last period, for a number of those different reasons, has come together to be a soft point.

Alan DOCHERTY: In terms of the margin applications of consumer finance, I mean one of the things you will see as well, there is a mix shift within the credit card portfolio from growth and some of our newer, low rate card products. And so there is, if you like, an offset within the mix of that consumer finance portfolio. So I would not even expect to see material margin tailwind from that.

Melanie KIRK: We will take the next question from Brian.

Brian JOHNSON: Brian Johnson, Jefferies. First is congratulations on the actual execution, which has probably got not much to do with where the share price is, but it is very noticeable you're out-executing your peers. Two questions; the first one is that when we have look right at the back slide, 127 and the following slides, there's a lot of stuff about share count and the value of franking credits. And also when I have a look at the NIM slide, I can see a fairly substantial NIM headwind coming forward. And it's not unreasonable to think that EPS and DPS is going to fall. The argument between maintaining the dividend versus off market structured buybacks, I'd just be interested if we could just get an explanation of how you think about maintaining a dividend in the face of earnings falling and saying that the share count is going up versus basically reducing the share count by more by doing a bigger structured buyback? It kind of seems if you're running a private business as opposed to a public company in Australia, all that matters is dividend, I think you'd be opting for a buyback, except the share price is too high.

So I'd be interested if you could explore that then the second one is, an even more esoteric question, slide 61. For the first time I can recall you've actually disclosed your cost of capital at 10. You are always sitting at 12.7. If we were to go back last year, we saw an environment where basis risk rose and all the banks used that as an excuse to basically disenfranchise the back book housing by increasing the rate. Basically as we saw basis risk improve, basically, we didn't see any banks passing it back on. The central issue on Australian banks remains, have you got the pricing power to keep on raising basically back book housing rates, particularly now that you've told us your cost to capital is 10. You're doing an ROE of 12.5%, I'm just wondering, I'd like to get a feel how those dynamics play out.

Matt COMYN: Why don't I take a stab at both of those, Brian, and I will throw to Alan. Maybe the second one first. Yes, cost of capital, a number of people, I think particularly you have been asking for that for a while. So we decided to include it. I think it has more of an impact, frankly, in our businesses like Institutional, where obviously there is pricing, and we have elected to keep it above the way we would calculate our cost of capital at this point in time because we want it to drive, and I think Andrew is doing an excellent job of having a lot of discipline there.

I do not really want to speculate too much about pricing power, particularly as it relates to home lending. It does not have a huge impact on the day to day management of the other businesses. In the context of price setting, that is an area of huge focus for us in terms of making the best decisions for our customers and for the long term.

Then maybe going back to the first part of your question. Yes, look, that disclosure towards the back of the slides. I mean, clearly management of the share count has created value in the context of CBA, where we are very conscious of that. But I guess to go to your broader question, how do we think about the context of potential capital management, dividend, dividend sustainability, I mean, between the management team, and I obviously have this regular discussion with the Board, we sort of think about it over multiple years of projection. What level of credit growth are we assuming? What do we expect is happening with net interest margin? You are right. You are quite right. We assume base case interest rates are going to stay low for a long period of time. We have got a big headwind that is coming. But we feel that there are a number of things that we can still manage within that, including our expense line.

We think a lot about the organic capital generation, some of that is our business mix and our settings. That is one of the strengths that I think of this result with 37 basis points, notwithstanding a high payout ratio, it is a very good organic capital generation. That is one of the reasons why our share counts have been able to remain low.

So we have factored that all into the way we think about potentially capital management as well as the dividend decision each six months. And based on all the information that we have in front of us today, we feel very comfortable that the appropriate decision has been made. I think Alan set out some of those considerations. If at any point, and yes, absolutely, it would not be an insignificant move to reduce the dividend for the Commonwealth Bank, given the broad retail shareholder base. But if at any point in the future we felt that it was in the best interests of the organisation, then we would do it.

The other factors I would add in would be obviously credit outlook, movement and risk weighted assets, et cetera. So we have done that modelling as you would expect, going out multiple years and tried to consider all of those factors.

Alan DOCHERTY: Yes, I mean, in the additional disclosures, Brian, what we are really trying to do is give people a sense that we are very focused on earnings per share and dividend per share, there is both a numerator and earnings component to that. There is also a denominator and share count component to that. That goes to the capital intensity of your earnings, and how much franchise capital generation you can provide, subject to a certain level of payout ratio. So it was more to give a sense that we are very focused on both aspects of earnings per share and dividend per share.

Melanie KIRK: Great. Thank you very much to everyone for joining. That brings to the end our briefing. If you have any follow up, please come back to the Investor Relations team. Thank you.

END OF TRANSCRIPT