COMMONWEALTH BANK OF AUSTRALIA

TRANSCRIPT – 2018 HALF YEAR RESULTS BRIEFING

FOR THE HALF YEAR ENDED 31 DECEMBER 2017

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Melanie KIRK: Hello, and welcome to the Commonwealth Bank of Australia's results briefing for the Half Year ended 31 December 2017. I am Melanie Kirk and I am Head of Investor Relations. Thank you for joining us for this briefing. This morning we will be hearing from our CEO Ian Narev and our CFO Rob Jesudason. This will be followed by the opportunity for analysts and investors to ask questions. I will now hand over to Ian. Thank you.

Ian NAREV: Thank you very much Mel. Good morning, all. Thanks for joining us for the discussion of our results for the period ending 31 December. It has obviously been a big six months for the CBA. And it has been a six months characterised by a lot of additional activity, particularly in the world of regulation and compliance. And I just want to start by acknowledging that and saying, we did bring a lot of that on ourselves and we did so by just not reaching standards that others expect of us or, for that matter, that we expect of ourselves. And that caused reputation damage and you can also see some obviously financial impact of that in this result. And I think any discussion of the six month period, any discussion of the results needs to start with that. We acknowledge that, we are already doing a lot of work to fix it, and obviously that work is going to continue into the future.

At the same time, as we were devoting a lot of time and resource and energy to all of that, there was understandable concern from stakeholders, from observers, about during that period in the AUSTRAC proceedings and Royal Commissions and the APRA inquiry and CEO succession, whether the business would be able to keep focused at the same time on what it has always been focused on. And from that perspective, I would say that the focus and the dedication and the pride of 50,000 people really shows up in this result. Because in addition to highlighting what needs to get fixed, it really did highlight the fact that people stuck to what they know to do, what they love doing, which is serving customers and running a financial institution. And as a result of that, even with everything else going on, the underlying business momentum of the Commonwealth Bank remained really strong. We maintain very high levels of customer satisfaction which kept customer activity high. We kept up the disciplines on margin management, on credit quality, strength in the balance sheet. We kept innovating and investing for the future. So while we were doing all that fixing and have more work to do, we can just see really strong underlying momentum of the business.

That you can see underneath the headline results, so the headline level, and this is on a continued operations basis: you can see statutory profit up 1.2%, cash net profit after tax down 1.9%, corresponding cash earnings per share down 3.2%, a cash ROE on the base of that cash NPAT at 14.5, and then a slight uptick in the dividend $0.01 up to $2.00.

Now, particularly for this audience I need to acknowledge and apologise for the fact that this isn't quite as easy to understand a result as some of them have been in the past. And just to be clear on that and to sort of the scene, and Rob will go into this a little bit more because I am not going to make too many of these distinctions. We have got the usual distinction between statutory NPAT and cash NPAT, which you all know well. The slight challenge on this period is because we wanted to make sure we took the AUSTRAC penalty provision above the line, and extra program costs above the line, and we have got this accounting standard difference between continued operations and discontinued operations; that cash NPAT line isn't really quite as clear a view of underlying performance as it might have been in the past.

Now underlying performance is ultimately up to you to judge. You take your own view on that. If you want to know what we think about underlying performance, it is really saying you take that cash NPAT line, you add back the $375 million provision for what we currently expect to be the court-dictated outcome of the AUSTRAC proceedings, and then you adjust for Aussie Home Loans and a couple of prior one-offs which you know in the previous period.

One thing I do want to point out that there is also, as you know, a $200 million provision relating to remediation program legal costs for all known regulatory and compliance issues. We have kept that in the underlying number. And that is not because we think those particular line items are necessarily going to continue, but because we accept that we are in an environment where the demands of regulators, the demands of other stakeholders, are probably going to remain pretty high. So as Rob talks about underlying momentum, he will take out the provision for the AUSTRAC fine, but we will leave in that $200 million.

To come back to what I said before about certainly the way Commonwealth Bank people have felt during this month about the task at hand. It has very much been maintaining the focus on the strategy that has been going for the last decade. And there remains a lot of discussion and appropriate discussion about our businesses sufficiently long term and how they've managed. And you look back at the underlying performance of the Commonwealth Bank over the last decade. And it is very important just to track how the Bank has progressed during that time, very significant improvements in productivity measured by cost to income ratio, and this 40.8% number is off the underlying number.

We have kept investing for the future and, yes, our regulatory and compliance costs have gone up and that has been part of the increase in investment. The other part has been an absolute commitment through the cycle to keep investing in our people and our technology. Customer satisfaction has gone up from four to one. And then if you look at the balance sheet strength and you actually take the metrics, we have got common equity tier one here, but you also look at the tenor of wholesale funding liquids, the deposits as a proportion of liabilities, it is just a demonstrably stronger balance sheet than it was 10 years ago. And at the same time with everything that has gone on, we have maintained sector-leading dividend DPS growth and sector-leading total shareholder returns.

In this result, moving back now to the shorter term: we can see these signs of really positive operating momentum. So the operating income at 4.9%. Operating expenses we have shown you here what the BAU expense roughly would be, which is that 2%, but as I have said, we consider that 4.7% to be the underlying expense momentum, and then 5.1% for operating performance. And then to come back to the points that I said before, and Rob is going to talk a little bit more about the work that he and his team have done, which I think in light of the events of the last few days has an even more significant context. Deposit funding up, LCR up and a strengthening of capital. And at the same time you can see here ROE obviously down. If we add back the provision for the AUSTRAC penalty, that is 15.7%, enabling us to keep the dividend a little bit higher than it was last time around.

In terms of where these profits go, 72% of it this time paid out to the 800,000 Australian families who own us directly and the millions more who own them through their pension funds. And then beyond that we are the second largest taxpayer for the period in Australia, and then retaining the balance as you would expect to keep strong and keep being able to support our customers well into the future.

The strategy descriptions of our performance, whether it is here with you or whether it's in the boardroom or whether it is our people, has always got to start with how the customer is feeling. If we go to the measures that we have used consistently over the last decade, we can see that on all of the key dimensions we are first or first equal on that customer satisfaction measure, particularly important here on internet customer satisfaction, which I will come back to.

But this is the first period where we have seen the move also to use of the Net Promoter Score and I foreshadowed this, you might recall, six months ago. The rationale for moving to the Net Promoter Score was to recognise that even as we have really been happy with the level of overall satisfaction going up and up and up over a decade, we did need to focus ourselves more on the root causes of dissatisfaction, and the Net Promoter Score enables that. And you can see here that it is positive, it is the most positive of the major banks. But I would say a couple of things here, number one is that 4.4 is not a good enough number, and I have no doubt that Matt and his team will be really focusing on driving that up, because the number needs to be higher and particularly in a world where people are judging their experience not just by relative to other banks but by other new players in the industry. And the other thing you can see in business banking, it is not at the level it needs to be. It is a more volatile measure that you'll see in the materials, but we are not at number one in business banking and a lot of work needs to happen in that business.

Beyond just the normal benefits of continuous investment and the frontline continuous investments in technology, we have done a lot in this period just focusing on better outcomes for customers. And you will recall that a couple of years back, we really put financial wellbeing as the absolute core of Commonwealth Bank's vision and in this period a lot of work has been done really focused on financial wellbeing and translating it into real customer outcomes.

Leading the industry in cutting ATM fees, reorienting our frontline remuneration practices to make sure tellers are rewarded on service and less on sales. Maintaining our commitment to keep our call centres here. And that is not because we are favouring customer service over productivity, we actually think the two things go together. Better customer experience, better productivity.

And then a number of different other initiatives for our customers, and I wanted to highlight this because the fact that since the launch in October 2017, 2,700 customers have accessed this Domestic and Emergency Violence Assistance Package, just shows this is a scourge on our community. This is one number where the uptake of it is a real disappointment for us because it means there are that many people who need the help, and that is only a proportion of them. But just one example of where we are committed to do whatever we can where we have capabilities to bring to bear on improving really serious problems out in our community.

The investment and technology has continued to pay off, not in terms of promising and talking about what our technology may or may not be able to do, but on real customer outcomes. And you can see a couple of examples here, the Ceba chatbot through our Australian business, and then the Tyme coach for financial wellbeing in South Africa.

One of the aspects of this result we really do want to call out is that through this period and for the remainder of this year, you are really seeing the benefits of our businesses offshore, not just building business models in those markets, but being an R&D hub for the Commonwealth Bank to bring back into our developed markets.

So there have been interesting examples like the first commercialised blockchain solution in South Africa, which is an experiment we have run and can now scale up enabling us to actually give the customers their own digital identity for use on the blockchain where they are in control of it. And you can see that in coming months the leading in-branch kiosk technology we have developed in South Africa is going to be rolled out in all of the branches in ASB. So beyond what we are doing within those markets, we are seeing the signs of building capability in those markets for application back in our home markets and starting to disrupt ourselves.

I have talked already about strengths, about the positive movements in the balance sheet that Rob will talk more about. Also just worth reflecting on how much has gone on in the Commonwealth Bank portfolio over the last number of years. So the strategic review of Global Asset Management is continuing, as we said it would, preceding the timetable that we had initially envisaged. Nothing new to announce on that, except to say that the work is ongoing.

In addition to talking about how the business maintained momentum through the additional regulatory and compliance challenges, we also managed to do a very successful divestment during that time, the sale of our Australia and New Zealand life insurance operations to AIA, we expect that to close during this calendar year. And then you can just see closure of the Vietnam branch, closure of the Mumbai branch, sale of the County Banks, all happened through this period, and then a couple of other examples that pre-date this time. So looking not only at the balance sheet strength but also making sure that we are optimising our portfolio to suit the times.

In terms of the regulatory and compliance activity that I have spoken about, I have mentioned that we took the $375 million provision being our best estimate of the most likely court outcome in those proceedings. A lot of work has continued, and obviously as we have said, started before the proceedings have issued, but continues at pace in our program of action strengthening policies, systems and processes.

I would just reiterate what I said six months ago based on further work that has been done, no evidence of deliberate misconduct was alleged by AUSTRAC and none of it has been found by us as we've done our work.

You saw last week a progress report from the APRA Inquiry. We continue to work very hard to be as co-operative and transparent as we can. Engaging constructively with ASIC on all matters, and then engaging actively, as obviously all the banks are in the Royal Commission. But also using as an opportunity to what I said before, to review what we have been doing, feedback into ways that we can do better and become a bigger bank, a better bank, sorry.

I will now hand over to Rob to give you a bit more detail on the financials.

Rob JESUDASON: Thank you. So unusually for us, it has been a bit of a noisy result. And I will take you through some of the one-off items that have impacted the result in the last six months. However, I do want to stress, we have had really strong underlying performance. And that is another period of positive jaws on a underlying basis, but also very strong volume margin management across the portfolio. Six months ago I spoke about adjusting to the new environment and in this period we have been very selective about where we grow. We have also been optimising the portfolio. We have strengthened our capital ratios, our leverage ratios and we have extended our wholesale funding duration.

But there are some areas that we continue to focus on, and I think there continues to be an opportunity. One is clearly cost and efficiency. We have made good progress in the half. But going forward, that is one of the biggest areas of opportunity. Optimising the portfolio, and today I will also spend a bit of time talking about IFRS 9 and the adoption of IFRS 9 on the 1st July 2018.

So if we reconcile between reported and the underlying result, firstly if we start with CommInsure. In September we announced that transaction. That transaction is signed, but not completed. But for accounting standards, what we have to do is treat it as discontinued operations. So in the Profit Announcement you will see continued operations and then CommInsure taken out of that result and it appears as a single line in discontinued operations. As we talk about underlying performance, we have stripped that out.

Secondly, in August we completed the final 20% acquisition of Aussie Home Loans. So that business is no longer equity accounted for, and it appears in the full P&L and balance sheet, but for underlying purposes, again, we have excluded it. Ian mentioned that we have taken a provision for $375 million. That is our reliable estimate of what a court would fine in terms of a civil penalty. It is in cash NPAT, so i.e., it is above the line. But for the purposes of underlying performance, we have taken that out. Then lastly, a year ago we had the impact of the Visa share sale and also the impact of accelerated amortisation of software. So on an underlying basis we have stripped that out.

So on an underlying basis, operating income up 4.9%, operating expenses up 4.7%. That led to operating performance up 5.1%. Loan impairment continues to be very benign. LIE 16 basis points in the half. The cash NPAT is $4.735 billion down 1.9%. Now if you strip out the impact of the penalty provision, on a continued basis cash NPAT would be up 5.8%.

Turning to operating income up 4.9%. NII, this is where you can really see the volume margin trade off story coming through, volume up 3.5%, margins very strong up six basis points. Other banking income flat. So lending fees, and those are effectively line fees in the business bank and also we had higher structured asset finance sales. Offset by lower trading income. Sales was strong, but trading, our revenues were lower and that's really down to lower volatility in the half. Commissions down $37 million, that is the impact of lower interchange fees and also the three month impact of abolishing ATM fees. Funds and insurance up 6.3%.

If you look at our home lending growth, you will see that we let, our volumes were below system, so 5.2% against 6.3%, but we chose to grow in owner occupied, so that was up 7.5%. We did grow in investor but that was only up 0.5%. Now the reason for that was to meet our macroprudential obligations around interest only flows and so you can see six months ago we had 38% of flows in interest only and now that is down to 21%.

In apartment development, and this portfolio really sits in the business bank, again we have cut our exposure in that area. Now those loans are generally two to three year loans, so that portfolio rolls off relatively quickly and in the last year, our exposure in that segment is down 23%.

Margins up six basis points, asset pricing up five basis points. Now this is the full effect of the home loan repricing that we had in May and July last year.

Funding costs are down three basis points. That is the impact of the Bank levy flowing through for the first time in this result.

In capital and other, up three basis points. We had a one basis point benefit in basis risk, so that is a narrowing of the spread between the cash rate and BBSW. We had improved margins in New Zealand and we held lower liquids in the period. So that had a one basis point positive impact.

So NIM at 216 basis points. Ian mentioned BAU costs up 2% and to reconcile from the 4.7% to the 2%. If you strip out the provision for expected compliance legal regulatory spend of $200 million, but you have to add back the benefit we received of $64 million for the in period benefit of software amortisation.

In the Profit Announcement, if you just strip out the $200 million, you will get to a number of roughly 0.7%. And you can see productivity is offsetting staff costs, but we continue to invest through the cycle. So investment spend in technology in the half is up 19%.

In Retail Banking, very good volume margin story, home lending up 4.8%, deposits up 3.9%, margins up 10 basis points. That is the home lending repricing flowing through offset by slightly lower margins in consumer finance. Cost income very strong at 30%, positive jaws of 3.3% and NPAT up 7.7%.

Turning to Business and Private Banking; very selective growth on lending. We grew in agriculture and health, respectively 7% and 8%, but the roll off of those apartment developments had a -2% property growth in the period. So business lending up 1.4%, very strong deposit growth. Margins up five basis points. Now you will remember that BPB has quite a large home lending book that really sits in the private bank and SME. So you can see on the revenue side that the private bank revenue up 18% and that is the investor home lending book. But also on margin in business banking, lending margins stabilised and deposit margins were also fairly stable. So revenue growth up 5.4%, good productivity in the business, so expenses only up 0.3% and NPAT up 9.3%.

Turning to the Institutional Bank; another period where there was active portfolio management. Credit risk rates now are just under 16% lower over the last 12 months. Margins are down seven basis points. Now you recall with the bank levy that we treated that as a funding cost, so you see that flowing through into this result. Institutional banking revenue down 1.8%, markets down 13%. So 12 months ago we had the impact of both BREXIT and the Trump effect, that led to greater volatility in markets. So that was a particularly strong markets period and you are seeing the relative impact in this half. So revenue down just under 5%, expenses well managed down 1.6% and NPAT down just over 13%. Now provisions were up and when I talk about LIE I will refer to that.

In Wealth; very strong market so both AUM and FUA strong performance up 8.7% and 10% respectively. Insurance income down 24%, now that is really driven by insurance claims in the first half, which was the impact of the Victorian storms. So revenue up 6.2%, expenses down 2.8% as wealth remediation rolls off and NPAT up 33%.

So impairment, very benign, another year of benign LIE, it has really been pretty stable around 15, 16 basis points since FY14. Consumer slightly lower by one basis point. In corporate you will see an elevation of 10 basis points in the half. Nothing systemic or thematic in the portfolio. A couple of idiosyncratic losses. But you should note in the second half 17 LIE was very low, and that was really a series of write backs on provisions that we took a couple of years earlier particularly related to both dairy and oil and gas. So LIE in the corporate book pretty much at the levels it has been in the last two or three years. Arrears very stable in personal loans and credit cards over the last couple of years. In the last six months home lending arrears have stabilised. Their elevation in the portfolio continues to be from Western Australia.

In terms of provisioning, the benign environment really rolls into both the collective and individual provisions. So corporate, a slight reduction. A slight elevation in consumer. But in this period we have taken $100 million for increased management overlays.

I will just spend a minute on the impact of adoption of AASB 9. Now the implementation is only on 1 July 2018. So it is important to note there is no impact in this financial result. But I wanted to take you through what the impact could be if it was applied to the June 2017 result. It would equate to approximately an increase of provisions of $850 million. This increase is only in the collective provision. So the adoption of this accounting standard has no impact on individual provisions. It is also important to note that it has taken through retained earnings when you adopt. So there is no P&L impact. And if applied on June 2017 it would have roughly a 25 basis point CET1 impact.

Now the reason for the increase is this accounting standard requires you to take forward looking factors into account. So we design models and they are based on various scenarios that you weight. And in those scenarios you take a forward looking view on GDP, on factors like interest rate, household debt, unemployment, and then you weight them, and that flows through into the results. So that is what leads you to this estimation of approximately $850 million.

Turning to funding and liquidity: very strong. Liquids at $139 billion. LCR 2% to 131%. Now it is important to note from 1 January we have agreed with APRA an increase of the CLF of $5 billion. That would have a positive impact on LCR roughly 4%, and NSFR of just over 1%. So that is hugely positive. And that will allow us to look at managing our liquids down in the coming periods. Deposit funding very strong, up at 68%, transaction account growth just under 15% up, and NSFR now at 110%.

Now six months ago I talked about our strategy of going long on wholesale funding. And there were two reasons for that. One is we had very benign funding conditions. The biggest impact is actually on managing your average maturity in your portfolio. So over the last few years we have had roughly $28 billion of maturities. When you factor in balance sheet growth that has meant that average issuance has had to be around $33 billion. In FY17 you will see from the Profit Announcement issuance was $45 billion.

Now by going longer that spreads out your maturity profile. So in the coming years average maturities will be down at $24 billion. This allows us greater flexibility of when we issue and where we issue, particularly in a higher interest rate environment, and also if there is greater volatility in markets. And we have seen in the last week what volatility can look like.

Now the impact in this period to wholesale funding costs has been negligible and that is because of two factors. Absolute spreads have come in. And also the spread between 30 year bonds and 10 year bonds have contracted to lows post the GFC, and between 10 years and five years.

So in terms of issuance, average new issuance has been at 8.9 years and we have taken the weighted average maturity of the portfolio up to 4.6 years and 63% of the portfolio is now long term wholesale funding.

Capital very strong at 10.4%. Now the impact of the AUSTRAC penalty is roughly 10 basis points, very strong organic capital generation. I will just talk to a couple of numbers here. On operational risk weights, we have increased them by $7.5 billion. This is to reflect the current environment in risk and regulation, and we have had discussions with APRA as we have made these changes. That has had a 17 basis points impact.

In terms of interest rate risk in the banking book, that has had a 15 basis points impact on capital. There are two reasons for that, one we are holding more capital and then secondly, as we go longer in terms of our positioning of the balance sheet for higher US interest rates, we’ve held US treasuries and that has had an impact on IRRBB. Leverage ratio very strong at 5.4%.

The strong operating performance has enabled the Board to announce a dividend of 200 cents. That is $0.01 up on the prior comparable period and the payout ratio is 72%. So with that, I will hand back to Ian for the outlook.

Ian NAREV: Thank you very much Rob. Well it is certainly is an interesting week in which to be talking about an outlook. I think the starting point as we look ahead, is if you look at global developed economies, as well as the Australian economy at the headline macro level, the underlying trends and momentum are pretty good. GDP is growing at or around trend above in some markets. The trends for unemployment look positive, and a lot of the tail risk that has been talked about from a macroeconomic perspective probably look a little bit better now than they certainly did one or two years ago. So the underlying macro backdrop actually looks pretty good.

Underneath that, of course, we have got to go back to this fundamental economic driver of confidence. There are really a couple of things which we really all do need to keep our eyes on. Number (1) is just market volatility, even in the face of relatively strong macroeconomic stability. And all of you are obviously aware of the drivers, but as central banks and federal reserves, et cetera readjust following a really unprecedented period of expansion, the markets making certain assumptions as to the pace and the steepness of the interest rate rise and if there are any signs that the assumptions might be slightly off, we are going to get periods of volatility. They are inevitable. The longer those periods of volatility last, the more they will impact confidence. So that is certainly trend number one that causes a bit of a wariness against the positive backdrop.

Trend number two, that causes a bit of a wariness is that the fundamental strength in the macro trends is not finding its way yet in developed markets into wage growth and increase household income. It is naturally going to supress families' feelings of wellbeing and economic confidence. So I think against that macro backdrop, we just need to be wary of those couple of risks and the impact that they may have on the confidence in the short to medium term.

As to how the Commonwealth Bank will react in that environment, well that is obviously not up to me. I can assure you, it is in absolutely excellent hands and

I am very confident that it will continue to really keep its eyes on the long term into the future.

Mel over to you.

Melanie KIRK: Thank you Ian. We will be taking questions from analysts and investors during this briefing. We will be starting in the room and move to the phones. To ensure everyone can hear you, please wait for the microphone. State your name and the organisation that you represent and limit your questions to two questions. We will start with Andrew Lyons.

Andrew LYONS: Thanks Andrew Lyons from Goldman Sachs. Just two questions if I could. Firstly just on the IFRS 9 adoption and the 25 basis point capital hit, would have expected more of a buffer from the GRCL and the regulatory expected loss. Can you maybe just talk through the workings of that and if there is any offset as far as the capital impact is concerned?

Then just a second question on the margin volume trade off in the Retail Bank. You had 10 basis points of NIM expansion in RBS versus continued subsystem growth, albeit I think the quality of that growth has continued to improve with the propriety channel. Can you maybe just think about, is there a need now to perhaps reinvest some of that margin strength back into volumes?

Ian NAREV: Let me address the second point first, then Rob you can talk about the IFRS matter. I do think it is really important, again this is a five or six year view of that volume margin balance and the reality is certainly over the time I have been at the Bank and been sitting here, every so often we have one of these periods where people say, you seem to be growing too fast aren't you thinking enough about margin. Then later you seem to not be growing fast enough so you are overdoing margin, and the answer is always it is a balance.

We have been in a period particularly over the last year where there has been macroprudential limits, a lot of different forces at work in the market. And right across the Bank, Matt and his team, Adam and the business bank, Kelly, Rowan Munchenberg and Bankwest and then through to ASB have just kept thinking about that trade off. I can only repeat what we have said before, we do not sort of work to hard lines and the level of market share, we will not drop below or above every time we are achieving this balance. And I think the really important observation is the one that you made, is there is a real focus on the quality of the growth in the business. That is a combination of margin, of channel and of credit quality.

Rob JESUDASON: On your question, there are two major impacts through the adoption of IFRS 9. One is the lifetime expected losses on stage two loans and also these forward looking macroeconomic factors and depending on the balance of that, that is how it flows through into your increased provisioning and then obviously the impact on capital.

Melanie KIRK: We will take the next question from Craig Williams.

Craig WILLIAMS: Thank you. Craig Williams from Citi. I have two questions as well. Is it reasonable to assume that the $200 million in regulatory costs that were incurred in first half ’18 would otherwise sort of likely have been ordinarily spent on the business in terms of efficiency or growth initiatives? Is that sort of the message you’re trying to say by saying this is part of the underlying expense profile of the business?

And the second question, you’ve talked about a reliable estimate on the legal fine, what sort of factors have been considered in determining this number please?

Ian NAREV: So on the two questions: I do not think we are calling it out in underlying, because we said otherwise it would have been spent on something else. I think we are saying that that for a period for us, because as I said at the start, some of this is undoubtedly unique to us but also for the banking system, there is going to be a certain level of this kind of expense which we expect it to be around for a while in one way, shape or form. We have really done our best as the CBA over time, not to let regulatory and compliance spend crowd out good productive innovation investment and other investment, but the reality is there is only so much people can get done. And the constraints have been historically less about the money and much more about the fact that we just want to make sure that we embed the change through the investments. Whether it is regulatory and compliance or a new customer experience.

In terms of the second question, the accounting standard really requires us to do a couple of different things. Number (1) is form a view on where the money is likely to go out the door as a result of this event. The moment we filed our Statement of Defence and clearly as we have said all along, there are a bunch of things in there which we did not do well enough, we have reached a conclusion that it is going to cost us some money. The standard then says can you make a reliable estimate, and in doing that we take into account everything we know at the time and obviously a big part of that is what our lawyers are telling us what they would expect to be what a court will determine as the civil penalty if this reaches a conclusion. That is the basis of the judgement call.

Melanie KIRK: The next question from Jon Mott.

Jon MOTT: John Mott from UBS. My question is to Matt. So I've actually had this question before in the last couple of years, but it's getting a bit more extreme. If you look at the NIM in the Retail Bank, you've just cracked 3%, 3.01% and in absolute terms that's the highest NIM you've ever recorded in the Retail Bank including before the financial crisis when rates were above 7%. If you back out given you give us the risk weight, and you can apply some other capital deductions; it implies the ROE is north of 30% in that business. So the question then becomes, are these returns of 30% ROE and above 3% NIM appropriate for the largest Retail Bank in Australia? So balancing the shareholders versus the other stakeholders.

The second question, and this goes back to what you were just commenting on, the potential provision for the fine, have you had discussions with AUSTRAC or any other counterparties, or is that based on your own lawyer's advice?

Ian NAREV: Let me answer the second question first and Matt can take the first one. I am not going to comment any further on what discussions we have had with AUSTRAC. We have done what we are required to do which is take into account everything we know and make a reasonable estimate.

Matt COMYN: Yeah, thanks John. So, on the first question on Margins. So, clearly in the period there were a number of things that were very favourable. One of course the interest rate repricing and home lending from both the May and July flowing through are very good conditions from a funding perspective. If you look, I guess, back, clearly there has been quite a bit of expansion on the asset side of the book. I think also when we talk about how we have actually positioned and the selectiveness of the growth, one of the things that we did when the interest only cap came out, was we basically moved early to make sure we were well underneath that. I think we can safely say we overshot based on where the market gained. So we thought it was actually going to be quite challenging to get to sub 30% when the limit came out initially but we ended up in the low 20%. So actually that is why we grew below system. And so some of that was selective and some of that was actually also just a function of the competitive dynamics of the market.

I think overall, looking forward, and even if you look at the results more broadly, we are seeing the major banks losing share at the moment, there is a lot of competition in the home lending market. We are seeing the regionals growing at one and a half times system and of course the non-bank financial institutions. So, the volume, the question of volume margin is something that we spend a lot of attention on trying to adjust the appropriate conditions, range of stakeholders as you pointed out, and trying to get that balance right.

Ian NAREV: Yeah, the other thing I would say on this topic in general, and you know our investors and analysts have quite rightly talked a lot about the current environment, the characteristics of the current environment. And I just think people need to be very careful about drawing return extrapolations from the environment that we are in at the moment. Whatever they are, the environment we are in at the moment is one of very strong organic capital generation, very good credit quality et cetera and those things are going to move, and banks must manage themselves through the cycle.

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

Jarrod MARTIN: Jarrod Martin from Credit Suisse. No surprises I'm going to talk about volume margin trade off as well. Look, we can understand on the asset side of the balance sheet with macro potential, that seems reasonable in terms of managing that. But the liability side of the balance sheet, household deposits are high quality, and you are also growing at 75% of system in household deposits. I'm just wondering whether it's convenient to talk about the macro prudential as being the reason for the subsystem growth versus, you know, there is issues in the franchise from a momentum perspective. So that's the first question. The second question, just some clarification around the $200 million provision for costs et cetera, could you confirm that that does include any estimate of ultimately what remediation actions will come out of some of the reviews either from ASIC or from APRA, it is purely just your legal and project costs?

Ian NAREV: Oh look, on the two questions: first of all, yes, we like household deposits and we like transaction accounts, and we like them for a couple of reasons. Number (1) it is why we are here. And number (2) they are very good for funding purposes. They also have a cost in exactly the same principles that apply over time in trading off volume and margin on the asset side applying the liability side. I have seen absolutely no evidence of any fact that suggested the deposit growth was a result of anything other than our volume margin trade off and we cannot see any evidence of that anywhere else in the business.

Secondly, good question on the $200 million. You know, clearly in any regulatory proceedings, we are talking about the APRA inquiry or the Royal Commission et cetera, there is a wide range of potential outcomes. We have discussions about some of the things that we think might come out of it, we have been having that for a while. We have done our best to get going on a few things that we think are going to make the Bank a better bank anyway. So, we haven't sat down and taken a provision for absolutely every outcome we think might be likely. What we have talked about is some of the things we think might be most likely to come out of those, and in particular, where we think they are good business anyway, got on and done them.

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

Brian JOHNSON: I'd like to ask two questions. The first one, on the $350 million post-tax provision for AUSTRAC. I for the life of me can't believe that wouldn't be tax deductable? Is that because it's really $350 million after tax and you don't want to get the bad press? Or, is there genuinely, so it's really $500 million. Or is it genuinely because it would not be tax deductable?

Ian NAREV: It is $375 million and it is not tax deductable.

Brian JOHNSON: Okay. The second question is, great questions from everyone else about the Retail Banking business. But just on the Institutional Banking business: we see the margin continuing to come down. We have quite a big specific loan loss on a UK exposure. I'm just wondering (a) could you give us an explanation for why Commonwealth Bank of Australia has such a big chunky exposure to something in the United Kingdom that is troublesome? And the other one is, fantastic message on discipline today Ian, but when you have a look at that business, when you actually normalise everything, is there some kind of review you should be undertaking on the position of the Institutional Bank?

Ian NAREV: Well look Brian, you know, the dynamics of the Institutional Banking business are different from in the other parts of the portfolio and there is no doubt that particularly at this point in the cycle, and probably at most points through the cycle, it has got different return dynamics then from example the Retail Bank. I would say a couple of things: number (1) it is a critical part of what we do and why we are here. And we have clients who want to do business outside Australia and we have overseas clients who have a connection with Australia, we want to be in a position to serve them. Number (2) I would say particularly in the last couple of years under Kelly's watch, the trajectory of that business has been repeatedly get smaller. We have been cutting risk weighted assets, we have been selling down from exposures. We have raised the bar on the volume margin trade off. So the trajectory of that business is actually to keep it, because we believe in it and it is an important part of what we do, but really, have it coming smaller for some of the dynamics you have talked about.

You know, a couple of years ago we had one big period, there were privatisations et cetera, a big period of activity in Australia. We did grow the balance sheet. A lot of people were calling out the fact that the strategies seem to have changed, we have said that it hasn't. There was one period of a lot of activity at every half since then you have seen if anything, the direction be contracting the business, it is for a number of different reasons. So we are committed to it but it is getting smaller.

Brian JOHNSON: [off mic] And Ian, some justification for this big exposure …

Ian NAREV: Well I am not going to go into individual exposures Brian, except to say, in any business in an institutional banking business, you are going to get some lumpy exposures. The question we always ask ourselves is, we go back and ask ourselves why was the decision made?

And in certain cases we get a lumpy exposure, you find it is a legacy exposure that wouldn't have been originated according to the strategy or the standards today.

Melanie KIRK: Okay, we will take the next question from Victor.

Victor GERMAN: Thank you, Victor German from Macquarie. Just actually following up on Brian's question. I appreciate that you don't like to comment on specific clients, but assuming that this is no longer a client, perhaps you will be able to provide some commentary.

But maybe just even a broad comment, assuming you have an exposure which, you know, the senior debt is currently trading at two cents in the dollar, would it be fair for us to assume that all provisions for that exposure would already have been taken? Or do we need to sort of be concerning ourselves for the next half?

Ian NAREV: No, I think under that hypothetical, you could assume all provisions have been taken. The other thing I would say is, look, provisioning is a science but with judgement. And what you can see from what Rob said last time, one of the reasons why the period on period half on half institutional banking LIE is so far up, is because of write-backs in the previous time.

Now, this is no guarantee that we will always get it perfect in the future, but the pattern, the track record of the Commonwealth Bank over some period of time is take the provision hard, take it early, we don't always do that perfectly but you can be assured that will be the case more often than not.

Victor GERMAN: Thank you. And second question for Rob. You sort of alluded to, and I think Ian alluded to as well, that productivity improvements is something that you are really focusing on. Clearly this half you've had lots of moving parts, you've had taken provisions, your compliance spend has gone up, and certainly when we look at your compliance spend it looks like its fracking at the pretty elevated level frankly. At what point do you think you would actually kind of get through that hump? And also, even taking out some of this additional overlays and provisions, cost growth still sort of a couple of percent, one of your peers is targeting flat costs on sort of two year/three year view. Are you able to give us some indication of what you think that trajectory might look for CBA in the future?

Rob JESUDASON: No. I am not going to give you a forecast, but what I would say is, look, we have got to manage the short term, and in the short term we have got some remediation spend. And that is why when we look at it as a business, we do strip it out and look at are we delivering underlying productivity? But medium term, we all understand the sort of structural change happening in financial services. And that is going to lead to lower costs base. So what we are trying to do is balance investment in technology, to digitise, you know, to drive digitisation of the customer experience and to service customers. The sort of short term pressures on remediation and compliance spend and deliver ongoing productivity.

Melanie KIRK: We are just going to shift to the phones quickly, and we have Matthew Wilson from JCP on the line.

Matthew WILSON: Yes good morning. Two questions if I may. Firstly the Bankwest half on half performance outlined on page 71 looks remarkable for a challenged economy. You had revenue growth up 5% half on half on 3% asset growth, and you combine that with a 5% cut to costs. Can you explain the magic there? And then secondly further to Craig and John’s questions on AUSTRAC, it seems your reliable estimate therefore doesn’t include any assessment of potential US action where fines are typically more serious and in the billions, or is it just a classic low ball, first offer?

Ian NAREV: Look, on the first point, Western Australia from a macroeconomic position has had its challenges. Bankwest I think adjusted to that market pretty effectively on the revenue line, took the right decisions in terms of risk appetite et cetera, and is now in a position to be able to support the economy as it starts to turn, and so revenue growth picked up a little bit. Bankwest by design does a little bit more in the broker channel than the Commonwealth Bank does, that is fine. And its overall volumes have been doing okay. It's LIE as we have said consistently because of its history it has managed itself pretty well through the difficulties of the Western Australian economy. And it has continued to look for ways for harnessing some of the productivity benefits of closer alignment with the Commonwealth Bank, particularly on some of the middle and back office aspects of its operations, so that explains the performance. Number two, the provisions that we have got and are required to make are always regarding everything we know and all things that we can take into account of. And that is all in that provision.

Rob JESUDASON: So I would just add one point Matt on the Bankwest performance. You have to remember it is a national business. So there is growth in the east coast as well, it is not just Western Australia.

Melanie KIRK: We will take another call from the phone. We will take a call from Frank at Merrill Lynch.

Frank PODRUG: Good morning gents. A couple of questions. Firstly Rob, you call out portfolio optimisation as one of the three areas for focus. Where do you see the greatest opportunities and how meaningful are they? And secondly just one for Ian. Just keen to get your reflections on (a) what industry developments most surprised you during your tenure as CEO? And secondly putting your management consulting hat back on, what is the greatest opportunity and threat for banks in the next five years?

Ian NAREV: I will let Rob answer this first question and by then you will hopefully have forgotten you asked the second one.

Rob JESUDASON: So on portfolio optimisation, six months ago we said big focus in the Institutional Bank on credit risk weights. But we said that trajectory will slow, because in the first six months that you implement a strategy there is more low hanging fruit, and over periods that closes out, and you have seen a smaller impact in this six months than the first six months. For any substantive reduction in risk weights now, you are really talking about lower assets. So that is a strategic position for Kelly and the team around client activity.

You have seen in the last six months in particular there have been a series of asset sales as well, particularly in IFS but there are announcements in Wealth. And again what we have announced is basically what we have focused on, so there is nothing more at the moment in terms of divestments.

Ian NAREV: In all seriousness on the second one I think the big change in the financial services industry over the recent period has just been, we have needed to adjust just to much different scrutiny and expectations. The levers you used to look at to decide whether the Bank was going well, which were much more at the aggregate level, we have needed to realise that even when things are going extremely well in all sorts of dimensions at the aggregate level there can be aspects of what is going on within the business that can weaken it. And I would say that would be the big change. It is something I think people might argue we were too slow to learn, and if we were I would certainly take accountability for that. But I can tell you what, we have learnt the lesson. And on that note I think the biggest opportunity for the Commonwealth Bank is better management, so we will see how we go.

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

Richard WILES: Good morning, Richard Wiles, Morgan Stanley. A couple of questions. Firstly on slide 12 you mentioned the APRA inquiry and also the Royal Commission. You don’t include the Productivity Inquiry into competition in financial services, and you also omit the ACCC Inquiry into mortgage pricing. I’m wondering if that means you think they provide less risk to the bank, or it’s less likely that you’ll need to respond to those inquiries. And are those inquiries affecting your current pricing and tactics in the mortgage market?

Ian NAREV: Good question. The reason they are not on page 12 is the intention of page 12 is really to show the link between the things going on in the regulatory compliance world and the things we are specifically putting aside money for, investing for. To the point I said before it is not presupposing outcomes from any regulatory inquiry, and we certainly are taking both the Productivity Commission's work and the ACCC's work extremely seriously. I mean obviously we know what we have been doing. We have a high degree of confidence in what we have been doing. But we just need to be very thoughtful and very careful.

We do as I said before whether it is these regulatory interactions, whether it is broader inquiries across the industry, we spend a lot of time talking about what might come out of those inquiries, not because we are trying to predict what it would be, but because part of it is actually challenging ourselves to see where areas of the business, to the point I said before about the changes, where we feel we have not paid enough attention and we need to do more. Now areas like the ACCC inquiry we have already said we are very, very comfortable with the practices that we have got. But we have learnt in the past that inquiries take their own turns and we need to be wary of that.

Richard WILES: And just my second question relates to costs. Rob you said you obviously need to manage them in the short term and take into account the remediation and other compliance costs. On this half on an underlying basis you delivered positive jaws. That was obviously helped by the margin expansion on the back of repricing. Do you remain committed to that philosophy around targeting positive jaws between revenue and cost growth?

Rob JESUDASON: Yes, I mean we have had that philosophy for now nearly a decade, and we are committed to it. And we manage the business on an underlying basis to deliver it.

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

Andrew TRIGGS: Thank you. Andrew Triggs from JP Morgan. Just a couple of questions please. The first one, just the replicating portfolio, how much of a drag was that on margins this half, and do you expect similar for the next little while? And the second question, around interest only switching you gave us some very good disclosure around a bit of a slowdown in switching in the December quarter. You did see I think a 6 percentage point reduction in the amount of the book in that space. Where do you think this might end up? And I see that the maturities are very heavily weighted towards 2018.

Ian NAREV: Well let me answer the second question and then Rob can talk about our old friend the replicating portfolio. I mean, I think given what has been going on in the market and the questions we have got it was very important for us to be very clear about what the activity actually is. And you can see in the materials the split between people coming to the end of interest only and people who have made the election to switch, both of which are dynamics which will continue to some extent into the future.

We have taken a pretty conservative approach to keeping within the cap for various reasons and we will probably remain pretty conservative. But I think there is credit there for people who want to do that kind of borrowing. The key thing for us is to make sure within all the regulatory requirements we are very focused on the best product for the customer and for the needs of that customer at any period of time, and beyond that it will be determined by customer preference.

Rob JESUDASON: On the replicating portfolio, there is nothing really exciting to say. As rates come in and the rate of volatility or decline in rates stabilise, the impact gets smaller and smaller, so it is quite a small impact in this half.

Melanie KIRK: We will take a question from David Ellis.

David ELLIS: Thank you, David Ellis from Morningstar. I have a follow up question on home loan interest only switching, and at slide 76. What are the potential risks around, credit risks, low risks around interest only loans expiring and borrowers moving to P&I? And secondly when you look at both customer initiated and interest only expiries, what potential negative impact is there on margins from moving from a higher interest rate interest only loan to a lower interest rate P&I loan?

Ian NAREV: Well on the credit risk, the first thing to bear in mind is that when customers are taking out an interest only loan their ability to service the loan is tested as if they were paying back principal. Now clearly, over particularly a five year life on an interest only loan, people's circumstances can change, as all of our circumstances do, but that lets you know that the vast majority of people are able to service the loan on the restructured basis where they are paying off principal and interest. We said for some period of time though that for some families where a payment increases that is obviously less money for something else. And an important part of our responsibility again is to do what we can with all the regulatory guidelines to help people translate that into budgeting and lifestyle and all those sorts of things. But the credit quality aspect of that is not an immediate concern.

In terms of margin clearly if you have got a trend where you are doing less of a higher margin business and more of a lower margin business that will have some mix effect. But again in this environment and based on what we are here to do, what we will set out to do is give the right product with the right structure to the right customer and see where that gets us.

Melanie KIRK: We are going to move back to the phones and take a call from Azib Khan at Morgans.

Azib KHAN: Thanks Mel. Ian look in terms of asset sales and divestments, you made the comment that you are looking to optimise the portfolio to suit the times. From that perspective how much sense does it make to keep the Australian general insurance business and the Indonesian life insurance business? I have also got a question for Rob on the markets income. Now Rob look I understand that lower volatility plays a big part in the movement in that income. But the sales component is also a function of volatility. That's holding up pretty well, so that's been flat from PCP. It's the trading component that's really just dropping. Is there something other than volatility that's also playing the part on that trading side? E.g. has there been a change in the composition of liquid assets, or are you adopting more conservative trading positions? And if I can just one more quick one for Rob. Of that incremental $200 million expense provision, how much of that relates to the Royal Commission?

Ian NAREV: So on the portfolio to start with, look clearly any further portfolio decisions from here will be up to Matt and the Board and others to work through. What you can see here is a high degree of commitment and diligence towards assessing the portfolio and where it does not make sense to own something, selling it. You go back four or five years and there were all these things being written that Commonwealth Bank would probably be on an M&A binge, and the answer was we were because we have sold a whole lot of stuff. And I am sure that the discipline of assessing businesses et cetera will continue. But a lot of the obvious work has now been done. Rob, you can answer your questions.

Rob JESUDASON: On the $200 million provision we do not break it down any further. But you are right in saying that it includes a portion of that for the Royal Commission. In terms of the trading activity, it is nothing to really do with our liquids position. It is trading activity in the Institutional Bank. Kelly, is there anything you would like to add?

Kelly BAYER ROSMARIN: Yes. I think what was characteristic in the previous period where the results were very high which was true of many banks is just having a portfolio that is naturally in fixed income quite long on bonds, and in that period you saw credit spreads tightening, and that was favourable.

Melanie KIRK: Great. Well that now brings the briefing to an end. Thank you very much for attending. If you have got any further questions please come back to the IR team and we will help you. Thank you.

END TRANSCRIPT