Australian Shareholders' Association

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A horrible result and next year will be worse. Can BOQ pull out of its spiral?

Company/ASX Code	**Bank of Queensland/BOQ**
AGM time and date	10:00am (AEST) Brisbane time Tuesday, 5 December 2023
Location	Sofitel Hotel, Ballroom 1, Level 1, 249 Turbot Street, Brisbane
Registry	Link Market Services
Type of meeting	Hybrid
Monitor	Paul Donohue and Noel Ambler
Pre-AGM Meeting	Yes, with Warwick Negus (Chairman), Patrick Allaway (MD & CEO) & Jessica Smith (GM Investor Relations).

Monitor Shareholding: The individual(s) (or their associates) involved in the preparation of this voting intention have a shareholding in this company.

1. How we intend to vote

No.	Resolution description	Intention
2	Re-election of Director – Mr Bruce Carter	Against
3	Remuneration Report	For
4	Grant of Securities to the Managing Director & Chief Executive Officer – FY24 Long Term Variable Reward	For
5	Grant of Securities to the Managing Director & Chief Executive Officer – FY23 Premium Priced Options	For

2. Summary of Issues and Voting Intentions for AGM

- **Financial performance.** This has been another disappointing year.
- **Write down of $200m goodwill.** That is a lot of shareholder value to destroy.
- **Regulatory issues.** APRA and AUSTRAC have both raised concerns with the Group.
- **Strategic transformation.** How is it tracking, and can they deliver?

See ASA Voting guidelines and Investment Glossary for definitions.

3. Matters Considered

Overview

The message to shareholders in this year's annual report paints a bleak picture. "FY23 was a challenging year for BOQ Group with an eight per cent decline in cash earnings, changes in leadership and identified weaknesses in our operational resilience and risk culture resulting in two Court Enforceable Undertakings."

The Australian Financial Review's Chanticleer column was blunter. "This was an ugly set of numbers from a bank facing serious problems – a brutal mortgage price war that is smashing its margins and market share, ballooning costs, two enforceable undertakings with the prudential regulator, and the difficult integration of a major acquisition."

In our pre-AGM meeting, Warwick Negus (Chair) and Patrick Allaway (Managing Director & CEO) confirmed that conditions were tough now and were going to get worse in FY24 but there was optimism beyond that.

They told us ME Bank has been successfully absorbed into the BOQ Group and their ambitious technology agenda is starting to yield results. They acknowledge past compliance and risk failures, but the regulators are now on board with their action plan and the culture is slowly changing. High interest rates are punishing their cost of funds but hopefully we are nearing the end of the Reserve Bank of Australia's tightening cycle.

If everything goes according to plan, they will emerge in FY25 (or maybe FY26) as a leaner, focussed and competitive banking group powered by a state of the art, low cost technology platform.

The question is, do shareholders believe they can deliver?

Results

Cash earnings are down 8% to $450m while cash expenses are up 8% to just over a billion dollars. Consequently, the cost to income ratio increased 150 basis points to 58%. After you factor in some substantial one-off items, the statutory NPAT has collapsed by 70% to just $124m.

Housing loan growth was down 1% to $700m which was almost balanced by business loan growth which rose 4% to $600m. Net Interest margin is down 2 basis points to 1.69%. One positive is the Common Equity Tier 1 capital (CET1) ratio which rose 20 basis points to 10.91%

The per share metrics were dismal with EPS down 10% to 68.4c and the full year dividend down 11% to 41c per share.

It is worth noting that the results included material one-off items after tax:

- $200m impairment of goodwill.
- $57m of ME integration costs.
- $42m provision for the Group's Remedial Action Plans.
- $35m in restructuring costs to simplify the Group.

Of these, the goodwill write-off is most disturbing. Between 2006 and 2023, BOQ made numerous acquisitions including Home Building Society in Western Australia. This resulted in a goodwill balance of $767m. A fall in market capitalisation below the Group's net asset value led to a review of the carrying amount of goodwill and a $200m impairment.

The impairment may be a "non-cash" item, but this isn't like the unwinding of a contingency item. The acquisitions to which the goodwill relates were very real transactions in prior years and the write down represents a loss of shareholder value.

Financial performance

(As at FYE)	**2023**	**2022**	**2021**	**2020**	**2019**
NPAT ($m)	$124	$426	$369	$115	$298
UPAT ($m)	$450	$508	$389	$225	$320
Share price ($)	$5.76	$7.03	$9.46	$6.13	$9.17
Dividend (cents)	$0.41	$0.46	$0.39	$0.12	$0.65
Simple TSR (%)	-12.2%	-20.8%	60.7%	-31.8%	-14.5%
EPS (cents)	$0.68	$0.66	$0.67	$0.26	$0.74
CEO total remuneration, actual ($m)	$1.25m *See notes*	$1.86m	$1.41m	$1.34m	Transition yr w/3 CEOs

Simple TSR is calculated by dividing change in share price plus dividend paid during the year, excluding franking, by the share price at the start of the year.

NOTES

- Patrick Allaway effectively replaced George Frazis as CEO on 28 November 2023, so this does not represent a full year of CEO remuneration.
- During this financial year, the previous CEO received $1.7m including a $1.29m termination payment. This related to contractual and statutory obligations.

Strategic Transformation

ME Bank which was acquired in 2021 has now been integrated into the BOQ Group at a cost of $133m. At the conclusion of the program an additional $43m of property and software assets were written down bringing the total cost to $176m.

BOQ claims to have achieved "annual run-rate synergies" of $72m which is at the lower end of their expected range of $70m to $80m.

The ambitious technology transformation that began in 2020 is starting to yield results. Core Banking platforms are down from eight to six with a target of two sometime in 2026. This sounds impressive but the new cloud-based core banking platform cannot yet handle all of the Group's products and most of the customers and their accounts are yet to be migrated. We were told that $5.5b of deposits are on the new platform but that is only 15% of the retail banking total. As far as we can determine, no home or personal loan products have been implemented on the new platform.

This means the legacy core banking systems continue to operate and that comes at a cost. Both systems must be maintained, regulatory changes applied twice and enhancements with significant business benefit maybe deferred on the old system. This period is called "coexistence”, and it is when many core banking projects begin to flounder.

There are also customer impacts. With accounts spread across multiple platforms, customers can only use the new myBOQ mobile banking app if their account is on the new platform. App store ratings for the new mobile apps are poor but better than the previous apps. For comparison, the new myBOQ scores 2.7 on the Apple store versus 1.2 for the previous BOQ app. Compare that to an average of 4.6 for the big four, 4.3 for Suncorp and 4.0 for Macquarie.

However, there does seem to be some good progress. A new "digital mortgage" product will be launched soon for all retail brands. This will allow customers and brokers to originate new loans online without having to visit a branch. This will be a key part of the strategy to be a low cost, fully digital bank.

Given the recent publicity about cyber security, it is no surprise that BOQ has taken steps to improve its security posture with a recent independent audit yielding a positive outcome.

Governance and culture

In 2022, BOQ was fined by the ACCC for failing to meet a deadline for the Open Banking scheme. This year they have fallen foul of other regulators, i.e. APRA and AUSTRAC.

APRA found the "design and operation of BOQ’s Risk Management Framework was insufficient for a bank of BOQ’s size and complexity." while AUSTRAC concluded that "BOQ's approach to customer risk assessment and its methodology for determining customer risk required strengthening". Both regulators noted some of the issues had been known to BOQ for several years but had not been acted on appropriately.

It appears that APRA's concerns were in the areas of liquidity, business continuity management and outsourcing while AUSTRAC found weaknesses in anti-money laundering and counter terrorism financing particularly in the process of customer identification and due diligence.

BOQ has agreed to enforceable undertakings with both regulators and established comprehensive programs of work to address the issues. APRA has also added $50 million to BOQ's operational risk capital requirement.

Those directly accountable for these failings are no longer employed by the Group and there were financial consequences for those responsible for governance. Non-executive Directors’ fees will be reduced by 20%, the CEO voluntarily gave up his FY23 Performance Shares and there was significant forfeiture of restricted equity held by current and former executives.

Key events

Key events during the reporting period included.

- Completion of the ME Bank integration.
- All three retail brands (BOQ, ME & VMA) are now using the new cloud-based core banking platform for some products.
- Decision to exit the New Zealand market, although a sale has not yet been achieved.

Key board or senior management changes

George Frazis was abruptly terminated as CEO just before last year's AGM with the Chairman, Patrick Allaway, stepping in as Executive Chairman and later becoming interim CEO while an executive search was performed. That search was discontinued in August 2023 when Allaway was confirmed as permanent CEO.

There was other movement in the senior executive team:

- Rod Finch replaced Paul Newham as Chief Transformation & Operations Officer.
- Martine Jager moved from Retail Banking to People and Customer and replaced Debra Eckersley who retired.
- We recently learned that Martine Jager has left BOQ and the "People and Culture" role is being overseen by Racheal Kellaway (CFO) on an interim basis.
- Greg Boyle replaced Martine Jager as the Group Executive, Retail Banking.

In response to the regulatory issues, senior leaders in Finance, Operations (including Financial Crime Operations), Group Risk, Legal and Internal Audit were also replaced.

Sustainability/ESG

BOQ publishes a sustainability scorecard which shows progress towards or achievement of most of their ESG goals. The only areas in which they are lagging are customer experience (they didn't hit their net promoter score targets) and gender diversity in senior leadership (36% vs their target of 40%).

BOQ Group's lending portfolio has no exposure to fossil fuel power generation and minimal exposure to equipment directly used in the extraction of fossil fuels. They no longer offer new equipment financing for that purpose and have a plan to run off the remaining $4.6m exposure in 2024.

They are well advanced on their goal of 90% reduction in scope 1 & 2 emissions by 2030. Currently, 84% of energy for their operations is renewable with the 2025 / 100% target on track.

ASA focus issues (not discussed elsewhere)

At our pre-AGM meeting, it was confirmed that the Group does not make donations to political parties or campaigns although they do donate to charities.

4. Rationale for Voting Intentions

Resolution 1. Re-election of Director – Mr Bruce Carter (AGAINST)

Bruce Carter brings valuable skills and experience to the BOQ Board and his commitment to the group is not in question.

He holds 211,430 BOQ shares which at today's price are valued at more than $1.1m. That is close to 3½ times his annual director's remuneration. Bruce opts to take most of his remuneration as shares under the NED Plan and this year increased his holding by more than 20%.

However, we have concerns about his workload. His current board positions include the following.

- Chair of AIG Australia (Unlisted subsidiary of a US listed company)
- Chair of Sage Group Holdings (Unlisted)
- Chair of Australian Submarine Corporation (Government)
- Chair of the Resources Infrastructure and Investment Taskforce (Government)
- Director of Bank of Queensland (Listed)
- Director of Lovisa (Listed)

The ASA has guidelines for director workloads. While we recognise that not all roles are equal, we count both listed and unlisted companies, government and not for profit as they all take up time and attention. Any chair role is counted as a double workload. Using that formula, Bruce scores ten which is double the ASA limit of five. Even if we do not double count the unlisted Chair positions, he still scores six. The Lovisa director role is most recent with Mr Carter joining that board in November 2022.

Our other concern relates to the enforceable undertakings with APRA and AUSTRAC. APRA noted that "BOQ identified gaps in its risk culture in 2016, 2018, 2020 and 2022. However, BOQ's risk culture remained immature and BOQ did not prioritise risk culture uplift sufficiently over that time" and AUSTRAC first raised their concerns about the AML/CTF deficiencies in 2018 but they were still not rectified in 2022.

While no single person is responsible for this lapse in governance, we note that Bruce Carter was the Chair of the Risk Committee during the period of concern, i.e. 2018 to 2023.

The Risk Committee's role is to oversee BOQ's risk framework and to take a Group wide view of current and emerging risks.

At our pre-AGM meeting, we learned that it is intended that Mr Carter serve an additional year if re-elected, while the recruitment of an additional NED is finalised, although this is not mentioned in the Notice of Meeting.

We will vote against Mr Carter's re-election on the basis of his workload and to hold the board to account for the regulator assessments above, notwithstanding that Mr Carter was instrumental in identifying and escalating risk issues and reporting them to the regulators.

Resolution 2. Remuneration Report (FOR)

This year we saw two positive elements of the remuneration report.

Firstly, the risk and governance failings that led to enforceable undertakings with APRA and AUSTRAC resulted in downward remuneration adjustments to Non-executive Directors and both current and former senior executives.

Secondly, in response to APRA Prudential Standard CPS 511 the remuneration framework has moved to a more traditional structure comprising fixed reward, short-term variable reward (STVR) delivered partly in cash (50%) and partly in Restricted Shares (50%), and long-term variable reward (LTVR) delivered in rights to BOQ equity which are tested over a four-year period.

One negative aspect are the hurdles for STVR. These come from a Group Scorecard full of subjective metrics such as net promotor scores, app store ratings, employee engagement surveys, etc. All of these are important and valid metrics, but they seem a bit superficial to base incentives on and they are mostly indirect rather than specific measures of executive performance.

To be fair, the scorecard also includes some clear financial metrics and perhaps the weightings of different elements of the scorecard strike an appropriate balance?

The specifics of the LTVR plan align with ASA's guidelines. The LTVR hurdles which will be tested over four years are:

- Customer Experience (20%) = Customer net promotor scores across BOQ Retail, BOQ Business and ME Bank. The target NPS is not specified nor is the sample size or methodology.
- Strengthen (30%) = Project status of the two remedial action plans based on a red/amber/green scale.
- Optimise (50%) = Return on Equity (ROE) of at least 9.25% and absolute total shareholder return (aTSR) of at least 46%.

Net promotor scores are a bit fluffy but it's a fairly standard way to measure all of the things that feed into the customer experience. ROE and aTSR are shareholder friendly metrics so it's good to see them in the hurdles. You could argue that if the remedial action plans are showing a RED status at the end of four years, the CEO might not be around to claim his LTVR. A minor gripe is that the LTVR targets were not included in the remuneration report but were only found in the notice of meeting.

Another aspect of the remuneration report that got our attention was the golden handshake paid to former CEO George Frazis. He had worked for three months before going on nine months of gardening leave. George left the organisation with a tidy $1.7m for the year including $1.29m in termination payments. No doubt, this was all contractually obliged but we will be raising it at the AGM.

Resolution 3. Grant of Securities to the MD & CEO for FY24 Long Term Variable Reward (FOR)

This item relates to the CEO, Patrick Allaway's, long term variable reward for FY24 which will be measured over the next four years against the hurdles described earlier.

The intention is to grant Executive Performance Rights (EPRs) equivalent in value to $1.5m which is equal to 100% of the CEO's fixed remuneration.

Given that we support the remuneration report, we also support this resolution.

Resolution 4. Grant of Securities to the MD & CEO for FY23 Premium Priced Options (FOR)

The CEO, Patrick Allaway's, potential remuneration for FY23 included Fixed Reward (cash), Performance Shares (short term equity) and Premium Priced Options (long term equity). This item relates to the Premium Priced Options (PPOs).

The intention is to grant PPOs worth up to $441,534 relating to the financial year ended 31 August 2023.

Shareholders may think the CEO should not be rewarded for such a disastrous year, but the board makes two points in his defence.

Firstly, Mr Allaway did not receive any short-term rewards (the Performance Shares) in F23 as he voluntarily forfeited them in response to the regulatory issues.

Secondly, the exercise price for each PPO will be $8.3143, being 120% of the VWAP of BOQ shares over the ten trading days immediately after the 2022 AGM. This means the PPOs will only be valuable to Mr Allaway if the BOQ share price increases by more than 20% by the vesting date. Half of the PPOs will vest in December 2026 and the other half in December 2027.

Given that we support the remuneration report, we also support this resolution.

Appendix 1
Remuneration framework detail

CEO rem. Framework for FY23	Target* $m	% of Total	Max. Opportunity $m	% of Total
Fixed Remuneration	$1.50m	37%	$1.5m	34.5%
STI - Cash	$0	0%	$0	0%
STI - Equity	$1.53m	37.8%	$1.83m	42.15%
LTI	$1.02m	25.2%	$1.02m	23.4%
Total	$4.05m	100.0%	$4.35m	100.0%

The amounts in the table above are the amounts that are envisaged in the design of the remuneration plan.

*Target remuneration is sometimes called budgeted remuneration and is what the company expects to award the CEO in an ordinary year, with deferred amounts subject to hurdles in subsequent years before vesting. Some remuneration framework set a maximum opportunity amount, but not all.

Notes on actual CEO remuneration

It is important to note that the CEO did not receive the target amount.

Because he was not in the role for a full year, he received a pro rata amount of the fixed remuneration. He also received director fees for the period prior to becoming the CEO.

Because of the regulatory issues, he voluntarily forfeited his STI, i.e. his Performance Shares.

Based on the information provided in the remuneration report and notice of meeting the CEO's actual remuneration, assuming resolution 4 is supported, appears to be as follows:

- FR = $1,251,454
- STI = $0
- LTI = $441,534
- TOTAL = $1,692,988

Notes on the FY23 remuneration framework

This is showing the FY23 remuneration framework which is changing in FY24.

Variable reward (STI & LTI) is based on 170% of the fixed remuneration.

Max opportunity is the same as target except for LTI which rises from 102% of fixed remuneration (target) to 122% (maximum).

Notes on the FY24 remuneration framework

The major changes between FY23 and FY24 are as follows:

- Performance Shares (short term equity) and Premium Priced Options (long term equity) will no longer be offered.
- Fixed remuneration is unchanged.
- STI, which BOQ refer to as short-term variable reward (STVR), will be paid as cash (50%) and equity (50%) in the form of restricted shares.
- STI is tested at the end of the financial year.
- STI hurdles relate to the group scorecard which includes metrics covering customer experience (10%), people experience (10%), strengthen (10%), simplify (10%), digitise (15%) and optimise (35%). Refer to the remuneration report in the annual report for more details.
- LTI, which BOQ refer to as long-term variable reward (LTVR), will be paid as equity (10%) in the form of performance rights.
- LTI is tested after a four year period.
- LTI hurdles relate to the group's strategic pillars which includes metrics covering customer experience (20%), strengthen (30%) and optimise (50%). Refer to the notice of meeting explanatory notes for more details.

Alignment of FY24 STI hurdles with ASA Guidelines

Guideline	BOQ Alignment	Notes
A majority of STIs should be based on quantifiable performance metrics, or measures that are clearly tied to the executive driving company to meet strategic goals	Partial	Some of the metrics are very subjective, based on surveys, etc. Many of the metrics are only directly linked to executive performance.
STIs should not be paid beyond target remuneration levels unless a financial gateway is met.	Full	There is no opportunity for STI to exceed the target remuneration.

Alignment of FY24 LTI hurdles with ASA Guidelines

Guideline	BOQ Alignment	Notes
Have at least two hurdles for an LTI scheme.	Full	The LTI has four hurdles.
Use different hurdles in the LTI plan than the hurdles used in the STI plan.	Full	Although STI and LTI refer to similarly named strategic goals, they use different hurdles.
Limit non-financial metrics in an LTI scheme to 50% of the award.	Full	The "customer experience" and "strengthen" categories are non-financial and represent 50% of the LTI.
Measure performance for more than three years, and preferably four or more.	Full	LTI is measured over four years.
Apply specified hurdles in the year of vesting.	Full	There are additional performance tests at the time of vesting.
Avoid structures that deliver excessive awards in a single measurement period as they are less likely to encourage out-performance and may encourage excessive risk taking.	Full	The LTI is a reasonable amount compared to fixed remuneration.
Have one hurdle based on Total Shareholder Return (TSR), which reflects share price performance plus dividends paid over the performance period of preferably at least 4 years.	Full	Absolute Total Shareholder Return (aTSR) measured over four years is one of the hurdles.
Apply any absolute TSR measure to a maximum of 50% of the LTI award.	Full	Absolute Total Shareholder Return is only applied to 25% of the LTI.
Not pay out-performance bonuses if TSR is negative in nominal terms whether relative TSR or absolute TSR is the measure.	Partial	There is no specific provision to cater for negative TSR however the sliding scale for the aSTR hurdle means a negative aTSR will forfeit 25% of the LTI.
When measuring relative TSR, include comparator companies from similar industries or a specific index such as Financial Services or Resources. Any	N/A	Absolute Total Shareholder Return is used rather than relative

Guideline	BOQ Alignment	Notes
comparator group should include key competitors and at least five companies, including relevant companies listed on foreign exchanges.		
Show graphically the company's TSR performance as against the comparator group(s) in the remuneration report.	Not aligned	There is no such illustration.