Association of Superannuation Funds Australasia

Changing the face of the Finance Sector in Australia

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Thank you for inviting me along today.

What a year your industry has had.

In fact, what a year the entire finance sector has had.

After strong growth over a decade, we now are all weathering the storm and volatility of equity markets both here and overseas brought on by the sub-prime mortgage issues in the United States.

I should also point out that, despite what some may say, the market for AAA rated residential mortgage-backed securities like those offered by Bank of Queensland will not go away.

However, there may be some upward revision of credit margins as this plays out.

In fact, despite the recent market disruptions, we recently settled a $1 billion equipment leasing securitisation.

While the strength of the funds management industry has continued to grow and the private equity tsunami has hit the world's markets, I am here today to speak of another, quieter, revolution which has occurred.

It is the revolution which has changed the way banking is undertaken in Australia in the last decade.

And it largely focuses on one word, service.

After years, decades even of being left in the PR wilderness, the marketing black hole, service is back, and now we're all on board.

Customer service, service with a smile, relationships, personal, one-on-one, face-to-face….they go on and on. Marketing budgets are on fire with the word, the underlying belief, that service is everything.

Service… what was old is new again.

Products are cookie cutter clones of each other, marketing budgets blur into one another, space on TV, on the internet, on ipods, billboards, T-shirts or skywriting - it doesn't matter because it is all just noise.

We need to return to the good ol' days.

Service is the new black, the hot buzzword, the key to the future.

The fact is, of course, that service never went away. Sure, corporate Australia stopped talking about it, stopped delivering it some would say, but service was never at the bottom of the customer's list.

Customers never stopped wanting good service, they just stopped expecting it.

So why now, why has service made such a comeback to the lexicons of corporate leaders, spin doctors and advertising executives?

Why has the service bandwagon been hitched back on to the modern corporate horse and dragged back into the ring?

Competition, that's why. Fading market shares, that's why.

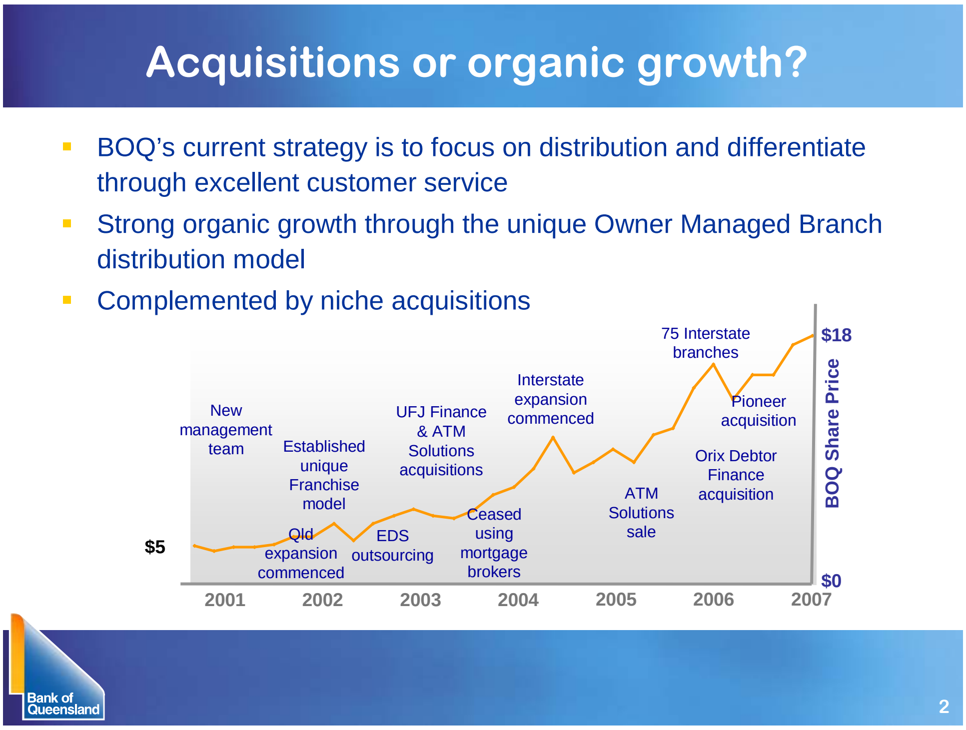
In the finance sector there has never been a more competitive environment in Australia than now.

I will also speak of the issues facing finance sector participants when it comes to organic growth versus acquisitions, and the future for retail channels for Australian banks

Using Bank of Queensland as the obvious example, I will speak on the dramatic changes in the financial sector over the last five years, and also the changes to come.

BOQ has been at the forefront as the other banks returned to a customer-focused retail model after years of Australian banks spurning the traditional banking models.

The key to this strategy has been a mix or organic growth and strategic acquisitions.



The impact of both has resulted in continuing double digit EPS growth flowing through to a strong share price performance.

It has been a transformation for Bank of Queensland from a sleepy customer-centric bank which was the smallest in Australia to a market performer which has effectively quadrupled in size in five years.

Over this transformation period we've significantly exceeded system growth, with the exception of a brief period when we first stopped using mortgage brokers.

The decision not to source our customers through third party distributors like mortgage brokers was considered, in Yes Minister-speak, "courageous" at the time.

Since then I believe we have shown that we used the decision to carve out growth well ahead of the rest of the banking sector using our own channels.

Decisions like this, and expanding through a branch franchise network, have kept our margins within market while reducing the expense traditionally associated with such rapid expansion.

We've also undertaken other strategic initiatives such as alliances to bolster our product and service offerings. Most recently this included the alliance with Citigroup which included the sale of our $260m card portfolio.

These have been complemented by the outsourcing of IT and business processing to EDS, providing an efficient IT and processing platform for all growth initiatives.

It has been a case of identifying where we can not be the best at providing a product or service, and then partnering with industry leaders to ensure our customers still get the best, even if we don't manufacture it.

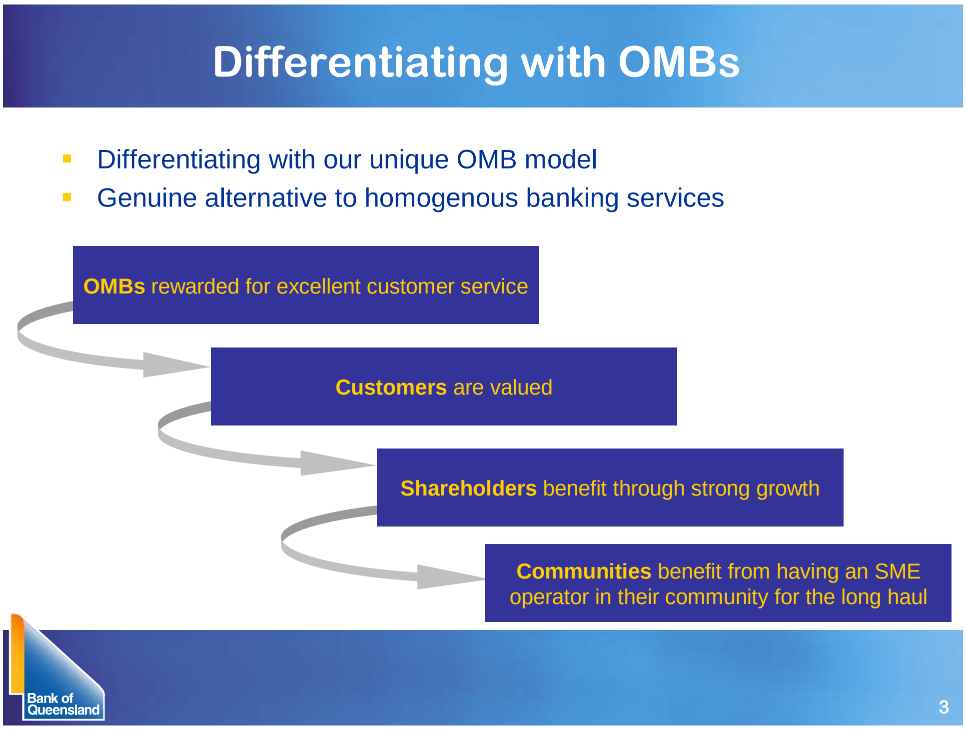
Of course, the platform for all of this change, the key spark which lit our internal revolution, was the development of our branch franchise model, or Owner-Managed Branch model back in 2001.

We started with a 30-year-old agency model which was actually value-diluting for the bank.

We flipped it on its head and created a franchise model which has been closely investigated by all our competitors, but is difficult to copy.

It allowed us to expand with a variable cost model where the franchisees meet much of the cost of setting up the branch while the Bank provides branding, product and credit support.

Importantly, it has also created, in my opinion and reflected in our performances, the best sales network in Australian banking.



As this slide highlights, we carved out a niche, a differentiation for Bank of Queensland which has grown to be a cultural difference as well as a business difference.

The sales and service culture which started with this model is now, I believe, the envy of larger competitors who face the prospect of having to change direction with their own branch networks.

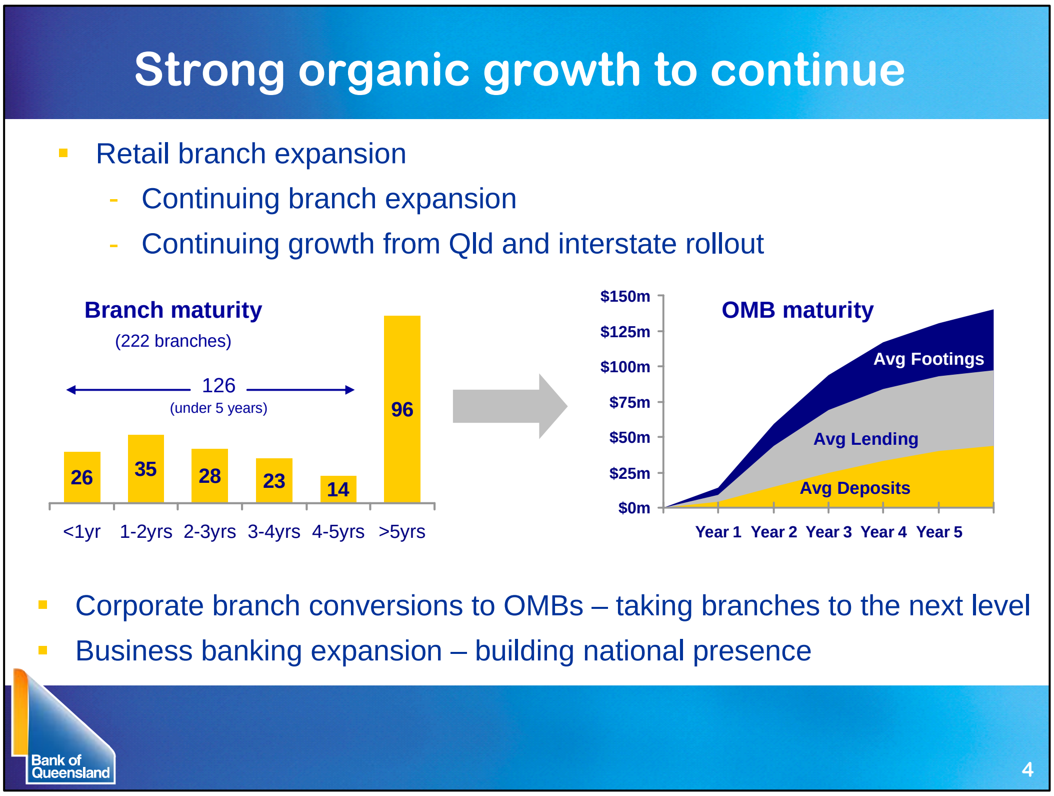
Our branch managers have a vested interest in the success of the branch, which only comes through great service and valuing their customers.

The success of our OMB network is seen clearly with the continuing strong performance against system for both credit and deposit growth.

APRA data for the 12 months to the end of June shows that, in credit BOQ grew at 24% compared to the rest of the banking system at 15%. In housing loans BOQ grew 28% compared to system growth of 13% and in housing deposits BOQ grew 30% compared to the system growth of 8%.

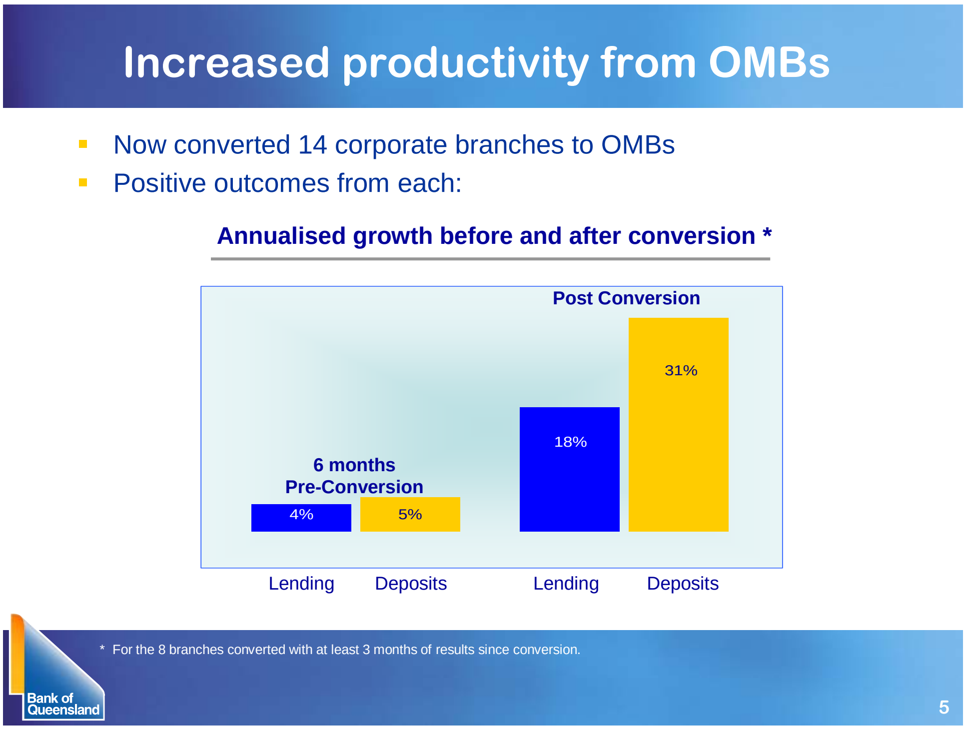
This growth highlights just how powerfully the model has driven the culture of service and sales in BOQ, and how it has differentiated us, not just from the big banks, but from our regional bank competitors as well.

Importantly, there is still a lot of upside to go.



Most of our branch roll-out, particularly outside of Queensland, is still relatively immature and still has its major growth years of 3-5 ahead of it.

On top of that it is fair to say that New South Wales, as a market, has been lagging the rest of the country over the last few years. With our presence in New South Wales of 50 branches, out of a total network of 222 branches of which 180 are franchises, we are well placed to take advantage as the economy in that state turns.



We are also in the process of changing many of our remaining corporate branches in Queensland into franchised OMBs with spectacular initial results.

What has been fascinating is how the franchise-based culture has spread backwards through the rest of the bank.

Our drive to ensure SMEs received a personal business banker or branch, the growth of our private bank and even the provision of our head office services, have all been focused on a higher customer service measure.

Now, we are far from perfect, but we are on the way to my target of being the best customer service bank in the country.

And despite the massive growth in our retail banking network, it has been business banking, through organic growth and acquisitions in the areas of equipment and debtor finance, which has been our fastest growing sector.

It highlights the advantages BOQ has over some of its competitors at the smaller end as 40% of its assets under management are not housing loans, but commercial and personal loans.

This diversification of the bank, both geographically and through segment, has been part of our overall strategy to provide accessibility for our customers and channels for future growth regardless of regional economic variations or cyclical market movements.

So, that's Bank of Queensland and where we are now. However, as we are only one player in the Australian finance sector, it is important to look at the industry overall and the challenges facing us.

As the title of the speech suggests, the face of the finance sector has changed dramatically in the last few years, and more, and possibly even more dramatic change is ahead of us.

Apart from the dramatic growth in your own, superannuation industry, and the associated funds management and financial planning streams, there has been no greater change in the finance sector than in the access to finance by the consumer.

Now, more than ever, consumers face a dizzying array of choices when it comes to obtaining credit and banking services.

The dynamic which drives the finance sector, in the banking space, has changed dramatically over the last decade.

The decision by the big banks to turn away from personal service opened the doors for the mortgage brokers and originators, along with the regionals, building societies and credit unions, to step into the gap and take the customer relationship.

And they did it with gusto.

Mortgage brokers, in particular, tapped into the desire of consumers to actually want to talk to someone about the biggest decision of their lives, and they have now made themselves a major player in the finance industry in Australia.

While Bank of Queensland does not utilise mortgage brokers, they are definitely here to stay and source up to 40 or 50 per cent of some banks' mortgage sales.

Bank of Queensland tapped into the same customer desire as the mortgage brokers by having franchisees because, once again there was actually a bank manager for people to talk to, and that bank manager hung around for more than six months.

Bendigo adopted a community franchise model while Adelaide went down the wholesaling route.

The building societies and credit unions also benefited as customers looked for local branches and understanding managers.

We all found our own way to take customers from the big banks and grow our businesses.

And that growth, for Bank of Queensland, has been spectacular.

In 2001 our statutory net profit after tax was $24 million, while last year it is $92.7million.

Our assets under management have quadrupled over the same period, from $5.2 billion to around $20 billion.

And the share market has rewarded us for the growth. In 2001 when I joined BOQ our market capitalisation was $400 million, while we are now around the $2 billion mark.

While our financial year does not finish until the end of this month, that strong growth has continued this year.

It has come about because of a refocusing of financial services back to a retail environment – to providing accessibility, products and customer service.

So the changing face of the finance sector has seen the big banks now forced to change tack, to turn around and compete with their smaller cousins in an area where size is not necessarily an advantage.

This has been tough for the big four, but their customer satisfaction numbers are improving, although well behind banks such as BOQ and Bendigo.

Some have said this refocus on to customer needs by the Big Four spells danger for banks like BOQ, but I disagree.

We have the ability to continually evolve, to move quickly with the market, to remain flexible, and that has not changed.

However, where the new competitiveness of the big banks, combined with regulation and customer expectations, is having an impact is in the smallest end of the market – the credit unions and building societies, and some of the single-product style mortgage shops.

Tightening margins and slower housing industries, particularly in NSW, have adversely impacted on these smaller organisations which have been unable to diversify into the SME markets, or through commercial lines such as equipment finance or margin lending.

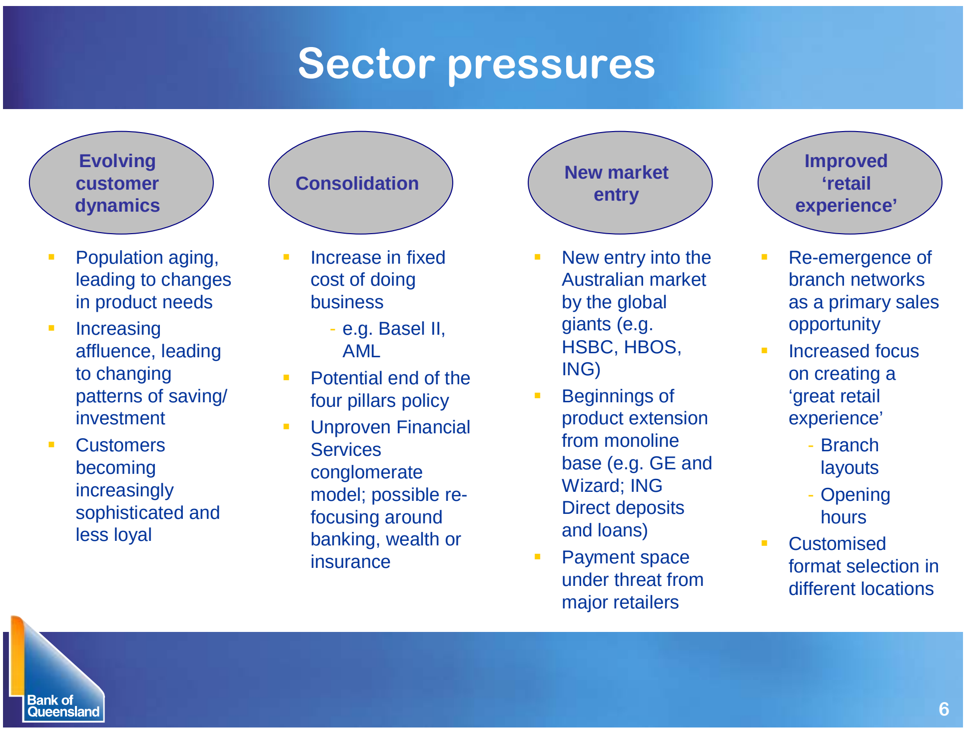
While the jury is still out on whether customers will accept wealth management advice from banks, the big banks have made their wealth management arms profitable, and customers do expect a full range of the more basic financial products, such as insurance, from their bank.

BOQ has been able to ensure we provide competitive products across the entire range, if not through our own manufactured products then through the alliances I have mentioned previously.

This allows us to go head-to-head with the big four while maintaining our small bank feel.

But the industry faces some changes ahead, and we are already seeing some movement.

The finance sector faces pressures which are growing, and which have led to some large amalgamations of credit unions, and the movement in the building society sector which has seen consolidation leaving 14 across the country, including Pioneer and Mackay.



As this slide shows changes are occurring and more are coming, and not everyone in the sector will be able to ride the wave to greater prosperity.

The first and fourth pressures outline some of what I have already spoken about when it comes to the changing expectations of customers, and how the finance sector is moving to meet those expectations.

Where the crunch is occurring now though is in the second and third pressures.

Let me focus on consolidation and new entrants.

I have been quite vocal in the past about the past-its-use-by-date Four Pillars policy which will ensure that none of our major banks will be big enough to compete on the international stage in the next decade.

However, there is absolutely no intention, on either side of politics, for the policy to change in the foreseeable future, despite everyone in the finance sector, and in Canberra, knowing that it is no longer good policy.

This, I believe almost guarantees that our big four or five Australian banks face the prospect of eventually being snapped up by those American, Asian and European banks which have grown through mergers and international acquisitions.

We have seen the success of those overseas acquisitions already here in Australia, with HBOS and HSBC increasing their impact on the local market, and others such as GE, ING, RaboBank and CitiGroup also making their mark, often in niche areas, but all taking skin off the big Australian banks.

They are here because they are large and cashed up from a decade of successful mergers and consolidations in the UK and US banking sectors.

In particular, the moves by HBOS and GE to move into the retail financial services sector through their acquisitions of BankWest and Wizard drives at the heart of the core retail client base of the big four.

A heart which has already been savaged by the regionals and mortgage brokers.

This combines also with the unproven financial integration model, which I touched on earlier, of banking with wealth management and insurance. Customers seem to be willing to take a small bite out of what their banks can offer, but will not necessarily take the whole pie.

Consolidation efforts have included our recent acquisition of Pioneer Permanent Building Society and our move to also merge with Mackay Permanent Building Society.

These mergers bring us far higher physical presence in the booming central and north Queensland economies while also bringing customers on to our books.

As you know, we recently also attempted a merger with Bendigo Bank, a merger which I believed would have created a new retail banking powerhouse in Australia while maintaining the inherent strengths of both organisations.

Unfortunately, Bendigo knocked us back, which I believe was a mistake but hey, we move on. And you can't go forward looking backwards. They have also moved on by announcing this month a merger with Adelaide Bank.

While I won't comment specifically on the merits of one proposal over another, it is fair to say that there seems to be a strange logic sometimes as to why one merger would be better than another. At the end of the day it will be about what value can be created for the sharemarket.

To me it seems a defensive move on both their parts….but I wish them luck.

Fortunately though, BOQ has many more clubs in its bag when it comes to continuing its successful growth story.

However, others are being hamstrung. The building societies and credit unions are faced with huge issues around compliance with new national and international regulations such as Basel II while also maintaining IT and payment systems which are up to market demands.

Their cost burden is increasing while the market squeezes margins and therefore income from the standard housing mortgage.

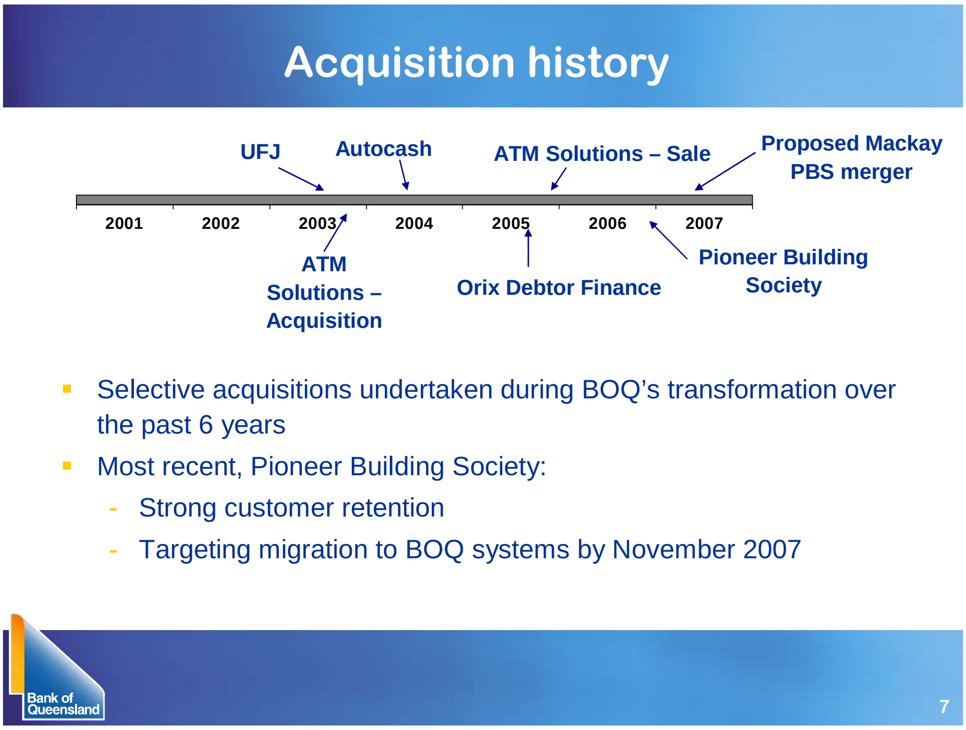
BOQ has countered this trend by dramatically increasing its footprint, and therefore our access to new customers from greenfields sites, over the last five years.

We also have the advantage of being based here in Queensland, where the economy is performing well and growth looks to be sustainable over and above the resources boom.

And finally, through the afore-mentioned OMB model which gives us a sales-focused channel superior to the rest of our banking competitors.

We have added advantages over the smaller building societies and credit unions through our commercial banking lines which contribute about 40 per cent of our assets under management.

These strengths have allowed us to maintain a strong organic growth strategy while also being able to look to strategic acquisitions.



Each acquisition over the last six years has added to our growth, built our capacity and broadened our customer reach.

As I have said in the past, BOQ has aimed at being a big small bank, not a small big bank. In that way we maintain the touch and feel of a small regional, while matching it with the big banks on product and accessibility.

This is the challenge facing all of us.

While the jury is still out on the success of the financial services conglomerate model in areas like cross sell and access to the customer wallet, the fact is customers expect more and more of a one stop shop, while often questioning how the advice they receive can be objective.

It is a conundrum for the sector as a whole.

In our case we have moved strategically to fill the holes we had in our service offering five or six years ago, and then moved to broaden our reach to ensure we can attract more customers.

As this slide shows, each acquisition must complement the Bank's growth strategy, and provide yet another brick in the platform for future growth.

With the recent announcement on Mackay Permanent and other ongoing discussions we expect to continue our twin-pronged approach of growth through both organic and inorganic streams.

We see ourselves as a natural fit for those building societies and credit unions which want to find a customer-centric organisation to merge with as sector consolidation continues.

We have the runs on the board when it comes to these acquisitions, and have shown we can merge with these types of institutions without burning the value inherent in them.

And consolidation is the going to be the buzzword of the next five years, if not in the top end of the banking sector where it should start, at least in the lower end.

I foresee a future where there are few if any building societies left, as their prime reason for being, access to mortgage funding for customers who were not getting what they want from banks, has now been supplanted by other providers and the banks themselves.

I foresee trouble ahead for credit unions too as their profits struggle under increased regulation and tighter margins.

I foresee consolidation in the mortgage originators, and an overdue shake-up of the mortgage brokers' sector, particularly if housing outside of Sydney begins to taper off.

I foresee the possibility of the deconstruction of some of the finance sector conglomerates which combine banking, insurance and wealth management, although this will occur later rather than sooner. However, we have seen the beginning of the move with Westpac's announcement this month that it would float its BT wealth management arm.

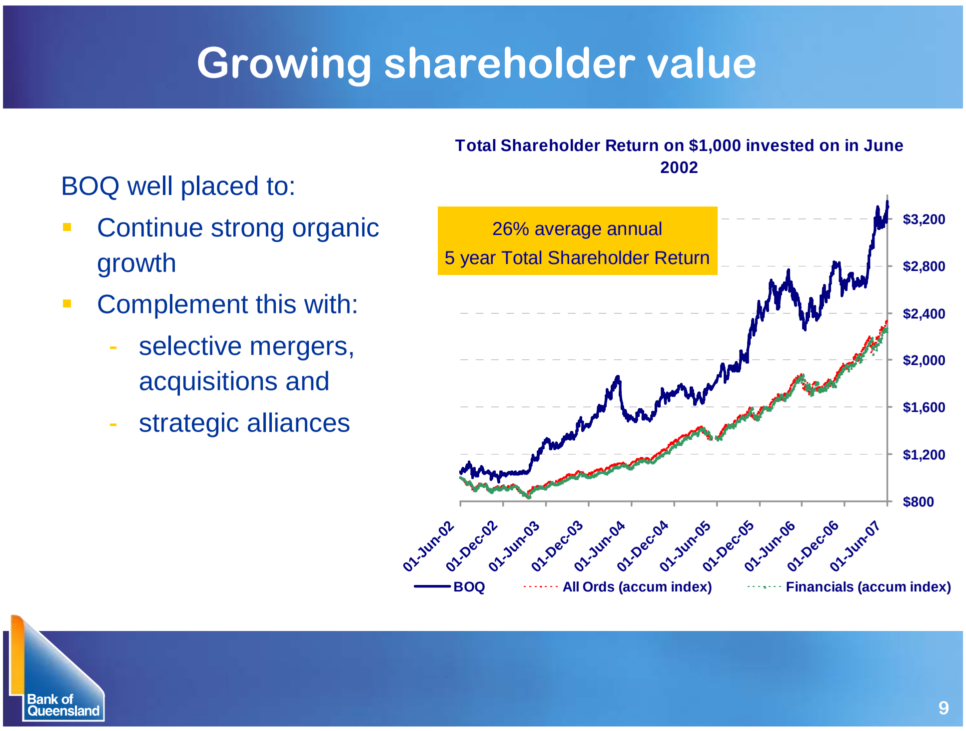
And I believe this may sort out some of the smaller financial players although, as I have said quite a lot today, I believe BOQ is perfectly placed to take advantage of this continued evolution in the finance sector.

In terms of the superannuation industry, the recent changes by the Howard government have no doubt made you all very busy over the past few months. I heard the other day that superannuation savings in Australia have now exceeded our annual GDP, which is incredible!

The rapid growth in superannuation funds in recent years has certainly been a main driver of the successful development of the Australian funds management industry to date.

However, the value of exports of funds management services FROM Australia remains very low, despite the growth in regional demand for this and our relative comparative advantage in this area.

Expanding the export of Australian funds management expertise is certainly a key growth opportunity for the funds management industry in the short to medium term, however the Government will need to come to the party and review the taxation impediments which are currently preventing this.



So, allow me to finish with a plug directly to you as those who control and manage much of Australia's investment wealth.

While the Australian market, like those around the world, undergoes some volatility at the moment, the fact remains, as this slide shows, BOQ has been a success story for our shareholders over the last six years.

And the best is yet to come.

While we have opened a lot of branches in the last three years, most of those branches are only now hitting their straps as genuine value providers for the bank.

The growth we expect will continue to increase as they come on line, the "bow wave" as Credit Suisse called it.

We are also uniquely capable of dealing with the current volatility in lending markets.

With very little in the low doc or sub prime space, entrepreneurial branch managers and a branch expansion which has been able to select high quality growth areas, along with our strong roots in the SME sector, we feel very confident about the future.

Our position, I believe, as the natural partner for those financial institutions looking for a white knight is also well established and will benefit us as we continue to acquire strategic assets.

It's been a good news story for the last five or six years, but there is still much to come for BOQ.

And finally, because again of the audience I have today, I would like to return to where I started this presentation – with the issues facing the world financial markets.

I think what has happened in the sub-prime mortgage market in the US has reaffirmed the importance of a quality, stable banking sector as a platform for the financial markets generally.

Here in Australia, where the banks have such low exposure to the sub-prime markets, we will see the stability and robustness of our banking sector come into its own once again as investors look for that quality in the market.

It hasn't gone away here in Australia, or with Bank of Queensland, and that's good news for all of us.

Thank you for your time.