Australian British Chamber of Commerce

Friday 29th February 2008

12 noon, The Westin Sydney

BOQ: Being a growth company in challenging times

Let me start by thanking Susan and David, and the Australian British Chamber of Commerce, for the invitation to speak here today.

I'd also like to thank Marsh and Customers Limited for sponsoring today's lunch.

Marsh are BOQ's insurance brokers, and we have had a very long and I'm happy to say, trouble-free relationship over several years with them; and Customers are the owners of our branded ATM fleet, of which we have 2,400 across the country.

I have had a very British week this week, starting on Tuesday with lunch on the very luxurious Queen Victoria, which stopped in at Brisbane for a day, and culminating in lunch here today with the Australian British Chamber of Commerce.

I was particularly delighted to receive the invitation to speak to the Chamber, as I feel a strong connection to Britain given I lived and worked there, like many Aussies do, for 4 years in the 80's.

At the time, I was 32 years old and had a very young family – three children under 5 – and was employed by one of the big four banks here who have a red 'W' in front of their name.

I was sent over to further my development in the corporate banking division, and I have to say, like most young Aussie men feel when they set off to work in London, I was somewhat of a confident young buck who perhaps "thought they knew everything".

And, like most young Aussies who head over to the Old Dart thinking that, I realised pretty quickly that that may not be the case.

The lessons started on the first day I landed in London.

When we arrived at our transit home in Leatherhead in Surrey, straight from the 24 hour flight with our 3 young kids, I thought I'd do the right thing by popping out to grab lunch for everyone.

I walked down the road to the nearest corner store, bought 5 pork pies, took them back to our room and heated them up in the oven, slathered them in good old tomato sauce, and presented lunch to the troops.

Lesson 1 – pork pies are not meant to be heated, and are definitely not meant to be eaten with tomato sauce!

Lesson 2 was later that night, when I nipped out to grab a nice bottle of red for my wife and I to toast our new life in the big smoke.

That lesson was that you don’t drink Australian wine in London – very very ordinary wine you’d buy here for $10 was 30 pounds!

It prompted an introduction for me to French wine – cos you could get that for 3 quid!

I learnt other small, but nevertheless important, lessons in my few years in London, like the Brits were very happy to become token Aussies on the train at Christmas time when we had vegemite toast and beer with us. This was in a first class cabin on an economy ticket mind you!

But I also learnt some very big and very important lessons which I’ve carried throughout my career since.

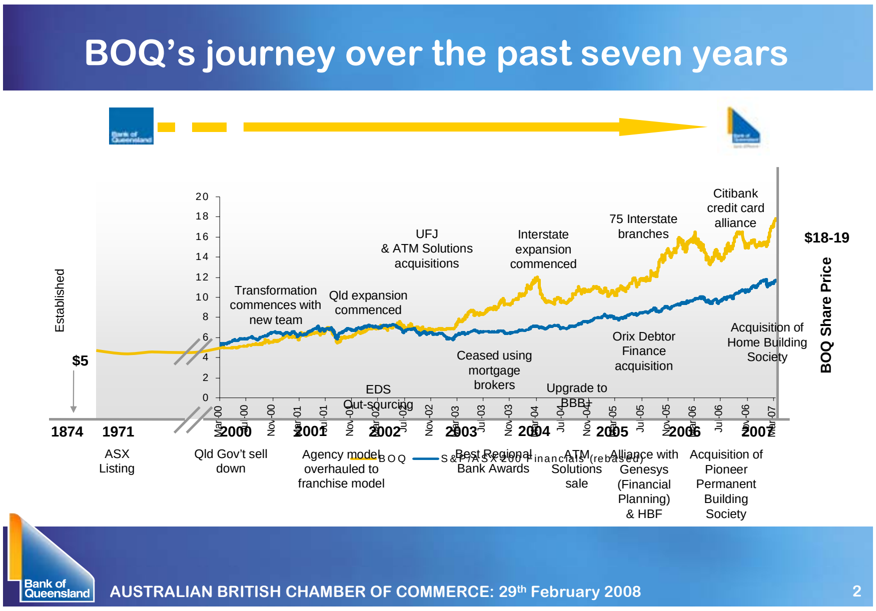
The main one is that it doesn’t matter who you are, or how big or small your wealth is in either a personal or commercial sense, at the end of the day people just want to receive good service.

To some people, good service in banking terms means having someone they know that they can call directly at any time.

To others, it’s the ability to do their banking in whatever channel they choose, whether it be face-to-face or electronic.

And it is this lesson, that people just want to receive good service, which has been central to my leadership at BOQ since arriving almost 7 years ago.

For those of you here who are not familiar with Bank of Queensland’s story to date, I would like to briefly share this with you, and touch on where we are headed in these challenging times.



As you can see from this slide, in 2001 Bank of Queensland was chugging along.

It had a great brand, but had seen little growth above $5 a share for 30 years.

To be frank the Bank was 120 years old and in some ways, was showing distinct traits of happily slipping into the twilight of its illustrious life!

It was more an institution than an enterprise. Was more inward looking than eyeing distant horizons. It had bred a culture that encouraged conformity and repetition rather than reward competition and innovation. In metaphorical terms it was content to just idle along Australia's eight lane financial freeway <u>but</u> it had potential!

Every step we have made since then has been designed to support our strategy of attaining more customers, of keeping them, and of growing their commitment to the Bank.

This growth strategy has seen a corresponding growth in the Bank as a whole, as our results continue to show.

In 2001 BOQ had 93 branches, only in Queensland while its competitors had around 130 in this State.

And today we have 283 branches, including 118 outside of Queensland and 55 here in New South Wales and the ACT.

In 2001 our statutory net profit after tax was $24 million, while in 2007 it was $102 million.

In 2001 our cost-to-income ratio was 72.9 cents in every dollar, compared to 62.6 in 2007.

In 2001 our cash earnings per share was 38.2 cents, and in 2006 it was 93 cents.

In 2001 our loan approvals amounted to $2.8 billion whereas in 2007 they reached $13 billion.

And the share market has rewarded us for the growth. Our market capitalisation five years ago was $400 million and now it is around $2 billion.

And last Thursday, we were rewarded with inclusion on the S&P / ASX100 index… not bad for what we're referred to sometimes back in the Brisbane newspapers as "Liddy's banking minnow".

And we have attracted investment from all around the world, evidenced in this week's announcement of a new major shareholder in BOQ being a French bank based in Paris.

It's a good growth story, and one which is far from over.

But growth alone is not the strategy. Growth without customer retention is little more than rowing a boat in circles. To my way of thinking and in terms of growing shareholder value, customer attrition risk is a bigger risk than credit risk.

Retention comes through customer service. Attraction of new customers more often now comes through good service and word of mouth. Growth in the commitment of the customer to the Bank comes through over-servicing and building relationships.

Can you see the trend?

The fundamental understanding which has driven this growth by Bank of Queensland is that we must match our competitors on product range, accessibility and innovation while out-performing them on personal service.

After all, we see our competitors as the Big Six, and even the smallest of the Big Six is more than ten times our size when it comes to market capitalisation.

We can’t outspend them on TV advertising.

We don’t have a huge residual pool of customers who are finding it too difficult to switch banks.

What we <u>do</u> have is a culture which is completely different from the traditional banks.

What we do have is an entrepreneurial network of branch managers and business bankers who are the best in their field.

What we do have is a nimbleness, flexibility and speed to market.

But most of all, what we do have is a team behind the BOQ brand which actually does care about customer service.

And the team is, in turn, supported by a model which infuses the staff with a service culture.

It is interesting to note that when we changed the old agency model over to the Owner Managed Branch, franchise model in 2001 we believed we were creating a new culture in our branches.

What we did not anticipate was how that culture would push back into the other areas of the bank, driving change by its sheer dynamism, its need for a support structure which matched its own enthusiasm and drive.

Because the Owner Managers, as franchisees with skin in the game, would not, and will not, settle for service from the back end which fails to match their own high levels out the front.

They would not be let down by systems and processes which stymied instead of supported their own service culture.

They demanded better, and we at head office have had to come up with the goods to provide them with better.

If you ask them, they will say this is still a work in progress. After all we have had a lot of catching up to do.

And despite all this, and our internal surveys, it still irritates me no end when I hear we are number two when it comes to customer satisfaction in banks, and number two (behind a different bank) when it comes to customer satisfaction for business banking customers.

Still, we have put everything in place to achieve the number one spot.

As the timeline above shows, we have done a lot over the past several years, from replacing our core banking system, to opening 177 new branches, rebranding and repositioning the bank, relaunching business banking, and selectively acquired where we believed we had weaknesses, all in the past three years.

This was supported in the equipment finance and debtor finance areas through the acquisitions of UFJ and the Orix debtor finance business.

It included the purchase of a small Melbourne based company called ATM Solutions which we doubled in size from 900 ATMs to 2200 ATMs, allowing us to have the second largest bank-owned and branded ATM fleet in the country.

ATM Solutions is now owned by one our hosts here today – Customers Limited.

Now, they weren't on high street. In fact, you are more likely to find them in the local corner store or service station, but the fact remains they gave us an instant, national ATM fleet to support our national expansion.

In 2004, with a national ATM and business banking support network already in place, we started our interstate expansion. We took little old Bank of Queensland into the heartland of our opponents. As Sun Tzu says, we attacked in undefended places.

We went back to the CBD, inner-city suburbs, strip malls and shopping centres and provided a new alternative for customers in New South Wales and Victoria.

At around the same time we made one of our more momentous decisions. We decided to stop using mortgage brokers to sell BOQ loans. We replaced these loans through our own channel within a year, and we haven't looked back.

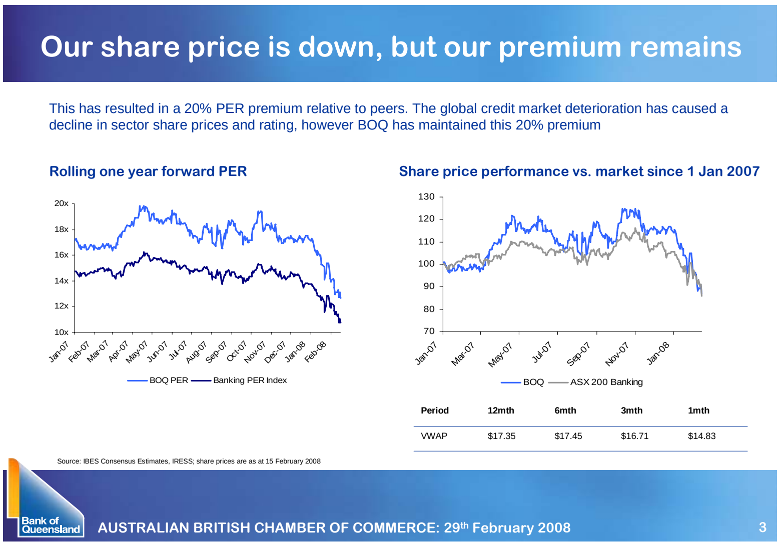
We bought Pioneer Building Society in Mackay, adding $300 million in assets and 23 more points of representation throughout central Queensland.

And last year we bought Home Building Society in Western Australia, which has given us 35 branches throughout the Perth metro area (and a couple in the Margaret River region which I was devastated to find out about), $2.4bn in assets and importantly, in today's world, almost the same in deposits and another circa 126,000 customers!

Importantly, it's given us a real foothold in WA from which we plan to leverage and grow from, and exploit the booming West Australian economy.

So it's been a busy few years, and it will only get busier!

Now as we all know, the events of late 2007 have delivered us into 2008 and a somewhat unprecedented situation. Fear and uncertainty are spreading through global capital markets like a plague, and no-one is sure when things are going to return to normal – or what normal even is.



It is fair to say that no public company is totally immune to the current pressures, and I'm not going to pretend for a second that Bank of Queensland is totally immune either.

The nervousness of investors to back mortgage related securities, the worldwide repricing of risk, and the subsequent share market turmoil obviously impacts all companies – both banks and finance companies, who are suddenly faced with much higher funding costs, and all other businesses who need to borrow money from financiers, and therefore also face higher funding costs.

BOQ's cost of funding has increased, and our margins have subsequently been put under pressure.

We are not alone in this situation, all banks in Australia have the same issues, which are becoming more transparent in the interim results reporting season that is now underway.

Although, I think it's important to point out that whilst all of our share prices are down, BOQ has still maintained its 20% premium relative to our peers.

However it's not all doom and gloom!

As News Limited journalist Terry McCrann wrote last Thursday, "It ain't nearly as bad as it seems"!

Corporate Australia is alive and well, and our main companies as a rule are well run and well managed.

Terry wrote, and I quote, "Most importantly, our banking system is in almost pristine shape. Even the odd-ANZ style bad or dubious debt not excluded. You want to send a country really heading down the tubes? First wreck confidence in the banking system.

"That's why it's so critical that our banks don't fall hostage or worse, victim, to feel-good populist measures. Scan down the top 150 list in the *Weekend Australian* and it's hard to find a name synonymous with bad management and/or failure – contemporary or looming."

I think this is a really important point for us all to remember. Knee-jerk reactions aren't going to help anyone, and the consequences could be dire.

Let's not forget that our overall economy is still good.

The key drivers are still in place – high employment and the consequent upward pressure on wages, continuing increases in commodity prices and the increased income as a result, upcoming tax cuts.

Even if the USA does fall into recession – if it hasn't already – the impact on Australia will be less than it would have been in the past.

A major concern has been that if consumer demand falls in the US due to recession, this will mean a decrease in Chinese exports to the US, a decrease in Chinese revenues, and therefore a decrease in Chinese demand for the Australian resources that are underpinning our strong economy.

However China is continually becoming less dependent on overseas demand as their government focuses on domestic consumption and investment as opposed to being completely dependant on exports for their growth.

In fact, only 2% of China's 11% growth last year came from the value that China added to its exports (that is, the value of exports net of the cost of imported raw materials).

In a corporate sense, the pain of the current credit crisis has not been widespread – it is has been confined to a few highly leveraged companies like Centro, Allco and MFS.

In a general public sense, the major impact of the credit crisis on Australians has been the increased interest rates as banks have been forced to pass on the higher cost of funding.

All banks access wholesale funding markets, to varying degrees, to bridge the gap between what is raised in deposits and the demand for loans.

As everyone knows, the global liquidity crisis has meant risk has been repriced, and the cost of these wholesale funds has increased dramatically.

Financial institutions absorbed the increased cost for several months, before starting to pass some of these costs on to customers through higher interest rates last month.

This has unfortunately been exacerbated for Australians by the tightening fiscal policy being adopted by the Reserve Bank at the same time, who are trying hard to curb inflation.

Most analysts are predicting at least another two RBA rate rises this year, and there are no signs yet of the wholesale funding markets improving.

The situation we're in really is a conundrum.

As a customer-focussed bank, we don't want to increase our mortgage rates and potentially put pressure on families by increasing their cost of living.

But when our costs have increased, and the dynamics of our stockmarket insists that as a company you improve your profits and your returns every six months, what is the choice?

The answer is, as far as I can see it, to balance our shareholders' interests with our customers' interests.

BOQ has certainly tried to do that, and we will continue to do so going forward.

On a more macro scale, the answer I think lies in addressing the inherent short-termism that our public markets – and market analysts – demand.

Every public company CEO talks about the pressure of the markets constantly demanding quarterly or bi-annual results that are bigger and better than the previous results.

It is the treadmill of capital markets, making decisions based on constantly trying to meet the market's expectations – which are always a certain percentage point higher than the previous result.

It is one of the main reasons that private equity will always exist – buying public companies and taking them private and away from the constant public glare, taking the write-offs and making the investments that might not be accretive in Year 1 or 2 but are actually necessary for longterm, sustainable performance.

Then – voila – the company is performing strongly again, and can be trotted out for a market listing, and everyone makes a lot of money.

Maybe a little while down the track, the cycle will repeat itself – it certainly has the potential to be self-fulfilling.

This is a very simplistic viewpoint, I know, but the short-term approach that is forced on public companies is very real.

Our current market structure demands more, better, fitter, faster, stronger… every six months!

Is this actually constraining the performance of listed companies? Who knows.

How could – or even should – this issue be addressed? That is for greater minds than mine to ponder.

But it is a fact of life for every public company CEO, and for every bank CEO, and so when Wayne Swan implores us think of the average working class family when we consider raising our mortgage rates - we do.

Well Bank of Queensland certainly does.

But we also need to balance this with thinking of our shareholders, and the markets' reaction if we fully absorb the higher cost of funding and subsequently release a lower profit.

Just as an aside, isn't it amazing how quickly times change – to think that this time last year the world was up in arms wondering whether private equity was taking over the world.

One little subprime bubble later… cheap money is gone and private equity is no longer the 'threat' it was being seen as.

But I digress.

Not only is Australia dealing with the flow-on effects from the global credit crunch and the threat of rising inflation, but we also have a new Federal Government who are rightfully trying to make their mark on the economy and industry.

I encourage this new Government to make their mark by thinking big, by taking the bull by the horns and making structural changes that will improve the competitiveness of Australia, and improve our ability to better weather events like those that are happening right now.

The banking sector has been in the headlights of this new Government over the past several weeks, mainly due to the interest rate issue I've just been talking about.

However I feel the Government’s response has been somewhat piecemeal and narrow in focus – whilst there is value in asking all banks to set up a switching service to allow customers to more easily switch their direct credit and debit commitments to another institution if they wish to move their accounts to another bank, I don’t believe it is a silver bullet or a significant step to improving competitiveness.

Nor is a review of all banks’ mortgage entry, exit and early termination fees.

These initiatives have value, don’t get me wrong, particularly to a bank like BOQ who will stand to benefit from customers being able to more easily change banks from one of the majors.

But if the Government really want to improve competitiveness in the banking sector, it should be looking more widely across all financial services markets, as most of these need competition promoted more than the already heavily competitive mortgage market.

And it should also address the elephant in the room, the four pillars policy, once and for all.

The elephant, or as my old boss, Dr David Morgan has been quoted as saying, the “woolly mammoth dug from the Siberian tundra and shipped still frozen to Australia as a structure for banking”.

How many more economists, academics, businesspeople and average Joe’s do we need until action – or at least a review – is undertaken?

Preventing the major Australian banks from merging whilst leaving them open to foreign takeover just doesn’t make sense!

Particularly given the emergence and increasing importance of sovereign wealth funds who are cashed up and unaffected by the current credit crisis.

We have already seen numerous examples of these funds buying into the major multinational banks over the past three or four months, as a result of the current conditions.

And unfortunately, the Australian banking sector is also being affected on the stockmarket by these conditions, even though it doesn't make much sense.

To put Australian banks in the same category as the big multinational banks who participated in sub-prime lending and other problematic practices is unfair in my opinion.

Australian banks have minimal exposure to sub-prime debt, collateralised debt obligations, or complex structured investment vehicles that some of the big multinationals have to now bring back on balance sheet.

Our banking sector is very well regulated, and Australian banks are in a much better position than some of our global peers.

And while I'm on my soapbox, so to speak, what I find even more unfair is that on the local stockmarket, and within the analyst community, BOQ is being put in the same category as the major banks in Australia.

Take last week. ANZ announces that they will be holding back circa $365 million from profit for the six months to March 31, due to their dealings with companies impacted by the sub-prime crisis.

The market response? - the entire banking sector went into meltdown, resulting in the worst one-day sell off in the sector in 19 years.

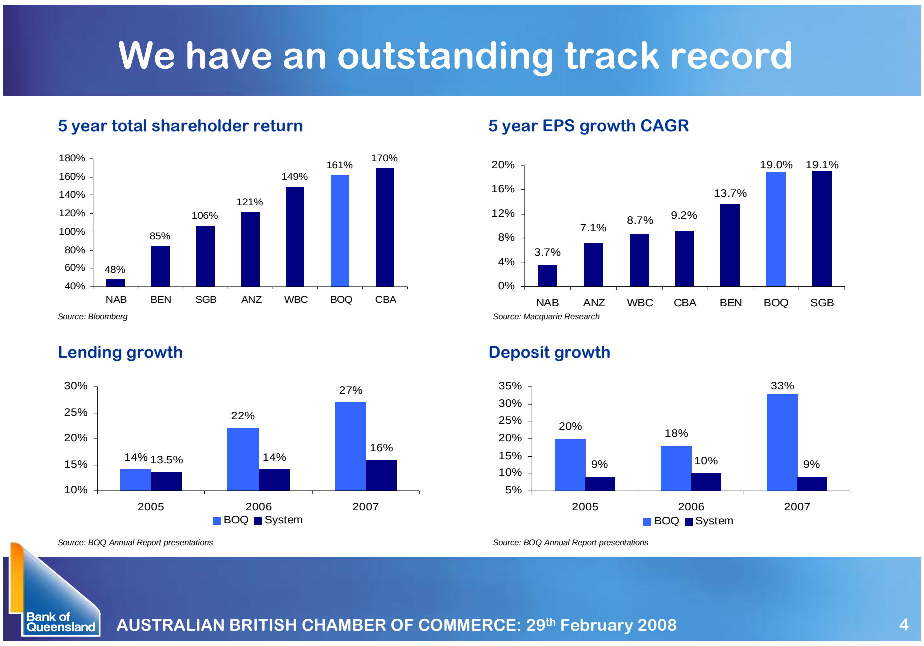
Why on earth should BOQ be tarred with the same brush as ANZ??

We don’t have any corporate exposures – we have 48 exposures over $10 million, each of which I know personally – we don’t have any exposures outside of Australia and New Zealand, we don’t have any collateralised debt obligations.

We don’t even have any exposure to non-conforming lending in Australia.

We have a full complement of products like the rest of our competitors, however we've inoculated ourselves from the riskier segments of the consumer portfolio by outsourcing credit cards, margin lending and insurance.

We are a pure retail bank, we sell loans and deposit facilities to households and small businesses – so when our share price tumbles because one of the big guys here ups their provisions, and we get downgraded as part of the sector call - it really frustrates me.



Our prospects are good. We have an outstanding track record against our peers. We have a fabulous growth engine in our OMB model, and we have a lot of blue sky in front of us.

Whilst I can't give you an insight into our current performance until we announce our interim results in early April, I can tell you we hold a very strong capital position, possibly the strongest it has ever been, and we hold strong liquidity.

APRA's most recent growth data, which is as at the end of December 2007, will also give you some sort of indication.

BOQ's annualised home loan growth is 2 and a half times the rest of the banking system, and our deposit growth is 3 times.

We have our platform for growth in place and are continuing to fire on all cylinders!

I won't go on any further, however I'd like to finish by posing everyone in the room a question.

Are you happy with your current bank?

No, come on, I mean really happy?

If not – give us a go! At the Bank of Queensland table here today, you will find several of our local Owner Managers who would be more than happy to talk with you.

Thank you all so much for your time.