Brisbane Club Young Executives Committee

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Speech Notes

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Thank you for the invitation to talk with you all today, about the Global Financial Crisis, Bank of Queensland, and the future.

Given I'm in a room of bizzoids, I can't resist the opportunity to share with you some of the new Wall Street definitions that the global financial crisis, or GFC as it's now known, has caused.

Like the new definition for a bull market – which is a random market movement causing an investor to mistake himself for a financial genius.

Or a P/E ratio – the percentage of investors wetting their pants as the market keeps crashing.

A broker – is what our brokers have made us.

Or cash flow – the movement your money makes as it disappears down the toilet.

But on a more serious note, I'm delighted to be here today to talk about what is a very topical subject. 18 months ago I don't think people were as interested to hear or talk about the banking industry, but, as we all know, banking is inextricably linked with the GFC, and the spotlight is well and truly on our industry.

It's therefore natural in these unprecedented times that people want to understand what's happening and where we're going.

The good news is I have over forty years of banking experience I can call on… the bad news is I have no crystal ball.

The past twelve months or so have been unlike any in my career. We have seen major international banks collapse, government bail-out packages, and economy after economy slide towards recession.

We all know that we are seeing a global financial crisis unlike any we have seen since World War 2.

And while I don't have a crystal ball to be able to tell you what will happen next, I can certainly give you my thoughts on what has happened to date.

I don't believe the Global Financial Crisis was the result of one specific incident, or issue.

It was a combination of factors that created a snowball effect in terms of the American economy, and then like a particularly nasty virus, its impact spread quickly to all of the economies America has dealt with. Which is to say, almost every economy in the world.

One of the underlying factors was people leveraging themselves to the hilt as they tried to amass wealth at the height of the stock market boom. Some refer to this as greed!

Another factor was the watering down of risk procedures and lending standards as companies became complacent in the wake of an extended boom period.

And on the issue of risk, innovation in the financial sector grew at such a rate that financial institutions and regulators were unable to understand, let alone manage, the level of risk being taken on.

The results have been far-reaching and widespread. Massive financial powerhouses including Merrill Lynch, RBS, AIG, HBOS, Bear Sterns, and Lehmans, among many others, have either failed or required bailing out.
As I said earlier – an absolutely unprecedented series of collapses unlike anything I have seen in my 40 years of banking.

So, what does this mean to Australia?

Again, everyone here would have heard our government and our bankers say that the Australian banking system is far more stable than our overseas counterparts. This isn't just rhetoric; it comes down to a number of factors.

Firstly, our regulatory framework has proven to be one of the most effective in the world. We are far more conservative in our approach to risk than many of our US counterparts.

We also tie the re-payment of mortgages to the borrower, not just the house, which meant we didn't see the 'jingle mail' that happened in the US where home-owners simply mailed their house keys to the bank when they couldn't keep up with the mortgage – or burnt their houses down rather than hand them over to the banks.

And we didn't undertake the kind of sub prime housing lending that was one of the initial landslides in the earthquake that became the GFC.

The conversion of mortgage securities from huge, illiquid assets owned by local banks into liquid financial instruments that could be sold across the world combined sophisticated U.S. financial services dangerously with relatively unsophisticated financial services elsewhere.

The sub prime lending and the 'jingle mail' phenomenon, combined with an excess supply of housing, were a toxic combination that set the credit crunch in motion.
And I'm delighted to say we don't have these three factors here.

Essentially, we are in a much better place than the banking systems off-shore.

But it's obvious that the Australian banking industry has been impacted by the GFC. A quick scan will show that consolidation in the industry has reduced the number of regional banks to three, if you include our big Queensland cousin as a regional bank, with almost constant speculation that all three are about to be bought out or taken over.

For my money I don't believe the current Federal Government is all that worried about that prospect.

In a marketplace where the funding costs are higher for regional banks than for the four majors, the government are now charging regional banks more for their wholesale funding guarantee.

I can't see how it can be anything other than anti-competitive to sting the regional banks more for the funding guarantee when they are already paying more for their funding. It has created a very uneven playing field, making it difficult for regional banks like BOQ to build shareholder value and at the same time remain a competitive alternative in the marketplace.

Earlier this year David Morgan, the former Westpac CEO, spoke about the future of Australian banking. In his speech he indicated that any stand alone financial institution with a credit rating much below AA will, at best, struggle to obtain funding on a cost competitive basis with the Australian majors.

And he's right.

What he also mentions is that the second tier of financial institutions in Australia is fast-disappearing, rapidly becoming an extinct species.

What he doesn't mention is that this doesn't seem to bother the Federal Government.

Now this is something I have been quite outspoken about and for good reason.

To my way of thinking the last issue on the Government's agenda is competition in the Australian banking system. They want stability for the 'big four' and in my view don't really care if the rest of the banking players disappear.

As Managing Director of one of the last remaining regional banks, I have a pretty good reason to be outspoken about this.

From my perspective the Federal Government's interventions on that Sunday in October last year were both timely and necessary and potentially avoided a major financial crisis here in Australia. However the initiatives also had the effect of distorting our competitive banking system, particularly in the area of wholesale funding. I think now is the time to reassess some of these initiatives in order to remove the distortions created.

I am heartened that the head of the ACCC, Graham Samuel, has spoken out in the past couple of weeks of his concern about the growing concentration of power of the big four banks.

He recognises that the funding guarantee has created a sufficient gap between the majors and everyone else that has had an impact on some of their ability to compete, and has stated that restoring competition will require government policy intervention.

A number of economists and business commentators have suggested that the Big Four will actually prosper from the banking crisis, as a result of reduced competition, increased market share and enhanced pricing power.

I agree with these suggestions.

Look at the foreign players in our marketplace. Most have either packed their bags and gone home or significantly downsized their scope of activities in Australia.
Non bank lenders such as Wizard and Rams have either disappeared or been taken over. Even "we'll keep 'em honest Aussie John" has taken refuge in the bosom of one of the Big Four.

In fact, I don't see how the Big Four can anything but benefit from the situation we are currently in. And the market share figures coming in now are proving that - as at the end of March, the big four had 72% of the retail deposit market. Without the takeovers of St George and Bank West by Westpac and CBA respectively, this would have been 61.5%.

And as at the end of March, the big four hold 72% of all outstanding mortgages, whereas last year they held 57.5%.

I'm confident the big four believe it is only a matter of time before the name Bank of Queensland ceases to exist in Australian banking.

So let me assure you that it is my very clear intention to ensure that doesn't happen.

It is my intention to ensure that BOQ continues to be a real alternative to the big four in Australia.

We still want to be a 'big small bank', and not a 'small big bank'. We still want to offer Australian consumers, and shareholders, an alternative in banking.
And I believe that is something Australian consumers are looking for. Well, I know they are, because the majority of our business comes from customers who have had it with the big four and are looking for something different.

So competition in the Australian banking industry is important, and it's never been a more topical or critical issue than it is today.

But the economic downturn is obviously having an impact in our backyard beyond consolidation and a reduction in competition in the banking industry.

Economic growth is slowing, with unemployment rising towards 7 to 8%. The economy is expected to bottom in late 2010.

In terms of the wholesale funding markets, whilst the "panic" factor we saw last year and earlier this year has eased, the markets will remain volatile and expensive for the foreseeable future.

Credit growth is slowing, with consensus estimates estimating only 4 to 6% growth in housing and 1 to 5% growth in SME lending – however there will be pockets of strong growth, such as in the First Home Loan segment due to the Government rebates.

And I think it's commonly accepted that the impact of the credit cycle on the real economy is only just starting, with defaults moving from only highly leveraged corporates, to SMEs and households.

Despite all this doom and gloom, I have full confidence that BOQ will survive this downturn, and that we will actually come out of it well-positioned in the new banking landscape.

Why am I so confident?

Because we're building on our sustainable competitive advantages.

We're continuing to grow through our Owner-Managed Branch Model; which, with some exceptions specifically in New South Wales, has shown its resilience over the past twelve months. We have tweaked the commission structure to re-focus our franchisees on growing retail deposits given the increased costs of funding, and the result of that was a 25% jump in retail deposits as at the end of the first half 2009. In fact retail deposits funded 169% of our first half LUM growth.

We're sticking to our knitting by continuing to avoid high risk property and corporate lending opportunities. Our conservative approach to commercial lending has stood us in good stead in these difficult times, as we don't have the exposure to the high risk corporate lending that our competitors do, and our impaired assets and 90 days-past-due results continue to demonstrate the relatively higher asset quality of our book.

We are continuing our focus on smaller size lending, under $5 million, which is well secured and in line with our value proposition.
Impaired assets, while increasing in line with softer conditions, show no systemic issues and will remain in comparative terms well below our peer group.

We are keeping excess liquidity in the mid teens and a high Tier 1 capital ratio of around 8%, which is comparable to the major banks, despite our much lower risk profile; and we have line of sight to a cost to income ratio in the mid 40s which provides us a more efficient model to challenge scale players.

And we kicked off a major strategic review in December last year called Project Pathways, which is designed to help us exploit the once-in-a-generation opportunities which are arising in the current market, whilst ensuring our viability and shareholder accretion as a stand-alone entity.

Pathways acknowledges that consolidation in Australian banking is inevitable and is already well underway – however it is also irreversible. The takeovers of St George and Bankwest leaves a big opportunity for someone to become the new 5th bank alternative for Australian consumers, and we expect that competition concerns will be a significant barrier to the major banks further consolidating.

The internal workstreams of Project Pathways, our efficiency stream and portfolio optimisation program, are in execution phase. In terms of the efficiency stream, approximately $50 million in expected annualised cost savings has already been identified, with Phase 2 about to commence.

The external workstream of Pathways is evaluating all strategic partnership and merger opportunities available to us, and there has been significant interest in partnerships from domestic and global players seeking a beach-head in a stable and profitable banking market.

BOQ's distribution platform is seen as the most productive and disciplined in terms of quality asset origination in the mortgage and SME market segments.

We hope to be in a position to make an announcement regarding this stream within the next couple of months.

So BOQ is in good shape to tackle the GFC and come out the other side in a much stronger position.

Our focus remains on building shareholder value, and we understand the need to think outside the square to do so in the current economic environment.

We have come a long way since I joined the Bank in 2001; we have grown from a small Queensland-based company with limited market share and a virtual unknown outside its home state to a national player, listed in the ASX Top 100 and a real contender in the Australian banking industry.

And the story's not over just yet.

Now, this might be a good point to talk about why I chose a career in banking, as I was asked to by Brad Summerson, who many of you may know is the son of our Chairman Neil Summerson.

Well, while I am extremely passionate about banking today, and particularly about Bank of Queensland, my career actually started the same way as the careers of many young people… with a fair bit of direction from my parents.

My father thought banking would be a good, safe career, and he also knew the local branch manager in the country town we lived in. So I got all dressed up and went in to meet him, conscious of my handshake and the shine on my shoes, and not a little nervous about my first job interview.

What I haven't mentioned yet is that I grew up in South Australia. Now for any of you who grew up in South Australia, or even Victoria for that matter, you won't be surprised to hear that the first, and only question the Branch Manager asked me was what position in AFL.

Clearly my position was OK, because that was the end of the interview! And I got the job. Then, on the first day, he gave me one piece of advice - "I don't care what you do Liddy - just smile and call the customer by their name".

It is this advice that has stuck with me through the years and I believe is a real part of what makes BOQ different. We believe in the little things. Like smiling, and calling the customer by their name. It may not sound like much, but it makes a difference.

So from the head teller at Bank of Queensland, let me say thank you for the opportunity to talk to you today.

Thank you.