

**DibbsBarker Lunch**

**Wednesday, 3 March**

**Speech Notes**

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**Managing Director**

I'm thrilled to be here today with so many interesting and successful Brisbane businesspeople, at this great venue. Before I launch in to my discussion of the future of Australian banking, I think it's worth mentioning how it is I came to be speaking at lunch today.

Each year BOQ holds a fundraising appeal in conjunction with Children's Hospital Foundations Australia. Last year, our own legal team decided to try to raise funds by auctioning me off to one of their clients for a couple of hours. Despite concerns that this auction may be surpassed in fundraising terms by the Risk Team's sausage sizzle, the warm-hearted people at DibbsBarker put forward a sizable donation of \$6,000. And here I am. But I'm not sure if I'm worth the \$6K!

I truly and delighted to be here today talking about what's next - for the economy, for the Australian banking landscape, and for Bank of Queensland. And it is very much a positive sign that we are now starting to look forward, instead of backwards.

It's an exciting time to be talking about the future. After two years of doom and gloom, newspaper headlines have started to herald the end, the Australian central bank Board has feathered the brakes, and emerging

countries such as China and India are demanding more Australian resources.

So it's almost safe to assume the worst is over here in Australia. Almost. As we start to raise our collective thinking towards the future and navigate the new world, it is important to consider what it is we have actually learned throughout this more than two year ordeal and how the landscape has changed.

But first, let's take a quick look at how it all happened.

Like most of us, 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 were far-reaching and widespread. Massive financial powerhouses including AIG, HBOS, Bear Sterns, and Lehmans, among many others, either failed or required bailing out.

And while the US economy is on the road to recovery, unemployment remains high and there is still significant stress on the American economy.

As a commentator said towards the end of last year, “While it appears to us that the recession is over, there are a lot of lingering signs of pain on Main Street”.

And I think the same could be said for the Australian economy.

While unemployment actually decreased in January, a closer look at the numbers shows that there are actually 2,200 fewer full-time jobs across Australia than there were at the same time last year.

The unemployment figures are being driven by a huge increase in part time work; in fact, the number of part time workers has increased by a huge 7.7% over the past calendar year.

So while business owners are hiring, and let's be honest – our labour market has performed amazingly compared to the rest of the world – we're not yet at pre-GFC levels.

Sure, our economy positively sparkles when compared to that of Greece, which is today hammering out tough new austerity measures needed to rein in a bulging deficit and earn the EU's financial support, or even Germany, which recorded zero growth in the last quarter of 2009, and Italy and Spain, which both went backwards.

And without wanting to gloat, we are of course in a far better position than the States, where unemployment rate is at a lofty 9.7 per cent and Ben Bernanke is trying to outline his strategy to wean the country off the enormous stimulus measures that saw the US central bank pump more than \$US1 trillion into the economy.

But while the Australian economy is certainly looking a lot rosier here than in the States, it is not all champagne and caviar just yet.

We have a lot of Australians on part-time wages trying to pay off mortgages with increasing interest rates.

Our communal coffers are being depleted at a rate of knots as our government's stimulus measures continue to rocket along, even though unemployment is falling and interest rates are on the rise.

The good news, however, is that the Australian banking system has proven to be far more stable than our overseas counterparts. And this 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, fortunately for those of us down under, we don't have these three factors here.

Essentially, we are in a much better place than the banking systems offshore.

But that is not to say that Australian banking industry has been left unscathed by the GFC. A quick scan will show that consolidation in the industry has reduced the number of regional banks to three, with a number of mortgage brokers and non-bank lenders falling by the wayside too.

The Commonwealth Bank of Australia bought Bank West and took a major shareholding in Aussie Home Loans, Westpac bought St. George Bank and RAMS and Wizard Home Loans disappeared.

Obviously competition in the Australian banking sector has suffered as a result of this consolidation. But there has been another factor too. An unintended consequence of the government guarantee of wholesale funding, which of course is now being removed, is the anti-competitive nature of the pricing structure.

You see, confidence in the banking system returned with a bias towards bank deposits as riskier asset classes fell out of favour at the height of the GFC as volatility in all non-cash asset classes increased exponentially.

Australia's four major banks, which are heavily dependent on offshore funding to maintain their balance sheets, took advantage of the

Commonwealth's guarantee with the relatively low cost (compared to other jurisdictions), to issue the lion's share of all debt issued under the government guarantee as at the announcement of its withdrawal a few weeks ago, contrary to what you may read in the press.

What you may have heard in the press are my frequent calls for the fee to access the government guarantee to be levelled between all the banks and authorised deposit-taking institutions, or ADIs. Let me explain why.

The investors in government guaranteed term debt issued by banks have taken advantage of the government guarantee but still priced the debt on the underlying issuer's credit rating. This effectively meant that in addition to the 150 basis point fee the government charges us, as a BBB bank, to access the guarantee, investors were still "looking through" to our credit rating and charging a further 15 to 25 basis points.

The government only charges the majors, as AA rated banks, 70 basis points to access the guarantee.

This means that the regional banks, building societies, credit unions and un-rated institutions, have been paying an additional 95 to 105 basis points versus the major banks, and this has had a tremendous impact on the competitiveness of the smaller banks in the mortgage market where prior to the government guarantee margins on home loans averaged 140 basis points.

Combine with this issue with the incredibly aggressive pricing on retail deposit funds, and the outcome is a significant increase in the cost of retail deposits; resulting in all regional banks reporting significant reductions in overall bank net interest margins in the latest reporting period, while the major banks all reported improved net interest margins.

During this time, APRA released statistics flagging that the major banks in Australia were capturing more than 90% of all new business being written. This compared with their market share of 64% pre-GFC. Clearly, this is no coincidence.

So, what to do about it? And more to the point, why am I still beating this same drum when the government has already announced the guarantee's withdrawal?

Because BOQ will continue to be disadvantaged – we will continue to be charged the additional 80 basis points for the remainder of the term debt we carry – for the next four years. The disadvantage we have faced under the guarantee's pricing will become an albatross around our neck, and that of competition in Australian banking, well into 2014.

Now I'm not for a minute saying the government doesn't care about competition in Australian banking. They have said time and time again that they do, and that it is a priority for them. But to my way of thinking they have not addressed the key impediment!

They have certainly assisted access to funding by investing up to \$16 billion in the RMBS market, which had a real impact on smaller lenders like BOQ in accessing funding throughout the GFC. But let me be clear – it's not the access our concern is with. It is the **cost** of this access.

This is a real issue. It is an issue to the tune of \$30 million pre-tax profit for BOQ. It is an issue in that it hampers our ability to price aggressively against the major banks and offer real price-based competition. Fortunately for us, we have a unique service proposition that is very attractive to many Aussies, and as a small bank we're used to fighting against tough headwinds, but that's not the issue. The issue is that we shouldn't be put in a position where we may have to disadvantage our customers because of a pricing decision out of our hands, which is an unintended consequence of public policy.

Now some people I've spoken to have warned me against continuing to speak out about this issue, as they believe it makes BOQ look like we are in trouble. Let me say this clearly – BOQ is in an extremely strong position in terms of funding and liquidity.

In fact, despite the uncompetitive costs, we have been active in the Government-Guaranteed term debt markets with the strategic goal of increasing our term debt maturity profile.

In addition, we recently received such strong investor demand for the Series 2010-1 REDS Trust RMBS, the transaction was upsized from A\$500 million

to A\$850 million. And only on Monday our \$500 million 5-year term debt bond issue was increased to \$1 billion due to demand.

So don't for a minute think we are expending all of this energy because we are facing funding difficulties.

We just want a level playing field. We don't want hand-outs; we don't want a leg up. We just want a fair go.

I don't want to sit back and watch while competition in banking disappears and the majors grow bigger and bigger, until we are facing a Coles vs Woolworths style oligopoly in banking?

It's not over just yet. There is still time to reinvigorate competition in Australian banking and that is my driving ambition for the next couple of years. I want BOQ to become the real alternative in Australian banking. When an Australian consumer gets fed up with the way they're being treated by the majors, I want the first bank they consider to be BOQ. But I want to be able to offer them extremely competitive pricing on all our products and if the Government take no action to level the playing field, it will be difficult for BOQ to do so, along with all the non-major banks and financiers. That's not to say we're not competitive - you wouldn't survive in banking unless your customers were happy to pay what you were charging – but there is a lot more we could do if we weren't starting from behind.

I'll talk a bit more about BOQ becoming the real alternative shortly.

So what other challenges does the future hold?

Well, I believe the future will be punctuated by Government and regulatory intervention, a need for banks to reconnect and build greater confidence with the communities they serve, and as an optimist I believe market forces will ultimately see us return from whence we came.

At the centre of public and policy debate around the world, Government intervention - whether through the implementation of sovereign guarantees, executive salary reviews, liquidity rules, public investigations or outright ownership of banks - has been swift and far reaching.

It is the far reaching nature of some of these decisions that we are now required to come to terms with, as speed was of the essence as Governments globally sought to ward off the impacts of the GFC.

Legislating consumer protection will be one of the battle grounds established by the regulators. As we have seen with the Financial Services Reform Act, the practical will no doubt give way to a tsunami of bureaucracy, which after long consultation and with lofty goals, will leave a consumer who can't decipher an FSG or a PDS, and couldn't tell you what they were if you asked them.

The banking industry will then diligently comply with the new requirements at great cost without generating any real value as we attempt to implement a "risk free" regime to a marketplace that attempts to manage and price risk.

And that brings me to the topic of the new National Consumer Credit Protection Legislation, or NCCP legislation, that the Government is in the process of introducing.

The new legislation imposes certain responsibilities on lenders, including the new requirement to assess the suitability of the credit contract for each borrower.

Suitability is defined in terms of the ability of the contract to meet the consumer's requirements/objectives and the capacity of the borrower to comply with the obligations under the contract without substantial hardship.

While such a responsibility may appear attractive on the surface, and BOQ certainly agrees with the spirit of the concept, it potentially opens up a range of unintended consequences in terms of the cost and availability of finance, the implications of which need to be weighed by the Government very carefully.

This legislation hasn't had a lot of media or public coverage, but there should be! Let me try and quickly summarise for you why.

Banks currently lend to clients for a myriad of activities including running businesses, purchasing houses and cars, making investments, and personal pleasures such as vacations.

What we need to clearly understand and articulate is how far responsibility should extend with respect to a bank's borrowers, as proposed by the new

legislation. As is often the case, the answer is very clear in extreme situations, but much less so in the vast majority of cases.

The traditional role of banking has been to assess loan applications from the perspective of the bank as lender, rather than from the perspective of the borrower.

That focus ensures that the bank takes responsibility for assessing the creditworthiness of the loan, while borrowers take appropriate responsibility for their own spending decisions.

While the legislation refers to “suitability” and provides some guidance, the legal interpretation of this concept will be determined in the courts, and extended in regulations.

If, for example, a customer bought a rental property with the expectation of achieving a certain level of capital growth and rental income, could the customer then hold the Bank liable if they didn’t achieve the capital growth they were expecting, or the property rented for less than they had hoped?

Even more importantly, there is a material risk that transferring responsibility to the lender could cause access to finance to be significantly withdrawn.

It is a very fine line to tread, but 300 years of banking experience has shown that there is a sound basis for separating responsibility for the lending and spending decisions.

For this reason I would urge caution and more discussion and deliberation around these points. As it is, the discussion guide for responsible lending isn't due out until mid-year, giving only six months until we need to comply – this is unrealistic!

As we have already learned with the Government Guarantee, even the best-intended intervention can have unforeseen or unexpected consequences. But as these issues have already been made clear, it would be foolish in the extreme to push ahead regardless, and could have dire consequences for small businesses, even big businesses, and everyday Australians right around the country.

In Australia, Government ownership of banks due to financial crises has not been necessary, but intervention by government owners of major global banks will, I believe, have a massive impact on the pace of recovery of those businesses and ultimately the economies that they serve.

The double-edged sword for governments will be seeking protection of their capital through low risk banking at the expense of the pace of economic reform.

Finally, the interconnectedness of the global financial system, which we intuitively all understood, has been exposed warts and all.

The imminent failure of the global financial system last February was a near failure whose consequences even now are impossible to fathom.

Regulators will seek to ensure viability and liquidity of the system under

many unlikely future scenarios. Once again this will be a balancing act between risk and return that is sure to be hotly debated.

On that note, it is also relevant to mention the proposed new liquidity rules, which are currently just in the white paper stage, which put forward the concept of all banks holding liquidity in the form of the safest debt securities - Commonwealth Government securities.

Now this is probably not the best solution when in any liquidity crisis the investor base engages in a flight to safety, and when such a solution can exacerbate the lack of liquidity in higher risk debt, for example, issued by triple B banks.

I would suggest that to improve liquidity it should be mandated that individual banks hold a spectrum of credit rated instruments in their liquidity books, thereby ensuring that liquidity is preserved in each risk category.

There have been a number of suggestions made that would change the definition of acceptable regulatory capital. Again, I would recommend that all of these initiatives are scrutinised closely, as they have the potential to increase the cost of equity capital for banks, which ultimately will result in more expensive financing from these institutions.

It is fair to say that, although we haven't necessarily seen the outpouring of public sentiment we have seen in the US or UK, the Australian community has also raised concerns about the structure and leadership role this

industry has in the overall success of this country's and their personal economy.

I believe one of the major challenges faced by the industry will be in rebuilding the confidence and support of the community.

The global and domestic consolidation that has occurred has stunned the world and left Australian consumers fearful of the potential of an uncompetitive oligopoly.

Good leadership by Boards and Management, sound and balanced business plans and recognition of the current state of play will be the order of the day. We are already seeing the major retail banks move their messaging from security to reconnection.

As a proponent of the theory of market forces, I believe we will gradually see a return to "normal" as capital is freed up to seek returns.

Domestically, the adjustment of asset values and re-pricing of risk has seen a return of capacity in the market and signal a return to a new "normal" lending framework.

What may not return to "normal" so quickly is the feverish competition for retail deposits I mentioned earlier. As banks have sought to reduce their reliance on the dysfunctional wholesale markets and some of our regional competitors, like Bendigo Bank, have shied away from the government guarantee because of the incredible pricing disadvantage, the industry has

exposed the imbalance of savings versus lending which is further exacerbated by Australia's compulsory superannuation regime.

As fund managers seek to diversify risk and maximize portfolio returns, we find ourselves in an interesting scenario whereby we produce the capital here in Australia and then export it internationally through the super funds, leaving Australian ADIs fighting for an inadequate pool of retail funds and being forced to import it back again.

Although I believe that this will be a long term concern for us to deal with, it will require structural reform that is unlikely to have any real outcome or consequence in the short term.

So what does all this mean for BOQ?

To be honest, these past two years have drawn my focus, and that of my colleagues, back to the very essence of banking.

In a recent publication by Booz & Co, the role of banks was somewhat loftily described as having three fundamental roles:

- Providing a safe haven for the savings of individuals and businesses
- Efficiently and effectively allocating capital across the economy
- And bridging the divergence between short term depositors and long term borrowers.

Maybe more simplistically, my focus has been drawn to the fact that we buy and sell money, a notion up until now taken very much for granted and built

on the assumption that there would always be buyers and sellers. For me then, and probably a number in financial services, the GFC has served to refocus us on the cornerstones of funding, liquidity and capital which I believe will serve many of us well as we navigate the uncertain future.

However, most Australian banks do not need to return to first principles in relation to either their strategy or business model – as perhaps some of our northern hemisphere counterparts do.

For Australia, the task is largely one of adjusting to a changed environment rather than the recasting of strategy or business models.

We believe the GFC and subsequent consolidation of major financial services players in Australia, while reducing competition, has created a massive opportunity for BOQ to evolve as the real alternative to the major banks.

As I mentioned earlier, we believe we can offer Australian consumers the real alternative to the big banks and we have recently launched our largest ever campaign engaging both staff and consumers about our new brand proposition: Your own personal bank.

In fact, a fortnight ago we launched the biggest advertising campaign in the Bank's history to spread the word so you may have heard this voice pretty regularly! But don't worry –the focus of the campaign has shifted to the real heroes of the Bank – our Owner-Managers. But that's another story for another day.

So in the new post GFC environment, the good news is that while we will face the same costs of regulation as the big banks, which as a small bank with less money to throw around puts us at a disadvantage, in some ways we are actually ahead of the big guys.

While the other banks are now finally realising the importance of relationship managers, of connecting with the local community, we have been doing this for years.

Some of you would have heard Westpac's announcement late last year that taking managers out of branches was wrong and that they would be putting 600 managers back in to branches.

Well, I'm afraid they've got a lot of ground to make up. Because our Owner-Managers have been quietly building relationships and supporting their communities for years.

We have around 200 Owner-Managers, right around the country, and these people remain our point of difference and the main driver of our growth. Because they each own and manage their own branch, they demonstrate a level of commitment to their customers that you just don't see at the big banks.

And you can probably pick the BOQ Owner-Manager or Branch Manager on the street because a lot of them are now wearing shirts that say 'I'm a Bank of Queensland Owner-Manager. I never left.' A simple message, but effective.

But I'm not here to spruik the Bank or our OMB Model; I'm here to talk about the future of banking.

And to my mind, the future looks bright. We have, as a global industry, seen the dark days, and we have made it through. We have learnt from our mistakes, and it is time to push forward again.

Never again will we take for granted the good times, and never again will we forget that banking is fundamentally about risk and return.

But then again, I'm sure that's what our great grandfathers said following the last great crash.

While we have been through more than two years of hard times, the economy has well and truly hit the bottom. Which can only mean that we are at the start of the upwards cycle, and surely that is a better place to be than at the top, waiting for the first sign of a slide...

Thank you for your time.