

FINSIA Panel Luncheon

Friday, 20 March 2009

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The Sub-Prime Crisis and Queensland

A year ago, when asked to discuss what ramifications the sub-prime meltdown crisis in the US lending market would have for the financial future of Queenslanders from a banking perspective, I talked about three issues: the higher cost of debt, a slow-down in lending and the potential for credit rationing.

One year on, and I am almost surprised by how spot on we were in terms of key issues.

The higher cost of debt has been one of the most significant issues for the banking sector, and has had far-reaching impacts for both customers and shareholders.

This time last year banks were increasing interest rates outside of the RBA movements; one year on, and banks are passing on most, but not all, of RBA rate cuts. The direction has changed but the need to pass on some of the additional funding costs to customers has not.

We have also definitely seen a slow-down in lending, and the potential for credit rationing, while not yet realised, certainly remains as a threat.

However I would like to add here that the slowdown in lending is not because the banks have stopped lending, as some parts of the popular media and some politicians would have us believe. Yes, banks are charging more for risk, because as we all know – for good reason – risk has been repriced forever.



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Banks are also ensuring that their lending criteria adequately reflects risk – but we have not stopped lending.

What we did not foresee this time last year was the collapse of major international banks like Merrill Lynch, government bail-out packages for everything from insurance giants to car manufacturers, and economy after economy slide towards recession.

What we did not foresee was that the subprime crisis would escalate into a global financial crisis, which is unlike any we have seen since World War 2.

In terms of banking, the good news is that the Australian banking system is 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.

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.

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 significantly 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



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Queensland cousin as a regional bank, with almost constant speculation that all three are about to be bought out or taken over.

I made some comments at an ABN Amro Morgans' breakfast this week that 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.

I'd like to expand on this point a little, as it was incorrectly portrayed in the media. I believe the pricing of the government's funding guarantee fails in three key ways.

First, if the pricing of the guarantee is meant to reflect the risk of the institutions using it, it fails. Not even public markets have priced the difference between the regionals and the majors in the way the government has.

Second, the government guarantee fails to take into consideration the term of the loan.

And third, because of the way the market is pricing risk and the government also incorporating a risk differential into its guarantee, essentially regionals are being hit twice for the same thing.

The pricing of the guarantee 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.

In a recent speech about the future of Australian banking, David Morgan, the former Westpac CEO, 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.

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.

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'm sure some of you are sitting there thinking "who cares David? You're just being selfish and looking at this from your own point of view."



Perhaps.

But unless you're prepared to accept an oligopoly in banking, unless you're happy with the prospect of a Woolworths and Coles situation in financial services, then you should be concerned too.

Anyway, let me get back to the Big Four.

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 save ya honest 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 I'm confident they 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. One of the benefits of being a small, nimble player is that we're able to react quickly, and we're used to punching above our weight!

But let me stray outside the banking sector into government just one last time; but this time, state government.

This time last year I encouraged the State Government to look at reducing stamp duty fees for Queenslanders to improve housing affordability in our state.



This year, with the election looming, Queensland business is being promised everything from payroll tax reductions and staff retention incentives, on the LNP side, to investment in training budgets and a focus on protecting jobs in the state's north-west mineral province, on the Labor side.

Regardless of which party wins, we will watch with interest to see whether these claims are backed up with action, or whether the promises were just that – empty rhetoric.

Well I think that's my 5 minutes up. Hopefully next year I can come back and talk about an Australian, and Queensland, economy that has hit the bottom and is bouncing back, and state and federal governments that are demonstrating they understand the importance of supporting business, and more importantly, competition in business.

Thank you for your time.