Funding Australia's Future

Welcome and thanks.

It is an honour to be asked to address such a prestigious body as the Lowy Institute, and I am honoured to be the first bank CEO to deliver the Lowy Lecture.

The Lowy Institute plays such a significant role in the public policy discussion of our nation, demonstrated most recently by its hosting of the launch of the Federal Government's White Paper on Asia.

My pleasure in addressing you this evening is made even more so by the support from the Lowy Family, which NAB has proudly banked for more than 50 years.

I'm proud to lead a bank that, at that crucial point in 1960, said yes to Frank and to Westfield. By the time of Westfield's 50th anniversary, a £500 investment at the time of float would have translated to nearly $160 million for investors. Frank's entrepreneurial efforts have led to significant social and economic benefits both in Australia and abroad.

Entrepenuralism.

Frank's story is a reminder that we ought to elevate the fact that Australia has benefited from the efforts of its entrepreneurs just as we once said that Australia "lived off the sheep's back."

It is the effort of our entrepreneurs which has led to growth, and jobs, and higher tax receipts to be applied for education, health and other essential national initiatives.

Entrepreneurs time and again have looked beyond the ruck and have sensed opportunity worth pursuing relentlessly.

Across the nation there are hundreds of thousands of entrepreneurs who approach banks every year, seeking funding to pursue opportunities with the prospect of taking the nation forward.

Indeed, one of the fastest and most reliable ways to stall an economy is to stop funding the very engines of its growth. Banks, regulators, and governments, all play their part in establishing the settings and therefore the availability of credit. All of these stakeholders need to work not just at the overall design level but at ground level where individual businesses, entrepreneurs and investors operate to pursue opportunity.

To put this in context from 2000 to 2008 Australia's banking assets grew from 110 per cent of GDP to 215 per cent, demonstrating the need to examine the structure of both our banking and financial systems carefully in order to devise solutions which work practically at ground level. Ensuring credit gets where it is needed when it is needed.

While we often spend time focussing on the market implications, the reality is – as we have seen from recent overseas experience – the fallout of any crisis has greater social implications.

It is for this reason that it would be wrong to assume this is only an issue for the finance industry. It is an issue for us all. That is why it is a worthy topic of discussion to be explored at the Lowy Institute which has contributed enormously to our national and international policy debate.

Which brings us to the GFC.

As we move past the 4th anniversary of the Lehman's collapse, informally recognised as the key moment of the financial crisis, it is clear that the GFC has not been a short or easily resolved issue. While there have been periodic outbreaks of optimism they have been outshone by the obvious long term implications of debt in major economies. The reality of debt has weighed on financial markets as politicians have debated the merits of austerity and stimulus to deal with sovereign budgets.

For Australians, the GFC has served as a reminder of just how closely integrated our own economy is with the rest of the world.

This had both positive and negative consequences. People rightly questioned why was it that the US sub-prime losses led to interest rates movements beyond or independent of the RBA movements? This has created a negative sentiment around the industry and a challenging environment for real reform.

At the same time from a positive perspective, while Europe and the US have been severely affected, Australians are beginning to see greater advantage of our adjacency to Asia and the economic benefits that flow from that.

One of the lesser referenced statistics from the GFC from an Australian viewpoint, yet a significant one in my view, is the considerable amount of business credit which was withdrawn from the system by banks. Many European and US banks quickly retreated into their own shells and over the past four years foreign banks' participation has been patchy. The Australian banks – to varying degrees – picked up the slack. In a subsequent crisis we should expect the foreign banks to retreat again but will Australian banks be able to repeat their efforts?

The situation of course could have been much worse, were it not for the co-operation between government, regulators and banks at the most critical of times. More of that shortly.

The role of banks

Having averted the worst, there has been much reflection. Debate around the role of banks in an economy is always essential. It is only natural that when there is a severe financial crisis that this debate will come into sharp focus.

The extended nature of this financial crisis – and the immediacy of the digital age - has served to keep banks on both the front pages and the business pages as well as generating significant online debate. Banks have made periodic and brief appearances on the front pages of newspapers in the past but this has been a unique period where there has been an extended focus.

The focus is as legitimate as is the debate that has followed.

That debate began with the very real question as to what role the banks played in fuelling the crisis, especially when taxpayers overseas were forced to directly inject equity to prop up failing institutions. This only intensified the public and political anger.

As some commentators have noted, the severity of the GFC was because it was not one crisis but three. One, the housing bubble in the US leading to asset devaluation. Two. Highly leveraged bank balance sheets meaning there was a low capital cushion and three, the reliance by banks on short-term wholesale funding which caused a liquidity crisis.

Australia fared better than many countries across the OECD. We did not experience all the turmoil seen in foreign markets. We did not require the taxpayer injections of equity to underwrite our financial institutions but we were not immune from the public debate. And nor should we be.

In Australia we have had no less than five banking inquiries since the GFC, reflecting a range of concerns. I do expect more inquiries in the future but I hope they would focus more on future reform rather than other issues which are adequately addressed by existing frameworks.

These other issues such as customer service, executive remuneration, fees and charges, levels of profitability and rates of interest do warrant discussion.

Banks have traditionally done a poor job of directly engaging with the public – our customers - on these concerns. These are genuine public concerns and should be taken seriously.

Over the past three and a half years NAB has led the banking industry in making changes to bring greater competition, transparency and fairness into the system - building greater trust in our industry. It's not enough to talk about trust which is why we took action to build it. But that is a discussion for another time and another place.

The ongoing debate about transparency in the banking industry is as important as it is serious but this focus has clouded other key areas of reform that need to be debated.

Lessons from history: crisis brings reform

One of the greatest strengths of Australia's economy has been our preparedness to change, to ensure that we remain nimble and able to respond to the challenges of a constantly evolving market.

This is not new. Each economic crisis has resulted in reflection and reform.

In 1820 the liquidity crisis prompted the establishment of currency standards and better basic management.

The bank runs and collapses between 1850 – 1890 led to changes to bankruptcy, reconstitution and capitalisation regimes and Government intervention.

In 1911, the Commonwealth Bank was established which ended up as the central bank. In 1937 a Royal Commission instituted reforms following a review that found that loss of access to international capital markets and big foreign debt fuelled the Depression.

The liquidity squeeze of the early 1970s was accentuated by a requirement to place one-third of overseas borrowings in a non-interest bearing account, highlighting the sensitivity of the economy to tight liquidity conditions. This quantity of offshore borrowings worsened - not strengthened - the system because the system had become too rigid and it needed deregulation.

And in 1983, the Australian dollar was floated and a year later that was followed by the issuing of 40 new foreign exchange licences. In 1985 16 banking licences were awarded to foreign banks.

Then we saw bank collapses and other financial institution problems which ultimately led to the establishment of APRA and with it a stricter prudential oversight.

What history has shown is that each crisis has led to improvements in the system.

In the wake of the GFC, the regulatory framework has been adjusted, through Basel III and other changes, to reflect the requirement of a safer financial operating environment. But we are wasting a crisis by not advancing public understanding and therefore a climate conducive to subsequent reform.

Public debate in Australia continues to centre on rate movements and profit levels. We are yet to meaningfully explain the way in which banks work, the risks they face or how a healthy financial system that can withstand international pressures is vital in underpinning a healthy Australian economy. A national economy that continues to create jobs and provide confidence and certainty for all Australians.

A safer financial system will require structural changes and we need to provide customers with the context of why this reform in important and necessary.

We need to reduce our reliance on foreign wholesale funding. We need to fund Australia’s future and we need to fund Australia’s future engagement in the Asian century.

You could argue that with the worse of the crisis averted that these are not pressing issues. And as we stand here today they are not. Australian banks are stable and well-funded which is why it is exactly the right time to debate these issues.

Availability of credit

The implications of solving this funding problem will have a real impact on business and commerce. It will influence the availability and price of credit – business, housing and personal – and that impacts all Australians.

If we don't provide the context and create an informed and engaged debate then any changes to credit availability and pricing will be seen negatively rather than as the nation's insurance policy to promote future stability.

It is currently estimated that approximately $700bn of essential infrastructure is needed in Australia. The nature of these projects is clearly long term, but our banking system and financial system is not set up optimally to support long term financing. International banks have been withdrawing capacity, and indeed European banks are estimated to have withdrawn $13 billion in just the past twelve months alone. As the European banks retreat, who will fill this void and meet new funding needs?

Australia's banking system is not optimised to finance smoothly the long term investments which Australia currently needs. This needs to be urgently addressed if we are to prosper over the coming decades.

While larger organisations, of sound credit standing, have a variety of funding options via the capital markets, small and medium businesses are much more limited.

SMEs are the engine of economic growth and yet remain disproportionately reliant on commercial banks for the credit required to fulfil their growth needs. So much of our confidence – from job creation to housing prices, to retail expenditure – is determined by a strong SME sector which is why it is in the national interest that credit remains accessible to SMEs.

Australia's funding task

In any given year Australian banks need to raise more than $100 billion offshore.

When the crisis intensified in late 2008, the real impact on Australian banks was the increasing difficulty to secure funds in offshore markets.

The wholesale funding issue was averted by the introduction of the Federal Government guarantee on our commercial banks' borrowings. The provision of the so called "sovereign wrap", for which banks will pay the Government approximately $5.5bn, allowed credit to remain available in Australia.

This was vital to our economy. One of the fastest ways to send an economy into recession is to restrict credit. If banks cannot source funding they have to restrict lending. This is a simple equation.

It is clear that any financial crisis, no matter the trigger, automatically leads to a crisis in counterparty confidence.

It therefore flows that when the next financial crisis emerges we will again remain at risk of a wholesale funding crisis, even if Australia remains immune from the root causes.

Some would have you believe that this reliance on foreign funding places Australia in a similar situation to Greece.

This is not the case – even remotely.

In contrast to Greece's ongoing problems, the Australian Government guarantee was enacted in October 2008 and by May 2009 National Australia Bank secured unguaranteed offshore funding - the first of the Australian banks to do so.

In a matter of months the immediate funding crisis had passed and the underlying quality of a AA bank was again at the forefront. Greece is a much more complicated and different problem though it continues to influence funding markets.

The fact that Australian banks, armed with a Government guarantee, were able to access funding should not be a case for complacency.

What it demonstrates was that Australian banks were stable, the economy was performing and once the immediate crisis had passed we were an acceptable risk once again.

The reason there should be no case for complacency for banks, for governments or for regulators is that we can never be sure when and how the next crisis will emerge.

We can never predict how long funding markets will remain dysfunctional or how effective traditional mitigants such as the sovereign wrap will be.

What we should do is minimise our exposure to offshore wholesale funding markets.

Now while I have no knowledge or insight as to what might cause the next crisis, history shows there will be one sometime in the future so let's make sure we're ready for it. Why do I know there will be another crisis?

Because there was one in 1637, 1797, 1819, 1837, 1857, 1884, 1901,1907, 1929, 1937, 1974, 1987, 1997 and in 2008.

The global regulatory regime is certainly getting ready for it And we must ensure that Australia is in the best possible shape whatever the future can throw at us.

However the solution is long term, complex and multi-faceted.

So what do we want?

Australian banks have significantly reduced exposure in recent years and we have sat out of the offshore markets for extended periods when spreads were wide and credit demand was low. But our banks still regularly feature in the top 10 of global issuance which is disproportionate given we represent only two per cent of global GDP. We are reluctant to further increase that position but we do need to move towards more stable balance sheet settings required by regulators.

Some in the market may argue that currently we have no wholesale funding issues and that there are mechanisms in place to correct for any future contractions of global wholesale markets.

There is merit in that argument and today we have ready access.

But I believe there is also merit in taking a “no regrets” approach.

Generating greater funding flexibility is a sensible response.

We should look at all our future funding needs and how we can protect the Australian economy and Australian jobs from any future international shock.

Maybe it won’t be a problem and next time we face a crisis the wholesale markets will remain open and accessible.

Maybe next time a Government guarantee will be enough for Australian banks to secure the required funding.

And maybe next time Australia sails through it.

But why wouldn’t we ensure we have “no regrets” about the actions we take now?

If we can take action now to ensure that Australia’s future growth is less exposed to the vagaries of the international markets then we should do it.

We can look at profit levels. We can look at the relationship between banks and the RBA cash rate. We can look at the amount of available credit.

But the first thing we must look at is our reliance on foreign wholesale funding.

There is no one single solution to this issue. We need to examine all options in all areas including:

- **Changes to the taxation system** recognising that tight fiscal settings are unlikely to provide much flexibility to provide net tax relief. Some thought should be put into aligning the tax treatment of debt and savings.

- **Reviewing how investment mandates may change given an ageing population** which will require a greater need for diversification and more fixed income options. As OECD data shows, Australian Pension Fund allocations to Fixed Income are only 9% compared to an average of 53%.

- **Expansion of the domestic corporate bond market is currently receiving attention and that should continue.** The advantages of a deeper corporate bond market include a lower risk funding model for the banking system, with less reliance on offshore funding, resulting in a system that would be less susceptible to offshore market closures and improved stability of economic growth. An important ingredient to assist the growth in corporate bond issuance is to take a more considered approach to the current levels of required prospectus disclosure requirements. Transparency is vital for retail customers to make informed decisions but a streamlined approach is something that should be closely considered.

- **Further development of the securitisation market and the treatment and role of prime residential lending on balance sheets remains an area of opportunity, particularly given models that operate offshore.**

I acknowledge that addressing Australia's overseas funding reliance is a very complicated issue as it has been for over 200 years. There is no simple, one-step solution that we can pull off the menu of change.

It is more a degustation – bringing in all of the required changes across the system that will leave Australia better placed to deal with future crises.

If we are to have a Son of Wallis inquiry or Grandson of Campbell or great-grandson of Martin then let's ensure that it is far more targeted and focussed than the five inquries we have had since 2008.

Let's ensure that it leaves us well-positioned not only in dealing with our domestic funding issues but in supporting our growth into and with Asia.

Engagement with Asia

As the Federal Government's recent White Paper set out, we have an ability to develop our markets and our relationship with Asia. To not only extend our relationship, but deepen it.

Never before have we had the opportunities that the Asian Century provides our economy. Never before has the centre of the global financial world been so close to our shores.

And we must be ready to engage.

The Australian financial markets are in a great position on the world stage. Australia has safe, strong banks, a well regulated financial services sector, large pools of funds in the private wealth sector through our superannuation savings and the Australian government is in a strong fiscal position.

We have continuing regional demand for our exports from Asia but it is more than banking and commodities. It is education, health, professional and financial services, manufacturing and tourism to name a few. The opportunities are vast.

As the White Paper on Asia pointed out, Asia's share of global output has doubled in the past 40 years and real GDP is projected to increase from $US 27 trillion in 2011 to $US67 trillion in 2030 – larger than the Americas and Europe combined. And in the last week the Chinese authorities have announced their goal to double GDP by 2020.

The reality is that the investment needs in Asia are huge and with European and US banks constrained, there will be a growing expectation that Australian banks will match the political intent of greater engagement with financial support.

The issue around financing the domestic economy is only part of the challenge.

As we continue to build our engagement with Asia we will need to leverage our banking system strength as a source of advantage in Asia.

But we must remember this is a two-way street.

While direct foreign investment and foreign funding are different asset classes, they can be influenced by similar factors. Any signs of a closed Australian mentality or economic xenophobia is completely unhelpful and not in keeping with our aim to be an engaged partner in the Asian century, not just a beneficiary.

So our economy needs to be match-fit. It needs to be ready and above all, it must be vigilant to the dangers of complacency.

We must be better prepared for future growth here and in Asia. Our economy must continue to evolve and become more nimble.

If we are to have another inquiry into the finance sector, we must make it count. We must focus on the fundamental issue of how we fund the future of Australia and ensure we are ready, willing and able to be an engaged partner in the Asian century.

It will help to build confidence in our economy and our ability to withstand future international turmoil. Given that the real impact of the GFC in Australia has been the impact the crisis has had on confidence at all levels of the economy.

As confidence builds we must ensure we have the right settings and frameworks to fund our entrepreneurs and to fund growth.

One certainty in life is that there will be another financial crisis – whether it is in the next five years, the next decade or beyond.

So we have the opportunity now to take action to better prepare Australia to meet the credit demands of Australian business' and households in the future.

In summary:

The way our economy has emerged from the GFC has given us the right to be able to discuss future options for our economy at a time when many countries are still waist deep in working through the impact of the GFC.

With rights come responsibilities and that responsibility is to the future generations of Australians to ensure our economy is strong, resilient and able to create the right jobs given the opportunities that are on our doorstep.

Let’s do the hard work today, and not waste this crisis. That way we will hand onto future generations an Australian economy which is considerably stronger than the one we inherited.

Thank you.