



Future Challenges of Banking from a CFO Perspective

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Thank you Kevin

And Good Morning.

There's an Ancient Chinese saying: "May you live in interesting times".

It's a bit of a backhanded compliment more than anything, but feels pretty applicable to my initiation into the CFO role at Westpac role nearly two years ago. They have certainly been interesting times. Coinciding as it did with the introduction of new international IFRS accounting standards.

The first 6 months felt like a baptism of fire. Trying to understand 2 sets of accounting standards, old and new so that I could explain the impact of the change.

Perhaps I should have guessed when, at my first presentation with analysts and investors, CEO David Morgan handed me a construction hard hat. At the time, I thought he was joking. It turned out to be perceptive – maybe even prophetic as the first year was a bit of a bumpy ride.

What I'm really enjoying is the intellectual challenge of getting my head around the complexity of the role, of being CFO of Australia's oldest bank. And particularly the opportunity to see up close and influence the major drivers of the overall business performance.

My first observation today, is that it's not only interesting but an exciting time to be in Financial Services.

I'm sure many of my predecessors would say "so, what's new?" But, everywhere we look, the landscape is changing., the ground is shifting. What brought success yesterday, will not bring it tomorrow.

The banks are considered the arteries of the economy. We are part of an industry that is a dynamic part of the Australian economy, Generating 7% of GDP or \$70 billion. The finance industry has nearly tripled in the past 20 years. So we not only contribute to economic growth – but we are a part of it.

As CFO, I look across Westpac's portfolio of businesses and I see great drivers of future growth. And none so more than in our Wealth Management business, BT. Australia is now the 4th largest managed funds market in the world. With the fastest growing superannuation funds in the world².

When you consider that today, there is already two-thirds more money in Super than there is in deposits throughout Australia's banking system³, and that deposits are projected to be growing at about 8-10% versus 12-15% growth in super, then you can see how much the Australian landscape is changing. So one of our key challenges of banking is in dealing with the changing nature of household savings.

For me it feels like banks will have to become much more flexible organizations in serving the different stages of our customer's life-cycle: from asset accumulation (mortgages), through to transactional needs (credit cards) and life after work with broader wealth preservation requirements.

So our challenge is really about changing ourselves to meet changes in the broader landscape.

For Westpac it means changing the way our 28,000 staff think about the organization: as we move from a bank to becoming a financial services firm, as we increase the range of products and services we offer and their complexity.

These are significant changes: culturally; and how we organise ourselves. They will also require a depth of skills and breadth of knowledge we do not have today and all of that within a labour market for finance staff with zero unemployment.

So the challenge to control and deliver change management within the bank will be important.

And our environment sees greater competitive intensity chasing greater growth.

Although the prize is getting bigger, it's getting harder to win. And in some fields we find ourselves competing against organisations up to 5 times our size.

To put it in perspective, a merger between ABN AMRO and Barclays or RBS would be almost as big as the big US banks, such as Citicorp and Bank of America, which today are bigger than all four Australian majors combined.

And size does matter, for example when it comes to lead bank roles and taking on the exposures involved with larger corporations or in applying the scale needed to be efficient in global custodian and payment roles.

And this leads me to my second observation today: the challenge of managing risk and return in a complex global environment.

At its heart, banking is fundamentally about managing risk. From working to balance the long term and short term.

As a CFO I am constantly asking myself the question: "Is this the Right thing for the Company?" Is this the best thing and the best thing now?

And there is enormous scrutiny of our performance – not least from the analyst community where we have 10-11 broking firms focused on the 4 majors and a handful of other listed banks – seems amazing there are more banking analysts than banks!

In my experience, this scrutiny builds sentiment and sentiment can quickly become extended in both the positive and the negative and put pressure on you to do some dumb things. So the challenge is to keep a balanced perspective and to achieve both short and long term.

And you do feel very much like a steward for the Company. If we look at where companies go wrong, history tells us that most companies that trip up got the balance wrong.

And Westpac has some enduring scars of getting it wrong – we still call it the 'near death experience' where we got it wrong in the early 1990s and almost came undone. Chasing growth in an undisciplined way. Fifteen years later it is still a sharp reminder – even for those of us who were not at the bank then.

A reminder that in banking when things go wrong, they can go wrong really quickly and the consequences are sizeable – is what is happening to Northern Rock in the UK. In the space of 3 months, it has gone from writing 1 in 4 of all new mortgages in the UK to having queues of customers

withdrawing deposits, its stock price has fallen 80% and its future is very likely in the hands of former competitors.

The current disruption in capital markets has some unique characteristics with the reduction in global liquidity, more rapid and then more prolonged than I have seen at least over the past 25 years. I believe one of the key contributors is a lack of understanding of risk inherent in some of the complex securities purchased by institutions and banks over the past few years.

Sub-prime loans have been packaged by derivatives markets into a host of securities but for many there has been insufficient transparency on what the underlying risks of the instruments were.

And, because of that lack of transparency, perhaps combined with a lack of rigour on their own part, buyers of risk haven't had a full appreciation of what their real exposure was. There has probably been undue reliance on ratings company assessments and an under appreciation of the impact of leverage and the contagion impacts. Investments that looked secure one day have been undermined the next.

As we all know, investor (and depositor) confidence is especially critical to financial institutions – much more so than it is to most businesses. And it is the damage to confidence around the globe that has contributed to the withdrawal of liquidity.

When looking at how this situation may play out in the future and the impact on banking, I think parallels can be drawn with what happened to currency derivative markets in the 1980s and 1990s.

In the 5-10 years following the floating of the A\$, we saw a very rapid development of complex currency derivative products in Australia allowing considerable tailoring to normal payment schedules and optionally built into “hedging” transactions. Many Australian corporate treasuries were actively involved in these transactions.

However, market complexity had moved ahead of a deep understanding by the users and like today the end buyers discovered inherent risks they were unprepared for. The outcome in the currency markets was a move back to more simple products and less complex hedging. An approach which has continued even to today.

The initial response by investors to today's crisis is an extreme example of that. Investors have put their hands back in their pockets and have been unwilling to invest in all but the most reputable institutions in their home markets and for much shorter terms – fear is clearly winning out over greed as the driver of investor behaviour.

Now this massive risk aversion will eventually be wound back but at the very least we will likely see a more prudent pricing for risk. Another likely outcome is that investor interest will show a sizable preference for simple, transparent product.

From an Australian banking perspective there seems a likely confluence of two challenges I have mentioned:

- 1 On the one hand, Australian household savers will increasingly place their savings outside of bank deposits and into the superannuation realm; and

- 2 At the same time borrowers who had previously accessed investors through the global capital markets may well turn back to banks to source funding – relying on the banks more extensive credit assessment processes to be able to appropriately assess the risk.

The combined pressures on bank balance sheets may well see product spreads widening on loans (at least for a time) reversing a trend of narrowing that has largely been in place for over 15 years. And with the driver more to do with a fundamental rebalancing of supply and demand rather than due to credit losses.

Being a major bank in Australia feels like a much stronger relative competitive position compared to others in the financial system than it was and perhaps has been for the past decade.

I've talked about the challenges of changing ourselves in response to the changing landscape and in particular the challenge of managing risk and return.

The third challenge is one of strategic planning for long-term, sustainable growth. Because the balancing of risk and return has to be seen in the context of growth.

There is a clear tension between being careful without being so careful that we won't grow. Because at its heart, banking is a risk-reward game. And we create sizable value for shareholders by getting the right balance at different stages of the economic cycle. And shaping the portfolio of our businesses for the long-term.

A good example is our BT purchase in 2002. If Westpac hadn't acquired the BT wealth management business, we would today be in a much more pressured position on future growth. And we got plenty of negative comment from analysts and investors at the time.

The bets we place today will determine in a few short years whether we have been able to emphasise the higher growth and performance elements at an acceptable risk. The challenge then is to sort out which path will lead to the best outcome of return and risk, growth with control and investor confidence.

These strategic decisions involve choices. Organic growth versus M&A, and which customer segments and geographies and products should get investment focus.

There is an interesting range of strategies being pursued by different Australian banks today, including investments in different countries and with quite different focus. Whilst it is possible we will all be right and / or it's just a matter of which time horizon you use. Somehow I think that is unlikely.

Irrespective of which strategy is chosen, what is critical is that your choices are understood by all your stakeholders – shareholders, customers, staff and the communities we operate in.

The impact of “nasty” surprises to any of those groups has proven to be severe – in management you shouldn't expect many (if any) second chances!!

The last challenge I'd like to talk about is the challenge of increased regulation and external engagement.

As CFO, you have to keep learning, to keep up with not only technological changes and changes in the regulatory environment, but the increased responsibilities that they bring.

The legal and regulatory burden on Australian business has grown mountainous.

The volume of business red tape has been growing in Australia at three times the rate of economic growth. It's estimated that since 1990, the Australian Parliament has passed more pages of legislation than was passed during the first 90 years of Federation.⁴ In just one year – 2003 – Commonwealth and State Governments together produced 33,000 pages of new laws, rules and regulations. No wonder the Commonwealth spends more than \$5 billion a year administering business regulation.

This vast and complex array of laws and regulation imposes time and monetary constraints on business. Submissions to the Government's Taskforce on Reducing Regulatory Burdens on Business, "indicated that compliance issues can consume up to 25% of the time of senior management and boards of some large companies".⁵

And surveys of CEOs around the world report that increasingly time at the top of the company is spent on regulatory and compliance, when most want to spend more time with customers or developing management.⁶ This global emphasis on corporate governance is having real impacts on all industries, and for those of you in banking you will also know all about the impact that Basel II compliance and accreditation has had.

So I've had to come up to speed with the issues and requirements of APRA, RBA, ASIC, ATO, ACCC, RBNZ, NZCC, FSA, OCC to name but a few! And it's not just the regulators where engagement is growing, but the CFO also needs to be a key face to investors and suppliers.

The sheer volume and intensity of these external demands has risen markedly as has the pressure on public companies. Investor relations, up to 10-20% of the CFO role, has become more challenging because the timeframes are shorter and the information economy means that international investors access real-time data about what's going on in a Company. You could be getting off a plane for a market update in London and be asked about a story overnight on Westpac's mortgage market share in New Zealand.

So the challenge is to always be up to date with what the market is thinking and in not just gathering information but disseminating it. Operating in this market is a bit like racing Formula 1. You are expected to move at a very rapid pace, but also do lap after lap at the same speed.

Conclusion

In conclusion, then, the challenges for banking involve charting a course through some fundamental changes in our business environment, whether it be:

- How our customers will look to us and the role we can play with them;
- How our staff will need to develop;
- How our competition and competitive position might change; or
- The change in the expectations of our investors and regulators.

They say the greater the challenge, the greater the opportunity and reward – and I'm sure that's right. Although, I am also keeping my hard hat close at hand in my office.

Thank you.

References:

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6. IMC, *CEO Survey unpublished. 2007.*