Changes impacting global markets and financial institutions

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I am very pleased to be speaking this morning at a time that I believe is an important juncture for capital markets and for banking.

Over the last 3 years capital markets have been in a state of flux, tossed around by the Global Financial Crisis (GFC) and the subsequent economic slowdown. We've seen most markets exhibit extreme volatility; many markets have been functioning inefficiently; and, of course some markets have been largely closed. The banking industry has been similarly volatile with major structural change.

We are now in a second phase, a transition phase, where markets are adjusting to a new environment, risk is being reassessed, and regulators are finalising changes designed to improve the stability and confidence of the financial system.

These are significant changes and I don't think anyone has all the answers to what the new environment will look like.

Hopefully this conference will help fill a few gaps.

This morning I would like to talk a little about the GFC and some of our insights. I'd also like to discuss how markets are beginning to evolve and respond to regulatory change. Given Australian bank funding is closely connected to these developments, I will also deal with that topic.

GFC Insights

The origin of the GFC is a topic that has been well covered, I'll not go over that ground, but I would like to touch on what we consider to be the key insights and consequences from the GFC.

While I don't think many in this room need to be convinced, I'm not sure the broader community has fully appreciated the change that is now underway.

In Australia, we avoided the severe economic pain associated with the GFC, and banks remained open for business. Given that, it is not surprising that some sections of the economy continue to use phrases like:

'Markets have shown early signs of returning to normal levels.' Or 'Bank lending spreads are much wider than previous years and hence they must be gouging!'

While this can be frustrating we, as an industry, must take some of the responsibility for not properly communicating what is taking place and the fundamental change involved. Some recent commentary combining individual strategy and company promotion with historical context is not helpful for a consistent industry message.

Unfortunately, with change comes uncertainty and we must also be prepared for a bumpy ride as markets, and economies, adjust to this new environment.

The fragility of markets created by the GFC has certainly made life interesting and we can expect heightened volatility to persist for some time.

The sovereign risk crisis in Europe has been a case in point. The challenge of pulling together a long-term solution across European banks and European countries has created severe volatility in both debt and equity markets. Recent events have also highlighted that a lack of transparency can be a dangerous thing when market confidence remains fragile.

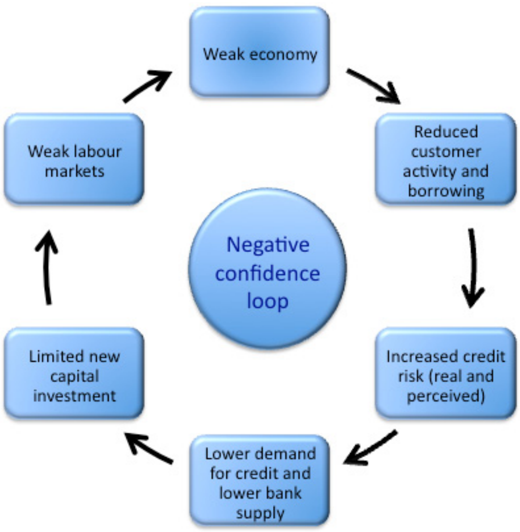
Because the recovery remains fragile, and because there are likely still significant losses buried within some balance sheets, it is likely that greater market stability is some way off. And even then, while volatility may reduce, oscillation will be around a different equilibrium.

The global uncertainly has also lead to a drastic reduction in risk appetite evident in a number of different and interrelated ways. In particular we have seen:

- Reduced leverage in both the corporate and banking sector;
- Much wider credit spreads; and
- Lower equity valuations (also the result of lower growth expectations).

The consequence of this shift has been lower economic growth in most developed economies notwithstanding a burst of increased government spending and unparalleled monetary stimulus.

The negative confidence loop continues and has not been materially broken by the flood of cheap money provided by central banks. In effect, we are seeing the impact of 'pushing on a string' and while government spending and a slowing in the inventory run-down has been helpful, it has not addressed the fundamental issue of weak confidence. The underlying real economies appear to be slowly on the mend, but for the most part confidence is trailing behind as the wounds are fresh and pain aversion is strong.



'Better off putting money in a safe investment and earn minimal interest than put it to work and maybe loose a chunk' seems to be the current thinking.

Of course the brewing regulatory change poised to impact banks across the globe has not helped confidence either with some banks extremely cautious in their lending practices given uncertainty over future capital requirements.

In contrast, the Australian economic performance has been remarkably strong. Confidence was maintained through successful monetary policy and fiscal expansion along with a strong banking sector. These factors, combined with a Chinese led terms of trade boost, have continued to facilitate credit growth and prevented a weakening in employment.

Looking forward

I'd like to touch on four areas of change that will have a significant impact on global markets; those areas are; economic; regulatory; funding; and capital markets.

On the global economy, I believe the GFC has left two major legacies.

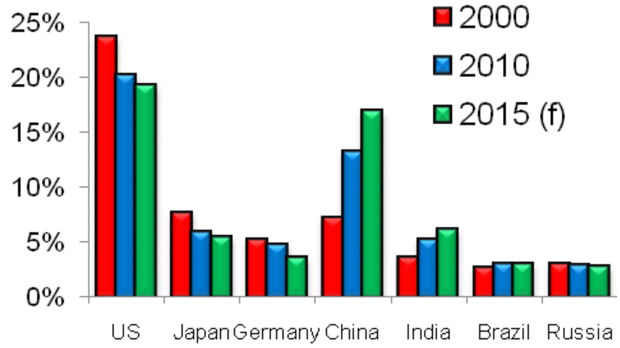
Firstly, the increased government debt raised to support banking systems and stimulate economies has left a sovereign debt hangover that will be with us for some time.

We have already seen a significant widening in relative sovereign spreads (even within a common economic union) and these pricing adjustments are likely to be the mechanism for markets to deal with potential ‘crowding out’.

I expect investment capital will be sufficient to meet borrower demand, as both sovereign debt servicing and corporate investment needs eventually co-exist in global markets. But we are likely to see quite differentiated pricing and non-traditional pricing relationships with high quality global corporates priced more aggressively than weak sovereigns.

Secondly, I have little doubt that when the history of the last few years is written, the GFC will be seen as a key turning point in the transfer of economic power from the developed West to the developing nations, including China, India and Brazil.

New Economies of Size (GDP as a % of world GDP)

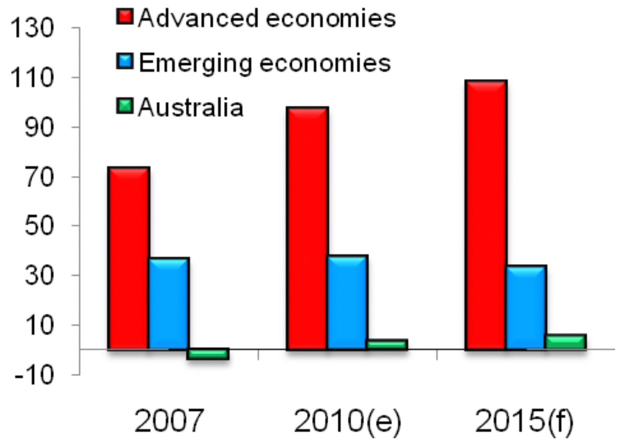


Sources: Westpac, IMF

This has particular implications for the financial system because emerging economies have less developed capital markets. In the West, the governance and transparency behind markets is strong, and while the GFC put a bit of a dent in those ideals, the foundations have remained intact. In the developing world, these features are less advanced.

However, global markets have proven an inventive mechanism for re-circulating capital even in the face of significant shifts. A good example was the global oil price shock of the 70’s; which led to the rapid redistribution of national income and savings. It wasn’t long before ‘petro dollars’ were effective sources of global capital.

Net public debt (as a % of GDP)



Sources: Westpac Economics, IMF, Australian Treasury.

In the current circumstance, I’m confident the additional aggregation of global savings in developing economies will be made available to meet external investment demand; we just don’t know all the mechanisms yet. It’s possible that some solutions may look like old fashioned banking, with the savings deposited in developing banks and invested through lending rather than in public capital markets.

Regulatory change

On the regulatory front, there is significant change on the horizon as governments and regulators seek to reshape the global financial architecture to ensure the events of the GFC are not repeated.

It is interesting to watch how certain governments and regulators have responded to what they see as the problem and how, at times, this has led to responses that may not be in the best interests of market efficiency.

A key catalyst of the GFC was of course a break-down in effective risk management and a disregard for appropriate risk/return. While much of the blame can be directed at the banking sector, like any crisis, there were multiple contributing factors, including a failure of the ratings system, inadequate banking supervision and ineffective regulation.

To date, much of the regulatory change has been focused on banks and bank risks. But there is also a need to address all of the issues and in some markets, a stronger supervisory regime would go much further than a raft of new rules.

The aim should be to get the right balance between market efficiency and the risks that can emerge in unregulated markets and entities. History has shown that it is hard to get the right balance and easy to overcorrect when things get out of whack.

In the US for example, new regulation has sought to curb the activities of banks by removing some of their trading activities. Those of us who have worked in markets, will appreciate what a difficult task it is to separate trading and customer related market activity.

Moreover, if history has taught us anything, it is that markets find a way. As a result, if we move certain activities away from banks they are likely to re-emerge in other places. It could prove quite counterproductive for certain financial products to be forced out of the regulated banking sector to a less regulated sector. The shift in proprietary derivative risk from the banking system to hedge funds and insurance companies pre 2007 is a good example of the downside from unlevel scrutiny and control. We need to be clear about the problem to be solved and then carefully test and work through options.

Don't get me wrong, it's very obvious that regulatory change is necessary to ensure that the banking sector is better equipped to absorb, and respond to, future financial stress. I also feel regulatory change is needed to restore the credibility of capital markets that has been so severely shaken over the last few years.

In Australia we are extremely fortunate and our current arrangements seem to have served us pretty well. As a result we are well placed to implement sensible change.

Let me touch on some of the key elements of regulatory change that are emerging.

Amendments to capital rules are at the forefront and we can expect that banks will be required to hold more capital and a higher quality mix of capital than prior to the GFC.

The Australian banking system has a very strong starting position given:

- Our capital position was already strong in both absolute and relative terms;
- Secondly, capital was not decimated by GFC related losses; and
- Thirdly when APRA introduced Basel II, its adoption was already conservative and so the proposed changes should be more of an adjustment to existing capital rather than a step change.

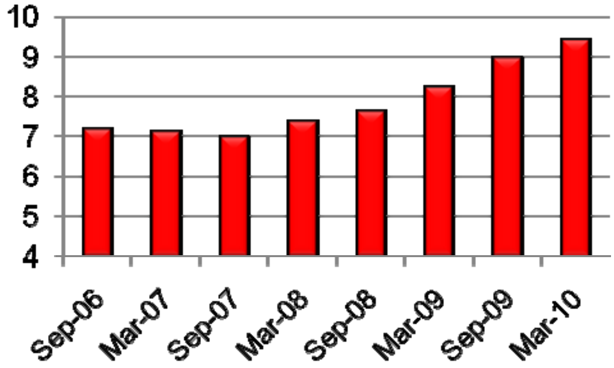
It's worth noting that Australian capital ratios have already risen by around 30% over the last few years with Tier 1 capital ratios increasing from around 7% to above 9%.

The proposed standards also introduce a capital conservation buffer and a countercyclical buffer. How these buffers are applied will be key for the sector.

Nevertheless organic capital generation should limit the extent to which Australian banks need to either raise new capital or reduce asset growth to comply with new standards.

A leverage ratio is also being proposed, and while I think any measure of capital that does not take risk into consideration is fundamentally flawed, it is seen as a fail-safe against a major miscalculation of risk weighting. This issue emerged in a number of banks globally that over invested in US sub-prime mortgages, and related structured instruments.

Average Tier 1 Ratio of Major Australian Banks(%)



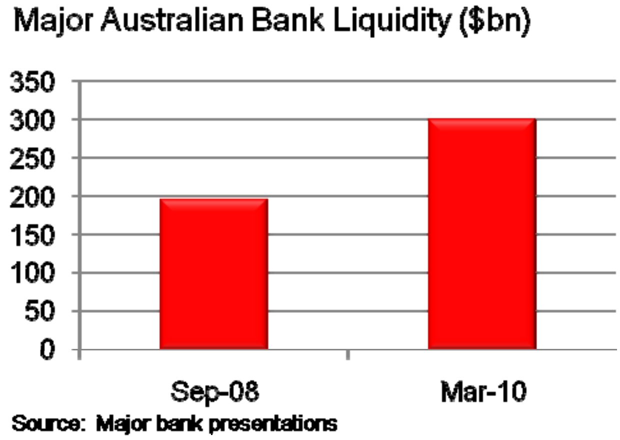
Source: Company reports

This seems like a very blunt stick and it has been encouraging to see recent amendments to the calculation of the leverage ratio that address key industry concerns. It is also good to see that the leverage ratio is being proposed as a 'supplementary' measure and that its implementation is being accompanied by a significant period of monitoring. As is often the case the devil will be in the detail and hopefully at all times the binding capital constraint for Australian banks will be risk weighted rather than basic leverage.

A more significant change for the local banking sector will likely be changes to liquidity and funding requirements which we expect to be quite material.

Westpac supports stronger liquidity requirements and, like others in the industry, we have already materially increased our liquid asset holdings. At the same time, we are cognisant of the impact such change could have on our ability to lend, and on the economy as a whole.

As part of developments released earlier this week the Basel Committee[1] has amended some of the stress scenarios and broadened the definition of liquid assets. The Basel Committee has also acknowledged the need to develop standards for those countries with insufficient government securities. This is a positive development for Australia.



In a speech to the Anika Foundation just last week Reserve Bank Governor Glen Stevens[2] when talking about the implications of regulatory change, highlighted that the reforms need to be carefully calibrated watching for potential unintended consequences. This includes the possibility of an unnecessary crimp on growth if the reforms are not well designed and/or implementation not well handled.

This is an important point that I think is well understood by Australian banks and regulators, so I'm confident that changes in regulation, and their transition timetables, will be implemented cautiously.

One aspect of the new liquidity rules that still needs quite a bit of thinking is how liquid assets can be practically used in a new regulatory framework. Today, changes in liquid assets are seen as part of the normal ebbs and flows of the balance sheet.

However in a crisis, any run down in liquidity is likely to be an indicator of concern, and no amount of highly liquid assets will necessarily prevent a run on a bank.

Reportedly, Morgan Stanley held US$178 billion[3] in liquid assets in September 2008, but when markets and institutions became alarmed about their solvency, only official support (Trouble Assets Relief Program TARP) prevented a financial collapse.

Accordingly, there needs to be more thought given to how liquid assets can be used to support a bank without triggering the very event they are seeking to prevent.

I'll make my comment on the draft Net Stable Funding Ratio brief mainly because I believe its construct still needs more thinking. A key premise of the proposed Net Stable Funding Ratio is that banks should seek to match the duration of their funding with that of their borrowing.

This risk limiting approach is overly simplistic and contrary to a bank model that intermediates the desires of savers for flexibility with the needs of borrowers for certainty. The resulting mismatch is managed via asset and liability management processes supported by capital and liquid assets and does not need an additional regulatory overlay. The mismatch is also of great value to the community, as it increases economic growth which is why the community places such high value on the banking system and the way it is run.

[1] Bank for International Settlements, Basel Committee on Banking Supervision
[2] Source: Glenn Stevens, Governor RBA, 'Some Longer-run consequences of the Financial Crisis', 20 July 2010
[3] Source: Andrew Ross Sorkin, 'Too Big to Fail', (The Penguin Group, 2009) Page 410

It has been encouraging to see the Basel Committee continuing to review this measure as well as committing to an extended monitoring period.

Notwithstanding my concerns about some of the elements of the new regulatory framework, especially at the pace that is being pursued, there are significant benefits from measures that:

- Increase confidence in the system;
- Facilitate consistency in metrics; and
- Highlight the quality and strength of balance sheets.

Bank Funding

One of the more significant changes from the GFC has been the changes to the funding environment and funding costs.

This has been one of the more difficult issues for banks to manage because it affects so many parts of our business. It affects our balance sheet and profitability, our risk profile and of course it affects our customers.

This has also been a topic that has been discussed at length but it is worth me quickly touching on the implications of this new funding environment.

Australian iTraxx Index (basis points spread)

Source Markit

Firstly, the change in funding markets has broken the relationship between the cash rate and bank funding costs. While banks have never effectively borrowed at the cash rate, the relative stability of credit markets had meant that movements in the cash rate were a reasonable proxy for movements in the yield curve and an important determinant in a bank's cost of funds.

What we are seeing in Australia, and around the world, is that credit market shifts have been significant and independent of monetary policy and are now a much more important driver of funding costs. And these shifts are somewhat outside domestic regulatory control.

This has important implications for economies and monetary policy. You can see that in a number of markets where cash rates are virtually zero yet borrowing costs remain elevated for consumers and businesses as banks recover higher funding costs.

Similarly, early this year, the Reserve Bank indicated in a variety of forums that its need to raise interest rates further had been partially mitigated by banks passing on higher funding costs to borrowers outside of cash rate moves.

Monetary policy is still an effective policy tool but it will now be influenced by a broader range of factors.

Secondly, funding costs have moved fundamentally higher. That trend has been fairly obvious in global asset markets since August 2007. This has not been a one-way shift and hopefully current levels will moderate as they did earlier this year. Our US registered raising earlier this week was some 45 basis points more expensive than the raising we did in September 2009 but some 40 basis points better than what could have been achieved a few weeks ago.

Nevertheless a weighted term borrowing cost of around 140 basis points is 120 basis points higher than existed in 2006 and represents a prolonged period of higher costs.

These are large and material changes to our business.

What has perhaps been a little less obvious has been the impact on retail funding.

The more challenging and expensive global capital markets have led to a significant increase in the value of retail deposits and this is reflected in higher deposit rates relative to the benchmark bank bill. As was highlighted in the March RBA bulletin[4], average term deposit rates at that time (March 2010) were around 140 basis points higher than the cash rate, whereas prior to the GFC term deposit rates were some 60 basis points below the cash rate.

While term deposit pricing has eased somewhat since then, the material increase in retail funding costs has almost matched the increases in wholesale markets. Retail funding can no longer be regarded as cheap. Indeed some of the proposed new regulatory rules will make some deposits as valuable as long term wholesale funding which will act to keep those deposit rates and thus lending rates higher.

Thirdly, the structural shift in funding has materially changed the way we manage our balance sheet. Pre GFC, our balance sheet was predominantly driven by loan demand. Capital was plentiful and we were able to easily raise funds.

Balance sheet management is now more multidimensional. In addition to loan demand, we must also focus on the quality of our funding, assess how the mix of lending/deposits impacts liquidity and ensure that position is sustainable in the long term.

The new liquidity rules are likely to have further impact on how customer deposits are managed and priced.

Relatively 'hot' retail deposits today may be priced at a material premium as they make the funding structure look stronger. However, if the funds are deposited solely on the basis of best price then they are only likely to qualify as a source of funding until their contract maturity date. In this instance, it's hard to see why banks will pay a big premium for 3 month professional retail funding verses 3 month professional wholesale funding when both are likely to be treated similarly for liquidity coverage ratios.

The new model will inevitably lead to deposit product innovation as banks seek to optimize funding, liquidity and their balance sheet mix.

So what have been the impacts on capital markets, and where to next?

For those of you involved in origination, the answer to the first question is 'not much'. That lack of activity has been driven by both the demand and supply side of the equation in Australia.

Globally, capital markets activity has also fallen as the number of high quality borrowers has decreased, and the risk appetite of investors has also declined. At the same time, weaker global demand has limited the need for additional capital. As a result, certain sovereign borrowers, and Australian banks, have been amongst the few issuers in a position to tap markets – and with the need to do so.

It shouldn't surprise us then that Australian banks have made up a bigger proportion of the much reduced total global issuance. This point seems to have been lost on those making comments about the level of Australian banks global borrowing.

That said, the Aussie bank funding model will probably need some adjustment over time. Notwithstanding our strong credit ratings and our healthy relationship with global investors, at some point, institutional investor appetite or concentration risk may become a constraint. It is unusual and untested for an ongoing current account deficit to be funded so much by the majors of a banking system.

A few elements will likely contribute to how this situation is resolved, and may include:

[4] Source; RBA Bulletin, March 2010, 'Recent Developments in Banks' Funding Costs and Lending Rates'

1. Reducing concentration risk by expanding the investor universe by uncovering new global investor supply. For example, savers in developing nations previously mentioned are likely to have little exposure to Australia today.

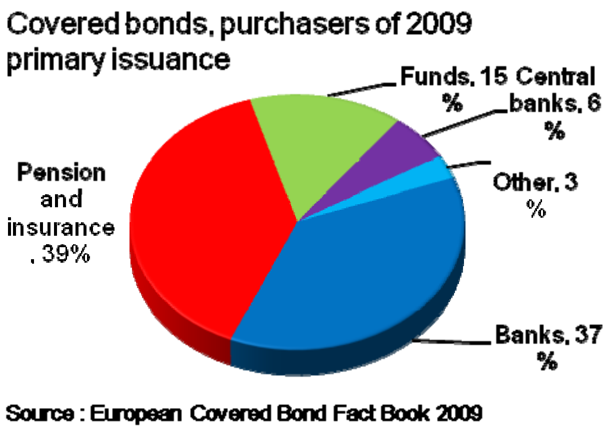
2. Reducing concentration risk by developing new instruments that tap new investors. Covered bonds are a good example here as an established instrument with a deep investor base.

   This is a market that performed well through the GFC and has a proven international track record. Indeed through the recent sovereign debt crisis, covered bonds were one of the few markets that remained open for the banking sector.

   In the past, covered bonds have been dismissed by some because of the preference they place on certain banking sector assets. As well, banks were indifferent about pursuing this market because funding was readily available elsewhere and securitisation was highly effective.

   Today, with the right structure, covered bonds could go some way to meeting the market's current needs without putting depositor protection at undue risk, undermining wholesale ratings or diminishing competition.

   By utilising our low risk mortgage assets, covered bonds also have the potential to both alleviate funding concerns and operate as additional qualifying liquid assets.

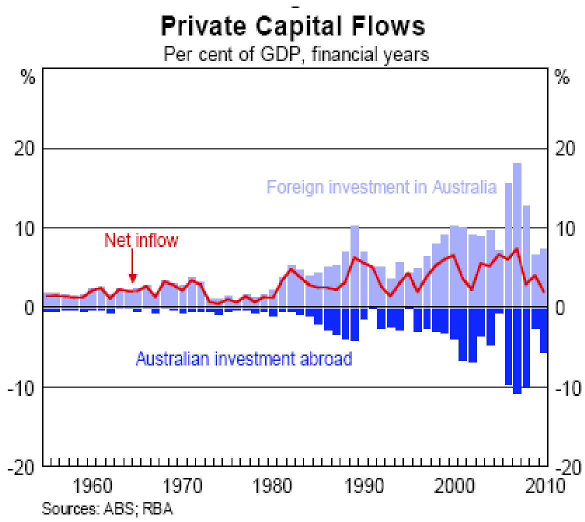


   While covered bonds are unlikely to be the only option, they are an obvious mechanism for capitalising on the strength of the Australian banks' balance sheets. We should not dismiss it too quickly from a discussion which should be seeking to broaden the pools of funding that can be accessed and to increase the tools, products and mechanisms for doing so.

3. Saving calibration. As the charts in Ric Battelino's paper of June[5] this year demonstrated, the growth in private capital inflows has been related to the growth in Australian investment abroad. As Australian super funds have lifted their global investment they have created the need for global funding to immunize the flow: the balance of payments do balance!

   During the peak of global market dislocation (and unfortunately we have witnessed the imperfection of markets too readily in the past 3 years) this calibration can be messy, with steep falls in the $A and sweaty palms for some bankers. Of course we've been fine, and we are all getting better at this, but the combination of more restrictive liquidity arrangements may exacerbate this situation.

   A more balanced saving proposition in Australia would help to alleviate some of the pressure. It is



5 Source: Ric Battelino, Deputy Governor RBA, 'Aspects of Australia's Finances', 15 June 2010

important to note that Australia does not have a savings problem per se. With around $1.2 trillion in superannuation and a national saving rate over the last 10 years similar to banking self-funded nations such as Germany and France, Australia's high bank loan to deposit ratios are not from a low saving rate. But we do have a regime that attracts/pushes saving outside the banking system which increases the complexity and the number of hands involved before the funds ultimately arrive in the banking system.

The tax discount of 50% for the first $1,000 of interest income announced in this years federal budget is a good first step in simplifying arrangements but there is still quite a long way to go before the savings playing field is level.

Fortunately we have time to work through these issues and the more they can be progressed with an aligned market, regulatory, Government and banking industry approach the more likely we will see sustainable improvements.

Of course we don't always have identical objectives;
- Protection vs. Profitability;
- Depositor's vs. Shareholders; and
- Risk limitation vs. Growth.

All are likely to require balancing but I think a healthy banking system is in everyone's interest as has been drastically highlighted over the past few years.

Conclusion

Let me sum up.

The last few years have been an extraordinary period for banks and for capital markets. In effect, the Global Financial Crisis has changed the game.

We've mostly got similar players on the field although all those players are a bit more cautious and hopefully a bit wiser – a bit like an over 50's soccer match.

At the same time, the rules of engagement have changed including new regulation, new baselines for funding and new baselines for risk.

Getting capital markets back on a more stable foundation is a significant prize. It improves the allocation of resources; it enhances competition in financial services and assists in the proper functioning of economies.

These changes bring with them some challenges but also major benefits. On the challenges:
- Funding costs are higher;
- Global economic activity is likely to be more moderate for some time; and
- We can expect a rough ride as markets adjust to the new operating environment.

But the positives are also significant including:
- Greater international consistency in regulation:
- Improved system confidence ; and
- A more stable long-term platform better able to weather financial crises.

In Australia, banks and capital markets have a healthy starting position with which to deal with the next round of change. But there are opportunities and benefits from new solutions. Solutions that are self sustaining and long term.

These are some of the challenges that this conference can help address.

Thank-you very much and I would be happy to take questions.