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Trans-Tasman Business Circle – 3 September 2015

'Capital: The next chapter'

INTRODUCTION

Good afternoon everyone and thanks to the Trans-Tasman Business Circle for inviting me to speak today.

I'd also like to acknowledge the Traditional Owners of the land on which we meet; the Gadigal people of the Eora Nation and pay my respects to elders both past and present.

Ladies and gentlemen, for the eight years since the GFC, banking capital has been a topic of interest, moving from the business pages, to the front pages.

Understandably, particularly given the overseas experience, it's received unprecedented focus from governments and regulators, and naturally it's been of great interest to our investors.

In Australia, one of the focus areas of the Financial System Inquiry was the strength and resilience of the banking sector, and the importance of this in supporting robust Australian economic growth.

It was an important inquiry and participants were constructive and engaged.

Most recently we've had announcements from APRA comparing the relative capital position of Australian banks compared to global peers, as well as changes to mortgage risk weights.

I do feel that the strength discussion has focused too heavily on increasing capital, as a proxy for minimising risk. I'll come back to this point later.

Having said that, we know the bar's been re-set. Banks are now operating in a new paradigm and there's no going back.

So today, I want to focus on three areas that are top of mind for me as we transition to the new world:

- The first is how managing the liabilities side of a bank balance sheet has changed. Capital management has been the focus but there's a lot more that is different now;
- The second is risk based capital measures remain important. In particular, changes to capital should be based on sound economic outcomes so we don't distort the financial system;
- Finally, while capital has become a synonym for strength, a broader view of bank strength is required.

Turning first to bank balance sheets, they're much discussed and often misunderstood, so let's start by walking through the elements of Westpac's capital and liabilities.

[TURN TO – Slide 1]

This slide shows the debt and equity Westpac uses to fund its assets.

We've ordered these from lowest ranking at the bottom to highest ranking at the top, consistent with our legal framework. This reflects the creditor hierarchy or the order in which capital and then liabilities are absorbed in the event of loss.

The slide helps frame my comments on areas which I expect will continue to be debated.

At the top are **deposits**, which are the highest ranking category of liabilities. One of the large changes since the GFC has been the Government Guarantee of Deposits up to $250,000.

However, you can see from the chart that there's a deep pool of capital and liabilities that stand between losses and depositors.

To give you some dimension of the size of the coverage, Westpac would need to see losses equivalent to 54% of loans for deposits to be impacted. This is nearly 200 times our current loss rate.

<u>The size of the coverage here is one of the reasons we've argued the deposits guarantee shouldn't be pre-funded.</u>

Next is Senior debt, that's the $137bn on this slide. Looking ahead, with other overseas jurisdictions implementing Bail-in regimes for these securities, I expect that Australia will need to consider its response.

I'm pleased that we're progressing slowly here as this is a complicated area and Australia already has a legislated creditor hierarchy unlike many other overseas jurisdictions.

Next in the hierarchy are **hybrids and sub ordinated securities.** In a post-GFC world these securities can be converted into equity if certain triggers are met. This is a new feature of the post-GFC world and one we now consider in deciding our target capital structure.

At the bottom is our $50bn of equity which is the first category to absorb a loss and therefore the most expensive to raise. It's also the category regulators have asked us to increase. It now accounts for 72% of total regulatory capital up from 60% in 2008.

Finally, on this slide, to the CET1 ratio - which you can see on the right hand side of this graphic. The ratio is closely watched by both our debt and equity Investors and has been the subject of many articles in the business press of late.

The regulatory minimum is 4.5% and when the ‘capital conservation buffer’ of 3.5% is added - the 8% ratio is the one I’m very focused on.

In fact, the operation of the Capital Conservation Buffer or CCB for short is something that has been lost in the debate about capital recently.

The intent of the CCB is to ensure that banks conserve and rebuild capital. The further a bank falls into the 3.5% range, the less capital it can distribute.

For example, once in the CCB, there are constraints, including on dividends and hybrid distributions. So we aim to operate well above 8% in normal times.

We hold a management capital buffer over the 8% to give us that headroom. It's set using a range of analysis including stress testing, peer analysis, and considerations of rating agency requirements.

So in summary, while many in the market have focused on a 10% ratio, in the long run we expect to be running the bank to a buffer over 8%.

The other relevant topic here is ongoing review of risk weight calculations. This is a technical area and continues to be debated by the Basel committee.

However, there's a couple of points I'd make on the international debate on risk weights:

- Firstly, it makes sense to have a system that encourages investment in risk management. The differentiation between Advanced and Standardised approaches is important to incentivise investment in risk management and should be maintained;

- And secondly, valid differences in the risk characteristics of countries should be a legitimate basis for some variation in risk weights globally.

This second point is particularly important for Australia, given the strong risk management and market features, particularly of mortgages in this country.

In summary, you can see that Bank liability management is more complicated post the GFC - with:

- Government guarantee deposits;
- Discussion on ‘bail-inable’ debt;
- Hybrids and sub-ordinated debt triggers; and
- Debates on the appropriate capital levels.

Who wouldn’t want to be a Bank CFO!

2 RISK BASED CAPITAL REMAINS IMPORTANT

So, having discussed capital, I’ll now turn to my second point, which is about the importance of capital allocation for the economy.

In particular, maintaining a risk-based approach to capital allocation - is important in the new world. In my mind, this is the best way to ensure that changes to capital settings produce sound economic outcomes.

Our financial system is founded on the concept of risk and reward. This sees resources directed at achieving returns corresponding with relative risk.

[Sustainable economic growth]

In intermediating finance, banks price risk and allocate funding. Risk-sensitive models help us to do that in an efficient way.

The better risk can be priced, the better funding will be allocated in the economy.

So, capital is not just about banks and resilience - although that’s important – capital allocation is an important factor in supporting Australia’s growth.

[Turn to slide 2]

This is probably best illustrated with an example from the Institute of International Finance.

Turning to my second slide, this is a study that compared returns on capital of sub-prime mortgages under the Advanced modelling approach, which is risk-based, versus a Standardised approach, which is less risk sensitive. [1]

You can see that the subprime mortgage is risky. The assumed probability of default is 3% and the loss after default is 40%. Both of these are much higher than what you would expect in a prime mortgage.

Under the Advanced approach, the difference in riskiness is reflected in the higher risk weight outcome for the loan. In the study, the Advanced approach produces a nearly 3 times higher risk weighted asset than the standardised approach.

[1] P. 21, *Risk Sensitivity: The important role of internal models,* Institute of International Finance, September 2014.

As a result, the return on capital for the same sub-prime mortgage would be much higher under the Standardised approach, at 14% compared to around 4.6% under the Advanced.

You can see from this example that a risk-based system is important to incentivise pricing for risk.

Capital and risk management

Before moving off this topic I'd like to deal with the suggestion that the use of risk based measures is flawed because of RWA calculations.

The key is to improve the models and ensure people are confident in them - not to cast them aside.

The variability of outcomes generated by models around the world shows that risk-based models are not perfect. However, Westpac has been working with the industry and with APRA to improve these models.

We believe a non-risk based system, such as leverage ratios, lessens the focus on relative risks. Being less focused on risk may reduce the long-term resilience of the system, an outcome we should seek to avoid.

[Consistent application of capital requirements]

It’s also important that capital requirements are applied consistently across the financial system.

If unregulated providers are not bound by regulatory capital requirements, they can maintain levels of capital close to what is viewed as economic with fewer buffers for the cycle.

If pricing differs due to regulatory factors, and not underlying risk, efficient resource allocation reduces and systemic risk may go up.

Interestingly there are examples emerging with the growth of the shadow banking sector being seen offshore.

The IMF has noted that in advanced economies, non-bank lending is growing rapidly as banks withdraw from certain activities due to tightening regulation.[2]

For example, in the US, the non-bank share of leveraged lending rose to about 80% in 2013, up from about 20% in 2000.[3]

In contrast in Australia, the growth of the shadow sector is not a problem for today. However, if incentives are materially different between the two sectors, it could become an issue down the track.

[CAPITAL DOES NOT EQUAL STRENGTH]

Finally, to my last point, I'd like to expand on my comment that capital has become shorthand for strength.

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[2] p.65, IMF, Global Financial Stability Report

[3] Ibid at p. 76

Strong banks aren't just well capitalised. They need to be well funded, have quality assets, sound risk management and operate in a well-supervised system.

We know this because we see our investors, credit rating agencies and other stakeholders using all these benchmarks when assessing us.

For example Australian banks, rank well on these measures, with the four Majors among 12 banks globally that have a stable AA- Standard & Poor's credit rating.

Australian banks also rank well on S&P's stand-alone credit profile assessment, which considers amongst other areas the business position, capital levels, asset quality and funding of banks. This assessment excludes the effect of any external support, such as implied government support.

On these ratings, S&P has assessed that Australia's major banks have a stand-alone credit profile in the top 30% of the world's top 100 banks, with only 13 banks having a higher stand-alone credit position.[4]

So while I agree with the FSI **recommendation** that Australian banks' capital ratios should be 'unquestionably strong, as I've just outlined these other factors are important.

In managing a bank, we don't solely focus on the size of the capital buffer. We run the bank to operate prudently, so that we're making the right risk-reward decisions that support our customers, drive growth and maintain our resilience.

CONCLUSION

So in conclusion, banking and capital will continue to be a topic of intense discussion in the years ahead.

Global capital requirements remain highly relevant to Australia's system and higher capital requirements in the post-GFC world are a permanent feature.

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[4] *Top 100 Banks: Risk-Adjusted Capital Ratios Continue to Differentiate Banks,* Standard & Poor's, August 2015.

We understand and accept the new reality and are charting a workable route. We support and encourage APRA to set rules in a way that is appropriate for Australia’s circumstances and in setting new rules we need to preserve the risk based principle of capital allocation. Increased capital levels that don’t reflect this principle may actually increase risk in the long run.

At Westpac we’re well capitalised and pride ourselves on managing risk well. No matter what the future of capital holds if banks continue to assess and price risk, and efficiently allocate capital, we can keep supporting high-quality, sustainable growth.

As the Australian economy remains in transition and looks to improve growth, Westpac has an important role in supporting the country’s development.

Thank you for listening to me today and I’m happy to take any questions.

(approx. 20 mins)