

Australia-Israel Chamber of Commerce

Address by:

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What is the future of Australia's Financial Services Industry?

The main subject I want to talk about today is what is the future for Australia's Financial Services Industry.

Will it grow to become the main financial services hub for Asia?

Or, will it miss the boat and in financial services terms let Australia become a branch economy?

But before addressing that issue I thought it might be helpful if I spent a few minutes giving you my view on what is happening in the financial markets.

The first key point I want to make is that we need to keep things in perspective.

- Almost all markets have been touched by the knock on effects from the meltdown in the US subprime market.
 - Equity and credit markets in Australia have weakened
 - The banking system has also faced a significant test, with some of the normal funding channels, like the commercial paper market, becoming extremely illiquid in recent weeks
 - And, some of these challenges will be with us for a while.

But it is important not to lose sight of the fact that our banking system is sound, extremely well capitalised, and is coping with this period of stress very well.

The second key point I want to make is that sub prime is a symptom of a wider US downturn.

- Problems in the US sub prime market may appear to have come from nowhere, but a downturn in the US economy has not been unexpected.
- NAB, for example, has been warning publicly for some time that the US is approaching a period of slow or no growth.
- Housing in particular is a problem, because the US still remains heavily overstocked in housing.

- This oversupply has resulted in falling house prices and, of course, this affects consumer confidence and spending.
- It is worth noting that the US situation is likely to get worse before it gets better.
- There was a time when if the US had a sniffle Australia would catch flu.
- Not any more.

The US is a big part of the global economy, but other factors, including ongoing strong demand from China, mean Australia is well placed to ride out any turbulence.

So where do we go from here?

- Well, going forward, there are a number of things that are likely to happen.
- First, the situation with the sub prime market will get worse before it gets better.

One of the problems are sub prime mortgages called ARM's, that is short for Automatic Reset Mortgages.

These start at a low rate, say 2% but after two years reset to market rates.

This means a jump from about 2% to 6 or 7% and many borrowers can't cope.

There are nearly half a trillion dollars worth of mortgages that will face their first rate reset in the next twelve months.

- Second, the US economy is going to be flat for some time.
 - There is even a slight risk of a US recession.
- Third, the US situation means the supply of credit will tighten.
 - When supply tightens, prices go up.

- That does not necessarily mean that we will see further increases in interest rates from the Reserve Bank in the near term, as there are many other factors that come into play
- Nor does it necessarily mean that banks will be putting up mortgage rates, but we will need to continue to monitor the situation and it is a possibility.
- Fourth, remember that before the sub prime problem, the Australian economy was powering along
 - based on strong business confidence, export demand, strong employment levels and contained inflation and wages pressure
 - none of those conditions have or will change in any significant way because of the US subprime problem
 - At nab we are still forecasting that the Australian economy will continue to grow at around 4% into next year.

So what does it all mean?

It means that it will take some time to weather this storm but in all likelihood, this crisis will make little difference to the underlying fundamentals of the Australian economy

However, what the events of the last few weeks have shown is how global financial markets are.

A problem in one segment of the mortgage market in a country on the other side of the world can cause wild gyrations in our stock market.

And that brings me to my main subject, which is “What is the future for Australia’s Financial Services Industry?”

Let me start from where we are today.

Despite our small population our financial services industry does very well by international standards.

For example:

Our banks alone, in terms of market capitalisation account for around 25% of the ASX.

And,

We have the 4th largest funds management industry in the world

So what are the options for the Industry?

First, we could stay as we are but, in my opinion, that will become increasingly difficult as more and more business becomes regional and/or global.

Like many things in life, staying as you are is not an option and you either spiral down or you spiral up.

So let's look first at what spiralling down would look like in terms of financial services.

I mentioned earlier that the market capitalisation of Australian banks account for over 25% of the ASX.

But, even our big banks are only medium sized globally and all are of a size where they could be taken over.

So imagine a situation where all of our large banks and much of our fund management industry has been acquired by overseas companies.

The healthy financial services industry we have now could turn into a "branch economy" where head office is always someplace else.

But not in Australia.

Gone with the head office presence are many of the service jobs that supported it.

Such as;

Accounting services

Legal services

Advertising

Etc

And I believe in one way or another the loss of these highly paid jobs would affect everyone in this room.

Fewer cars would be sold, our restaurants would be less busy and there would be lower economic activity affecting most businesses.

The big decisions would be taken in London or New York not in Sydney or Melbourne.

We already have a problem keeping our brightest and best young people working in this country.

In financial services they tend to migrate from their home town to Melbourne or Sydney because that is where the best jobs are.

How many of you or your workmates are from a smaller town or city and moved to Melbourne for a better job.

Think what it would be like if all the top jobs in financial services were overseas not in Australia.

Think what affect that could have for your kids.

Could it happen?

I hope not but why leave it to chance.

Let's look at the alternative option which is spiralling up and turning Australia into a regional financial services centre for Asia.

With lots of highly paid jobs.

First, we need to recognise that there is limited scope for growth in the Australian market.

No matter how strong our economy is there is only so much business 21 million people can support in the domestic market.

If we want our financial services industry to flourish then they must do more international business.

But look at the opportunity we have.

For the last hundred years most of the strong global economic growth has been in the west with the exception of Japan.

In the future, and for as far as we can predict, most of the strong global economic growth will be in the east with the exception of the United States.

Think of Australia as a giant aircraft carrier with western business know-how parked off the coast of Asia.

And look at the advantages of Australia:

We have one of the largest and most highly developed market places for financial services in the Asia-Pacific region.

We are located in the world's fastest growing region.

We are an extremely stable democratic country.

We enjoy a strong and stable regulatory environment.

Australia's legal and business law system is quite similar to that of Europe and Canada, providing certainty, familiarity and security for investors.

Australia is an easy place to start a business.

The World Bank 2006 Doing Business report rated Australia the 8th most business friendly country in the world.

We have a world-class education system.

Two of our universities are ranked in the top 100 in the world and the proportion of the workforce with tertiary degrees is 31% compared to the OECD average of 23%.

We have a skilled and flexible workforce.

Australia offers the familiarity of a western business culture with a workforce skilled at operating in both Asian and western business environments.

And last but not least, Australians enjoy an excellent quality of life.

According to the economic intelligence unit, Australia's 5 major capital cities rank in the top 11 most liveable cities in the world.

This is enhanced by a relatively low cost of living as compared to other major financial centres.

The 2006 Worldwide Quality of Life Index by the Institute of Management Development lists Australia as enjoying the seventh best quality of life, ahead of Singapore at 18th, Hong Kong at 23rd and Shanghai at 38th.

The opportunity is there for us to seize.

We know that regional economies like China and India will continue to boom, creating huge demand for resources.

But, it is not just in our traditional commodity export markets where we could benefit from the economic growth in Asia.

We should also expect growing markets for our services.

And financial services offers us a real opportunity to be part of the Asian economic growth story.

But is it realistic for us to be a financial services hub for the region?

I believe it is.

In the three years I have lived here I have been deeply impressed with what Australia is capable of achieving despite some very real challenges.

Let's be honest, on many measures, Australia is not a big place

Our population is only the 53rd largest in the world

We account for around 1.5% of the world's economy.

But this does not stop Australia being a world-beater in other fields.

In 2000, we put on the best Olympic Games ever, under the intense scrutiny of the whole world

We consistently win more Olympic medals per head of population than nearly any other nation.

Just last month, an Australian came within 23 seconds of winning one of the most watched sporting events in the world, the Tour de France.

Everyone knows we excel at sports on a global scale, despite our small size and geographical isolation

So why can't we seize the opportunity in financial services with the same focus and determination we apply to sport.

I am conscious that some of you may be saying that you have heard this all before.

There have been other efforts to make Australia a financial centre.

So let's do a reality check.

Well we are already regionally competitive when we compare ourselves with existing centres such as Singapore and Hong Kong or the emerging presence of Shanghai?

Consider these facts.

The Australian share market is larger than either Singapore's or Hong Kong's.

In fact, it is the second largest in Asia after Tokyo.

In the decade to 2004, Australia's foreign exchange market turnover grew over 100%, while Singapore's grew 19% and Hong Kong's just 13%.

Australia has the largest investment funds asset pool in Asia, larger than Singapore, Hong Kong or Japan.

As you know financial markets operate 24 hours a day.

Australia is the first major financial centre to open in the Asian time zone, providing a market that bridges the closing of the US and the opening of European markets.

Australia already has more people employed in finance and insurance than Singapore and Hong Kong combined.

And office space, even in Sydney, is cheaper than Tokyo, Hong Kong, Singapore or Shanghai.

There are areas of financial services where our ambitions should not be limited to being a regional leader.

There are areas where we can lead globally.

For example:

We have one of the world's leading retirement savings and funds management industries

And with more than \$106 billion in funds under management, NAB's own MLC is the third largest Manager of Managers in the world.

At the same time that Australia has accumulating significant funds under management, we have also been accumulating significant expertise in advising on how best to invest those funds.

As a result we have seen the development of arguably the world's most sophisticated financial planning systems.

The combination of these has led Australia to become a world leader in this field.

This is not just my view, the example set by Australia was evident in Lord Turner's report last year to the Blair Government on behalf of the UK Pensions Commission.

Australia is setting a global standard in managing its own funds.

And there is no reason in theory why we should not take that expertise and manage the funds of others.

Instead of exporting our talented people and their expertise why don't we keep them in Australia and bring the money here to be managed.

As the population of Asia gets wealthier why should that wealth not be managed in Australia?

Importantly, different financial institutions will have different views about which areas of financial service they are regionally or globally competitive in.

This is as it should be we should not seek to pick winners.

But we do need to make sure we remove any impediments that can prevent us from realising our opportunities.

For example;

Business regulation – Australia lags behind some other developed countries in terms of the steps, time taken and cost of complying with regulations.

Secondly - the four pillars policy.

Removing the four pillars policy would not be a panacea.

But the policy has no place in an Australia out to maximise the potential of its financial services industry.

One or two very large Australian banks could be regionally or even globally competitive.

And last but not least taxation.

The rate and complexity of our withholding tax regime is a significant impediment for managed funds wanting to attract non-resident investors from offshore.

For Australia to be truly a funds manager to Asia, we need a withholding tax regime that is globally competitive and removes the need for complex administration.

In addition our dividend imputation system does not recognise foreign tax paid by Australian companies on their offshore earnings.

In effect this means that as the amount of revenue an Australian based company derives from offshore increases, the level of franking on dividends to Australian investors decreases, resulting in double taxation of the offshore earnings.

Ironically, this can make Australian based companies with strong growth offshore less attractive to Australian investors.

Also, our corporate tax rate is, as you know, 30%, which is high compared to Singapore at 20% or Hong Kong at 17.5%.

Indeed according to the Business Council Australia our corporate tax burden is twice the level of the United States and the UK.

The purpose of my talk today is not to discuss the detailed solutions for these impediments but to get the issue of the future of our financial services industry back on the agenda because it is important for all Australians.

Are we happy to allow Australia to turn into a branch economy with head office always somewhere else?

Or can we take the same focus and determination that we show in sport and other areas to turn an already successful industry into the financial services powerhouse of Asia?

Remember our success in sport has not happened by accident.

It is not that Australians are faster and stronger because of consuming Milo and vegemite.

It is because we have put in place the appropriate infrastructures to create success.

In 1976, Australian sporting achievement hit rock bottom when Australia received only five medals at the Montreal Olympics – four bronzes and a silver – the lowest tally in 40 years.

The result caused much angst in Australia, with headlines like “Australia’s golden days have gone”.

Why did this situation change?

Why does Australia now consistently win more Olympic medals per head of population than virtually any other country?

Because the response to the Montreal Olympics was an all out effort to make sure we created the best environment in which naturally talented individuals could reach their full potential.

If we can do it for sport, why not do it for our financial services industry?

That is the debate we should be having.

To prompt that debate I am announcing today that NAB is prepared to sponsor a series of lectures and debates in various parts of the country so that interested people can voice their opinions and their ideas for how we could create such an environment.

Thank you.