WALLIS INQUIRY — COMMERCIAL IMPLICATIONS FOR FINANCIAL SERVICE PROVIDERS

Strategic Imperatives — The Post-Wallis Environment

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TRANSCRIPT

Thank you very much and good morning. What I would like to demonstrate this morning is that change is already under way and it is rapid change. The financial services marketplace here in Australia has over the last five years seen remarkable change and really, whichever of the Wallis recommendations are implemented, the pace of change is going to continue – it is going to accelerate. The change is driven, in my view, primarily by innovative market participants, competitors driven by enlightened self-interest. They aim to gain a position in the marketplace which yields profits for them and which is defensible from rivals. So I would like to quickly go through some data which demonstrates that in both the life and superannuation market, and indeed in the banking market, we have already seen remarkable change, and then to try and hypothesise what some of the linkages may be in the future that these enlightened providers are likely to take advantage of.

So first of all to demonstrate the changing market structure, to demonstrate that that is driven by new and indeed existing competitors, and to conclude that those that prosper are going to have to devise quite different strategies.

If we look first of all at the life market we can see that it is shrinking very rapidly, and that it is the single premium business in particular, which has reduced over the recent years.

If we look at superannuation, in contrast, it is growing and it is the single premium business which is growing in that marketplace. It seems to suggest that maybe there is some substitution between these two products. We can also see that superannuation is particularly important to life offices. It is an important line of business for them. They must amortise fixed costs so they need to be very effective in this superannuation market. And, as has been mentioned, with the changing age structure of the population, one can only assume that that is going to continue to be necessary.

We have seen life offices increasingly reliant upon the superannuation business, but their share is declining. So with change in market structure existing players seem to be losing out, and this is a theme which is running through a lot of lines of business.

In the interests of time I am going to skip over a couple of slides.

We have seen also changes in the product emphasis in each of these markets. If we look at life new business we are seeing an increasing emphasis on term, and accident and disability products. And clearly, as players are trying to cement advantage in this changed marketplace, having the right products and delivering them via the right distribution channels is going to be increasingly important.

One of the things that comes out for us as we analyse these statistics is that those that thrive are going to be very good at capturing information and systematically analysing it so that they understand what to emphasise in the future. These displays are difficult to read but the headline thoughts, I think, are very important. If we look at the life market, we see that it is becoming less concentrated. New players are winning market share. The same is true in the superannuation market.

Banks are being extremely successful at targeting both the life market and indeed the superannuation market. All of the dots on those displays (which I guess are impossible to read – certainly at the back) demonstrate that there are different rates of success by States. So we may be moving towards a global market, we may have an increasing reliance on technology, but certainly, when you look at the statistics in Australia, you see some very important differences State by State. It is our contention that whilst those may lessen, they are very marked at the moment and will only lessen slowly. So those that are anxious to underpin a very profitable future would be unwise if they ignored those important local differences.

So to sum up, we can see that there have been significant inroads by the banks. Between 1991 and 1995 the banks have increased their market share of new business premiums in most regions. The major banks have been particularly successful in winning a share in the single premium business, especially life single premium. And that penetration is greater in life than in superannuation.

Now the obverse of change is obviously that the life offices (AMP, National Mutual, MLC and Colonial) are losing out. They are losing out in life; they are losing out in superannuation. And so to sum up, between 1991 and 1995 they have lost share in new business premiums in most regions. They enjoy higher market share in annual premium rather than single premium business. And they have a higher penetration in superannuation than in life. This is obviously the opposite of the situation with the banks.

So much for life and superannuation. Let us look at just one other market category. If we look at Australian mortgage spreads, we can see that they have fallen dramatically between 1991 and 1997. There was about a 5.5% difference between the variable mortgage rate and the 90-day bank bill rate back in 1990. And that is about 1.5% or 150 basis points, depending on exactly how you calculate and the allowance you make for honeymoon rates etc, in 1997. A dramatic fall. And if you look at the consequence of that for the financial institutions that are heavily reliant upon that market category, it is of course dramatic. We are seeing the market wake up to that in the most recent results round, because the typical mortgage net present value across that period has halved from some $16,000 to possibly $8,000. All we are doing is looking at the prospective income streams over the course of the mortgage life and discounting those back to the present to get a one-off value for the worth of the business. We are not talking about gradual change here. So there is some debate in the Wallis Report between incremental change and paradigm shift. I think the important thing coming out for us is that with new competition taking advantage of new technology or an inclination on customers to embrace change, it can have a very rapid and marked effect on the marketplace. We have seen that certainly in the mortgage business. We have seen it in the life and superannuation business. And we are about to see, in our view, a similar change on the liability side of the bank balance sheet, with feverish competition for deposits.

Just going back to mortgages for the moment, we see the competition continuing very much in the mortgage market. We see the duration of mortgages become shorter, rather than people keeping a mortgage for the seven or eight years between moving houses, refinancing after one or two years – well if they do that and the net present value of those mortgage products on which many financial institutions have been heavily reliant for their profitability in the past diminish to something to $1,000 or $2,000 – it is a very marked change.

To conclude with changes by product category, we see higher deposit rates very likely, so competition on the liability side of the balance sheet. If we look at the current situation time deposits are getting a very modest rate of interest of maybe 0.5%, whereas larger value savings deposits are getting 4% or 5%. We see the disparity between the smaller deposits and larger deposits in terms of rate of return diminishing. And we see that diminishing by new players coming into the market and players embracing new technology, which will of course squeeze the income base of the banks yet again.

So to try and pull all of that together, we can see a lot of change in the marketplace over the last five to ten years. That is not going to stop – far from it, it is going to increase. In our view, the principal driver of that change is increased competition.

In the past we would have had just three categories – building societies, banks and insurers. But we are seeing increased competition because of convergence between those distinct entities and new players coming into the marketplace, whether they be information providers, retailers or indeed gateway providers on the Internet.

It is very difficult to predict the direction and pace of change, but it is our view that the change will really be driven by these innovative providers that are looking at an angle to underpin their future profitability. So they will undertake the systematic market analysis and they will be trying to second-guess what others are doing. And as a result of that analysis and that thought about the actions of others, they will put in place their own strategy.

It will be important to have an understanding of what has happened in the past, but nevertheless to be quite creative. We can talk about retailers being important, for example, in the financial services business, but if that is going to be the case then how does one align oneself maybe with a retailer to take advantage of that change? There was an article earlier this week talking about Sainsburys Bank in the UK, and I think it is quite interesting that over the last twelve months we have seen major initiatives in financial services from both Tescos and Sainsburys to supermarket chains in the UK.

Now these concepts have been in gestation for three, maybe four years. And it is not just a question of retailers saying: "Well, OK. We can see an opportunity to take advantage of the profits that are available in the financial services sector." But really, they are driven by a need to understand more about their customers, to have better information on their customers so that they can drive their retail business more effectively. They can stock the right lines of merchandise in certain stores and they can emphasise the lines of merchandise to sell. And what they realise is that by providing financial services they can build up better information on certain customer segments within their customer group. And they can amortise the costs of creating and manipulating that customer information across a new income base.

Being in financial services makes sense because you make money out of it, but it also makes sense because you can get the information that is necessary to run your business well. And I think if you generalise from that principle, then we can see all sorts of new entrants into the financial services business, driven not just by a desire to make money out of financial services, but by a desire to have better information on customers, so that they can segment the market and devise different value propositions for the different segments. So we will see the telecommunications providers and maybe other utilities being players in the financial services business.

So increased competition, but competition driven by this more enlightened view of the skills that one needs to build to thrive in numerous businesses. We believe that many businesses are going to see a requirement for better information on their customers and that entering the financial services business is a very good way to gain that information. More competition, but the prospects are not all bleak for financial services providers.

If we look at a simple graphic that would describe the life cycle in the financial services business in the past, we have a situation where, if we look at the red line, the income rises gradually across one's working life, and that expenditure starts off being a little bit below income and one is saving, then maybe the expenditure exceeds income and hopefully, at the end, again the income exceeds the expenditure. So a very simple, straightforward picture.

What we believe is likely to happen in the future is much greater volatility in that income line. We are going to see performance-related pay, maybe continuity of employment a thing of the past. If financial services institutions are good at smoothing that imbalance then of course there are enormous opportunities. So rather than being concerned about increased competition, concerned about all of these new players, because they are inevitable, it would be our advice to providers to think about how the opportunities are changing, how customer needs are changing. And those that really do focus on those customer needs, have good prospects in the future.

To try and pinpoint some changes which are very likely in the make-up of the financial services marketplace and speaking particularly from a retail bank perspective, I would like to draw on some work that we undertook over the last 18 months or so, looking at the distribution approach market by market. And clearly there is much speculation in the press about what will happen to the number of bank branches as banks focus upon reducing costs and need to reduce costs to match the cost structure of some of these new entrants. For example, many speculate that they may have a cost to income ratio of something like 20% compared with 50% or thereabouts of retail banks. And if retail banks are to match these new players on the cost basis, then brutal surgery may be in prospect as regards the branch network.

I guess what we have learnt when we looked around the world at the different ways in which branches were used, the desired cost reduction can be achieved without compromising branch density. You do not necessarily need to close half the branch network. Maybe the first port of call should be to get smaller branches. But the real problem in Australia is not that it is over-branched with 430 branches on average per million people, but that the branches are too large. And if we look, for example, at Norwest in the United States or Svenska Handelsbanken in Sweden, we find that they have got a very dense branch network and indeed Norwest are opening branches – but they are small branches. Maybe there is an opportunity there.

To demonstrate the need for innovation rather than stalemate thinking, maybe instead of closing branches we should be sharing space in those branches with other retail businesses. Wells Fargo, for example, share some of their traditional branches with a drugstore chain Thrifty PayLess. Royal Bank of Canada offer mobile phones. Others, such as Banco Comercial Portugues, are specialising within the branch network, and they have different branches for different parts of the market. Automated kiosk branches for the mass market and very up-market branches for the private bank segment. They have got seven different variants and Banco Comercial Portugues is a very successful new bank which has only been operating for eleven years.

If you look in South America at Banco Itau and Unibanco in Brazil, they are very successful at putting the bank branch where the customers are. Place of work distribution. Or at Wells Fargo and National Commerce, putting the bank branch where the customers are – in the supermarkets.

We see a lot of possible changes rather than just brutal cuts in the branch networks. And I think finally, if we look at electronic banking, we see enormous opportunities to target this improved functionality at the customers that are predisposed to use it. That may sound obvious, but we are sceptical that change is going to be driven by the technology itself. The important thing is to make that which is possible attractive to customers. Give them a reason to use it. And if we look at ATM technology, for example, when we look around the world we find that the most successful institutions at promoting the use of ATMs are, for example, Banco Itau in Brazil. They promote ATMs because in a high inflation economy it is simply impossible for all of their customers to stay in touch with their finances on a daily basis as they wish to by visiting the branch. If 3,500 customers all turned up at lunch time it would be somewhat problematic. So they have emphasised ATMs and telephone banking. Wells Fargo have emphasised ATMs as well. Likewise Nedcor.

If we look at telephone banking, we have examples such as First Direct and Svenska Handelsbanken in emphasising that, but emphasising it in terms of the benefits it delivers to the customer.

PC banking – we see Unibanco in Brazil and Charles Schwab with mutual funds being particularly effective there.

And finally with Internet banking, likewise Charles Schwab, Wells Fargo, Huntington in the US and Barnett Banks.

In conclusion, therefore, we have a marketplace which has been changing rapidly. It is going to change increasingly rapidly in the future in our view. The principal driver of that is going to be new competitors and innovative competitors. But it is our contention that with customer needs which are also changing rapidly, existing players start with an inherent advantage in that they have linkages with customers and they have information on customers. They are well placed to be very innovative and indeed very successful.

Thank you very much.