Banking on Our Future: Framing a Vision for the Australian Banking Industry

Five trends could create a vibrant economy or a stagnant one. The right banking sector vision can tilt the odds.

Table of Contents

Executive Summary

A compelling forward-looking vision can play a valuable role in informing and guiding the national debate on the evolution of Australia's banking industry. In the absence of such a vision, we run the risk of focusing on the urgent instead of the important.

This independent, self-funded paper by A.T. Kearney seeks to develop and propose such a vision for consideration by the industry and its various stakeholders. It has been developed in dialogue with a panel of global and Australian experts, including many from outside our firm, as well as discussions with senior industry executives.

To articulate this vision, we first need to frame the dialogue. Our approach is anchored in the core economic functions—deposits, lending, transactions, and advisory and managing the crucial interfaces between these functions—that banking plays in any economy and the three often-competing objectives—providing returns to shareholders, investing in customer protection and stability, and delivering value to customers—that banks must continually balance if the system is to grow and support a vibrant economy.

The Australian banking industry has performed remarkably well over the past decade.[1] Demand for the core economic functions has increased steadily, and banks have stepped up to satisfy a lion's share of this demand (more so than in many comparable markets). Additionally, the industry has managed to strike an enviable balance between the three competing objectives.

Rather than relying on expanding margins, the industry has created economic surplus by successfully meeting growing market demand. Further, banks have controlled their operating expenses, reinvested in the business, and redeployed the increased surplus towards shareholders, including a significant part of the Australian public who directly or indirectly hold bank shares.[2] Almost a third of investment spending was directed towards risk and compliance projects and a large part of the remaining investments was applied to enhancing the proposition to the customer.[3]

However, an objective analysis of the industry does also raise a few questions that suggest the need to challenge the status quo and embrace a new vision. Is the current return on equity (RoE) sustainable or likely to face downward pressure on average? Are current measures of customer satisfaction truly representative of how customers perceive and choose their banks? Can greater economic surplus be created through bolder, industry-wide productivity initiatives? And are all core sectors of the future Australian economy benefiting from an increased availability of funding?

To articulate a forward-looking vision, we need to first look ahead and imagine the future Australian economy. Our economic future will be shaped by five mega trends: a maturing population, emerging Asia, the rising impact of digitisation, risk averse and expensive global capital, and scarce natural resources. Crucially, these trends are double-edged and pose both opportunities and threats to the country's economic success. It is possible to articulate an optimistic and pessimistic outlook for the Australian economy with equal conviction.

We believe the banking industry must play a central role in helping tilt the odds in favour of an optimistic economic future. It should therefore aspire to be the **key enabler of the future Australian economy.** This vision has four dimensions:

[1] Data used is for the decade ending 2012 (2002-2012).

[2] From the 2012 net profit after tax of the major banks, 83 percent has been paid out in the form of dividends, and 17 percent was retained.

[3] Analysis is based on information in annual reports from ANZ, Commonwealth Bank of Australia, National Australia Bank, and Westpac.

Support the unlocking of capital to fuel the future economy. Banks play a significant role in the country's economy. They must therefore play a central role in unlocking capital in real estate investments, cash, and deposits and making these funds available for growth. Funding options in the economy need to be broadened, and banks can play a vital role in leading this development.

Develop and deliver financial solutions to core growth sectors of the economy. Small and medium-size enterprises (SMEs) and potentially crucial growth sectors such as agriculture, services, infrastructure, and environment need continued access to funding and other financial solutions to become economic growth engines. While some argue whether this is indeed a challenge today, it is harder to argue the challenge will not grow with time. Banks again can play a valuable role in ensuring these needs are met efficiently and effectively.

Facilitate Asian integration through superior insight into the risks and rewards of doing business in Asia. Increased trade and capital flow to and from Asia demands a deeper understanding of the risks and rewards involved in dealing with these markets. Banks are well-positioned to help businesses navigate these risks. Further, to facilitate the mobility of talent, banks need to explore ways to provide a seamless multi-geographic banking experience.

Pioneer the charge into the digital economy. Australian industries must embrace the use of technology to become smarter, more productive, and more innovative to create both economic value and customer value. Banks must lead the way, along with other sectors, and create the infrastructure for others to follow.

There is much to do for the industry to realise this vision. Individual banks have a significant part to play but cannot succeed alone. As listed, for-profit enterprises themselves, banks will (and should) always behave in a way that is economically rational. Thus, the alignment and support of regulators, policy makers, and even the analyst community will be essential to create the environment in which economically rational choices for banks and the long-term interest of our nation are aligned.

Should Australian banking embrace the bold vision of becoming a key enabler of our economy? Whether we agree or have reservations, we can benefit from a rigorous dialogue to avoid continuing with the status quo. If this paper contributes—even in a small part—to fuelling such a dialogue, we will have succeeded in our objective.

Framing the Dialogue

The public dialogue on Australian banking focuses at times on a few topics, such as the perceived low levels of sector competitiveness, concerns regarding supernormal profitability, and the need for more stringent or more lax prudential and customer protection regulations. We believe a forward-looking vision is vital to informing a healthy debate at the national level.

At this stage, we seem to lack an independent, forward-looking narrative on how the industry should evolve over the next decade. This paper aims to narrow this gap. This independent, balanced view of the industry provides a framework for a forward-looking discussion, paints a picture of how the banking system can and should look in the next decade ("the industry vision"), and suggests actions for individual banks and other key stakeholders to move towards this vision.

Defining the required state of Australian banking tomorrow provides the necessary backdrop for a well-informed debate on the industry today. In this chapter, we introduce the principles, or foundations, for this discussion.

Foundational principles of a banking system

Banking plays a crucial role in an economy's success through core value-creating functions. At the same time, the system needs to balance three often-competing objectives. The success of a banking system should be viewed against how it performs these functions and balances these objectives. Discussion about a future vision must be anchored in a clear understanding of the needs that banks address (among other alternatives) and how they create value.

The core functions considered in this paper are deposits, lending, transactions, and advisory (see figure 1). By effectively and efficiently meeting the needs of customers (both individual and businesses) in each of these areas and by thoroughly managing the interdependencies between these core functions, banks create real value for the economies in which they operate.

- **Deposits.** An economy needs a safe house for surplus liquidity and a low-risk, low-return investment destination. To satisfy this demand, banks provide current accounts, saving accounts, and term deposits, which offer the public convenience, safety, and transparency. Banks create value by providing protected returns on excess liquidity, bearing the burden of any risks.
- **Lending.** Banks provide funding to the economy in two main ways: lending against future cash flow and lending against tangible assets. Examples of the former are personal loans, credit cards, and factoring; examples of the latter are mortgage loans, car loans, and leasing.

Figure 1
Four core functions of banking

	What the economy needs	What banks provide	How value is created
Deposits	• Safe house for surplus liquidity (interest-free accounts) • Low-risk returns (interest-bearing accounts)	• Convenience • Transparency • Safety	• Providing protected access to money market and returns on excess liquidity
Lending	• Funds against future cash flow (personal loans, credit card, factoring) • Funds against tangible assets (mortgage, car loan, leasing)	• Risk assessment • Risk management	• Bearing the risk between long-term lending and short-term funding • Assessing and pricing credit risk, allowing available funds to generate positive yields
Transactions	• Ability to make and receive payments accurately and efficiently • Efficient conversion of currency across markets	• Efficient infrastructure • Connectivity	• Providing benefits of economies of scale and guaranteeing security of transactions
Advisory	• Advice to retail customers on adjacent financial needs investments, retirement, and protection • Advice to corporates on M&A, capital markets, and risk management	• Risk assessment • Risk management	• Leveraging scale, professional skills, and market access to create opportunities for customers

Balance-sheet business (Deposits, Lending) · Fee-based business (Transactions, Advisory)

Source: A.T. Kearney analysis

As part of their lending business, banks provide risk assessments and risk management. They create value by assessing and pricing credit risk, allowing available funds to generate positive risk-adjusted yields. As the intermediary between depositors and lenders, banks bear the risk between long-term lending and short-term funding and receive an interest rate spread in return.

- **Transactions.** In addition to deposit and lending functions, the economy needs the ability to make and receive payments accurately and efficiently and to convert currencies across markets. For example, banking provides an efficient infrastructure and connectivity in the form of a payments system. By doing so, banks provide economies of scale while also guaranteeing the security of transactions.

- **Advisory.** Banks provide advisory services by counselling retail customers on adjacent financial needs investments, retirement, and protection and by advising corporate customers about mergers and acquisitions (M&A), capital markets, and risk management. To do this, they provide intelligence, information, and professional, unbiased advice. Value is created by leveraging scale, professional skills, and market access to create opportunities for customers.

The competing objectives banks face

The primary challenge for a healthy banking system is to run these four core functions—and balance or manage the interdependencies between them—in a way that allows the system to simultaneously meet the often-competing objectives of shareholder returns, customer value, and regulatory compliance.

A banking system that creates sufficient economic surplus to continually invest in these three objectives is likely to enjoy a virtuous cycle of stability, profitability, and growth. Growth of the banking system in turn drives growth of the economy and vice versa. Put more simply, successfully balancing these objectives enhances the ability for the banking system to support economic growth. The nature of these objectives is shown in figure 2.

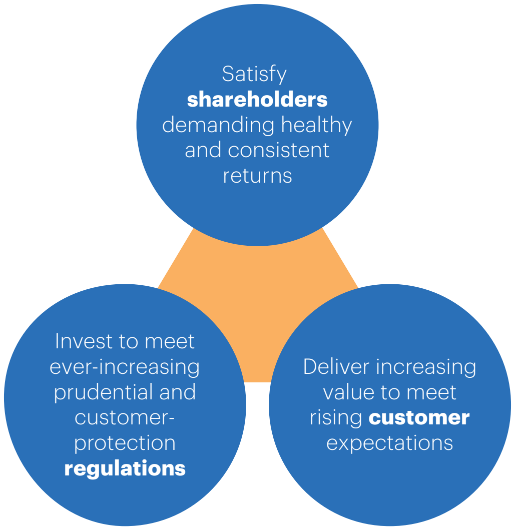
Figure 2
Banks need to balance competing objectives

Shareholder return

- **Baseline:** Meet shareholder dividend yield expectations
- **Stretch:** Outperform market in total shareholder return

Regulatory investment

- **Baseline:** Meet regulation requirements
- **Stretch:** Go beyond regulatory requirements to improve system stability and customer protection



System efficiency

- **Baseline:** Maintain economic surplus in system at current levels
- **Stretch:** Increase system efficiency to grow economic surplus satisfying all three competing objectives

Customer satisfaction

- **Baseline:** Hold ground on customer satisfaction
- **Stretch:** Continuously improve customer satisfaction

Source: A.T. Kearney analysis

Shareholder return. Satisfying shareholders' demand for healthy and consistent returns is a vital objective in any commercial business. Banking is no exception. Healthy, predictable returns are essential to ensure sustained funding and an ongoing ability to serve the economy. Shareholder returns can be compromised if customers and competitors demand service or price levels that are unsustainable or if regulators demand excessive protections.

Regulatory investment. As part of a regulated industry, banks must continue to meet the increasing demand from regulators through sustained investments in compliance and increases in capital reserves to ensure the stability of the industry and customer protection. The system's stability can be compromised if customers can access funding too cheaply or banks take on excessive risks to drive up short-term shareholder returns.

Customer expectations. Customers demand value (safety, convenience, price, or expertise) across all of the core functions. Meeting or exceeding customers' expectations is imperative. For example, customers demand innovative products for a competitive price while being able to use state-of-the art technology to access these products. This objective can be compromised if, for example, regulatory requirements are too onerous or returns to shareholders come at the cost of market innovation.

Given the industry's current focus on productivity, it is also useful to understand how productivity fits into this model. In a growing economy, economic surplus is continually generated by meeting additional demand. However, in the absence of growth or to supplement slow growth, productivity must increase to create more economic headroom to fund competing objectives and to ensure the system does not slide backward.

How has Australian banking performed in terms of these four economic functions? How well has it balanced the three competing objectives? The next section explores answers to these questions.

Holding Up a Mirror

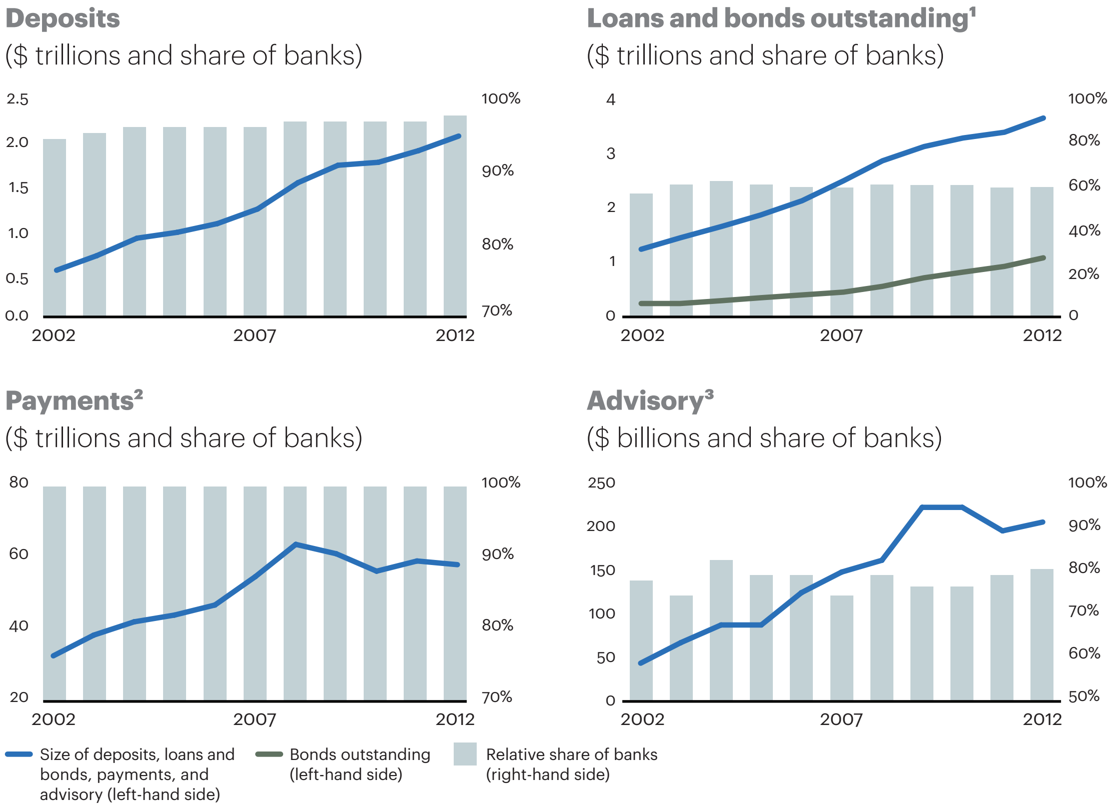
Banking has played a significant role in Australia's economy. The industry has delivered on the four core economic functions discussed in the previous section to a larger extent than in most comparable markets, and it seems to have managed the delicate balancing act of meeting the three competing objectives relatively well. However, a deeper look raises some questions that reinforce the need to challenge the status quo and create a refreshed, forward-looking vision for the industry.

Demand for all four core economic functions in Australia has increased significantly over the past decade, with banks playing a larger role in meeting this demand (see figure 3 on page 9).

- **Deposits.** The volume of deposits almost quadrupled from 2002 to 2012 (see figure 4 on page 9). Rising from $0.5 trillion to $2 trillion, growth has been more aggressive than in other countries, partly because of the buildup of funds through the superannuation pool and the battle for customers' money over the past couple of years to fund a rise in mortgage lending.[4]
- **Lending.** Funding supplied by Australian banks and capital markets grew 190 percent over the past decade to $3.7 trillion in 2012. Funding supplied in the form of loans grew from $1 trillion in 2002 to $2.7 trillion in 2012, with banks increasing their share of the loan market from 72 to 85 percent. During the same period, funding supplied in the form of bonds grew from $0.24 trillion

[4] "$" is used for Australian dollar and "USD" for U.S. dollar.

Figure 3
Australia's demand for the core functions of banking has grown



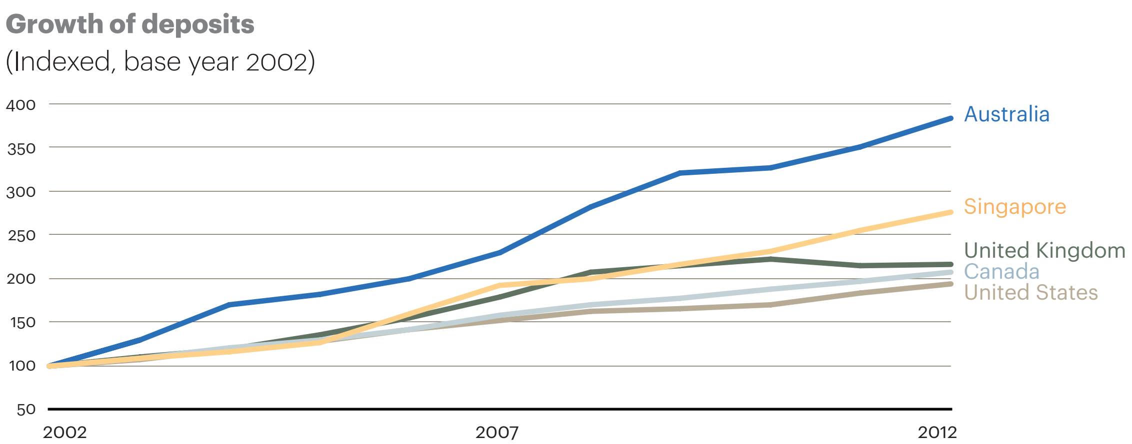
[1] Bonds outstanding for all sectors in the economy, in market value

[2] Transaction volume of cards (credit, debit, and charge cards), cheques, direct entry payments, and real-time gross settlements

[3] Transaction volume of equity and debt capital markets

Source: Australian Prudential Regulation Authority, Reserve Bank of Australia, Australian Bureau of Statistics, Bloomberg; A.T. Kearney analysis

Figure 4
Deposits in Australia have nearly quadrupled



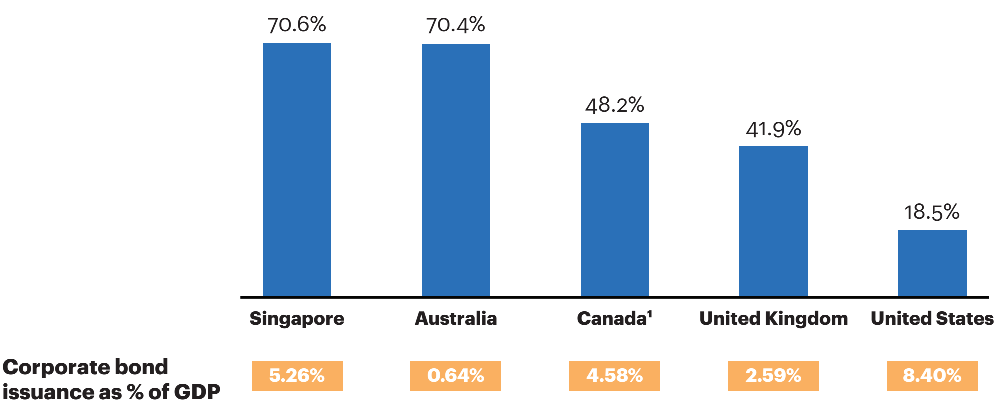
Sources: Bank for International Settlements, Bloomberg, Australian Prudential Regulation Authority, Reserve Bank of Australia, Bank of England, Federal Deposit Insurance Corporation, Monetary Authority of Singapore, Bank of Canada; A.T. Kearney analysis to $1.1 trillion.[5] Further, the share of total domestic funding fulfilled by loans (70.4 percent) is high compared to peer countries, pointing to a smaller role of the bond market as a source of funding (see figure 5). In fact, a look at the amount of money raised in the local corporate bond market reveals that Australia's bond market is small, with raisings only being 0.64 percent of GDP in 2012.[6] Although the appetite for bond funding is there, corporates often decide to raise funds overseas ($169.5 billion or 76 percent) instead of domestically ($52.4 billion).

The role that banking plays in "servicing" the deposit and lending markets is substantial compared to peer countries.[7] Only Singapore's banks (among those profiled) have a higher share of serving these economic functions in their market (see figure 6 on page 11).

- **Transactions.** The amount of money flowing through the payments system in Australia has grown 80 percent between 2002 and 2012, reaching $17 trillion. This category includes transactions by card, ATM, cheque, direct-entry payments, and real-time gross settlements. The share of payments being processed by Australia's banks is similar to peer markets.
- **Advisory.** The advisory business includes equity capital market (ECM) and debt capital market (DCM) transactions on the corporate side and advice given for superannuation, insurance, and investments on the retail side. The ECM and DCM transaction volume grew steadily from 2002 till 2012 from $44 billion to $208 billion. Banks' market share has hovered around 80 percent. On the retail side, the funds under advice by financial planners reached $387 billion in 2012. The share of banks in this market (the funds under advice of dealer groups owned by banks) has been stable around 46 percent.[8]

Figure 5
A large share of Australia's domestic funding is met by loans

% of domestic funding provided through loans
(2012 total loans/total loans and bonds)



Note: The share of loans in domestic funding is calculated as loans as part of total funding (loans and bonds). Data is for 2012.
[1] For Canada, bonds issued abroad have also been included due to data unavailability.
Sources: Australian Prudential Regulation Authority, Monetary Authority of Singapore, Bank of England, Federal Deposit Insurance Corporation, Securities Industry and Financial Markets Association, ASB, United Kingdom Economic Accounts, Statistics Canada; A.T. Kearney analysis

[5] Bond market size measured by market value

[6] Compared to 2.59 percent in United Kingdom, 8.40 percent in United States, and 17.36 percent in Singapore, according to A.T. Kearney research. Corporate bonds issuance data represents face value of bonds issued onshore by non-financial corporations.

[7] A.T. Kearney research

[8] Bank market size and share calculated over the top 50 financial planner groups according to *IFA Magazine*.

An enviable balance

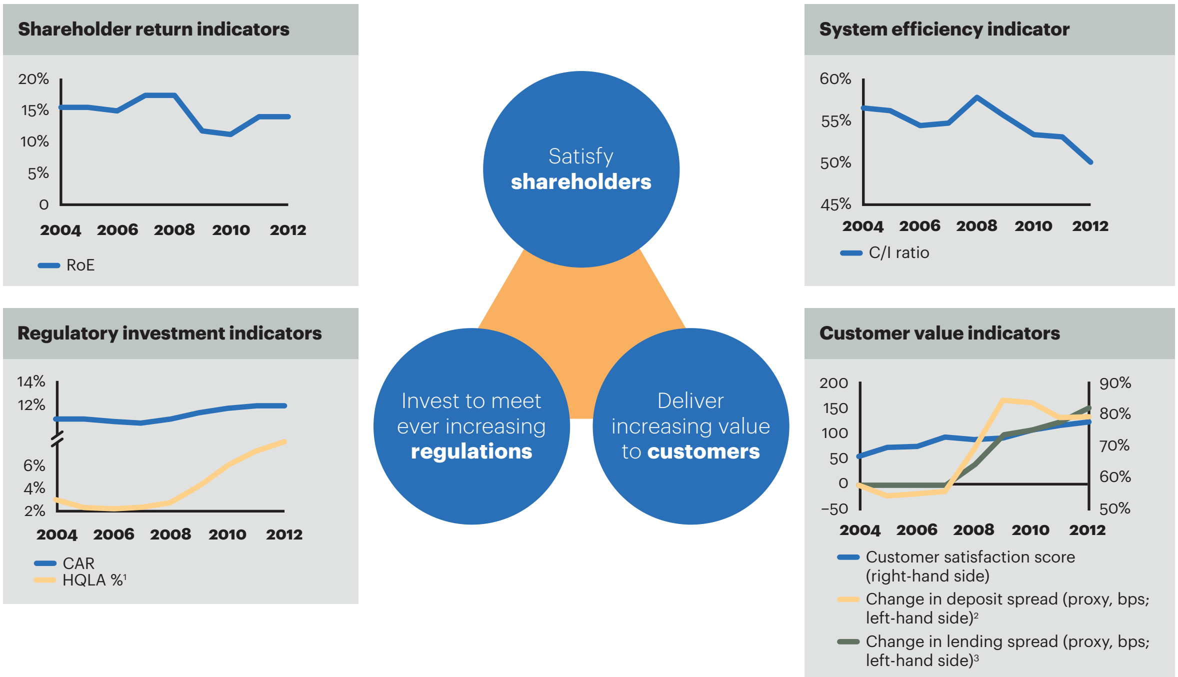
A look at how the industry balanced potentially competing objectives reveals that Australia's banks achieved an enviable balance when compared with the struggles and compromises seen in several global markets (see figure 7).

Figure 6
The role of banking in the deposit and lending market is substantial

	Market share of banks		Market growth (2012 vs. 2002)	
Country	Deposit	Lending	Deposit	Lending
Singapore	98.6%	95.6%	2.8x	3.2x
Australia	97.2%	85.7%	3.8x	2.5x
United States	92.6%	84.1%	1.9x	1.5x
Canada	82.7%	75.1%	2.1x	2.0x

Sources: BIS, Bloomberg, Australian Prudential Regulatory Authority, Reserve Bank of Australia, Bank of England, Federal Deposit Insurance Corporation, Monetary Authority of Singapore, Bank of Canada, Stat Canada; A.T. Kearney analysis

Figure 7
Australian banks successfully balanced competing objectives



[1] High quality liquid assets as a percentage of short-term liabilities
[2] Movement of special term deposit rate versus cash rate, in bps, relative to 2004
[3] Movement of variable mortgage rate versus cash rate, in bps, relative to 2004

Sources: Australian Prudential Regulation Authority, Reserve Bank of Australia, Bloomberg, Roy Morgan Research; A.T. Kearney analysis

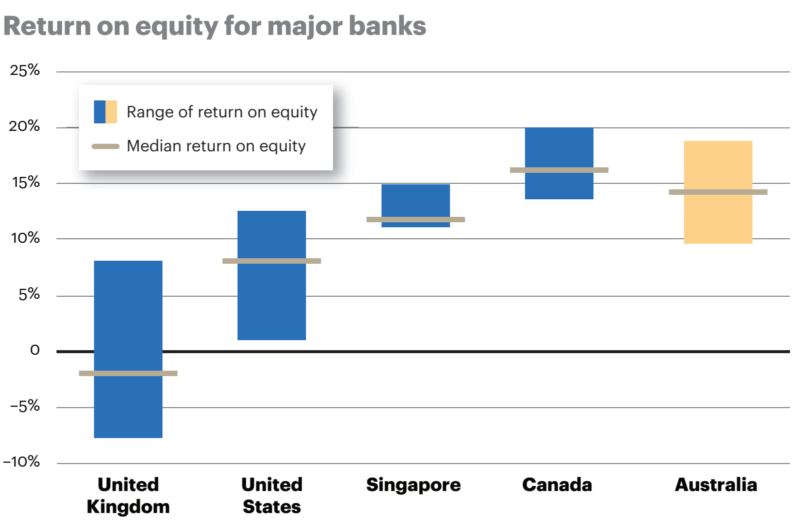
Shareholder return. On average, shareholders' RoE has been fairly stable at around 15 percent after tax. A comparison of the RoE of the major banks in Australia with those in a set of peer countries reveals healthy RoE (see figure 8). The United Kingdom performs especially poorly, with significant funds being allocated to customer redress issues.

Regulatory investment. Australian banks managed to maintain a stable RoE on average despite increases in investments directed towards stability and protection. Investments to meet regulatory requirements around the stability of the financial system increased after the global financial crisis. The amount of high-quality liquid assets, including cash and securities held, grew from around 2 percent of short-term liabilities before the global financial crisis to 8 percent in 2012 in anticipation of the implementation of Basel III. The capital adequacy ratio, which is the ratio of a bank's capital to its risk, increased from 10.6 to 11.8 percent.[9] Additionally, Australia's major banks currently allocate about a third of their investment spending to risk and compliance.[10]

Customer satisfaction. During the past decade, Australian banks have placed greater emphasis on customer satisfaction. This decade has seen a tremendous rise in customer convenience and control. After expanding their branch network and building out a large infrastructure of owned and third-party ATMs, the industry has invested in digital channels and mobile applications that are in many ways global firsts. For example, Australians take "pay anyone" online functionality for granted without realising this is a rare convenience that is alien to many other developing markets.

This growing focus on customer convenience and service levels has resulted in a rise in customer satisfaction scores from 66.8 percent in 2004 to 78.2 percent in 2012.[11] At the same time, the increased gap between the term deposit rate and the cash rate, driven by banks competing for deposit money, benefited customers tremendously.

Figure 8
Australia's banks have seen a healthy return on equity

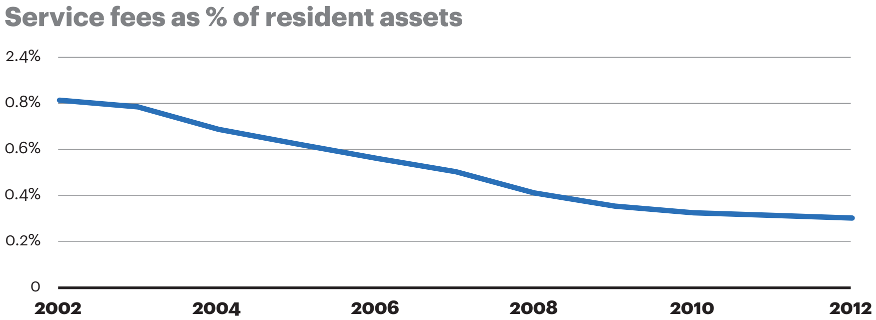


Note: This data comprises the major banks in each economy.
Sources: Bloomberg; A.T. Kearney analysis

[9] Risk weighted assets divided by total capital base, according to the Australian Prudential Regulation Authority
[10] 2013 annual reports from ANZ, Commonwealth Bank of Australia, National Australia Bank, and Westpac
[11] Roy Morgan Research

Bank service fee revenue adjusted for asset growth decreased in this period, falling almost 50 percent, from 0.85 percent in 2002 to 0.44 percent in 2012 (see figure 9). But not all costs dropped. While loan rates are driven by multiple factors such as cost of funds, expected losses, marketing, and sales costs, the difference between the variable mortgage rate and the cash rate began to creep up to offset the benefits received by the broader customer base.

Figure 9
Service fees as percentage of assets have declined



Source: Reserve Bank of Australia

This balance does not appear to have been so easily achieved in other markets. In the United Kingdom, for example, banks' RoE came under pressure after the global financial crisis because of levies, as the financial services compensation scheme and the bank levy to protect customers and increase the stability of banks as well as the significant customer redress because of mis-selling and selling overly complex products. Or put more simply, returns to shareholders were compromised as regulatory and customer value took precedence.

What enabled Australia's banks to achieve this balance? The impetus behind the industry's improved performance seems to be the growing demand from the market.

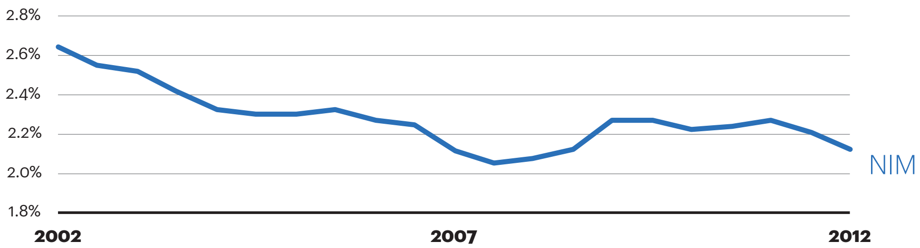
Profit for the collective banks increased from $17 billion in 2005 to $26 billion in 2012. This growth has been fuelled by a surge in net interest income (NII), which doubled from $30 billion in 2005 to $60 billion in 2012. The portion of fee and commission income, as pointed out above, declined from 29 to 22 percent because of regulation and competition.[12]

Contrary to public perception, overall margins have not increased but have in fact declined pre-GFC and have remained relatively stable since then. However, these margins over increased balances have resulted in increased NII. Net loans doubled from $1.1 trillion in 2004 to $2.2 trillion by 2012, while the net interest margins declined slightly from 2.30 to 2.13 percent over the same period (see figure 10 on page 14).

This increasing economic surplus has brought many benefits. Profits have been distributed across all three objectives. Shareholders have benefited in the form of dividends, with the percentage of profits being distributed as dividends increasing from 73 to 83 percent. This is highly relevant in an Australian context since Australian households own more than $300 billion in bank equity either directly or indirectly via their superfund investments.

[12] Australian Prudential Regulation Authority, Statistics: quarterly authorised deposit-taking institution performance, June 2013 and A.T. Kearney analysis.

Figure 10
Net interest margin has contracted over the decade



Note: Net interest margin includes major banks.
Source: Australian Bankers' Association

Of the remainder (retained earnings), more investments have been made in regulation and compliance, estimated to be a third of investment spending.[13] The rest of investment spending has been directed towards increasing customer value through innovation, technology, and convenience.

At the same time, the overall system efficiency improved, creating economic headroom to invest simultaneously in the three competing objectives. The efficiency of the banking system, indicated by the cost-to-income (C/I) ratio, of Australian banks has been on a positive trend over the past decades. The major banks in Australia have a C/I ratio that is at the bottom end of their peers around the world.[14]

This delicate balancing act had one significant benefit: It allowed the system to grow to meet increasing demand. Without balance, a large share of demand would have gone unmet in a market where banks play a vital role in meeting demand and few scale options are available.

Is the status quo sustainable?

Although Australia's banking sector has performed well over the past decade, a closer look reveals some trends that merit evaluation. Five thought-provoking questions indicate a need to challenge the status quo and chart a new vision for the industry:

1. Are all sectors of the economy benefiting equally from the increase in funding availability and the strength of Australia's banking industry?
2. Is the stable average RoE for the industry sustainable?
3. Are current measures of customer satisfaction truly representative of how customers perceive and choose their banks?
4. Can banks continue to inject equity at rates required by more conservative regulations?
5. Can greater economic surplus be created through bolder, industry-wide productivity initiatives?

The following focuses primarily on the first two questions and touches lightly on the remaining three.

[13] Major banks are ANZ, Commonwealth Bank of Australia, National Australia Bank, and Westpac. Investment spending is for the 2012 reporting year.

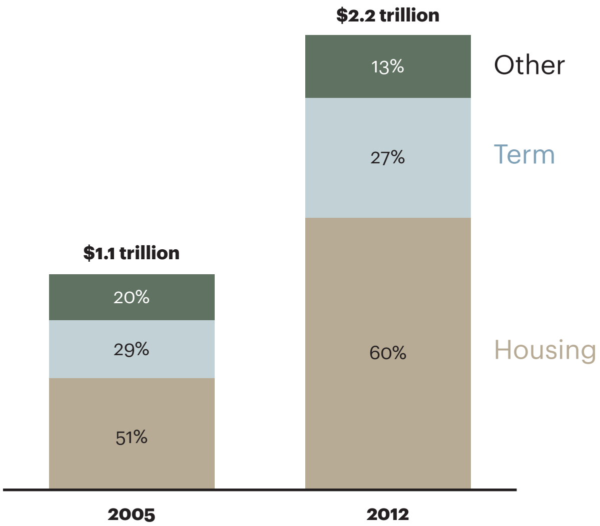
[14] Reserve Bank of Australia, Financial Stability Review, September 2013

1. Are all sectors of the economy benefiting equally from increase in funding availability and the strength of Australia's banking industry?

From 2004 to 2012, the amount of loans provided by banks doubled to $2.2 trillion. A strong contributor was the growth in housing loans, which increased from 52 to 60 percent of the total loan balances (see figure 11).

Figure 11

Loans provided by banks doubled, mainly driven by home loans



Source: Australian Prudential Regulation Authority

Is there a challenge with SME lending, as an illustration of a skewed funding pattern in Australia towards some sectors and away from others? Answering this requires understanding how important SMEs are to Australia's economy.

As in several markets, SMEs seem to be volatile and challenging but are also a vital part of the economy. More than two million SMEs in Australia contribute 57 percent of the private-sector industry value while employing approximately 70 percent of the workers in the private sector. This is in line with Europe where SMEs represent 58 percent of the gross industrial value and employ 67 percent of the workers in the private sector.[15,16]

SME funding has become a topic for debate, particularly since the financial crisis. While SMEs have often said they receive a raw deal relative to corporate and residential customers, major banks claim they have made enough funds available for SMEs. The amount of business loans to non-financial corporations in the past decade confirms that major banks are more forthcoming than regional banks in financing the sector (see figure 12 on page 16).

However, the distribution of new business loans seems more skewed towards larger corporates (loan value of more than $2 million). While the distribution of outstanding business loans is

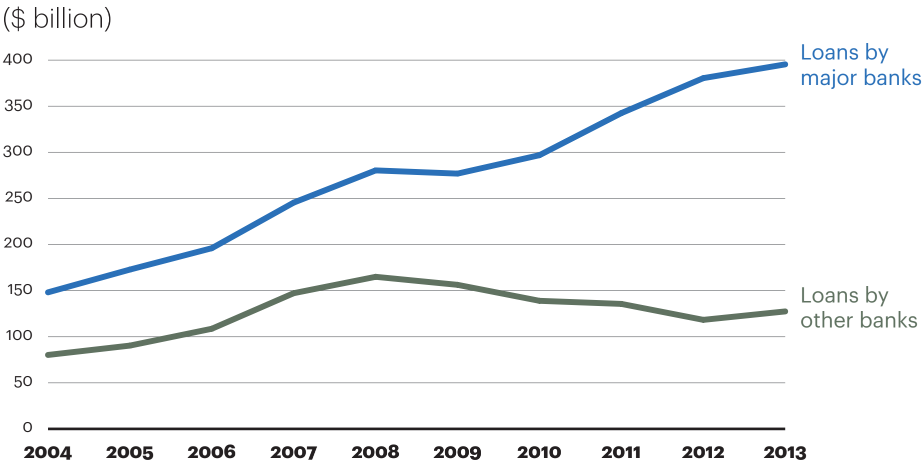
[15] Australian Government, Department of Industry, Innovation, Science, Research and Tertiary Education, Australian Small Business, Key Statistics and Analysis, December 2012

[16] Edinburgh Group, Growing the global economy through SMEs

two-thirds to corporates and a third to SMEs, for new loans this ratio is 78 percent to 22 percent in favour of corporates, based on average values since 2008 (see figure 13).

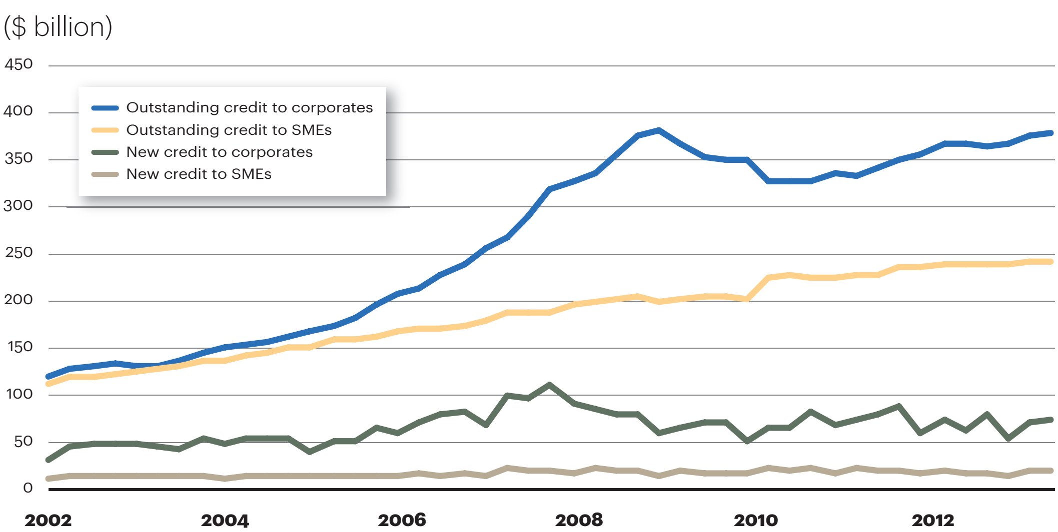
The situation is complicated for SMEs by a preference for property-backed loans. Over the years, the banking industry has become—some would argue understandably and prudently—more conservative towards non-property-backed loans. This trend can trace its origins to lessons learned from previous crashes (the property crash of 1990-1991 and the global financial crisis) and the capital provision under Basel norms that promotes property-backed loans.

Figure 12
Loans outstanding to non-financial corporations by bank type



Source: APRA—Outstanding loan values as of 31st December of the relevant years

Figure 13
Growth of business lending primarily driven by corporates



Source: Reserve Bank of Australia

Through this evolution, capabilities to underwrite areas such as specialised inventory-backed loans, receivables, and cash flow financing have understandably also begun to fade across the sector. Today, only two of the four majors provide debtor financing.

A further issue has to do with property-backed loans: The interest differential of about 100 basis points between a secured business loan and a housing loan is often questioned as to whether higher documentation requirements, more capital provisions under the Basel system, and the riskier nature of business loans justify such a differential.

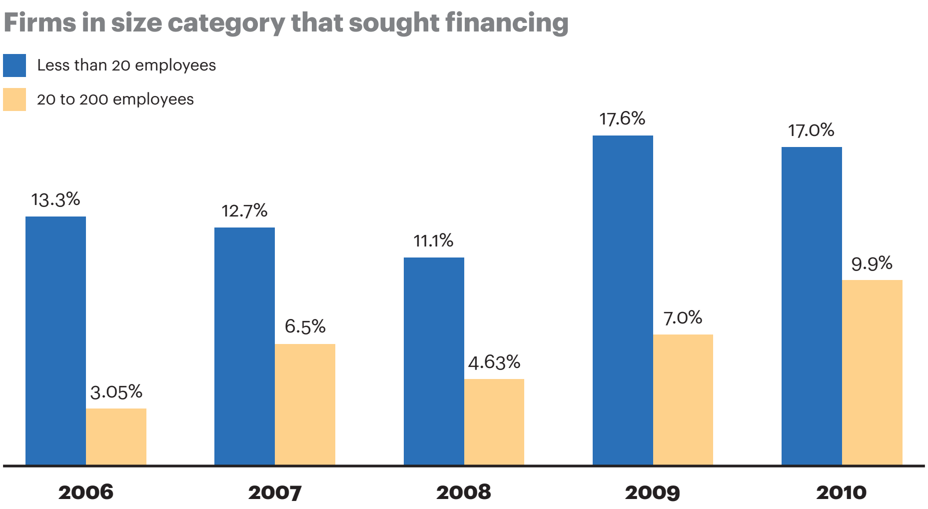
This reality seems to have led to debt products designed for households being used for business purposes, though it is hard to find accurate data to establish this fact.

Potentially as a result of some of these trends, Matić, Gorajek, and Stewart found that the percentage of SMEs failing to obtain external finance has increased.[17] This issue is more acute for smaller firms (see figure 14). Startups find it more difficult to fund their ventures as well. More than 40 percent of those seeking outside funding do not get it (see figure 15 on page 18).

Some banks have made an observation that SMEs are not financially savvy enough to get financing. SMEs, on the other hand, point out that more documentation is required for raising a loan, and the process takes a long time. In about 15 percent of the cases, potential borrowers withdrew their applications because the process took too long, according to an East & Partners survey.[18]

There is likely to be merit on both sides of this debate. However, the debate itself points to the fact that further discussion and effort on both sides are likely to be required to ensure that all sectors of the economy—of which SME is only one example—receive the support they need from the banking industry as a whole.

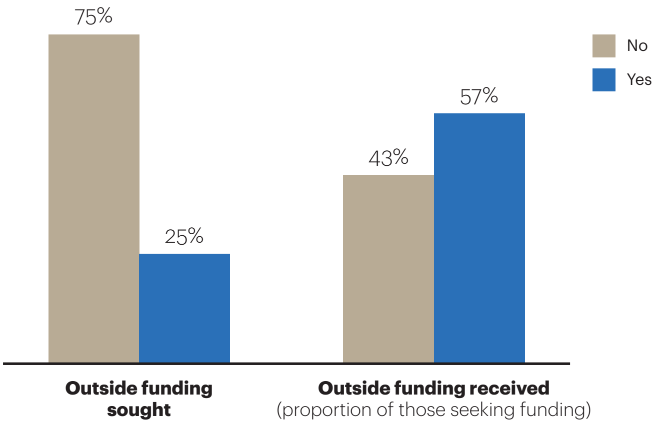
Figure 14
The percentage of SMEs failing to obtain external financing increased



Source: *Small Business Funding in Australia*, 2012

[17] Reserve Bank of Australia, Small Business Funding in Australia, Matić, Gorajek, and Stewart, 2012
[18] BankingDay

Figure 15
The experience of startups seeking outside funding



Source: Department of Industry, Innovation, Science, Research and Tertiary Education, "Australian small business key statistics and analysis", December 2012

2. Is the stable average RoE for the industry likely to be sustained?

For a rational investor, expected return is a function of the estimated risk of an investment. The previous section showed that the RoE for Australian banking on average has been stable around 15 percent over the past decade. However, some argue that the industry's inherent structural risks have been reduced, and therefore, RoE expectations could drop over time.

Thanks to the efforts of individual banks and the regulator, banking in Australia is indeed structurally less risky than before. Four indicators of risk are shown in figure 16 on page 19.

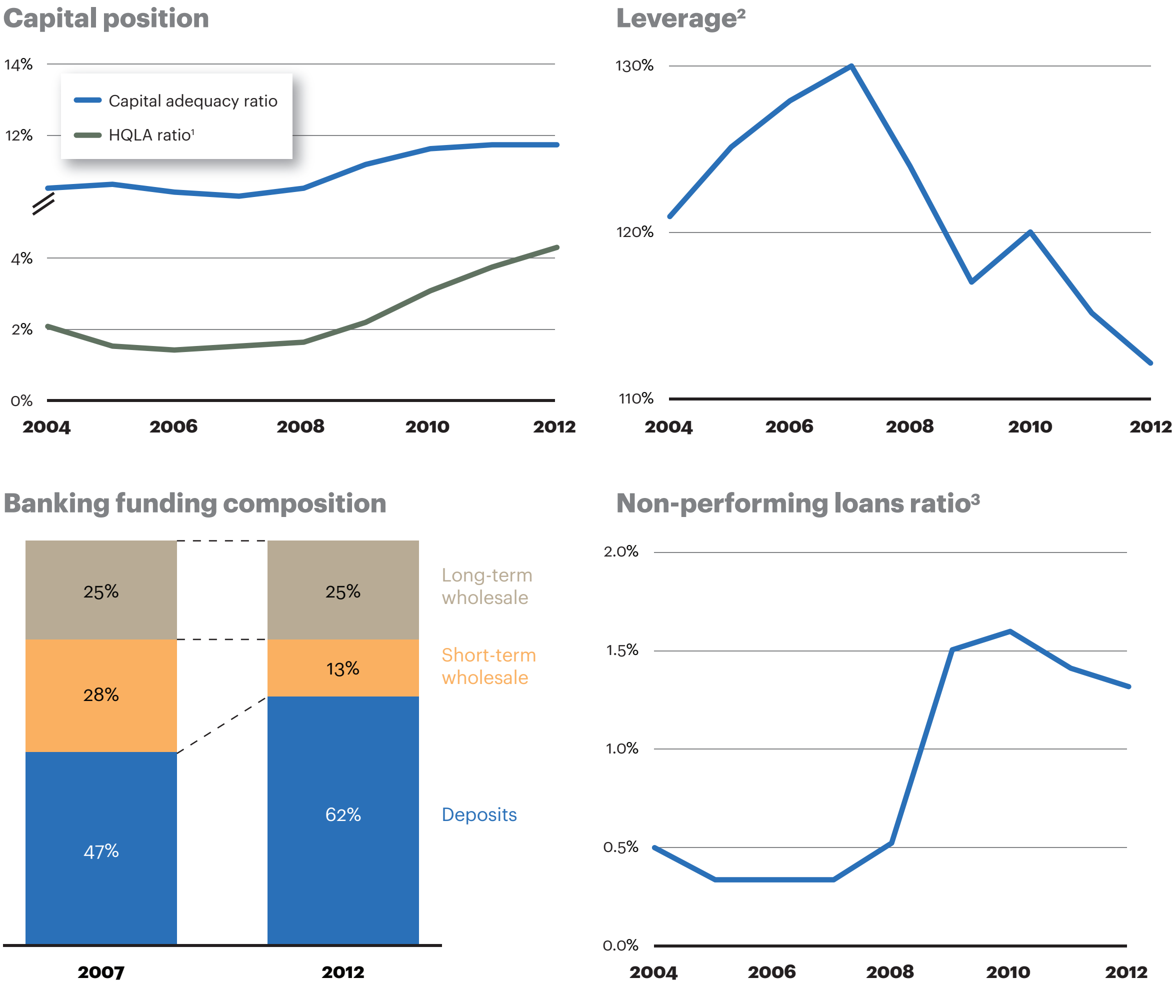
Capital position. When a bank holds more capital, its stability increases, and its risk is lower. The ratio of high-quality liquid assets more than doubled over the past five years to more than 4 percent of domestic assets, and the capital adequacy ratio rose from 10.6 to 11.8 percent.

> Thanks to the efforts of individual banks and the regulator, **banking in Australia is indeed structurally less risky than before.**

Leverage. The lower the leverage of the industry, the lower its systemic risk. Leverage is the amount of loans a bank provides relative to its deposits. A bank's risk profile increases if the leverage goes up. In Australia, this leverage has been declining since the 2008 financial crisis, dropping from 130 percent just before the crisis to 112 percent in 2012.

Funding composition. There are three main sources for funding for a bank: short-term wholesale funding, long-term wholesale funding, and deposits. The larger the part of short-term wholesale funding, the riskier a bank is perceived to be. This is because short-term

Figure 16
Australian banking is becoming less risky



[1] High quality liquid assets as a percentage of short-term liabilities
[2] Net loans and advances divided by deposits
[3] Impaired facilities to loans and advances
Source: A.T. Kearney analysis

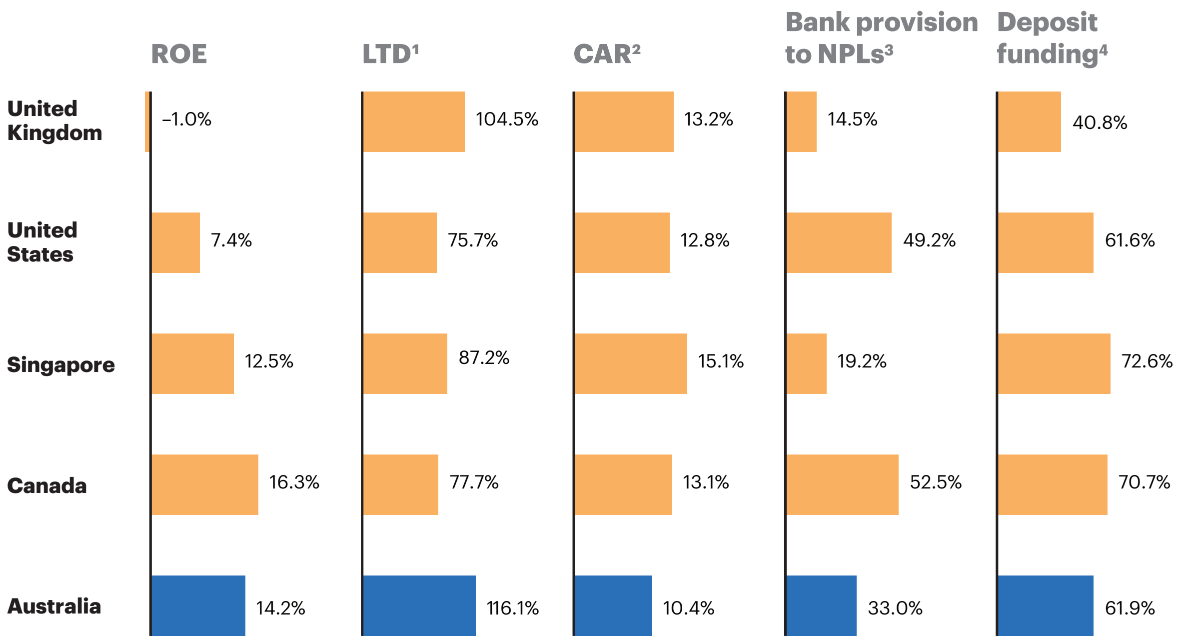
wholesale funding is perceived as the least "sticky" source of funding because its short duration means it has to be renewed more often. This renewal can become more difficult if market conditions change. To lower the risk in their funding footprint after the financial crisis, Australian banks reduced their exposure to short-term wholesale debt from 28 to 13 percent of their total funding needs while increasing their exposure to more sticky deposit funding from 47 to 62 percent.

Non-performing loans. If a bank has a significant number of bad loans in its books, it is a riskier bank. The non-performing loan ratio of Australian banks has been historically low, hovering around 0.4 percent.[19] During the financial crisis, it grew to 1.7 percent and is now on the decline (1.3 percent for 2012).

[19] The Australian Prudential Regulation Authority defines the non-performing loans ratio as impaired facilities to loans and advances.

How does Australia's situation compare with other markets? Singapore is one example of a low-risk sector commanding lower RoEs than Australia. However, Canada seems to be an exception, given that its structural risks appear less but its RoE on average appears higher (see figure 17).

Figure 17
Comparison of key ratios of leading banks across multiple geographies



Note: Data set consists of the major banks in each economy
[1] Loans to total deposits
[2] Capital adequacy ratio (core capital expressed as a percentage of its risk-weighted assets)
[3] Provision for loan losses over non-performing loans
[4] Total customer deposits and liabilities
Sources: Bloomberg, A.T. Kearney analysis

Across all these indicators, systemic risk seems to have been reduced. On one hand, this should result in lower RoE expectations. On the other, given the "scared" nature of global capital (as discussed in the next chapter), RoE expectations for the same risk level are rising. These competing forces raise a compelling question: Will RoE levels remain stable on average (fully acknowledging that individual banks may always perform far better or worse than the industry average)?

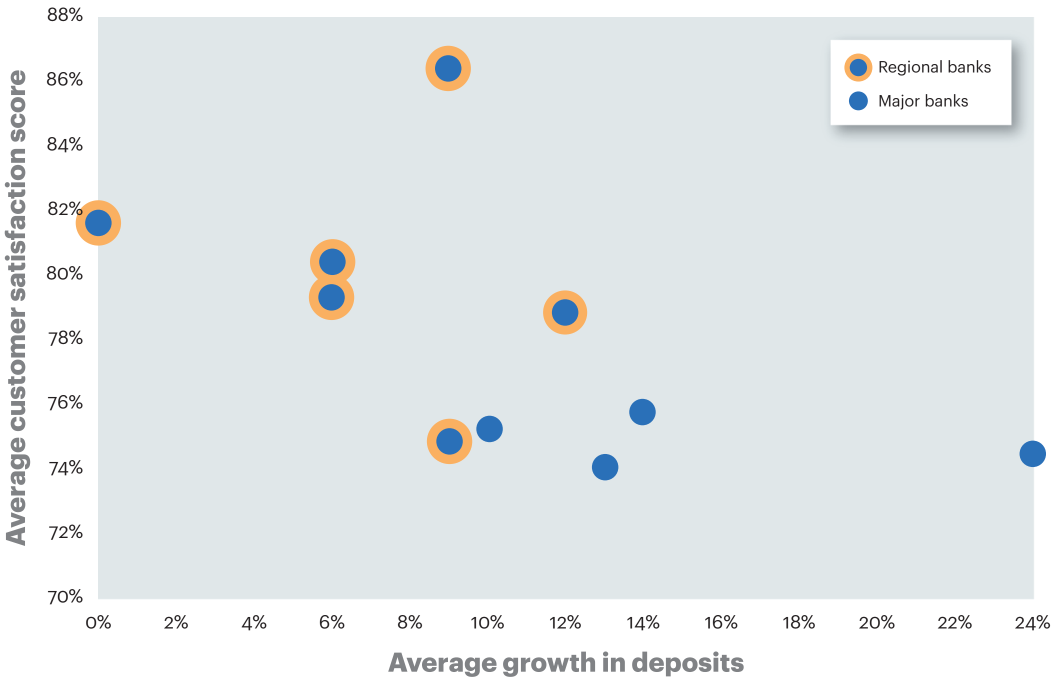
3. Are current measures of customer satisfaction truly representative of how customers perceive and choose their banks?

Perhaps a less crucial question, but a thought-provoking one nonetheless, addresses the measures banks use to assess customer value, specifically customer satisfaction scores. Overall customer satisfaction scores have risen from 66.8 percent in 2004 to 78.2 percent in 2012.[20] The underlying scores for most banks have continuously improved over the past few years. Some

[20] Roy Morgan Research

Figure 18

Some smaller banks are outperforming bigger players in terms of customer satisfaction



Note: Customer satisfaction scores and deposit growth have been averaged over five years (2008–2013).

Sources: Australian Prudential Regulation Authority, Roy Morgan Research; A.T. Kearney analysis

smaller banks, however, have consistently outperformed the major players in absolute customer satisfaction numbers (see figure 18).

Higher customer satisfaction would be expected to increase loyalty and drive business growth. However, the assumption that banks with the highest customer satisfaction rating get the highest business growth does not hold. In fact, the highest growth rates are with the major banks, not with the banks that deliver the highest customer satisfaction score. For example, all four major brands have higher growth rates than some regional banks, which have the highest customer satisfaction scores.

Are banks therefore justified in celebrating these scores as comprehensive indicators of customer value, or do they paint a meaningful but incomplete picture that points to the need for more customer value creation in the decades ahead?

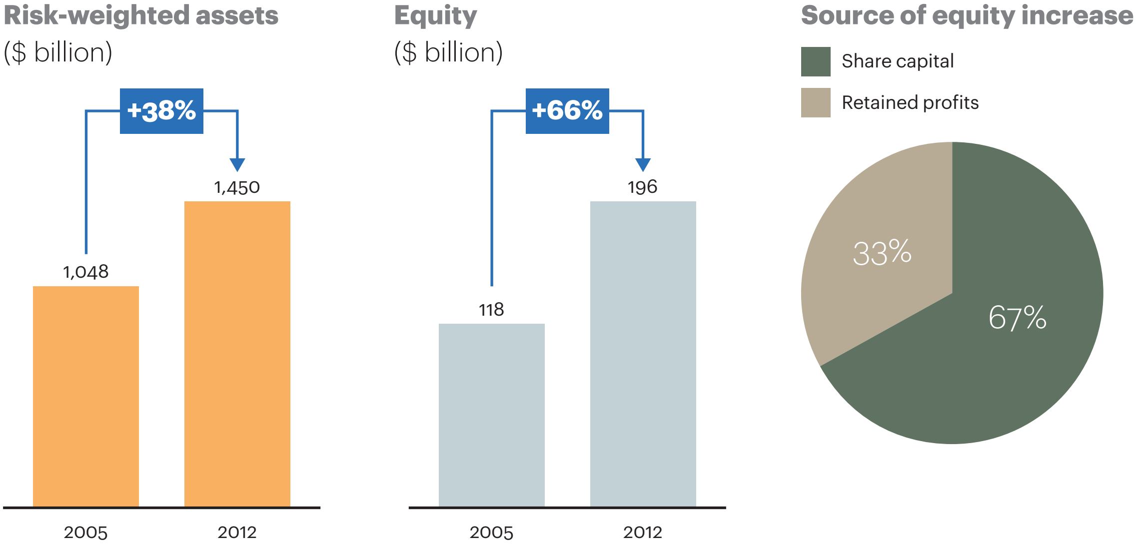
4. Can banks easily continue to inject equity at rates required by more conservative regulation?

From 2005 until 2012, banks' risk-weighted assets have grown by 38 percent.[21] However, to support this growth, banks' equity had to increase 66 percent (see figure 19 on page 22). This has been driven by more stringent prudential regulations. However, to facilitate future growth, equity on the balance sheet will need to grow faster than risk-weighted assets if more conservative regulations are introduced.

[21] Risk-weighted assets are the risk-weighted sum of a bank's individual credit exposures.

Figure 19

Banks' risk-weighted assets have grown, but equity also had to grow



Sources: Australian Prudential Regulation Authority; A.T. Kearney analysis

If banks are to keep up with funding the economy, the demand for equity will grow faster than before. Assuming regulations don't become more conservative (and expensive), will growth imply the need to raise additional equity if retained earnings do not keep pace? Otherwise, growth of lending through banks will be curtailed, and new sources of funding will need to be discovered. Neither scenario is appealing for the industry.

5. Can greater economic surplus be created through bolder, industry-wide productivity initiatives?

The final question focuses on the industry acting in a coordinated fashion to identify and capture further productivity improvements. As discussed, the C/I ratio of Australian banks has dropped over the past decades and is one of the world's lowest. However, this drop does seem to be driven more by an increase in income without a proportional increase in costs. (Income has grown 38 percent with a cost increase of 23 percent.)[22]

While this is indeed a major achievement, are there ways the industry as a whole can explore sector-wide or multi-bank initiatives to reduce costs and increase productivity more dramatically? Given that banking's role in the economy is larger than the people it directly employs, should banks explore more ambitious productivity initiatives such as industry-wide utilities, as we have seen globally and in the superannuation industry (for example, shared administration platforms across industry funds)?

Success in such sector-wide experiments could mean higher economic surplus available to meet competing objectives without compromising any one of them, and as we have seen, this is crucial for the virtuous cycle of growth in the industry and the economy.

[22] A.T. Kearney analyses on data from Australian Prudential Regulation Authority comparing 2012 with 2005.

A Tale of Two Futures

Coming out of the global financial crisis and the natural resources boom, Australia is about to write the next chapter of its economic history buffeted by five mega trends, which pose both opportunities and threats to the country's economic success and provide an essential backdrop to shaping a vision for the banking industry.

Collectively, these trends present a double-edged sword. For example, consider growth in Asia. On one hand, Asia's growing population and burgeoning middle class could give Australian companies an almost endless marketplace. However, if they miss this opportunity, they could be driven out of their home market by cheaper products coming in from Asia.

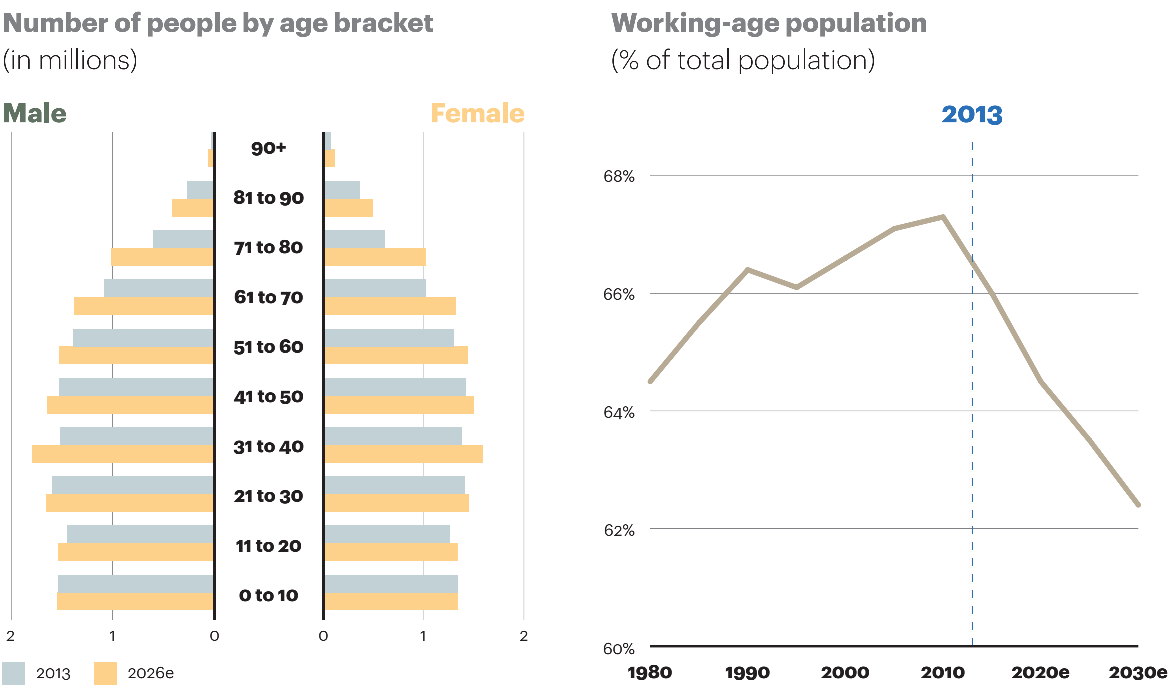
The following section looks at each trend and aggregates the impact of these trends into two extreme economic scenarios.

Mega trend 1: The ageing population

Australia's population is not only growing, it is also maturing. Over the past three decades, the economy has benefited from this larger population and its growing share of people who are of working age. Going forward, the population is expected to continue to grow, but the relative share of the population that is of working age—the labour force—is expected to shrink (see figure 20). Therefore, over time, a decreasing share of the population will support an increasing share.

This ageing population will create both opportunities and obstacles for the economy. The opportunities will be mostly around wealth accumulation. While becoming older, Australians

Figure 20
Demographics of Australia



Sources: Australian Bureau of Statistics; Reserve Bank of Australia have also become richer with average net worth rising more than 40 percent from $0.5 million to $0.7 million in the past 10 years.[23] Australians are also accumulating funds at a faster rate with a net saving rate of 11 percent of disposable income.[24] Both these trends point to larger balances and faster growth of funds available for investment in building the new economy. In addition, average superannuation funds available at retirement and the total superannuation pool will keep growing, primarily driven by a higher guaranteed contribution.[25]

The obstacles could emerge on three sides. First, the funds accumulated in the superannuation system are substantial, but is it enough to support the retirement of an expanding part of the population? Retirement costs are due to increase because of the rising cost of living, higher medical costs, and greater longevity. Costs from increased longevity are expected to rise from 10 percent to 12 percent of GDP by 2030, with higher costs for health services because people are living longer.[26] This could result in superannuation balances that, although higher, will not be enough for a population that is living longer than ever before.

Second, a growing part of the population is fast approaching retirement. This group will not have a long-term horizon to invest in riskier asset classes to ensure adequate wealth accumulation, and there is a lack of investment opportunities with a suitable risk-return profile.

Finally, overall GDP could fall if productivity does not offset what the demographic dividends (that is, the benefit of an expanding workforce). Because the relative size of the working-age population is declining, workforce productivity needs to increase to sustain the same GDP growth. To sustain a 3 percent GDP growth towards 2030, the productivity growth rate needs to increase at least 0.3 points (from 1.5 to 1.8 percent) to offset the impact of a shrinking labour pool.[27]

In an optimistic scenario, Australia will be rich in capital and funds from savings and pensions being productively deployed. These funds find their way to growth investments to build the new economy and allow the country to become a net exporter of capital. In turn, investments result in productivity improvements, which sustain GDP growth despite the demographic discount. However, in a pessimistic scenario, capital is cautious, and GDP growth declines. Wealth balances are substantial, but they are locked in unproductive, low-risk investments that don't fuel the economy. In addition, low yields combined with high longevity costs translate to a high social bill. As a result of productivity initiatives not finding funding, GDP growth begins to drop.

Mega trend 2: Emerging Asia

Asia is growing. A rapid increase in income and an expanding population are creating a larger middle class. Growth in the region is forecasted to be higher than in any other part of the world. GDP growth for developing Asia is forecasted to be around 6.8 percent for 2014 and 2015 versus 2.2 percent for advanced economies.[28] In an Asia-driven world economy, a close integration is instrumental for Australia's future, and some would argue, it is inevitable. Australia's economy is connected with Asia on three important dimensions: trade, capital, and people.

[23] Household Wealth and Wealth Distribution Australia, Australian Bureau of Statistics, August 2013

[24] Economic Outlook: Statistics and Projections – Household saving rates, OECD iLibrary, November 2013

[25] Speech by Bill Shorten MP at the Conference of Major Superannuation Funds, March 22, 2013

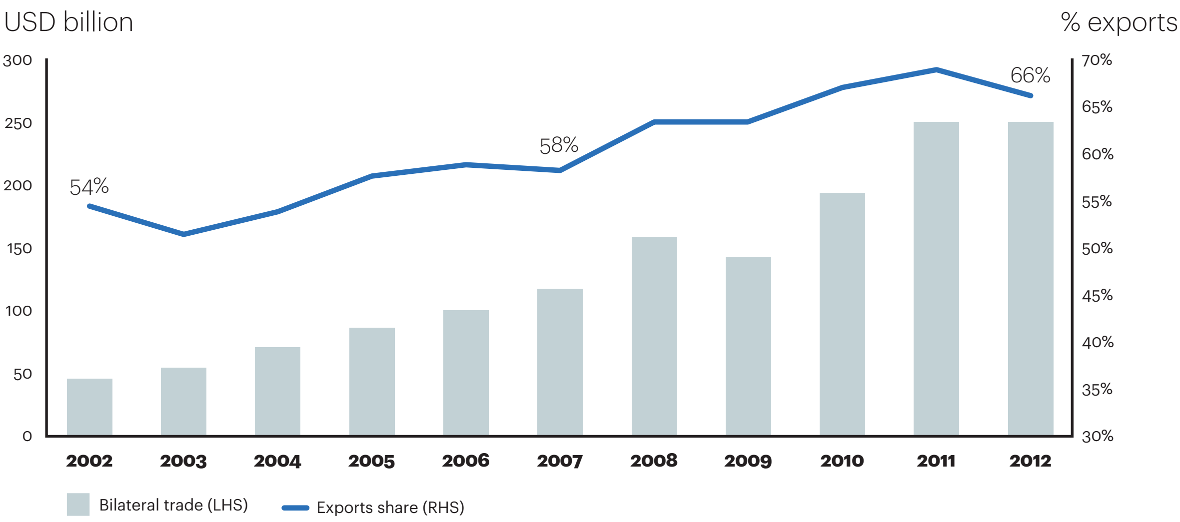
[26] An Ageing Australia: Preparing for the Future, Productivity Commission Research Paper, November 2013

[27] Intergenerational Report, Australian Treasury, January 2010

[28] *World Economic Outlook*, International Monetary Fund, 21 January 2014. Developing Asia includes China, India, Indonesia, Malaysia, Philippines, Thailand and Vietnam.

- **Bilateral trade with key Asian economies has seen strong growth over the past decade.** Trade grew with an average of 18 percent per year, rising from USD 46 billion in 2002 to USD 250 billion in 2012 (see figure 21). Exports from Australia to Asia have grown faster than imports to Australia, primarily driven by the increased demand for resources in Asia, particularly China.

Figure 21
Bilateral trade with key Asian economies[1]



[1] China, India, Indonesia, Japan, and South Korea
Sources: UN Comtrade; A.T. Kearney analysis

- **Capital investments from Australia into Asia and vice versa have increased.** Incoming investments from Asia have grown steadily, increasing 50 percent over 10 years to reach $20 billion in 2011.[29] Outgoing investment has been more volatile but has grown 200 percent in the same period, reaching $3 billion in 2011. Currently, Australia is a net importer of capital.

- **People are more mobile.** Migration from Asia to Australia grew 12 percent per year in the decade leading up to 2011, with China and India as major contributors.[30] This growth includes permanent and temporary migration, which encompasses Asians spending a limited amount of years in Australia for their education and Australian workers on assignments in Asia. Of Australian emigrants, 40 percent are moving to Asia.[31]

Opportunities will occur in all three dimensions. In trade, the large and growing Asian countries could represent a highly attractive export market beyond the resources sector that currently accounts for a big part of exports. In capital investments, a closer integration with Asia could provide Australia with access to capital that is seeking returns in a low-risk environment. This in turn can be used to fuel Australia's growth investments. In migration, the local market in Australia could grow thanks to permanent and temporary migration, which will bring a bigger marketplace in general and more opportunities for products and services focused on immigrants in particular.

[29] Economic Outlook: Statistics and Projections – FDI flows by partner country, OECD iLibrary, November 2013
[30] Includes: Korea, Vietnam, Sri Lanka, Malaysia, Philippines, India, China; OECD, International migration database
[31] Australia in the Asian Century White Paper, Australian Government, October 2012

The same dimensions, especially trade and capital, can pose threats to the Australian economy. For instance, closer integration with Asia could cause stiffer competition for local players as Asian players enter the Australian market, leading to value degradation for local businesses. Also, closer economic relations can trigger a flood of low-cost imports. Finally, if international opportunities prove to be an attractive risk-reward proposition, there will be greater competition for capital.

The potential economic impact of a close integration with Asia is twofold. In an optimistic scenario, local businesses could grow because of access to Asian consumers and the bigger marketplace. In addition, foreign investment and immigration could drive growth of multiple local sectors, including education, tourism, real estate, professional services, and financial services. In a pessimistic scenario, competition from low-cost imports could increase, leading to a progressive demise of the local sector and growing dependence on Asia. Value could also be eroded by low-cost Asian competitors. Economic growth could be constrained by limited access to capital if Australia fails to appropriately attract Asian capital.

Mega trend 3: The rising impact of digital

A digital tsunami is driving structural changes in industries across the world. The impact of this change on Australia's economy, individual businesses, and consumers will be significant. The overall economic impact of implementing the National Broadband Network, for instance, is expected to be more than 1.2 percent of GDP per year.[32] On a business level, rapid growth of the online distribution channel is bringing radical changes. Australian online retail sales rose to $14.4 billion in the year to October 2013, a level that is equivalent to 6.4 percent of traditional retail spending.[33] The number of mobile handsets with Internet access has tripled in the past year to around nine million. By 2014, more mobile devices than personal computers will be accessing the Web.[34] This accelerated mobile Internet penetration has led to aggressive growth in m-commerce. Australia's sales in this channel have surged from $0.16 billion to $5.6 billion in two years.[35] Broadband data usage is estimated to grow 40 percent per year towards 2025, with individual monthly consumption expected to rise from 10 gigabytes to one terabyte.[36]

The opportunities for the Australian economy can be divided into four major themes:

- Increased efficiencies through the use of technology and improved productivity via automation, transparency, and simplicity in business transactions
- Maximised customer value through faster access to better and cheaper products and services
- Greater access to the global marketplace for local businesses as more people are connected to the Internet at faster connection speeds
- Use of more local talent leads to more innovation around digital technology; new startups contribute to GDP growth and job growth

The digital tsunami brings threats as well:

- Gradual competing away of margins because of highly automated processes, low barriers to entry, and increased transparency of options

[32] Australian Business Expectations for the National Broadband Network, Access Economics, November 2010

[33] NAB Group Economics, Online Retail Sales Index: Indepth & Special report, October 2013

[34] OpentoExport.com, article by UK Trade and Investment, 2013

[35] Consumer Discovery Australia, Secureinsight, November 2012

[36] A snapshot of Australia's digital future to 2050, IBISWorld, 2012

- More volatile digital environment due to shorter development cycles and low barriers to entry
- Stiffer competition in all sectors as additional foreign players gain access to the Australian market
- Security and privacy risks if doing business online comes with a loose or absent regulatory structure

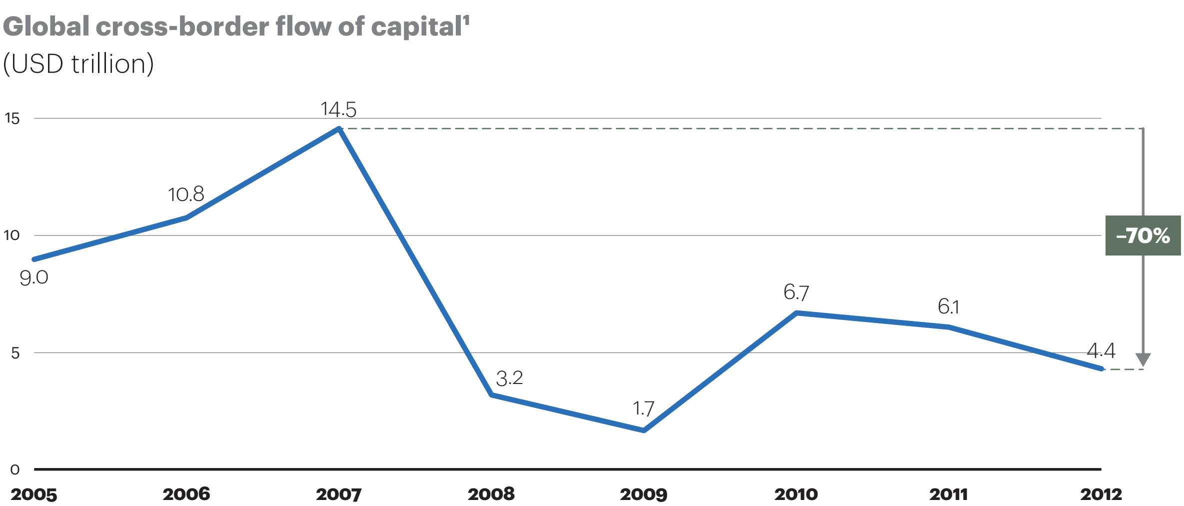
The rising impact of digital and the subsequent structural changes can have a positive economic impact. An optimistic scenario is characterised by a boost in economic growth as Australian companies expand into global markets, powered by increased connectivity and innovation across all sectors of the economy, including a thriving tech startup sector. At the same time, digital developments substantially increase productivity and boost economic output. Foreign players will enter the Australian marketplace but will nurture a healthy competitive environment across all sectors.

In a pessimistic scenario, economic surplus gradually erodes across sectors and has a negative impact on GDP growth. Lack of consumer trust because of the security and privacy risks of doing business online hinders innovation and limits growth. Growth of local businesses slows down or declines as a result of increased foreign competition from companies riding the digital tsunami unencumbered by the requirements of brick-and-mortar businesses.

Mega trend 4: Global capital is "scared" and expensive

Although the quantity of global capital has recovered and even surpassed levels from before the global financial crisis (estimated at USD 240 trillion mid-2013), capital remains more risk averse than pre-GFC.[37] The flow of cross-border capital has dropped 70 percent from the 2007 peak (see figure 22).

Figure 22
Cross border capital flows have fallen 70% since 2007



[1] Includes direct investment (net incurrence of liabilities excluding exceptional financing), portfolio investment (net incurrence of liabilities excluding exceptional financing), and other investment (net incurrence of liabilities, debt instruments, other financial corporations excluding exceptional financing)

Sources: International Monetary Fund Balance of Payments; A.T. Kearney analysis

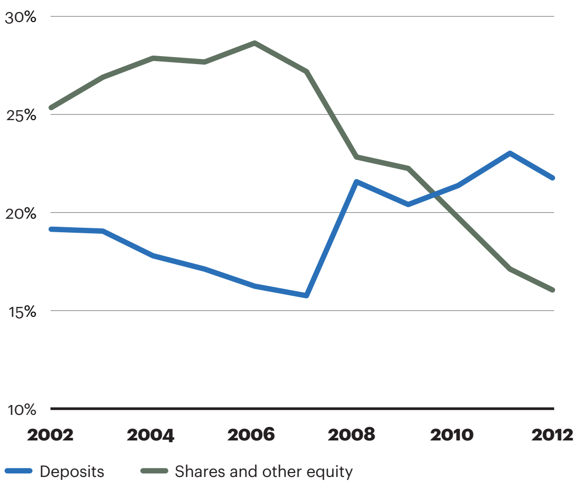
[37] Credit Suisse Global Wealth Databook 2013

Capital also became more risk averse on a household level, where investments in equity dropped in favour of holding funds in deposits. In the wake of the financial crisis, the allocation to equity has dropped, and the allocation to deposits has increased (see figure 23).

Capital is more expensive to attract. Investments with similar risk levels now demand higher returns than a few years ago. The spread for A-rated corporate bonds has increased compared with pre-crisis levels, implying that a higher risk premium is demanded for the same levels of risk (see figure 24). Looking ahead, it does not seem likely that the cost to attract capital will decline.

Figure 23
Australian households have become more risk averse

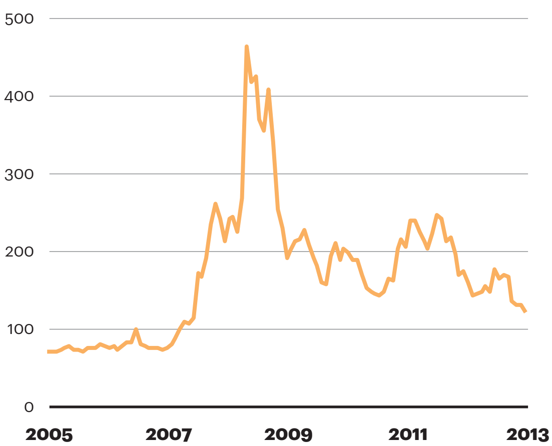
Deposits and equity share for Australian households (% of total financial assets)



Sources: Reserve Bank of Australia; A.T. Kearney analysis

Figure 24
Risk premiums have declined since GFC but are higher than a decade ago

Spread of A-rated non-financial corporate bonds (basis points over government bonds, tenor five years)



Sources: Reserve Bank of Australia; A.T. Kearney analysis

This development can bring opportunities for Australian capital in the form of increased potential returns and a broader variety of investment opportunities. High returns could be expected if there is excess domestic capital willing to venture into global opportunities, while other countries stick to home markets. A wide range of investment opportunities will become available as developing countries seek capital to fund accelerated growth. The infrastructure investment needs in Asia are massive, requiring lots of funding. Indonesia, for example, needs more than $300 billion in infrastructure investment.[38]

However, as pointed out earlier, risk averse and expensive capital brings threats as well. If capital is not available or invested in low productive alternatives, local enterprises become capital starved, which in turn stifles growth. In addition, innovation and new business ventures will struggle to access the capital pool because of their risk profile.

[38]*Masterplan for Acceleration and Expansion of Indonesian Economic Development* (2011 to 2025) from the Indonesian government

In an optimistic scenario, Australia could become a capital-exporting country. Its capital will generate healthy returns in the global marketplace, the abundance of investment opportunities will make diversification easier, and the country would benefit from a healthy global portfolio.

In a pessimistic scenario, domestic capital is locked up, forcing Australia to import capital for which high returns will be demanded. This will slow down investments and lead to on average low returns, low innovation, and high costs.

Mega trend 5: Key natural resources will become more scarce

Demand for energy, steel, food, and water has been growing over the past several decades. In the years to come, demand for natural resources will continue to grow, putting more pressure on prices and potentially on geopolitical stability. The increase in demand is underpinned by a worldwide population expansion and accelerated income growth in emerging economies with up to three billion more middle-class consumers expected by 2030. Price volatility, which has already increased over the past decade, is expected to continue to rise as a result of increasingly harder-to-find resources and the use of more expensive methodologies to source the supply.

Greater demand for resources will also bring development opportunities in various sectors, including agriculture and infrastructure, **which in turn will attract foreign investment.**

For Australia, global scarcity of resources can be good news. If the country can maintain its surplus of key resources, opportunities will be plentiful. As a resource-exporting country, Australia will be well-positioned to profit from the increased global demand and higher prices on global markets. Greater demand will also bring development opportunities in various sectors, including agriculture and infrastructure, which in turn will attract foreign investment. In addition, the limited availability of resources and the rising costs associated with more complex methods to extract resources from harder-to-reach locations will drive technological innovation. This knowledge can then be exported, creating new income streams. Finally, the fact that most of the demand growth is expected to be driven by Asian economies gives Australia a geographic advantage as well.

A downside of scarce natural resources is that if productivity in the Australian resource sector drops to suboptimal levels in combination with higher extraction costs, there could be a resource shortage. In addition, investors could be deterred by price volatility and hold back investments in resources sectors, which would limit economic development in Australia and in the recipient economies. Finally, if competition from other resource-supplying countries intensifies, accessing capital and customers could become more difficult.

In an optimistic scenario, Australia is a diversified resource-exporting country. The economy will benefit from domestic resource availability and high export prices. Investments in and innovation by resource sectors such as infrastructure, agriculture, and mining will underpin economic growth. Innovation becomes a competitive advantage and is leveraged on a global scale.

In a pessimistic scenario, Australia is no longer a pure exporter but relies more on imports. More imports creates more exposure to price volatility on global markets, which will add costs to sectors of the economy and stifle growth. Constrained investments lead to suboptimal resource productivity as a result of a lack of technological developments and innovation.

Australia's Economy 20 Years Out

These mega trends will have a significant impact on Australia's economy. Taking these trends into account, we can paint a picture of two future extreme scenarios (see figure 25).

Figure 25
Two possible scenarios for Australia's future

Optimistic

Australia as a rich, diversified, integrated, and digital economy

- Two growth engines at work:
  - A vibrant SME sector underpinning economic stability
  - Agribusiness, infrastructure, education, tourism, services, and technology
- Asia regarded as an opportunity rather than a threat with linkages through migration, trade, and capital
- Wealth of the mature generation is available to the economy through many paths (bond market, long-term investment instruments)
- Digital innovation used to drive up productivity across the economy and create new sources of value

Pessimistic

Australia as an isolated, stagnant, old economy with unproductive capital locked up in property and low-risk investments

- Growth engines have not flourished because of lack of funding and entrepreneurship:
  - SME sector steadily eroded through Asian competition and scale players dominating locally
- Asia opportunity missed because of aversion to migration to and from Asia, hesitation to deploy Australian capital overseas, and a trade balance in Asia's favour
- Mature generation's wealth locked up, leading to increase in social costs and low economic growth
- Digital innovation takes foot in other markets before Australia, creating a competitive disadvantage

Source: A.T. Kearney analysis

Optimistic scenario: Australia as a rich, diversified, integrated, and digital economy

Four dimensions describe a successful future for Australia's economy:

Several growth engines are at work. The resource sectors, including agribusiness, infrastructure, and mining, are flourishing thanks to increased domestic resource availability and high export prices. The services sectors, including education and tourism, are growing and in turn increasing economic growth and attracting foreign money to Australia. The country is leveraging its knowledge advantage, supported by strong innovation in the domestic market. A healthy technology sector is positioning Australia at the forefront of digital innovation. Innovation is thriving across the economy, including more tech startups, leading to a boost in economic growth and stimulating innovation in other sectors. A vibrant SME sector is underpinning the country's economic stability by providing employment to a significant number of Australians and making a healthy contribution to GDP.

Asia is regarded as an opportunity rather than a threat. Strong linkages have developed in several areas. Bilateral trade has flourished. Australian companies make full use of the growing Asian market, and Asian companies create a healthy competition in the domestic market. Asian investments in Australia fuel the growth sectors and innovation, contributing to economic growth. Australian investors looking for a different risk-return proposition invest in the Asian growth story, for example with infrastructure investments. More people migrate between Australia and Asia. Asian people migrating permanently or temporarily to Australia drive population growth and boost sectors such as education. More Australians move to Asia, exporting skills and building close ties between Australian and Asian companies.

Accumulated wealth is used productively. Capital has stayed risk averse and become more expensive. However, Australia has unlocked the mature generation's wealth and made it available to the economy. Capital is channelled through a range of pathways, such as the bond market and long-term investment instruments, to growth engines. The country exports capital in a world suffering from a lack of accessible funding.

Digital innovation drives economic growth. Digital innovation has led to increased productivity across all sectors of the economy, for example through automation of production processes and by offering customers easier and faster access to service providers. Australian companies successfully tap into the global marketplace, using online platforms to increase sales.

Pessimistic scenario: Australia as an isolated, stagnant, old economy with large swathes of unproductive capital locked up in property and low-risk investments

If Australia is unable to capitalise on the five mega trends, a pessimistic scenario is likely to unfold:

Growth engines have not flourished because funding is lacking and entrepreneurship is stifling economic growth. Resource sectors such as agribusiness, infrastructure, and mining struggle to attract funding and lack innovation, leading to lower production levels and higher costs. Foreign competition is plentiful in the global marketplace, and foreign players reap the benefits of scarce goods. Domestic supply cannot meet demand, so Australia must import resources at a high price. Services growth stalls and dampens economic growth. The country loses its knowledge advantage in the region, leading to a decline in sectors such as education. Australia becomes an expensive tourist destination, and the tourism sector fails to attract foreign capital. The climate for technology firms is no longer seen as attractive, leading to an exodus of companies and talent. This stifled innovation in the technology and other sectors results in lower economic growth. SMEs are steadily eroded by Asian competition and scale players.

The Asian opportunity has been missed. Trade is impacted when increased imports from Asia create tougher competition in the domestic market, putting unhealthy pressure on local players. Exports decline because they are too expensive in the global market, resulting in a trade balance in Asia's favour. The economy has been unsuccessful in attracting investments from Asia to fund growth sectors, and innovation is stifling economic growth. Because Australia is perceived as too expensive, entrepreneurs have moved abroad. Australian companies have hesitated to invest in Asia, which has made Australia miss the boat. Financial ties with Asia are not well-developed, and the gap has become too big to close. Aversion of migrating to and from Asia has resulted in less integration and understanding between cultures and missed economic opportunities associated with increased mobility of people between Australia and Asia.

The mature generation's wealth is locked in unproductive investments. Capital remains risk averse and expensive. Australia has been unable to unlock the wealth of the mature generation. Capital sits in real estate and low-risk, low-return investment destinations such as deposits, and it is not being used to fund economic growth. As a result, social costs are rising, and economic growth is dampened. Australia needs to import capital, which comes at a high cost.

Digital innovation takes foot in other markets, leaving Australia at a competitive disadvantage. Other countries capitalised sooner and better on the advantages of productivity, putting Australia at a disadvantage in the global marketplace. Opening up of the global marketplace as a result of greater connectivity has increased foreign competition in the domestic market, leaving Australian companies with much less market share and slimmer profit margins.

Both the optimistic and pessimistic scenarios are plausible. Political leadership, national enterprise, and vibrancy of business will play crucial roles. With this backdrop and recognising the significant role banking plays in the economy, the value of a vision for the industry's future is clear.

Banking as a Key Enabler of the Future Australian Economy

As we have seen, Australia's banking industry can make a substantial economic impact. Depending on how one believes the forces will play out, one can take an optimistic or pessimistic view of the country's economic future. Against this backdrop, it is neither possible nor advisable to try to predict which future will materialise. However, the banking industry can and should play a pivotal role in tipping the odds in favour of an optimistic outcome. Thus, becoming the key enabler of the future Australian economy should be at the core of the vision for the industry. Banking can bring this vision to life over the next crucial decade. This section explores four dimensions of our proposed vision (see figure 26).

Figure 26
How banking can enable Australia's vision and future

Source: A.T. Kearney analysis

1. Support the unlocking of capital to fuel the future Australian economy

What if Australian banking could lead the world in its ability to mobilize multiple sources of funding—efficiently and effectively as well as directly and indirectly? What impact would this national capability have on the country's ability to weather the storms of the mega trends?

To increase the funding options for Australian companies, banks may have to consider the role they can play in stimulating the development of the domestic bond market, developing new products to attract and unlock funds from less-productive assets (such as property), and play a pioneering role in facilitating new funding markets.

Funding options in the Australian market are limited. A shallow bond market and unfavourable pricing have caused large corporates to look overseas for funding. As mentioned earlier, only 24 percent, or $52.4 billion, of Australian non-financial corporations' outstanding corporate debt securities is domestic versus 76 percent, or $169.5 billion overseas.[39] When we look at total funding, including bonds and loans, we find that 31 percent is overseas.[40] In Australia, the value of bonds issued by non-financial corporations was only 0.64 percent of GDP in 2012, compared to 2.59 percent in the United Kingdom, 8.40 percent in the United States, and 17.36 percent in Singapore.

What if Australian banking could **lead the world in its ability to mobilize multiple sources of funding?**

Paradoxically, with the maturing of Australians, this ratio of assets to GDP is only likely to grow. However, more than half of total household assets are locked up in property investments, and more than 20 percent of financial household assets are in low-yielding deposits.[41] This raises the question as to whether these assets will be enough for maturing Australians to fund their increasing lifespans (referred to as a longevity risk).

Multiple interventions are possible through policy, regulation, and new market participants. Here the banking industry could play three significant roles.

- **Explore new products.** Banks in other markets have developed equity-release products that can be used to unlock value from property and free up equity. These products are a way for the owner to sell part of the real estate structured as a bond. In the United Kingdom, this sector has grown 15 percent, and £284.1 million of equity was released in the third quarter of 2013.[42] Similar products have been explored in Australia but have not flourished for various legitimate reasons. With real-estate equity only climbing, it may be prudent to consider how to reapproach this opportunity. Cooperation with the government may be required to introduce regulation around equity-release products and potentially develop a government guarantee on the equity-release bond to give investors additional protection, resulting in a more attractive risk-return profile. Alternatively, partnerships with insurance players can help provide the necessary hedge to protect customers.

[39] Reserve Bank of Australia, Statistical Table D4

[40] A.T. Kearney Analysis

[41] Reserve Bank of Australia, Statistical Table B20

[42] FTAdviser.com

Beyond this specific product opportunity, investment banking arms may want to revisit the manufacture of longer-term instruments aimed at attracting more funding from superannuation balances at a time when more consumers are seeking to manage longevity risks. However, doing so will most likely require a more efficient bond market, as outlined below.

- **Facilitate efficient markets.** To attract additional funding for the economy's growth sectors, banks may want to explore developing sector-specific securitised lending products. With these products, smaller loans can be aggregated to a bigger ticket size, which can then be sold to institutional investors in Asia and Australia. Regulations would need to be reviewed to ensure such a market could function efficiently.

  Conversely, banks could channel smaller-ticket fund providers to the bond market by designing products to bundle contributions to overcome minimal ticket sizes often associated with participation in bond issues. This could help attract additional funding for new corporate bond issues and will also provide Australian retail investors with new investment options.

  Peer-to-peer lending can give clients that need credit but do not match the risk-return criteria of standard banks a chance to access funding. This in turn will create a new asset class for investors with a higher risk-and-return profile. Lending Club, America's largest peer-to-peer lender, has facilitated USD 3.4 billion of loans since inception. Rather than see this as a threat, banks could consider how they can embrace this market by facilitating, servicing, and adding value to the market.

  Originate to sell is emerging as a compelling way for large investment-grade fund consumers to access fund providers in a more efficient way. Banks can consider ramping up their role in growing this model to the benefit of all parties, but this will include investments in origination capabilities and developing the skills of the organisation to succeed in this new approach to funding.

  Public-private partnerships (PPP) can lead to increased long-term funding relationships between banks and government. Currently, the involvement of banks, advisory firms, and other financial institutions in PPPs is mostly related to the deal itself. Banking could take the lead in providing the necessary advice to PPP participants in developing more innovative infrastructure investment relationships and solutions that are more in line with the nation's development plans, more forward looking, and more prepared to value longer-term relationship by sharing risks.

  Indices (for example, for the agricultural sector) are crucial for asset managers to have a benchmark index and bundle smaller credit needs into bigger tickets. Banks can again consider playing a valuable role in constructing such indices, as they have done in other markets.

- **Stimulate the domestic bond market.** Dialogue with governments, regulators, and market operators is required to grow an active, liquid, and deep domestic bond market. Much has been said about this topic in Australia. As seen in other markets, the government must anchor the development of a yield curve, often through the regular issuance of government bonds. Regulators need to implement supportive regulations to stimulate the bond market by launching and marketing innovative products such as special purpose bonds (for example, general or specific infrastructure bonds) that are tradable in Australia and by reaching out to offshore parties interested in longer-term investments. Banks may want to consider how they can actively support these efforts, potentially even initiating and leading the dialogue while also being prepared to participate as anchor clients through domestic bond issues.

2. Develop and deliver financial solutions to key growth sectors

What if each growth sector, including SMEs, could find a partner in the Australian banking industry that was specialised and focused on serving their needs? To what degree would such a utopia help ensure that the country can build a portfolio of growth options to ensure long-term success? To move closer to this situation, perhaps the most important question is this: What is the full risk-return spectrum we are comfortable with the banking industry operating across?

Within that risk-return spectrum, it is likely that both banks and customers will need to evolve to ensure the needs of growth sectors are met profitably and prudently. Sectors such as SMEs, agriculture, infrastructure, and the environment are likely to be vital growth engines in tomorrow's Australian economy and will need to access funding and tailored financial solutions if they are to succeed.

- SMEs make up a significant share of Australia's economy. In fact, 99 percent of the country's businesses are SMEs, employing 70 percent of the workers in the private sector, or seven million people, and contributing 57 percent of the private-sector industry value.[43, 44, 45]
- Agriculture is expected to experience accelerated demand thanks to population growth and the changing diets of a growing middle class, particularly in Asia. There will be constraints in the growth of the production capacity because of scarcity of water, declined soil fertility caused by the use of chemicals, and agricultural land turned into urban areas. Australia's government is keen to tap into this profit pool with its vision of becoming Asia's food bowl. However, the agricultural output per square kilometre of agricultural land in Australia is only 11 percent of the Organisation for Economic Co-operation and Development average, and it is estimated that it would require a $500 billion investment in equity to make Australia the food bowl of Asia.[46, 47]
- Infrastructure investment needs are substantial. Domestically, there is estimated to be a shortage of $200 billion to $800 billion, and aggressive urbanisation plans in Asia could require up to USD 8 trillion of new infrastructure investment to 2020 to support the current levels of economic growth.[48, 49]
- Environment. With increasingly scarce natural resources such as water, food, and fossil fuels, addressing the demand for robust sustainable environmental practices is an urgent priority that requires funding.

To ensure enough funding is available, the industry as a whole needs to reconsider the prevalent risk-reward spectrum and rebuild bank capabilities to serve these segments.

- **Expand the risk-reward spectrum—licensing and credit guarantees.** The banking industry will need to serve a broader spectrum of clients with a greater variation in risk-return. A challenging but interesting solution is to expand the set of licenses available to allow new entities that cater to the high risk-return growth sectors. In the past, we have seen this with non-banking finance companies and authorised deposit-taking institutions. Going forward,

---

[43] Australian Government, Department of Industry, Innovation, Science, Research and Tertiary Education, Australian Small Business, Key Statistics and Analysis, December 2012

[44] Edinburgh Group, Growing the global economy through SMEs

[45] Small Business Access to Finance, NSW Business Chamber, 2013

[46] Downunder digest, HSBC Global Research, November 2013

[47] Extract from the Global Food Forum, The Australian, April 2013

[48] InvestorDaily, Australian Treasurer on infrastructure deficit

[49] Australia in the Asian Century, white paper by the Australian Government, 2012

are there new license structures that should be considered that do not interfere with the level playing field between banks and non-banks? Is there scope for a new license for higher risk-return banking?

Another way to manage a broader risk-reward spectrum is for the government or insurance sector to evaluate possibilities for a credit guarantee scheme. A government guarantee or lenders mortgage insurance type of scheme will lower the risk profile of the loan, which will make it attractive for a bank to supply the loans within their risk appetites while making the loan more affordable for these growth businesses.

- **(Re)build SME banking capabilities.** As discussed, SMEs and banks have yet to see eye to eye about the extent to which their funding needs are being met. Most banks see the potential of increased SME banking, but there is an opportunity for a differentiated player to emerge in this space. At its core, this will require an upgrade and could transform SME risk assessment to support a wider range of risks and rewards, especially as this is seen by many industry experts as a dying art. Furthermore, using new techniques, new data, and new warning systems can help banks manage risks more efficiently by taking advantage of new capabilities to capture and respond to data about SME businesses.

What if each growth sector, including SMEs, could find a partner... that was **specialised and focused on serving their needs?**

Beyond product availability, the customer experience needs to be simplified further to support SME access to a broader range of more appropriate banking solutions. SMEs, especially micro enterprises, often lack professional office administration capabilities and rely on streamlined processes to manage business complexity that would otherwise be a barrier to widespread adoption of banking solutions.

Finally, the use of household debt products for business purposes needs to be better understood and possibly addressed. Failure to do so could result in risks called out by the business bank side going unmanaged. Success is likely to drastically increase the convenience that business customers face in meeting their banking needs without having to explore alternative pathways.

- **Build deeper industry specialisation.** Because new growth segments are likely to emerge, banks may want to consider developing industry-specific solutions and capabilities designed to deliver highly efficient financing solutions to business customers in these sectors. Most banks have capabilities in agribusiness, but customer feedback suggests that gaps exist.

Solutions founded in a robust understanding of the priority industry sectors that bring industry-wide benchmarks and insights to business customers can help influence the success of these ventures. Banks have the opportunity to play a strong role in using their scale and access to customer information to develop these valuable solutions in a cost-effective manner that others cannot.

Finally, solutions must go beyond lending. Banks are on a journey to move out of their product silos and deliver multiproduct solutions to meet customers' needs at "critical customer episodes" (for example, for a technology company that needs to start building a supply chain into Thailand). Doing so will raise the game in commercial banking and ensure a win-win outcome for both customer and bank.

3. Facilitate Asian integration through superior insight into the risks and rewards

What if Australia finds itself on the front foot in navigating the Asia opportunity because its banks have invested in building and then leveraging a distinctive understanding of the risk and rewards of doing business in each Asian market?

Risks are inherent in all flow to and from Asia, be it capital, trade, or people. Given the very nature of their business, banks are in a superior position to help businesses understand and navigate these risks. Doing so would require banks to see themselves as more than a provider of funds or facilitator of transactions. They would have to see themselves as advisors on Asia.

Asia holds significant opportunities for the Australian economy. However, Australian businesses have yet to fully embrace these opportunities. Banks should help Australian companies capture those opportunities by facilitating integration around trade, capital, and people, primarily by being the go-to entity to understand and manage bilateral risks.

Asia already represents significant economic value for Australia. Bilateral trade with key Asian economies—China, India, Indonesia, Japan, and South Korea—grew at an annual rate of 18 percent from USD 46 billion to USD 250 billion over the past decade.[50] In the decade ending in 2011, capital investments from Asian countries into Australia grew 50 percent, reaching $20 billion, while investments from Australia into Asia grew 200 percent and reached $3 billion.[51] On the people side, migration from Asia to Australia is growing 12 percent per year, and 40 percent of all Australian emigrants choose Asia as their destination.[52] However, Australia is still in the early stages of capitalising on the opportunities that Asia brings.

First, there is an opportunity to attract more capital from Asia and increase investments in Asia. Until now, capital investments into Australia have been dominated by the United States (27 percent of total investments) and the United Kingdom (23 percent of capital investments), while the whole of Asia only accounts for 10 percent. The other way around, only 6 percent of Australia's foreign investments find their way to Asia.[53] Australian superannuation funds have a minimal exposure to Asia. Only a few funds invest in Asia while the region provides more than 50 percent of the global economic growth. The ones that do invest in Asia have a fairly limited exposure with only 2 to 6 percent of their assets invested in Asia.

Second, there is an opportunity to increase exports to Asia, especially services. Asia is already Australia's biggest export destination for goods and services, with 63 percent of exports going to Asia. However, export to Asia is skewed heavily towards resources; of Australia's top 50 exporters to Asia, 40 percent are resources companies. Goods make up 92 percent of the exports to Asia, while services represent only 8 percent.[54]

[50] UN Comtrade, A.T. Kearney analysis

[51] Economic Outlook: Statistics and Projections – FDI flows by partner country, OECD iLibrary, November 2013

[52] Australia in the Asian Century White Paper, Australian Government, October 2012

[53] Trade at a Glance 2013, Australian Government Department of Foreign Affairs and Trade

[54] Trade at a Glance 2013, Australian Government Department of Foreign Affairs and Trade

Third, there is an opportunity to better serve Australia's domestic market by more efficiently catering to the increasing migration from Asia and to strengthen the country's ties and understanding of Asia by better serving Australians who migrate to Asia.

To best capitalise on these Asian opportunities, banks must facilitate integration at all three levels:

- **Facilitate capital and trade out of Australia.** One main factor inhibiting the flow of capital and trade is a lack of understanding about the inherent risks of doing business in Asia. By developing a better understanding, either directly or through selective partnerships, and potentially underwriting risks with Asia, banks can lubricate exports of capital, goods, and services. Investment banks in particular can bring investment opportunities to Australia by connecting institutional investors, especially superfunds, to the right partners and by providing them with the appropriate intelligence. Corporate banks can scale up back-to-back arrangements in key trade corridors with a special focus on the next set of opportunities, such as Indonesia and Indochina.
- **Facilitate capital and trade into Australia.** There is already a significant flow of capital driven by the stability of the Australian dollar, but more is possible. For example, as discussed in the previous section, securitisation could be explored to give Asian investors access to small-ticket borrowers such as SMEs and growth sectors. Conversely, Australian investors may want to enjoy the returns of Asia, and an originate-to-sell model aimed at mobilising international borrowers finding funding across a breadth of Australia companies might be an exciting opportunity to continue to explore.
- **Facilitate the flow of people.** Banks are focusing on migrant communities. The biggest hurdle left to cross is creatively providing continuity of credit history, allowing people to access local financing despite regulatory and other obstacles. Similarly, Australians going abroad need domestic banks to establish partnerships with foreign banks, enabling them to set up services upon arrival and giving them access to their credit histories. However, while having an Australian network of international branches may be convenient, it is not the only way to serve home customers abroad.

4. Pioneer the charge into the digital economy

Technology presents three opportunities for Australia's economy: improving productivity, enhancing customer value, and creating new business opportunities. What if our banks became the poster child for Australian businesses at home and globally, modelling what the country can achieve with digital innovation? What if the creative energy arising out of Australia's banks were to systematically seed and nurture communities of technological innovation centred around them, like supply chains and service networks arose around the country's mining players in the past 10 years?

One of the effects of an ageing population is pressure on productivity growth. As mentioned earlier, to sustain a 3 percent GDP growth rate towards 2030, the productivity growth rate needs to increase at least 0.3 percentage points (from 1.5 to 1.8 percent) to offset the impact of a shrinking labour force as the population matures.[55] One way to counteract this and increase the productivity growth rate is to use labour-saving technologies and increase digitization by, for example, adopting connected digital technologies and applications.

Technology has already boosted customer value through greater convenience and transparency provided by online channels. Customers can buy products and get support online 24/7

[55]Intergenerational Report, Australian Treasury, January 2010

from the convenience of their home. Online product offerings and comparison sites have increased transparency in the market, creating stiffer competition, which translates into better value for the customer. Already, 62 percent of Australian shoppers—online and offline—compare prices online before making a purchase. There is, however, room for improvement. Only 51 percent of Australians shop for goods or services online, while 60 percent of UK consumers shop online. And while Australia's online sales growth is 3.8 times stronger than traditional retail sales growth, online channels account for only 6 percent of sales, compared with 10 percent in the United States and the United Kingdom.[56]

Technology has already delivered—and will continue to bring—new business opportunities. Digital channels give companies easy access to the global marketplace, and the fast-growing tech sector will provide opportunities for new business and talent. Banks should lead the way and foster the necessary new technology infrastructure for other sectors to build on.

In all three areas—productivity, customer value, and new business opportunities—banks are in a strong position to become more innovative. Innovation can emerge around new ways to provide existing services. For example, a company called Simple, which is not a bank but uses the infrastructure of an existing bank, transforms the traditional current account into a financial planning tool. By looking at past transactions, Simple forecasts future payments and expense patterns, providing customers with an "available to spend" number instead of a traditional current account balance. This is coupled with highly sophisticated customer interaction facilities.

Innovation can also emerge around the use of new technologies to optimise the customer experience. Examples include digital credit card startup Coin, which allows customers to hold multiple credit cards in one digital card, and Apple's iBeacon, which lets banks communicate with customers' phones when they pass by or are in a branch. This has the potential to become the basis of a mobile payment system.

There is much hype around big data (massive, real-time amounts of information created on a minute-by-minute basis). Rather than consider this as a technology question, banks—indeed, all companies—must first approach analytics as a tool to create business value. Technology exists that will allow banks to create mass customisation and predictive offers. Triggers can help anticipate customer needs and proactively solve problems before they arise. In time, meeting customer needs will not be enough. Banks will need to anticipate and over-deliver.

Analytics has relevance and value across the entire banking value chain beyond sales, products, and risk. Operations costs can be reduced through better cash-demand prediction capabilities. Call-centre service levels can improve through better demand forecasting. More creatively, analytics can be used to select and hire talent and better manage performance.

Perhaps the most powerful use of analytics is to create a central intelligence advisory capability that allows the front line, no matter how junior, to speak with the authority of the bank and provide robust, consistent advice to all clients. This has immense benefits for customer protection and capability building. Banks around the world that have begun experimenting with these approaches are finding that staff retention rates improve, as does customer satisfaction and business.

Beyond the individual bank, opportunities may exist for more creative and systemic reduction of cost structures. Examples exist in other markets, and it merits further consideration by Australian banks. For example, HSBC Bank and Morgan Stanley are exploring the use of a

[56] eCommerce disruption: a global theme, Morgan Stanley, 2013

centralized service for on-boarding new clients and other know-your-customer requirements.[57] Barclays, HSBC Bank, and Lloyds Bank established a joint venture with Unisys for cheque processing, image archiving and retrieval, lock-box services and reconciliation, and other related back-office functions.[58]

In creating new business value, banks' focus on driving digital innovation is likely to have a positive effect on the broader economy. Networks of startups may emerge around an ecosystem anchored by individual banks. This would lead to growth in the vital technology sector, leading to job creation and accelerated innovation. Intellectual property rights can be exported globally, creating value for the Australian economy.

A Collective Way Forward

Moving towards an industry vision where banking plays a crucial role in tilting the economy towards an optimistic outcome is not likely to be achieved through the efforts of any one institution alone. If the industry and its key stakeholders accept such a vision to inspire the journey ahead, individual banks will need to preemptively consider which dimensions of the vision to focus on and excel in, choosing different aspects to together deliver the holistic vision.

This is easier said than done. Being a first mover is challenging because it involves venturing into unknown, unproven territories. However, being a follower is also challenging because it involves playing catch-up with those that had the courage to invest in capabilities ahead of the curve. Each bank will have to evaluate these opportunities and choose where it is confident to sow new strategic options.

Whatever the choices, they will surely be economically rational. Therefore, the alignment and support of regulators, policy makers, analysts, and the public are essential to creating an environment in which economically rational choices align with the country's long-term interest and, in doing so, make this bold vision of Australian banking as a key enabler of our economy a reality.

This vision opens up a range of opportunities for individual banks. While many have been presented in this paper, five opportunities are central to the vision and hold vast potential to create substantial value. Each bank will need to explore the relevance of these opportunities to their strategic direction, existing capabilities, target risk profile, and investment appetite.

1. Facilitate the creation of new funding markets

As Australia grows and diversifies, the demand for funding from a range of sectors will only increase. At the same time, the spectrum of investors looking for a broader range of risks and returns will also widen. Beyond banks' traditional role as fund recipients and fund providers, they are uniquely placed to facilitate the creation of crucial funding markets. For example, a retail-focused bank might choose to concentrate on building frameworks and infrastructure to encourage peer-to-peer lending in a way that allows it to be regulated and successful. A corporate-focused bank may choose to champion the originate-to-sell route to fund mobilisation or partner with the government and other anchor corporates to encourage the growth of the bond market. An Asia-focused bank might opt to explore the securitisation of SME debt across Asian markets.

[57] Wallstreetandtech.com
[58] Business Wire

In the near term, these efforts are not likely to rival the profitability of a bank's core business, but a player with vision can sow the seeds for its future growth engines by exploring these opportunities at an early stage.

2. Innovate to support our SMEs

Australia will (and must) have a diversity of growth engines. But a vibrant SME sector is perhaps more important than any one large corporate sector because it is through these SMEs that innovations will develop and flourish. Diversity brings resilience and builds an economy that does not rise and fall with the success of any one sector.

However, SMEs are volatile. This is a fact across markets. Banks that deal with SMEs beyond securitized lending need to underwrite risk portfolios that are different from the ones on the bank books today (but perhaps similar to those from a decade ago). Terms and conditions of lending, cost to serve, cost of operations, and cost of talent all need to be fundamentally scaled to this market—and not just a simplified version of corporate lending or a more sophisticated version of retail banking, as we have seen in other markets.

Whether holding on to or looking to substantially gain market share, systematically exploring bolder moves into this space is likely to be the key to determining the winners and losers in Australian banking over the next decade.

More than any other industry in Australia, **banks are well-positioned to develop robust insights into Asian risks.**

---

3. Help Australian business navigate Asian risks

Integration with Asia is an unstoppable reality. Benefiting from Asia is in many ways a holy grail for Australian banks.

Winning in Asia will require banks to go beyond simply planting flags in various markets. At its core, the challenge of Asia for Australian businesses is a lack of understanding about the risks and rewards associated with Asian opportunities. More than any other industry in Australia, banks are well-positioned to develop robust insights into Asian risks and help Australian businesses benefit from these insights. Providing funding stands second to providing knowledge in this opportunity.

A bank seeking to explore this option needs to understand the risks that are holding Australian businesses back and invest in developing the necessary insights, tools, capabilities, and partnerships to help its clients navigate these risks. Trade flow is the obvious part of the equation. However, capital flow is likely to become more important and people flow to become more common. Banks need to think through their triple-corridor strategies and invest smartly to maximise returns without overinvesting capital.

4. Nurture a network of innovation start-ups

Banks represent some of the largest pools of technology investments in the Australian economy—creating a pole position to influence the extent to which technology innovations shape the economic landscape.

One interesting opportunity to explore is to become a hub for technology innovation by acting as the epicentre for tech talent—much like a Silicon Valley. While there are good reasons for banks to rely on internal IT divisions, there is considerable potential to create value—for themselves and for the economy at large—by nurturing a confederation of startups and technology innovators. There is some limited evidence of this model in other parts of the world. However, we believe this is an idea whose time is about to come as new technologies and development methodologies reach maturity. A bank that takes the first steps in this direction could be well-positioned to tackle the next decade of unpredictable evolution.

5. Champion system-wide initiatives to reduce the structural cost of the banking system

Banks in Australia have thought hard and invested heavily in productivity improvement. At first, the focus was on cost containment, then cost reduction, then cost transformation. Are the opportunities to increase economic surplus through cost reduction fully exhausted? We think not.

As discussed in the previous section, there are encouraging experiments in other parts of the world, with banks coming together to create industry utilities to structurally reduce costs further. In those markets, banks are being pushed to do so because of rapidly deteriorating economics. In Australia, banks don't yet need to pull these levers but would be wise to do so to create a war chest of economic surplus that can increase their appetite to invest in longer-term strategic options.

We have seen early examples of shared cash management infrastructure across banks and can look to the super industry for examples of industry-wide utilities. It may be implausible to expect the entire industry to come together; government or regulatory mandates in this regard are fraught with challenges and have a limited likelihood to succeed. However, two banks may choose to partner on specific opportunities, such as call centres, loan processing operations, or staff training. These opportunities take time to be realised. Conversations need to start today if there is to be any hope of success.

Pursuing the vision requires coordination

Undoubtedly, banks play a crucial role in realising the stated vision. However, they cannot do it alone. Regulators, policy makers, the analyst community, and the industry collective all need to play their part to tilt the Australian economy towards an optimistic future.

Regulators

Regulation is a complicated and challenging balancing act. It is difficult to be prescriptive, given the various considerations involved in almost every decision. However, a few key aspects are worth further considering to create the necessary environment for the vision to materialise.

If the vision of banking as outlined in this paper is agreeable in part or as a whole to the regulator, each aspect of the articulated vision will require regulatory support in eliminating barriers, more so than creating incentives or directing the market.

Unlocking capital will require collaboration on the creation of new products illustrated in the previous section and alignment on the nature, function, and role of banks in the funding markets that we believe need to evolve in Australia, including peer-to-peer lending.

Investing in SMEs and new growth engines will require asking if the industry's risk-reward spectrum needs to expand, if new forms of licenses are required, and if new regulatory frameworks might be considered to encourage smaller players looking to fulfil niche needs or cater to specific segments to flourish while remaining well-regulated. Particular to SME lending is perhaps the need to explore harmonisation of household and business debt products where they are effectively used by end consumers. Either these products are seen as truly interchangeable and hence terms and conditions, criteria, pricing, and regulatory requirements are harmonized, or they are seen as fundamentally different. The industry may need to move away from the current grey zone.

Helping navigate integration with Asia can only benefit from policy harmonisation (where possible and in the best interests of our economy) and collaboration with regulators across Asian markets. The dialogue on the funds passport in the asset management world is a good parallel of what is possible as well as how painstaking the journey is to reach pan-jurisdictional alignment.

With regard to digital innovation, regulations around security and interaction in a digital age are already recognised as crucial. Taking the lead among other markets in framing these regulations will be essential to determine the extent to which Australia's banks thrive or stall in leading the digital charge.

Finally, when considering offering a broader range of solutions to a larger share of the market, it will be necessary to ensure that regulations build a level playing field. This is a challenging, widely debated task. Regulating on the basis of economic function provided (rather than by the entity that is delivering the function) is an idea that merits consideration. For example, mobile banking could be regulated as one function regardless of whether the service is provided by a telecom player or an authorised deposit-taking institution. Failure to ensure this inclusive but standardised regulatory playing field may inadvertently push more parts of the banking sector outside the regulatory boundaries, creating a dual market—one highly conservative and lacking innovation and one innovative but lacking stability. Avoiding this outcome is crucial if the banking industry is to fulfil its vision as an enabler of the Australian economy.

Policy makers

Banks and regulators operate within their economic spheres and, in doing so, influence the rest of the economy. However, policy makers, have a far more direct and profound influence on the broader economy, and hence, their commitment to this vision will be essential if it is to be realised sooner, or indeed at all.

Policymakers recognise the need to take actions to support the development of areas in the economy that will drive future economic diversity and growth. There are several ways in which their efforts can be symbiotic to those of banks trying to realise a new vision for the industry.

- **Develop the bond market.** Policy makers will be instrumental, just as they have been in every other market, to developing the bond market. In other markets, this was achieved by the government announcing a long-term programme of government bond releases to support the development of a yield curve and a deepening of the market.

- **Explore new funding pathways for SMEs.** To support SME growth, governments around the world have explored mechanisms such as grants and guarantees for business funding. Alternatively, new funding pathways, such as equity funding, might find higher support in Australia. Funding for non-traditional business, such as foreign expansion, is difficult for SMEs to obtain. Recent research from Australia's Export Finance and Insurance Corporation (EFIC) identified obtaining finance as a major obstacle for establishing a footprint overseas: "Australian SMEs are primed and keen to invest overseas but are often restrained by difficulty in accessing finance and professional advice and support, new research from Australia's export credit agency, EFIC, has found. However, despite a strong appetite and the best of intentions, obtaining finance was identified as a major obstacle for SMEs establishing a footprint overseas. 58 per cent of Australian SMEs that have already established overseas facilities reported difficulties in accessing finance for these investments."[59]

Beyond these examples, the extent to which policy makers can influence and encourage banks to invest in new opportunities ahead of the curve—such as offering incentives to fund the environment sectors, seeding innovation hubs, establishing Asia partnerships, and encouraging the proliferation of PPP in infrastructure finance—is worthy of a deeper look. We are not proposing major government intervention, but a close scrutiny of roadblocks and a concerted policy to eliminate these roadblocks will go a long way to help the banking industry, and hence our economy, achieve its full potential.

Undoubtedly, banks play a crucial role in realising the stated vision. But regulators, policy makers, the analyst community, and the industry collective all need to play their part to **tilt the Australian economy towards an optimistic future.**

Analysts

The analyst community has the power to shape industries, standing at arm's length and offering measured opinions about the potential success of strategies and the relative success of companies. Given this level of influence, the extent to which this community appreciates and endorses the efforts of individual banks to develop new strategic options will have a sizable impact on how aggressively the banks, and therefore the industry as a whole, can pursue these opportunities.

We believe analyst foresightedness is anticipating these shifts and evaluating the impact of these shifts in a fact-based, objective manner—potentially articulating both the short-term implications as well as long-term value creation potential and confidence levels. This will be vital for the industry to move ahead with confidence.

[59] Export Finance and Insurance Cooperation media release, 18 November 2013

The industry collective

Navigating the road to the new vision will require constant communication across all stakeholders as well as alignment on the strategic questions that will arise over the course of the industry's journey. This crucial role is likely to fall on the shoulders of the industry collective. An effective dialogue will require the collective to identify the industry's goalposts and report back to the various stakeholders, and potentially the public, about progress towards—or away from—these goalposts.

Communication is key. Beyond building support for industry efforts, it will also position the industry in the minds of the next generation so that banking, a core sector of the economy, continues to attract the best and brightest talent.

Shaping the Banking Industry's Destiny

In conclusion, in shaping the destiny of Australia's banking industry, it is not surprising that the main protagonists are the banks themselves. On them lies the primary responsibility to anticipate and reach for the future before it becomes the present, when it may be too late to exert any influence on the course of the economy.

However, there is a limit to what an individual bank can do. The full cast of stakeholders—regulators, policy makers, the analyst community, and the industry collective—need to be aligned to create a positive, supportive environment in which the industry can flourish and innovate, individual players can compete, and the economy can find a new vitality that will sustain it for years to come.

Authors

Nigel Andrade, partner, Sydney
nigel.andrade@atkearney.com

James Deighton, partner, Melbourne
james.deighton@atkearney.com

Scott Glover, partner, Melbourne
scott.glover@atkearney.com

Peter Munro, partner, Syndey
peter.munro@atkearney.com

Robert Bustos-McNeil, principal, Sydney
robert.bustos-mcneil@atkearney.com

Harman Lidder, principal, Melbourne
harman.lidder@atkearney.com

John O'Shaughnessy, director, Sydney
john.oshaughnessy@atkearney.com

Robert Kuijken, consultant, Sydney
robert.kuijken@atkearney.com

The authors would like to thank the following individuals for their contributions to this paper:

The Advisory Panel: Catherine Hallinan, Tony D’Aloisio, John Fraser, Paul Kerin, and Andy Penn for their valuable inputs.

The Australian Bankers’ Association for challenging our thinking and sharing an independent perspective about the vision for the Australian banking industry.

Maria Martinez, Lotta Rehn-Molin, Salman Gul, Ankit Mishra, Varun Mohankumar, Alex Romanov, and Marc Thiebaut, who worked on this report.

Shirley Fernandez, Nitima Malhotra, and Rohit Chopra for the valuable support to our team.

ATKearney

A.T. Kearney is a global team of forward-thinking partners that delivers immediate impact and growing advantage for its clients. We are passionate problem solvers who excel in collaborating across borders to co-create and realize elegantly simple, practical, and sustainable results. Since 1926, we have been trusted advisors on the most mission-critical issues to the world's leading organizations across all major industries and service sectors. A.T. Kearney has 58 offices located in major business centers across 40 countries.

Americas	Atlanta Bogotá Calgary Chicago Dallas	Detroit Houston Mexico City New York San Francisco	São Paulo Toronto Washington, D.C.
Asia Pacific	Bangkok Beijing Hong Kong Jakarta Kuala Lumpur	Melbourne Mumbai New Delhi Seoul Shanghai	Singapore Sydney Tokyo
Europe	Amsterdam Berlin Brussels Bucharest Budapest Copenhagen Düsseldorf Frankfurt Helsinki	Istanbul Kiev Lisbon Ljubljana London Madrid Milan Moscow Munich	Oslo Paris Prague Rome Stockholm Stuttgart Vienna Warsaw Zurich
Middle East and Africa	Abu Dhabi Dubai	Johannesburg Manama	Riyadh

For more information, permission to reprint or translate this work, and all other correspondence, please email: insight@atkearney.com.

The signature of our namesake and founder, Andrew Thomas Kearney, on the cover of this document represents our pledge to live the values he instilled in our firm and uphold his commitment to ensuring "essential rightness" in all that we do.