

## **OCCASIONAL ADDRESS**

**Frank J. Conroy**

**16<sup>th</sup> April, 2008**

**Deputy Chancellor, Members of the University, graduates and guests.**

**It is an honour to return to my former University to deliver the Occasional Address for this Graduation Ceremony. I express my warmest congratulations to all who have had degrees conferred on them today and wish them every success for their future.**

**It will be no surprise that I propose to direct my remarks in this address to the current financial world in which we now find ourselves. Matters of economics and finance dominate the headlines in our newspapers daily. Although now retired, I can speak from the perspective of the experience of just short of fifty years in banking.**

**In many respects, we have seen the current situation before. Twenty years ago, there was a major disturbance to the world equity markets and values decreased markedly. I was at an Australia/Japan Business Co-operation Meeting in Perth at the time and viewed at first hand the terror in the eyes of many chairmen and chief executives of leading Japanese industrial and banking companies as they became to realise the potential implications of the sudden downturn.**

**Subsequently, most western countries allowed their economies to inflate to offset the effects of a significant decline in stock market values and avoid any likelihood of a liquidity crisis. Bank deposits rose steeply and improved the banks' capacity to lend freely.**

**By the end of the decade of the eighties, commercial property had become the flavour of the time and significant funds were invested in the property construction industry, much of it lent by banks, finance companies, merchant banks, building societies and credit unions.**

As the graduates today learned from their first year economics lectures, however, when supply increases beyond demand, the price or the value of property, decreases.

Meanwhile, in an attempt to reign in liquidity and subdue activity, the Reserve Bank increased interest rates and kept on increasing them until the bank rate reached 21.5%. The then Treasurer, Paul Keating, stopped the banks from increasing housing rates and they were capped at 17%. The Reserve Bank was determined to break the back of the excess which had been built up in the economy.

It was not long before economic activity in Australia declined significantly. It was not surprising. Although the bank rate reached 21.5%, banks then applied their margin of up to 5%. Some enterprises, for example, had debts increasing by a quarter each year. Unemployment and bank defaults increased and so began the longest period of recession since the Great Depression of the early thirties.

It was a harsh recession, particularly for small to medium size businesses and those individuals who became casualties of failed businesses. The organisation with which I was associated, Westpac, was involved heavily through the Bank and its group of subsidiaries in excess lending, including to the commercial property sector.

I remember when presenting to the Westpac Board the first bad debts to emerge in the recession, of the list of eight distressed loans as we called them at that time, six of the borrowers were involved in either deliberate misleading of material facts or outright fraud. It was a salient lesson – when borrowers are under stress, the standards of integrity, truthful disclosure and corporate ethics diminish rapidly. Many other examples came to light as the recession deepened.

As the chief executive of Westpac, I was accountable and paid the ultimate price. A thirty three year career with Westpac was severed.

For many of us who were involved day to day, there were other lessons to learn from our experience. When reviewing the state of the current financial markets, however, it seems the lessons of the past have either been forgotten or ignored by today's practitioners.

Take, for example, the state of the Australian economy immediately prior to the recent downturn.

By any measure, we were in boom times and the Reserve Bank had been trying to cool down economic activity by increasing interest rates. Stock market values had grown significantly. There was exceptional growth in the financial and resources sectors. Any cursory glance at history would discover that boom times would not continue and that the economic cycle would peak and turn down. Regular announcements of interest rate increases by the Reserve Bank was the big clue.

Yet, some institutions and individuals continued to behave as if the boom times would never end. The lesson here is that boom markets breed complacency.

There was another warning from the United States. Concern had been expressed about the quality of certain lending for housing which was regarded as subprime. That is to say, the criteria for granting loans did not conform to normal lending standards and a higher rate of interest rate was charged to offset the increased risk. The loans became known as NINJA loans – no income, no job and no assets.

Even worse, several loans were provided with an upfront honeymoon period of a lower interest rate and borrowers were later faced with a large increase in rate as part of their loan contract. Subsequent investigation proved that many borrowers had little or no ability to meet the increased repayments. Many borrowers went into default.

As smart investment bankers had packaged up most of these loans and sold them to investors around the world in the form of tradeable securities called collateralised debt obligations, the trouble spread beyond the United States.

**Another lesson – trouble in one country can spread to others in the global financial markets.**

**When confidence in the value of assets is eroded, liquidity and capital strength become paramount. Mistrust in asset values quickly dries up the availability of liquidity in the financial markets. The next lesson – make sure you have good and continuing access to liquidity and you are well capitalised.**

**So, as the Chief Executive Officer of the Australian Securities Exchange stated recently “we are now in the midst of a global financial crisis inspired by a potent combination of forces.” Some are saying that the United States is in the worst financial crisis since the Great Depression.**

**In Australia, we have a compulsory superannuation system which gives us the world’s highest level of share ownership. Wealth destruction during this downturn is on a massive scale. I do not think anybody really knows when the debt markets will stabilise.**

**In the meantime, several large and previously reputable financial institutions have announced very big losses.**

**It does beg the question: what were the central banks and regulators doing in the lead up to this mess? Similarly, what of the rating agencies which were responsible for the ratings granted on all the so called collateralised debt obligations?**

**The rating agencies respond by saying that the issue should be kept in perspective. They say that only 15% of their rated institutions and debt instruments have had their rating downgraded and only a small proportion have defaulted. This may be true, but the financial markets work on confidence, integrity and trust. An erosion of all or any one of these will produce instability on a wide scale.**

**The lesson here is – do not rely on the credit rating of an institution or security. Do your own homework and understand the principles of the underlying transaction and what is involved before investing. Some of our local government bodies are learning this lesson the hard way.**

**A further lesson is – do not rely on the regulators to protect you. They are usually bound by some very prescriptive legislation and precedents of law which have been framed deliberately to protect the innocent against an overzealous regulator. In addition, they can only rely on past information like everyone else. They do not have the advantage of a crystal ball.**

**In the United States, which is at the heart of the financial instability, the head of the Federal Reserve, Ben Bernanke, has announced certain reforms aimed at increasing transparency, improving risk management and better coordination among regulators. Australia has concentrated on margin lending activities and short selling where several institutions and individuals have come to grief.**

**I know it is unduly harsh, but some of the individuals and their institutions which have encountered troubles in recent times seem to have many common themes: they had heavy debt burdens; they involved themselves in complex structures with unclear communications; there were questions of appropriate disclosure to the market of the financial arrangements between individuals and their companies; there was a fine line between the personal fortune of the individual and their company's value; the individuals concerned were usually highly ambitious and aggressive for expansion; and, they fed on relatively cheap debt to finance their activities and were left vulnerable when everything turned down.**

**There were a string of names in the previous downturn who shared the same or similar themes and characteristics. Alan Bond and Christopher Skase would be just two examples. As before, there were a group of lenders of all persuasions and type ready to lend. The lenders were supported by teams of legal and accounting professionals, all of whom encouraged these activities which were boosted by high remuneration and incentive policies and attractive fees.**

**The lessons of the past apparently swept from view or consideration.**

**As the graduates here today enter the world of financial markets, or they may be already active within it, can I attempt to encourage you to take heed from the lessons from the past. Try and avoid the perfectly normal human reaction to be drawn in to what may seem to be tempting incentive payments.**

**Draw on your intelligence and the learning from this great institution and apply sensible judgment and balance. Do not be persuaded by aggressive and inappropriate behaviour which you know lacks integrity and good sense. Should you already belong to a professional organisation, take special notice of their code of conduct and abide by their provisions.**

**Above all, apply sound risk management principles to all decisions in which you are required to participate or make. Continually consider the proposition – what if?**

**During my term as Chairman of St. George Bank, one of the directors used to request the Board to consider whether the matter which was under consideration would pass the “Daily Telegraph test”. How would the Bank, its shareholders and customers react to seeing the matter over the front page of the “Daily Telegraph”? Perhaps this may be simple, but it was certainly an effective test.**

**The future is in your hands, but the past has been through many others’ hands, thereby creating important lessons which should not be ignored.**