THE MARKETS OF CHINA & VIETNAM

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Outline

Firstly I'd like to say thank you for the invitation to speak at this forum today. The Commonwealth Bank is excited about the possibilities that lie ahead in China and other markets in Asia. China's an exciting growing market with huge potential that is currently going through enormous change as its banking industry prepares for deregulation and eventual privatisation of some institutions.

Although we have a joint venture life operation in Vietnam, Bao Minh CMG, I'll focus on China and in particular, our two banking investments. Our portfolio in China currently includes an 11 percent investment in Jinan City Commercial Bank and a 19.9 per cent investment in Hangzhou City Commercial Bank. We also fully own a Shanghai based mortgage broking business called CommFinance and have a life insurance joint venture with China Life called China Life CMG.

Today, I'd like to talk about deregulation in Australia and our privatisation experience, and some of the unique insights this has given us into the issues that China and Vietnam may face as they go through similar changes in their market.

I'll also briefly discuss how we are currently assisting our partner banks in meeting these challenges through the Capability Transfer Program we are implementing. Of course, while we are experienced in the challenges of deregulation and privatisation, we are realistic in our approach in China and we don't pretend to know it all.

Our approach and strategy in China

Firstly, I'd like to briefly outline our approach to the selection of our banking investments in China, which was to identify strong local banks in attractive economic regions that we could work together with to create a win-win outcome.

It's been clear to us from an early stage that banks in China are not just looking for capital or western banking theory from foreign investors, they are looking for real "strategic" investors - a partnership that will help them to modernise quickly and faster than their competitors and, to get them ready for increased competition and growth as market restrictions decrease.

So for us, it was just as important to find banks that were not only financially sound, but also aligned to our approach and receptive and enthusiastic about the Commonwealth Bank being an 'active' investor in their future, for mutual benefit. This is where we think we can be most helpful in these growing markets, by transferring our capabilities and skills, especially the ones we have gained from deregulation and privatisation, which I'd like to speak a little more about now.

Deregulation & privatisation

The purpose of deregulation in Australia was to enhance the financial system's efficiency, competitiveness and choice and quality of financial products. Interestingly, deregulation wasn't due to any immediate crisis in Australia, but was the result of a longer-term awareness of pressures arising from areas such as technology and globalisation and how these factors might lead to changes in the financial services industry over time and in turn put pressure on the regulatory structure.

Prior to deregulation of the financial system, the structure of the banking industry in Australia, has been described as operating as an informal cartel. This means the banking market was monopolistic in its character and highly regulated by the Reserve Bank in terms of pricing, interest rates and volume of activity.

The process of deregulation began in the early 1980s and involved many changes to the way the industry operated. Some of the key changes early on included:

- Interest rate liberalisation through the removal of various Reserve Bank controls. This allowed among other things, for banks to set their own interest rate pricing. This meant that all banks had to substantially improve their risk and credit management capability and close the skills gap in this area. The Australian experience showed that developing adequate risk and regulatory frameworks was difficult and that as a body Australian banks lacked experienced and skilled staff to do the work. The state of the credit cycle in the late 1980s / early 1990s and the difficulty that some banks found themselves in is testament to this.

- Floating of the Australian Dollar was another key change that broadly contributed to the internationalisation of the Australian economy by facilitating more efficient investment and capital flows in and out of Australia; and

- The removal of barriers to entry for foreign competitors intensified competition in the industry. The significant increase in competition generally has helped to drive product innovation and also led to substantial improvements in operational efficiency across the industry. The Commonwealth Bank lowered its cost to income from about 68% in 1991 to less than 50% today. Banking customers have benefited from lower prices through margin contraction, and have significantly wider choice through the diverse range of banking and wealth management products now offered.

From the Commonwealth Bank's perspective following deregulation, it became increasingly clear that the operation of the Bank under government ownership was causing significant problems. For example, management lacked experience operating under purely commercial objectives in what was a deregulated and much more competitive market.

In 1991, the government moved to partially privatise the Commonwealth Bank, with a 30% reduction in its shareholding undertaken through an initial public offering of new capital.

This required many fundamental changes to be addressed as we stepped through the privatisation process. For example the need for separation of public policy from commercial operations – the Bank had historically been burdened with these competing interests. The Bank also had to shift its focus to becoming a listed company, subject to the Corporations Law and securities regulation – this included completely transforming our market disclosures, increasing transparency and becoming adept at engaging with investors.

In 1996, the Bank achieved full privatisation and share market listing. This removed all government influence and control and meant that we needed to put into place robust Board and governance frameworks, make changes to our Board structure and composition, and define the relationship between the Board and management. Getting this right was critical as we entered an environment where we had to perform and compete on the same basis as other banks – but importantly the Bank was finally able to set its own strategic direction through commercial and capital management objectives consistent with maximising long-term shareholder value.

This is just a flavour of some of the areas for consideration by our partner banks as the China banking market moves toward deregulation and some banks consider privatisation.

Our Capability Transfer Program in China

We decided the best approach to ensuring our partner banks were prepared for the changes ahead was through the development of a Capability Transfer Program.

The key objective of the program is to increase the competitive positioning of our partner banks in the medium to long-term and to ensure they are ready as the market deregulates and opens to increased competition.

Along with our partners, we agreed on a broad range of work streams that transfer knowledge, skills and capabilities across six core workstreams. These workstreams cover areas from credit and risk management to marketing and finance.

We commenced the Capability Transfer Program with Jinan City Commercial Bank in January 2005 and will begin implementation with Hangzhou City Commercial Bank before the end of the year.

Summary

In summary, the transition to a deregulated market was a long process and we had many challenges along the way, but deregulation has been very successful in transforming the Australian banking sector to what it is today – a highly competitive, efficient, and innovative industry, which is supported by a sound regulatory framework.

The Commonwealth Bank's experience and success since deregulation and full privatisation can be measured in terms of:

1. The significant improvements in operational efficiency
2. The strength of our market position
3. The reduced cost of banking and the full range of products and services available for our customers and
4. The considerable value that we have created for shareholders.

We believe the banks that are best prepared for China's deregulating system are more likely to have an immediate advantage over their competitors in the short-term, and achieve superior performance over the long-term.