THE WIDER ROLE OF AUSTRALIAN BANKING'

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I had the honour some years ago to talk to the former society of security analysts on “Banking in Australia”. It is a pleasure to be here again today, to address the reconstituted Securities Institute on the “Wider Role of Australian Banking”. Conscious of the broad scope of this subject, I intend to break it down into two main themes:

(i) The widening scope within traditional banking activities.

(ii) The provision of associated services and facilities, including the so-called financial supermarket concept.

I would also like to comment briefly on a subject dear to many of you, the question of a wider, more detailed disclosure of banks’ profitability and activities.

Traditional Banking

For many years traditional banking activities in Australia have been criticised on a number of grounds. People have found fault with the fact that there are only a handful of major banks, that there is costly duplication of branch networks, that banks have been cautious in expanding their services with the result that they have lost market share to a proliferation of non-bank financial intermediaries.

In summary, according to this general line of argument, the picture is one of a cosy cartel living on the memories of the past and deservedly, though slowly, declining in significance. That of course is not the case and more importantly, it overlooks a number of recent changes which are having a significant impact on that perception of the banking system.

That there are only a small group of major banks in Australia is fact. The reasons for this are partly policy and partly historical. The authorities have taken the view over a long period, rightly or wrongly, that a country of Australia’s relatively limited population and financial resources in relation to its physical size cannot support a large number of banks — size and stability are key ingredients in the public’s trust of these institutions. We had many bank failures last century leading to the 1893 bank crash, when just a few survived. In the last two years there have been highly publicised bank collapses in America and Germany and failures of similar financial institutions in Japan and Britain. Apart from some land development companies, Australia has been spared such collapses in contemporary experience. This would appear to be a vindication of official policy.

That is not to say there is no scope for new entrants. I would not oppose competition from foreign banks provided they had to operate on exactly similar terms to those operating here today and were willing to let us compete on equal terms in their home markets. In view of the reluctance of some foreign countries to approve such access it would be risky for the Australian authorities to adopt a unilateral approach to this question. Moreover, any decision would have to be reconciled with the criticism that Australia is overbanked — you will appreciate the irony of having apparently too few banks, but too many branches.

The branch network system is a long-established feature of Australian banking, arising partly out of a heritage acquired from United Kingdom practice and partly out of an early recognition of basic customer requirements and the now fashionable consumerism. It also reflects Australia’s peculiar socio/geographical situation, a combination of major urban and widespread rural population clusters. Unquestionably, potential for rationalisation exists.

A second obvious alternative is mergers between individual banks.

This, of course, revives criticism on the score of concentration and reduced competition. Any proposed merger would probably depend on trade practice considerations and the attitude of the government in power at the time.

The question of declining market share is a vexed one for the banks. Statistics confirm that assets of the trading and savings banks declined from 60% to about 40% of the total assets of financial institutions between 1953 and 1972. The reason for this was not inertia on the part of the banks but the result of various policy measures. These included interest rate controls on borrowing and lending, suasive policy directives from the authorities, restrictions on areas of operation (e.g. inability to become official short term money market dealers).
both the banks and their customers. In some quarters, inflation is having a pernicious effect on the competitive environment, this optimism is clouded by the act of acquiring stakes in finance companies, merchant banks, and the like — I will comment on this later; suffice to observe that the commercial banks, including related companies, probably hold over 50%, rather than the 40% quoted above, of total financial assets at the present time.

From the authorities' point of view, the leakage of assets from the controlled to non-controlled parts of the financial sector had the unfortunate side effect of reducing the effectiveness of monetary policy. In recent years they have moved to stem these consequences. In 1973 the trading banks were granted freedom to negotiate interest rates on fixed deposits of $50,000 and over. Maximum overdraft interest rate restrictions on large (currently $100,000 and over) advances have been removed. A financial corporations act, empowering the government to regulate non-bank financial intermediaries, has been placed in the statute books. Very recently the authorities have acknowledged the punitive effect on bank profitability of continued S.R.D. calls by displaying a welcome, if liquidity-denting, flexibility in application of L.G.S. requirements.

The ultimate effect of these changes is not clear, but the signs are hopeful. The lessening of interest rate restrictions has fostered competition among the banks in a way that must gladden the trade practices commissioner's heart. There are at times significant differences in the borrowing and lending rates quoted by individual banks, and in their management of liquid reserves. Moreover, from the authorities' viewpoint the flow of deposits back into the banking system is heartening for monetary policy management.

The most recent (1973) flow of funds figures from the reserve bank revealed a useful recovery in the commercial banks' share of total financial assets and my guess is that this trend has continued between then and now. The impact of the financial Corporations Act is uncertain as its powers have not yet been tested. However, the government's decision to set-up committees to advise it on how best to regulate the various groups of institutions covered by the Act is encouraging. This sort of dialogue may contribute to lessening the risk of "overkill" which occasionally results from well-intentioned policy reversals.

While I am confident of the banks' prospects for expanding their traditional operations in a competitive environment, this optimism is clouded to some extent by the effects of inflation. To digress briefly, inflation is having a pernicious effect on both the banks and their customers. In some quarters the banks are regarded as virtually inflation-proof because both their assets and liabilities (and profits in theory) expand rapidly under the impetus of inflation. In the last three years trading bank deposits have jumped by over 60%, while savings banks' deposits have grown at only a slightly lower rate. Profits have more or less kept pace despite the devastating wage cost pressures on a labour intensive industry, nevertheless, retained earnings have not been sufficient to maintain capital ratios. Most of the banks have made share issues in this period and have restrained growth in dividend payouts.

More importantly, the bald figures conceal the increased risks of being in the banking business under conditions of rapid inflation. As the prime providers of short term funds for business enterprises the banks have been intimately involved in their customers inflation-inspired working capital problems. The deterioration in corporate debt-equity ratios over the last few years has of course not gone unnoticed by the bankers. Further erosion is inevitable unless these people are able to raise fresh equity capital to restore their financial position. The current spate of share issues by public companies comes as no surprise. But further action to control and account for inflation is essential if the corporate sector's efforts to restore its financial position are to bear fruit. The Wales welcomes the Government's acceptance of the fact that reducing inflation must be its primary economic policy objective. In this context the Federal Treasurer's recent statement clarifying the government's intentions on money and credit was useful but it is to be hoped that liquidity management will remain sufficiently flexible, in Mr. Lynch's words, "To permit financial institutions to underwrite recovery within the private sector".

We remain hopeful that the government will act soon on its promise to introduce appropriate recommendation of the Mathews Committee's Report. To win general acceptance and understanding, application of the Mathews proposals probably should be integrated with the results of work being done by the accounting profession to update accounting principles and practices.

We recognise the risks to capital markets which could occur if the concept of profit is distorted by changes in accounting practice without offsetting taxation adjustments. Bankers, of course, would welcome accounting methods which more realistically cope with the effects of inflation than the traditional historical cost approach.

Ancillary Services
Now, to the second part of my talk, about ancillary services. As you probably gathered from my earlier remarks the banks' initial moves into related financial activities were prompted in part by the constraints imposed on their traditional activities.
These days diversification is pursued in its own right to provide additional services for bank customers, which we aim also to be profitable for the bank.

The savings bank and finance company connections of the trading banks are well known. I do not propose to dwell on these at length today except to remark on the speed and size of the trading banks’ penetration into these fields. Savings bank subsidiaries of the five major commercial banks (i.e., excluding the Commonwealth Trading Bank) currently control nearly 40% of total savings bank deposits. Bank-affiliated finance companies hold a similar proportion of total finance outstandings. Further penetration of these sectors appears quite likely. Many depositors appear to draw comfort from the association of these institutions with major banking groups, even though the parent companies do not stand as guarantors to finance company debenture and unsecured note raisings.

International trade has always been an important part of Australia’s economic activity. The trading banks, naturally, have played a major part in helping to provide export/import finance. The traumatic events of recent years, with violent fluctuations in international currencies and a movement away from fixed to floating exchange rates, have changed the rules of this game. Australian banks now share in currency risks, willing or not. This does not mean that they are currency speculators. As you know, the Australian dollar parity varies according to changes in a trade-weighted basket of currencies. As a result, the parity of the dollar has not been subject to sharp fluctuations, although significant changes can occur against individual currencies within the “basket”. For instance, the New Zealand dollar has depreciated against the Australian dollar by approximately 20% in the last 18 months. The trading banks, in meeting customers’ export/import requirements can be exposed to these risks. Forward cover is normally available through the reserve bank, at a premium, but scope exists for judicious deliberate exposure by individual banks, on a short term basis, where the risk appears to be in their favour.

The acquisition of in-house expertise in “reading” international currencies is a relatively recent phenomenon, which has encouraged the international activities of the local banks. This development has coincided with the growing sophistication of Australian companies in seeking funds from the cheapest source, including access to overseas money-markets when interest rate differentials outweigh the exchange risks involved.

Scope exists, therefore, for a substantial expansion of the work done to date on procuring overseas funds for resource development. I would not be surprised if bank-organised consortium and syndicated overseas loans make a significant contribution to Australia’s development capital needs over the next decade. Moves by the various banks to establish representative offices in various parts of the globe are pointers to their confidence in the growth of international activities. This should not be taken to mean that traditional banking operations are likely to be extended world-wide in the foreseeable future. For reasons mentioned earlier, extension of operations into foreign countries is not easy. As I see it, Australian banks will maintain and develop their important regional presence in South East Asia. Wider geographical penetration will be slow and not necessarily worthwhile, except in selected activities such as international finance, and I suppose in that context you go where the money is.

The banks’ international financing aspirations are actually part of a wider corporate financing role. The trading banks have established links in this field through their equity in various merchant banks. The growing demand by corporate customers for non-overdraft funding and advice has caused the banks to increase their involvement in this field. The Wales, for instance, established a corporate finance department eighteen months ago which has arranged loans of more than $600 M. since then. The Wales’ direct involvement exceeds $300 M.

Loan facilities encompass the resources of both local and international money markets and have been directed mainly to the development of natural resource projects. This field offers scope for leasing as well as loan finance. The finance subsidiaries of the various banks are heavily involved in leasing, but the banks could usefully increase their presence in this field also. The relatively short term nature of many leasing contracts, coupled with the high cash flow they generate, complements the banks’ term deposit structure.

As you know the various banks professionally manage the investment funds of superannuation and private customers as well as providing nominee services to overseas investors. Incidentally, they collectively generate probably more than $3 M. in brokerage commissions each year, which should make some people happy. Looking ahead, the combined investment and corporate finance expertise within the banks provides them with a framework in which to extend their services to allied fields. In several European countries banks carry out the functions of underwriters and brokers as well as traditional banking. These multiple roles appear to be not only workable but also successful. Given the differing circumstances in Australia, it is conjectural whether local banks would want to enter into these activities on their own account. But it may be feasible to break down the rigid compartmentation between financing and associated activities that has traditionally persisted.
There is no reason why banks should not discuss with their customers equity as well as fixed interest requirements. Nor should they be deterred from taking direct equity stakes themselves if circumstances justify such a stance, provided such action does not interfere with their primary role as providers of loan finance. Whether ancillary services should extend to making investment recommendations is a difficult question. The banks provide extensive research facilities to support their corporate finance and investment management activities. It is appropriate at this stage to stress the at-arms-length basis on which these services operate. We are very conscious not only of the provisions of the various securities industry acts on insider trading but also of strong ethical obligations which we observe strictly. For this reason and because of the unwitting conflicts of interest that may arise on occasions, my personal opinion is that the banks should be very wary about giving investment advice to customers, except as a normal part of their other activities, such as investment management.

Of the banks’ other services consumer credit is one which comes readily to mind. The trading banks’ long-standing involvement in personal loans, which has been supplemented relatively recently by the introduction of the jointly owned bankcard credit card operation, is still in its infancy but has been accepted enthusiastically. After an initial launch in Sydney, Melbourne and Canberra, the service has been expanded to Brisbane, Adelaide and some country areas of New South Wales and Victoria.

The volume of business to date has exceeded expectations. There are currently 897,000 bankcard holders, which indicates that this has been a welcome addition to the banks’ range of financial services. Insurance is another potentially profitable adjunct. Several of the banks have insurance associations, mostly through affiliated finance companies.

So much for ancillary services.

Turning now briefly to the question of disclosure — my friends in the securities industry suggest from time to time that the various banks should tell more about themselves to their shareholders and intending investors. In particular they refer to published annual accounts and profit announcements to the Stock Exchanges. The banking industry has a unique position in the economic life of the country. Banks are established and survive on the trust of depositors and play a key role in maintaining public confidence in the financial system generally. The recent support operations of the clearing banks in the United Kingdom, the part played by the Australian banks after the Minsec Crash in 1971, and more recently during some major credit failures, underlines the importance of this function. The Cohen and Jenkins Committees, which studied the question of bank disclosure in the United Kingdom, concluded among other things:

- In the case of banks the interests of depositors outweighed those of shareholders,
- Confidence in the stability of the banks was an asset of national importance as lack of confidence could cause a “run” on deposits and impair the working capital of the banking system.

That Committee also said that:

- Full disclosure in the accounts might embarrass the banks given the effect transfers to and from loss provisions could have on confidence in a bank’s stability.

As the Australian system is modelled on that of the U.K., we are very conscious of the significance of these conclusions. As a consequence the question of greater disclosure is one which the banks must handle in a responsible and careful fashion. I am glad to say, that progress is being made. As you are aware the banks now generally conform to Stock Exchange requirements, in giving detailed interim and preliminary profit statements. Matters such as disclosure of bad and doubtful debts, interest paid, provisions for long service leave and the like are currently being investigated. The implications of work being done on inflation accounting and the recommendations resulting therefrom have to be considered also. At this point I do not know what will come out of the “melting-pot”. Hopefully, we will be able to reconcile our sometimes conflicting obligations to depositors and investors in a manner which will satisfy both groups.

In closing, this straightforward matter of fact paper, I would like to leave you with the thought that the banking financial supermarket concept is alive and well in Australia. In traditional banking and money market operations the banks are now in a position to compete effectively, both among themselves and with other similar institutions. They have started to recover their share of Australia’s total financial assets after many years of slow decline. At the same time related activities are being expanded aggressively — corporate and international finance, leasing, investment management, consumer credit and insurance. There are still a few gaps in the product range but I am confident these will be filled as the banks expand their role as providers of efficient and economical financial services to the whole community. Indeed it is our duty to do so.