The luxury of the overdraft system:
Shift to F.D.A.'s

There are few banking systems in the world today that provide the luxury of a facility permitting immediate drawdown and repayment without notice, with interest not running against the customer.

The luxury of this system is obvious, and it was inevitable that the banks would eventually move to bring about changes. It was not so long ago that discussions with your bankers mainly centred on the size of the overdraft, with a small number of other facilities suggested to support this main limit. Today the position is far different, with the overdraft playing a minor role in a larger and more diversified package of short to long term domestic and overseas lines.

Although in the past ten years there have been but few additions to the fluctuating type facility, the number of other facilities available in the banking system has grown quite considerably.

We now have term loans, farm development loans, fully drawn advances, personal loans, leasing, resources bank loans, etc., all of which are of a fixed and amortizable nature. The only new non-fixed type facility we have seen in recent times is Bankcard, which in itself has inbuilt amortization provisions.

There are also other factors contributing to the swing to fixed lending. There is the continuing shrinkage in free money held by the banks, and represented by balances in current accounts. This shrinkage has caused the banks to buy more of their deposits thus increasing costs; this in turn has highlighted the cost of maintaining excess liquidity to service the widely fluctuating overdraft.

And then there is the continuing appreciable rise in operating costs of the extensive branch banking system, which is further aggravated by the pegging of interest rates for loans under $100,000. This has accentuated the desirability of directing new approvals to fixed lending. There seems little doubt that in future we will see a rationalisation of branch banking rather than the expansion we have seen in the past.

The total limits within the trading bank system for both overdraft and fixed lending are around the $15,000 million mark and, while there are no segregated public figures available, it is estimated that about half these limits are of the fixed lending type. This leaves say $7,500 million in the overdraft category, where every 1% in movement, up or down, represents a figure of $75 million.

We have seen peaks and troughs in overdraft usage over the past four years when percentage figures have moved from a low 62.7% to a high of 74.1%; this represents 11.4% and in money terms, $850 million. These are peak figures and there would be no need to record what year this occurred. The average over the last three years has been about 7%.

While we retain the overdraft system, these peaks and troughs will persist but the trading banks, although fully recognising the needs of their customers, will continue to move to decrease the volatility of the overdraft, with the aim of reducing surplus liquidity, thus making best use of funds, resulting in more loans. The commencement of quarterly corporate tax payments this month will considerably assist towards this objective.

Whilst each individual bank will continue to adopt varying philosophies and concepts for its lending, the emphasis will continue to be on reducing the extent of movements within overdraft limits, with the trend more clearly turning to the American system of fixed lending and the Canadian concept of the note. There appears to be no signs of a movement, at least in the foreseeable future, of bringing in compensating credit balances.

Although the banks clearly favour the fixed lending concept, it should also be said that...
the borrowers’ preference for this type of lending is growing. As you are aware, the overdraft is repayable on demand and in the main is reviewed annually by banks. The fixed type loan, however, provides the borrower with a term facility, encompassing a set amortization programme and backed up by a commitment letter from the bank. The trend is for management and company boards to prefer this firm commitment rather than the on demand limit.

We are all familiar with the words “come and go”, which are invariably associated with the overdraft concept; perhaps we should now define the term in the broadest sense. “Come and go” can probably best be described as the mix of cash flow arising from profit and depreciation benefit accrual, pending tax and dividend payments, debtor and creditor movements, stock level variations, capital raisings and expenditure, etc.

Let us now move on to discuss how banks in the future may achieve these objectives.

Firstly, we could well see banks seeking to confine the usage of the overdraft to the foregoing true definition of “come and go”. We could see them discouraging customers from using the overdraft as a standby for their borrowings from the market to take advantage of lower rates of interest from time to time. These movements in and out of the market have played a major part in the peaks and troughs in overdraft usage in the past; obviously, if the banks want to rectify the situation, these borrowings from the market by overdraft customers will need to be minimised.

Secondly, we may well see a change in the overdraft fee structure, which could entail the existing unused limit fee being replaced by a front-end fee large enough to encourage overdraft usage on a steady basis and to discourage borrowings from the market. When this fee is paid in advance over the whole line, the incentive will be to use the limit.

Thirdly, while fixed lending (including the fully drawn advance) will continue to play an increasing part in new lending approvals, we can also expect to see some measurable growth in bill acceptance facilities, with banks firmly committing themselves to discount the paper. These lines will be approved for periods up to 4/5 years, as are fully drawn advances.

Such limits may or may not be approved on an amortizable basis but, with few exceptions, will be fully drawn. In effect, there is no real difference between the fully drawn advance and the bills accepted/discounted line, except that the latter facility provides paper for on sale by the banks when desired.

Ultimately, through new approvals on a fully drawn basis, the banks will appreciably build up their holdings of commercial bills, thus complimenting the range of their other fixed lending facilities.

These bills, whilst increasing the assets of the individual banks, will also provide them with the means of adjusting liquidity which at times will be preferable to raising further deposits. Sale of bills provides a 100% adjustment in liquidity, whereas the raising of deposits means that allowance has to be made for L.G.S. and S.R.D. requirement.

To sum up — while we might not see a great decrease in the present levels of overdraft limits, we can expect to see:

1. A larger proportion of new approvals directed to fixed lending in line with the American system.
2. An increase in fully drawn bill acceptance facilities with discounting by the banks.
3. The confinement of overdrafts to true “come and go” purposes.
4. A change in the overdraft fee structure to encourage the use of the overdraft on a steady basis.

And this, with the implementation of quarterly corporate tax payments, will produce in a few years time a considerable reduction in the peaks and troughs now experienced in the overdraft system. The banking system will then be able to use its assets more efficiently, with benefits for the financial system as a whole.

*Development of corporate finance divisions involvement with overseas currency and clients*

Australian banks generally have for some time been extending their international operations to complement their domestic business and service their international
customers. This is being achieved by the establishment of representative offices throughout the world, equity participation in merchant banks (including provision of staff from Australia) and recent establishment of agencies in New York and Los Angeles. These U.S. offices will handle the investment of the U.S. dollar holdings of the Australian banks, which are held primarily for settlement of trade transactions. Around 70% of Australia’s trade is now financed in U.S. dollars. Authority is also held for these agencies to accept certain types of deposits, make loans, issue letters of credit, perform correspondent banking activities and conduct money market and foreign exchange transactions. These operations will complement the extensive services already provided by the offices of the Australian banks in London.

The growth of domestic corporate finance divisions within the banks is running parallel with this international diversification, to the stage where near-complete merchant banking services are being provided, including leading and participating in local and overseas loan consortiums, including major resource projects, both as competitors and partners with the merchant banks. These are recent developments that will lead on to a wider range of international and local fund raisings, and a much greater involvement by banks in the needs of their customers in such areas as long term corporate financial planning, financial consultancy services, cash flow analysis and budgeting, etc.

As a further extension, we may see corporate people from the banks joining management in those companies where banks hold an equity interest. We have seen one or two cases of this over the past few years, but the practice of equity participation and interchange of management is not expected to grow to any extent—certainly not to the same degree that exists in a number of countries overseas.

I think it fair to say that the banks will continue to devote their energies to the areas involving loan raisings, with the specialist areas of equity funds, flotations and new capital raisings continuing to be handled by the stockbroking community, merchant banks, etc.

In summary—the banks have entered the merchant banking field both locally and internationally, and look forward to competing and working with existing similar established organisations.

The deposit base:
Rising cost of funds
Trading bank customers still rely on the chequing system to settle most debts but at the same time are unwilling to hold as high a level of credit balances relative to their transaction levels as they once did. Now that there is such a wide variety of short-term investments available—particularly to the larger company—this is scarcely surprising. Many cheque accounts are fast becoming mere clearing accounts for the purpose of passing payment transactions, with balances related mainly to the value of cheques “in the pipeline”. Liquid funds that are not to be spent in a few days are “up for grabs” in a highly competitive market and it is only by competing directly in this market that the banker can retain some of these funds. Back in 1952, 18.0% of trading bank deposits were classified as fixed term interest bearing deposits, and the rate of interest varied between 0.5% and 1.5% per annum.

I need not list the current bank interest rates of today, although it should be mentioned that fixed deposits and certificates of deposit now form 60% of trading bank deposits—an increase of 42% and the figure is still rising. Furthermore, the branch system is providing less deposits percentage-wise, the difference being found by purchase of deposits by the banks in the higher cost professional area.

Current deposits, because they command no interest rate, are sometimes referred to as “free deposits”. These deposits, however, are not as profitable as they may appear. Costs of operating the cheque account system, with its high turnover and activity, are by no means covered by activity charges despite the rationalization of fees that banks have been obliged to make over the years. It goes without saying, therefore, that trends during the past quarter century have raised the effective costs of so called “free deposits” at the same time as interest rates have soared on the growing portion of market rate deposits now included in the system.
These changes are of course inevitable and even desirable in the context of the increasing sophistication and efficiency of financial arrangements in this country. They are essential to our economic development. The businessman has gained both in the range of financing options available to him at competitive prices and in the opportunities afforded to him of making his surplus funds work profitably even for periods of a day or two.

At the same time, those same businessmen must accept the consequences not only of the need for banks to rationalize their charging procedure, but also of the need to price their lending realistically. If banks must pay market rates for much of their funds and still meet their traditional banking obligations on the liability side of their balance sheet, there must be a corresponding move in lending rates on the other side of their books. There will be less room for concessions.

**Banks as intermediaries**

In fact, within a quarter of a century or less, bankers have gained considerable experience in their new role as financial intermediaries. On the one hand they now compete with building societies, finance companies, credit unions, short term money market, inter-company market and others to build-up deposits; on the other hand they now finance in a proliferation of competitive packages beyond the field of the traditional overdraft loan—leasing, bridging finance, overnight to long-term lending, to mention a few. In this way the widening demand for tailor-made financing is met while banks are earning a more realistic return to match higher deposit costs.

I believe that the banker has faced the challenge, but old traditions die slowly and not everyone outside banking has kept pace with the profound and quite basic changes taking place in the banking world. Academics and governments still talk of the money supply as “M3”, comprising notes and coin and trading bank current accounts (the “M1” component, which we would not wish to argue with) plus trading bank fixed deposits plus savings bank deposits but completely ignoring Treasury Notes, Australian Savings Bonds, Building Society and Credit Union deposits and the many more money substitutes.

Use of such a measure merely echoes the current policy of controlling financial activity through the banking system alone. The banker’s role as an effective intermediary is being hampered not only by the fact that he is controlled, but also by the nature of those controls.

SRD and LGS ratios, for example, are not based merely on those deposits that do form part of the payments mechanism, which is still unique to banking, but they relate equally to deposits gained as part of the banker’s more recent but no-so-unique role as financial intermediary. This imposes costs on this intermediation, hindering competitive drive. Savings bank ratios are another example, although their reduction in recent years in the face of deposit-gathering difficulties and housing loan requirements has made this problem an historical one in so far as its effect today lies in the stock of low-interest official and semi-official paper still being held by savings banks.

Direct lending controls and, more particularly, enforced concessional lending to various groups or for various purposes are also becoming less appropriate and, in terms of the long term health of our financial markets, less desirable as time passes.

To sum up under all headings — I think it fair to say that the banks have responded to and are responding to change; that they welcome the widely diversified competitive role they are playing; and they look forward to the future with confidence — in competitive co-operation with the financial community as a whole.