“COMPETITION IN THE FINANCE SECTOR”

An Address by

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During this talk I propose to suggest one or two theoretical ways in which we can think about the subject of competition in the finance sector, apply this to what we have seen happening over the last twenty years or so and then put forward a few thoughts about future trends in financing. To conclude, I will say something about how one company, which is the one I know best, plans to capitalise on these future trends.

There is a management theory that corporations are subject to the same sort of biological factors of growth as all of us are. The early stages of vigorous organisational growth give way to maturity and, in the absence of some magic rejuvenation, finally to gradual decline. I find that “life cycle” theory easier to accept when it deals with a particular product or service but, I believe, it can also be applied to corporations.

Newly established corporations, directed by entrepreneurial individuals, have a very clear idea of what objectives they are trying to achieve. Everybody in the organisation is headed in the same direction and there is a concentrated drive towards achievement. Assuming the basic idea is sound, the company is well structured financially and that it is well managed, this is the period of strong and flourishing growth.

This growth phase often passes as the organisation reaches maturity. Frequently at this stage, employee numbers increase, often more quickly than during the growth phase. Departments proliferate. Communications begin to break down. Objectives become blurred. People begin to shuffle papers around in the organisation. Often the entrepreneurial people who began the business disappear from the scene.

And it can happen that, at this stage of an organisation’s life, it becomes more bureaucratic. This bureaucracy means inevitably that more people are concerned with things other than the primary objects of the corporation. More and more effort is often put into doing very efficiently those things that shouldn’t be done at all. This process leads inexorably to decline.

This biological theory of corporate evolution can be observed often enough in real life to give it some validity. I am not saying it is inevitable, but it does happen.

Bearing this theory in mind, let us look at what has happened to the finance sector over the last twenty years or so.

The attachment sets out movements in the shares of the total finance sector market enjoyed by the different types of institutions.

- The trading banks’ share dropped between 1960 and 1970 by about 6 percentage points from 32% to 26%, and then stayed level until 1980.
- Savings banks showed a continuous decline – they started off with over a quarter of the assets of the whole financial sector and have dropped to 20% now.
- The building societies showed the greatest proportional growth in share of market, particularly over the last ten years, having moved from 4% in 1960, to 5.7% in 1970 and to 10% in 1980.
- Finance companies have shown a steady growth over the whole period from 1960 to 1980.
- The credit unions, starting from a small base have got up to just over the 1% mark.
- The life offices have been the big losers of market share, particularly during the 1970’s for obvious reasons.

I do not propose to analyse in any depth the reasons for all the movements – that would be well beyond the scope of this address. It is possible however to identify quickly a few factors that have been at work.

The establishment of the official money market diverted assets in the form of government securities and the deposits with which to fund them, from the banks into the hands of the authorised dealers.

The growth of the finance companies was a different sort of story. The Reserve Bank in the 1950’s decided that the growth of these “fringe bankers” as they were then described, was too rapid. They directed the trading banks not to extend further credit to them. The finance companies, with a fine show of innovation, therefore made the trust deed and the debenture prospectus their own instrument for directly approaching the public. The success of this instrument led to their very rapid growth – right through the 50’s, and their continuing growth until today.

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The private trading banks established their own savings banks in mid-1956. This gave an impetus to growth in savings banks, as well as a major rearrangement of their deposits from the existing savings institutions - which were then generally government owned - to the private sector banks.

The growth of the merchant banks started in the late 1960's with the mining boom. They filled the need in the corporate sector for loan facilities and by rediscovering the accommodation bill of exchange they created, virtually from nothing, the commercial bill market. That was a magic story and it enabled the merchant banks to develop into a real market force in the field of corporate lending.

The rapid growth of the permanent building societies is apparent from the attachment. It is notable that their growth, and to a much lesser extent, that of the credit unions, have just about exactly offset the decline of the total market share of the savings banks.

All these developments - with the possible exception of the movement of the private banks into the savings bank field - stemmed from an unfilled demand for loans or other financial assets. It was the ability of groups of new institutions to meet that demand by raising funds either from existing or new sources, and sometimes by the introduction of new borrowing instruments, that has given the financial sector the tremendous vitality that it has enjoyed over the last generation or so.

There was one basic reason why this considerable diversity of financial institutions occurred in the 1950's and the 1960's. This was the inability, or perhaps the unwillingness of existing major financial institutions, to provide the service that the market was demanding. This unwillingness or inability may have been due to the extent of the perceived risk, perhaps to a lack of entrepreneurial skill or expertise or possibly to excessive government regulation. Whatever the cause, the result was a significant diversion of business from the tightly controlled to the largely uncontrolled segments of the financial sector.

Before looking at the future I will comment briefly on what will without doubt be a most important determinant of how the future develops. That is the basis of the controls over the financial sector that will be exercised by the authorities at Federal and State levels.

It was Edmond Burke, writing about two hundred years ago, who observed that men are qualified to liberty in exact proportion to their willingness to put moral chains on their own appetites and ambitions. He said society could not exist without such chains. The less control there is from within, the more must be imposed from without. Men of intemperate minds, he said, could not be free and he ended by saying “Their passions forge their own fetters”.

Well I guess that we are now carrying the very considerable fetters of government control, which the appetites and ambitions of some of our predecessors helped to forge. There is an ugly face to Australian business, to quote from the title of Timothy Hall's book. It's not necessary to accept all of Hall's largely generalised criticism of some Australian businesses to acknowledge that this ugliness does appear from time to time. Clearly it is to the benefit of all of us to eradicate it. All we need to do - and how deceptively simple that sounds - is to achieve fair dealing based on sound and complete information, plus that degree of internal control which Edmond Burke saw as a prime necessity of social existence, of any excessive corporate ambitions.

It would be most unfortunate if the authorities - through actions that are so clearly evident today, were left to impose this control from without and, in the process, developed a regulatory system that created for the future a system of control through confrontation.

We can’t yet know the outcome of the Campbell Enquiry. Hermann Kahn and Thomas Pepper in their book, “Will She Be All Right?”, gave a surprise-free prediction of the future. Their main prediction was that the only surprising thing would be if there were no surprises. I echo that comment.

But let me chance my arm at a few predictions for the next few years or, better perhaps, the next decade.

Certainly interest rate controls - everybody agrees - can go - the sooner, the better. The only impediment might be if the government takes note of what happened in the United States last year when the Federal Reserve System resorted to direct controls rather than their normal market based operations to achieve a turn-around of monetary conditions in the short term.

I believe we will see the bank reserve ratios rationalised and that will be a good thing. It's only necessary to look at the new lending commitments of the trading banks in relation to their total assets, and compare that with the new lending commitments which finance companies are able to make based on their existing body of assets. Finance companies are able to turn their assets over more quickly than the banks, they are able to maintain a higher rate of new lending with benefit for the companies and their customers. A high
rate of new approvals and a good flow of repayments in relation to total assets enables a finance company quickly to achieve a turn-around in its liquidity situation if the inflow of new funds slows down. In addition, it makes a finance company more conscious of the need to match the maturities of its assets and liabilities – a matter which many other institutions largely ignore. But they do so at their peril. Abolition of present controls will not all be favourable for the banks.

We will see, I believe, the captive markets for government bonds freed up. I wouldn’t think they would be completely released but Government open market operations could increasingly replace direct controls. In this regard, it must be noted that the captives – the insurance companies and the savings banks – are amongst the two groups whose share of market has been declining most rapidly.

I suggest, also, that we should see considerable relaxation in exchange controls. I hope that the first area where this happens will be in the area of forward exchange cover for non-residents, particularly for capital transactions. This seems to me to be an area where there is great reform needed, but I stop short of predicting that this reform will be achieved.

I’ll predict that we will see at least two – perhaps three – foreign banks operating in Australia by the end of the 1980’s but obviously I won’t be so rash as to predict which ones will receive the call.

It’s also to be hoped sincerely that the present reliance on market disciplines will not only free existing institutions from control but will also relieve them of their countervailing privileges. I don’t believe that, for example, the banks should expect deregulation, while at the same time maintaining the need so strongly for their almost exclusive access to the Reserve Bank window. I think both sides – the obligations and the privileges – should be broken down. The same comment applies to the very artificial proposals for insured deposits with the building societies. I don’t believe that when we are trying to allow the forces of the market to regulate the financial sector that we should at the same time be introducing factors that will perpetuate non-market based distortions.

I would argue also that we should see a greater internationalisation of Australian business in the future. This could happen in two ways.

The three great Australian fears observed by Hermann Kahn are of multinationals, unemployment and of the coming “computer holocaust” to use his words. The first way Australian business could become more international would be to increase its own investment abroad. It would be good to see more Australian owned multinationals. Familiarity in this way might breed less fear.

Secondly, I believe that our foreign investment guidelines need considerable reworking. The Stock Exchange has in the past taken the view – and I believe personally that it was right – that there is no reason why the finance sector or some other industrial groups should be so heavily “protected” as they are by the guidelines from investment from abroad.

We need to rethink what are the strategic industries that Australia needs to control. We can all agree that manufacturing fairy-floss isn’t one of them, but how far up the line should “protection” extend towards uranium and the strategic metals? It is very much a matter of political judgement. Personally, I think we could be drawing the line further up towards the base metals than it currently is. I guess that would include the finance industry in the area which is more open to foreign investment than at present.

In regard to international operations also, it is clear that, towards the end of the 1980’s, we are going to have to develop a much greater propensity to import in order to avoid the need for continuing revaluations of Australian currency, to the detriment of our import competing and export industries. This propensity to import could be complemented by the willingness of the government to develop a financial centre within Australia. Many people will argue that this would have a destabilizing effect. Clearly I cannot develop this argument here but I nevertheless observe that relaxed exchange controls – particularly on capital flows – need not add to instability and could well have the reverse effect, while producing other benefits.

That’s a very brief resume, Ladies and Gentlemen, of the sort of framework within which we might think of the development of financial institutions in the next decade. I’ve touched on the highlights of how the financial sector has become more institutionally diversified over the last twenty-five years and mentioned a few specific predictions as to how the finance sector might develop in Australia. Perhaps in the time remaining to me, I could illustrate how one organisation (United Dominions Corporation) plans to handle the developing future.

Clearly if the major institutions, the banks and the insurance companies to a lesser extent, are going to be decontrolled, they will become competitively more effective. They will have the ability, the legal right, to engage in activities which are currently denied to them. The banks work slowly but they work
thoroughly and after decontrol I am sure they could become very effective intermediaries in ways that we currently haven’t seen.

What does this do for people like United Dominions. It means, I believe, that we have to become even more entrepreneurial.

It means that we have to maintain a clarity of objectives, to come closer to our market and structure our organisation so that it can respond quickly to changing trends in the markets—lending and borrowing—in which we operate.

The finance industry has shown great ability to innovate by developing new forms of securities for borrowing from the public and by providing new forms of consumer and business credit.

Gradually the banks have rolled along behind. I believe the banks will gain a larger—perhaps a much larger—share of the consumer credit industry over the next decade. The plastic card and revolving credit is going to make personal lending, by people who don’t have that matching facility, more difficult to compete in. Companies wishing to compete in the consumer credit area will have a lot to contend with.

In the area of services to commerce and industry I think the picture is a little different. It certainly has been different recently in terms of growth. Nevertheless finance companies wishing to compete in this area are going to have to be quick on their feet and, probably, more specialised in terms of the industries they serve, the facilities they extend. They are going to have to be more responsive to market needs. They are going to have to have the flexibility to structure lending transactions in ways which take account of the real needs of businesses, in terms of their liquidity, their repayment capability, their taxation situation.

Indeed, at UDC that’s happening to a very large extent now.

So that, Ladies and Gentlemen, people like UDC are going to have to stay lean. We won’t be able to afford to build up the bureaucracies that exist in many bigger organisations at the present time. We are going to have to continue to focus our attention on the market and we are going to have to concentrate our total staff effort on high priority areas. There will be a premium on market-based strategic planning, innovative skill, staff motivation and lending expertise.

That’s basically the formula we have been following at UDC for a couple of years and I’m sure that we at any rate are going to continue to follow the formula in the future.

We will continue to need plenty of help from outside specialists and I include the securities industry in that category. We buy our services from stockbrokers, from the merchant bankers, from the analysts. Our aim is to provide high quality information about our company and its performance. For it is my firm belief that only by helping people to know us—warts and all—we will continue to attract the support from the market that will enable us to grow and prosper.

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SOURCE: Reserve Bank of Australia and Australian Finance Conference estimates.