A BIGGER TIN OF SHILLINGS

by CHRIS DISNEY

The new capital adequacy provisions are going to have a profound effect on banking and on those who have to deal with banks. Capital adequacy means that banks must have a sufficiency of their own shareholders’ funds in each transaction they undertake and that in future various off-balance-sheet items such as swaps must be brought to account.

In effect, a bank must put a shilling of capital into the tin each time it undertakes a risk transaction with a customer and these shillings are going to be much more numerous in the future. I would like to examine the possible effects these changes will have on the price of credit in the market-place.

One thing appears certain: the new rules will make doing business with your banker more expensive. Because capital is an expensive resource for a bank and because your bank will now have to consume more of it in his dealings with you, he will be obliged to charge you more for his credit facilities.

If you are the Commonwealth Government or a State Government, your banker will be able to offer you attractive terms because the capital needed to support his transactions with you is modest. If you are a local government body you are still in a privileged position, but if you are a corporation you are in the least attractive area, regardless of your credit standing. Corporations carry a 10 per cent risk weighting regardless of whether they are AAA Pty Limited or ZZ Limited on the ratings scale.

Strangely, corporations such as Telecom and Qantas, whose obligations usually carry a Commonwealth guarantee, are also on the 100 per cent list. Australia remains the only civilised country I know where unconditional government guarantees are treated by both banking and bond markets as obligations of a lesser quality than the very government that guarantees them. At the moment, a three-year Commonwealth bond yields about 11 per cent, whereas a three-year Northern Territory bond, which bears the unconditional guarantee of the Commonwealth, yields 12 per cent, or a full 1 per cent more, which seems quite illogical.

It seems that the cost of short-term banking credit for all corporations is going to rise. I cannot put a figure on it, but let’s assume that the rules force a bank to charge 30 basis points to accept a 90-day corporate note. Those corporations whose credit standings are in the general range of a “single-A” or above will find that they can probably raise funds by direct placement to institutions rather more economically than via the bank bill method.

Institutions with credit analysis skills will be prepared to buy the notes at a lower yield than the total costs of bank acceptance, and the result will be an expansion of the corporate paper market as corporations further down the credit scale enter the fray.

Most important, the process by which Single-A Pty Limited borrows 90-day money from, say, the ABC Life Insurance Company is completely outside the banking system and, therefore, outside the banking regulatory process. If ABC Life further flexes its muscles and goes into the swaps business, there is the possibility of a major market developing among the financial elite but away from the banks.

Factors and regulations such as these were the origins of the euro-markets and we see a real likelihood that this will develop among the financial elite in Australia.

The process will also encourage the rapid development of the mid-term corporate note market that is emerging in Australia today; in all probability, the non-bank elite players will be able to provide strong swap activity to support their purchases of the medium-term notes.

As these new markets unfold, who will be the winner and losers?

First, banks and bank-owned enterprises are now obliged to assess their outstanding risks much more comprehensively. DBSM’s ultimate owner is the Midland Bank PLC, and Midland is subject to very close scrutiny by the Bank of England, which has clearly put the fear of God into the UK banks on the capital adequacy front. A bank’s failure to comply incurs a requirement to place non-interest-bearing deposits with the Bank of England and other fates-worse-than-death. From time to time DBSM faces the unusual situation in which, as an Australian investment bank underwriting a securities issue of an Australian corporation, we have to clear limits via the Old Lady of Threadneedle Street. The process does not impress the Aussie nationalists among us!

But through this exhaustive credit allocation process, the big banks are likely to achieve an even higher relative standing in the Australian market-place — a standing acquired at the expense of the small banks and the merchant banks.

The “New 16” banks, which have done a fair percentage of their business in what were previously off-balance-sheet areas, will have to bolster their capital base as these transactions are brought on to the balance sheet. The accompanying call to their foreign head offices for capital will not be overly welcome, particularly in view of their difficulties in the profit-and-loss department.

Another winner is likely to be Australian Ratings and the other ratings agencies that will surely spring up in competition. Credit analysis and its resultant impact on pricing corporate paper is going to be increasingly important if our domestic corporate market starts approaching the relative importance that corporates enjoy in other domiciles.

Major investing institutions are also likely to be winners as they see more non-bank market opportunities. Corporate borrowers will need to be more innovative to get a good deal but, most important, a viable short and medium term corporate market should develop rapidly in Australia.

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