In 1982 the Australian Finance Conference undertook a major review of the balance-sheet and operational profile of finance companies in the context of the Campbell report and deregulation. The review focused on prudential and competitive considerations. Its findings have provided guidance to AFC members in determining their objectives and balance-sheet structures.

This report notes the AFC’s conclusions about capital, earnings, maturity structure of assets and liabilities, liquidity, and loan losses. It also discusses depositor protection and the regulatory environment, and makes comparisons with other major groups of intermediaries in Australia. In this last aspect, it relies considerably on the Peat Marwick Hungerfords survey of financial institutions.

It should be noted that the capital adequacy guidelines advanced by the Reserve Bank of Australia will affect the operational areas mentioned, although overall the effect on finance companies is not expected to be adverse.

In developing their capital structures, finance companies have recognised the role of the individual components of capital – paid-up capital, retained earnings and general reserves – as well as the distinguishing features of subordinated loans.

Subordinated loans provide protection to depositors because, in the event of a failure, depositors will receive priority over the holders of subordinated debt. Subordinated loans also enable losses to be absorbed by ordinary capital with less threat to creditors’ confidence.

But subordinated loans have limitations. Unlike capital, they impose a fixed charge on future earnings, thus reducing the capacity of those earnings to absorb losses. Accordingly, the limitations of subordinated loans are recognised but, subject to appropriate conditions, they are a legitimate inclusion as part of the capital base. In practice, finance companies have relied on subordinated loans only to a small extent – in 1987 they represented only 3 per cent of total capital.

Before the substantial deregulation in the 1980s, finance companies were achieving acceptable returns on shareholders’ funds, despite exceptionally high levels of capital, because they operated in markets in which other intermediaries were regulated or excluded. Finance companies were operating with a capital base about three times that of their major competitors. Deregulation provided grounds for concluding that finance companies had an over-capitalised base which would make it difficult to maintain sufficient returns, the quality of the asset portfolio and the stability of cash flows.

In a more competitive environment, lending margins are under substantial pressure; if finance companies had continued with an over-capitalised base, other balance-sheet components would
have to be adjusted to maintain returns on shareholders’ funds. For example, finance companies could have attempted to reduce the average cost of funds by an increased dependence on short-term borrowings; or they could have employed a large proportion of assets which did not have predictable cashflow characteristics but promised high returns. The effect of such changes on risk and cashflows is obvious.

In the event, finance companies have effected a smooth and gradual transition to a more appropriate capital base. This is shown in Graph 1, where capital is defined as net tangible assets, including subordinated loans, as a percentage of total assets.

Finance companies have a substantially higher capital component than other institutions – almost 40 per cent more than trading banks and merchant banks, and 80 per cent more than State banks (see Graph 2). Further, finance companies engage in only limited off-balance-sheet activities, enhancing their comparative capital adequacy.

**The role of earnings**

Earnings are the first line of defence against both expected and unexpected losses. In the final analysis, all losses must be absorbed either by capital or by reduced dividends. Retained earnings are also an important source of new capital.

The rate of return on shareholders’ funds is crucially important to the ability of an intermediary to raise additional funds and to add to capital through retained earnings.

In most recent years, finance companies have achieved after-tax returns on shareholders’ funds of about 12 per cent. An exception was in 1986, when the return declined to about 9 per cent. A contributing factor in this decline was a substantial jump in the bad-debt expense, partly because of macro-economic moves requiring tight monetary policy and wages restraint. Graph 3 illustrates the relative stability of this earnings measure.

The earnings performance of finance companies has improved, and the after-tax return on shareholders’ funds for 1988 could be somewhere near 14 per cent. This improvement is partly the result of the progressive adoption of more fee-for-service activities, generally involving little balance-sheet risk and leading to improved returns.

The most recent performance statistics of the major institutional groups
show the solid returns of finance companies (Graph 4). Although the merchant banking sector has a superior performance in aggregate because of higher gearing, a small number of merchant banks account for a large part of the total profits. Finance company returns are spread more evenly across the range of companies in the sector.

Measured in terms of total assets, finance companies’ earnings are considerably above those of the other institutional groups, as is shown in Graph 5.

A measure of profit to external liabilities places earnings in relation to gearing. As a measure, it does not reflect the ability of earnings to service external liabilities because it takes no account of the cost of servicing those liabilities. However, it provides a useful picture of the relationship between earnings and capital.

Obviously, finance companies will have the highest percentage of profit to external liabilities because they have the lowest gearing and the highest return on total assets (see Graph 6).

**Liquidity and matching**

Although liquidity is related to capital, the functions of each are clearly quite separate. An excess of one cannot compensate for a deficiency of the other.

Studies of bank failures in the US suggest that they have been caused principally by illiquidity; levels of capital have not been materially related to the failures.

Nonetheless, liquidity is not simply a matter of “the more, the better.” By increasing its liquidity a financial institution normally reduces the capacity of its current earnings, the first defence against losses, to absorb any such losses, and decreases the amount of net earnings from which it can increase capital through retaining earnings.

Conversely, by reducing liquidity, the intermediary increases the chances that maturing assets will not cover maturing liabilities. This could force the sale of less-liquid assets at less than optimum prices. Thus, there is a level of liquidity which balances lower risk against lower revenue. This level of liquidity will be related to the net cashflow position, which is determined by the maturity pattern of assets and liabilities.

Institutions which engage in little maturity transformation will need lower levels of liquids. A concentration on relatively short-term assets and a funding strategy of borrowing at term produces a high net cashflow business. Net cashflows are available to cover unexpected withdrawals and, unlike high amounts of liquids, do not necessarily result in a reduction of earnings.

Finance companies engage in very little maturity transformation, typically borrowing term funds and lending over relatively short periods. Graph 7, showing the contractual terms of assets and liabilities, conservatively portrays the maturity structure of finance companies. In practical terms, cashflows are superior to those depicted by the contractual terms because a considerable proportion of loans are paid out before maturity.

**Mismatch and liquids**

As noted, the level of liquidity is related to the net cashflow position, which in turn is related to the maturity pattern of assets and liabilities. An indication of the liquids/mismatch relationship is provided by comparing liquids and
standbys with the mismatch of receivables and less-than-one-year borrowings, as shown in Graph 8.

The finance company mismatch, even on a contractual basis, is not large and, in practice, the relatively high incidence of pre-payment improves the cashflow. Liquids are currently at quite high levels by the industry’s long-term standards, partly because of the existence in recent years of an inverse or flat yield curve. For an intermediary borrowing mostly at term, an inverse yield curve means that liquids are not a drain on earnings. Hence, the level of liquids held is a reflection not only of the mismatch position, but also of the shape of the yield curve.

**Loan losses**

Loan losses are a reflection of the risk profile of a financial intermediary’s portfolio and an indication of the intermediary’s ability to manage risk.

Finance companies lend further along the risk spectrum, but Graph 9 shows that the heightened risk of such operations is managed effectively and kept within tolerable limits. Loan losses have to be considered in the context of earnings, and it has been noted earlier that finance companies as a group report the highest returns on assets.

In the early 1980s, the bad-debt expense was about 0.8 per cent of average net receivables. This declined in 1985 to the exceptionally low level of 0.4 per cent, which was lower than the comparable figure for the trading banks. The increase in 1986 was caused by a combination of depressed economic activity, high interest rates, subdued wages growth and strong competition in the finance market resulting from new entrants.

The bad-debt expense of 1.1 per cent for 1987 is higher than the long-term trend – but it represents a stabilisation following the large increase in 1986. The 1988 result will probably show a slight downturn. However, most importantly, earnings recovered in 1987 following the deterioration of 1986, indicating that finance companies acted to counter the effect on earnings of the bad-debt expense.

Finance companies have also been making significant progress in reducing the level of non-accrual loans. Again, the experience of 1986 had a substantial negative impact on non-accruals, but despite this reversal non-accruals in 1987 had almost halved from the 1983 level.

**Investor protection**

Finance companies operate under the Companies Code requirements for prospectus registration and disclosure, and in a self-regulatory environment which incorporates:
- the existence of trust deeds which specify limits on the ability to create debt;
- supervision of investors’ interests by an independent trustee;
- provision of timely, adequate and independent information to the trustee;
- the prospectus registration requirements of the Corporate Affairs Commission.

Investor protection is also assisted by the scrutiny of the financial performance of borrowing corporations by the financial press, and the increasingly important discipline of credit rating by the established rating agencies.

The regulatory environment in
which finance companies operate is relevant to prudential considerations. It influences the ability of finance companies to compete and has a direct effect on earnings.

As an industry group, finance companies have been active in achieving significant changes to the regulatory system. An example is the progress made in the fund-raising area. In recent years, the Australian Finance Conference has radically altered the conditions under which finance companies operate on the liabilities side of the balance sheet.

If the current objectives are achieved, the fund-raising regime applying to finance companies will bear little resemblance to that applying only five years ago. Those objectives include:

- loose-leaf application forms;
- short-form prospectus;
- ability to take funds without prospectus application forms;
- elimination of loan security duty on borrowings;
- more appropriate gearing ratio;
- elimination of stamp duty on transfers of debentures;
- 12-month prospectus;
- significant freeing-up of advertising;
- trustee status;
- automatic acceptance of prospectus in New Zealand;
- protection of debenture registers;
- substantial improvements in the registration process.

The impact of these changes on industry earnings is substantial. Just three of the changes listed would save members $25 million a year:

- short-form prospectus - $4 million;
- debenture duty - $20 million;
- 12-month prospectus - $1 million.

**Capital adequacy requirements**

Although the Reserve Bank's capital adequacy requirements do not apply directly to finance companies, the flow-on effects are expected overall to have a positive impact on the finance company industry.

Most of the institutional competitors of finance companies will be required to lift their capital base. Consequently, if they are to maintain the existing level of return on shareholders' funds, then the higher capital will require a lift in the existing returns on total assets. Margins for straight lending business and fees will therefore have to be higher.

Because finance companies on average are already operating with a capital base above the 8 per cent required under the Reserve Bank guidelines for banks, they will not have to undertake these structural changes and will be in a relatively enhanced competitive position.

Further, finance companies generate very little income from trading in foreign exchange, government securities, etc. Therefore, they will not be affected by the risk weightings applying to these.

Finance companies have found it difficult in the past to compete for business which other intermediaries have conducted off-balance-sheet. As the incentives for off-balance-sheet business are now greatly reduced, finance companies will be in an enhanced position to compete.

It could be expected that the cost of obtaining bank enhancement for funding purposes will rise because of the need for capital support. Since finance companies raise a relatively small proportion of funds through such arrangements, there will be little flow-on impact on the cost of funds.