THE AUSTRALIAN BANKING INDUSTRY

By P.G. Russell & B.L. Campbell, Melbourne

(This report to members was prepared as a background paper to an address by the General Manager of a major trading bank, delivered to a meeting of the Victorian Branch of the Society on June 18, 1973. The graphs have been omitted from this re-publication.)

1. TRENDS IN BANKING PROFITS

Over the last fourteen years the major trading banks have improved their return on shareholders' funds from 5.8 per cent in 1958-59 to 11.0 per cent in 1971-72. The main improvement took place over the eight years 1960 to 1968. Since then the rate of return has remained around the 10-11 per cent level which is high by Australian company standards. (The average of all Australian public companies is approximately 8.5 per cent). It would be unreasonable to expect it to rise much above this level.

A comparison of bank pre-tax profits and the business cycle shows that profits tend to accelerate sharply out of each economic recession (easy monetary policy) and then gradually flatten in the last stages of economic expansion (tightening liquidity). Finance companies have contributed a fairly steady percentage of bank profits since 1959, although it is clear that their contribution has started to increase over the last few years.

2. PROFIT DETERMINANTS

The level of bank profits is determined by a combination of the following factors:

- The volume of money in the economy. This depends upon the balance of trade on current account and the balance on capital account, and internally, on government deficit or surplus financing policies.
- Government regulatory controls - Statutory Reserve Deposit ratios, lending limits, interest rate restrictions and open market operations.
- Movements in interest rates in general. One beneficial impact of falling bond rates, not often considered, is that the banks are very large holders of Commonwealth Bonds and can reap significant capital profits.
- The rate of increase in labour costs. These account for approximately 80% of total operating expenses.
- Demand for funds - level of advances.
- The proportion of interest bearing to non-interest bearing deposits.
- The extent of overseas exchange business. Banks have a monopoly in this area and profit margins are believed to be quite attractive.

There are many fringe factors that will influence bank profits from time to time, but basically, the prime profit determinants can simply be summed up as the flow of money into the banking system, the cost of this money, the rate of increases in advances and the lending rates charged.

Over the past twelve months banks have experienced very close to ideal conditions for good profit growth.

An easy money policy. Relaxation of various borrowing and lending restrictions (December 1971) and lower S.R.D. ratios.

- Government deficit financing.
- A positive balance of trade on current account.
- A high level of capital inflow (foreign exchange profits as well as higher deposits).
- Falling bond rates.
- Economic recovery and a growing demand for funds (mainly due to growth in personal advances as growth in business advances has been slow).
- Rising propensity to save a very cheap source of funds.
- Lower utilization of working capital requirement by business and growth in interest bearing deposits (I.B.D.'s) by institutions flush with funds and with no immediate alternative investment avenue.

An increase in the velocity of business can have a marked impact on a bank's profitability (as evidenced in the past year) because of the high fixed cost element, mainly wages.

3. THE INDUSTRY ENVIRONMENT

I. The Business of Banking

Commercial banking in Australia is dominated by seven major trading banks and these currently account for approximately 93% of all trading bank deposits.

In addition there are three State Government owned trading banks, three foreign banks, and the Bank of Queensland. All of the trading banks now operate savings banks and subsidiaries (accounting for approximately 36% of all savings banks deposits), the rest of the deposits being split up between the Commonwealth Savings Bank and the various State Government Savings Banks.

The Savings Banks are strictly regulated by the Reserve Bank and must hold 60% of their Australian deposits in designated liquid assets and government securities. The balance is available for housing loans or other purposes on the security of land.

The Trading Banks are also regulated by the Reserve Bank and their liquidity controlled through the dual mechanism of the Statutory Reserve Deposit (S.R.D.) system and the L.G.S. (liquid assets and Government securities), convention. Interest rate and open market policies also bear indirectly on bank liquidity. In addition, the Reserve Bank has the power to determine lending policies followed by Trading and Savings Banks and to give directions to them concerning the class or purpose for which advances may, or may not be made.

Australian Banking has its traditions set in the branch system and although it is generally accepted that Banks should provide this service to the community and industry, it is not always profitable - witness the large duplication of branches in rural area. Future banks mergers may help to rationalize this side of the industry.

Traditionally the banks have not ventured into the fringe financial areas, such as merchant banking and hire purchase. However, in recent years the trend has changed to the extent that all the major trading banks now have interests in these fields.

The main market for Trading Bank funds remains the provision of working capital for industry and commerce, but growing rapidly is the provision of personal loans, housing finance, bridging finance, commercial bill finance, lease financing, overseas buyers credit and export finance.

In the past, the main source of Trading Bank deposits has been in the form of non-interest bearing deposits. However in 1971-72, for the first time, total interest bearing deposits exceeded total non-interest bearing deposists (by $74 million). Since 1961 non-interest bearing deposits have grown by 53%, and interest bearing by 272%. This trend is expected to continue.

II. Competition

On December 13th 1971, the Reserve Bank announced the removal of official restraints on bank lending.

It added that the banks should feel free to meet the requirements of their customers, subject to their normal commercial judgement and to their individual liquidity positions. This decision has generally been hailed as an important breakthrough in terms of the competitive position of the Australian Trading Banks.

On the 3rd February 1972, the banks' borrowing requirements were altered so that they can now:

- Offer up to 6.5% for deposits in excess of $50,000 for periods from thrity days to four years, and 6.5% for certificates of deposit for three months to two years.

- For deposits of less than $50,000 maximum interest rates ranging from 4.3% to 5.5% can be paid for periods extending from three months to four years. A specified maximum is applicable to each period.

The removal of lending constraints had an immediate impact. During the early months of 1972, lending approvals rose to almost double the rate of the corresponding period in the previous year.

In relation to borrowings, banks have also proved to be highly competitive over the past twelve months. The thirty day I.B.D. rate offered by the banks (for amounts in excess of $50,000) proved equal to and often better than that offered by the nine official short term money market dealers - the only money market borrowers with anything approaching a bank's security. Given the banks combination of higher security and potentially attractive interest rates (scope to offer up to 6.5%), they should continue to provide strong competition to the many other borrowers in the short term money market.

Building societies have been attracting a larger slice of the personal savings market in the past one or two years, and this has proved somethings of a problem for the banks. However, there is a wide divergence in the degree of security offered by the two organizations and it is probably true to say that they serve different markets segments, although it appears that there has been a recent swing away from the building societies back to the banks.

The so-called fringe financial institutions have multiplied rapidly in the past decade and have gradually attracted a greater share of the total assets of all financial institutions in Australia. Of these, merchant banks have experienced the greatest growth, expanding from an insignificant position in 1960, to one where they now hold probably over 2% of the total assets. The more traditional financial institutions, such as life offices, pension funds, hire purchase companies etc., have also expanded their share of the total assets available at a faster rate than have the banks. It is probably unrealistic to expect the banks to significantly increase their share at the expense of these others, but they have made attempts over the past decade to come to terms with the problem:-

- they have themselves diversified into hire purchase and merchant banking.

- they have established Saving Bank facilities.

- and they have attempted to increase their competitive position in relation to the other financial institutions - the Government announcements in December 1971 have assisted in this direction.

III. Reserve Bank Controls

S.R.D. Ratios

Each Trading Bank which is subject to the Banking Act is required to maintain a S.R.D. Account with the Reserve Bank. The bank determines the minimum amount which each bank must have on deposit in its S.R.D. Account, and this is expressed as a percentage of the banks current level of Australian deposits.

Since 1960 the S.R.D. Ratio has been changed a total of thirty two times - the highest ratio being 17.5% and the lowest 6.6% (in November 1972). In the last few years the Government has noticeably reduced its dependence on changes in the S.R.D. Ratio as a means of effecting monetary policy, although some observers regard the recent action by the Labor Government to increase the ratio to 7.6% as an indication that it may once again be used as a major monetary weapon. The average S.R.D. Ratio in the early to mid 1960's was around 13%, but since 1966 it has never risen above 10%, and since April 1971 it has been below 9%. This is a clear indication of the increasingly competitive nature of the banks.

L.G.S. Convention

L.G.S. assets are defined as notes and coin, cash with the Reserve Bank, Commonwealth Treasury Bills and notes and other Commonwealth securities. The L.G.S. Convention has no statutory basis, but is a formal expression of certain firm understandings which were reached between the Central Bank and the major Trading Banks in 1956. Under the Convention, each Bank undertakes to direct its policy to ensuring that its L.G.S. Ratio (ratio of L.G.S. assets to deposists) does not fall below an agreed minimum. At the present time this minimum is 18%, although the average L.G.S. Ratio of the major Banks is substantially above this, being closer to 30%.

The L.G.S. Ratio of the banks is generally around 22%-23% over the May, June, July period, rising to around 30% in December. It is apparent therefore that the very high L.G.S. Ratio at the present time is most unusual and a reflection of the unique monetary conditions experienced over the past year. In January 1973, the L.G.S. Ratio reached 34.1% - its highest level ever.

The L.G.S. and S.R.D. Ratios combine to give the Reserve Bank effective control over Trading Bank liquidity. The other economic controls at its disposal consist of -

- Supervision of Savings Bank investment policy.
- The power to control bank lending.
- The power to control bank interest rate policy.
- Open market operations.

These weapons are designed to enable the bank to fulfil its charter as expressed in the Reserve Bank Act: "To contribute to:

- the stability of the currency in Australia
- maintenance of full employment
- the economic prosperity and welfare of the people of Australia".

Some of the power and influence of the Reserve Bank in the Australian economy has been restricted by the growth of the "fringe" financial institutions and the international approach taken by Australian business towards finance. Recent steps to overcome these shortcomings have included clamps being placed on overseas capital inflows, and the stated intentions of moving towards some form of control over the finance companies, merchant banks and building societies. The Concrete Pipes case appears to have cleared the way, constitutionally, for controls to be exercised.

If controls are imposed to any extent over the borrowing and lending activities of the fringe institutions, it would improve the banks' competitive position in the finance industry. This would seem to be consistent with Labor Party policy as it would give it direct control over a greater percentage of the nations financial resources.

If the Government acts in a short sighted manner and moves to re-impose tighter restrictions on bank lending and borrowing rates, they will not be able to compete as effectively. A reduction in the volume of money available to the banking system would force industry to turn to more expensive funds from the "fringe" institutions and this would increase the cost of money available to industry and create stronger inflationary pressures. To a certain extent this would also occur if there was a very significant lift in the S.R.D. Ratio.

4. DISCLOSURE

The banks operate under the Commonwealth Banking Act 1959-67, and not under the Companies Act. Requirements governing financial disclosure to the Reserve Bank under the banking act are exacting and comprehensive, but the requirements for disclosure to shareholders and the public are very sparse. The original reasoning behind the lack of disclosure to shareholders was to enable banks to make significant allocations to reserves from profits in any one year, to spread the disclosed results and even out the impact of a bad year. This was to prevent the possibility of a panic run on any of the banks.

The Australian Banks have now grown to a size and have developed financial depth sufficient to remove this threat and the need for the spreading of results is diminishing. Pressure is mounting both from within the banking system and from outside groups for full disclosure of profits. There seems to be a good chance that this will be achieved within a few years and as a build up to this taking place it seems logical that banks at least will gradually release some hidden reserves. The impact on declared earnings and other possible ramifications are uncertain.

5. THE FINANCE COMPANY AFFILIATES

Finance Company	Major Shareholders	Percentage Ownership
Alliance Holdings	Chase-Manhattan	32.75
	M.L.C. Limited	32.75
Associated Securities	Royal Bank of Scotland	28.7
Australian Guarantee Corp.	Bank of N.S.W.	51.0
Beneficial Finance	Bank of Tokyo	20.0
	Southern Farmers	10.0
Cambridge Credit	R.E.M. Hutchinson	20.0
	Hooker Corporation	10.0
C.A.G.A.	C.B.C.	80.0
	Bank of America	20.0
Custom Credit	N.B.A.	100.0
ESANDA	A.N.Z.	100.0
Finance Corporation	Bank of Adelaide	100.0
General Credits	C.B.A.	100.0
I.A.C.	F.N.C.B.	40.0
Lensworth Finance	Elder Smith	48.8
Mercantile Credits	Hong Kong & Shanghai Bank	30.0
	National Mutual	27.0
Mutual Acceptance	Chartered Bank of London	34.2
	Phillips Industries	14.4

The major trading banks have moved in to merge with the rapidly growing "finance" industry and they now control approximately 32 per cent of the total assets of the listed Australian finance companies.

The move to take an interest in the finance companies has been the first significant diversification strategy undertaken by the banks.

Finance companies have a different business philosophy. They developed to meet the financial needs of the community that the banks were unable, because of government restrictions, or unwilling, because management was tied to "the business of banking", to provide.

In their early years they were mainly involved in providing consumer hire purchase finance but recently the main growth has been in the field of commercial credit such as leasing and real estate finance. They are in business to provide finance on the most profitable terms, to balance risk and reward.

Management is quite flexible and innovative and does not have to contend with a large branch system or the heavy fixed costs involved with servicing a large number of re-occuring transactions. Compared with the banking system the finance companies are not particularly labour intensive. They are ideally complementary to the banks and affiliation between the two makes a lot of sense.

Integration of the finance companies into the banking system raises some interesting conjecture on the aspects of both government control over liquidity and the banks' business strategy.

If the existing government controls remain on the banks and are not applied to the finance companies, then potentially at least, the banks would be able to encourage the borrowing and lending activities of their finance affiliates in times of tight liquidity. Naturally the banks cannot directly channel funds into their finance companies but the emphasis of managerial effort and business promotion could conceivably be shifted. The banks will profit by this flexibility as finance companies traditonally do better in times of tighter liquidity because of their ability to borrow at competitive rates. The extension of government controls over the finance companies, of similar nature to those now applicable to the banks, appears inevitable. Such action will have a side effect of re-enforcing the borrowing status of the finance companies and after a settling down period, the net impact will be to the benefit of the whole system of banking and finance.

The various banks will probably take a different view of the integration of their finance affiliates. Strategically, the two basic alternatives are to let the finance companies continue to operate as separate units or to integrate them fully in a business sense as a first step to the development of a banking system providing a much wider range of finance services.

6. THE CURRENT OUTLOOK

As far as the profit outlook is concerned for the banking system as a whole, the direction of some of the key determinants is changing and the outlook for the others is uncertain. As the economic recovery gathers pace there must be growing pressures on available resources and the need will ultimately arise to restrict the availability of credit to prevent overstimulation of some sectors of the economy. The S.R.D. ratio has already been increased slightly from 6.6% to 7.6%.

The direction of the flow of capital from abroad is changing from net inflow to net outflow and the volume has tapered off considerably.

Internal interest rates in general have started to move up. There appears to be evidence that consumers are beginning to spend the large build up in savings deposists.

On the external side, the outlook for the balance of trade is good and some degree of government deficit financing, can be expected to continue. The demand for funds, involving probably quite a rapid utilisation of the available credit within the banking system, will build up in line with the expanding economy.

The profit contribution from the finance company affiliates should grow as economic recovery accelerates and liquidity tightens.

7. FUTURE TRENDS

Diversification moves started slowly but the momentum has been gathering pace. The major Australian trading banks now have significant interests in finance companies and merchant banks, and are involved in investment fund management, unit trust, trustee and nominee company services, insurance and travel. Some are also planning to actively develop their property interests. The basic move towards the development of a one-stop finance house is clearly evident.

Innovations towards facilitating credit transactions in the retail trade have been slow to materialize. The provision of a credit card service has been under investigation for some time. Experience in the U.S.A. has been rather sobering as far as profit contribution is concerned and the Australian banks are likely to proceed with caution. Profit prospects are not exciting.

The possibility of a Giro banking operation being established by the Australian Post Office has recently received some publicity. What is the possible impact that this could have in competition with the money transfer system operated by the bank? As wages rise the impact of fixed costs on the bank's branch system could conceivably mean that the bank's profitability may not suffer significantly if a large number of the transactions involved in the money transfer system are replaced.

Perhaps the most important future trend, as far as the impact on profitability is concerned, is likely government philosophy. Will the banking system be regarded as an extension of treasury and the reserve bank which should be, in effect, nationalised?

Or will the Labor party's philosophy of the 1940's fade and be replaced by a changing attitude towards the desirability of a growing flexible and well managed banking system capable of increasing its role of providing the cheapest source of finance to meet a wider range of business and community needs?
i.e. will an attempt be made to recoup the old controls on lending and borrowing and perhaps to increase them particularly in relation to the direction of lending, or will free market prices be accepted as economically desirable? The influence of the Reserve bank and Treasury and of course the balance of power in Caucus, will be important. Will the government choose to try and reduce the cost of finance in the business community by encouraging the growth and competitive ability of the banks or will they take the narrow and short sighted view that finance costs can be reduced by restricting interest rates and placing clamps on the bank's profit levels?

Changes in managerial philosophy are generally slow in materialising. Over the past few years there have been stirrings within the banks and the use of management consultants, statements of business strategy and a more enlightened recruiting programme, have all emerged as clear signs of some change in thinking by top management. A stronger profit motive seems likely to be injected into the business of banking and much more thought is no doubt being given to the direction of future growth. A more aggressive marketing approach is emerging and this has been encouraged by the timely removal of lending and borrowing restrictions in December 1971.

Future trends in disclosure may be quite enlightening.

Mergers have been significant throughout the entire history of the Australian trading banks. The system is still considered to be "over banked" but this is really only in relation to the branch system. Further the over banked element could probably be removed by rationalization of branches by the existing banks.

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ECONOMIC FLUCTUATIONS IN AUSTRALIA: 1948 TO 1964

By A.M.C. Waterman (A.N.U. Press) 1972

Dr. Waterman, now Associate Professor of Economics in the University of Manitoba, Canada, was awarded a Research Scholarship at A.N.U. from 1964 to 1967 for a study into fluctuations in the Australian economy. This work is the outcome of those studies.

The first chapter summarises the results of an attempt to measure the post-World War II business cycle. Chapter 2 contains a simple theoretical model, together with a brief review of the econometric literature relevant to fluctuations in Australia. These first two chapters comprise the statistical and theoretical skeleton around which the four subsequent narrative chapters are composed. The conclusions reached by Dr. Waterman after his study of the history of economic fluctuations in Australia are the following five propositions, arranged in descending order of certainty.

1. Each episode was unique.
2. The behaviour of the world economy was highly influential upon that of Australia throughout the whole of the period studied.
3. Government policy of a disinflationary nature was nearly always directed not to the internal situation, but to the balance of payments; and was, therefore, put into effect at times when the forces of contraction had already begun their work.
4. Government policy directed to expansion was generally successful and well timed.
5. The average rate of growth would not have been faster, but possibly slower, had fluctuations not occurred.

"The alternation of expansion and contraction", he argues, "has probably afforded more opportunity to enterprise than would a long period of steady growth. New ventures have been attracted in booms and inefficient firms weeded out in slumps. The recurrent possibility of bankruptcy is essential to the health of a free-enterprise economy. In addition to this the occasional collapse of artificially inflated values has probably been to the long-run advantage of the economy ..." (Page 213).

This is a scholarly addition to that series of analyses of particular periods of Australia's economic history which have originated from the A.N.U. and other research establishments. It contains abundant detail on the period covered of interest to economists and policy-makers.

- E.F.G.