So far as the future prospects of my bank are concerned the Board has already announced that profit from banking for the year to September is expected to be a record. To this will be added 100% of CCC's profit for four or five months.

However, 1974 is most difficult to forecast but again, so far as my bank is concerned, September 1974 will be the first occasion on which consolidated profit will benefit from the whole of CCC's profit for a full year.

Whether this will suffice to allow us to show another increase in consolidated profit depends on what direct the Government's expected anti-inflation moves take and the effect of that upon those profit determinants mentioned in your working paper.

The group is now stronger than ever - more diversified (although still in the type of business it understands) and is demonstrating increading flexibility. These are all, surely, grounds for some optimism.

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SOME ASPECTS OF THE SHORT TERM MONEY MARKET IN AUSTRALIA

(An address delivered by Mr. L. Wilkin to the Queensland Branch of the Society on 26 September, 1973.)

1. INTRODUCTION

The short term money market in Australia can be divided into two broad sectors, the official and the unofficial markets.

1.1 Official

The official market consists of 9 dealers, the main characteristic of which being that they have the right to borrow "lender of last resort" funds from the Reserve Bank. In return for this security, the dealers are subject to controls placed on them by the Reserve Bank.

1.2 Unofficial

The unofficial market at the present time consists of possibly about 100 organisations which are involved in different capacities. The unofficial market could be further divided into

- the buy-back market
- the intercompany market
- the commercial bill market.

However, it is difficult to see a complete distinction between the official and unofficial markets, as there is dual membership by most official dealers as well as a strong inter-relationship between the securities provided. It is generally estimated that if that estimate is correct, then at present (September 1973) somewhere between $1,500 million to $1,600 million would be deposited on the money markets.

In describing how a money market dealer functions, I will use the official market as the example. Time only permits a very sketchy outline.

2. HISTORY

Until the 1950's the opportunities for short term investors were largely limited to the banks' fixed deposits. During the 1950's hire purchase companies began to offer short term debentures to finance their growth, and at the same time some sharebrokers developed a short term "buy-back" market in Commonwealth Bonds. Buy-backs took the form of sales of Bonds by the broker to the lender, subject to the broker's agreement to repurchase at a pre-determined price and time. As this market grew in size, some concern was felt at the market's ability to handle repayments and, in 1959, the newly-formed Reserve Bank established the Official Short Term Money Market by granting last resort loan facilities to four dealers - soon increased to the present nine. The short term investor could now rest assured that his loan would be repaid if he used the official market.

3. SOURCE OF MONEY

The official market draws its funds from a number of sources, the main ones being:

- Banks - drawn to the official market particularly because of the security provided and because the volatile nature of bank funds requires that most funds deposited be available on an 11 a.m. basis - a facility not always provided by unofficial dealers.
- Semi and local government bodies - subject to restrictions as to how surplus funds can be invested but in most, if not all states, the official market qualifies. Loan monies and rates acquired in advance of need would comprise most of their short term surplus funds.
- Companies - large and small, insurance offices and other institutions, building societies, finance companies, and so on might produce a surplus from normal cash flow, capital increases, loan raisings or build up for payment of tax or dividends.

4. PATTERNS IN FLOW

There are quite definite patterns in the supply of money available to the money markets in Australia. For example, there is a:

- yearly pattern. Normally, a gradual build up occurs to November, a run down to Christmas, a further build up to February, then a run down to June as Company tax is paid. Government action to spread the payment of company tax over a longer period will even out some of the fluctuations.
- monthly pattern. Commonwealth payments to the States on the 1st and 15th of each month usually means a greater supply of funds in the first and third weeks of the month than in the second and fourth weeks.

- weekly pattern. The popularity of Thursday as a pay-day requires the Banks to fund their Branches to cover pay cheque withdrawals and thus leads them to call money off the market on Thursdays.

Then unusual events can have a very significant impact on the flow of funds to the short term money market. Recent examples ot events have been:

- Minsec problems of February 1971 lead to a significant switch of lenders from the unsecured to secured sectors of the market.
- Currency realignments of February 1973 saw large withdrawals of overseas funds from Australia.
- Government action aimed at controlling inflation through such monetary measures as increasing the Banks' S.R.D. requirements, and increasing interest rates have lead to withdrawals from the money market.

5. DEALING

Having seen the main sources of money and the patterns in money flow that one can anticipate, we come to the dealing process.

5.1 Daily Balancing Operations

A dealer's activities during each day follows a fairly regular time pattern:

8.30 - 9.30 a.m.	Dealers ascertain the Banks' money movement. This virtually sets the pattern for the day, as the Banks are the largest single group of lenders to the market. If the Banks are large callers, dealers will be actively seeking funds to balance and interest rates may rise during the day. Conversely, if the Banks are large lenders interest rates may fall as dealers seek to activate calls.
9.30 - 11.00 a.m.	Deposits and calls made. 11.00 a.m. is the deadline for calls.
11.00 - 2.30 p.m.	Further deposits, sales or purchases of securities until dealer balances. If a dealer wishes to use the Reserve Bank's lender of last resort facility he must arrange this before 2.30 p.m.
3.00 p.m.	Banks close.

The times shown are Australian Eastern Standard times. In view of the tight time pattern it will be appreciated that different time zones as between the States have to be taken into consideration by parties to money market dealing and can be a complicating factor.

It has already been indicated that the supply of money each day influences interest rates, and it is this fluctuation in supply of money which causes interest rates to fluctuate widely. A dealer must also have regard to the following factors in setting his rate:

(i) His earings yield on funds invested, and the available yield for the investment of new funds.

(ii) Term of each loan i.e. call or fixed.

(iii) Type of lender. It will be recalled that money comes to the market from a number of sources; a dealer will try to spread the source of his deposits to play down the effect of concentrated calling from one source. Furthermore, some lenders prefer a daily fluctuating market rate, others prefer an average market rate; the dealer must ensure that the average rate is a fair one, having regard to market fluctuations over a time. Finally, some lenders will shift money around the market seeking the best available rate each day; they tend to get high rates on "tight" days and very low rates on "easy" days - a dealers expectations of market conditions on subsequent days could determine the attractiveness of this sort of money and thus the rate of interest he will offer.

Thus a dealer is trying to:

(a) Seek money to replace loans called.

(b) Profitably invest additional funds, or find a buyer for securities if he wants to sell.

In other words, he can balance either with:

- money - through lenders to the market
  - borrowing from or lending to another money market dealer
  - borrowing from the Reserve Bank, using the lender of last resort facilities.

- or securities - buying or selling so that at the end of the days operations the amount of money held on deposit is equal to the securities held.

Incidentally, money on the short term money market is very volatile. A high percentage - probably over 90% is at call, and a dealer can expect to turn over his holding each week.

5.2 Dealing in Securities

An indication of the holdings of dealers in recent years is given below. The table is taken from the Reserve Bank's Statistical Bulletin, and gives some details of the influence of seasonal fluctuations.

Authorised Dealers - Selected Assets (a)

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	Commonwealth Government Securities (face value)				
	Treasury Notes	Bonds	Total	Commercial Bills	Certificates of Deposit
June 1967	13.7	454.1	467.7	32.8	-
June 1968	116.2	375.1	491.3	35.7	-
June 1969	46.4	459.2	505.6	28.9	15.0
June 1970	7.6	567.7	575.4	38.3	3.6
June 1971	20.6	661.4	682.0	45.4	3.4
Sept 1971	29.8	758.9	788.7	39.3	2.9
Dec 1971	83.4	778.3	861.7	21.7	9.0
Mar 1972	110.9	860.1	971.0	15.2	16.5
June 1972	40.9	934.1	975.0	39.8	20.8
Sept 1972	213.8	743.1	956.9	22.0	54.4
Dec 1972	287.7	763.6	1,051.3	17.6	41.3
Mar 1973	232.6	724.8	957.4	34.9	55.1

(a) Weighted average of weekly figures.

As the above table shows, the major investment held by dealers is Commonwealth bonds, maturing within five years. Over the last few years, Treasury Notes have been extensively used, particularly when dealers want to shorten the average maturity of their assets.

Dealers stand prepared to make bids and receive offers for parcels of securities at competitive prices at all times. Normally, Commonwealth securities are dealt in $100,000 minimum lots; however, other assets have no such minimum.

Any fluctuation in market yields on the assets held by a dealer affects the market value of his portfolio. Dealers therefore attempt to forecast future movements in yields in order to vary the maturity structure of their assets according to expected movements. Thus, when a rise in yields is expected dealers will shorten their assets to minimise capital losses; when a fall in yields is expected the maturity of assets is lengthened to maximise capital gains.

6. RESERVE BANK INVOLVEMENT

The Reserve Bank plays a vital role in the operation of the official market. It provides various facilities and imposes some requirements.

6.1 Facilities

(a) Lender of Last Resort: Its most important function is as lender of last resort. This provides liquidity to dealers in that they can borrow against the bulk of their assets. Although the Reserve Bank does not accept responsibility for the repayment of the dealer's individual loans or for his solvency generally, this facility provides the essential stability of the market and insulates it against the effects of abnormal situations in the general level of liquidity. Loans made to dealers under the last resort facilities carry a penal rate of interest, and as a further discouragement to their use, the Reserve Bank requires that last resort loans may not be repaid in less than seven days.

(b) Safe Custody System: The Reserve Bank maintains a safe custody system for dealers' holdings of Commonwealth Government securities. Under this arrangement, Commonwealth Government securities acquired by a dealer may be lodged with the Reserve Bank; on the dealer's instructions, the Bank issues safe custody certificates which are delivered by the dealer to the lender against loans accepted. On repayment of the loans, the certificates return to the dealer to be available as security for new money found in replacement.

(c) Interstate Movement of Funds and Securities: The Reserve Bank maintains special clearing accounts for dealers by means of which funds and securities may be transferred quickly from city to city. As the Reserve Bank provides safe custody facilities at all its branches it can arrange the issue of certificates at any of these points as required by the dealer.

(d) Daylight Overdrafts: Normally the dealer must be able to settle an amount called before he has been able to collect replacement funds. Although the new funds are likely to have been arranged quite early in the day, the lender will not be prepared to hend over his bank cheque until security is available. Therefore the dealer must issue cheques for repayment before new money is available. The Reserve Bank allows dealers quite substantial overdrafts during the day to meet these commitments but requires all accounts to be in credit by the close of business. On the security side, to assist with the movement of safe custody certificates as security cover between lenders, and also in security trading, the Bank is prepared to issue to a dealer certificates and securities in excess of his holding through the day, provided his position is covered by the end of the day.

(e) Direct Access for Dealing: Official money market dealers and stock brokers are the only institutions to which the Reserve Bank allows direct access to deal in securities. All other institutions must deal through an intermediary. The Reserve Bank trades actively with dealers in securities to assist with the smooth operation of the market and also to provide an orderly market for Government paper. The Reserve Bank also provides a market for large parcels of securities which otherwise could have a disrupting effect on market yields.

(f) Information Collection and Publication: Dealers are required to consult regularly with the Reserve Bank on all matters pertaining to the market. They must provide the Reserve Bank with detailed information about the composition of their assets and liabilities and about the level of interest rates currently being paid for money. Dealers must also provide the Reserve Bank with copies of their balance sheets and profit and loss accounts at regular intervals. Much of the information provided by dealers on a regular basis is collated and published by the Reserve Bank. Details of dealers' Commonwealth bond trading can be seen in the "Financial Review". Figures of net movements in total liabilities to clients over the week, together with minimum and maximum rates of interest paid on loans accepted by dealers, are released each week. Details of dealers' liabilities classified by type of client, and some details of asset holdings and interest rates are published each month in the Reserve Bank's Statistical Bulletin.

6.2 Requirements

(a) Composition of Assets

The Reserve Bank limits the amount of loans a dealer can accept to a multiple of 33 times its shareholders' funds ("the gearing ratio"). This means that the more capital a dealer company issues or the more reserves it accumulates the greater will be the volume of liabilities to clients which it can accept.

The Reserve Bank also imposes a limit on the assets which a dealer may acquire, which is currently as follows:

- A maximum of twenty per cent of the maximum amount of loans as determined by the gearing ratio may be held in non-government securities:
  - (i) commercial bills, both bank and non-bank endorsed,
  - (ii) certificates of deposit maturing within five years, and
  - (iii) a small holding ($2\frac{1}{2}\%$) in "other assets", such as long bonds, shares, debentures, etc.,
- The balance must be held in:
  - (i) Commonwealth Government bonds maturing in less than five years,
  - (ii) Treasury Notes,
  - (iii) A limited amount of securities of public authorities (i.e. semi and local governments).

(b) Capital

Each dealer company must have a minimum paid up capital in cash of $400,000.

(c) Minimum Transaction

The minimum amount for deposits or repayments is $50,000.

(d) Bank Cheques

A loan to a dealer must be made by bank cheque, and must be secured by the delivery to the lender of appropriate security. The determination of an appropriate security margin for each loan is a matter for negotiation between the lender and dealer.

7. DEALER PROFITABILITY

As described above, the business of a dealer in the official money market may be considered in two parts - money and securities. Apart from his shareholders' funds, a dealer cannot acquire or deal in securities without borrowing money and conversely he cannot borrow money without having securities to cover loans.

The emphasis on the area of concentration to make profits (or minimise losses) varies between dealers. There are three profit areas, as below:

(a) A dealer may concentrate in deriving income from the margin between the buying and selling prices for securities, using the money side of his activities mainly as a way to finance his security portfolio;

(b) Allied to this a dealer will derive income from the correct composition of his portfolio when the bond market rises and falls in sympathy with movements in interest rates;

(c) A dealer may concentrate on deriving his income from the margin between the yield on his portfolio and the interest paid to lenders, and trade in securities only as much as is required to maintain a balanced book.

As movements in interest rates is the major determinant of profit - ability, money market dealers results tend to fluctuate considerably as they benefit from falling interest rates or suffer when interest rates rise.

These trends clearly emerge from an examination of the annual results of each dealer since the inception of the official market. For example, all nine official dealers showed profit down turns in 1970, and all showed record profits in 1972 when every dealer recorded an earing rate on shareholders funds in excess of 20%.

8. MONETARY POLICIES AND THE OPERATIONS OF A MONEY MARKET DEALER

The Reserve Bank sees the official dealers as a source of funding for government debt or stated another way they increase the market for government bonds. Obviously the unofficial dealer, with his greater freedom, cannot be counted on by the Reserve Bank to participate heavily in the financing of the Government.

In return for its services, the Reserve Bank, through the constraints it places on the authorised dealers, is provided with means to be informed about the monetary movement in the economy; it also gains access to a sector, other than the banks, through which it can conduct its open market operation in order to influence the money supply and related interest rate structure.

At the present time we are seeing very dramatically the effects that sharp rises in the interest rate structure have on a short term money market Company. These effects have of course been widely publicised in the last week or so, and one comment made that a fall in values of around 2% would mean a <u>paper</u> write-down of \$16 - \$20 million in the value of the nine official dealers' total portfolio would not be far out.

Extent of effect of write-down for each dealer would vary according to the length of his portfolio - the sooner existing holdings mature the sooner a dealer can transfer into higher yielding stocks (assuming he holds to maturity). So, for example, an official dealer who has a large percentage of Treasury Notes in his portfolio, or an unofficial dealer who has a large percentage of bank bills or N.C.D.'s is better placed to quickly improve his earing yield.

Dealer doesn't have to hold to maturity. He can sell. This however converts a <u>paper loss</u> into a <u>real</u> loss, and when the rise in interest rates is sharp as what we are seeing now, the prospective capital loss if these assets are sold is such that most dealers would rathe hold to maturity than sell. It's not an easy decision - he must weigh the prospective loss on sale against the higher yield he can earn with the funds released. Also he needs to consider whether or not interest rates have peaked, and the higher cost of borrowings funds should money become less plentiful.

Rising interest rates produce other effects; if dealer regards himself as being locked in as far as securities are concerned he can't run down to help him balance on a tight day. So it reduces his balancing options on those days which tend to force interest rates higher.

I have described the major effect of rising interest rates. In case this presents too gloomy a picture of the STMM Company in the present situation, let us not forget that a dealer benefits from falling interest rates. At that time he stands to make capital gains on his securities, and also will probably be able to earn a significant margin on money borrowed.

Official dealers have been operating for 14 years. Many unofficial dealers also have plenty of experience. They are well aware that they operate in a cyclical industry and adopt a policy of accumulating reserves at times of healthy profitability to cushion the effects of difficult times such as are being experienced at present.

9. CONTROLS OVER THE MARKET

The question of controls - or lack of them - over short term money market dealers is one which has also been getting a lot of coverage lately.

(a) Official Dealers

I have already indicated the controls placed on Official Dealers and the effect of those controls.

I might say that the requirements laid down by the Reserve Bank in relation to the composition of portfolios have been modified on various occasions to bring the requirements to their present levels. Dealers would wish to see further relaxation, as the market becomes more sophisticated.

(b) Unofficial Dealers

Unofficial dealers are free from controls as to composition of portfolios although a dealer must register under the Securities Industry Act in each state and these Acts impose some constraints.

As you all know, the present Australian Government has announced its intention to bring down legislation to in some way impose controls on "fringe banking". This is likely to interest Merchant Bankers and others who operate as unofficial dealers, so this sector of the market too, is likely to be controlled in the future.

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