THE BANKS' SHARE OF THE FINANCIAL SECTOR — THE TREND AND ITS CONSEQUENCES

Address by
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The Subject

This afternoon, I should like to spend a few minutes talking about a subject which I believe is not only important to banks, but also to you and everyone else who is interested in promoting and encouraging an efficient financial structure in this country. The subject? — "The Banks' Share of the Financial Sector — the Trend and its Consequences".

In the time at my disposal I will attempt to:

- demonstrate the declining share of banks within the sphere of their trading and savings bank operations.
- offer some views to explain the reasons for this decline.
- put forward some arguments as to why a continuation of the present trend would be unfortunate not only for the banks but for the efficient functioning of the financial system.
- and finally, to suggest ways in which the present trend may be arrested and hopefully reversed.

To do full justice to such a wide-ranging topic would take a much longer time than I have at my disposal so I will attempt to keep as short as possible my comments on the first section establishing the evidence of the decline. This will allow me to concentrate on the reasons and consequences of the decline continuing, and to discuss the remedies which I have to offer to arrest and hopefully reverse the trend.

Declining Bank Share

Turning first then to the share of assets of banks compared with the total assets of all financial institutions operating in the Australian markets. To establish that the banks' share has in fact declined I want to make a short excursion into statistics quoting from the "Financial Flow Accounts" supplement of the Statistical Bulletin of the Reserve Bank of December 1977, earlier issues of the same statistics dealing with the position prior to 1965, and the Australian Bureau of Statistics series relating to the Financial Corporations Act to examine the trends beyond 1976. I apologize that this will involve a recitation of figures.

Looking back 25 years to 1953 the Reserve Bank series indicate that trading banks held about *36%* of total assets of all financial institutions. This figure declined by well over one-third to 23% in 1976. Savings banks declined from 23% in 1953 to 17% in 1976. The December 1977 Reserve Bank supplement tracing the year-by-year performance from 1965 to 1976 reveals some even more interesting trends of what has been happening in comparatively recent times. Trading banks, for example, held 23.4% of total assets in 1965. This share remained unaltered in 1975. But, in the intervening years it fell to a mere 19.5% in 1972. It recovered as I said in 1975, to the level of 11 years previously. In 1976, however, the decline was on the way again.

The savings banks declined from 22.1% in 1965 to a low point in 1974 of 16.9%. Their subsequent recovery to 17.6% in 1975 was far less decisive than the trading banks, but like the trading banks their share also edged down again in 1976 to 17.4%.

The Reserve Bank combines trading and savings banks in their financial flows study along with the relatively minor and stable item of "other banking institutions" which includes the assets of the Commonwealth Development Bank and the Australian Resources Development Bank. This series records that the combined banks' share declined from 45.4% in 1965 to 37.5% in 1972, recovering to 41% in 1975 before tapering off again in 1976 to 40.7%, and this represents a net loss of nearly five percentage points in 12 years. As we have seen, most of the loss was in the savings banking operations.

Where have the main gains been made? Certainly not by the life offices or pension funds, or even the Reserve Bank itself.

Collectively these three have in fact also suffered a decline in the 11 years to 1976, from 33.5% of total assets to 25%. This highlights the rapid gains of the others, particularly the money market corporations or merchant banks, the credit co-operatives, the permanent building societies, general financiers, and finance companies. In fact the annual rate of growth of the merchant banks of 42.5% in the 11 years to 1976 was three times as fast as the average asset growth of all institutions. Credit co-operatives grew at the rate of 34% per annum, general financiers 26.6%, and finance companies 20% per annum. By comparison the "all banks" growth was only 11.9% per annum.

While these figures show graphically the varying rates of growth of the institutional groups they are now two years out of date. But it is possible to deduce an approximate performance from the statistics of those corporations subject to the Financial Corporations Act. The statistics are not strictly comparable but they are useful in illustrating trends compared with the banks over the same period. In the 19 months from July 1976 to February 1978 when the rate of growth of all financial assets has declined, credit co-operatives grew at an annual rate of 46%, permanent building societies 28%, merchant banks and finance companies both 17%, compared with trading banks 13% and savings banks 12%. So it seems conclusive that banks' share of total assets is continuing to decline.

Reasons for Decline

Before I go on to discuss the reasons for this decline, I thought it may be useful to mention that this trend of a declining bank sector is not something peculiar to Australia. In fact I read recently of an address by Mr. Gordon Richardson, Governor of the Bank of England, in which concern was expressed about the rapid growth of building societies in the United Kingdom at the expense of banks. The Governor is reported to have admitted that the growth of building society deposits is a matter that may have to be taken into account in future in administering monetary policy. The implication from these remarks is that the Bank of England may not be able to ignore any lack of response from building societies, for example, to a general market fall in interest rates. If the societies chose to hold their rates in, say, some cartel-type operation they would probably attract a flood of funds from other savings institutions. In current jargon, the Governor is recognizing the limitations of implementing monetary policy by a surveillance of M_3 alone, i.e. notes and coin and bank deposits, when there is a large and growing volume of private sector liquidity held by building societies.

The statement is significant because the Bank of England is obviously flexing its muscles to bring the societies into line when interest rate changes occur in the market, to stop the surges of funds into the housing market. He called on the societies to become more flexible to changes in rates and to compete rather than pursue competitive policies akin to a cartel-type of operation. He also suggested they diversify their lending into other areas, to become more cost-control conscious in branch establishment, and to seek a portfolio of term deposits in the light of their long-term lending.

My point in airing these recent comments by the Governor of the Bank of England is simply to demonstrate that the problem of supervising, or at least monitoring, the operations of financial institutions beyond the banking system is not just a local Australian problem. Even in countries which do not operate under a federal system of government as we do in Australia, there is confusion and hesitancy as to how far one goes in regulating financial institutions other than banks.

Returning then to my theme concerning the local scene, why is it that the banks have seen their pre-eminent position in the Australian financial market gradually whittled away over the past 25 years? As we have noted, the drift was steady until the mid-1960s, moved down further in the subsequent seven years until 1972 and recovery was short-lived before a new decline set in after 1975.

Many would argue that it is the banks' own fault that they have lost market share. They have been too slow off the mark to identify changes in the market. They are conservative to the point that they are incapable of innovation. Banks do not compete with one another, they are a "cosy club"; they have been so preoccupied with lending on a fully-secured basis that they won't take reasonable risks; banks are passive or insular. Some would even go so far as to say that banks are "sleepy", "unsophisticated", and possess a "steamship mentality".

If you subscribe to these views, and I certainly don't, let me remind you of some of the innovations that have occurred in banking over the past two decades.

Term lending, including farm development lending, personal loans, leasing, leveraged leasing, active operations in the commercial bill market, consortium loans, the establishment of the Australian Resources Development Bank Limited, plus a wide range of export and import financing procedures, and the establishment of the Australian Banks' Export Refinance Corporation Limited. In addition, since the relaxation of interest rate controls for larger transactions, banks have become far more competitive with other financial institutions and with each other in issuing marketable certificates of deposit and in attracting larger interest bearing deposits. On the lending side they are equally competitive. Savings bank investment accounts introduced in 1969 offer attractive rates with a minimum of restrictions on their withdrawal. If I may indulge in a little advertising, my own Bank now conducts over 4m savings accounts and having regard to that number and the size of the populations we serve, I don't feel happy about being called sleepy. In more recent times Bankcard has been introduced. I could go on. In my view, banks have served and are serving Australia well with a highly sophisticated, cheap, and efficient payments mechanism in their retail banking operation through a wide net-work of conveniently located branches, most of which are now computerized. This has greatly added to the efficiency of the cheque-handling process. They are efficient and competitive funds gatherers and their lending rates are generally more favourable than their non-bank competitors. The banks' operations, in other words, extend into the so-called wholesale banking sphere competing for very large deposits and generally overseeing and advising the corporate sector on their total fund-raising programs and contributing to these in their own lending operations.

I can assure you bankers are not lazy; they are innovative. They are not members of a cosy, cartel-like club; they are sophisticated. They may be still a little conservative but this depends largely on definition; they certainly don't like taking unnecessary risks. After all, they are offering loan facilities at the cheaper rates and naturally they place their funds first in the less risky ventures but I can assure you banks do take risks and they don't always pay off or should I say pay up!

You may well ask at this juncture why have the banks lagged behind other financial institutions in asset growth. If they are so innovative and competitive, where is the problem? The answer lies, I believe, in the inordinately heavy burden banks have to bear in taking the full brunt of monetary policy restraints imposed by the Reserve Bank. These restraints are designed to limit the growth of financial aggregates by directly controlling changes in the volume of money. We are all well aware that for some years now Commonwealth Governments have indulged in heavy deficit spending with mixed success in funding these deficits by non-bank public subscription to government bonds. The impact of these fiscal transactions has forced the authorities to rely increasingly on monetary policy measures as the main instrument of restoring economic stability.

I am sure you are all familiar with the terms direct controls and market-oriented policies when applied to monetary policy. Over the past two decades successive Reserve Bank Governors have made frequent reference on public rostrums and in annual reports to their preference for the market policies.

We in the banking fraternity have welcomed these statements because it had become alarmingly apparent to us that a continuation of the central bank's policies of the 1950s would have led ultimately to the relegation of the banks to an insignificant role in financial markets. Obviously the shrinking role of the banks was a matter of concern to the Reserve Bank and more particularly so in the years prior to the re-discovery of the "Corporations Power" in the Constitution and the subsequent enactment of the Financial Corporations Act in 1974.

Viewed from the other end of Martin Place in the years up to 1971 and from across the road since then, we in the Bank of New South Wales were heartened to see concrete evidence that the Reserve Bank, from about the late 1960s, was beginning to place less reliance on direct controls of the banks through the statutory reserve deposit mechanism and quantitative restrictions on bank lending. Instead, the central bank began placing greater emphasis on influencing the quantity and price of money across the entire spectrum of financial corporations by dealing in its portfolio of government securities.

The bank also seemed prepared to take a lead role in confirming official interest rate changes when market trends and pressures indicated the need for new rates.

The birth of this new strategy, I suggest, pre-dates the establishment of the official short-term money market in 1959 for it was a lack of a market in government paper which circumscribed use of other than direct instruments of control in the 1950s. The implementation of the market-oriented approach was delayed until the late 1960s and hence the continuing attrition of the trading banks' share of total assets of all financial institutions.

As an essential part of the market scheme the trading banks certainly began to see evidence of a lessening of control by the Reserve Bank after the mid-1960s. This was manifest in the gradual relaxation of interest rate controls and with permission to engage in a wider range of banking activities such as personal loans, special type bridging finance, and leasing at rates of interest above the then current overdraft maximum rate. Permission to issue certificates of deposit dates from 1969 and restrictions on interest rates for these were removed towards the end of 1973. All quantitative restrictions on bank lending were removed towards the end of 1971. I could go on at length to quote all the pieces of evidence that the Reserve Bank was committed to a policy of liberalizing its direct control over the banks to enable them to compete more effectively with the non-bank financial institutions. At the same time, the central bank indulged to a greater extent in open-market operations to influence the volume and availability of liquidity.

It is indeed unfortunate that this long-term change of strategy began to bear fruit in the early 1970s at a time when world economic affairs were moving to a state of turmoil. For this reason the soundness of this market-oriented approach has never been given a fair trial but the emerging evidence after 1971/72 was encouraging. Looking back, it was little wonder with M_3 increasing by 20% per annum and inflation running at about 17% that the Reserve Bank saw the need to restrain new bank lending in March 1975. In that month the Reserve Bank decided to take the extreme step of re-imposing quantitative restrictions on bank lending; we thought, as a temporary measure. The banks received a second major shock early in 1976 when their controlled-lending interest rates were reduced (at the same time as loan limits falling within the control were extended to loans up to \$100,000). At the time, this move was taken it was against the general trend of interest rates and coincided with the launching of the Australian Savings Bond. This latter development had a direct impact on the growth of the savings banks. I will return in a moment to comment on the special and continuing disability of savings banks to compete with higher cost, permanent building societies which not unnaturally are less attuned to a national perspective.

The third major contemporary change affecting the rate of growth in bank assets has been the setting of targets for growth in the volume of money (M_3). This development first appeared in the 1976 Budget and emerged again with an even tighter target for 1977/78.

I do not seek to be brought into any public debate on the efficacy of any of these moves which have, in my view, had a decidedly dampening impact on the growth of both trading bank and savings bank assets. I must admit that the Government and the monetary authorities were faced with a Herculean task in reining in the rate of inflation and in view of the size of budget deficits and the subdued tempo of economic activity, it was almost inevitable that crisis measures would be implemented through monetary policy.

During the period since March 1975, the Reserve Bank has also practised a policy of firm restraint on the margin of free liquidity held by the banks, even though the banks have adhered fairly closely to the quantitative guidelines on new lending activity. The banks have found this additional restraint all the more irksome as the move in itself has not altered the growth in M_3, but simply led to a re-arrangement of trading bank assets. The re-arrangement has involved giving up reasonable yields on government securities in exchange for low interest earnings on statutory reserve deposits. Since 1975 S.R.D. accounts have risen to a proportion as high as 10% of deposits yielding a mere 2½% or at least 6% below the shortest-dated government paper and even further below the cost of the underlying deposits to the bank.

From the foregoing comments you will have an inkling of the final section of this paper. I am a firm believer in the market mechanism with all its imperfections as being more efficient than a controlled and regulated system.

I believe that it would not be in the best interests of the Australian financial system to impose statutory restraints on the full range of financial institutions. The weight of evidence from countries which have attempted draconian measures to regulate the full spectrum of financial institutions, suggests that new forms of institutions emerge to by-pass the restraints. In the Australian scene, where we have the additional hazard of the federal system of control and divided responsibility for the supervision of the operations of institutions, I would doubt the wisdom and certainly discount the success of such an approach.

Instead, I would see merit in the Reserve Bank capitalizing to a greater extent on the information supplied under the Financial Corporations Act to guide and influence, quite firmly when necessary (but still by moral suasion), the volume of lending operations of these institutions. Merchant banks with extensive off-balance sheet operations could pose a special problem but a solution should not be insurmountable.

Having declared my hand against the wisdom of spreading formal controls over a wider range of financial institutions than simply the banks or having declared my hand in favour of fiscal neutrality, where does that leave the banks?

So far as the savings banks are concerned there would seem to be no justification for the continuation of the requirement to invest 45% of deposit liabilities in prescribed assets of Commonwealth local and semi-government securities along with cash and deposits with the Reserve Bank. In practice, the savings banks invest a major part of the 45% in local and semi-government securities, thereby contributing substantially to the basic government infrastructure provided by local and semi-government authorities. By contrast, building societies are required by State legislation only to maintain liquidity ratios varying from 10% of share capital (or deposit as they are referred to in common usage) in New South Wales, to no liquidity requirement whatsoever in Tasmania. Moreover, building society deposits have demonstrated far greater volatility than savings banks in recent years, at times and fortunately in isolated circumstances, placing severe strains on their ability to meet the pressures of withdrawals exceeding lodgments of new money. These occurrences have been rare because the large majority of societies, and particularly those in New South Wales, through responsible management have voluntarily maintained realistic margins of free liquidity well in excess of the statutory requirements.

In short, the prescribed assets ratio of savings banks at 45% is far too high in relation to a reasonable proportion of liquid assets for purposes of safety or for purpose of reasonable liquidity requirements. Equally, the State Government statutory liquidity requirements of building societies appear to err in the opposite direction. The competitive aspects of this situation are fairly obvious.

So far as the trading banks are concerned, I am satisfied that given the removal of quantitative restrictions on their lending operations and further gradual easing of controls on their borrowing and lending rates, they would more than hold their own with other financial institutions. In other words, I would hope that the authorities will take the first opportunity of reverting to heavier use of market-oriented policies and lighter use of the direct controls methods to achieve its central banking role.

I do not see this happening overnight but the remarkable progress that has been made in bringing down the rate of inflation to just over 8% from the dizzy heights of 17% four years ago encourages me to think that a degree of normality in the financial markets is not too far distant.