SOME ASPECTS OF THE INTER-COMPANY MONEY MARKET IN AUSTRALIA

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I will begin by giving a brief history of the general growth of the inter-company market, the users of the market, the patterns of cash flow in the market, the controls exercised by users of the market, and some general comments and to then remark on some obvious advantages and disadvantages of using the inter-company market.

Whilst one would expect the professional users of the inter-company market such as the merchant banks to employ strategies for both borrowing and lending funds, all users of the market should be aware of some obvious strategies which will be financially rewarding to their company through the intelligent use of the market. I do not profess to know too many of the various strategies of the inter-company market, but I shall conclude my address later with what I hope may be some examples of either 'playing one's hunches' or employing skilled strategies — you may take your own choice of which you think is the more positive interpretation.

History And General Growth of Inter-Company Market

Unlike the official money market which came into being in February 1959, the inter-company money market saw its commencement back in the early 1950's when several large pastoral companies and finance companies were lending part of their surplus liquids to first class companies. In the early 1960's the monetary restraints in the banking system at that stage encouraged the banks themselves to arrange for certain of their clients who had surplus credit funds to lend direct to certain of their other clients who were seeking short term loans,with the bank itself marking down the borrower's limit facility during the period of the loan to give a protection to the lender that the funds would be repaid when required. This stimulus to the inter-company money market has resulted in this section of the market now growing to be probably the largest area of funds placements in the whole range of the short term money market.

Whilst no accurate figure has been ascertained as to the volume of funds that flow through the inter-company money market, the general opinion of those close to the market would be that the inter-company market would be approximately two or three times the size of the official money market, that is, currently say $3,000 to $4,000 million.

Prior to the late 1950's, a number of the larger stock and share broking houses in Australia participated in the 'Buy Back' market whereby government and semi-government securities were sold and re-purchased at a later date at an agreed rate of return to the investor. This 'Buy Back' market continued to expand through the 1960's, although today it has limited use. The late 1960's and early 1970's also saw the advent of both overseas and locally connected 'merchant banks' entering the Australian money scene, which led to large developments in the overall money market, including establishment of a bills market which will be covered by other speakers.

This development of 'merchant banking' has led to several alternatives available to depositors seeking to place funds. First, of course, there is a secured deposit made against the lodgement of securities such as bonds or semi-government stock, debentures, or bills, either bank or non-bank. Next there are unsecured deposits. Rates quoted by 'merchant bankers' vary from 11.00 a.m. call through to term periods ranging from 14 days fixed to perhaps one year, although sometimes longer. Generally speaking, most 'merchant banks' would tend to fund their operations with six months as a maximum. For both secured and unsecured deposits rates vary in line with the volume of funds available in the market, throughout the year, 24 hourly call rates for example having moved over the past ten years anywhere from a low of less than 4% p.a. to a high of over 20% p.a. — it's the simple rule of supply and demand.

The growth of the market from its beginning back in the 1950's can be put down to two factors. One obvious factor is inflation and companies just have more loose money now than they did back in the 1960's and have to do something with it. Secondly, financial controllers are now far better educated in how to manage money than they were some years ago. Companies are now aware of the advantages of placing out their short term funds, and of the cost savings in borrowing as an offset against overdraft or for a term.

One area of the inter-company market which has shown a strong growth over the last decade is the placement of funds against the security of an irrevocable letter of credit from an overseas bank.

Following the recent collapse of Associated Securities Limited, I think it would be fair to say that the medium and smaller finance companies in particular will avail themselves to an even greater extent of fund raisings from this section of the market.

Whilst the overall total of funds lent in the inter-company market has shown an increase over the years, one change which has developed is that up until about five years ago the inter-company market was almost invariably the leader in terms of rate variation upwards and downwards, whereas since 1974, it has become more and more apparent that commercial paper bank and non-bank now tends to set the trend in rate, and the inter-company market follows. We have had an example of this in the period from February of this year where bank and non-bank bill rates have been rising steadily whilst the inter-company rates remained comparatively static, and indeed probably lagged by about six weeks before they started to move noticeably. It was interesting to compare inter-company rates early in April both for call and periods to six months, and to note that there had been virtually no change since January. Between April 3 and April 17, a period of 14 days, inter-company rates rose in the call end by at least one per cent and showed a similar variation in the 180 day end; which is a fairly steep rise over a relatively short period. By comparison, commercial bill rates had been creeping up slowly since about the end of February. Conversely, early last month good quality inter-company borrowers were paying 11% p.a. to 11.25% p.a. for 180 day fixed term funds from the market and 180 day bank accepted bills were trading in the market at yields of 10.85/10.90% p.a. to the investor. Four weeks later in the last week of May good quality inter-company borrowers were still paying 11/11.25% p.a. for 180 day fixed term funds whereas 180 day bank accepted bills had fallen to yields of 9.90/9.95% p.a. This was certainly seen as a signal by astute term investors to take advantage of the more attractive area for investment in the inter-company section of the market.

Users Of The Market

Public and private companies both large and small, insurance offices and other institutions, finance companies, manufacturing companies, mining companies and major retailers provide the bulk of surplus funds for investment in this market from normal cash flow, capital increases, loan raisings or the build up of liquidity for the payment of company taxation or dividends.

A large percentage of the top 200 companies in Australia transact business on the inter-company market. In addition, hundreds of private companies, both large and small, lend to the various areas of the money market and this number is increasing with the growing sophistication of company secretaries, investment managers and finance controllers.

Patterns In Cash Flow

The patterns in cash flow for the whole of the money market were covered in detail by one of the previous speakers, Mr. Robert Biven of Trans City Holdings Limited, and I would like to cover those aspects in the patterns in the supply of money which have an effect on the inter-company money market in Australia. There are a number of definite patterns and these can be classified under the following headings.

1. Yearly Pattern

Normally there is a gradual build up to November of each year, a run down to Christmas, a further build up to February and then a major run down to June as final company tax and provisional tax is paid.

2. Quarterly Pattern

Following an earlier unsuccessful attempt to introduce the quarterly payment of company taxation in the mid 1970's, the Commonwealth Government legislated for the re-introduction of this pattern as from November 1977. This quarterly flow of money which commences in mid-August of each year has tended to smooth out the major peaks and troughs of liquidity for the money market system.

3. Monthly Pattern

The Commonwealth Government makes payments to the various state governments on the first and 15th day of each month and this usually means a greater supply of funds in the first and third weeks of each month than in the second and fourth weeks.

There are also other factors which influence the monthly flow of funds on the inter-company money market and these relate to the monthly tax payments of payroll tax, PAYE tax and sales tax. In addition, the Australian banks are required to adjust with the Reserve Bank their Statutory Reserve Deposits on the second Wednesday of each month.

4. Weekly Pattern

The popularity of Thursday as a pay day requires the banks to fund their branches to cover pay cheque withdrawals and this leads to the banking system requiring money from the money market on Thursdays of each week.

Weekly excise payments by the brewery and tobacco companies also has an affect on the weekly cash flow.

5. Other Factors Affecting the Pattern of Cash Flow

There are a number of factors which affect the pattern of cash flow such as the major injections of cash into the banking system to cover in particular Christmas spending and, to a lesser extent, Easter spending; buoyant seasonal conditions that occur from time to time and are now being experienced by the rural sector of the economy, and unforeseen events such as industrial confrontations which result in mail strikes and even instances of bank strikes.

6. *Unusual Events* can also have a very significant impact on the flow of funds to the short term money market. Examples in recent years have been:

(a) Minsec problems in 1971 which led to a significant switch of lenders from the unsecured to secured sectors of the market.

(b) Currency realignments of February 1973 saw a large withdrawal of overseas funds from Australia.

(c) Governmental action aimed at controlling inflation through such monetary measures as increasing the bank's S.R.D. requirements and increasing interest rates have had significant effects on the flow of funds to the market.

(d) The effectiveness of the banks in competing for funds on the money market has been dramatically demonstrated since September 1973, particularly since the rates at which they were allowed to borrow funds on their Negotiable Certificates of Deposit raisings were not fixed by the Reserve Bank and they were allowed to actively compete within the money market at rates which they considered were necessary to attract funds from major corporate lenders.

(e) The collapse of Cambridge Credit Corporation Limited in 1974 and more recently the collapse of Associated Securities Limited in February of this year has influenced lenders to be very selective and/or security conscious when lending to the finance section of the money market.

The pattern of flow of funds plays a major part in the volume of business that is transacted through the inter-company money market particularly with companies who are seasonal and who are very mindful of reciprocity to the market when opportunities present themselves. For example, a large manufacturing company may find that for three of four months of the year his cash flow is such that he is a major borrower from the market. An intermediary will be able to arrange loans for him in view of his good name and commercial standing to satisfy his requirements during this period. The lending company will be mindful of the fact that later in the year its cash flow situation will be such that it could be seeking short term funds from the market and reciprocity could be available if circumstances permit.

Controls

Most companies who lend to the inter-company money market do so from approved lists of borrowers and depending on the standing of the borrowing company's name, approved loans usually vary from $100,000 up to $10 million (and even higher in exceptional cases) in any one parcel. The vast majority of all loans are done on an unsecured basis and the strength of the borrowing company's name is the major reason which governs the size of the limit that is afforded to him by the lending company.

Generally speaking, lenders prefer to lend to companies who have a minimum capitalisation of $10 million (although a lesser amount could be accepted in the light of the strength of the major shareholders of the borrowing company), show a good record of profitability, good management and proven directorate, display a regularity and consistency in dividend payments, and preferably be listed on an Australian Stock Exchange. Exceptions to this last requirement would be major merchant bankers and multinational corporations such as major oil companies, etc.

In addition, all lenders to the market will have their own yardstick for assessing to which companies they are prepared to lend their surplus funds. The main considerations normally centre around:—

- Paid Up Capital
- Shareholders' Funds
- Net Profit
- Comparison with other companies in same industry
- Current Ratios
- Long Term Ratios
- Total Ratios
- Cash Flow.

General Comments

Intermediaries have played a major part in the development of the inter-company market and it would appear that whilst there will always be a section of the market whereby various companies will lend direct to borrowing companies, the major volume of funds has tended to flow through intermediaries such as stock brokers, merchant banks, and money brokers, and this pattern is expected to continue in the future.

The reason for this is the fact that an intermediary who specialises in this area of the market is able to provide a much wider coverage of the companies who borrow from the market and a number of lenders prefer to keep at 'arms' length' from the companies with whom they place funds. This is particularly the case where a lender may not wish to disclose to a particular borrower the volume of funds that he has surplus to his requirements and which can be invested in the market until he has ascertained the most attractive rate that is available from any of the companies who are borrowing from the market and whose name would appear on his approved list of borrowers.

One cannot stress too highly however the ethics that must apply to all dealings on the money market, and this relates not only to all the lenders and borrowers on the market but to intermediaries as well. As a broker acts for both borrowers and lenders at the same time he must ensure that the interests of both parties are served. At times there can be difficulties in this regard but the simplest way for a broker to act is to place himself in the position of the other party to the transaction.

Supply and demand dictates the rates of interest on the inter-company money market:—

(a) the floor rate is usually the bank deposit rate for 30 days or the daily official short term money market rate or short term treasury note rate;

(b) the theoretical ceiling rate is represented by the maximum bank overdraft rate.

In practical conditions however the ceiling rate moves in excess of the maximum overdraft rate during periods of strong borrowing pressures and in such circumstances is related to the alternative cost of stand-by loans such as the drawing down of commercial bills, etc. This applies particularly when traditional lending sources in the banking system are under restraint.

Advantages of the Inter-Company Money Market

1. In the majority of cases a higher average interest rate is obtained by lenders of funds invested in the inter-company market.
2. The convenience of issuing ordinary cheques as against the drawing of bank cheques.
3. With a lower incidence of movement in interest rates there is less administration by borrowers and lenders with funds

invested on the inter-company money market.

4. Over a period of time consistent users of the inter-company money market benefit from reciprocal business that flows because of the different cash flows that occur on a seasonal basis with users of the market.

Disadvantages

1. The main disadvantage of the inter-company market is that with fixed term loans there is no degree of flexibility for a lender who may wish to have access to his funds prior to maturity. In this regard the inter-company money market has suffered by the build up of business in both the commercial bill market and the market for one name or Promissory Note paper.
2. The majority of loans are on an unsecured basis and as such a constant review of approved companies is necessary by lenders to ensure the quality of borrowers from time to time.

Strategies

Some Practical Examples for Lenders:

1. Lending longer in periods of declining interest rates, e.g. September lending six months.
2. Lending either at call or for short term periods only (maximum say 30 days) in periods when because of the shortages and anticipated shortages of funds in the money market system, rates are moving upwards.
3. Whenever possible arrange for term funds to mature when the market will be tight and a keen demand will exist for funds, for example the last Thursday before the first of the month or the 15th of the month.
4. If the market is tight and term interest rates high and if rates are expected to fall substantially prior to the anticipated receipt of funds earmarked for investment on the money market, the finance controller of a well respected public company should consider the possibility of lending term funds in advance and borrowing call or short term funds from the market to bridge the period prior to the expected inflow.
5. Avoid investing in other areas of the market, e.g. the purchase of 180 day bank bills, when official market rates are very low. It is better to invest funds on an 11.00 a.m. basis with an inter-company borrower at a steady rate of interest and then commit to the purchase of 180 days bank bills when the official market is tight. A recent example of this strategy was on Friday, 8th of this month when a lender to the market received a cash inflow of $½m late in the day. During the day the official market interest rates had eased quite substantially and the 180 day bank bill rate had also eased from 10.3% to 10.1%. Rather than buy bank bills at 10.1% the lender decided to invest the $½m with an inter-company borrower at a steady 11.00 a.m. of 9% p.a. The following Thursday the official market interest rates were in double figures and the 180 day bank bill rate had recovered to 10.3%. The lender consequently recalled the 11.00 a.m. funds at 9% p.a. and invested in 180 day bank bills at 10.3%.

   Financial benefit to the lender is summarised as follows:—

Interest for 180 days @ 10.3% p.a. on $½m.	$25,397.26
as against	
Interest for 180 days @ 10.1% p.a. on $½m.	24,904.11
Gain:	$493.15
less: Difference between investment for 6 days @ 10.1% p.a. as against 6 days @ 9% p.a.	90.41
Net Gain:	$402.74

6. A variation occasionally used by lenders of term funds, normally of say 90 days duration, who have budgeted that for a recent percentage of their short term investments no requirements will be needed for at least 12 months, is to place funds for a term period of say 12 months with the right-to-break at three monthly intervals subject to say

seven to 30 days prior notice to the borrower. This strategy, used intelligently with likely downward movements in interest rates, can be most rewarding for the lender. In the event of an unexpected exercising of the right-to-break the deposit, there is normally a penalty provision for an abatement of the interest rate.

Strategies

Some Practical Examples for Borrowers

1. If term funds are considered more prudent borrowing in lieu of steady funds at 24 hours' notice of call consideration can sometimes be given to taking a portion of the total term borrowing on a fixed period of 30 days and continually rolling over the funds for say the next five months rather than initially committing one's borrowings totally to the interest rate for six months at the outset. I should hasten to add that this strategy is best followed when interest rates normally tend to decline after the tax rundown in the June quarter and the flow of funds to the inter-company market is increasing.

   Let us take as an example a good quality industrial company borrowing say $4 million on July 15, 1978 and taking a mixture of say $3 million for six months at the then interest rate of 10.50% p.a. and $1 million for 30 days at 10.25% p.a. with a view to rolling the later borrowing each 30 days for the next five months. The average interest rate for 30 days borrowings would have been:—

15.7.78	10.25% p.a.
15.8.78	10.00% p.a.
15.9.78	10.00% p.a.
15.10.78	10.00% p.a.
15.11.78	9.75% p.a.
15.12.78	9.00% p.a.
6)	59.00
Average Rate	9.83% p.a.

   As against a fixed rate for 6 months of 10.50% p.a.

   This strategy of course should only be considered if the borrowing company is confident that in the event of an unforeseen tightening in money supply it can either borrow replacement funds from the market in the event of a recall or avail of stand by lines of credit, either trading bank or merchant bank.

2. It is essential for a company who anticipates to be a borrower on and off for a number of years on the market to build up the reputation of fair and ethical dealings. A lender will always give preference to a borrower who does not consistently repay funds on very liquid days in the marketplace and who is not too quick to renegotiate interest rates downwards when the market is falling. A number of borrowers also tend to keep existing call borrowings ¼% per annum above the market when rates are falling and it is not surprising how the goodwill from this practice is remembered by lending companies when interest rates turn upwards and when further borrowings are difficult to obtain from the market.

Conclusion

Because of the convenience and ease in which the inter-company money market operates it is expected to grow in size although inhibiting factors in this regard will be the development of the commercial bill and Promissory Note market and any governmental action that could be taken as some future time such as the imposition of stamp duty requirements, etc.

During the past 20 years there have been several occasions when one could have anticipated a major contraction in the size of the inter-company market because of company crashes already mentioned, such as Mineral Securities Australia Limited and Cambridge Credit Corporation Limited. Such contractions however of the inter-company market have proved to be of temporary nature only and following a return of investor confidence the volume of funds for investment has continued to surge ahead until at the end of 1978 record levels would have been held on this section of the market.

The Associated Securities Limited crash in February of this year has once again thrown the market on to the defensive but it would not be surprising to see that after a period of re-assessment and a tightening of the quality of companies to whom lenders are prepared to lend their funds, the market will regain confidence again and continue to expand because of the convenience, speed and simplicity that it affords to users of the market.