MERCHANT BANKING AT THE CROSSROADS

An Address by

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The development of merchant banks in Australia is a relatively recent phenomenon. What may be forgotten is that most of the early merchant banks were offshoots of stockbroking partnerships.

I suspect the spinning off of merchant banks resulted from a realisation of the inadequacies of the self imposed partnership structure in stockbroking. It is peculiar that the partnership structure is still being religiously defended today — at least officially — the more so because the arguments being used for its retention are weak at best.

The arrival of the foreign banks in the late sixties and seventies brought a commercial banking perspective to the Australian merchant banks who soon found it more lucrative to compete largely against the banking cartel than against the broking cartel.

The trading banks were accustomed to handsome margins and there was more profitable business unprotected in that area than in trying to compete on the fringes of the equity area without access to the secondary market business.

Merchant banking as it developed through the seventies had a distinctly commercial banking flavour to it and I suspect the greatest proportion of industry profitability came, and still comes in fact, from the simple business of borrowing and lending money.

Some merchants, however, have developed skills more traditionally associated with investment banking overseas such as debt and equity underwriting, corporate advisory roles related to mergers and acquisitions and general financing, investment management, project finance advisory, lease packaging and more recently futures trading.

Presumably each merchant bank has made deliberate choices about business direction, reflected in their product range.

It is also important to point out that some stockbrokers have diversified their services over the full range of merchant banking activities and some now advertise themselves as investment banks. The lines of demarcation, particularly between stockbrokers and merchant banks, have become almost indistinguishable with one rather glaring exception — secondary market trading in pieces of paper called "shares" as opposed to secondary market trading in the multitude of other similar pieces of paper.

More recently the trading banks, showing a commendable measure of charity and community spirit, have moved into debt underwriting. How far the banks will seek to go in this direction is an open question.

By a remarkable coincidence, we will have two very important inquiries affecting our business options reporting in the one financial year. Of course the first of these, the Campbell Report, has already been hailed, largely by those who haven't read it, as a blueprint for reform of the financial system. In my opinion, a classic case of judging the book by its cover.

It is the first report of its kind in 45 years.

The second inquiry, a determination by the Trade Practices Commission on the restrictive practices of the stock exchanges, is due in its interim form in less than a month. These restrictive practices had their origin in the U.S. in the signing of the Buttonwood Tree Agreement in 1792 — almost 200 years ago.

On my calculation that makes stockbrokers the oldest profession to retain fixed scales of fees but of course only the second oldest profession overall. The oldest profession, I understand, has had negotiated rates for centuries but still competes actively on service and manages very successfully to differentiate the product. If these two inquiries are to have an impact on the finance industry, we may yet live in historic times. Merchant banking is very much at the crossroads.

I believe the Cambell Report fails by its own test on the issue of competitive neutrality between banks and non-banks financial intermediaries.

Tim Congdon writing in the critique of the Report titled "A New Financial Revolution?" ed. by Professor Malcolm Fisher says:

> "it is no exaggeration to say that competitive neutrality is the conceptual pivot of the Campbell Report"

Professor Fisher himself in the introduction writes:

> "The Committee attaches great importance to competitive neutrality, a term never really defined ... In essence, the Committee wants every financial institution to have a fair go, and no undue privileges to be preserved for any category ... Unfortunately it is less clear that the Report advances its objective".

I take my hat off to the banks for their success in convincing almost everyone and especially the Committee that the growth of merchant banks in the credit business has been a reflection of the restrictions placed on banks.

It's peculiarly fortunate for the banks that this tremendous burden of regulation has not adversely affected profitability which one might have expected to be the case.

The consolidated results of 5 major private banks, now conveniently merged into 3 banks to facilitate more aggressive competition amongst themselves, reveals a growth in profit over the last 5 years of 264 per cent or a compound rate of growth of 30 per cent per annum on average.

The Labor Party has singled the banks out for nothing less than a super profits tax. On my calculations of profitability, the banks rate very highly on any international comparison.

The Campbell Committee concluded that:

> "The banks have long had exclusive rights to provide cheque payment and foreign exchange services. This represents a *very significant privilege*[1] ... the ability of banks to provide a comprehensive range of financial services, including cheque payment and foreign exchange facilities, can confer competitive advantages over the full range of their facilities" (32.11).

In Campbell's Interim Report the advantages banks enjoy were described as a "competitive inequality" (I 27.20)

In the light of its objectives of competitive neutrality the Report strangely recommends that

— banks retain their monopoly in foreign exchange

— banks retain effective government credit status through the investor protection provisions of the Banking Act and in any event, through sheer political reality (do you take seriously the prospect of a bank failing in this country?)

— and banks retain their monopoly of the payments mechanism.

Even more strangely, the Report also recommends the removal of all competitive offsets to these "very significant privileges", even as far as near market rates of interest on the Variable Deposit Ratio. It's about as competitively neutral as having a Frenchman referee a French Rugby International in Paris.

Quoting again from Congdon on the British experience:

> "The ending of quantitative lending restrictions in 1971 enabled the banks to enter and eventually dominate the medium term corporate finance market ... Again analogous developments are likely in Australia if deregulation proceeds on the lines favoured by the Campbell Committee."

In my view, banks will have such a superior competitive advantage, not because of their own initiatives or energies but because of legislated monopolies recognised by Campbell. They can and may well further dominate the corporate lending market.

This had significant implications for all merchant banks but particularly for those who are heavily oriented to the lending business.

Many merchant banks have probably taken heart from the Committee's recommendations on the question of entry to banking. After extensive deliberation, the Committee recommended unrestricted domestic entry and "carefully managed" entry for foreigners, whatever that means.

However, there is one small problem that seems to have been overlooked. The Bank (Shareholdings) Act limits participation in a bank by any one shareholder to less than 10 per cent. This, in my opinion, has been the single most prohibiting factor to new bank sponsorship.

Now the Report recommends that the Act be repealed but they did not deal with the political likelihood of that happening. The Committee have come up with an elaborate scheme for deregulation of financial

[1] Speaker's emphasis.

intermediation on the assumption that the Act can be repealed. It is like coming up with an elaborate plan for the intensive irrigation of the Gibson Desert on the assumption the water will be available.

Well the water is not available and the Bank (Shareholdings) Act has no better chance than a few numbers on a roulette wheel of getting through the Senate in this political climate let alone whats coming in 1983.

But the Government has already embarked on a horse-trading exercise changing the competitive balance between banks and non-banks in the fairly certain knowledge that there will be no new players in banking — domestic or foreign.

So much for the high road to merchant banking success, what about the low road? Will merchant banks take a path similar to the investment banks in Japan and the US which requires gaining access to the equity markets?

This now hinges on the Trade Practices Commission but I understand they have asked permission to release their report under that wonderful title "Where are the Customers' Yachts?".

These days it's more "Where are the Customers' Champion Racehorses and Personal Jets?".

I'm not going to bore you with the arguments for and against negotiated commissions. That's for the Commission to battle with, but the lead up to the Trade Practices investigation, so full of ironies, deserves a mention.

After the issuing of the writ of mandamus by AMBA against the TPC, no lesser figure than the Chairman of the AASE telexed the foreign shareholders of merchant banks asking them in quite colourful terms to "exert sufficient influence" to have the writ withdrawn.

The merchant banks were described as taking "irresponsible and immature action" thereby showing to the world that "they could not conduct themselves responsibly": of "alienating the government" and their own clients and bringing "everlasting harm" to our financial markets, and to themselves "in the eyes of the Australian Government and community at large"

The attack then switched to a version of guerilla warfare waged through the Letters to the Editor Column of the Financial Review. The objective seemed to be to point out the dangers of foreign domination and influence on financial intermediaries. What seemed to escape the letter writers was that the alleged and much feared foreign domination and influence had been decidedly difficult to enlist when called upon by the Chairman of the AASE.

I suspect many merchant bank shareholders had their attention drawn to the mandamus writ for the first time on receipt of that telex and were thoroughly bemused by the whole affair. What the letter writers would have us believe is that the foreign shareholders were sitting back and pulling the strings of the local puppets.

It is not clear whether these letters from interested members of the public, who by some remarkable coincidence also happened to be stockbrokers represented the threat of the AASE to "fight back with every weapon at their disposal" but it did bring to my attention and I'm sure to many others the extreme dangers we run on a day-to-day basis with a foreign dominated and controlled accounting profession.

I was only surprised they did not go on to expose the threat of communist infiltration.

The complete irony of the whole mandamus affair was that AMBA was persuing its lawful right in the Federal Court. I hope I won't see the day in this country when the exercise of one's rights under the rule of law is regarded as an "irresponsible and immature" act.

All the fun aside, the Commission did finally begin its work and the Report is imminent.

For the punters among you, a study of the form guide would have the collusive activities of the stock exchanges, long odds-on to be abolished.

In the period since the introduction of the Act, I can find only two cases where authorisation has been granted in respect of anyway analogous applications. Both are in the media area.

Against these cases, one must weigh up such closely comparable cases as the engineers, real estate agents and stock and station agents where the applications for restrictive practices were refused.

For my money I'd bet on negotiated commissions and freer entry to set the stage for the removal of the artificial differentiation between investment banking stockbrokers and investment banking merchant banks. Any other result would seem to go against all the basic tenants of the Trade Practices Act.

In fact great credit goes to the authors of the AASE submission for having the imagination to write 271 pages in defense of the indefensible.

I believe merchant banks will find the going increasingly tough in the banking side of their business. The fight for profitability, perhaps even survival, will be conducted as much at the political level as in the market place.

I think we all have far less to fear from a widening of the competitive parameters in the securities industry than we might imagine. Notwithstanding negotiated commissions in the US market, the investment banks have just recorded a year of record profits.

In a business where personal skill and energy are the ingredients of success, the productive among us will still be much in demand. Fair and unfetted competition is at the very root of our economic system and philosphy. It would be sad to lose sight of that in the nerve centre of our capitalist system.

THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

Members are advised of a congress of the European Federation of Financial Analysts Societies (EFFAS) being organised by the German Society of Financial Analysts. The congress is to be held in Mainz from September 28 to October 1, 1982. The theme of the congress is:

"Forecasting — Investment Decisions in a Rapidly Changing World"

If any members of the Institute are interested in attending the congress and would like further details please contact the Federal Secretary.