AUSTRALIAN MERCHANT BANKING TWENTY FIVE YEARS YOUNG†

by

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Over twenty-five years the Australian merchant banking industry has undergone tremendous and rapid growth and development. After beginning in the late 50's they have become a major force in the Australian financial markets. In spite of two reviews of the financial system, both recommending wide deregulation, they remain a strong influence in the market.

FROM MYTHS TO MAGNATES

Evolution rather than revolution, has characterised the development of Australia's capital and financial markets. Their progress and direction has largely been a result of government policies and guidelines which, in retrospect, have been somewhat pragmatic. Consequent to such a highly regulated environment, potential for growth, initiative and innovation have been rather stifled.

Yet, within, the confines of the Australian system, one group has emerged, in the space of just a quarter of a century as the most adaptable, progressive and strongest growing in the financial services sector. This group is the Australian merchant banking industry, which since the late 1950's has contributed most to the melioration of Australia's capital markets. In the last twenty-five years, they have pioneered in the commercial bill markets, provided avenues for off-shore finance, various short-term finance options, for example the promissory-note market and cash-management trusts, and they have maintained a competitive edge in the corporate services sector of the market. Their initiative and aggression has given them the enviable position of being viewed in the market as "financial intermediaries offering a complete range of financial services to business".[1]

However, it is only in recent times that merchant banks have cast off a mystique which surrounded them into the seventies. In fact their obscurity prompted the Federal Treasurer in 1983 to observe that "that state of knowledge about just what these merchant banks are doing and whom they are is very poor".[2] But there can be little doubt that in the last twenty-five years it has been the merchant banks who have injected real dynamism and innovation into the marketplace and perhaps after twenty-five years it is worthwhile to reflect on their development.

OUT OF THE MARSHES

It is generally viewed that merchant banking in Australia began in 1959 when the official money market was established, but there were many forces at work prior to 1959 which laid the foundations upon which not only the official market would rest but from which the secondary market was to grow. Hence it is instructive to consider how the capital markets were operating both at and prior to 1959.

In the early post-war period the banking system held sway over two-thirds of private sector assets, the remainder being in the hands of life offices and pension funds.[3] Consequently the corporate sector was faced with very few alternatives when attempting to invest short term surpluses. Trading banks were prohibited from paying interest on deposits for periods of less than thirty days and with little or no market in government paper it was the sorry fact that surplus funds generally lay idle.

On the other side borrowers had recourse to: the intercompany market, debt/equity issues or finance companies. But the very nature of the intercompany market closed it to all but the most creditworthy companies. Debt/equity issues were an unrealistic option for small firms and unlisted companies and the interest burden inflicted by the finance companies made them a generally unpopular option.[4]

During this post-war period government policy was directed toward low interest rates despite strong pressure for redevelopment. This pressure saw the floating of many new companies with a consequent flood of new equity and debt securities hitting the

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market. And it was during this period that stockbrokers initiated a 'buy-back' market where they offered short-term deposit facilities against the security of a parcel of government bonds. In this context of a sudden surge of corporate fund raising and the slow hatching of the money market, the first small emergence of merchant banking could be seen in about 1949.[5] Pressure on the government continued to mount with the market widening the rate structure and an increased money supply until finally it succumbed, abandoning its low-rate policy in 1951. This was followed by action removing support from the existing bond market. Interest rates freed up and a real market in government securities appeared imminent.

But into and during the fifties it remained the stockbrokers who provided short term money facilities through the 'buy-back' market. And it was two of Australia's leading brokers who were responsible for the formation of two of Australia's first merchant banks. In 1953 Australian United Corporation was formed, promoted by Potter Partners, in the same year the Development Finance Corporation opened its doors.

And thus we arrive at 1959 and the year Capel Court Corporation began business, inspired by that other broker J.B. Were & Son.[6] Yet still the corporate sector retained a vast volume of untapped surplus funds. Seeing this opportunity the Reserve Bank took the step of establishing the official money market by extending lender of the last resort facilities to, initially four, but later a further five, dealers to become a primary market in government paper. Naturally the government responded by increasing its use of open market operations and by releasing new types and shorter term paper. And so began the primary market after a period of more than ten years during which the Australian financial markets were permitted or contrived into the conditions which prevailed in 1959 and thus facilitate the basis upon which the infant merchant banking industry was to grow.

THE FOUR AGES OF MERCHANTS

(1) 1960 - 1965 (Infancy)

In these early years the market in which the official dealers traded was still government securities, prior to 1960 the bill market was still untapped for other than trade purposes. But in the early sixties "one or two companies realised that the process of intermediation might be just as effective with negotiable bills of exchange as with government bonds. At the same time, it provided an opportunity to tap the considerable volume of funds being placed with trading banks."[7] In addition the early to mid-sixties was a period of tight credit whilst booms in equity and real estate created new interest in overseas investment in Australia. This awareness encouraged three new merchants with origins in London to begin operations in Australia, and another local merchant was opened to facilitate the interchange of funds through the money market.

In 1964 the Reserve Bank conducted a formal enquiry into the future of the market, the upshot of which was that the nine official dealers were allowed to expand their portfolios to include bank endorsed and bank accepted bills of exchange. And in 1965 the trading banks received assent to issue and endorse bills of exchange and commercial bills.

So, whilst in this period actual penetration of the market by merchants was low it was during this period that conditions ripened for the merchants to make their push. The vanguard of foreign interests into the sector was established and as the government had done little to relinquish controls over the trading banks and other institutions the way was clear for progress.

(2) 1965 - 1972 (Adolescence)

It was in 1965 that "a private enquiry was conducted to consider whether a commercial bill market was necessary. The decision was that such a market had a place in the finance sector but that participation... should be restricted to the banks and authorised dealers. But the people and organisations interested in promoting an active market pressed forward, and the decision gave birth to a viable primary and secondary market in bills of exchange outside the official banking sector."[8] It was in this secondary market that the merchants found a niche from which was to originate most activity and penetration into the markets at large.

The mid to late sixties were highlighted by the mineral discoveries of the resources boom. The acceleration in mining activity in this period was to make heavy demands on the capital market's capacity to provide funds and support for the development of both the mining and its allied industries. However, it was apparent that our own capital markets were at that time incapable of servicing the demand.

Coupled to this was the obvious attraction Australia then represented to overseas investors, and such a keenness to be involved was just as obviously welcomed in Australia for it was Australia's lack of overseas connections and its long standing restrictions on the granting of new bank licences which necessitated the development of new methods of injecting funds into and through the market.

June 1967 saw Australia's merchants holding only 0.3 per cent of total assets held by financial institutions[9] yet it was from the merchants that the initiative and injection of funds would flow.

As overseas institutions became enthused with the prospect of new markets they opened representative offices or sought shareholdings in local merchants. Affiliations of nature were naturally welcomed to improve both borrowing capacity and to secure standby facilities. For those growing and new banks, most with overseas links, the logical place in which to participate was the bill market, and consequently Australia benefited from the importation of expertise in this area. By 1969 the bill market had developed to the extent that the official dealers could deal in no-bank endorsed bills.

The merchants had, until 1969, been dominated by AUC Ltd, Development Finance Corporation Ltd, Darling Holdings and Capel Court. In 1969 these four controlled 82.1 per cent of the total assets held by merchant banks, 64 per cent of loans outstanding and 57.7 per cent of bills receivable.[10]

Despite this dominance, at the end of the sixties most of Australia's trading banks had an interest in merchant banking. And these interests ranged from 5 per cent to 33.3 per cent.[11] In the years until 1972 the industry had little time for else but expansion. At the peak of its growth there were some 105 foreign banking interests represented in Australia, often by a merchant bank.[12]

In fact, by 1972 ten of the seventeen members of the London Accepting Houses Committee were shareholders in Australian merchants. In addition several American banks had aligned themselves with merchants by this time. Such was the growth during the resources period that the domination exerted by Capel Court and the others had been diminished in three years to 20.9 per cent of the total assets and just on 40 per cent of gross receivables.[13]

1972 saw the formation of the Accepting Houses Association of Australia (AHAA) comprising sixteen of the largest institutions, with the aim of formalising professional and financial standards of the members in addition to providing a forum and a unified body for industry representation. In the same year the Issuing Houses Association of Australia (IHAA) was formed (also promoted by merchant Hill Samuel), along similar lines, but with a smaller membership of eight.

The growth between 1969 and 1972 has often been attributed to the 'guideline policy' maintained by the Federal government to restrict access of overseas owned corporations to the Australian capital markets. At home this tended to create demand for the services of an institution which could raise funds on overseas capital markets. The merchants could do this by having: (1) large overseas shareholdings and (2) standby facilities offshore. Hence merchants could provide desired services to those companies who found domestic monetary policy unsympathetic. The expansion of multi-national corporations and of the transcontinental finance markets also provided incentives for the formation of merchant banks in Australia because of the inherent international flavour attached to a merchant bank.

But as 1972 drew to a close the days of plenty for the merchants did likewise in much the same fashion as they did for the Liberals uninterrupted reign. However, in the preceding seven years the merchants had carved themselves out a foothold by expanding into hitherto untapped areas of Australian finance, namely the bill market and international financial connections.

(3) 1972 - 1979 (Coming of Age)

If the years until 1972 had been the golden years, then it was at the end of that year that dark days were to beset what was a maturing industry. August 1972 witnessed the introduction of an embargo on Australians contracting loans of A$100,000 or more for periods of less than two years. This was followed, with the election of a Labor government, in December with a 25 per cent Variable Deposit Requirement (VDR) for all new foreign borrowing. The effect of having to place 25 per cent of all such borrowings in a non-interest bearing deposit with the Reverse Bank was, to say the least constrictive.

Because the VDR did not apply to existing lines of credit the actual effect was really in favour of the larger internationally affiliated merchants, for the VDR virtually removed from the Australian international sector all those without offshore credit lines. This obvious advantage was compounded in October 1973, when the VDR was raised to 33.3 per cent. This remained until June 1974 when it returned to 25 per cent and by November 1974 it had been abolished. But the damage had been done, smaller interests had, in many cases, been squeezed from the market place and the growth experienced in the halcyon days before 1972 seemed to evaporate.

Not only did the merchants suffer from the VDR but for the economy generally the mid seventies will be remembered as a time of tight liquidity. The spiral in interest rates (rising some 16 per cent in the quarter ending June 1974)[14] accompanied by general economic uncertainty meant that capital investment programmes in the corporate sector were largely suspended. Despite this environment, to the end of 1973 merchants had increased their share of total assets of financial institutions to 3.9 per cent.[15] It was during this period that growth was achieved by the merchants relying on their traditional skills of flexibility and adaptability, skills they managed to marshall successfully in this period.

In 1974 the Parliament passed the Financial Corporations Act, which finally gave statutory recognition to merchant banks (amongst other NBFI's[16]), some twenty years after they had begun to establish some presence in the market place. Part IV of the Act was not, however, proclaimed and it was this part which would have allowed government regulation not dissimilar to that under which trading banks had always existed. Part IX was destined to raise its head again in a later age but for the years remaining until 1979 the merchants relied on a more general run of corporate banking, yet still pioneering in the market with involvement in, for example, leveraged leasing.

(4) 1979 - 1982 (Adulthood)

Up until 1979 the merchants maintained their growth and at that time held assets just short of $5,000m. Foreign interest was as strong as ever, with the Reserve bank estimating that 62 per cent of the industry was foreign owned and about 12 per cent Australian owned. 1979 was also the year when the AHAA and the IHAA amalgamated to form the Australian Merchant Bankers Association (AMBA). Perhaps the most salient event of 1979 was the review of the Australian financial system inspired by the Fraser government and conducted by the late Sir Keith Campbell. This review was destined to have a major impact not only on the merchants but on all participants in the market. However that was still some two years away. The merchants maintained their initiative and aggression in this period, also highlighted by high interest rates. In 1980 they began a move to enter the household sector for the first time, it was long time market leader Hill Samuel which opened the first cash management trust in December of that year. The rapid and significant growth made in this area in the last three years has escaped no-one's notice. It was also in 1980 that the Campbell Committee released its interim report. It became clear that the committee was viewing the financial system and any reforms to it from a basically economic stance. Apart from the well canvassed deregulation it foreshadowed it also showed an astute understanding of money market corporations (or merchant banks), "The money market corporations have shown themselves to be highly adaptable to changing market circumstances. The focus of their operations has changed in recent years from the import of foreign capital towards a more integrated role in local wholesale money markets".[17] This was perhaps mirrored in their increased share of total assets which had by June 1980 climbed to 4.2 per cent, commanded by some fifty-four registered corporations.[18]

In 1981 the harbinger proved correct, as the final report of the Campbell Committee was released. Its basic thrust was that the financial markets in all sectors should be deregulated either totally or partly. Some of the more salient recommendations were:

1) Removal of the power to impose direct interest rate controls from s.50 of the Banking Act and s.15 of Part IV of the Financial Corporations Act.
2) Removal of exchange control regulations.
3) Embargoes on short term borrowings (eg VDR) should not be used as an instrument of exchange control.
4) Removal of the embargo on non-resident participation in Australian banking.
5) Foreign bank participation should be restricted only by the number of licences granted.
6) Banking licences issued to non-residents should carry no encumberances additional to those attaching to licences held by residents.[19]

The impact of the report and the magnitude of its recommendations led the government to refrain from instant and widespread implementation, rather it chose to consider the finding further before acting either way, however in March 1982, the government announced modification of the old thirty day rule. The new rule became such that interest could not be paid on deposits above $50,000 for terms less than 14 days and similarly for deposits less than $50,000 for terms below 30 days.

Nonetheless, under the shadow of the Campbell recommendations the merchants continued to grow and in June 1982, 58 companies were registered under the Financial Corporations Act as money market corporations. Of these, 51 (each with assets above $5m) accounted for virtually all the merchant's business, the remaining seven held combined assets of $15,000,000. Total assets for the industry were in the order of $10,000m.[20]

After a period of consideration the Fraser government began to move slowly in the direction of the Campbell report. It began by removing barriers and controls applying to trading banks, yet did little in reciprocation for the merchants, and by the end of 1982 no commitment had been made by the government to the granting of new bank licences so once again it appeared that the merchants were in for a hard time unless some sort of equity could be established.

The Present (1983 - 1984)

Dawn of 1983 finally saw a commitment from the Fraser government, Treasurer Howard announced the intention of the government to permit "entry to about ten foreign banks as an initial step to possibly opening up the market to full overseas competition"[21]. This announcement was to prove just the first in what was destined to be a eventful year, for certain members of the community. Naturally most of the larger overseas interests, the back bone of the merchants, were enthusiastic, but tempered this with the knowledge that 'announcement' and 'implementation' were entirely different nouns. The catchcry of the announcement was that such moves make for 'an efficient and competitive financial system'.

However, the merchants remained cautious, one source from Barclays doubted that the select ten would be known before June.[22] Nevertheless merchants progressed in the market, attaining accolades for their corporate advice reports.[23] The doubts voiced in January were borne out in February when the Treasurer announced extension of the applications deadline until June.[24] This added to existing uncertainty but the final straw came with the announcement of the March 5th Federal election. Now not only was there confusion about Liberal policy but what would a Labor government do, with its traditional tenets toward more not less regulation. The merchants were again out on a limb, wondering just how much longer it could support their collectively waiting weight! To this point about forty foreign interests had expressed a desire to apply for a licence.

As it happened the Liberal policy ceased to be a problem after the fifth of March, however, the new Labor government loomed large in everyone's eyes. Merchants began to envisage proclaimation of Part IV of the Financial Corporations Act, delivering control into Mr. Hawke's hands. Naturally the new government suspended the old Liberal plans, but Mr. Keating was quick to follow up with an announcement on the 29th of May that there was to be a new review of the financial system.

While Mr. Keating was formulating his review group the merchants got back to business and showed once again their capacity for innovation, this time in the currency hedge market. A group of eleven merchants agreed to a reduction of credit exposures and increased liquidity to overcome limitations on trading limits restricting the level of business carried on the market.[25] It was a move to which some 24 merchants would ultimately agree.

So it was that on June 2nd the Treasurer announced the members of his review group, and the Martin Inquiry was born. It lasted some six months and its final report was released in December, shortly after the dollar had been floated. The upshot of the Martin Inquiry was such that its recommendations mirrored those of the Campbell Inquiry and that the financial system would be deregulated, but unlike Campbell, they suggested a controlled or phased approach as needed. Specific recommendations relating to merchant banks were in the following vein:

1) Short term controls on large deposits (the 14 and 30 day rules) to be abolished.
2) Removal of the 60 per cent ownership rule.
3) Access to the cheque clearing system for NBFI's.
4) Part IV of the Financial Corporations Act *not* to be proclaimed.
5) Removal of controls on interest rates applying to all Trading and Savings Banks.
6) Development of a secondary mortgage market.
7) A one-off tender for between 4-6 new banks to be granted new licences.[26]

These recommendations, whilst concessional to the merchants are most directed to the Trading banks, and overall are less beneficial to the merchants. The tender could successfully eliminate many merchants from their market when they fail to attain bank status, the removal of the 30-day rule, controls on interest rates and removal of ownership restrictions all point to the merchants facing a squeeze from the trading banks. One of the merchants great fears must be the impending creation by the trading banks of their own, 100 per cent owned, 'merchants', for provided "that the normal criteria are applied the group sees no prudential grounds for restricting a banks equity in a merchant bank".[27] The Martin Report hints at the future for the merchants in the following way, "Merchant banks generally provide services . . . additional to the acceptance of deposits and the provision of funds. In the past, merchant banks have shown great flexibility and an impressive ability to innovate. The further that they can develop the range of services, the better placed they will be to counter any contraction of their role in financial intermediation. Nevertheless the group acknowledges that structural adjustment may be necessary in this sector"[28]

Chanticleer in December 1983 was rather more blunt, stating that 1984 "is the decisive year for them. Many members of this intrepid species have big survival problems . . . with the float and the inevitable demise of the 14-day rule . . . Australian trading banks will become real full service banks, with money market operations . . . Australia is a small market and there just isn't room to duplicate downtown Manhattan in Sydney and Melbourne".[29]

Yet as 1984 rolls onward government in its infinite bureaucracy has instigated no major changes whilst the financial community collectively sits back out on its limb, well worn now after some five years of reviews and announcements. However one feels that whilst 1984 may be the decisive year, and may yet cause a further thinning of the merchant ranks, they will still be able to call on their traditional skills and adroitness within the market to remain a decisive force themselves.

CONCLUSION (CIVILISED SOCIETY?)

Driven by aggressive and somewhat inspired management, largely unfettered by the traditional controls which have hindered the progress of other market participants the merchants have been Australia's fastest growing financial institutions. They have taken challenges by the teeth and with imagination and a keen sense of opportunism have forged a significant presence in the marketplace, a position they continually improve be it in the face of regulation or deregulation. It is largely via the merchant's influence that the bill market has its current strength. They pioneered in the hedge and note markets, broke new ground in household finance previously ignored as an area for development. They had led the way as corporate advisors and in international finance. For this group particularly the balance sheet position is not a full guide to their contribution to financing, or their relative importance in the system, because it does not capture either their security trading activities or their role in matching borrowers and lenders directly.[30]

It is perhaps just as true now as it was in 1973 that "one may speculate that the inevitable rationalisation of the number of merchant banks will be accompanied by an increasing trend towards greater size and to become not merely mobilisers of capital but increasingly lenders of their own money. This is not to underrate the role of a merchant bank putting together difficult and complicated deals. This is something which a merchant bank is particularly adept at doing . . . It is this sort of skill which will be needed in Australia."[31]

In twenty-five years the merchants have come, seen and conquered, despite rather inhospitable climates, however perhaps whilst they now face a new era of uncertainty they should view their first twenty-five years with some sense of achievement.

FOOTNOTES

1. Stroud, J., 'What Is A Merchant Bank?', *COMDEC*, Aug/Sept 1982 p.35.
2. Mr. F. Crean, quoted in the *Australian Financial Review*, Jan. 4th 1973, p.1.
3. AMBA, Submission to The Committee of Inquiry Into The Australian Financial System, p.18.
4. Skully, M.T., *Merchant Banking In Australia: It's Development, Functions and Future*, University of N.S.W., June 1975, p.2.
5. AMBA, loc cit.
6. Kolts, R.T., 'Merchant Banking in Australia', *The Bankers Magazine of Australasia*, May 1974, p.329.
7. Clarke, D.S., *Handbook of Australian Corporate Finance*, p.152.
8. Collyer, H., 'Changes Require a New Balance' *Australian Financial Review*, Nov. 11th, 1982.
9. Noble, B.A., 'Money Market Corporations', *Reserve Bank Bulletin*, Sept. 1982, p.143.
10. Kolts, R.T., op cit, p.332.
11. Ibid, p.336.
12. Skully, op cit, p.4.
13. Kolts, R.I., op cit, p.334.
14. Skully, M.T., op cit, p.1.
15. Noble, B.A., op cit, p.144.
16. Non-Bank Financial Institutions.

17. Australian Financial System, Interim Report of Committee of Inquiry, Australian Government Publishers, May 1980, p.145.
18. Handbook of Australian Corporate Finance, p.15.
19. Ibid, appendix 2.
20. Noble, B.A., op cit, p.144.
21. *Australian Financial Review,* Jan.14th 1983, p.1.
22. Ibid, p.3.
23. Thomas, T., 'Room To Improve Corporate Advice Reports', *Business Review Weekly,* Jan. 22-28 1983, p.51.
24. *Australian Financial Review,* Feb.1983.
25. *Australian Financial Review,* May 5th 1983, p.47.
26. Australian Financial System, *Report of the Review Group,* Dec. 1983, ch.14.
27. Ibid, ch.14.
28. Ibid, p.98.
29. *Australian Financial Review,* Dec. 29th 1983, pp.23-4.
30. Campbell Inquiry, Interim Report, p.92.
31. Santow, C.F.K., 'The role of Merchant Banks in Australia', *Business Law Review,* Dec.1973, p.323.

ASAC, EFFAS AND ICC

The S.I.A. participated in several analyst forums in October.

ASAC

The New Zealand Society of Investment Analysts (NZSIA) hosted the Sixth Asian Security Analysts Council (ASAC) Meeting in Wellington. Leigh Hall, who had been the ASAC Chairman for the previous two years, stood down from that position in favour of Brian Gaynor, the President of NZSIA. The meeting allowed for a useful interchange of information and ideas between the member countries: Australia, Japan, New Zealand and Korea and the associate members: Singapore, Taiwan, Malaysia and Indonesia.

In conjunction with the ASAC Meeting the New Zealand Society conducted a 1½ day seminar on the New Zealand economy, capital market and industries. Following the seminar a three day field trip was held which included visits to a pulp mill, a food processing plant, an abattoir, the methanol conversion plant, the new steel works, and of special interest for some participants, a race horse stud.

The Seventh ASAC Meeting will be held in Tokyo in early October 1985 and the Security Analyst Association of Japan will arrange presentations by, and visits to, Japanese industries. This is bound to be of interest to SIA members and details will be provided when received in 1985.

EFFAS

The European Federation of Financial Analyst Societies (EFFAS) held a three day Congress in Madrid which was attended by some 700 people. The theme of the Congress was Financial Analysis — New Technology, New Products, New Markets. The proceedings were well organised and the multiple choice programme allowed attendees to choose those topics which were of particular interest.

One of the sessions at the Congress was presented on behalf of ASAC. Mr. Shoichi Saba, President of Toshiba Corporation, made a presentation on the importance of technology for the continued growth in the Japanese economy and Leigh Hall made a presentation on the importance of the resources industry for the Australian economy.

The next EFFAS Congress will be held in two years' time in early October 1986 and will be located in Venice.

ICC

The International Coordinating Committee of Financial Analysts Association (ICC) met in conjunction with the EFFAS Congress. The ICC is made up of representatives from the European Federation, the Financial Analysts Federation (USA) and ASAC.

The ICC allows for an interchange of views by analyst societies and is also a forum which allows analyst societies to express views to such organisations as the International Accounting Standards Committee (IASC).

SIA Participation

Members who attend meetings conducted by our sister organisations find them to be of considerable interest. It is desirable that members who have arranged to attend international analyst conferences inform the Federal office so that S.I.A. can ensure that it has representation at those meetings.

Leigh L. Hall