

WELCOME BACK REGULATION

... BUT CORPORATES MAY BEAR THE BRUNT



by GERRY van WYNGEN

In a move which will have sweeping effects on Australia's recently deregulated financial system, the Reserve Bank has proposed new controls on the capital adequacy of banks.

The latest catch phrase in the financial markets is "back to regulation." This is the call from central banks responding to the proliferation of financial activities and products that arose from deregulation.

Central banks are demonstrating increased anxiety over the lack of adequate control in the market, especially after uncovering such excesses as recent insider-trading scandals in London and New York. It has become increasingly obvious to central authorities that the excesses of a totally deregulated market can be as damaging as the extremity of constraints in a regulated market.

Extreme off-balance-sheet financial engineering and the associated risk present a threat to the stabilising function of central banks. It is therefore logical to expect the authorities to play a more aggressive role in monitoring the financial sector.

Deregulation is not the only "culprit." Central banks and regulatory authorities have watched with considerable alarm what might loosely be called "the debt problem." Bank loan receivables, as an aggregate, have been deteriorating for some decades with the mountain of defaulting sovereign debt, particularly in Latin America, being a well-known example. In some cases, bad and doubtful debts, if classified honestly, exceed banks' capital bases.

The first move in the authorities' revised role is outlined by the Bank of International Settlements Basle Supervisors Committee in its paper entitled

"Proposals for International Convergence of Capital Measurement and Capital Standards."

The objectives of these proposals are fourfold:

- Provide a competitive equality for banks operating internationally.
- Improve the capital base of banks.
- Catch and control the spread of all off-balance sheet commitments that were previously not disclosed.
- Encourage banks to hold liquid or other assets that carry low risk.

The Reserve Bank of Australia has endorsed in principle the BIS proposals which cover the composition and the adequacy of capital, and the risk weighting of different categories of assets, both on and off-balance-sheet.

The composition of capital

The RBA will follow the BIS proposal to divide the capital of banks into two tiers; i.e., primary and secondary. Tier 1 includes items such as paid-up capital and general reserves, and Tier 2 includes a percentage of general provision for doubtful debts and asset revaluation reserves (see Table 1).

The RBA proposes to follow the West German example by excluding subordinated term debts from second-tier capital. The Bank of England and the US Federal Reserve are reluctant to disallow such inclusion because of strong

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objections from the banks concerned.

The adequacy of capital

Having defined capital, the RBA proposes a minimum capital-to-risk-asset ratio of 8 per cent – 4 per cent primary and 4 per cent secondary.

At this stage, there has been no formal announcement of the exact timetable for its implementation. However, the BIS proposes a three-phase transitional arrangement. The immediate minimum level of capital ratio is the level prevailing at the end of 1987. The capital ratio will then be raised to 7.25 per cent by the end of 1990 and 8 per cent by the end of 1992. The phasing-in proposal allows the banks about four years to get their books in order. One would expect the RBA to be looking at a similar, although perhaps shorter, time frame.

The risk weighting of different categories of assets

Having defined capital and the minimum level of capital, the RBA then proposes to assign a risk weighting to different categories of assets, based on their perceived risk. A scale of five weights is recommended, at 0, 10, 20, 50 and 100 per cent. Risk weighting applies to both on and off-balance-sheet assets.

The treatment of the off-balance-sheet transactions is through a two-step process. The exposures are first converted to credit-risk equivalents by multiplying the nominal principal amounts by a credit conversion factor. The resulting amounts are then further weighted according to the nature of the counterparty.

Table 1 is an example of how capital-to-assets ratio is calculated.

Domestic implications

This, then, is the essence of the RBA proposal: defining capital and controlling the minimum level of capital a bank must hold in relation to its risk-weighted total assets. What implications will this change have for Australia?

The effect of such a broad-based structural change will be significant. The likely impact will be felt across the spectrum by the market participants. It will affect not only licensed banks, but also other non-bank financial institutions as well as corporations generally.

Licensed banks, at first glance, would appear to be the outright winners because of the enhancement of their reputation and credibility. With the

TABLE 1: Composition of capital

Tier 1 — Primary

- Paid-up ordinary capital and retained earnings
- Share premium account
- General reserves
- Non-cumulative irredeemable preference shares
- Minority interests in subsidiaries

Tier 2 — Secondary

- General reserves for doubtful debts (1.5% - 1.25%)
- Other preference shares
- Mandatory convertible notes
- Perpetual subordinated debts

lesser weighting imposed on banking assets, it is clear that the banks will have a greater incentive to deal among themselves rather than with non-bank entities. This may effectively eliminate the "semi-banks" from the interbank money market.

Assume, for example, that the ANZ bank has \$A100 million to lend on the money market. If it is lent to a licensed bank, it will account for only 20 per cent of the risk asset for capital adequacy purposes; i.e., the amount of capital required to back-up this asset will be only \$A1.6m. However, if the same amount is lent to a non-bank financial institution, such as a reputable merchant bank, the entire amount may be risk-weighted at 100 per cent, a fivefold increase in capital requirement.

Although the implicit discrimination against the non-bank financial institutions will undoubtedly improve the market share and influence of the licensed banks, it comes at a cost. As the capital adequacy ratio will be calculated on a global consolidated basis, the RBA will for the first time have a complete knowledge of licensed banks' assets and activities including all subsidiaries — stockbrokers, finance companies, merchant banks, insurance companies and others.

The banks are expected to raise their average capital-to-assets ratio from 5.9

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per cent to a minimum of 8 per cent by the end of 1992, if the RBA adopts a timetable similar to that of the BIS. This average capital ratio is calculated from the 3 major banks, Westpac, ANZ and National Australia Bank. Adopting the methodology used by J.P. Morgan in its 1987 annual report, the risk assets are worked out to approximate the on-balance-sheet assets. From these figures, one can reasonably assume that all three local major banks are in need of capital injection in the next few years in order to bring their respective capital ratio to a minimum of 8 per cent. In dollar terms, the three major banks are expected to raise a combined total of at least \$A4 billion at the current asset level.

Given that the three banks have been growing at a rate of between 10.8 per cent and 15.8 per cent in asset terms, the internally generated growth is in fact far less at 8.1 per cent to 9.4 per cent. The gap has to be filled with a further mixture of debt and equity, within the minimum capital ratio constraint.

Hence, \$A4 billion represents just a tip of the iceberg. Adding the further appetite for capital from licensed banks, it is inevitable that the demand for primary and secondary capital will make a significant impact in the capital markets.

Further compounding the problem, the return on average capital for the three banks has fallen from an average of 19.9 per cent in 1984 to 13.8 per cent in 1987. The difficulty of capital raisings against this background is obvious.

Overall, the three major banks should still come out ahead, given their large economies of scale. The fortunes of the new banks, on the other hand, may suffer. They have not had a chance to build up a sufficient level of reserves and profitability, yet will have to account for all their disproportionate amount of off-balance-sheet assets, which are their traditional "niche" markets.

According to the March 1988 issue of *Triple A*, new banks in fact account for only 9 per cent of the balance-sheet assets of the industry, but make up 17 per cent of the total off-balance-sheet assets.

Blow for non-banks

Non-bank financial institutions will be deeply affected. Australia has proposed to accord a 100 per cent risk weighting on all claims on the non-bank private sector. These include claims on non-bank financial institutions such as merchant banks, life offices, building societies and finance companies.

The merchant banks, which compete directly with the licensed banks, will be hardest hit. This is particularly true in the wholesale banking sector. The proposals will effectively render merchant banks unattractive counterparties across a wide range of interbank and professional market transactions. The likely overall effect is to reduce the level of competition and depth in the financial markets.

For example, the cost of standby lines from the licensed banks to the merchant banks will increase to reflect their higher risk weighting. In fact, there will be an opportunity cost for the licensed banks every time they decide to deal with a non-bank entity.

On the positive side one might argue that as licensed banks will have to back a good deal of their assets with capital, capital-raising costs could force the banks to vacate areas of marginal profitability. This may leave a void for the merchant banks to step into as they are not supervised by the RBA.

The brunt of the change will be borne by the corporates. Not only will they suffer from the reduced competition and liquidity in the financial sector, but also the increased cost of transactions, whether on or off-balance-sheet. Worse, their ability to raise loan funds in the future may be impaired.

Take the example of Technological Export Ltd, which was used in the Medici column of *Australian Business* on March 23, 1988. The company, with basically no borrowing and a strong balance sheet comprising \$200 million of shareholders' funds, will potentially be refused a \$100 million credit facility for strange but valid reasons (see Tables 2 and 3).

The company has a \$50 million note issuance facility on a two-year evergreen basis with its bank. In addition it also establishes a \$30 million documentary letter of credit for its import requirements. Being a conservative company, it also hedges all its export and import sales, which are denominated in \$US, with its bank. A rough calculation using the capital adequacy standards will show that its bank already has a total exposure of \$103 million to the company.

The majority of the exposure is due to the fact that the RBA will not recognise the netting arrangement of the multiple hedge contracts with its bank. An additional \$100 million facility, as requested by Technological Export Ltd, would increase its bank's total exposure to \$230 million, which is greater than the company's \$200 million equity capital. The credit facility may accordingly be withheld by the company's bankers.

Corporate treasurers will have to review the use of the banking facilities

as a matter of urgency. Their bankers will certainly do so.

Global rationalisation

These potential implications have a global perspective.

Capital adequacy proposals will undoubtedly force a convergence in the regulatory standards in the banking industry across the world. Most banks will need to embark on new capital raisings. Those banks that can raise capital cheaply and manage to retain a high proportion of their earnings should fare better.

In other words, the re-regulation of the banking industry will result in a new round of rationalisation, with banks expecting to scrutinise their operation costs and marginal activities in order to achieve a competitive edge and provide a higher return on shareholders' funds.

A likely consequence of this change is the emerging domination of Japanese banks. As reported in the February 1988 issue of *Euromoney*, the world's 21 leading financial institutions, by market capitalisation as at December 1987, are Japanese. With the average of the Western banks trading at a P/E ratio of less than 10, Japanese banks are in fact trading at an average of about 80. It follows that Japanese banks are in a better position to raise cheap equities. The removal of tax exemptions on nearly \$US 2.36 trillion, or Yen 300 trillion, of Japanese saving accounts on March 31 1988, should further gladden the Japanese institutions.

Another possible consequence is the development of a "grey" market to facilitate off-balance-sheet activities, such as foreign exchange hedging, without impinging on banking facilities.

The boundaries between financial institutions and non-financial corporations may begin to crumble, as corporations seek to issue paper in their own names to avoid hefty transaction costs.

Other institutions such as life offices and general insurance companies may become counterparties in financial transactions.

The banks will no doubt be stronger, though at the expense of other non-bank financial intermediaries and corporates.

On the whole, as a result of capital adequacy requirements, the strengthening of the financial sector is welcome. However, the financial sector must be vigilant to ensure that re-regulation does not impair the depth and liquidity of the market. This can be sustained only if new bank players are not left out in the cold. □

TABLE 2: Technological Export Ltd

	Factor	Credit Equiv (\$m)	Risk Weighting	Bank's Exposures (\$m)
\$ 50m NIF 2 year	50%	25	100%	25
\$ 30m Documentary LC	20%	6	100%	6
\$400m 12-month export hedges	2%	8	50%	4
\$400m 24-month export hedges	6%	24	50%	12
\$400m 36-month export hedges	10%	40	50%	20
\$400m 12-month import hedges	2%	8	50%	4
\$400m 24-month import hedges	6%	24	50%	12
\$400m 36-month import hedges	10%	40	50%	20
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TABLE 3: Capital-to-risk-assets ratio calculation

	Factor	Credit Equiv (\$m)	Risk Weighting	Deemed Risk Assets (\$m)
(a) On-balance sheets assets				
\$ 20m Cash			0%	0
\$ 20m Loans to authorised money market secured 6 months			10%	2
\$ 10m Commonwealth govt bonds 2 year			20%	2
\$ 20m Housing loans			50%	10
\$100m Deposits with a merchant bank			100%	100
(b) Off-balance sheet assets				
\$ 50m NIF 2 year	50%	25	100%	25
\$ 30m Documentary LC	20%	6	100%	6
\$400m 12-month export hedges	2%	8	50%	4
TOTAL RISK ASSETS				149
(c) Minimum capital required at 8%				11.92