THE PARTY'S OVER: NOW THE CLEANUP

THE GREAT IMAGE DEBATE: IS IT BALANCED?

By NEVILLE CLEARY

Australia has much to be rueful about following the flamboyant but costly corporate activity of the past decade. Restoring our reputation will be hard work.

By any measure, the latter part of the 1980s was a turbulent period for Australia and there is reason to believe that the early 1990s will be equally difficult. Australian corporations have had to manage significant volatility in financial markets. Their experiences have varied widely. The better-run have survived with their managements stronger, wiser and more experienced. Others have simply died.

And there is no indication that the number of patients in the intensive-care wards of the banks is decreasing. One expects a more-than-acceptable level of terminal cases.

Bankers are not looking so healthy, either. In some cases an over-indulgence in a deregulated, under-prepared menu of unlimited credit has resulted in a range of adverse symptoms. Boards of directors of banks prescribing a wide range of treatments, including amputation in severe cases. They have approved, with understandable reluctance, the resultant debits to their profit and loss accounts for the necessary provisions and write-offs.

In another area of commerce, some State governments may be wishing they had stayed with the businesses they knew best.

So where will this lead us in the 1990s? Will we over-adjust or will the lessons simply be dismissed and excused as unforeseen consequences of financial deregulation?

The outcome may not be left entirely in Australia's hands. We are very much a part of the so-called global village - and the rest of the world will impose its judgment on our financial position. All that we can hope for is that the debate is properly balanced.

Apart from meeting the need to finance continuing balance of payment deficits, we have been using international markets as a supplement to our own capital base. This has been done cheaply and almost without limit. Australia's high credit rating has been a great help but there is evidence that this may be about to change.

One suspects that exposure to Australia is under close scrutiny in the boardrooms of international banks, investing institutions and international credit-rating agencies. My judgment tells me that the outcome may not exactly please us.

If we accept that very few corporates actually intend suicide when entering into borrowing commitments, and that bankers normally accept that loans will be repaid, what happened in Australia in the past few years to explain our present predicament?

Is the overall position as parlous

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as the media may make it appear? Is the great debate taking place externally properly balanced? I suspect the answer to both questions is no, and I shall explain my reasoning a little later. But we do need to understand why the phenomenon has occurred.

Forces of the 1980s

Any realistic look at banking in the 1990s must start with the impact on banking that occurred in the 1980s. During that decade, a number of very powerful forces converged to define the attitudes and directions of the Australian banks. The principal factors include:

- the deregulation of the Australian financial market;
- the imposition of capital adequacy guidelines by the Reserve Bank: and
- the lending experiences of banks in the difficult economic climate in 1989, which has continued into 1990.

Deregulation

Few of the world's financial markets have been required to handle such pace and scope of financial deregulation as Australia's.

The possible exception is New Zealand. The extent of the deregulation and the speed with which it was initiated is demonstrated by the following:

- All term restrictions on bank deposits were removed by August 1984.
- Controls on business and personal lending were abolished in April 1985.
- Liquidity requirements on saving banks were progressively amended from August 1982 and for trading banks from May 1985.
- The Australian dollar was floated and the majority of exchange controls were removed in December 1983.
- The foreign exchange dealing market was dramatically opened to a large number of new players from 1984.
- The policy of managing money supply shifted from direct controls on bank liquidity to open-market operations by the central bank.
- Specific guidelines on capital adequacy were imposed on banks from 1988.
- Significant changes took place in the ownership and role of merchant banks in Australia. Banks were permitted to increase their ownership of merchant banks to 100 per cent from a previous limit of 50 per cent.
- Sixteen new banking licences were granted to foreign banking institutions.

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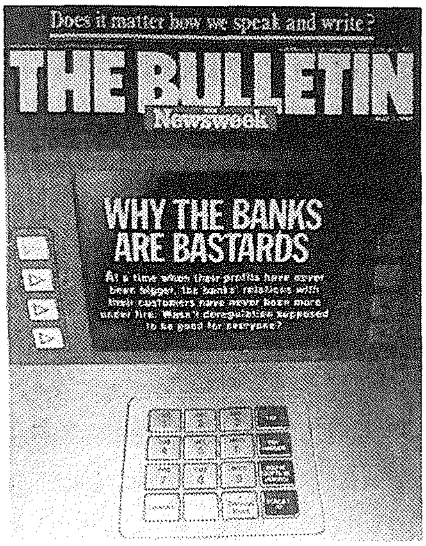

The Bulletin cover in April 1989 reflected the poor image of banks

In reflecting on the above list, which is by no means catalogues the full extent of change, it can be seen that it was not only the scope but the speed of change which fully tested the skills and flexibility of local banks.

Capital adequacy

Although there has been substantial deregulation of the banking industry during the 1980s, it would be wrong to assume that deregulation means the elimination of all regulation.

Partly to compensate for the deregulatory change, central banks developed new guidelines for capital adequacy that banks now need to interpret and manage. The broad intention of capital adequacy requirements is to ensure that a bank's capital base is sufficient to recognise the risks inherent in their business.

Before the introduction of the new capital adequacy requirements, the Reserve Bank simply considered the ratio of a bank's capital to its total balance sheet. While this may have been sufficient when lending and risk-management products were fairly simple, the rate of change of deregulation and the move to securitisation has dramatically changed the real risks in banking business.

The balance sheet of a bank has become much more diverse and the extent and type of risks that followed the adoption of new market products have given fresh meaning to the term "risk management".

Of particular importance is the especially rapid growth in "off-balance-sheet" items. While adherence to capital adequacy provisions will take greater account of off-balance-sheet business, it will also help banks in making distinctions between the degrees of risk associated with "on" and "off" balance-sheet items. The Commonwealth Bank's approach has been to determine its own weightings for the purpose of establishing credit limits. In almost all cases those internal measurements are more stringent in their application than those imposed by the Reserve Bank.

As far as credit is concerned, the new guidelines have had the following effects:

- All off-balance-sheet items (which previously had a nil level of capital dedication) are now looked at much more critically.
- Because of their low risk weightings, exposures to government and banks are now obviously more attractive. It should be noted that government business enterprises which are not guaranteed are significantly disadvantaged.
- All products and all individual lending facilities are tested for their after-tax return on capital employed.

Before the introduction of the capital adequacy guidelines, banks played a leading role in the underwriting of commercial paper into local and international markets. Such underwritings, being of a contingent nature, required no capital dedication and were considered as straight fee income.

As a result, corporates, statutory authorities and some government business enterprises were able to obtain extensive support for their issues of commercial paper at underwriting fees as low as 10 basis points.

Under the new arrangements, such cheap underwriting support will be harder to find.

Lending experiences in the 80s

At the same time that banks were coming to terms with the new regime, their corporate clients were also undergoing a period of change.

Before deregulation, in an environment in which new credit was tightly controlled, lending bankers held the upper hand. Deregulation threw the market into reverse. The corporate treasurer became the target of a massive over-supply of both credit and banking services.

Deregulation also encouraged banks to consider a substantial upgrading of their balance-sheet size. A race began to achieve so-called "world scale".

I am not convinced of the wisdom of such a step. There is an optimal size for Australian banks and, in my view as a lending banker, perhaps that should be a level of capital sufficient only to support the maximum prudential exposure contemplated for an identified target market or client.

At the same time, banks became concerned with regaining the market share they had lost because of the constraints of the regulated environment. Unfortunately, this led to some business being pursued which proved to be not particularly prudent.

All of the above occurred in a period of high economic growth in Australia. The bull market in the latter part of the 1980s encouraged some bankers to believe that asset values would continue to rise indefinitely.

Banks also experienced an under-supply of staff sufficiently skilled and experienced in identifying and managing credit risk in a down-turn. During the bull market, insufficient time and effort had gone into upgrading training, credit management systems and methods of monitoring the large levels of new debt.

The business of lending during the latter part of the 1980s, while certainly exciting, had become fraught with danger. The fallout we are now experiencing is significant.

It would be my broad estimate that during the 1989/90 year, the major trading banks and the various State-owned banks will lose more than $2 billion in write-offs of bad debts. In a significant number of cases, poor management by corporates, coupled with excessively generous lending by banks, has been an unfortunate recipe for failure.

What does this mean for corporate clients in the 1990s? Some commentators believe that the correction of past excesses will not result in a return to ultra-conservatism. I am not so convinced.

History shows that large corporations are rather poor at managing change and over-reactions in behaviour do occur. The results of a number of the regulatory changes during the 1980s show that banks tend to over-adjust.

My feeling is that the market will see a period in which lending officers and credit committees will become excessively cautious in their approach to new credit and acceptance of new risks. This phase will last until the market is satisfied that the bulk of the present difficult accounts have been identified and the market has returned to a relatively even keel.

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We have already seen several announcements by foreign banks of their withdrawal from various local markets and statements that no new commercial lending will be undertaken for the time being.

It needs to be stated as a matter of balance that soundly structured corporations will find they have continuing access to bank funding for working capital and term development finance.

Role of banks in the 1990s

So what will happen to banking and banking attitudes in the 1990s? The starting point must be that banks will have to overhaul their methods of training and reappraise their attitudes to credit, security and documentation.

They will have to look critically at underlying cash-flows rather than relying on the apparent strength of borrowers as portrayed in their balance sheets.

There will certainly be a harsher attitude to unsecured borrowings. Only the very top credits will be able to gain access to banking market using unsecured negative-pledge arrangements.

I suspect that some new form of charging instrument will emerge. The standard debenture security arrangements which were fashionable in the sixties will not recur. Apart from their lack of flexibility, the policing of the various covenants is too arduous to impose on third-party trustees.

To go on prudently supporting industry, and to avoid the complex situations occupying the courts at present, bankers will need to develop a hierarchy of more tangible securities. Lenders will need to know precisely where they stand should a corporation fail and assets require disposal.

In turn, this emphasis on caution should create new opportunities for supplementary lenders and investors who may be prepared to provide subordinated funding with higher returns for the risks involved.

In the 1990s the trend to disintermediation will continue as corporate treasurers look to lower their borrowing costs by going directly into the capital markets. Banks should support this trend.

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Pricing will become an even greater issue for banks and their clients as the full effect of capital adequacy begins to bite.

It is unlikely that banks will want to provide finely priced facilities for credit risks which carry a 100 per cent weighting if they can employ their funds in lower-risk markets.

However, banks will continue to be valuable and effective channels for distributing a wide range of capital markets products. Further, their role in risk management for corporates and counterparties will increase in such markets as foreign exchange and interest and currency swaps.

New products, financing techniques and risk management tools will continue to flourish in the 1990s. Banks will continue to look for innovative lending opportunities - although not those of the highly leveraged style characteristic of world banking in the late 1980s.

A number of "sleepers" may have a very significant impact on both the strength and style of banks during the 1990s. The greatest of these could lie in the revolution which is sweeping Eastern Europe. Most international banks have provided strong support to these less-developed countries, principally through the financing of trade. If unforeseen difficulties occur and if the capital dedicated to these markets is lost for some reason, the result will be a contraction of available credit in home markets.

It is important to emphasise that there are and always have been close working relationships between banks and large corporate clients. It is only through the careful maintenance of these relationships that banks can fulfil their role. There must be regular communication, trust and acceptance that both parties must conduct business on a mutually satisfactory basis.

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Balancing the debate

It would be foolish to attempt to avoid the reality of the mistakes that occurred in the 1980s. Certain corporates indulged in an orgy of borrowing to fulfil under-prepared and in some cases ill-conceived business plans. That they managed to achieve this does not reflect great credit on the banking industry. After all, a borrower can only borrow himself into trouble if he has a banker who is willing to accommodate him.

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It is very easy to fall into the trap of assessing Australia and the health of its corporate and banking base purely by focusing on the demise of a small number of high-profile entrepreneurs.

When international judgments are being made, one would hope that the strength and skill of the management of the bulk of Australia's leading companies would be taken fully into consideration. These companies have weathered storms in the past. Their boards took advantage of the bull market of the eighties to raise new equity at attractive prices.

Many of these companies anticipated high interest rates and reduced their debt to more conservative levels.

Great strides have been made in improving the efficiency of companies and overall productivity. Management is more professional, better-educated and more hard-working. It is true that more needs to be done to restructure industries to make them more export-oriented. Inflation remains a problem but there is no reason to suppose that it is incapable of cure.

I would hope that people with influence in the international market will attempt to provide balance to the great debate. It would be tragic if Australia's access to international capital, which it sorely needs if it is to progress in the 1990s, is in some way adversely affected because of an ill-informed market.

What we must avoid is a tendency to accentuate the difficulties without properly recognising the strengths. □