

Prospects for Banks in Australia

Talk by the Governor, B.W. Fraser, to the Asian Pacific Bankers' Club, Sydney, 14 March 1992.

I welcome this opportunity to talk about prospects for banks in Australia, a topic of possibly more than usual interest to many of you following the Government's recent decisions to further open up banking in this country.

In part, of course, the prospects for banks are linked to the prospects for the economy generally. A strong economy will help to promote strong banks, just as a healthy banking system can help to foster a robust economy.

What then are the prospects for Australia?

Prospects for Australia

In broad terms, we have several good reasons to be confident about Australia's economic prospects in the 1990s.

One is that we are located in the most vibrant part of the world. In the 1980s, Asian economies grew about twice as fast as OECD economies. Some Asian countries may not be able to sustain the very high rates they recorded last decade, partly because their labour forces are forecast to grow less rapidly. Against that, the generally high savings and

investment ratios in those countries, and their capacity to adopt new technologies, will ensure further exceptionally strong economic performances in the 1990s.

Australia, increasingly, will be part of this performance. Already more than half of our total exports go to Asia; Singapore alone now takes more of our exports than the United Kingdom. We have opportunities to do great things in Asia but it is more than a five minute job.

A second set of reasons is Australia's own resource and other endowments. Australia is one of literally only a handful of countries that can boast large food surpluses, an abundance of energy and other resources, modern infrastructure, a skilled and educated population, democratic institutions and a hospitable living environment.

Thirdly, Australians are at last coming to terms with the challenges and opportunities inherent in their geographic location and resource endowments. This, for me, is the main reason for optimism about our economic future. Subtle changes in attitudes have permeated most sections of the community during the past decade. They are reflected in the growing internationalisation of the Australian economy, with a sharper focus on Asia; in greater competitiveness, including in manufactured exports; in genuine efforts to raise productivity through co-operative workplace negotiations; and in a general clamour for speedier micro-economic reforms.

We still have detractors – those who hanker for old ways and those afflicted with an El Greco-like sombreness. Fortunately, however, and notwithstanding the real shortcomings which remain, Australians generally are facing up to the need for on-going changes and are confidently making the necessary adaptations. We sell ourselves short if we fail to acknowledge how much has been accomplished, and how much momentum exists to push on and complete the job. Properly nurtured, these changes in attitudes will deliver a better economic future for Australia. Certainly, it is in our power to prove the pessimists wrong.

The effects of many of these changes have been masked by the recession but they will become more apparent as recovery gets underway. That is now occurring, albeit sporadically.

The housing and farm sectors are improving while stocks have been reduced to the point where future increases in spending will be reflected quickly in increases in production. The Government's recent economic package, together with earlier reductions in interest rates, will help to sustain a gradual recovery throughout 1992 – its gradualness being mainly a consequence of a slack world economy. As Australia's recovery gets underway, we expect to see on-going improvements in productivity and competitiveness, as well as the maintenance of relatively low inflation (about which I will say more later).

Prospects for Banks

Economic recovery, and the steadier property values that can be expected to accompany it, will provide a welcome boost to the banks. Although conditions remain difficult for many banks in Australia, there are some signs that the worst may be over. Non-performing loans, for example, appear to have flattened out at about 5½ per cent of

total banking assets in the second half of 1991. Several foreign banks have also issued improved results for 1991 compared with the preceding year.

Even with a favourable macro-economic environment, however, the next few years will not be plain sailing for the banks: for many the debris from the late 1980s will take a long time to clear away. Fortunately, the capital position of banks in Australia is quite healthy. At the end of 1991, the consolidated capital ratio of the banking sector was around 10.4 per cent. This was 1 percentage point above the corresponding ratio in June 1990 and 2½ percentage points above the minimum capital ratio of 8 per cent. All authorised banks operating in Australia have capital ratios in excess of that minimum; each of the four major banks has a ratio above 10 per cent.

The general environment for banks in Australia seems certain to remain highly competitive. The banking landscape itself is already crowded and some new players could soon appear on the scene.

As a group, the source of competition for banks is altering but it is unlikely to become any less intense. Over the past two decades, the main competitors were institutions engaged in "banking-type" business, such as building societies, merchant banks and finance companies. They were essentially off-shoots of regulation and their importance has declined following deregulation. In the years ahead, the main competitors are likely to be institutions linking businesses directly to the capital markets, and superannuation funds.

In the 1980s, the assets of banks and superannuation funds both grew quickly. In the latter case, the main cause of the strong growth was not the inflow of new money, but the exceptionally high rates of return which funds were able to earn. This was largely a function of the coincidence of high real interest rates and high asset price inflation over much of the period – more so, perhaps, than the exercise of exceptional investment skills as such.

In the 1990s, superannuation fund asset growth is likely to be more dependent on the inflow of new money (and the application of exceptional investment skills). Given the Government's encouragement of superannuation, large inflows are now on the cards. Banks, not surprisingly, are very interested in expanding their involvement in superannuation business.

Given these various competitive pressures, the banks' already low profit margins are likely to remain under threat for some time to come.

How should banks respond? As practitioners, you know better than I what is required but the major focus clearly has to be on ways to restore profitability and rates of return, with all that that means for pricing services, cutting costs, changing bank structures, diversifying into other activities and so on.

A good starting point would be to remember well the lessons so painfully learned in recent years. From our perspective, we would expect to see:

- more focus on profitability and rates of return, rather than on the size of the balance sheet or its rate of growth;
- a closer involvement of boards in strategic decisions and risk management of banks and their subsidiaries;
- more rigorous risk assessment and control procedures;
- less fixation with quick profits, which in the past was reflected, *inter alia*, in the way some institutions accounted for profits (relying excessively on up-front fees without amortisation) and in the way incentive packages for lending officers were structured;
- some rethinking of earlier attitudes towards off-shore expansion, particularly while banks' management and capital resources are already stretched;
- more vigilance by auditors; and
- greater efforts to raise the standing of banks in the community (through, for example, improvements in prudential standards, customer services and openness with the public).

Prudential Issues

As guardian of the integrity of the banking system, the Reserve Bank has an important role in all this. We want to maintain the special status of banks but we do not want to create an exclusive club with fixed membership. That is an important reason for freeing up the entry of foreign banks. We want to see a competitive, efficient banking and financial system: that is the best guarantee of delivering quality, affordable services to customers. At the same time, we accept that, if it is working properly, competition will exert pressure on banks' profit margins and make it more difficult for less efficient banks to survive.

Our task is to produce an acceptable balance between the benefits and risks of competition; between management's freedom of choice and stability of the system; between the rigid discipline of the market place and the flexibility of practical decision making.

In general, our approach has been to encourage banks to behave prudently (through capital adequacy requirements, limits on large credit exposures and such devices), without recourse to heavy handed regulation or interference in individual banking decisions. We try to ensure that our requirements do not add excessively to the pressures on capital already occurring as a result of competitive forces.

That will remain our approach, although certain procedures are being tightened in the light of experience – without, I trust, over-reacting to recent shortcomings. To this end, efforts are being made to upgrade the quality of information on banks' risks, problem loans and control systems, and to develop some in-house capacity to undertake limited on-site investigations.

As noted earlier, banks are moving into the provision of life insurance, superannuation and other funds management services. As this diversification continues, banks will increasingly become part of financial

conglomerates, with banks being the holding companies.

This trend towards “financial conglomerates” raises some important supervisory issues for the Reserve Bank, particularly in protecting depositors with banks. These issues have to do with the way problems can flow from one part of a financial group to another, and with possible conflicts of interest among the various parts.

We seek to minimise these problems by requiring funds management activities to be clearly separate from the banks themselves, if the banks are to avoid the need to hold capital against the relevant assets. Funds management activities must, for example, be conducted in subsidiaries, not by the banks themselves. There are also restrictions on the financial support which a bank may provide, as well as requirements for making clear to investors the separateness of the funds management vehicle from the bank. Similar principles apply in situations where banks form loose “alliance” arrangements with other financial institutions.

Foreign Bank Entry

As you know, the Prime Minister’s Economic Statement of 26 February opened the way for more foreign banks to operate in Australia. Moreover:

- foreign banks will have the option to operate as branches, provided their business is restricted to wholesale activities; but
- any retail banking activities will be required to be conducted through locally incorporated subsidiaries; and
- the existing exemption which allows certain non-bank institutions to label themselves as “merchant banks” will be removed.

The Reserve Bank also issued a statement on 26 February which outlined the general

principles to be followed in implementing these new arrangements. Some particular issues are currently being considered and a further statement will be issued at the end of April.

One obviously major issue to be resolved is the distinction between wholesale and retail banking operations. This is important because the Reserve Bank’s powers under the Banking Act to assume management of a bank in the interests of depositors are unlikely to be enforceable in the case of a branch of a foreign bank. That is why retail banking activities will be required to be conducted through locally incorporated subsidiaries.

Once the details of this and other issues are clarified, steps can be taken to draft amendments to the Banking Act to permit branch operations. At the same time, prospective applicants will also be better placed to consider their position, to do their sums, to consult with their home country supervisors and so on.

Even in a crowded market a place will always exist for new entrants who can provide some additional competition or some niche service. It has been suggested, for example, that there is currently rather less competition in the small and medium sized business market than there is in the corporate area.

As well as being able to satisfy our prudential requirements and being subject to appropriate supervision in the home country, we will expect foreign banks to make a worthwhile contribution to banking services in Australia, and not merely add to the number of banks. This will be an important consideration in assessing applications. We will not be looking for applicants to promise a full range of banking services, but we will expect them to plan a significant presence in Australia, and to add some depth and competition to local markets, especially in wholesale banking. In practice, any significant increase in competition at the retail level is more likely to come through a different route, such as the acquisition of an existing retail operation by a large foreign bank or the amalgamation of existing retail banks.

One further point about foreign bank entry. Banks have always followed trade flows and as Australia's two-way commerce with the Asian region expands, so too will the scope for banking services. Our hope is that there will be opportunities for Australian banks to increase their activities in neighbouring countries on terms similar to those we are extending to their banks in Australia.

Banking on Low Inflation

I want to end with some observations on banking in a low inflationary environment. Sustained low inflation in the 1990s will be a new experience for many bankers and others in Australia. Strategies that were appropriate in an inflationary environment will need to be rethought. That process should be occurring already, and preparations made for this new environment.

But first, can we be confident that inflation will stay down? How can we be sure it won't bounce back once the recession ends?

The main reason is that the recent fall in inflation – to an underlying rate of 3 to 3¹/₂ per cent – reflects structural as well as cyclical factors. There are several points:

(i) Inflationary expectations, which remained stubbornly high through the 1970s and most of the 1980s, have fallen sharply. Whereas expectations of inflation fell to a low of 14 per cent in the mid-1970s recession and were around 10 per cent at their low point during the 1982/83 recession, the comparable figure now is 4 per cent. These lower expectations are working their way through the economy, including to areas previously dominated by expectations of continuing high inflation, such as the property market. People have been reminded that property prices and rents go down as well as up, and this is being reflected in their behaviour – gearing up

for property acquisition, for example, has lost its earlier appeal.

Bond yields, on the other hand, remain stubbornly high. Investors in this market appear to be slow to adjust to the changed inflationary outlook, just as they were slow to adjust to the rise in inflation in the 1970s.

- (ii) The period of sustained wage restraint predates the recession and this experience provides grounds for believing that Accord-type processes will help to contain inflation as recovery proceeds. The centralised component of wage increases has become a progressively smaller part of the total over recent years, thereby easing earlier concerns that national wage increases would put a floor under future inflation. The understanding reached between the Government and the ACTU that wage rises in Australia be consistent with holding inflation to that in major trading partners will further underpin the contribution which wages policy is making to relative price stability.
- (iii) Businesses in all sectors of the economy are now acutely aware of the need to control costs and raise productivity. One obvious sign of this has been the paring of staff numbers, a process which began before the recession set in. The short term consequences are clearly adverse but large gains in productivity can be expected as production picks up; these too will help to hold down price increases.

It is usual for inflation to stay relatively low in the first year or two of recovery. This tendency will be reinforced on this occasion by the factors just mentioned, as well as by the determination of the authorities to hold on to the hard won gains on inflation – a determination, incidentally, which not all groups in the community exhibited when the going got tough.

What will sustained lower inflation mean for the banks? This is another question best answered by the banks themselves. As noted earlier, they should be thinking through the implications and preparing for them.

To jog that process along, we have tried to identify some possible implications. The main conclusion seems to be that bank balance sheets are likely to grow more slowly in the 1990s than they did in the 1980s. This is partly because of lower inflation but more importantly because the earlier unsustainably rapid growth will be wound back as a result of changes in the behaviour of borrowers and lenders in a low inflation world.

The main components of these changes in behaviour include:

- (i) On the **borrowing** side, lower inflation is likely to reduce the demand for debt. Less emphasis will be placed on purchasing existing assets for capital gains, and more on new income generating investments. Investors in property could start to view their investments in a manner similar to holders of a fixed interest investment i.e. to concentrate on the yield and allow for little in the way of capital gain.
- (ii) Lower inflation is likely to involve more equity and less debt than formerly. It will reduce the taxation attractions of debt and not erode debt servicing costs to the extent that high inflation does. Negative gearing should go out of favour.
- (iii) In a low inflation environment, investors are likely to take a longer term perspective. High inflation, and associated high interest rates bias investment decisions against long-lived projects because of the high discount rates applied to future returns. With low inflation, this bias should disappear. If investors think more in terms of long-lived projects, they may seek more long term funding.
- (iv) Low inflation should make interest bearing assets, such as **bank deposits**, more attractive to the majority of investors. This is because it will reduce the distortion caused by the interaction between inflation and the tax system. High inflation makes potential depositors very conscious of the tax bite because tax is levied on total interest income,

Slope of Yield Curve* per cent

United States	100
Germany	81
Japan	66
Canada	66
France	65
Australia	41
United Kingdom	35
Italy	3

* Proportion of period since 1983 that yield curve has been upward sloping between 90 days and 10 years (based on monthly observations).

including that part which compensates depositors for the erosion of the real value of their asset. Over time, as inflation falls, interest bearing assets such as bank deposits are likely to gain in attractiveness, relative to equity-type instruments and inflation hedges.

- (v) Sustained lower inflation can be expected to change the shape of the yield curve. In Australia, we have come to think of the downward sloping yield curve as the norm, and banks have developed cash management-type products to cater for those wishing to capitalise on high short term interest rates. Although downward sloping yield curves have dominated the landscape in Australia in the deregulated era, positive sloped yield curves have been the norm in a number of other countries, particularly those with relatively low inflation (see table).

A move to mainly upward sloping yield curves should increase the attractiveness of longer term deposits, relative to cash management-type accounts.

- (vi) If businesses are looking for more longer term fixed financing, they may, of course, go direct to the market for new issues of debt (particularly as lenders will also be looking for more longer term fixed interest assets). This could possibly lead to a revived domestic corporate bond market, with institutions such as superannuation funds holding a lot of the private long term bonds. Banks should

think about how they might respond to such competition; their experience in the bill market should be helpful in this regard.

Conclusion

The implications for banking of sustained low inflation might appear rather speculative at this time but it is important to look ahead. It is always easier to simply react to issues

when they arise, or to wait to see how others in the industry are behaving. As we have seen in the recent past, this is not good enough; the changes resulting from deregulation caught many in the industry napping, and there was a tendency to hold collectively to various nostrums that proved to be unwise.

It is also easy to fall back on the view that the 1990s will be another decade of rapid changes, many of which are unforeseeable. This is no doubt correct, but we all know that those who best anticipate changes and react promptly and sensibly will perform best.